★ CHAPTER FOUR ★

PERSONAL AND DEPENDENCY EXEMPTIONS; FILING STATUS; DETERMINATION OF TAX FOR AN INDIVIDUAL; FILING REQUIREMENTS

LEARNING OBJECTIVES

Upon completion of this chapter you will be able to:

- Identify the various requirements that a taxpayer must meet in order to claim a personal or dependency exemption
- Explain the phase-out of the deduction for personal and dependency exemptions
- Apply the rules to determine the taxpayer's filing status
- Compute the tax liability of an individual taxpayer using the tax rate schedules and the tax tables
- Explain the special approach used in computing the tax liability of certain children
- Describe the filing requirements for individual taxpayers and the role of the statute of limitations as it applies to the filing of tax returns
- Explain when taxes must be paid and the penalties that apply for failure to pay on a timely basis

CHAPTER OUTLINE

As seen in Chapter 3, numerous factors must be considered in the determination of an individual's net tax liability. Beginning in this chapter and continuing through Chapter 18, a detailed examination of these factors is conducted. This chapter is devoted to five particular concerns of individual taxpayers:

1. Personal and dependency exemptions;
2. Child tax credit;
3. Filing status;
4. Calculation of the tax liability using the tax rate schedules and tax tables; and
5. Filing requirements.

PERSONAL AND DEPENDENCY EXEMPTIONS

Since the inception of the income tax, policymakers have recognized the need to protect from tax some minimum amount of income that could be used for the support of the taxpayer and those who depend on him. The device used to accomplish this objective is the deduction allowed for exemptions. There are two types of exemptions for which deductions are allowed: personal exemptions and exemptions for a child or other dependent.[1] Taxpayers may deduct the *exemption amount* for each of their exemptions. The exemption amount for 2008 is $3,500.[2] Each type of exemption is discussed below.

[1] §§ 151(a), 151(b), and 151(c).

[2] Since 1985 the exemption amount has been increased to reflect price level changes based on changes in the consumer price index. The exact amount is announced by the IRS in the fall of the preceding year. For instance, the exemption amount for 2009 will be announced by December 15, 2008. §§ 1(f) and 151(d)(3). If the exemption amount had been adjusted for inflation since 1948, when it was $600, it would have been about $5,270 for 2008 (calculated using the Bureau of Labor Statistics inflation calculator based on the Consumer Price Index, http://data.bls.gov/cgi-bin/cpicalc.pl). Also see Steurle, "Decline in the Value of the Dependent Exemption," 62 *Tax Notes* 109 (October 4, 1993).

PERSONAL EXEMPTIONS

There are *two* types of personal exemptions:

1. Exemption for the taxpayer

2. Exemption for the taxpayer's spouse

Each individual taxpayer normally is entitled to one personal exemption. When a *joint return* is filed by a married couple, *two* personal exemptions may be claimed. This occurs not because one spouse is the dependent of the other, but because the husband and wife are each entitled to his or her own personal exemption. If a married individual files a *separate return*, however, a personal exemption may be claimed for his or her spouse only if the spouse has no gross income and is not claimed as a dependent of another taxpayer.[3]

Disallowance of Personal Exemption. A taxpayer is denied a personal exemption if he or she qualifies as a dependent of another taxpayer (see discussion below).[4] This rule prevents two taxpayers (e.g., a child and his or her parent) from benefiting from two exemptions for the same person.

Example 1. J is 21 years of age and a full-time college student. J receives a partial scholarship and works part-time, but the majority of his support is received from his parents. Assuming J is eligible to be claimed as a dependent on his parents' return, he is not entitled to a personal exemption deduction on his own return. This rule applies *regardless* of whether J's parents actually claim an exemption for him.

EXEMPTIONS FOR DEPENDENTS

For as long as most remember, an individual qualified as a taxpayer's dependent if he or she met one set of rules. Ironically, in an attempt toward simplicity, Congress added a second set of rules under which an individual might be considered a dependent. Beginning in 2005, § 152 now defines a dependent as either:

1. A qualifying child, or

2. A qualifying relative.

EXEMPTION FOR QUALIFYING CHILD

An individual is considered a *qualifying child* and can be claimed as a dependent of the taxpayer if he or she satisfies all of the following tests.[5]

1. *Relationship Test.* The individual and the taxpayer must meet one of the following relationship tests:

- Natural child, stepchild, adopted child, certain foster children
- A sibling or step-sibling
- A descendant of one of the above

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[3] § 151(b).

[4] § 151(d)(2).

[5] § 152(c).

Note that the scope of these rules goes far beyond the conventional definition of a taxpayer's "child." For example, a taxpayer's brother or sister is considered his or her child as are his nieces or nephews. Similarly, a taxpayer's "children" include a grandchild as well as great grandchildren and other descendants.

2. *Residence Test*. The "child" must have the *same principal place of abode* (i.e., residence) as the taxpayer for more than one half of the taxable year. For this purpose, temporary absences are permissible if due to special circumstances such as education, illness, business, vacation, or military service. Note that a child could live more than half of the taxable year with more than one person where several people, including the child, live together. For example, the child could live with his mother, grandmother and grandfather. Thus this test could be met with respect to more than one person.

3. *Age Requirement*. The "child" must also meet one of the conditions concerning age:

   - Has not reached age 19 by the close of the taxable year.
   - Has not reached age 24 *and* is considered a full-time student at a qualifying educational institution. For this purpose, "full-time" is whatever is considered full-time under the rules and regulations of the institution. The individual must meet the full-time condition for any part of five calendar months during the calendar year.
   - Is permanently and totally disabled at any time during the year. The age limitation does not apply to these individuals.

4. *Joint Return Test*. The "child" must not have filed a joint return with his or her spouse.

5. *Citizenship or Residency Test*. The "child" must be a U.S. citizen, resident or national, or a resident of Canada or Mexico.

6. *Not Self-Supporting Test*. To be a "qualifying child" the "child" may not be self-supporting; that is, the child must not have provided more than one-half of his or her own support. For this purpose, scholarships received from an educational institution are not considered an amount spent on support.

Tie Breaker Rules. Application of the tests above could result in an individual being a "qualifying child" for more than one taxpayer. For example, if a 10-year-old child lived with his father, grandmother and uncle in the same residence during the year, the father, grandmother, or uncle could potentially claim the child as a dependent since the child meets the relationship, age and residence test with respect to each. Such a situation is not surprising in an age when family structures are often unconventional due to divorce and remarriage, absentee parents, childbearing by unmarried individuals, and multi-generational households. When a child is a qualifying child for more than one taxpayer and the parties cannot agree as to who will claim an exemption, the following tie-breaker rules apply.[6]

- If only one of the taxpayers is the child's parent, the parent claims the exemption for the child.
- If both taxpayers are the child's parents and they do not file a joint return, the parent with whom the child resided for the longest period of time during the tax year claims the exemption for the child.

[6] §152(c)(4).

- If the child resides with both parents for the same period of time during the tax year and the parents do not file a joint return, the parent with the highest adjusted gross income claims the exemption for the child.
- If none of the taxpayers are the child's parent, the taxpayer with the highest adjusted gross income for the tax year claims the exemption for the child.

Example 2. For the current year, M and D, mom and dad, provide a home in which they live with their son, P, and P's daughter, G. P is unmarried, 23 years of age and a full-time student. P earned $6,000 for the year, which is less than 50% of his total support. M and D may claim an exemption for P—he is their qualifying child since he meets all of the tests (age, residence and relationship). Under the tie-breaking rules, P, as parent, would be able to claim an exemption for his daughter G; however, P cannot claim G as a dependent because P is, himself, a dependent. In this case, M and D could claim an exemption for their granddaughter G because she is a qualifying child with respect to them.

EXEMPTION FOR QUALIFYING RELATIVE

The second type of dependent is a *qualifying relative*—generally a relative or member of the taxpayer's household that depends on the taxpayer for support. In contrast to the definition for qualifying children, this term permits exemptions for a broader class of individuals but only if the taxpayer provides for their support and the prospective dependent meets an income test.

Technically, an individual is considered a *qualifying relative* only if he or she is *not* a qualifying child and meets the following requirements each of which is discussed in detail below.[7]

1. *Support Test*. The taxpayer must provide more than 50 percent of the dependent's total support.
2. *Gross Income Test*. The dependent's gross income must be less than the exemption amount.
3. *Relationship or Member of the Household Test*. The dependent must be a relative of the taxpayer or a member of the taxpayer's household for the entire taxable year.
4. *Joint Return Test*. The dependent must not have filed a joint return with his or her spouse.
5. *Citizenship or Residency Test*. The dependent must be a U.S. citizen, resident or national, or a resident of Canada or Mexico.

Although an individual could conceivably be a qualifying relative and a qualifying child, the Code makes it clear that in such case the individual is treated as a qualifying child, and therefore, he or she cannot be claimed as a dependent by someone under the qualifying relative rules.

Support Test. To satisfy the support requirement, the taxpayer must provide more than half of the amount spent for the dependent's total support.[8] Total support includes not only amounts expended by others on behalf of the dependent but also any amounts spent by the dependent. Note that only the amount *actually spent* for support is relevant. Income and other funds available to the dependent for spending are ignored unless they are spent.

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[7] § 152(d).

[8] § 152(d)(1)(c).

Example 3. During the year, C paid $10,000 to maintain her father, F, in a nursing home that provides all of his needs. No other amounts were spent for his support. C made these payments, even though her father could afford them since he has cash in the bank and tax-exempt bonds valued at $200,000. Although F has funds available for providing his own support, they are not considered in applying the support test because the funds were not spent. Consequently, the support test is satisfied.

Support is generally measured by the cost of the item to the individual providing it. However, when support is provided in a noncash form, such as the use of property or lodging, the amount of support is the fair market value or fair rental value.

What constitutes an item of support is not always clear. If, for example, a child receives a stereo or car, are these items considered support, or do only necessities qualify? The Regulations provide some guidance as to the nature of support, indicating that it includes food, shelter, clothing, medical and dental care, education, recreation, and transportation.[9] Support is not limited to these items, however. Examination of the numerous cases and rulings reveals a hodgepodge of qualifying expenditures as well as some that are not. For example, the costs for boats, life insurance, and lawn mowers are not considered support. Additionally, the value of any services performed for the dependent by the taxpayer is ignored.[10] Exhibit 4-1 presents a sampling of those items that constitute support.

The determination of support also is complicated by several items accorded special treatment. For example, scholarships and fellowships received by the taxpayer's child or stepchild are not considered support items. Accordingly, such amounts are not treated as being provided by either the taxpayer or the dependent.[11]

EXHIBIT 4-1
Partial List of Support Items

Automobile	Lodging
Care for a dependent's pet	Medical care
Charitable contributions by or on behalf of dependent	Medical insurance premiums
	Singing lessons
Child care	Telephone
Clothing	Television
Dental care	Toys
Education	Transportation
Entertainment	Utilities
Food	Vacations
Gifts	

Example 4. J was the recipient of an athletic scholarship that covered 100% of her tuition, books, supplies, room, and board. In addition, J was paid a small cash allowance. J's parents also provided her with $4,000 cash to be used for clothing, entertainment, and miscellaneous expenses.

The scholarship package, which was related to J's continued scholastic activity, was valued at $19,500 per year. Nevertheless, assuming the other four tests are met, J's parents are entitled to a dependency exemption, since the scholarship is not included in her support and she is not self-supporting.[12]

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9 Reg. § 1.152-1(a)(2)(i).

10 *Markarian v. Comm.*, 65-2 USTC ¶9699, 16 AFTR2d 5785, 352 F.2d 870 (CA-7, 1965).

11 Reg. § 1.152-1(c). Note that G.I. Bill benefits are not treated as scholarships and therefore are included as support items provided by the recipient.

12 Any part of a scholarship providing benefits other than tuition, fees and supplies, is *includible* in the recipient's gross income to the extent of those benefits. See Chapter 6 for a discussion of taxable scholarships.

Although social security benefits generally are not taxable income to the recipient, they are considered as support provided by the person covered by social security. Thus, social security benefits are included in determining support to the extent they are spent for support.[13] State welfare payments are considered provided by the state, and therefore are not treated as provided by the parent or any other taxpayer. This is true even though the parent is entrusted to oversee the prudent expenditure of the funds.[14]

Example 5. F received support during the current year from various sources, including amounts contributed by his son, S. The amounts spent toward F's support were provided as follows:

F's social security benefits	$ 7,500
Taxable interest income	900
Amount provided by S.	4,100
Total	$12,500

S is not entitled to a dependency exemption for F because he did not provide more than 50% of F's total support ($4,100 is not greater than 50% of $12,500).

Example 6. This year K received social security benefits of $8,000, $5,500 of which was immediately deposited in a savings account. The amounts spent toward K's support were provided as follows:

K's social security benefits spent	$ 2,500
Taxable interest income	600
Amount provided by K's brother, B	4,000
Total	$ 7,100

Assuming the other tests are met, B is entitled to a dependency exemption for K since he provided more than one-half of her support expenditures ($4,000 is > 50% of $7,100).

In many instances, an individual who is not self-supporting is supported by more than one taxpayer. Generally, no dependency exemption is allowed for such persons because no *one* individual provides more than 50 percent of the total support provided. However, an exemption may be allowed under what is referred to as a "multiple support agreement."

Multiple Support Agreements. A dependency exemption for a qualifying relative may be assigned to a taxpayer under a multiple support agreement if all of the following tests are met:[15]

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13 Reg. § 1.152-1(a)(2)(ii).

14 See Rev. Rul. 71-468, 1971-2 C.B. 115 and *N. Williams*, T.C. Memo 1996-126. A similar result was reached related to state payments for the care of a mentally retarded child. See *Trail*, T.C. Memo 1993-221, *aff'd* at 73 AFTR2d ¶ 94-931 (CA-5, 1994).

15 § 152(c).

1. No one person contributed over half the support of the individual.
2. Over half the support was provided by a group, all of whose members are qualifying relatives of the individual.
3. The citizenship, joint return, and gross income requirements are met by the individual.
4. The dependency exemption is assigned by agreement to a group member *who contributed more* than 10 percent of the total support.

The assignment is effective only if each of the members contributing more than 10 percent signs a declaration to the effect that he or she will not claim the exemption. This declaration is made on Form 2120 (see Appendix), which is then filed with the return of the taxpayer claiming the exemption.

Example 7. M is single and received her support of $12,000 for the current year from the following sources:

	Amount	*Percentage*
Social security benefits	$ 4,000	33.33%
Taxable interest income	800	6.67
From D, M's daughter	4,700	39.17
From S, M's son	1,500	12.50
From G, M's grandchild	1,000	8.33
	$12,000	100.00%

Together, D, S, and G contribute more than 50% of M's support for the year ($7,200 > 50% of $12,000). If a multiple support agreement is executed, either D or S may be allowed the exemption deduction. G is not eligible since he did not contribute more than 10% of the total support. Also, note that S may claim M as a dependent even though D provided more of M's support.

Gross Income Test. The second test that must be satisfied before an individual (other than a qualifying child) may be claimed as a dependent concerns his or her gross income. A dependency exemption generally is not allowed for a person whose gross income equals or exceeds the exemption amount ($3,500 for 2008).[16] In applying this test, the technical definition of "gross income" must be heeded.[17] It does not include items that are excluded from income. Accordingly, a person whose only sources of income are excluded from gross income (e.g., social security and municipal bond interest) may qualify as a dependent.

It also should be noted that gross income is not always synonymous with includible gross receipts. Regulation § 1.61-3 indicates that gross income for a merchandising business generally means the total sales less the cost of goods sold *plus* any income from investments or other sources. The importance of this distinction between gross receipts and gross income is demonstrated in the following example.

Example 8. T provides 60% of the support for his single brothers, F and R, for the 2008 calendar year. F's sole source of income is from the sale of fireworks. During the year, he sold fireworks costing $4,000 for $6,500. R's sole source of income is

16 § 151(c)(1)(A). Note that there is no relief from the gross income test for qualifying relatives. Under prior law, this relief was reserved for children of the taxpayer.

17 See Chapters 5 and 6 for detailed discussion of "gross income."

derived from rental property. During the year, he collected rents of $4,200 while incurring expenses of $1,700 for repairs, maintenance, and interest. Although F and R each earned $2,500 (F: $6,500 − $4,000 = $2,500; R: $4,200 − $1,700 = $2,500), F's gross income was $2,500, whereas R's was $4,200. As a result, T can only claim an exemption for F, since F's *gross income* was less than the $3,500 exemption amount for 2008.

Relationship or Member of the Household Test. The third of the five hurdles that must be cleared before an individual can be claimed as a dependent concerns the individual's relationship to the taxpayer. Regardless of the amount of support that the taxpayer provides for another person, no exemption is allowed unless the prospective dependent is properly related to the taxpayer.[18] Apparently the authors of the dependency rules believed that the tax law should not grant an exemption unless there is some obligation on the part of the taxpayer to support an individual. Such an obligation normally exists between relatives or others who are members of the taxpayer's household. Therefore, to qualify as a dependent, an individual must satisfy one the qualifying relationship tests below. All of these are *familial* (i.e., related by blood, marriage, or adoption) except one. These are:

1. A child or descendant of a child (other than one who would be considered a "qualifying child" under the tests discussed earlier)
2. A brother, sister, stepbrother, or stepsister
3. The father or mother, or an ancestor of either (e.g., a grandparent)
4. A stepfather or stepmother
5. A niece or nephew[19]
6. An aunt or uncle[20]
7. A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law
8. Any person who lives in the taxpayer's home and is a member of the taxpayer's household for the entire *taxable* year. Even though such a person is not legally related to the taxpayer (i.e., a familial relative), he or she is treated the same as one who satisfies one of the legal relationships as long as he or she lives with the taxpayer the entire taxable year; for this purpose, temporary absences due to illness, school, vacation, business, or military service are ignored; in addition, a person cannot be claimed as a dependent if the relationship with the taxpayer violated local law (e.g., cohabitation).[21]

A relationship created by marriage does not cease upon divorce or the death of the spouse. Thus, for tax purposes, a divorce would not terminate an individual's relationship with his or her mother-in-law.[22] Additionally, if a dependent dies before the close of the tax year, the taxpayer may still claim a dependency exemption.

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[18] § 152(a). Note: Recall that there is no dependency exemption for a spouse. The exemption for a spouse is the *personal* exemption.

[19] A niece or nephew must be a daughter or son of a brother or sister of the taxpayer. § 152(a)(6).

[20] An aunt or uncle must be a sister or brother of the father or mother of the taxpayer. § 152(a)(7). For example, the person married to your mother's sister would be her brother-in-law, but he would not qualify as your uncle for purposes of this definition. Technically, such a person would be your "uncle-in-law," a relationship not defined in Code § 152.

[21] § 152(d)(2)(h).

[22] Reg. § 1.152-2(d).

Example 9. This year F provided all the support for several individuals, none of whom had income in excess of the exemption amount. Each person and his or her status as a relative is shown below:

1. S, F's 25-year-old son, living in Los Angeles and attending UCLA. S is a relative; a son is a familial relative and such persons need not live in the home.
2. B, F's 29-year-old brother who moved in with F on November 1 after leaving the military. B is a relative; a brother is a familial relative and such persons need not live in the home.
3. C, F's 27-year-old cousin who moved in with F on October 1 after being unemployed for 10 months. C is not a relative; a cousin is not considered a familial relative and, therefore, qualifies only if he lives with the taxpayer the entire taxable year.
4. BL, the brother of F's former wife. BL is a relative; BL is F's brother-in-law, a familial relative; such a relationship continues to exist whether F is divorced or his wife dies.
5. Z, a friend who has been living with F since December 1 of the prior year. Z is a ''relative''; a person who lives with the taxpayer the *entire* taxable year qualifies as a relative even though such person is not related by blood or marriage.

Joint Return Test. The dependent must not have filed a joint return with his or her spouse. This requirement is discussed further below.

Citizenship or Residency Test. The dependent must be a U.S. citizen, resident or national, or a resident of Canada or Mexico. Additional exceptions exist as noted below.

PROVISIONS COMMON TO ALL DEPENDENCY EXEMPTIONS

As is apparent from the discussion above, there are several important differences in the definitions of a qualifying child and a qualifying relative. For example, there is no gross income test or support test applicable to a ''child'' of the taxpayer. In a sense, these conditions are assumed to be met where the individual is the child of the taxpayer. Notwithstanding these differences, it is important to note that—as may be apparent–there are some rules common to both types of dependents. Each of these is considered in greater detail below. Exhibit 4-2 also compares the two provisions.

No Joint Return. A taxpayer normally cannot claim a dependency exemption for a married individual if such person files a joint return.[23] This is true for both a qualifying child and a qualifying relative. This rule appears to reflect a presumption that married taxpayers usually rely on themselves for support rather than others. Note, however, that if a joint return is filed solely for a refund (i.e., the tax is zero and all withholding is refunded), the return is ignored and the individual may be claimed as a dependent (assuming the other tests are met).[24] Also observe that the test is met as long as a joint return is *not* filed. If the married individual files a separate return, he or she may still be claimed as a dependent. In certain situations, parents of newlyweds and others may find it beneficial for their child to file a married, separate return.

Example 10. B and C were married on December 21, 2008. B, a budding 25-year-old attorney, earned $48,000 for the year. C, age 23, is a full-time graduate student.

23 § 151(c)(2).

24 Rev. Rul. 54-567, 1954-2 C.B. 108.

Because C was fully supported by her parents, she was eligible to be claimed as a dependent on her parents' return. However, C's parents may not claim C as a dependent if B and C elect to file a joint return. The family must determine whether they are better off if: (l) B and C file a joint return and C claims her exemption on their joint return; or (2) B and C each file married filing separately and they relinquish C's exemption to her parents. A partial analysis would suggest the first alternative is far superior. If a joint return is filed, all of B's income would be taxed at 15% or less (see inside front cover of text for rates). Alternatively, the filing of separate returns would cause a substantial portion of B's taxable income to be taxed at 25%. In this case, it would appear that the additional tax caused by filing separate returns would more than offset any savings to be derived from shifting the exemption to C's parents.

Example 11. D and E were married on December 28, 2008. During 2008 D, age 22, attended State University full time. In addition, she worked part-time, earning $10,500 for the year. E, age 21, was also a full-time student, fully supported by his parents. E had no income. In this case, E's parents are entitled to claim an exemption for E even if D and E elect to file a joint return. The joint return requirement would not be violated because the couple owes no tax (the couple's standard deduction eliminates their taxable income). Consequently, under the IRS view, they would be filing merely to obtain a refund of any withholding and not filing an actual return.

It should be emphasized that the fact that a person files his or her own tax return does not bar another taxpayer (who otherwise meets all the necessary tests) from claiming him or her as a dependent. This is true as long as the dependent does not file a joint return for any reason other than to claim a refund of the entire amount of taxes withheld. Otherwise, the joint return test would not be met and the dependency exemption would be denied.

Citizenship or Residency Test. A dependent must be a citizen or national (e.g., an American Samoan) of the United States or a resident of the United States, Canada, or Mexico. In addition, an adopted child of a citizen qualifies, even though not a resident, if he or she was a member of the taxpayer's household for the entire taxable year. For example, if a taxpayer's employment results in his relocation to London where he adopts a British child, this rule enables the taxpayer to claim the child as a dependent even though the child is not a U.S. citizen or resident.

Taxpayer Not a Dependent. A person who is a dependent cannot claim others as dependents. For example, if a child is a dependent of his or her parents, the child cannot claim his or her own children as dependents.

Social Security Number. In order to claim an exemption for a dependent, the taxpayer must list the dependent's Social Security number on the tax return. If the number is not listed or is listed incorrectly, the exemption may be disallowed and a $50 penalty may be imposed. More importantly, the taxpayer's filing status (head of household, surviving spouse) or child credit could be affected. Since it usually takes about two weeks to obtain a social security number, obtaining one by the extended due date of the return normally does not present a problem.[25]

[25] The year that this requirement became effective the number of exemptions dropped 7 million below what had been expected, resulting in about $2.8 billion in additional tax revenue. Interestingly, more than 48 percent of the drop was attributable to single taxpayers. See IRS Pub. 1500 (August 1991).

EXHIBIT 4-2
Qualifying Child vs. Qualifying Relative

Test	*Qualifying Child*	*Qualifying Relative*
Relationship	Yes *(child and siblings, their descendants)*	Yes *(familial & certain nonrelatives)*
Residence	Yes *(> ½ taxable year)*	No *(but see support)*
Age	Yes *(< 19; < 24 & full-time student)*	No *(but see income)*
Tie-breaker	Yes *(parent first)*	No *(but see multiple support agreement)*
Support	No *(not self supporting)*	Yes *(> ½ spent)*
Income	No	Yes *(but not child if < 19; < 24 & full-time student)*
Joint return	Cannot file joint return	Cannot file joint return
Citizenship	Yes	Yes

CHILDREN OF DIVORCED OR SEPARATED PARENTS

If a married couple with children is divorced or separated, special rules may apply in determining who claims exemptions for the children.[26] These rules operate when the couple is:

- Legally separated under a decree of divorce or separate maintenance
- Separated under a written separation agreement; or
- Lived apart at all times during the last six months of the calendar year.

In these situations, if over half of a child's support is provided by one parent or collectively by both parents and the child is in custody of one or both parents for more than half of the year, the parent with custody for the greater portion of the year may claim the exemption. Thus, the custodial parent ordinarily receives the exemption regardless of the amount paid by either parent.

In certain situations, the divorced couple may be better served if the noncustodial parent claims the exemption. Consequently, if the conditions above are met, the custodial parent may surrender his or her right to the exemption to the noncustodial parent. To accomplish this, the release must be evidenced in the divorce arrangements or in a signed declaration that the custodial parent will not claim the exemption. For this purpose, the custodial parent may file Form 8332. The noncustodial parent should attach the form or statement to his or her return.

PHASE-OUT OF PERSONAL AND DEPENDENCY EXEMPTIONS

Since 1989 Congress has reduced the benefits that high-income taxpayers receive from their personal and dependency exemptions. Under § 151(d), taxpayers must reduce their deduction for personal and dependency exemptions by 2 percent for each $2,500 or fraction thereof ($1,250 for married persons filing separate returns) by which a taxpayer's A.G.I. exceeds the applicable threshold. These thresholds depend on the taxpayer's filing status, and the amounts are adjusted for inflation annually.

[26] § 152(e).

Filing Status	*Threshold A.G.I.*	
	2007	*2008*
Single individuals (not surviving spouse or head of household)	$156,400	$159,950
Married filing jointly or surviving spouse	234,600	239,950
Head of household	195,500	199,950
Married filing separately	117,300	119,975

For 2008 and 2009, the amount of the reduction is itself reduced by two-thirds. Thus the final reduction is 1/3 of that initially computed. The reduction in the exemption deduction may be computed as follows:[27]

$$\frac{\text{A.G.I} - \text{Threshold}}{\$2,500 \text{ (or } \$1,250)} = \frac{\text{Factor}}{\text{(round-up)}} \times \frac{2}{\text{percentage points}} = \frac{\text{Tentative}}{\text{reduction}} \times 1/3 = \frac{\text{Final}}{\text{Reduction}}$$

Example 12. H and W are married with four children. They are entitled to claim six exemptions. In 2008, their A.G.I. is $280,950. Their normal exemption deduction in 2008 before reduction is $21,000 (6 × $3,500). After reduction, their exemption would be $18,620 as computed below.

Total exemption deduction before reduction		
(6 × $3,500 for 2008)		$21,000
Computation of exemption reduction		
A.G.I.	$ 280,950	
Phase-out threshold for married filing jointly	(239,950)	
Excess	$ 41,000	

$$\frac{\$41,000 \text{ excess}}{\$2,500} = 16.4, \text{ rounded to } 17 \times 2\% = 34\% \times 1/3 = 11.333\%$$

Reduction (exemption amount $21,000 × 11.333%)	(2,380)
Exemption deduction allowed	$18,620

H and W are required to reduce their total exemption deduction by approximately 11.333%. As a result, the original exemption deduction of $21,000 ($3,500 × 6) is reduced by $2,380 to $18,620.[28] Because of their high income, the couple is allowed about 89% of their normal exemption deduction.

Note that in 2008 and 2009, the maximum one-third reduction in the exemption is reached if A.G.I. exceeds the threshold by more than $122,500. For example, if a married couple's A.G.I. exceeds $362,450 ($239,950 threshold + $122,500), their total deduction for exemptions would be subject to the maximum reduction. This maximum reduction is one-third of the exemption deduction: ($362,451 − $239,950 = $122,501) / $2,500 = 49.0004, rounded up to 50 × 2 = 100% reduction, then multipled by one-third. For each exemption, the maximum reduction for 2008 would be $1,167 ($3,500 × 1/3), producing a minimum exemption of $2,333.

27 § 151(d)(3)(E).

28 In 2007 and 2008, the IRS calculation of the reduction on the Deduction for Exemptions Worksheet accompanying the instructions for Form 1040 manipulated the mathematical terms so that the reduction would be the tentative reduction divided by 1.5 as seen below:

$$\$2,380 \text{ reduction in exemption deduction} = (\$21,000 \times 34\% = \$7,140)/3$$

CHILD TAX CREDIT

Although most credits are covered in Chapter 13, the child tax credit is addressed briefly here because it is so closely tied with exemptions.[29] Under § 24, the amount of the child tax credit is $1,000 for each *qualifying child*.[30] For example, if a taxpayer had four children, the potential credit would be $4,000 ($1,000 × 4). The definition of a qualifying child for purposes of the child credit piggybacks on the uniform definition of a child used in determining a taxpayer's dependency exemption (discussed earlier in this chapter). In other words, a *qualifying child* for the child credit is a *qualifying child* as that expression is defined for determining a taxpayer's dependents but with certain modifications. A qualifying child for the child credit is any person who meets the following conditions.

- The individual is a *qualifying child* as defined in § 152 relating to dependents (age, relationship, residence tests).
- The individual has not attained the age of 17 by the close of the calendar year.
- The individual is a U.S. citizen.

To summarize, a taxpayer normally can claim the $1,000 credit for each child under age 17. Also note that as mentioned above, if a divorced or separated taxpayer waives his or her right to an exemption, the child credit is also waived and transferred to the noncustodial spouse.

Example 13. M and D are the proud parents of a 16-year-old daughter, C. The parents file jointly, reporting gross income of $36,525 for 2008. After claiming a standard deduction of $10,900 and three exemptions of $3,500 each, their taxable income is $15,125. Their tax on $15,125 is $1,513. After claiming their child tax credit of $1,000 for C, the couple's gross income tax before prepayments is $513.

Refundable Child Tax Credit. As a general rule, most credits are limited to the taxpayer's tax liability for the year. For example, if the taxpayer's tax liability before the child credit is $5,000 and the child credit is $3,000, the taxpayer's regular tax usually would be reduced to $2,000. If the taxpayer's regular tax liability before the credit is $3,000 and the child credit is $4,000, the credit would reduce the tax to zero and *normally* the $1,000 balance of the credit would not be used and the taxpayer would not receive a refund of the unused credit. However, the law permits a portion of the unused child credit to be refunded. In other words, in the situation above, all or a portion of the unused credit of $1,000 would be refunded. The amount of the refundable credit depends on several variables, including the number of children, the taxpayer's earned income, other credits and some additional factors. The actual calculation of the amount of refundable credit can be found in Chapter 13 in the discussion of refundable credits.

Phase-Out of Credit. Like many other tax benefits, the child tax credit is phased out for higher income taxpayers. Specifically, the allowable credit is reduced by $50 for each $1,000 (or fraction thereof) of A.G.I. in excess of specified thresholds. The thresholds are $75,000 for unmarried taxpayers and $110,000 for married taxpayers filing jointly ($55,000 for those filing separately).[31]

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29 § 24.

30 §§ 24(c)(1)(C) and 32(c)(3)(B).

31 § 24(b). For purposes of this phase-out, adjusted gross income is increased by the amount of the foreign earned income exclusions under §§ 911, 931, and 933.

Example 14. R and S have two daughters, L and M (both under age 17). R and S are married and file jointly, reporting A.G.I. of $117,100 for 2008. After claiming a standard deduction of $10,900 and four exemptions of $3,500 each, their taxable income is $92,200. Their tax on $92,200 is $15,738. The child tax credit for two qualifying children is generally $2,000, but R and S must reduce their credit by $400 ($50 × 8, since $117,100 exceeds $110,000 by seven thousand and a fraction) to $1,600. Consequently, their tax after the credit is $14,138 ($15,738 − $1,600).

✓ CHECK YOUR KNOWLEDGE

Try these 10 true-false questions concerning exemptions. If the statement is false, explain why. Assume all tests are met unless otherwise implied.

Review Question 1. All individuals are entitled to claim a personal exemption.

False. An individual who may be claimed as a dependent on another taxpayer's return cannot claim a personal exemption. This prohibits two different taxpayers from claiming two separate exemptions for the same person.

Review Question 2. Certain people who are normally considered relatives (e.g., cousins) do not qualify as relatives for purposes of the exemption tests.

True. A cousin is not a familial relative.

Review Question 3. An individual, such as a cousin, can qualify as a "relative" even though he or she is not a familial relative.

True. An individual who lives in the taxpayer's home the entire taxable year is treated as a relative even though such person and the taxpayer would not be "related" under the statutory definition.

Review Question 4. T takes care of his mom. He satisfies the support test if he provides more than 10 percent of her total support.

False. A taxpayer must generally provide more than 50 percent of an individual's support in order to claim the individual as a dependent. However, an individual who provides more than 10 percent of a person's support may be able to claim a dependency exemption under a multiple support agreement.

Review Question 5. In determining whether T provides more than 50 percent of his mom's support, her savings of over $100,000, and any earnings from them, are not counted except to the extent they are actually spent.

True. Funds available for an individual's support are ignored in applying the support test. Only amounts spent (or the value of support items provided, such as lodging) are considered.

Review Question 6. T's mom has no income other than social security benefits of $5,000 and interest from City of Duluth bonds of $6,000. T may claim an exemption for her mom.

True. A dependency exemption normally cannot be claimed for an individual if such person's gross income exceeds the exemption amount. For this purpose, gross income includes only income that is subject to tax. In this case, T's mom's income from social security is excluded as is the interest from the municipal bonds.

Review Question 7. T's 25-year-old son lives with him. This year he earned $5,000 from his paper route. T may not claim an exemption for his son.

True. T is not a qualifying child since he fails the age test (not less than 19 nor a full-time student less than 24). He also is not a qualifying relative because he fails the gross income test since he earns more than the exemption amount and is neither less than 19 nor a full-time student less than 24. Had T been a full-time student less than 24, he would have qualified as either a qualifying child or a qualifying relative.

Review Question 8. In the case of a divorced couple with children, the custodial parent normally receives the exemption for the children even if the noncustodial parent provides all of the child support.

True. The custodial parent is entitled to the exemption unless he or she releases it to the noncustodial parent. This generally follows from the uniform definition of a child that requires a child to have lived with the taxpayer for more than one-half of the taxable year.

Review Question 9. H and W are married with three children ages 15, 16, and 17. The couple can normally claim a child tax credit of $3,000.

False. The child tax credit is generally available for dependent children less than 17 years old. Therefore the couple can usually claim a credit of $2,000 ($1,000 $\times$ 2).

FILING STATUS

EVOLUTION OF FILING STATUS

The tax rates that are applied to determine the taxpayer's tax liability depend on the taxpayer's filing status. From 1913 to 1948, there was only one set of tax rates that applied to individual taxpayers. During this period, each taxpayer filed a separate return, even if he or she were married. For example, if both a husband and wife had income, each would file a separate return, reporting their respective incomes. This system, however, proved inequitable due to the differing state laws governing the ownership of income (or property).

In the United States, the rights that married individuals hold in property are determined using either the common law or community property system. There are ten community property states: Alaska, Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. In a community property state, income generated through the personal efforts of either spouse is generally owned *equally* by the community (i.e., the husband and wife). In common law states, income belongs to the spouse that earns the income. The differing treatments of income by community property and common law states produced the need for a special rate schedule for married taxpayers.

Married Status. The category of married couples filing jointly and its unique rate schedule were added to the law because of an inequity that existed between married couples in community property states and non-community property jurisdictions (separate or common law property states). As noted above, earnings derived from personal services performed by married persons in community property states generally are owned jointly by the two spouses. Accordingly, both husband and wife in a community property state would file returns showing one-half of their earned income, even though only one may have been employed. Note that the total income of the couple would be split equally between the husband and wife regardless of who earned the income. If a couple in a non-community property state relied on one spouse's earnings, the employed spouse filed a return showing the entire amount of those earnings.

Since the tax rates are progressive, a married couple in a non-community property state would bear a larger tax burden than one in a community property state if only one spouse was employed outside the home or one spouse earned substantially more than the other. To eliminate this inequity, Congress elected to grant the benefits of income splitting to all married couples. This was accomplished by authorizing a new tax schedule for married persons filing jointly. A joint return results in the same amount of tax as would be paid on two "married, filing separate" returns showing half the total income of a married couple.

Example 15. L and M are married and reside in California with their two children. L is an executive with a major corporation and M works in the home. Under state law, L's salary of $70,000 is owned equally by L and M. Each may file a separate return and report $35,000 of the salary.

Example 16. S and T are married and reside in Virginia with their two children. S is an executive with a major corporation and T works in the home. S earns a salary of $70,000. If S were to file a separate return, she would report the entire $70,000 salary on that return. Since the tax rate schedules for individuals are progressive, S would pay a higher tax than the total paid by L and M in *Example 15*. Consequently, the total tax burden on S and T would be greater than that on L and M. By filing a joint return, S and T are placed in a position equivalent to that of L and M.

Head-of-Household Status. Introduction of the joint return in 1948 was not viewed by the public as merely a solution to a problem caused by differing state laws. Many saw it as a tax break for those who had family obligations. As a result, single parents and other unmarried taxpayers with dependents tried to persuade Congress that they should be entitled to some tax relief due to their family responsibilities. Their arguments were based on the fact that they suffered a greater tax burden than single-earner married couples. In 1957, a tax reduction was allowed in the form of a new tax rate schedule for taxpayers who qualify as a *head of household*. The rates were designed to be lower than the original rates, which applied to all taxpayers, but *higher* than the rates for married persons filing jointly.

Single Status. The most recent change in the overall tax rate structure was the addition of a separate tax rate schedule for single persons. This change was made because a single person was paying a higher rate of tax on the same income than married persons filing jointly and heads of households. The reduced rates for single taxpayers still are higher than those for a head of household, but lower than those in the original rate structure. As a result of this final change, the original tax rate structure that once applied to all taxpayers now applies only to married persons filing separately.

Summary. The Federal income tax on individuals is based on four tax rate schedules. Taxpayers must file under one of the following classifications, listed in order from lowest to highest in tax rates:

1. Married filing jointly (including surviving spouses)
2. Head of household
3. Single
4. Married filing separately

The 2008 tax rate schedules for these classifications are reproduced on the inside front cover of this text.[32]

MARRIED INDIVIDUALS

Marital status is determined on the last day of an individual's taxable year. A person is married for tax purposes if he or she is married under state law, regardless of whether he or she is separated or in the process of seeking a divorce.[33]

Joint Return. A husband and wife generally may file a return using the rates for married persons filing jointly.[34] If a joint return is filed, husband and wife are jointly and severally (individually) liable for any tax, interest or penalties related to *that* joint return. As a result, one spouse may be held liable for paying the entire tax, even though the other spouse earned all the income. For this reason, a spouse should be cautious in signing a joint return. However, under the *innocent spouse rule*, a spouse will not be held liable for tax and penalties attributable to misstatements by the other spouse in two instances. The first provision allows relief if the innocent spouse establishes that he or she did not know and had no reason to know of the understatement, that it is inequitable to hold him or her liable for the deficiency, and that he or she elected the benefits of this provision within two years after the date collection activities began. The second provision limits the liability of a spouse to only the portion of the deficiency properly allocable to him or her if he or she is no longer married to, is legally separated from, or is no longer living with the spouse with whom the joint return was filed.[35]

Surviving Spouse. To provide relief in those situations where a spouse dies and must continue to support the couple's children, the law permits use of the joint return rates for a short period. A so-called *surviving spouse* may use the lower rates in the first or second taxable year after the year of his or her spouse's death. Technically, a taxpayer qualifies as a surviving spouse if he or she meets two tests. First, the spouse must have died within the two taxable years preceding the current taxable year. Second, the taxpayer must provide over half the cost of maintaining a home in which he or she and a *dependent* son, stepson, daughter, or stepdaughter live.[36] In determining whether the child is a dependent, the following modifications are made when applying the qualifying individual or qualifying relative tests.

- For purpose of determining whether the child is a dependent under the "qualifying relative" standard, the gross income test is ignored.
- In applying either test, the fact that the individual files a joint return is ignored.
- In applying either test, the fact that a dependent is ineligible to have dependents is ignored.

Remarriage terminates surviving spouse status. Of course, a joint return can be filed with the new spouse.

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32 The 2008 tax tables had not been issued by the IRS at the date of publication of this text. However, the 2007 tax tables are reproduced in Appendix A.

33 Special rules apply to a taxpayer whose spouse dies during the year. See §§ 7703(a)(1) and 6013(a)(2).

34 § 6013(a). However, a special rule applies if the spouse is a nonresident alien. See § 6013(g). Also, both spouses must have the *same* taxable year.

35 § 6015(b) and (c).

36 § 2(a).

Example 17. H and W were married and had two children, S and D. In 2008, H died. After H's death, W continued to provide a home and all the support of S and D. As a result, W is entitled to claim S and D as dependents. For the year of death, 2008, W normally will file a joint return with her deceased husband, H. In the following two years, 2009 and 2010, W may file as a surviving spouse since she provides a home for a dependent child. As a surviing spouse, she may use the same rates as married persons filing jointly. In subsequent years, W may file as a head of household if she meets all the other requirements.

Separate Returns. Normally, it will be advantageous for married persons to file a joint return because it is simpler to file one return than it is to file two, and the tax will be as low or lower than the tax based on the rules for married persons filing separately. In some situations, a taxpayer may prefer to file a separate return. For example, a person may wish to avoid liability for the tax on the income—especially any unreported income—of his or her spouse. Similarly, a husband and wife who are separated and are contemplating divorce may wish to file separate returns.

Separate returns may be to the taxpayers' advantage in certain circumstances. Although rare, use of the separate rate schedules may result in a lower total tax than by using the rates applicable to a joint return. Filing of separate returns may also prove beneficial when the filing of a joint return would prevent another taxpayer (e.g., a parent) from claiming a dependency exemption deduction for either the husband or the wife *(see Example 10 above)*. State income tax laws may also make filing separately beneficial.

HEAD OF HOUSEHOLD

Head-of-household rates may be used if the taxpayer satisfies two conditions. First, the taxpayer must be unmarried (and not a surviving spouse) or considered unmarried (i.e., an abandoned spouse) on the last day of the tax year. Second, the taxpayer must provide more than one-half of the cost of maintaining as his or her home a household which is the principal place of abode for more than one-half the year of

1. A qualifying child, or
2. A dependent familial relative[37]

As might be expected, the same individuals that are considered "relatives" for exemption purposes generally qualify as relatives when applying the head-of-household rules (e.g., children, grandchildren, parents, grandparents). However, there is an exception. Even though a person who is not truly related to the taxpayer but who lives in the taxpayer's home for the entire taxable year is treated as a relative for purposes of the dependency exemption, such is not the case here. In order for the taxpayer to qualify for

EXHIBIT 4-3
Relatives for Dependency and Head-of-Household Tests

Relative	*For Dependency Exemption*	*For Head-of-Household Test*
Qualifying child	Yes	Yes
Familial relative	Yes	Yes
Other individuals—person who lives in taxpayer's home entire taxable year	Yes	No

37 § 2(b)(1).

head-of-household status, the individual living in the home must be a familial relative.[38] Exhibit 4-3 gives a listing of those who are normally considered relatives for purposes of meeting both the head-of-household and dependency rules. Note that they are all the same except for the nonfamilial relative.

An individual normally enjoys head of household status *only* if he or she is the taxpayer's dependent *and* lives in the taxpayer's household. Two exceptions exist to this general rule.

1. A parent must be a dependent but need not live in the taxpayer's home; however, the taxpayer still must pay more than half of the cost of keeping up a home for his or her mother or father.

For example, the taxpayer qualifies if he or she paid more than half the cost of the parent's living in a nursing home and the parent is a dependent.

Example 18. D, an unmarried individual, lives in Seattle and pays more than half of the cost of maintaining a home in Reno for her dependent parents. Although her parents do not live with her in Seattle, D qualifies for the head-of-household rates.

2. **An** *unmarried qualifying child* of the taxpayer need not be a dependent. This exception permits a divorced parent to qualify as head-of-household even though the former other parent claims the exemption for the child.

Example 19. R is divorced and maintains a household for herself and her 10-year-old daughter. Although R is the custodial parent, she allows her former husband to claim the exemption for the child. R still qualifies for the head-of-household rates.

Example 20. M is divorced. At the beginning of the year, M's son, S, started medical school and moved in with his mom to save money. M pays all of the cost of maintaining the home and also provides more than one-half of S's support. S is 25 years old and earned $46,000 during the year. M cannot claim head of household because S is neither a qualifying child nor a qualifying relative. S is not a qualifying child because he is too old. To be a qualifying child, S must be less than 19 or a full-time student less than 24. S is also not a qualifying relative since his income is too high (i.e., $46,000 exceeds the amount of the personal exemption).[39]

It should be noted that a person for whom a dependency exemption is claimed solely under a multiple support agreement (e.g., the taxpayer did not provide over half the cost of maintaining the home) is not considered a qualifying relative and the agreement *cannot* qualify the taxpayer as a head of household. In addition, a nonresident alien cannot be a head of household.[40]

Costs of Maintaining a Home. In determining whether a taxpayer qualifies for head-of-household status, it is necessary to determine whether he or she pays more than half of the cost of maintaining a home for the taxable year. This determination must also be made for surviving spouse filing status. The costs of maintaining the home include the costs for

38 §§ 2(b)(3), 152(a)(9), and 152(c).

39 Prior to 2005, M would have qualified for head of household treatment since the child of a taxpayer was not required to be a dependent.

40 *Supra*, footnote 36.

the mutual benefit of the occupants and include such expenses as property taxes, mortgage interest, rent, utilities, insurance, repairs, upkeep, and *food* consumed on the premises. The cost of maintaining a home does not include clothing, educational expenses, medical expenses, or transportation.[41]

Abandoned Spouse Provision. Without a special provision, an individual whose spouse has simply abandoned him or her might be forced to file using the high rates for married individuals filing separately. Aware of this problem, Congress has provided that a married individual who files a separate return may file as head of household if he or she qualifies as an *abandoned spouse*. To qualify, the individual must provide more than half the cost of maintaining a home that houses him or her and a child for whom a dependency exemption deduction is *either* claimed or could be claimed by the taxpayer except for the fact that the exemption was assigned to the noncustodial parent.[42] The child must live in the home with the taxpayer for more than half the taxable year and the taxpayer's spouse must not live in the home at any time during the last six months of the year. If each of these requirements is met, an abandoned spouse qualifies as a head of household.

> **Example 21.** M and N are married with six children. In October, M stormed out of the house, saying he would never return. N was hopeful that M would return and consequently had not taken action to obtain a divorce by the end of the year. Although M and N are eligible to file a joint return, M indicated that he would not. Consequently, N's filing status is married filing separately. She does not qualify as an abandoned spouse since her husband lived in the home during the last six months of the year. In the following year, however, N could qualify and file as head of household.

Single. Single filing status is defined by exception. A single taxpayer is anyone who is unmarried and does not qualify as a head of household or surviving spouse. Even though single rates are somewhat lower, they may not be used by married persons filing separately.[43]

Marriage Tax Penalty. A well-known tax phenomenon faced by couples contemplating marriage is the possibility of a marriage tax penalty. Whether matrimony is for better or for worse on the couple's tax return depends on a number of factors, such as how much each earns as well as whether either individual brings dependents into the marriage.

Joint filing originally was intended as a benefit to married couples. Prior to 1969, the joint return schedule was designed to tax one-half of total marital income at the tax rates applicable to single individuals. The resultant tax was then doubled to produce the married couple's tax liability. Note that this procedure produces a perfect split of a single earner's income between two spouses so that it is taxed at a lower marginal rate. While this approach is quite beneficial for married taxpayers, single taxpayers felt that they were paying an unjustifiable "singles penalty." To illustrate, consider the situation of a single taxpayer with taxable income of $24,000. In 1965, this taxpayer owed $8,030 of income tax, with the last dollar of income taxed at a 50 percent marginal tax rate. A married couple with the same 1965 taxable income owed only $5,660 (more than $2,000 less) and faced a marginal tax rate of only 32 percent.

In 1969 Congress attempted to alleviate the singles penalty by enacting a new (and lower) rate schedule for single taxpayers. While this action did reduce (but not eliminate) the singles penalty, it also created a marriage penalty for certain individuals as shown in the example below.

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41 Reg. § 1.2-2(d).

42 § 2(c) and § 7703(b). An adopted child of the taxpayer is considered a son or daughter for this test.

43 Single filing status is referred to in Code § 1(c) as "Unmarried individuals (Other Than Surviving Spouses and Heads of Households)."

Example 22. H is currently single and his only source of income is his salary of $90,000. He is considering marrying his girlfriend, W. As shown below, for 2008 his tax as a single taxpayer after considering his standard deduction and one exemption is $16,672.25. If H marries W and W has no taxable income, their tax on a joint return with its wider brackets and double the standard deduction and exemption amounts would be $10,712.50 or $5,959.75 less ($16,672.25 − $10,712.50). Observe that in this situation where there is one earner, there is a singles penalty. In other words, for the same amount of income ($90,000), those who are single pay more than those who are married. But now consider what happens if W also has a $90,000 salary, the same as H. If W and H remain single, they both will pay a tax of $16,672.25 for a combined total of $33,344.50. However, if they marry, their combined taxable income remains the same at $162,100 (2 × $81,050) but their tax on a joint return is $34,132 or $787.50 more. Here where there are two high-income earners both with about the same income, there is a marriage tax penalty.

Filing Status	*2008 H One earner Single*	*H & W One earner Married*	*2008 H & W Two earners Married*
Gross income of H	$90,000	$90,000	$ 90,000
Gross income of W	—	—	$ 90,000
Gross income	$90,000	$90,000	$ 180,000
Standard deduction	($ 5,450)	($10,900)	($ 10,900)
Exemption(s)	($ 3,500)	($ 7,000)	($ 7,000)
Taxable income	$81,050	$72,100	$ 162,100
Tax	$16,672.25	$10,712.50	$ 34,132

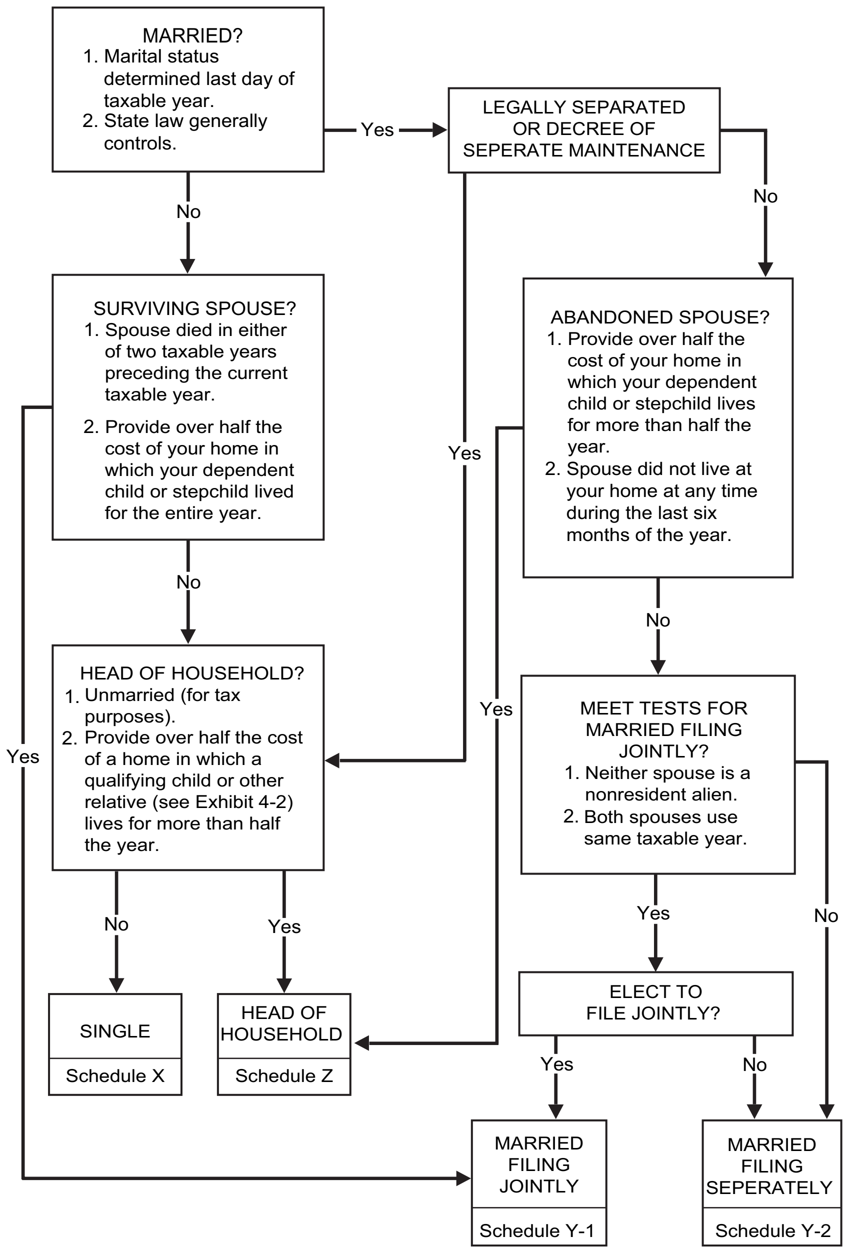
	H Single	*H & W Married*	*H & W Married*
Tax	$16,672.25	$10,712.50	$34,132
Tax for two singles (2 × $16,672.25)			(33,344.50)
Singles penalty ($16,672.25 – $10,712.50)		$ 5,959.75	
Marriage penalty ($34,132 – $33,344.50)			$ 787.50

As a general rule, if a couple marries and only one spouse has income (or there is a large disparity between their incomes), marriage will be beneficial due to the splitting effect (i.e., the married, one earner effect above). In contrast, if a couple marries and they have similar incomes, there may be a marriage tax penalty (i.e., the married, two earners effect above).

Tax Reform and the Marriage Penalty. One of the goals of recent tax reforms was to reduce the marriage penalty. The specific provisions are summarized as follows:

- The standard deduction for a married couple was increased to an amount which is exactly double that for a single individual.
- The tax brackets were adjusted in a way to reduce the marriage penalty. First, the 10 percent bracket for married couples ($16,050) is double that for single individuals ($8,025). Next, the 15 percent bracket was adjusted to an amount which is double that for single taxpayers. Note, however, that the higher tax brackets were not adjusted and will remain in the same proportions that they were before for married compared to unmarried persons (retaining an element of marriage penalty).

EXHIBIT 4-4
Determination of Filing Status



✓ *CHECK YOUR KNOWLEDGE*

Review Question 1. List the available rate schedules in the order of their progressivity (highest to lowest tax rates).

Married filing separately, single, head of household, and married filing jointly (including surviving spouses).

Review Question 2. H died in 2006, survived by his wife, W, and two young children, S and D. What rate schedule may W use in 2008 assuming she has not remarried?

She should be able to file as a surviving spouse and use the joint return rate schedule for the two taxable years after her husband's death (2007 and 2008). A taxpayer qualifies as a surviving spouse if his or her spouse has died in either of the two taxable years preceding the current year (i.e., 2006 or 2007 in this case) and he or she provides over half the cost of a home in which he or she and a dependent child live. In this case, H died in 2006, and it appears that W provides a home in which she and her dependent children live.

Review Question 3. Q, divorced, is alive and well in Los Angeles. She has a 19-year-old daughter who attends school full-time at Arizona State. Q provides all her daughter's support, including payment of her dorm bill each month. Can Q file as a head of household? What additional questions must be asked before this question can be answered?

An individual can normally file as a head of household if he or she provides over *one-half* the cost of maintaining a home in which a qualifying child or a dependent familial relative lives for more than *one-half* of the taxable year. In this case, it is not completely clear whether the half-and-half test is met. As a general rule, the relative must live in the home of the taxpayer one-half of the year. Here Q's daughter may only live in Q's home during the summer months, and it would therefore appear that Q could not qualify. However, temporary absences due to special circumstances such as those due to education, business, vacation, and military service are ignored. Since the daughter's absence is temporary, the test is satisfied. Note that Q's daughter need not be a dependent since this requirement is relaxed in the case of an unmarried child of the taxpayer.

COMPUTATION OF TAX FOR INDIVIDUAL TAXPAYERS

Once filing status and taxable income have been determined, the tax computation for most individuals is fairly straightforward. The gross tax is computed using the tax tables or the tax rate schedules. This amount is then reduced by any tax credits available to the taxpayer and any tax prepayments in arriving at the tax due or the refund. Children under age 18 with unearned income and all persons claimed as dependents are subject to special rules in the computation of their income tax.

TAX TABLES

The vast majority of individuals must determine their tax using *tax tables*, which are provided by the IRS along with the instructions for preparing individual income tax returns. The tables are derived directly from the rate schedules to simplify compliance and reduce taxpayer errors. The tax for any particular range of taxable income is determined by using the midpoint of the range and the appropriate rate schedule. For example, the tax in the 2007 tables for a single taxpayer with taxable income of $19,010 is $2,463, which is the tax computed on $19,025 (see Exhibit 4-5 for an excerpt and Appendix A for the complete 2007 Tax Tables). The tables cover taxpayers in each filing status with taxable incomes less than $100,000. A taxpayer who qualifies generally is required to use the tax tables.[44]

[44] § 3.

EXHIBIT 4-5
Excerpts From Tax Tables for 2007

If line 43 (taxable income) is—		And you are—				If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing sepa-rately	Head of a house-hold	At least	But less than	Single	Married filing jointly *	Married filing sepa-rately	Head of a house-hold
		Your tax is—						Your tax is—			
19,000	**19,050**	2,463	2,071	2,463	2,294	**30,000**	**30,050**	4,113	3,721	4,113	3,944
19,050	**19,100**	2,470	2,079	2,470	2,301	**30,050**	**30,100**	4,120	3,729	4,120	3,951
19,100	**19,150**	2,478	2,086	2,478	2,309	**30,100**	**30,150**	4,128	3,736	4,128	3,959
19,150	**19,200**	2,485	2,094	2,485	2,316	**30,150**	**30,200**	4,135	3,744	4,135	3,966
19,200	**19,250**	2,493	2,101	2,493	2,324	**30,200**	**30,250**	4,143	3,751	4,143	3,974
19,250	**19,300**	2,500	2,109	2,500	2,331	**30,250**	**30,300**	4,150	3,759	4,150	3,981
19,300	**19,350**	2,508	2,116	2,508	2,339	**30,300**	**30,350**	4,158	3,766	4,158	3,989
19,350	**19,400**	2,515	2,124	2,515	2,346	**30,350**	**30,400**	4,165	3,774	4,165	3,996
19,400	**19,450**	2,523	2,131	2,523	2,354	**30,400**	**30,450**	4,173	3,781	4,173	4,004
19,450	**19,500**	2,530	2,139	2,530	2,361	**30,450**	**30,500**	4,180	3,789	4,180	4,011
19,500	**19,550**	2,538	2,146	2,538	2,369	**30,500**	**30,550**	4,188	3,796	4,188	4,019
19,550	**19,600**	2,545	2,154	2,545	2,376	**30,550**	**30,600**	4,195	3,804	4,195	4,026
19,600	**19,650**	2,553	2,161	2,553	2,384	**30,600**	**30,650**	4,203	3,811	4,203	4,034
19,650	**19,700**	2,560	2,169	2,560	2,391	**30,650**	**30,700**	4,210	3,819	4,210	4,041
19,700	**19,750**	2,568	2,176	2,568	2,399	**30,700**	**30,750**	4,218	3,826	4,218	4,049
19,750	**19,800**	2,575	2,184	2,575	2,406	**30,750**	**30,800**	4,225	3,834	4,225	4,056
19,800	**19,850**	2,583	2,191	2,583	2,414	**30,800**	**30,850**	4,233	3,841	4,233	4,064
19,850	**19,900**	2,590	2,199	2,590	2,421	**30,850**	**30,900**	4,240	3,849	4,240	4,071
19,900	**19,950**	2,598	2,206	2,598	2,429	**30,900**	**30,950**	4,248	3,856	4,248	4,079
19,950	**20,000**	2,605	2,214	2,605	2,436	**30,950**	**31,000**	4,255	3,864	4,255	4,086

Example 23. William W. Bristol was single for 2007 and had no dependents. Bill's only income was wages of $27,410 and taxable interest of $350. Since his itemized deductions totaled only $1,650, Bill claims the $5,350 standard deduction allowed for 2007. Federal income tax of $2,820 was withheld from Bill's salary. Bill's taxable income and tax for 2007 are calculated as follows:

Salary			$27,410
Taxable interest			+350
Equals:	Adjusted gross income		$27,760
Less:	Standard deduction for 2007	$5,350	
	Personal exemption for 2007	3,400	−8,750
Equals:	Taxable income		$19,010
Tax on $19,010 from Tax Table for 2007 (See Exhibit 4-5)			$ 2,463
Less:	Income tax withheld		−2,820
Equals:	Tax due or (refund)		($ 357)

A completed Form 1040EZ for William W. Bristol, based on the information in this example, is shown in the Appendix at the end of the chapter.

Example 24. Clyde F and Delia C. Cooper were married during all of 2007 and had income from the following sources:

Salary, Clyde		$33,445
Federal income tax withheld	$1,170	
Part-time salary, Delia		23,600
Federal income tax withheld	780	
Interest from City Savings		950
Interest from U.S. Government		550

Clyde and Delia are the sole support for their two children, ages 2 and 7. During 2007 they paid job-related child care expenses of $3,500 and made deductible contributions of $4,000 to their Individual Retirement Accounts ($2,000 each). Their itemized deductions for the year do not exceed their standard deduction for 2007 of $10,700. The Coopers' taxable income and tax for 2007 are calculated as follows:

Salary ($33,445 + $23,600)		$ 57,045
Plus: Taxable interest ($950 + $550)		+1,500
Less: Contributions to IRAs		−4,000
Equals: Adjusted gross income		$ 54,545
Less: Standard deduction for 2007	$10,700	
Exemptions for 2007 ($3,400 × 4)	13,600	−24,300
Equals: Taxable income		$ 30,245
Tax on $30,245 for 2007 (See Exhibit 4-5)		$ 3,751
Less: Child care credit (.20 × $3,500)		−700
Child tax credit (2 × $1,000)		−2,000
Equals: Net tax		$ 1,051
Less: Income tax withheld ($1,170 + $780)		−1,950
Equals: Tax due or (refund)		($ 899)

A completed Form 1040A based on this information is included in the Appendix at the end of the chapter.

TAX RATE SCHEDULES

A taxpayer who is unable to use the tax tables uses the tax rate schedules in computing his or her income tax. These schedules contain the rates provided in § 1 of the Internal Revenue Code. The 2007 tax rate schedules are included, along with the 2007 tax tables, in Appendix A. The 2008 tax rate schedules are summarized in Exhibit 4-6. For future reference, the tax rate schedules for 2008 are also reproduced on the inside front cover of this text.

EXHIBIT 4-6
Individual Tax Rate Schedules for 2008

2008 Singles

If taxable income is				
Over	*But not over*	*The Tax is*	*% on + Excess*	*Of the Amount over*
$ 0	$ 8,025	$ 0.00	10%	$ 0
8,025	32,550	802.50	15	8,025
32,550	78,850	4,481.25	25	32,550
78,850	164,550	16,056.25	28	78,850
164,550	357,700	40,052.25	33	164,550
357,700	—	103,791.75	35	357,700

2008 Married filing jointly:

If taxable income is				
Over	*But not over*	*The Tax is*	*% on + Excess*	*Of the Amount over*
$ 0	$ 16,050	$ 0.00	10%	$ 0
16,050	65,100	1,605.00	15	16,050
65,100	131,450	8,962.50	25	65,100
131,450	200,300	25,550.00	28	131,450
200,300	357,700	44,828.00	33	200,300
357,700	—	96,770.00	35	357,700

2008 Heads of household:

If taxable income is				
Over	*But not over*	*The Tax is*	*% on + Excess*	*Of the Amount over*
$ 0	$ 11,450	$ 0.00	10%	$ 0
11,450	43,650	1,145.00	15	11,450
43,650	112,650	5,975.00	25	43,650
112,650	182,400	23,225.00	28	112,650
182,400	357,700	42,755.00	33	182,400
357,700	—	100,604.00	35	357,700

2008 Married filing separately:

If taxable income is				
Over	*But not over*	*The Tax is*	*% on + Excess*	*Of the Amount over*
$ 0	$ 8,025	$ 0.00	10%	$ 0
8,025	$32,550	802.50	15%	8,025
32,550	$65,725	4,481.25	25%	32,550
65,725	$100,150	12,775.00	28%	65,725
100,150	$178,850	22,414.00	33%	100,150
178,850	—	48,385.00	35%	178,850

A typical example illustrating the use of the tax rate schedules is given below.

Example 25. R, single, has taxable income of $175,000 for 2008. R's gross tax liability is $43,500.75, computed as follows:

Tax on $175,000	$40,052.25
Plus: Tax on income above $160,850	
[($175,000 − $164,550 = $10,450) × 33%]	3,448.50
Tax liability	$43,500.75

Tax Reform and the Tax Rates. As noted above, recent tax legislation included a phased-in reduction in the marginal tax rates for noncorporate taxpayers.

- A new 10 percent bracket was carved out of the existing lowest rate 15 percent bracket as reflected in the 2008 tax schedules above.
- There are four tax brackets above the 15 percent bracket, all of which were reduced under tax reform. The phase-in of the rates is summarized as follows:

Tax Year	*Rates*			
2001	28.0%	31.0%	36.0%	39.6%
2002	27.5	30.5	35.5	39.1
After 2002	25.0	28.0	33.0	35.0

The post-2002 rates are reflected in the 2008 tax schedules above. All of the tax brackets continue to be indexed for inflation and are scheduled to remain in effect through 2010.

SPECIAL TAX COMPUTATION RULES

Unfortunately, the computation of the income tax is not always as straightforward as shown in *Example 25* above. For certain individuals, special rules must be followed.

Persons Claimed as Dependents. As one might deduce from the brief introduction to tax rates, one of the most fundamental principles of tax planning concerns minimizing the marginal tax rate that applies to the taxpayer's income. The significance of this principle is easily understood when it is recognized that Federal marginal tax rates have at times exceeded 90 percent. Even with the reduction of marginal rates to their current levels, minimizing the tax rate can provide benefits.

Historically, one of the most popular techniques to minimize the tax rate has been to shift income to a lower bracket taxpayer such as a child. As discussed in Chapter 5, this could be accomplished most easily by giving the child income-producing property. For example, a parent might establish a savings account for a child. In this way, the income would be taxed to the child at his or her low rate rather than the parents' high rate. In addition, this strategy—absent any special rules—takes advantage of the personal exemption and standard deduction available to a child.

Congress has long recognized the tax-saving potential inherent in such plans. For this reason, it is not surprising that it has taken steps to limit the opportunities. These are:

1. **Personal exemption.** A taxpayer who can be claimed as a dependent on another taxpayer's return is not entitled to a personal exemption. This rule effectively prohibits all children from claiming a personal exemption. Observe that *without this rule*, a child could currently receive up to $3,500 (2008) income tax-free due to the exemption.

2. **Standard deduction.** The standard deduction available to a taxpayer who can be claimed as a dependent on another taxpayer's return is limited to the *greater* of $900 or $300 plus his or her earned income—but not to exceed the standard deduction amount ($5,450 for single taxpayers in 2008). Without this rule, a child could receive unearned income such as interest of up to $5,450 tax-free.

3. **Kiddie tax.** As explained further below, the investment income (technically referred to as unearned income) of most children is generally taxed as if the parent received it to the extent it exceeds $1,800.[45] Absent this provision, affectionately known as the *kiddie tax*, a parent could shift up to $32,250 of taxable income to the child in 2008, who would pay taxes at a rate of 15 percent or less.

The effect of these provisions is to severely limit the success of any schemes designed to shift income to children.

Example 26. V, age 15, lives at home and may be claimed as a dependent on her parents' return. Several years ago, V's grandfather died, leaving her with a tidy sum to help send her to college. For 2008 V received interest income of $3,225. Her taxable income is computed as follows:

Adjusted gross income		$3,225
Less: Standard deduction	$900	
Personal exemption	+0	−900
Taxable income		$2,325

Note that, in computing V's taxable income, her standard deduction is limited to $900 (the larger of $300 plus her earned income, $300, or $900). The limitation is imposed because she is eligible to be claimed as a dependent on another taxpayer's return. For the same reason, she is not allowed to claim her own personal exemption deduction. In addition, a portion of her income is subject to the kiddie tax as explained below.

Example 27. Assume the same facts in *Example 26*, except that V also earns $2,000 from a part-time job. V's taxable income is determined as follows:

Adjusted gross income:		
Earned income	$ 2,000	
Interest income	+3,225	$ 5,225
Less: Standard deduction ($2,000 earned income + $300)	$ 2,300	
Personal exemption	+0	−2,300
Taxable income		$ 2,925

[45] § 1(g). The annual threshold is adjusted for inflation and is twice the standard deduction for dependents.

As in *Example 26*, because V is a dependent, she is not allowed to claim her personal exemption deduction, nor may she claim the full standard deduction of $5,450. Note, however, that her standard deduction has increased because of her earned income. Her standard deduction is now $2,300 (the *larger* of $300 plus her earned income of $2,000, or $900). In effect, V is able to shelter income from tax with the standard deduction to the extent it is earned from personal services (plus another $300).

Kiddie Tax. The *kiddie tax* extends to children who at the close of the taxable year are either under 19 or are full-time students under the age of 24. However, the kiddie tax does not apply to the student group if their earned income exceeds one-half of the amounts spent on their support. For this purpose, scholarships received by a child are not included in the individual's total support. In addition, the kiddie tax does not apply if the child files a joint return or has no living parents.

The kiddie tax rules are triggered only when the affected child has *net unearned income*. For this purpose, unearned income generally includes investment income such as dividends, interest, capital gains, rents, royalties and income received from a trust. Net unearned income is unearned income in excess of $1,800 in 2008.[46] In short, most "children" who have unearned income exceeding the annual threshold, $1,800 in 2008, must compute their tax using a special procedure. The effect of this calculation is that the first $900 of unearned income is offset by the standard deduction and the second $900 of unearned income is taxed at the child's rates (currently 10 percent). Any unearned income exceeding $1,800 is taxed at the parents' top rates.

Example 28. J is 17 years old. In 2008, he received interest income from a savings account and earned income from his paper route. The table below shows several sample calculations of J's taxable income assuming various amounts of earned and unearned income. In addition. the amount taxed at his rates and his parents' rates is computed.

	A	*B*	*C*	*D*
Unearned income	$1,850	$ 500	$1,850	$ 3,200
Earned income	350	750	700	5,450
Total	$2,200	$1,250	$2,550	$ 8,650
Standard deduction:				
Greater of $900 or earned income + $300 not to exceed $5,450 standard deduction	−900	−1,050	−1,000	−5,450
Personal exemption	—	—	—	—
Taxable income (a)	$1,300	$ 200	$1,550	$ 3,200
Taxed at parents' rates				
Unearned income > $1,800 (b)	$ 50	$ 0	$ 50	$ 1,400
Taxed at child's rates [(a) − (b)]	$1,250	$ 200	$1,500	$ 1,800

In case B, there is no net unearned income because J's unearned income was less than $1,800. J has net unearned income in cases A, C, and D. In each case, the amount taxed at his parents' rate is the amount by which the child's unearned income exceeded $1,800. Any other income is taxed at the regular rates for the child.

46 § 1(i)(4).

When the child has net unearned income, the tax must be computed as if such income had been the parents' income. The child is required to pay the tax computed using his or her parents' rates except in rare cases where the tax computed in the normal manner is greater (in which case the higher tax must be paid). The tax computation cannot be completed until the parents' taxable income is known.

Although the thrust of the kiddie tax is to tax income that would be taxed at a 10 or 15 percent rate at a higher rate, determination of the child's actual tax is somewhat complicated.[47] The tax is computed on Form 8615 using the following approach:

Taxable income from parents' return	$xxx
Add: Net unearned income of child (children)	+xxx
Equals: Total income taxed at parents' rate	$xxx
Tax on total income taxed at parents' rate	$xxx
Minus: Tax on parents' income	−xxx
Equals: Parental tax on child's net unearned income	$xxx
Add: Tax on child's remaining taxable income at child's rate	+xxx
Equals: Total tax on child's taxable income	$xxx

The first step in this process requires the calculation of the parental tax. This is accomplished by combining the income of the parents with the net unearned income of the child and then calculating the total tax on this combined income as if the parents had reported all the income. Then, by subtracting the tax on the parents' income (from the parents' return), the amount of tax that the parents would have paid on the child's net unearned income is determined. This *parental tax* is, therefore, the tax that the parents would have paid on the net unearned income had they reported it directly.

The final part of the calculation involves determining the tax on the child's remaining taxable income at the child's tax rate of 10 percent (or higher). This tax is added to the parental tax to arrive at the child's total tax.

In those situations where the parents are divorced, the parental tax is computed using the taxable income of the custodial parent (or joint income if he or she has remarried). Where the parents file separate returns, the tax is computed using the greater of the parents' two taxable incomes.

In computing the tax on the parent *including* the child's net unearned income, such income is not considered when computing any of the parents' deductions or credits (e.g., the deduction for miscellaneous itemized deductions, which is limited to the amount that exceeds two percent of adjusted gross income).

Where there is more than one child under 18 with net unearned income, the parental tax must be computed using the net unearned income of all children. As shown below, the tax so computed is then allocated pro rata based on each child's relative contribution to total net unearned income.

$$\frac{\text{Child's net unearned income}}{\text{All children's net unearned income}} \times \text{Parental tax} = \text{Child's share of parental tax}$$

[47] If the child has dividend income or long-term capital gains, such income continues to be taxed at the favorable rates at the parents' level. See Form 8615.

Example 29. During 2008, T, age 15, received $5,200 in interest from a savings account created for him in 2003 by his now deceased grandfather. Similarly, his sister, V, age 6, had $2,400 of interest income. Since T and V are under 19 and have net unearned income of $3,400 ($5,200 – $1,800) and $600 ($2,400 – $1,800), respectively, their tax must be computed in the special manner. The children's parents had income of $105,000. In addition, due to special medical problems of the father, they incurred $12,875 of medical expenses. The couple also has other itemized deductions of $10,000. T's tax is computed as follows:

1. Tax on parents computed in the normal manner:	
Adjusted gross income	$105,000
Deductions:	
Medical expenses [$12,875 − (7.5% × $105,000 = $7,875)]	−5,000
Other itemized deductions	−10,000
Exemptions (4 × $3,500)	−14,000
Taxable income computed in the normal manner	$ 76,000
Tax [$8,962.50 + 25% ($76,000 − $65,100 = $10,900)]	$ 11,688
2. Tax on parents including net unearned income of all children:	
Parents' taxable income computed in the normal manner	$ 76,000
Net unearned income of children:	
($3,400 + $600)	+4,000
Taxable income including net unearned income	$80,000
Tax [$8,962.50 + 25% ($80,000 − $65,100)]	$ 12,688
3. Parental tax:	
Tax on parents including net unearned income	$ 12,688
−Tax on parents computed in the normal manner	−11,688
= Parental Tax	$ 1,000
4. T's share of parental tax [$1,000 × ($3,400 ÷ $4,000)] =	$ 850
5. Tax on T excluding net unearned income:	
Interest income	$ 5,200
− Net unearned income	−3,400
− Standard deduction (as limited for dependents)	−900
− Exemption deduction (none for dependents)	−0
Taxable income	$ 900
Tax (10% × $900)	$ 90
6. Total tax on T:	
Tax on T excluding net unearned income	$ 90
+ Parental Tax	+850
= T's total tax	$ 940

Note that in this case the total parental tax of $1,000 is simply the product of the net unearned income of $4,000 ($3,400 + $600) and the parents' marginal tax rate of 25%. Also note that the parents' deduction for medical expenses is computed without including the net unearned income of the children (i.e., the percentage limitation is based on $105,000 rather than $109,000).

Election to Report Child's Income on Parents' Return. In order to simplify the return filing process, parents may elect to include on their own return the unearned income of a child if certain conditions are satisfied.[48] Note that this is contrary to the normal procedure where the child files his or her own return and pays the tax computed with respect to the parents' rates. This election eliminates the hassle of filing separate returns for each child. However, the election can only be made where the child is under age 18, his or her income is more than $900 and less than $9,000, and it consists *solely* of interest and dividends. The election is not available if estimated taxes have been paid or taxes have been withheld on dividend or interest income (i.e., the child is subject to back-up withholding).

Although making the election may make it easier to file, it may not be wise. Inclusion of the child's income, increases the parents' A.G.I. and therefore may reduce the deductions and credits that are phased-out based on A.G.I.

DETERMINATION OF NET TAX DUE OR REFUND

Once the tax is determined using the tax tables, tax rate schedules, or the special tax computation procedures described above, it is reduced by the amount of any credits or prepayments. The primary prepayments are the Federal income tax withheld from the taxpayer's salary or wages by an employer, quarterly estimated tax payments, and the estimated tax paid when an extension of time to file a return is requested. Estimated tax payments and extensions of time to file are discussed later in this chapter.

Numerous credits are allowed in computing the Federal income tax. The credit most frequently encountered on an uncomplicated income tax return is the child care credit. This and other credits are discussed in detail in Chapter 13.

✓ *CHECK YOUR KNOWLEDGE*

Review Question 1. What are the top and bottom tax rates for individuals?

It depends on the year. For 2008, the lowest rate is 10 percent and the highest rate is 35 percent (on taxable income over $357,700 for Married File Jointly).

Review Question 2. Several years ago Grandma gave her grandchild K, now 17, $20,000 to be used for her college education. All of the money was invested in stock. This year K's dad, acting on her behalf, sold some of the stock for a $4,000 short-term capital gain. K's parents are in the 35 percent tax bracket.

48 § 1(g)(7). The parents use Form 8814 for this purpose. If the child file his or her own return, the child uses Form 8615 to compute the tax.

a. Compute K's taxable income and K's tax.

Income (unearned)	$4,000
Standard deduction:	
Greater of $900 or $300 plus earned income	−900
Exemption	0
Taxable income	$3,100

K's personal exemption and standard deduction are limited since she can be claimed as a dependent on her parent's return. Consequently, she is not entitled to an exemption, and her standard deduction is $900 since she has no earned income. K is also subject to the kiddie tax since she is less than 19. In computing K's tax, the amount of unearned income in excess of $1,800 is $2,200 ($4,000 − $1,800), which must be taxed at her parents' rates while the remainder is taxed at her rates. Thus her tax is $860 [(35% × $2,200) + ($900 × 10%)].

b. Assume there were no kiddie tax. How much unearned income could be shifted to a dependent child and taxed at the child's 15 percent or lower rate rather than the parents' rate?

The 10 percent bracket for 2008 extends from taxable income of $1 to $8,025 and the 15 percent bracket extends from $8,026 to $32,550 for single taxpayers. Plus, another $900 escapes tax all together due to the child's standard deduction.

FILING REQUIREMENTS

Individual taxpayers with extremely low levels of income are not required to file a Federal income tax return. In general, a taxpayer is not required to file an income tax return for the year if his or her gross income is less than the *total* of his or her standard deduction (including the additional amount for the elderly but not the blind) *plus* personal exemptions (but not dependency exemptions).[49] These taxpayers generally are not liable for any Federal income tax. The filing requirement is based on gross income, so taxpayers who have gross incomes exceeding specified thresholds *must* file even if they owe no Federal income tax. A partial list of filing requirements for 2008 and how they are computed is illustrated in Exhibit 4-7.

In addition to the general requirement for filing (gross income is at least as much as the taxpayer's standard deduction + personal exemptions), certain individuals *must* file returns. These include:

[49] § 6012(a)(1).

EXHIBIT 4-7
Gross Income Filing Requirements for 2008

	Personal Exemption	+	*Standard Deduction*	+	*Elderly Standard Deductions*	=	*2008 Gross Income*
Single person < 65	\$3,500		\$ 5,450		—		\$ 8,950
Single person ≥ 65	3,500		5,450		\$1,350		10,300
Head of household < 65	3,500		8,000		—		11,500
Head of household ≥ 65	3,500		8,000		1,350		12,850
Married filing jointly, both < 65	7,000		10,900		—		17,900
Married filing jointly, both ≥ 65	7,000		10,900		2,100		20,000
Married filing separately	3,500						3,500
Surviving spouse < 65	3,500		10,900		—		14,400
Surviving spouse ≥ 65	3,500		10,900		1,050		15,450
Dependents							Special Rules

1. Any taxpayer who has self-employment income of \$400 or more
2. An individual who is claimed as a dependent on another taxpayer's return *and* who has unearned income at least equal to his or her minimum standard deduction (i.e., generally \$900, but increased by the additional amount for elderly or blind taxpayers)[50]
3. Any person who receives any advance payments of earned income credit

Form 1040. The individual taxpayer is required to file Form 1040, along with related forms and schedules. A complicated return involves many forms and schedules in addition to the Form 1040, whereas a simpler return may require only a few or no attached schedules.

Two simplified forms are provided for taxpayers with uncomplicated tax calculations. The Form 1040EZ is available for taxpayers who are single or married filing jointly and have no dependents. To qualify, the taxpayer's income normally must consist only of salaries and wages plus interest income of \$1,500 or less. The only allowable deductions on this form are the personal exemption amount and the standard deduction.

The Form 1040A is available for a large number of taxpayers who do not itemize their deductions and have no income other than salaries and wages, dividends, interest, and unemployment compensation. This form provides for deductions for individual retirement account (IRA) contributions, personal and dependency exemptions, and the earned income credit.

Example 30. Jeremy S. Allen, a registered nurse, and Shelly R. Allen, an air traffic controller, are married and file a joint income tax return for 2007. They are the sole support of their three children: William, Susan, and Gregory (all under age 17). The following information is from their records for 2007:

[50] § 6012(a)(1)(C)(i). As stated earlier, certain children under the age of 19 are not required to file a tax return *if* their parents *elect* to include the child's income on their return and pay the appropriate additional tax.

Salaries and wages, Jeremy		$32,875
Federal income tax withheld	$1,700	
Salaries and wages, Shelly		44,900
Federal income tax withheld	2,400	
Interest income—Mercantile National Bank		1,800
Interest income—U.S. Government Bonds		700
Interest income—Ben Franklin Savings		500
Itemized deductions are as follows:		
Unreimbursed prescription drugs		200
Hospitalization insurance		700
Unreimbursed fees of doctors, hospitals, etc.		2,100
Real estate taxes on residence		1,200
State income taxes paid		3,400
Interest paid on original home mortgage		8,500
Investment interest		400
Charitable contribution—First Church		1,300
Charitable contribution—Home State University		200
Preparation of prior year's tax return		275

The Allens' adjusted gross income is $80,775 ($32,875 + $44,900 + $3,000 interest income) since there were no deductions for A.G.I. The deductible amount of their itemized deductions is $15,000, summarized as follows:

Medical expenses exceeding $6,021 [$3,000 < (7.5% × $80,775 = $6,058)]	$ 0
Deductible taxes ($1,200 + $3,400)	4,600
Qualifying home mortgage interest	8,500
Investment interest	400
Charitable contributions	1,500
Miscellaneous itemized deductions exceeding $1,616 [$275 < (2% × $80,775 = $1,616)]	0
Total itemized deductions	$15,000

The Allens' taxable income, gross tax, and tax refund for 2007 are determined as follows:

Adjusted gross income			$ 80,775
Less:	Itemized deductions	$ 15,000	
	Personal and dependency exemptions ($3,400 × 5)	+17,000	−32,000
Equals: Taxable income			$ 48,775
Gross Tax (from 2007 Tax Table)			$ 6,534
Less:	Prepayments ($1,700 + $2,400)		−4,100
	Child tax credit (3 × $1,000)		−3,000
Equals: Tax due or (refund)			($ 566)

The Allens' completed 2007 tax return is shown in the Appendix at the end of the chapter. It consists of a Form 1040 plus Schedules A and B.

The more common tax forms and schedules used by individual taxpayers are listed in Exhibit 4-8. Copies of these forms are contained in Appendix B at the end of the text.

EXHIBIT 4-8
List of Common Forms and Schedules Used by Individual Taxpayers

Form 1040	**U.S. Individual Income Tax Return**
Accompanying Schedules:	
Schedule A	Itemized deductions
Schedule B	Interest and dividend income
Schedule C	Profit (or loss) from business or profession
Schedule D	Capital gains and losses
Schedule E	Supplemental income schedule (rents, royalties, etc.)
Schedule F	Farm income and expenses
Schedule R	Credit for the elderly
Schedule SE	Computation of social security self-employment tax
Accompanying Forms:	
Form 2106	Employee business expenses
Form 2210	Underpayment of estimated tax by individuals
Form 2441	Credit for child and dependent care expenses
Form 3800	General business credit
Form 3903	Moving expense adjustment
Form 4562	Depreciation
Form 4684	Casualties and thefts
Form 4797	Supplemental schedule of gains and losses
Form 6251	Alternative minimum tax computation
Form 6252	Computation of installment sale income
Form 8582	Passive activity losses
Form 8615	Computation of tax for children under age 18 who have investment income of more than $1,700
Form 8814	Parents' election to report child's interest and dividends
Other Common Forms:	
Form 1040A	U.S. Individual Income Tax Return
Form 1040EZ	Income tax return for single filers with no dependents
Form 4868	Application for automatic extension of time to file
Form 2688	Application for extension of time to file

DUE DATES FOR FILING RETURNS

The day on which a Federal return must be filed with the IRS depends upon what type of return is involved. Generally the tax returns must be filed on or before the due dates, which are as follows:[51]

[51] § 6072(a).

Type of Return	*Due Date*
Annual Individual Income Tax Returns	Fifteenth day of the fourth month following the close of the tax year (April 15 for calendar year individuals)
Annual C Corporation and S Corporation Income Tax Returns	Fifteenth day of third month following the close of the tax year (March 15 for calendar year corporations)
Annual Partnership, Estate, and Trust Income Tax Returns	Fifteenth day of the fourth month following the close of the year (April 15 for calendar year entities)
Estate Tax Returns	Nine months after the date of the descedent's death
Gift Tax Returns	April 15 (All gift tax returns are for a calendar year)

Any return that is mailed via the U.S. Postal Service is deemed to be delivered when mailed, so any return postmarked on or before the above due dates is timely filed. If any of these due dates fall on Saturday, Sunday, or a legal holiday, the return must be filed on the succeeding day that is not a Saturday, Sunday, or legal holiday.

Extension of Time to File. The Internal Revenue Code provides extensions of time for filing returns. The extension must be requested on or before the due date of the return. Currently, there is an *automatic* six-month extension for filing the individual income tax return (Form 1040). Thus the extended due date for calendar year individuals is October 15. If the taxpayer desires to use the six-month extension, he or she simply fills out Form 4868 and mails it to the IRS by the original due date along with a check covering the estimated balance due. It should be noted that an extension of time to file is not an extension of time to pay. There is *no extension* of time to pay the tax due.[52] The penalty for failing to pay the tax due is discussed below.

Interest. Whenever a taxpayer fails to pay the amount of tax owed by the due date of the return, interest is charged. To encourage payment, the rate is 3 percent higher than the Federal short-term rate. For the first quarter of 2008, the annual interest rate charge on such a deficiency is 6 percent (3% + 3%), compounded daily on the unpaid balance. Interest is generally charged from the day the tax is due (e.g., the due date of the return) and continues until the tax is paid.[53]

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52 Reg. § 1.6081-4(a).

53 § 6601(a). The 6 percent rate is scheduled to remain in effect until April 2008, at which time it will be increased, reduced, or allowed to remain unchanged, based on a predetermined formula. Generally, the government pays interest to taxpayers in the case of overpayments, beginning on the due date for the tax (usually the due date for the tax return). The rate of interest is the same as that on underpayments for noncorporate taxpayers. See § 6621.

PENALTIES

Around April 15, it is not uncommon to hear procrastinating taxpayers ask what happens if they neither file their returns nor pay their taxes on time. When either of these occurs, taxpayers not only have to pay interest but also penalties. There are three types of penalties that may apply:[54]

1. A penalty for *failure-to-file a return* by the due date;
2. A penalty for *failure-to-pay* at least 90 percent of the *tax* by the due date; and
3. A penalty for *failure to pay estimated taxes* during the course of the year.

If the taxpayer owes nothing or is entitled to a refund, these penalties do not apply even if he or she does not file a return. On the other hand, if the taxpayer has an amount due, any one or all three of these penalties could be imposed. In addition, since these penalties are technically additions to and part of the total tax liability, any interest that must be paid effectively includes *interest on the penalties*. Finally, if the taxpayer wants to obtain a refund, there are time limits for claiming it. Each of these possibilities is discussed below.

Failure-to-File. Taxpayers who do not file their returns by the due date (e.g., April 15) or fail to obtain a proper extension on such date are subject to the *failure-to-file penalty*. Under § 6651, the penalty is 5 percent of the amount of tax due for each month the return is not filed.[55] The penalty cannot exceed a maximum of 25 percent (e.g., 5% × 5 months). For this purpose, any fraction of a month is counted as a full month. To illustrate how harsh this rule can be, consider a taxpayer who owes $10,000 and his return is postmarked one day late. Even though the return is only one day late, the failure-to-file penalty is 5 percent for an entire month on the amount due or $500 (5% × 1 month × $10,000 amount due)!

To deal with the administrative costs of handling small penalties, a minimum penalty exists. If the return is more than 60 days late, the minimum penalty is $100 or 100% of the tax due, whichever is less.[56] For example, a taxpayer who owes $300 and files her return on June 1 would normally owe a penalty of $45 (5% × 3 months × $300) but the minimum penalty is $100 (the lesser of $100 or the tax due of $300).

Taxpayers who fail to file their returns may not be penalized in certain situations. The penalty is not imposed if the failure was due to reasonable cause and not willful neglect. In addition, since the penalty is based on the amount due no penalty results if there is no amount due. Because of this rule taxpayers who are entitled to a refund are not penalized for filing late since there is no amount due.

Failure-to-Pay Penalty. Filing a return is not enough to avoid penalty. Section 6651 also imposes a *failure-to-pay* penalty if a taxpayer does not pay at least 90 percent of the total tax on or before the due date of the return.[57] In other words, the IRS does not assess a penalty if an extension of time to file is properly obtained and the tax due is less than 10 percent of the total tax shown on the return (i.e., gross tax after credits but before any withholding and estimated tax payments). The penalty can also be avoided if the failure is due to reasonable cause and not willful neglect. If the taxpayer does not meet either test, the *failure-to-pay* penalty is one-half of 1 percent (.5% or .005) per month (or any fraction of a

[54] Technically, the Internal Revenue Code does not refer to these as penalties but as "additions to the tax." See §§ 6651 and 6654.

[55] § 6651(a)(1). If the failure to file is fraudulent, the penalty is 15 percent per month up to a maximum of 75 percent. § 6551(f).

[56] § 6651(a)(1)

[57] § 6651(a)(2)

month) up to a maximum 25 percent of the amount due.[58] Note that if the taxpayer files an extension and pays 90 percent of the tax by the due date, the taxpayer must still pay interest on any tax due but avoids both the failure-to-pay and failure-to-file penalties.

Example 31. As the time approached for filing his tax return, W was too busy to file. Accordingly, on April 15 he requested an automatic extension of time to file until October 15. W estimated that his total tax would be $6,000, and he had prepaid taxes of $5,300 in the form of withholding. Therefore, when he filed his request for an extension, he paid $700 ($6,000 − $5,300). By filing a timely extension, he is treated as filing a return and avoids the failure-to-file a return penalty. When he finally did file his return on June 15, W's earlier estimate proved wrong and the return showed a total tax of $7,000 and a tax due of $1,000 [$7,000 total tax due − $6,000 ($5,300 withholding + $700 payment with the extension)]. W is required to pay a penalty for failure-to-pay since the total paid by the due date, $6,000 is less than 90 percent of the tax due, $6,300 (90% × $7,000). The amount of the penalty is based on the total amount due that was unpaid on April 15, $1,000 ($7,000 − $6,000 paid) and not the amount short of the 90 percent requirement ($300). In addition, assuming the current rate of interest on underpayments is 10%, W must pay interest of about $17 ($1,000 amount due at 10% annually, compounded daily until June 15 for 61 days).

Interaction of Failure-to-Pay and Failure-to-File Penalties. When both the failure-to-file and failure-to-pay penalties apply, the penalty for failure-to-file to file is reduced by the amount of the penalty for failure to pay.

Example 32. K forgot to file her Federal tax return for the most recent calendar year. When she finally filed the return on November 1 (7 months late), her return showed a gross tax of $5,200 and a tax due after withholding of $600. Assuming the current rate of interest on underpayments is 10%, K must pay not only her tax due of $600 but also late penalties of $156 and interest on the tax and penalties of $41, for a total of $797, as computed below.

Tax due		$600
Penalties:		
Failure to pay ($600 × .005 × 7)		21
Failure to file:		
Failure-to-file penalty ($600 × .05 × 5)	$150	
Reduced by failure-to-pay penalty ($600 × .005 × 5)	(15)	135
Total tax and penalties		$756
Interest on tax and penalties ($756 × 10% × 199/365)		41
Total due		$797

Note that the minimum failure-to-file penalty is not triggered here since the penalty of $135 computed in the normal manner exceeds the minimum penalty of $100 (the lesser of the total tax due, $600, or $100).

Estimated Tax Payments. The last of the three "late" penalties is the penalty for failure to pay estimated taxes.[59] This penalty should be distinguished from the *failure-to-file* and *failure-to-pay* penalties that begin to run as of the due date of the return. The

[58] § 6651(a)(2)

[59] § 6654

estimated tax penalty applies if the taxpayer fails to pay sufficient taxes *during the year*. In essence, the law sets forth a series of intermediate due dates for estimated tax payments during the tax year.

The estimated tax penalty is a product of the "pay-as-you-go" system for collection of taxes. Under this system, taxpayers are required to prepay Federal income taxes periodically during the year. Prepayments are made through withholding from certain types of income (e.g., salary and wages) and by making estimated tax payments. Failure to make adequate payments during the year results in a penalty that is computed much like interest.

As a practical matter, estimated tax penalties do not affect the vast majority of individuals. For those receiving only salaries and wages, withholding is usually sufficient to cover the required payments. However, those taxpayers with other income may need to make up the shortfall by making estimated tax payments. Regardless of the causes, if the amount of taxes paid during the year is insufficient, the penalty may apply.

Imposition of the Estimated Tax Penalty. Individual taxpayers avoid the estimated tax penalty if total prepayments (estimated taxes and withholding) equal or exceed the *required annual payment*, which is the lesser of:[60]

1. 90% of the tax shown on the return, or
2. 100% of the tax shown on the return for the individual for the preceding year. If A.G.I. in the prior year exceeded $150,000, the payment must be 110% of the prior year's tax.
3. The annualized income installment

For this purpose, the tax due includes the self-employment tax as well as the alternative minimum tax and certain other taxes. If the total amounts paid are less than the amount due, an *underpayment* exists and the penalty must be calculated and paid as explained below. However, there is no estimated tax penalty if the underpayment is less than $1,000.[61]

Example 33. For 2007, T, a single individual, reported an adjusted gross income of $165,000, a taxable income of $140,000, and a tax liability (after credits) of $40,000. In 2008 his tax liability is $60,000. Under the general rules T must have paid the lesser of 90% of the current year's tax, $54,000, or 100% of last year's tax, $40,000, to avoid the underpayment penalty. However, because T's adjusted gross income exceeded $150,000 in the prior year, 2007, he is subject to the 110% rule regarding his estimated tax payments for the current year, 2008. As a result, he can avoid underpayment penalties with respect to 2008 only if he pays the lesser of the following:

1. 90% of the current year's tax of $60,000.	$54,000
2. 110% of last year's tax of $40,000.	44,000

Thus, if T pays at least $44,000 on a timely basis during 2008, he will not be subject to any penalty for failing to pay estimated taxes.

The required payment is due in four equal installments or 25 percent on each due date. Although it is convenient to say that the payments are made on a quarterly basis, this

60 § 6654(d)

61 § 6654(e)(1)

is not quite the case. For calendar year taxpayers, the amounts are due on April 15, June 15, September 15, and January 15.

Whether the payments are adequate is determined at the end of each "quarter." For this purpose, withholding is treated as if it occurred proportionately throughout the year. For example, if a taxpayer had withholding of $3,650, he or she would be treated as if $10 was withheld each day. At the end of each quarter, the payments to date are compared to the amount required to be paid. If the proper amount has not been paid, an underpayment exists and a penalty must be paid.

The penalty is assessed on the amount of the underpayment at the same rate as the interest that is charged on tax deficiencies. This penalty is separate from the failure-to-pay penalty as well as the interest which is charged. As noted earlier, interest and the failure-to-pay penalty apply to underpayments of tax due as of the due date of the return (e.g., April 15, 2009). In contrast, the estimated tax penalty is charged from the date each estimated tax installment was due (e.g., April 15, June 15, September 15 of *2007* and January 15, 2009) until the tax is paid (or, if the tax is paid late, the due date of the return).

Example 34. For 2007 and 2008 G's gross tax was $12,000 and $16,000, respectively. G's withholding for 2008 was $6,500 and his estimated tax payments were $1,500 on April 15 and June 15 and $500 on September 15 and January 15. G's underpayment is determined as follows:

	Payment Due Date			
	4/15	*6/15*	*9/15*	*1/15*
Percentage due	25%	50%	75%	100%
90% of current year's tax ($16,000 × .90 × percentage due)	$ 3,600	$ 7,200	$ 10,800	$ 14,400
100% of prior year's tax ($12,000 × percentage due)	$ 3,000	$ 6,000	$ 9,000	$ 12,000
Payments to date:				
Withholding	$ 1,625	$ 3,250	$ 4,875	$ 6,500
Estimated tax payments	+1,500	+3,000	+3,500	+4,000
Total	$ 3,125	$ 6,250	$ 8,375	$ 10,500

G's payments are adequate for the first quarter and the second quarter, since the payments up to each date exceed the lesser of the two required amounts (the prior year's tax in both cases). As of the third payment date, G is underpaid by $625 ($9,000 − $8,375); and as of the last payment date, he is underpaid by $1,500 ($12,000 − $10,500). The penalty is computed based on these amounts from the due date until the day they are paid (or April 15, if earlier).

Assuming the current rate of penalty is 10% and G does not pay his tax early, G's penalty would be $58, which is the penalty on $625 from September 15 through January 15 [$625 × .1 × 122 days/365 days) = $21] *plus* that on $1,500 from January 15 through April 15 [$1,500 × (.1 × 90 days/365 days) = $37].

The penalty for failure to make adequate estimated tax payments is calculated on Form 2210 (see Appendix for a sample form). Unless a taxpayer can reduce the penalty by applying the annualized income installment or otherwise, he or she may simply let the IRS calculate this penalty and assess a deficiency for it. In addition, the IRS may waive the underpayment penalty in the event of a casualty or unusual circumstances where it might be inequitable to impose the additional tax. The IRS may also waive the penalty for retired taxpayers who are at least age 62 or disabled where the underpayment was due to reasonable cause rather than willful neglect.

Annualized Income Installment. If income for a year is earned disproportionately during the year, the taxpayer may be able to avoid penalty for one or more of the first three payments under the *annualized income installment* method.[62] Under this method, no penalty is imposed when the payment to date exceeds the tax which would be due on the income for the months preceding the payment date determined on an annualized basis.

Example 35. F, a calendar year individual, is engaged in a seasonal business that earns most of its income during the fourth quarter. F is able to demonstrate that the income was earned as follows:

	Payment Due Date			
	4/15	*6/15*	*9/15*	*1/15*
Months preceding payment	3	5	8	12
Net income earned for the months preceding the payment	$10,000	$18,000	$25,000	$50,000
Annualized amount [Net income × (12/months to date)]	$40,000	$43,200	$37,500	$50,000

To apply this exception, the tax on the annualized income is determined. There is an underpayment only if the estimated tax payments are less than the appropriate portion of the tax on the annualized income.

The required payment for April 15 is the fraction 3 months ÷ 12 months times the tax on $40,000. If the tax on $40,000 is $8,000, F has no underpayment for the first payment so long as she paid $2,000 ($8,000 × 3/12) or more. If she had paid less, the underpayment would be the amount by which $2,000 exceeded the payments. A similar process would be followed for each quarter.

To apply the annualized income installment calculations, a taxpayer completes a worksheet that accompanies the Form 2210. If this method is used to the benefit of the taxpayer for one payment, it must be used for *all* four payments.

Other Penalties. As mentioned in Chapter 2, many other penalties exist to ensure proper compliance with the tax laws. For example, the Code provides for an accuracy-related penalty of 20 percent of the amount of understatement due to negligence or intentional disregard of the rules (e.g., failing to report income), or substantial valuation misstatements.[63] In addition, severe penalties, both civil and criminal, exist for fraud.[64]

CLAIM FOR REFUND

The vast majority of taxpayers actually overpay their taxes and are entitled to a refund. For example, the IRS reported in 2005 that of the 134.3 million returns filed about 101.9 million (about 75 percent) claimed a refund. On average, this represented a refund of $2,287 per return. While most people routinely file their returns and receive their refund checks, others procrastinate. Unfortunately, some people assume it makes no difference how late they file if they wish to recover a refund. That can be a costly mistake. As a general rule, the Code requires taxpayers to file a tax return to claim a refund within two years of paying the tax, deemed to be April 15 in most cases.[65] Taxpayers who file a timely return, but subsequently realize that they overpaid, have a bit longer—three years from the due date of the return.

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62 § 6654(d).

63 § 6653 (a)(1)

64 § 6653(b)

65 See § 6511 and § 6513

Example 36. With April 15, 2006 just a few days away, C made a few quick calculations regarding his 2005 tax liability and determined that his tax was $12,000. Knowing that he had $14,000 withheld and did not owe any tax, C did not file a return. C continued to put off filing a return until one day he received a letter from the IRS. In the letter dated November 2008, the IRS explained that based on information available to it C owed a tax of $1,500. In response, C finally filed a correct return on May 1, 2009, showing that he did in fact owe $12,000 in tax and the government should refund him his overpayment of $2,000. C is not entitled to any of the $2,000 refund. Since C did not file a timely return on April 15, 2006, the time for filing a refund claim expired two years from the date the tax was paid, April 15, 2008. By procrastinating, C lost his entire refund. Had he filed a timely return, the date for claiming the refund would have been three years after the return was filed or April 15, 2009.

The two year rule applies if the taxpayer did not file a return.[66] If a return was filed, a claim for a refund can be filed by the later of three years from the date of filing the original return (April 15 if filed before such date), or two years from the time the tax was paid. In situations where a return has been filed, the claim for refund usually arises from the filing of an amended individual income tax return (i.e., Form 1040X—see Appendix).

Example 37. K filed a timely return for 2007 on March 12, 2008. The total tax on the return was $5,500, and after withholdings of $4,700, K owed $800. K's return was audited and she was required to pay a deficiency of $200 on June 3, 2009. K may file a claim for refund for any part of the tax of $5,700 ($5,500 on the original return plus the additional tax of $200) until April 12, 2011 (three years from the date filed). A claim for up to $200 could be filed up until June 3, 2011 (two years from the date the $200 was paid).

EXHIBIT 4-9
Interest and Penalties

Description	*Violation*	*Amount*
Interest on underpayments	Insufficient payment on due date; applies to tax and penalties	3% + Fed short-term rate until paid
Failure to file	Tax return or extension not filed by due date	5% per month of amount due (maximum 25%) If more than 60 days late, minimum penalty is the smaller of $100 or 100% of the tax due
Failure to file (fraud)	Tax return or extension not filed by due date because of fraud	15% per month of amount due (maximum 75%)
Failure to pay tax	Fail to pay 90% of tax due on due date	0.5% per month of amount due (maximum 25%)
Failure to pay estimated taxes	Failure to pay 25% of required annual payment on 4/15, 6/15, 9/15 or 1/15	3% + Fed short-term rate until paid
Accuracy Related Fraud	Negligence or disregard of rules or regulations	20% of tax underpayment 75% of tax underpayment
Claim for refund	Filed later that 2 years after tax paid or 3 years after return filed	Loss of refund

[66] *Comm. v. Lundy*, 116 116 S. Ct. 647, 77 AFTR2d 406, 96-1 USTC 50,035 (USSC, 1996).

STATUTE OF LIMITATIONS

Even in the administration of the Federal tax laws, all things must finally come to an end. As the U.S. Supreme Court has stated:

> Congress has regarded it as ill advised to have an income tax system under which there would never come a day of final settlement and which required both a taxpayer and the Government to stand ready forever and a day to produce vouchers, prove events, and recall details of all that goes into an income tax contest.[67]

Accordingly, there are certain time periods within which the IRS must take action *against* a taxpayer. If the Service does not take action within the prescribed time period, it is *barred* from pursuing the matter further. Technically the period in which an action must be commenced is called the Statute of Limitations. If the Statute of Limitations runs (expires) without any action on the part of the IRS, then the government is prohibited from assessing additional taxes for the expired periods.

Under the general rule, the IRS has three years from the date a return is filed to assess an additional tax liability against the taxpayer. If the tax return is filed before its due date, the three-year period for assessment begins *on* the due date.

Example 38. R, a calendar year taxpayer, files a 2008 income tax return (due April 15) on March 8, 2009. The IRS will be prevented from assessing R additional taxes for 2008 any time after April 15, 2012.

Example 39. Refer to *Example 38*. If R files a 2008 income tax return on October 15, 2009, the IRS may assess additional taxes for 2008 at any time through October 15, 2012.

There are several important exceptions to the three-year time period for assessing additional taxes. First, if the taxpayer has filed a false or a fraudulent return with the intention to *evade* the tax, then the tax may be assessed (or a proceeding may be initiated in court without assessment) at *any time* in the future. Similarly, if the taxpayer fails to file a return, the Statute of Limitations will not begin to run. Interestingly, a willful failure to file, a negligent failure to file, or an innocent failure to file are all treated the same. Thus, under any of these circumstances there is no limit to the time in which the IRS may make an assessment or begin a court proceeding against the taxpayer.

In the case of a *substantial omission of income* from a tax return, the Statute of Limitations is extended to six years. A substantial omission is defined as an omission of income in excess of 25% of the gross income *reported* on the return.[68] If the omission of gross income was committed with the intent of evading the tax, however, the assessment period would be unlimited.

Example 40. T, a calendar year taxpayer, unintentionally failed to include $8,000 of dividends in his 2007 tax return filed on April 15, 2008. If the $8,000 omitted is more than 25% of the gross income reported on T's 2007 return, the IRS may assess an additional income tax liability against him at any time until after April 15, 2014.

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67 *Rothensies v. Electric Storage Battery Co.*, 47-1 USTC ¶9106, 35 AFTR 297, 329 U.S. 296, 301 (USSC, 1946).

68 § 6501(e).

The periods within which assessments must be made are summarized in Exhibit 4-10, which follows.

EXHIBIT 4-10
Periods Within Which Assessments Must Be Made

Circumstances of Return	*Period of Assessment*
Normal return had been filed	Three years from date of filing or due date, whichever is later
Return filed with substantial omission of gross income	Six years from date of filing or due date, whichever is later
No return is filed	No time limit
False or fraudulent return	No time limit

INDEXATION AND THE FEDERAL INCOME TAX

Inflation has significant effects on a progressive tax rate structure stated in terms of a *constant* dollar. Taxpayers whose *real* incomes remain constant will have increasing levels of income, stated in terms of *nominal* dollars. Accordingly, their incomes will *creep up* into higher tax brackets. As an illustration, assume a taxpayer who earned $100,000 in 2007 is entitled to an annual raise at least equal to any increase in the Consumer Price Index (approximately four percent increase in 2007). Although his 2008 salary will creep up to $104,000, his before tax income in terms of 2007 prices remains at $100,000. At first glance, the taxpayer is as well off in 2008 as he was in 2007. Note, however, that the salary increase will be taxed at his marginal tax bracket, in which case he would have less after-tax income in real terms in 2008 than he had in 2007. Over time, this *bracket creep*, as it has been labeled, results in a larger portion of the taxpayer's earnings being paid to the Federal government. In effect, unlegislated tax increases occur.

For many years, Congress simply ignored the bracket creep phenomenon, choosing instead to allow the hidden tax increases to occur. As might be expected, this was a very palatable approach to politicians, particularly considering the alternative. The concerns of the few who objected were mollified in part by tax reduction packages enacted in 1981 and 1986. Both the Economic Recovery Tax Act of 1981 and the Tax Reform Act of 1986 directly reduced tax rates. These specific tax rate adjustments have since been followed by a permanent remedy for bracket creep: indexation.

Congress began adding the concept of indexation to the tax law in 1985. In 1986 it specified the amounts of the standard deduction, exemption amounts, and tax brackets for 1987 and 1988 (and the exemption amount for 1989). Thereafter, each of these amounts and many others have been annually adjusted for price level changes as measured by the Consumer Price Index.[69]

[69] See §§ 1(f), 1(g)(4), 639(c)(4), and 151(d)(3).

✓ CHECK YOUR KNOWLEDGE

Review Question 1. Z, age 16, earned $2,000 from umpiring baseball games and refereeing soccer matches during the year. Z—rather Z's parents—wants to know whether he is required to file a tax return since this was his only income.

A taxpayer normally is not required to file a return if his or her income is less than the sum of the personal exemption amount and the standard deduction. However, this general rule does not apply to an individual who can be claimed as a dependent on another return since he or she is not entitled to claim a personal exemption and the standard deduction may be limited. In this case, all of Z's income is earned income and is therefore offset by his standard deduction of $2,300 (the greater of $900 or $300 plus earned income). Consequently, it seems that there is no need for him to file a return. However, even though he is not subject to the income tax, he still must consider self-employment taxes (assuming the income is self-employment income). A return is required if a taxpayer has self-employment income of at least $400. As a result, Z must file a return.

Review Question 2. After spending three years on the auditing staff of a large accounting firm, Norm took a job as controller of a small construction company. On the first day of the job, Norm looked around his new office and noticed a bunch of tax forms on the corner of his desk. One looked like the 1040 for his boss, and the others were corporate and partnership returns related to the company. At first he panicked. But then he realized that it was only the end of February and he had until April 15 to figure out what needed to be done. Should Norm relax?

Doubtful. Although returns for calendar year individuals and partnerships are normally due on April 15, the returns for C corporations or S corporations are due on March 15.

Review Question 3. As always, April 15 arrived and T had not even begun to prepare his tax return. Not to worry, he thought. He could simply file for an extension.

a. Assume T does not file for an extension and simply files his return late. Are there any penalties?

Maybe. A failure-to-file as well as a failure-to-pay penalty may be imposed. Both penalties apply only if there is a tax due. If T is entitled to a refund, there is no penalty. The failure-to-file penalty is 5 percent per month on the balance due, not to exceed 25 percent.

b. How long is the extension?

An automatic extension of six months until October 15 is available.

c. Is an extension for time to file the return also an extension of time to pay the tax?

No. If T does not pay a sufficient amount of his tax by April 15, he faces penalties and interest imposed on the balance due.

d. Assuming T's gross tax liability before withholding is $10,000, how much must he pay by April 15 in order to avoid penalty?

T must pay 90 percent of the gross tax, or $9,000, by April 15. Otherwise, a penalty of ½ of 1 percent per month is imposed (up to a maximum of 25 percent) on the entire underpayment from the due date of the return (April 15).

e. Assume that T's net tax due for the year is $10,000 and he never files a return or a proper extension. What is the maximum failure-to-file and failure-to-pay penalty that can be assessed (ignore any potential fraud penalty and interest)?

The maximum failure-to-file and failure-to-pay penalty in this case is $4,750 (47.5% $\times$ $10,000). The failure-to-file penalty is 5 percent per month up to a maximum of 25 percent reduced by .5 percent per month for any month in which the failure-to-pay penalty also applies. Thus, the maximum failure-to-file penalty when the failure-to-pay penalty also applies is 22.5 percent [(5 $\times$ 5% = 25%) − (5 $\times$ .05 = 2.5%)]. The maximum failure-to-pay penalty is .5 percent per month up to a maximum of 25 percent. Adding the two penalties together produces a maximum penalty for failure to file the return and failure to pay the tax of 47.5 percent (22.5% + 25%) of the amount due.

f. If T fails to pay his tax and he is subject to penalties, how does interest work? Must he pay interest on just the tax due or on both the tax and the penalties?

He pays interest not only on the tax due but also on the penalties since the penalties are considered an additional tax.

Review Question 4. Penalties for failing to file a return and failing to pay at least 90 percent of the tax due by the due date must be distinguished from penalties for failure to adequately make estimated tax payments during the year (underpayment penalties). Try the following true-false questions concerning estimated tax payments.

a. T finally filed her 2007 tax return and is now worrying about 2008. As a general rule, an individual taxpayer must pay 22.5 percent of her 2008 tax (even though she has no idea what it will be) 15 days after the end of each quarter (i.e., April 15, July 15, October 15, and January 15).

False. Although it is true that the taxpayer must normally pay 90 percent of the current tax due during the year (or 22.5 percent per installment), the installments are due on April 15, June 15, September 15, and January 15. Notwithstanding the fact that these payments are not truly paid on a quarterly basis, most people refer to them as "quarterly" estimated tax payments.

b. In lieu of paying 90 percent of their tax liability, individual taxpayers may avoid the underpayment penalty by paying 90 percent of last year's tax liability.

False. Penalty can be avoided if the taxpayer pays 90 percent of the current year's tax or 100 percent of last year's tax. However, the 100 percent rule is increased to 110 percent if the taxpayer's adjusted gross income in the prior year exceeded $150,000.

c. T earns a salary but also does some tinkering in the stock market. In October she realized that she should have paid estimated taxes throughout the year given what her income was going to be. Asking her employer to withhold an extra $36,500 in taxes during October, November, and December will help solve T's estimated tax problems for April, June, and September.

True. Withholding is treated as being paid ratably throughout the year. Therefore the additional $36,500 is not simply applied to the later due dates. Instead, T is treated as having paid $100 per day each day of the year. For example, she is treated as having paid an additional $10,500 (105 $\times$ $100) on April 15.

Review Question 5. T filed her 2007 tax return on March 15, 2008. The IRS is barred from assessing a deficiency after

- **a.** March 15, 2010
- **b.** March 15, 2011
- **c.** March 15, 2012
- **d.** April 15, 2011
- **e.** April 15, 2012

d. The statue of limitations runs out on April 15, 2011, three years from the later of the due date or the date of filing.

APPENDIX

TAX RETURN ILLUSTRATIONS

The following pages provide realistic examples of uncomplicated tax returns for individual taxpayers. The information from *Examples 23, 24, and 30* of this chapter is used.

Form **1040EZ**

Department of the Treasury—Internal Revenue Service

Income Tax Return for Single and Joint Filers With No Dependents **2007**

OMB No. 1545-0074

Label (See page 8.)
Use the IRS label. Otherwise, please print or type.

LABEL HERE

Your first name and initial	Last name	Your social security number
WILLIAMS W.	BRISTOL	187 52 9034
If a joint return, spouse's first name and initial	Last name	Spouse's social security number
Home address (number and street). If you have a P.O. box, see page 9. 651 SOUTH HAMPTON	Apt. no.	▲ You **must** enter your SSN(s) above. ▲
City, town or post office, state, and ZIP code. If you have a foreign address, see page 9. BLUE SPRINGS, MO 64015		Checking a box below will not change your tax or refund.

Presidential Election Campaign (page 9) Check here if you, or your spouse if a joint return, want $3 to go to this fund . . . . ▶ ☐ **You** ☐ **Spouse**

Income

Attach Form(s) W-2 here.

Enclose, but do not attach, any payment.

1	Wages, salaries, and tips. This should be shown in box 1 of your Form(s) W-2. Attach your Form(s) W-2.	1	27,410
2	Taxable interest. If the total is over $1,500, you cannot use Form 1040EZ.	2	350
3	Unemployment compensation and Alaska Permanent Fund dividends (see page 10).	3	
4	Add lines 1, 2, and 3. This is your **adjusted gross income.**	4	27,760
5	If someone can claim you (or your spouse if a joint return) as a dependent, check the applicable box(es) below and enter the amount from the worksheet on back. ☐ **You** ☐ **Spouse** If no one can claim you (or your spouse if a joint return), enter $8,750 if **single;** $17,500 if **married filing jointly.** See back for explanation.	5	8,750
6	Subtract line 5 from line 4. If line 5 is larger than line 4, enter -0-. This is your **taxable income.** ▶	6	19,010

Payments and tax

7	Federal income tax withheld from box 2 of your Form(s) W-2.	7	2,820
8a	**Earned income credit (EIC).**	8a	
b	Nontaxable combat pay election. 8b		
9	Add lines 7 and 8a. These are your **total payments.** ▶	9	2,820
10	**Tax.** Use the amount on **line 6 above** to find your tax in the tax table on pages 18–26 of the booklet. Then, enter the tax from the table on this line.	10	2,463

Refund

Have it directly deposited! See page 15 and fill in 11b, 11c, and 11d or Form 8888.

11a	If line 9 is larger than line 10, subtract line 10 from line 9. This is your **refund.** If Form 8888 is attached, check here ▶ ☐	11a	357
▶ b	Routing number X X X X X X X X X ▶ **c** Type: ☐ Checking ☐ Savings		
▶ d	Account number X X X X X X X X X X X X X X X X X		

Amount you owe

12	If line 10 is larger than line 9, subtract line 9 from line 10. This is the **amount you owe.** For details on how to pay, see page 16. ▶	12	

Third party designee Do you want to allow another person to discuss this return with the IRS (see page 16)? ☐ **Yes.** Complete the following. ☒ **No**

Designee's name ▶ Phone no. ▶ ( ) Personal identification number (PIN) ▶

Sign here

Joint return? See page 6. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return, and to the best of my knowledge and belief, it is true, correct, and accurately lists all amounts and sources of income I received during the tax year. Declaration of preparer (other than the taxpayer) is based on all information of which the preparer has any knowledge.

Your signature	Date	Your occupation	Daytime phone number
		RESTAURANT MANAGER	( )
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	

Paid preparer's use only

Preparer's signature	Date	Check if self-employed ☐	Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code		EIN	
		Phone no. ( )	

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 32. Cat. No. 11329W Form **1040EZ** (2007)

Form **1040A** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return **2007** IRS Use Only—Do not write or staple in this space.

OMB No. 1545-0074

Label (See page 15.)
Use the IRS label. Otherwise, please print or type.

LABEL HERE

Your first name and initial	Last name	Your social security number
CLYDE F.	COOPER	234 56 7890
If a joint return, spouse's first name and initial	Last name	Spouse's social security number
DELIA C.	COOPER	345 67 8901
Home address (number and street). If you have a P.O. box, see page 15.	Apt. no.	▲ You **must** enter your SSN(s) above. ▲
1234 FINE STREET		
City, town or post office, state, and ZIP code. If you have a foreign address, see page 15.		Checking a box below will not change your tax or refund.
DESIRABLE, OK 66987		

Presidential Election Campaign ▶ Check here if you, or your spouse if filing jointly, want $3 to go to this fund (see page 15) ▶ ☐ **You** ☐ **Spouse**

Filing status Check only one box.

1 ☐ Single
2 ☑ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 16.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (see page 17)

Exemptions

6a ☑ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a.
b ☑ **Spouse**

Boxes checked on 6a and 6b: 2

c **Dependents:**

If more than six dependents, see page 18.

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 18)
GARY COOPER	777 99 6451	SON	☑
DEBORA COOPER	564 99 8765	DAUGHTER	☑
			☐
			☐
			☐
			☐

No. of children on 6c who:
- lived with you: 2
- did not live with you due to divorce or separation (see page 19):

Dependents on 6c not entered above:

d Total number of exemptions claimed.

Add numbers on lines above ▶ 4

Income

Attach Form(s) W-2 here. Also attach Form(s) 1099-R if tax was withheld.

If you did not get a W-2, see page 21.

Enclose, but do not attach, any payment.

7	Wages, salaries, tips, etc. Attach Form(s) W-2.		7	57,045
8a	**Taxable** interest. Attach Schedule 1 if required.		8a	1,500
b	**Tax-exempt** interest. **Do not** include on line 8a.	8b		
9a	Ordinary dividends. Attach Schedule 1 if required.		9a	
b	Qualified dividends (see page 22).	9b		
10	Capital gain distributions (see page 22).		10	
11a	IRA distributions. 11a	11b Taxable amount (see page 22).	11b	
12a	Pensions and annuities. 12a	12b Taxable amount (see page 23).	12b	
13	Unemployment compensation and Alaska Permanent Fund dividends.		13	
14a	Social security benefits. 14a	14b Taxable amount (see page 25).	14b	
15	Add lines 7 through 14b (far right column). This is your **total income.** ▶		15	58,545

Adjusted gross income

16	Educator expenses (see page 25).	16		
17	IRA deduction (see page 27).	17 4,000		
18	Student loan interest deduction (see page 29).	18		
19	Tuition and fees deduction. Attach Form 8917.	19		
20	Add lines 16 through 19. These are your **total adjustments.**		20	4,000
21	Subtract line 20 from line 15. This is your **adjusted gross income.** ▶		21	54,545

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 74. Cat. No. 11327A Form **1040A** (2007)

Form 1040A (2007) Clyde F & Delia C Cooper 234-56-7890 Page **2**

Tax, credits, and payments

22	Enter the amount from line 21 (adjusted gross income).		22	54,545
23a	Check if: ☐ **You** were born before January 2, 1943, ☐ Blind; ☐ **Spouse** was born before January 2, 1943, ☐ Blind. **Total boxes checked** ▶ 23a ☐			
b	If you are married filing separately and your spouse itemizes deductions, see page 30 and check here ▶ 23b ☐			
24	Enter your **standard deduction** (see left margin).		24	10,700
25	Subtract line 24 from line 22. If line 24 is more than line 22, enter -0-.		25	44,845
26	If line 22 is $117,300 or less, multiply $3,400 by the total number of exemptions claimed on line 6d. If line 22 is over $117,300, see the worksheet on page 32.		26	13,600
27	Subtract line 26 from line 25. If line 26 is more than line 25, enter -0-. This is your **taxable income.** ▶		27	30,245
28	**Tax,** including any alternative minimum tax (see page 30).		28	3,751
29	Credit for child and dependent care expenses. Attach Schedule 2.	29 700		
30	Credit for the elderly or the disabled. Attach Schedule 3.	30		
31	Education credits. Attach Form 8863.	31		
32	Child tax credit (see page 35). Attach Form 8901 if required.	32 2,000		
33	Retirement savings contributions credit. Attach Form 8880.	33		
34	Add lines 29 through 33. These are your **total credits.**		34	2,700
35	Subtract line 34 from line 28. If line 34 is more than line 28, enter -0-.		35	1,051
36	Advance earned income credit payments from Form(s) W-2, box 9.		36	
37	Add lines 35 and 36. This is your **total tax.** ▶		37	1,051
38	Federal income tax withheld from Forms W-2 and 1099.	38 1,950		
39	2007 estimated tax payments and amount applied from 2006 return.	39		
40a	**Earned income credit (EIC).**	40a		
b	Nontaxable combat pay election. 40b			
41	Additional child tax credit. Attach Form 8812.	41		
42	Add lines 38, 39, 40a, and 41. These are your **total payments.** ▶		42	1,950

Standard Deduction for—
- People who checked any box on line 23a or 23b **or** who can be claimed as a dependent, see page 30.
- All others:

Single or Married filing separately, $5,350

Married filing jointly or Qualifying widow(er), $10,700

Head of household, $7,850

If you have a qualifying child, attach Schedule EIC.

Refund

43	If line 42 is more than line 37, subtract line 37 from line 42. This is the amount you **overpaid.**		43	899
44a	Amount of line 43 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐		44a	899
▶ b	Routing number XXXXXXXXX ▶ **c** Type: ☐ Checking ☐ Savings			
▶ d	Account number XXXXXXXXXXXXXXXXX			
45	Amount of line 43 you want **applied to your 2008 estimated tax.**	45		

Direct deposit? See page 52 and fill in 44b, 44c, and 44d or Form 8888.

Amount you owe

46	**Amount you owe.** Subtract line 42 from line 37. For details on how to pay, see page 53. ▶		46	
47	Estimated tax penalty (see page 53).	47		

Third party designee

Do you want to allow another person to discuss this return with the IRS (see page 54)? ☐ **Yes.** Complete the following. ☒ **No**

Designee's name ▶ Phone no. ▶ ( ) Personal identification number (PIN) ▶

Sign here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and accurately list all amounts and sources of income I received during the tax year. Declaration of preparer (other than the taxpayer) is based on all information of which the preparer has any knowledge.

Joint return? See page 15. Keep a copy for your records.

Your signature	Date	Your occupation	Daytime phone number
		PROFESSIONAL MODEL	( )
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation PROGRAMMER	

Paid preparer's use only

Preparer's signature	Date	Check if self-employed ☐	Preparer's SSN or PTIN
	03-04-08		
Firm's name (or yours if self-employed), address, and ZIP code		EIN	
		Phone no. ( )	

Form **1040A** (2007)

Schedule 1
(Form 1040A)

Department of the Treasury—Internal Revenue Service

Interest and Ordinary Dividends for Form 1040A Filers

2007

OMB No. 1545-0074

Name(s) shown on Form 1040A: CLYDE F. AND DELIA C. COOPER

Your social security number: 243 | 56 | 7890

Part I

Interest

(See back of schedule and the instructions for Form 1040A, line 8a.)

Note. If you received a Form 1099-INT, Form 1099-OID, or substitute statement from a brokerage firm, enter the firm's name and the total interest shown on that form.

			Amount
1	List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see back of schedule and list this interest first. Also, show that buyer's social security number and address.		
	CITY SAVINGS	1	950
	U. S. GOVERNMENT		550
2	Add the amounts on line 1.	2	1,500
3	Excludable interest on series EE and I U.S. savings bonds issued after 1989. Attach Form 8815.	3	
4	Subtract line 3 from line 2. Enter the result here and on Form 1040A, line 8a.	4	1,500

Part II

Ordinary dividends

(See back of schedule and the instructions for Form 1040A, line 9a.)

Note. If you received a Form 1099-DIV or substitute statement from a brokerage firm, enter the firm's name and the ordinary dividends shown on that form.

			Amount
5	List name of payer.	5	
6	Add the amounts on line 5. Enter the total here and on Form 1040A, line 9a.	6	

For Paperwork Reduction Act Notice, see Form 1040A instructions. Cat. No. 12075R **Schedule 1 (Form 1040A) 2007**

Schedule 2 (Form 1040A)

Department of the Treasury—Internal Revenue Service

Child and Dependent Care Expenses for Form 1040A Filers (99) 2007

OMB No. 1545-0074

Name(s) shown on Form 1040A	Your social security number
CLYDE F. AND DELIA C. COOPER	234 56 7890

Before you begin: You need to understand the following terms. See **Definitions** on page 1 of the separate instructions.

- **Dependent care benefits**
- **Qualifying person(s)**
- **Qualified expenses**

Part I

Persons or organizations who provided the care

You **must** complete this part.

1	**(a)** Care provider's name	**(b)** Address (number, street, apt. no., city, state, and ZIP code)	**(c)** Identifying number (SSN or EIN)	**(d)** Amount paid (see instructions)
	HAPPY TRAILS PRESCHO	2391 BRONCO STREET DESIRABLE, OK 66789	44-5678656	3,500

(If you have more than two care providers, see the instructions.)

Did you receive **dependent care benefits?**
- **No** → Complete only Part II below.
- **Yes** → Complete Part III on the back next.

Caution. If the care was provided in your home, you may owe employment taxes. If you do, you must use Form 1040. See **Schedule H** and its instructions for details.

Part II

Credit for child and dependent care expenses

2 Information about your **qualifying person(s).** If you have more than two qualifying persons, see the instructions.

(a) Qualifying person's name — First	Last	**(b)** Qualifying person's social security number	**(c) Qualified expenses** you incurred and paid in 2007 for the person listed in column (a)
GARY	COOPER	777 99 6451	1,750
DEBRA	COOPER	564 99 8765	1,750

3	Add the amounts in column (c) of line 2. **Do not** enter more than $3,000 for one qualifying person or $6,000 for two or more persons. If you completed Part III, enter the amount from line 27.	3	3,500
4	Enter your **earned income.** See the instructions.	4	33,445
5	If married filing jointly, enter your spouse's earned income (if your spouse was a student or was disabled, see the instructions); **all others,** enter the amount from line 4.	5	23,600
6	Enter the **smallest** of line 3, 4, or 5.	6	3,500
7	Enter the amount from Form 1040A, line 22.	7	54,545

8 Enter on line 8 the decimal amount shown below that applies to the amount on line 7.

If line 7 is: Over	But not over	Decimal amount is	If line 7 is: Over	But not over	Decimal amount is
$0	15,000	.35	$29,000	31,000	.27
15,000	17,000	.34	31,000	33,000	.26
17,000	19,000	.33	33,000	35,000	.25
19,000	21,000	.32	35,000	37,000	.24
21,000	23,000	.31	37,000	39,000	.23
23,000	25,000	.30	39,000	41,000	.22
25,000	27,000	.29	41,000	43,000	.21
27,000	29,000	.28	43,000	No limit	.20

8		8	× .20
9	Multiply **line 6** by the decimal amount on line 8. If you paid 2006 expenses in 2007, see the instructions.	9	700
10	Enter the amount from Form 1040A, line 28.	10	3,899
11	**Credit for child and dependent care expenses.** Enter the **smaller** of line 9 or line 10 here and on Form 1040A, line 29.	11	700

For Paperwork Reduction Act Notice, see Form 1040A instructions. Cat. No. 10749I **Schedule 2 (Form 1040A) 2007**

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return **2007** IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2007, or other tax year beginning , 2007, ending , 20 OMB No. 1545-0074

Label (See instructions on page 12.) **Use the IRS label.** Otherwise, please print or type.
LABEL HERE

Your first name and initial: JEREMY S.	Last name: ALLEN		**Your social security number**: 123 45 9875
If a joint return, spouse's first name and initial: SHELLY R.	Last name: ALLEN		**Spouse's social security number**: 456 85 2447
Home address (number and street). If you have a P.O. box, see page 12.: 8473 SMITHSON PLACE		Apt. no.	▲ You **must** enter your SSN(s) above. ▲
City, town or post office, state, and ZIP code. If you have a foreign address, see page 12.: BORING OR 97832			Checking a box below will not change your tax or refund.

Presidential Election Campaign ▶ Check here if you, or your spouse if filing jointly, want $3 to go to this fund (see page 12) ▶ ☐ **You** ☐ **Spouse**

Filing Status

Check only one box.

1 ☐ Single
2 ☑ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 13.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (see page 14)

Exemptions

6a ☑ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a . . . . — **Boxes checked on 6a and 6b**: 2
b ☑ **Spouse** . . . . — **No. of children on 6c who:** • **lived with you**: 3
c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 15)
WILLIAM ALLEN	789 65 4321	SON	☑
SUSAN ALLEN	456 65 9879	DAUGHTER	☑
GREGORY ALLEN	321 72 9347	SON	☑
			☐

If more than four dependents, see page 15.

• **did not live with you due to divorce or separation (see page 16)**
Dependents on 6c not entered above

d Total number of exemptions claimed . . . . — **Add numbers on lines above** ▶ 5

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see page 19.

Enclose, but do not attach, any payment. Also, please use **Form 1040-V.**

7	Wages, salaries, tips, etc. Attach Form(s) W-2		7	77,775
8a	**Taxable** interest. Attach Schedule B if required		8a	3,000
b	**Tax-exempt** interest. **Do not** include on line 8a	8b		
9a	Ordinary dividends. Attach Schedule B if required		9a	
b	Qualified dividends (see page 19)	9b		
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 20)		10	
11	Alimony received		11	
12	Business income or (loss). Attach Schedule C or C-EZ		12	
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		13	
14	Other gains or (losses). Attach Form 4797		14	
15a	IRA distributions	15a	15b	b Taxable amount (see page 21)
16a	Pensions and annuities	16a	16b	b Taxable amount (see page 22)
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17	
18	Farm income or (loss). Attach Schedule F		18	
19	Unemployment compensation		19	
20a	Social security benefits	20a	20b	b Taxable amount (see page 24)
21	Other income. List type and amount (see page 24)		21	
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		22	80,775

Adjusted Gross Income

23	Educator expenses (see page 26)	23		
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24		
25	Health savings account deduction. Attach Form 8889	25		
26	Moving expenses. Attach Form 3903	26		
27	One-half of self-employment tax. Attach Schedule SE	27		
28	Self-employed SEP, SIMPLE, and qualified plans	28		
29	Self-employed health insurance deduction (see page 26)	29		
30	Penalty on early withdrawal of savings	30		
31a	Alimony paid **b** Recipient's SSN ▶	31a		
32	IRA deduction (see page 27)	32		
33	Student loan interest deduction (see page 30)	33		
34	Tuition and fees deduction. Attach Form 8917	34		
35	Domestic production activities deduction. Attach Form 8903	35		
36	Add lines 23 through 31a and 32 through 35		36	
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶		37	80,775

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 83. Cat. No. 11320B Form **1040** (2007)

Form 1040 (2007) *Jeremy S & Shelly R Allen* *123-45-9875* Page **2**

Tax and Credits

38	Amount from line 37 (adjusted gross income)			38	80,775
39a	Check if: ☐ **You** were born before January 2, 1943, ☐ Blind. ☐ **Spouse** was born before January 2, 1943, ☐ Blind. **Total boxes checked** ▶ **39a**				
b	If your spouse itemizes on a separate return or you were a dual-status alien, see page 31 and check here ▶**39b** ☐				
40	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)			40	15,000
41	Subtract line 40 from line 38			41	65,775
42	If line 38 is $117,300 or less, multiply $3,400 by the total number of exemptions claimed on line 6d. If line 38 is over $117,300, see the worksheet on page 33			42	17,000
43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-			43	48,775
44	**Tax** (see page 33). Check if any tax is from: **a** ☐ Form(s) 8814 **b** ☐ Form 4972 **c** ☐ Form(s) 8889			44	6,534
45	**Alternative minimum tax** (see page 36). Attach Form 6251			45	
46	Add lines 44 and 45 ▶			46	6,534
47	Credit for child and dependent care expenses. Attach Form 2441	47			
48	Credit for the elderly or the disabled. Attach Schedule R	48			
49	Education credits. Attach Form 8863	49			
50	Residential energy credits. Attach Form 5695	50			
51	Foreign tax credit. Attach Form 1116 if required	51			
52	Child tax credit (see page 39). Attach Form 8901 if required	52	3,000		
53	Retirement savings contributions credit. Attach Form 8880	53			
54	Credits from: **a** ☐ Form 8396 **b** ☐ Form 8859 **c** ☐ Form 8839	54			
55	Other credits: **a** ☐ Form 3800 **b** ☐ Form 8801 **c** ☐ Form____	55			
56	Add lines 47 through 55. These are your **total credits**			56	3,000
57	Subtract line 56 from line 46. If line 56 is more than line 46, enter -0- ▶			57	3,534

Standard Deduction for—

- People who checked any box on line 39a or 39b **or** who can be claimed as a dependent, see page 31.
- All others:

Single or Married filing separately, $5,350

Married filing jointly or Qualifying widow(er), $10,700

Head of household, $7,850

Other Taxes

58	Self-employment tax. Attach Schedule SE	58	
59	Unreported social security and Medicare tax from: **a** ☐ Form 4137 **b** ☐ Form 8919	59	
60	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	60	
61	Advance earned income credit payments from Form(s) W-2, box 9	61	
62	Household employment taxes. Attach Schedule H	62	
63	Add lines 57 through 62. This is your **total tax** ▶	63	3,534

Payments

64	Federal income tax withheld from Forms W-2 and 1099	64	4,100		
65	2007 estimated tax payments and amount applied from 2006 return	65			
66a	**Earned income credit (EIC)**	66a			
b	Nontaxable combat pay election ▶ 66b				
67	Excess social security and tier 1 RRTA tax withheld (see page 59)	67			
68	Additional child tax credit. Attach Form 8812	68			
69	Amount paid with request for extension to file (see page 59)	69			
70	Payments from: **a** ☐ Form 2439 **b** ☐ Form 4136 **c** ☐ Form 8885	70			
71	Refundable credit for prior year minimum tax from Form 8801, line 27	71			
72	Add lines 64, 65, 66a, and 67 through 71. These are your **total payments** ▶			72	4,100

If you have a qualifying child, attach Schedule EIC.

Refund

Direct deposit? See page 59 and fill in 74b, 74c, and 74d, or Form 8888.

73	If line 72 is more than line 63, subtract line 63 from line 72. This is the amount you **overpaid**	73	566
74a	Amount of line 73 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐	74a	566
▶ b	Routing number X X X X X X X X X ▶ **c** Type: ☐ Checking ☐ Savings		
▶ d	Account number X X X X X X X X X X X X X X X X X		
75	Amount of line 73 you want **applied to your 2008 estimated tax** ▶ 75		

Amount You Owe

76	**Amount you owe.** Subtract line 72 from line 63. For details on how to pay, see page 60 ▶	76	
77	Estimated tax penalty (see page 61) 77		

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 61)? ☐ **Yes.** Complete the following. ☐ **No**

Designee's name ▶ Phone no. ▶ ( ) Personal identification number (PIN) ▶

Sign Here

Joint return? See page 13. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature	Date	Your occupation	Daytime phone number
		REGISTERED NURSE	( )
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	
		AIR TRAFFIC CONTROLLER	

Paid Preparer's Use Only

Preparer's signature	Date	Check if self-employed	Preparer's SSN or PTIN
	03/04/08	☒	
Firm's name (or yours if self-employed), address, and ZIP code		EIN	
		Phone no.	( )

Form **1040** (2007)

SCHEDULE A (Form 1040)
Department of the Treasury Internal Revenue Service

Itemized Deductions

► Attach to Form 1040.
► See Instructions for Schedule A (Form 1040).

OMB No. 1545-0074
2007
Attachment Sequence No. **07**

Name(s) shown on Form 1040: *Jeremy S & Shelly R Allen*
Your social security number: *123-45-9875*

Medical and Dental Expenses		**Caution.** Do not include expenses reimbursed or paid by others.				
	1	Medical and dental expenses (see instructions)	1	3,000		
	2	Enter amount from Form 1040, line 38 ..... 2 80,775				
	3	Multiply line 2 by 7.5% (.075)	3	6,058		
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-			4	0
Taxes You Paid	5	State and local **(check only one box):**				
	a	[X] Income taxes, **or**	5	3,400		
	b	[ ] General sales taxes.				
	6	Real estate taxes (see instructions)	6	1,200		
(See instructions.)	7	Personal property taxes	7			
	8	Other taxes. List type and amount ►	8			
	9	Add lines 5 through 8			9	4,600
Interest You Paid	10	Home mtg interest and points reported to you on Form 1098	10	8,500		
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see instructions and show that person's name, identifying number, and address ►	11			
Note. Personal interest is not deductible.	12	Points not reported to you on Form 1098. See instrs for spcl rules	12			
	13	Qualified mortgage insurance premiums (see instructions)	13			
	14	Investment interest. Attach Form 4952 if required. (See instrs.)	14	400		
	15	Add lines 10 through 14			15	8,900
Gifts to Charity	16	Gifts by cash or check. If you made any gift of $250 or more, see instrs	16	1,500		
If you made a gift and got a benefit for it, see instructions.	17	Other than by cash or check. If any gift of $250 or more, see instructions. You **must** attach Form 8283 if over $500	17			
	18	Carryover from prior year	18			
	19	Add lines 16 through 18			19	1,500
Casualty and Theft Losses	20	Casualty or theft loss(es). Attach Form 4684. (See instructions.)			20	
	21	Unreimbursed employee expenses — job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See instructions.) ►	21			
	22	Tax preparation fees	22	275		
(See instructions.)	23	Other expenses — investment, safe deposit box, etc. List type and amount ►	23			
	24	Add lines 21 through 23	24	275		
	25	Enter amount from Form 1040, line 38 ..... 25 80,775				
	26	Multiply line 25 by 2% (.02)	26	1,616		
	27	Subtract line 26 from line 24. If line 26 is more than line 24, enter -0-			27	0
Other Miscellaneous Deductions	28	Other — from list in the instructions. List type and amount ►			28	
Total Itemized Deductions	29	Is Form 1040, line 38, over $156,400 (over $78,200 if married filing separately)? [X] **No.** Your deduction is not limited. Add the amounts in the far right column for lines 4 through 28. Also, enter this amount on Form 1040, line 40. [ ] **Yes.** Your deduction may be limited. See instructions for the amount to enter.			► 29	15,000
	30	If you elect to itemize deductions even though they are less than your standard deduction, check here ► [ ]				

BAA For Paperwork Reduction Act Notice, see Form 1040 instructions. FDIA0301 11/07/07 Schedule **A** (Form 1040) 2007

Schedule **B** (Form 1040) 2007 OMB No. 1545-0074 Page **2**

Name(s) shown on Form 1040. *Jeremy S & Shelly R Allen*

Your social security number *123-45-9875*

Schedule B — Interest and Ordinary Dividends

Attachment Sequence No. **08**

Part I Interest

(See instructions for Form 1040, line 8a.)

Note. If you received a Form 1099-INT, Form 1099-OID, or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total interest shown on that form.

			Amount
1	List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see the instructions and list this interest first. Also, show that buyer's social security number and address ►		
	Mercantile Bank	1	*1,800*
	United States of America		*700*
	Ben Franklin Savings		*500*
2	Add the amounts on line 1	2	*3,000*
3	Excludable interest on series EE and I U.S. savings bonds issued after 1989. Attach Form 8815	3	
4	Subtract line 3 from line 2. Enter the result here and on Form 1040, line 8a ►	4	*3,000*

Note. If line 4 is over $1,500, you must complete Part III.

Part II Ordinary Dividends

(See instructions for Form 1040, line 9a.)

Note. If you received a Form 1099-DIV or substitute statement from a brokerage firm, list the firm's name as the payer and enter the ordinary dividends shown on that form.

			Amount
5	List name of payer ►	5	
6	Add the amounts on line 5. Enter the total here and on Form 1040, line 9a ►	6	

Note. If line 6 is over $1,500, you must complete Part III.

Part III Foreign Accounts and Trusts

(See instructions.)

You must complete this part if you **(a)** had over $1,500 of taxable interest or ordinary dividends; or **(b)** had a foreign account; or **(c)** received a distribution from, or were a grantor of, or a transferor to, a foreign trust.

		Yes	No
7a	At any time during 2007, did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account? See instructions for exceptions and filing requirements for Form TD F 90-22.1		X
b	If 'Yes,' enter the name of the foreign country ►		
8	During 2007, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If 'Yes,' you may have to file Form 3520. See instructions		X

BAA For Paperwork Reduction Act Notice, see Form 1040 instructions. FDIA0401 06/11/07 Schedule **B** (Form 1040) 2007

PROBLEM MATERIALS

DISCUSSION QUESTIONS

4-1 *Personal and Dependency Exemptions.* Distinguish between personal and dependency exemptions.

4-2 *Dependency Exemption for a Qualifying Child.* List the requirements that must be met in order for one to claim a dependency exemption for a *qualifying child.*

4-3 *Relationship.* In addition to a natural child, which other *children* are included in the definition of a *qualifying child?*

4-4 *Tie-breaking.* Determine who gets the dependency exemption for D in each of the following independent situations. Assume that the parties cannot agree if more than one person could claim the exemption and that any requirements that are not addressed (e.g., citizenship) are met. F's other support (> $3,000) is provided by S.

- **a.** Q provides a home in which she lives with her daughter, C, and C's son, D. C is 25 years of age and has gross income of $6,500 for the current year.
- **b.** R provides a home in which she lives with her son, E, and E's son, D. E is 18 years of age and has gross income of $6,500 for the current year.
- **c.** S provides a home in which she lives with her daughter, F, and F's daughter, D. F is 25 years of age and has gross income of $3,000 for the current year.

4-5 *Tests for Dependency Exemptions.* List and briefly describe the five tests that must be met before a taxpayer is entitled to a dependency exemption for an individual other than a qualifying child. Must all five tests be met?

4-6 *Support.* Briefly describe the concept of support. As part of your definition, include examples of support items.

4-7 *Support—Special Items.* With respect to the support test, discuss survivor's treatment of each of the following items: athletic scholarships, social security survivors' benefits paid to an orphan, and aid to dependent children paid by the state government.

4-8 *Gross Income Test.* Describe the gross income test that is applied to the dependency exemption. Must all dependents for whom a dependency exemption is claimed meet this test?

4-9 *Gross Income Test—Dependency Exemption.* M provides more than half of the support for her father, F, who is single for tax purposes. F's other support is in the form of interest income of $5,000 and social security benefits of $9,000.

- **a.** May M claim a dependency exemption for supporting F in the current year?
- **b.** Would your answer differ if F's interest income were only $1,500?

4-10 *Relationship Test—Dependency Exemption.* Assuming Q provides more than 50 percent of their support and the dependent meets the gross income, relationship, and citizenship tests, which of the following relatives may be claimed as a dependent?

- **a.** Widow of Q's deceased son
- **b.** Q's husband's brother
- **c.** Daughter of Q's husband's brother
- **d.** Q's mother's brother
- **e.** Q's grandmother's brother
- **f.** Q's great grandson

4-11 *Joint Return Test—Dependency Exemption.* K and L were married in 2008 and elected to file a joint return. K had interest income of $5,000 and a salary of $30,000 for the year. L had interest income of $2,250 and received the remainder of her support from her mother and K.

a. If L's mother provided more than 50 percent of L's support, can she claim a dependency exemption for L?

b. If not, under what circumstances could the exemption be claimed?

4-12 This year P, 25, was accepted to medical school. P is a single parent. To save money, she and her one-year-old baby, B, moved in with P's mom and dad, M and D. The four lived together from May through December. May anyone claim an exemption for B? If so, whom?

4-13 *Community Property Law.* How does the treatment of earned income differ between a community property state and a non community property (i.e., separate property) state for Federal income tax purposes? Why?

4-14 *Filing Status, Tax Schedules.* List the four sets of rate schedules that apply to individual taxpayers. Refer to them by filing status and schedule designation (e.g., Schedule Z). Which taxpayers must use the rate schedules rather than the tax rate tables?

4-15 *Determination of Marital Status.* Married taxpayers are subject to a separate set(s) of tax rates. When is marital status determined? What authority (state or federal) controls marital status?

4-16 *Exceptions—Marital Status.* In certain instances, a person who is married may use the rates for unmarried persons. In another instance, a single person may use the rates for married persons filing jointly. Elaborate.

4-17 *Head of Household—Requirements.* What are the specific requirements for head-of-household status? List at least ten relatives who may qualify the taxpayer for head-of-household filing status.

4-18 *Head of Household—Divorced Parents.* May a divorced parent with custody of a child qualify as a head of household even though his or her former spouse is entitled to the dependency exemption for the child? Explain.

4-19 *Head of Household—Taxpayer's Home.* Must the person who qualifies a taxpayer as a head of household (i.e., the taxpayer's child or other dependent) live in the taxpayer's home? Are there any exceptions to this rule?

4-20 *Costs of Maintaining Home.* Which of the following expenses are included in determining the cost of a home when determining whether a taxpayer qualifies as a head of household?

a. Food consumed on the premises

b. Transportation for a dependent to and from school

c. Clothing for a dependent

d. Property taxes on residence

e. Rent paid on residence

4-21 *Abandoned Spouse.* M is married and lives with her dependent son, S. M receives child support sufficient to provide 65 percent of S's support from S's father, who lived in a nearby city for the entire year. M provides more than one-half of the cost of providing the home in which she and S live.

a. What is M's filing status and what is the number of exemption deductions that she may claim?

b. How would your answers differ if M agreed to let S's father claim the dependency exemption for S?

4-22 *Tax Tables*. Are taxpayers required to use the tax tables? Which taxpayers are ineligible to use the tables?

4-23 *Limited Standard Deduction*. W is 16 years old, single, and claimed as a dependent by his parents. His 2008 adjusted gross income is $6,100, and he claims the standard deduction.

a. If W's taxable income is $5,200, what is the character of his income, earned or unearned?

b. If W's taxable income is $3,700, what is the character of his income, earned or unearned?

c. If W's taxable income is $650, what is the character of his income, earned or unearned?

4-24 *Kiddie Tax*. G is 13 years old and claimed as a dependent by her parents. G's top marginal tax rate is 10 percent and her parents' is 25 percent. Calculate G's taxable income and the rate at which it will be taxed in the following instances:

a. Interest of $1,000

b. Interest of $1,900

c. Interest of $900 and wages of $4,700

d. Interest of $3,500 and wages of $450

4-25 *Filing Requirements*. Which individuals are exempted from filing a Form 1040 (or equivalent Form 1040A or Form 1040EZ)?

4-26 *Due Date*. P is a calendar year individual taxpayer with taxable income of $45,000 and a tax due of $350 for the current year.

a. When is P's tax return due?

b. Assuming P uses the fiscal year ending June 30, when is her annual income tax return due?

4-27 *Extensions*. Q is a calendar year individual taxpayer with taxable income of $25,000 and a tax refund of $150 for the current year.

a. If Q is unable to file on time, she may request an automatic extension of time to file her tax return. How long is the maximum extension period?

b. If Q is unable to complete her return by the extended due date and she has an appropriate reason, how long of an additional extension can she request?

c. How much is Q's penalty if she fails to file an extension?

4-28 *Due Dates for Estimated Tax Payments*. R is a calendar year taxpayer whose estimated tax liability for the current year is $4,000. What are the amounts and the due dates of R's estimated tax payments?

4-29 *Amount of Estimated Tax Payments*. H is a calendar year taxpayer who estimates his Federal income tax to be $5,500 and his self-employment tax to be $4,500 for 2008. For 2007, H's Federal income tax was $4,950, and his self-employment tax was $3,975. What is the amount of estimated tax that H must pay on each due date to avoid a penalty for failure to make adequate estimated tax payments?

4-30 *Penalties and Interest*. J is a calendar year individual whose gross tax for 2008 is $10,000. J had taxes of $5,750 withheld and made estimated tax payments of $500 each due date. She submitted $1,350 along with her request for an automatic extension on April 15. The remaining $900 was paid when J's tax return was filed on July 9. J's 2007 tax totaled $9,950.

a. Does J owe a penalty for failure to file for 2008?

b. Does J owe a penalty for failure to pay for 2008? If so, for what period?

c. Does J owe a penalty for failure to make adequate estimated tax payments for 2009? If so, over what period?

d. Does J owe interest on any of the amounts paid? If so, for what period?

4-31 *Statute of Limitations.* What is the importance of the Federal Statute of Limitations to the taxpayer? To the IRS? Generally, how long is the statute of limitations on tax matters?

4-32 *Six-Year Statute of Limitations.* Under what circumstances will the regular three-year statutory period for assessments be extended to six years?

4-33 *Indexation and the Individual Income Tax.* Congress has provided for indexation of certain deductions. What items are subject to indexation? What index is to be used as an estimate of price-level changes?

PROBLEMS

4-34 *Exemption Amount.* H and W are married and file a joint return. They claim dependency exemptions for themselves and their two children, S and D. Compute the amount of their deduction for personal and dependent exemptions if their adjusted gross income is

a. $196,400
b. $254,500
c. $370,000

4-35 *Exemptions.* In each of the following situations determine the proper number of personal and dependency exemptions available to the taxpayer. Unless otherwise implied, assume that all tests are satisfied.

a. R's mother, age 85, lives in his home. R figures that including the value of the lodging, he provides support of about $6,000. The remainder of her support is paid for with her social security benefits of $4,000.

b. This year D sent his father, F, monthly checks of $200, or $2,400 for the year. F used these checks along with $2,300 of rental income ($4,400 of rents less $2,100 of expenses) to pay all of his support.

c. H and W are married with one daughter, D, age 7. D models children's clothing and earned $4,000 of wages this year. D also has a trust fund of $50,000 established by her grandparents. All of D's wages were saved and none were used to pay for her support. Similarly none of the funds of the trust were used to pay for D's support.

d. Professor and Mrs. Smith participated in the foreign exchange student program at their son's high school. In December of 2007 a student, Hans, arrived from Germany, spent the spring of 2008 with the Smiths, then returned to Germany.

e. B and C are happily married with one son, S. S, age 20, is a full-time student at the University of Cincinnati. S worked as a painter during the summer to help put himself through school. He earned wages of $4,000, $2,500 of which was used to pay for his room and board at school and $1,500 for miscellaneous living expenses (e.g., gas for his car, dates, laundry, etc.). He lived with his parents during the summer. The value of their support including meals and lodging was $5,000. He also received a National Merit Scholarship, which paid for his tuition of $8,000.

4-36 *Personal and Dependency Exemptions*. In each of the following situations determine the proper number of personal and dependency exemption deductions available to the taxpayer.

a. A is single and 44 years of age. He provides full support for his mother, who is 67 and lives in a small retirement community in A's hometown.

b. D and K are married and file a joint return for the year. D is 67 years of age and K is 62. They have no dependents.

c. E and O are married and file a joint return for the year. They provide all the support for their two younger children for the entire year. E and O also provided all the support for their oldest child (age 19) for the eight months she was a full-time student.

After graduating from high school, she accepted a job that paid $3,000 in salary. Nevertheless, her parents contributed more than one-half of her support for the entire year.

4-37 *Married Dependents.* In November of this year Jim Jenkins married his college sweetheart, Kate Brown. Jim was 24 and Kate was 22. Jim had graduated two years ago. Kate still had one more year of school. The majority of Kate's support this year was provided by her parents. Jim earned $15,850 during the year while Kate received $950 of interest from her savings account. Assume Kate's parents are in the 28 percent tax bracket and would give the couple any tax savings to be derived from claiming Kate as a dependent.

a. May Kate's parents claim an exemption for Kate assuming the couple files a joint return?

b. Would the couple be better off filing separate returns (and thus receiving any taxes saved by Kate's parents) or filing a joint return? Show all computations you must make to determine your answer.

4-38 *Itemized Deductions and Exemptions.* G and H are married and file a joint return for 2008. They have A.G.I. of $252,950 for the year and the following itemized deductions and personal and dependency exemptions:

State and local taxes	$ 5,300
Residence interest	14,500
Investment interest	500
Charitable contributions	6,200
Personal and dependency exemptions	4

a. Calculate G and H's taxable income for 2008.

b. Calculate G and H's taxable income for 2008 assuming their A.G.I. was $262,950, a $10,000 increase over (a).

c. By what amount did taxable income increase due to this $10,000 increase in adjusted gross income? Why wasn't it $10,000?

4-39 *Multiple Support Agreements.* G's support is provided as follows:

Social security benefits	$3,600
Taxable interest income	800
Support from:	
A, G's oldest son—Cash for trip to Europe	1,600
B, G's daughter—Fair value of lodging and cash	2,300
C, G's youngest son—Cash	700
Total	$9,000

a. Who is entitled to a dependency exemption for G in the absence of any agreement as to who gets the deduction?

b. Who may claim a dependency exemption for G under a multiple-support agreement?

c. How would your answer to (b) differ if A contributed $650 instead of $1,600?

4-40 *Children of Divorced Parents.* For each of the following, determine whether M or F is entitled to the dependency exemption in 2008 for their only child, S. M and F were divorced in 2005 and M has custody, except when F has visitation privileges. Together, M and F provide 100 percent of S's support.

a. M was granted the dependency exemption under the divorce decree. F pays child support for the year totaling $1,500. Total support expenditures for S are $5,600.

b. No mention of the dependency exemption was made in the divorce decree. F pays child support for S of $3,400, and the total support for S is $6,500.

c. F was granted the dependency exemption in the divorce decree and he paid child support of $2,800 for the year. The total support for S for the year was $5,500.

4-41 *Filing Status and Standard Deduction.* Determine the most beneficial filing status and the standard deduction for each of the following taxpayers for 2008:

a. M is a 54-year-old unmarried widow whose spouse died in 2005. During all of 2008 M's 15-year-old son, for whom she claims a dependency exemption, lives with her.

b. S is a 67-year-old bachelor who lives in New York City. S pays more than half the cost of maintaining a home in Tampa, Florida for his 89-year-old mother. He is entitled to a dependency exemption under a multiple-support agreement executed by his brother, his sister, and himself.

c. R is a widower whose wife died in 2007. R maintained a household for his three dependent children during 2008 and provided 100 percent of the cost of the household.

d. J is divorced and has custody of his 9-year-old child. J provides more than half the cost of the home in which he lives with his child, but his ex-wife is entitled to the dependency exemption for the child for 2008.

4-42 *Head of Household.* Indicate whether the taxpayer would be entitled to file using the head-of-household rate schedule.

a. Y is divorced from her husband. She maintains a home in which she and her 10-year-old son live. Her ex-husband pays child support to her that she uses to provide all of the support for the child. In addition, Y has relinquished her right to claim her son as a dependent to her former spouse.

b. C is divorced from his wife. He provides 75 percent of the support for his mother, who lives in a nursing home. His mother receives $5,000 of interest income annually.

c. J's grandson, L, had a falling-out with his parents and moved in with him early this year. J did not mind because he had grown lonely since his wife died three years ago. L is 17 years old and earned $5,000 this year as a part-time grocery clerk. L's total support was $12,000.

d. B's wife died four years ago and he has not remarried. Last year his daughter, D, graduated from Arizona State University and moved to Hawaii. Unfortunately, D was unable to earn enough money to make ends meet and had to rely on checks from dad. B paid for D's own apartment and provided the majority of her support.

e. M's wife died last year. This year he maintains a home for his 25-year-old daughter, E, who is attending graduate school in a nearby city. E earned $8,000 as a teaching assistant. Nevertheless, M provided the majority of E's support.

f. Same as (e) except E is the taxpayer's sister.

g. F's husband died this year. She continues to provide a home for her two children, ages 6 and 8.

4-43 *Dependent's Personal Exemption and Standard Deduction.* K is 16 years old and is claimed as a dependent on her parents' income tax return. She earned wages of $2,800 and collected interest of $1,450 for the year. What is the amount of K's taxable income for the year?

TaxCut **4-44** *Dependent's Personal Exemption and Standard Deduction.* B is 20 years old and is claimed as a dependent on his sister's tax return. B earned $3,000 from a part-time job during the year. What is B's taxable income?

TaxCut **4-45** *Computation of Tax.* R and S are married and have two dependents. Compute their 2008 tax liability before credits, assuming they file a joint return and their taxable income is

a. $67,700

b. $198,850

c. $352,700

4-46 *High-Income Taxpayer*. H and W are married and file a joint return for 2008. They have no dependents and both are under age 40. H earned a salary of $120,000. W is self-employed and earned a net profit from business of $202,200. H and W have personal itemized deductions totaling $29,800 (all subject to the 2% cutback).

a. What are the amounts of their adjusted gross income and taxable income on their joint income tax return?

b. Calculate the 2008 tax liability, including W's self-employment tax. Assume that the 2008 self-employment tax is 15.3 percent on income up to $97,500 (2.9% MHI with no limit).

4-47 *Tax Tables*. S earned a salary during 2007 of $56,015. She is single, claims the standard deduction, and has no dependents for the year. Her only other income was taxable interest income of $560. Determine S's taxable income and her Federal income tax. (**Note:** This tax table computation is for 2007 because the 2008 tax tables will not be available until late 2008. See Appendix for the 2007 tax tables.)

4-48 *Tax Rate Schedules*. W and T were married and filed a joint return for 2008. Their adjusted gross income for the year was $141,950. Their total itemized deductions were $12,700 and they were entitled to three personal and dependency exemptions. Neither W nor T is 65 or older and both have good sight. Determine W and T's taxable income and their Federal income tax liability before prepayments and credits for 2008.

4-49 *Application of the Kiddie Tax*. For each of the following situations, determine the child's taxable income and the amounts that would be taxed at the child's and parents' rates for the 2008 tax year.

a. When J's rich uncle died, he left her GM corporate bonds. This year J received $1,850 of interest from these bonds, her only income. J is seven years old and her parents claim an exemption for her.

b. L, age 13, works in his father's music store on weekends. During the year, he earned $1,200 from this job. In addition, L had $800 of interest income attributable to a gift from his grandfather. L's father claims an exemption for him.

c. Same as (b) except L's earned income was $2,150 and interest income was $1,850.

4-50 *Computation of the Kiddie Tax*. G's great aunt gave her a certificate of deposit that matures in ten years when she is 21. The certificate pays interest of $2,200 annually. G's parents file a joint return. Their 2008 taxable income is $131,500. Compute G's tax.

4-51 *Failure-to-File Penalty*. T, overwhelmed by other pressing concerns, simply forgot to file his tax return for 2006 until July 20, 2008. When filed, T's 2007 return showed a tax due before withholding and estimated taxes of $10,000.

a. Will T be penalized for failure to file his return if the total income taxes withheld by his employer were $11,000?

b. Assuming T's employer withheld $9,000, what is the amount of the failure-to-file penalty, if any?

4-52 *Failure-to-Pay Penalty*. On April 13, 2009 R, a calendar year taxpayer, sat down to prepare his 2008 tax return. Realizing that he simply did not have time to accumulate all of his records, R decided to file for an extension. R's tax liability for the previous year, 2007, was $8,000. During 2007 R's employer withheld $2,500 and R paid estimated taxes of $500. R estimates that his final gross tax liability for 2008 will be $12,000.

a. Assuming R obtains an extension to file his 2008 return, when will his return normally be due?

b. Based on the facts above, what amount must R pay by April 15 to avoid a failure-to-pay penalty?

c. R completed and filed his return on July 20, 2009. Unfortunately, his initial estimate of his tax was low and his final tax (before withholding and estimated tax payments) was $15,000. Assuming R paid the amount determined in part (b) above, what is the amount of the failure-to-pay penalty, if any?

4-53 *Estimated Taxes and Underpayment Penalty*. K works as a salesperson for the National Hospital Supply Corporation, selling surgical and other hospital supplies. He receives a salary plus a percentage commission on sales over a certain threshold. In 2007 K's tax liability before prepayments was $20,000. His 2007 tax liability was $12,000. In each year his A.G.I. was less than $150,000.

a. What is the lowest required tax installment (including withholding) that K can make and avoid the penalty for underpaying his taxes during the year? (Ignore the annualized income installment.)

b. Assume that K paid estimated taxes of $1,000 on each due date. In addition, K's employer withheld a total of $3,000 during the year. K filed and paid the balance of his liability on April 15, 2009. Assume the applicable interest rate charged on underpayments for each period in 2008 is 10 percent. Compute K's penalty, if any, for failure to pay estimated taxes. Compute the penalty for the first installment only.

c. Assume that K works solely for commissions and that he had no income through March 31, 2008 because he decided to take a winter vacation. Income for the remainder of the year was sufficient to generate a tax liability before prepayments of $20,000. What implications do these facts have on the calculation of the underpayment penalty for 2008?

4-54 *Penalties for Inadequate Estimated Tax Payments*. Z is a calendar year individual whose gross tax for 2008 is $40,000. Z had taxes of $8,000 withheld and did not make estimated tax payments. Z's tax due was paid with his timely filed return on April 15, 2009. His 2007 tax was $35,000 on adjusted gross income of $148,000.

a. Calculate Z's penalty for failure to make adequate estimated tax payments, if any.

b. Does Z owe interest on any of the amounts paid? If so, for what period?

c. Same as (a) above, except Z's adjusted gross income for 2007 was $160,000.

4-55 *Penalties and Interest*. Y filed her tax return for 2007 on April 15, 2008. Upon discovering an inadvertent error, Y filed an amended return and submitted additional tax of $1,250.

a. Does Y owe a penalty for failure to pay? If so, how much?

b. Does Y owe interest on the $1,250 paid with the amended return? If so, how much?

4-56 *Statute of Limitations*. T, a calendar year taxpayer, filed her 2007 Federal income tax return on January 29, 2008 and received a tax refund check for overpaid 2007 taxes on May 17, 2008.

a. Assuming that T did not file a false return or have a substantial omission of income, what is the last date on which the IRS may assess an additional income tax liability against her for the 2007 tax year?

b. If T unintentionally had a substantial omission of income from her 2007 return, what is the last day on which the IRS may assess her an additional 2007 income tax liability?

c. If T had never bothered to file her 2007 tax return, what is the last day on which the IRS may assess her an additional 2007 income tax liability?

TAX RETURN PROBLEMS

CONTINUOUS TAX RETURN PROBLEMS See Appendix I, Part 1

4-57 *Form 1040EZ.* Samuel B. White was single for 2008 and had no dependents. Sam's only income was wages of $21,150 and taxable interest of $465. Federal income tax of $930 was withheld from Sam's salary.

Calculate Sam's Federal income tax and his tax due or refund for 2008. A Form 1040EZ may be completed based on this information. Supply fictitious occupation, social security number, and address. (**Note:** If the 2008 tax forms are not available, use 2007 forms.)

TaxCut **4-58** *Form 1040A*. Charles D. and Alice A. Davis were married during all of 2008 and had income from the following sources:

Salary, Charles	$27,100
Federal income tax withheld	1,425
Part-time salary, Alice	16,700
Federal income tax withheld	880
Interest from Home Savings	320
Interest from U.S. Government Bonds	430

Charles and Alice provide the sole support of their two children (both under age 17). During the year, they paid job-related child care expenses of $2,200. Their itemized deductions for the year are insufficient for them to itemize, but a deductible $2,000 was deposited in each of their individual retirement accounts.

Calculate the Federal income tax and the tax due (or refund) for Mr. and Mrs. Davis, assuming they file a joint return. If the 2008 tax tables are not available, use the tax rate schedules on the inside front cover of the text. A Form 1040A may also be completed. Supply fictitious information for the address, occupations, social security numbers, and children's names. (**Note:** If the 2008 tax forms are not available, use 2007 forms.)

TaxCut **4-59** *Form 1040*. William A. Gregg, a high school educator, and Mary W. Gregg, a microbiologist, are married and file a joint income tax return for 2008. Neither William nor Mary is over 50 years old, and both have excellent sight. They provide the sole support of their three children: Barry, Kimberly, and Rachel (all under age 17). The following information is from their records for 2008:

Salaries and wages, William	$34,550
Federal income tax withheld	$2,320
Salaries and wages, Mary	44,800
Federal income tax withheld	4,360
Interest income—Home Savings and Loan	690
Interest income—City Bank	220
Tax-exempt interest income	1,400
Itemized deductions as follows:	
Hospitalization insurance	320
Unreimbursed fees of doctors, hospitals, etc	740
Unreimbursed prescription drugs	310
Real estate taxes on residence	1,350
State income taxes paid	1,440
State sales taxes paid	720
Interest paid on original home mortgage	8,430
Charitable contribution—Faith Church	1,720
Charitable contribution—State University	200
Quarterly estimated taxes paid	3,500

Calculate the 2008 Federal income tax and the tax due (or refund) for the Greggs assuming they file a joint return. Form 1040, along with Schedules A and B, may be completed. Supply fictitious information for the address and social security numbers. (**Note:** If the 2008 tax forms are not available, use 2007 forms.)

RESEARCH PROBLEMS

4-60 *Nonresident Alien Spouse*. C is a citizen of the United States who resides indefinitely in Europe. C is married to N, a citizen of Greece. C has $32,000 of gross income subject to United States tax and would like to file jointly with N. Can C accomplish this goal? If so, what steps are necessary? How is the income of N treated?

Research aids:

Code § 6013(g) and Reg. § 1.6013-6.

4-61 Much to Ted's surprise, his employer, a major hotel chain, asked him to manage the company's premier resort property in Cabo San Lucas, Mexico for the entire calendar year. Ted accepted and was paid $110,000 in compensation for the assignment, visiting the U. S. for only two weeks during the year. Ted's only other income is interest income of $20,000. Ted is single, claims the standard deduction and has no dependents. He is a U. S. citizen. Calculate Ted's tax due and refund assuming he uses the foreign earned income exclusion rather than the foreign tax credit. Ted's tax paid to Mexico was $8,500.

Research aids:

Code §§ 901 and 911(a).