

## **Chapter I:2**

### **Determination of Tax**

#### **Learning Objectives**

After studying this chapter, the student should be able to:

1. Use the tax formula to compute an individual's taxable income.
2. Determine the amount of deductions from Adjusted Gross Income.
3. Calculate the income tax for individuals.
4. Explain the basic income tax rules relating to business entities.
5. Explain the basic income tax rules of capital gains and losses.
6. Describe tax planning considerations for various tax matters.
7. Describe compliance and procedural matters for filing tax returns.

#### **Areas of Greater Significance**

It is absolutely vital that students understand the individual formula for calculating the tax or refund due (including standard deduction and filing status). This formula is necessary throughout the balance of the text to work out the problems. Any deficiencies in understanding at this point would be carried over to subsequent materials.

#### **Areas of Lesser Significance**

In the interest of time, the instructor may determine that the following area is best covered by student reading, rather than class discussion:

1. Business income and business entities.

#### **Problem Areas for Students**

The following areas may prove especially difficult for students:

1. Whether a taxpayer qualifies for head of household filing status.

2. The relationship between the standard deduction and itemized deductions.
3. Whether the qualification (or non-qualification) of a person as a dependent affects the head of household filing status (i.e., the rules for head of household and qualifying dependents overlap, but are not totally consistent).

## **Highlights of Recent Tax Law Changes**

The following items of tax law have changed since the 2018 edition of this chapter:

1. The TCJA changes the treatment of alimony for any divorce or legal separation agreements executed after 2018. Alimony payments will be excluded from the gross income of the recipient and not be deductible by the paying ex-spouse.
2. The TCJA allows flow-through entities to deduct 20% of qualified business income.
3. The TCJA eliminates personal and dependency exemptions.
4. The TCJA provides for new marginal tax rates: 10%, 12%, 22%, 24%, 32%, 35%, and 37%. (See inside front cover for income limits.)
5. The TCJA returns the AGI floor for medical expenses to 7.5% for all taxpayers regardless of age.
6. The TCJA sets a cap of \$10,000 (\$5,000 if married filing separately) on the deduction of state and local taxes.
7. The TCJA reduces the maximum amount of indebtedness for the home mortgage interest deduction to \$750,000 on debt incurred after December 16, 2017 and eliminates mortgage interest deduction for home equity loans.
8. The TCJA increases the maximum amount of the cash charitable contribution deduction to 60% of AGI.
9. The TCJA eliminates deductions for personal casualty and theft losses, except those attributable to a federally declared disaster.
10. The TCJA suspends miscellaneous deductions subject to a 2% of AGI floor.
11. The TCJA significantly increases the standard deduction amount for each filing status.
12. The TCJA separates the “kiddie tax” from the parents’ marginal tax rate. (See Instructor Aid I:2-2.)

13. The TCJA sets a flat tax rate of 21% for ordinary income and capital gains for corporations.
14. The TCJA eliminates the reduction of itemized deductions for high income taxpayers.
15. The floor for filing a tax return for each filing status, except for married filing separately, has increased to match the new standard deduction amounts.

## Teaching Tips

1. Due to the annual changes in many of the rules covered in this chapter (e.g., standard deduction), you may wish to inform the students that examinations and/or quizzes will be held on an open-book basis or that you will provide any required statutory amounts for testing purposes. Using this approach allows the students to concentrate on the concepts rather than memorizing numbers.
2. This introductory chapter is a good place to begin emphasizing the difference between deductions for AGI and deductions from AGI. This distinction will increase in importance in subsequent chapters.

## Lecture Outline

### I. Formula for Individual Income Tax

1. Basic Formula (Table I:2-1, Example I:2-1; Figure I:2-1; Question I:2-1; Problem I:2-29)
  - a. The basic formula for calculating individual income tax is:
    - i.  $\text{Gross income} - \text{Exclusions} - \text{Deductions for AGI} = \text{Adjusted gross income}$
    - ii.  $\text{Adjusted gross income} - \text{Deductions from AGI} = \text{Taxable income}$
    - iii.  $\text{Taxable income} \times \text{Tax rate(s)} = \text{Gross tax}$
    - iv.  $\text{Gross tax} - (\text{Credits} + \text{Prepayments}) = \text{Net tax}$
2. Definitions (Tables I:2-2 through I:2-5)
  - a. Brief definitions of income, exclusions, gross income, deductions for adjusted gross income, adjusted gross income, deductions from adjusted

gross income, itemized deductions, standard deduction, taxable income, tax rates, gross tax, and tax credits are presented with references to detailed coverage later in the text.

## II. Deductions from Adjusted Gross Income

### 1. Itemized Deductions (Table I:2-6; Example I:2-2)

- a. The total of qualifying medical expenses, taxes, investment and residential interest, and charitable contributions are claimed only if the total of such items exceeds the standard deduction.
- b. Deductions for medical expenses and charitable contributions are limited by varying percentages of adjusted gross income. Deductions for taxes and residential interest are also capped (generally \$10,000 for taxes and interest on \$750,000 of indebtedness).

### 2. Standard Deduction (Examples I:2-3, I:2-4)

- a. The full amount of the standard deduction (which varies with filing status, age, and vision) may be claimed when it exceeds the taxpayer's itemized deductions.
  - i. **EXAMPLE:** A single taxpayer in 2018 has \$10,000 of allowable itemized deductions. Since the applicable standard deduction for this taxpayer (\$12,000) is greater than his itemized deductions, the taxpayer deducts \$12,000 in determining his taxable income.

Filing Status	Standard Deduction	
	2017	2018
Married couple filing jointly	\$12,700	\$24,000
Surviving spouse	12,700	24,000
Head of household	9,350	18,000
Single (unmarried individual other than surviving spouse or head of household)	6,350	12,000
Married individual filing separately	6,350	12,000

- b. Additions to the standard deduction are available for taxpayers who are 65 or older and/or blind. The 2018 additions are \$1,300 for married taxpayers and \$1,600 for single taxpayers.
  - i. **EXAMPLE:** A single taxpayer in 2018 who is 65 and blind would have a standard deduction of \$13,600 [ $\$12,000 + \$1,600$  (age) + \$1,600 (blindness)].

3. Dependency Requirements (Examples I:2-8, I:2-12, I:2-16, I:2-17; Topic Review I:2-1; Problem I:2-32)

- a. Qualification of dependents can affect a taxpayer's filing status and access to deductions and credits. Dependents must meet the following requirements:
  - i. Have a Social Security number reported on return;
  - ii. Be a U.S. Citizen, U.S. Resident, or reside in Canada or Mexico; and
  - iii. Not have filed a joint return (unless filed for the sole purpose of obtaining a refund).
- b. Additional requirements for "qualifying children"
  - i. Be a natural, adopted, foster child, or stepchild of the taxpayer, a sibling of the taxpayer, or descendants of any of the previous;
  - ii. Be under 19, a full-time student under age 24, or a permanently and totally disabled child;
  - iii. Have the same principal abode as taxpayer, and
  - iv. Dependent may not provide more than one half of his or her own support.
- c. Additional requirements for "qualifying relatives"
  - i. Be related to the taxpayer or reside in the taxpayer's household for the entire year;
  - ii. Have gross income less than \$4,150; and
  - iii. The taxpayer must normally provide more than one half of the dependent's support. (Receipts of the potential dependent are counted as support only if the receipts are spent for support, i.e., if the dependent puts all his social security payments in a savings account, the payments do not count in the support test.)
  - iv. Exceptions may exist under multiple support agreements and parental releases.

4. Child Credit (Example I:2-21; Problem I:2-51)

- a. Individual taxpayers may claim a \$2,000 credit for each qualifying child (U.S. citizen/national/resident under 17 who qualifies as the taxpayer's

dependent descendant, stepchild, or foster child) under age 17 plus a \$500 credit for each other dependent.

- b. The total credit for all children is reduced by \$50 for each \$1,000 (or fraction thereof) of AGI over \$200,000 (\$400,000 for married filing jointly).
- c. Under certain circumstances, the credit is refundable.

### **III. Determining the Amount of Tax (Examples I:2-26, I:2-27; Topic Review I:2-2; Problem I:2-48; Instructor Aid I:2-1)**

Gross tax is determined by applying the tax table (Appendix A) or tax rate schedule inside the front cover to the taxpayer's taxable income.

In 2018, tax brackets of 10%, 12%, 22%, 24%, 32%, 35%, and 37% are applicable to individual taxpayers. The income level covered by the six brackets varies with filing status.

#### **1. Joint Return**

- a. A joint return may be filed by a man and woman if they are considered married for tax purposes on the last day of the tax year. Common law marriages and same-sex marriages are recognized. Annulled marriages are viewed as having never occurred.
- b. Taxpayers legally divorced at the end of the year may be treated as married for tax purposes, if the divorce is considered a sham.
  - i. **EXAMPLE:** Taxpayers obtain a foreign divorce effective 12-30-2016 and remarry 1-2-2017. The only reason for the procedure was to improve tax filing status. The taxpayers will be treated as married for the tax year ending 12-31-2016.

#### **2. Surviving Spouse (Example I:2-28)**

- a. A widow or widower may file as a surviving spouse in the two years after the year the decedent spouse died if the surviving spouse:
  - i. Has not remarried;
  - ii. Is a U.S. citizen or resident;
  - iii. Was qualified to file a joint return in the year of death; and

- iv. Paid over half the costs of maintaining a household in which a dependent child, adopted child, or stepchild lives during the entire tax year.
  - b. The widow or widower may file jointly in the year of the spouse's death with the cooperation of the executor of the estate. Both the surviving spouse and the executor must sign any joint return. If either party does not agree to file a joint return, then they must file as married filing separately.
  - c. The widow or widower may qualify as head of household in the years after the expiration of the surviving spouse status, assuming the surviving spouse meets the qualifications outlined below.
- 3. Head of Household (Example I:2-29)
  - a. An individual may file as head of household if the individual:
    - i. Is considered single for tax purposes (see abandoned spouse, below);
    - ii. Is not a surviving spouse;
    - iii. Is a U.S. citizen or resident; and
    - iv. Pays over half the costs of maintaining a household in which a qualifying child or dependent relative lives for more than half of the tax year. Dependent parents may reside in a separate household, and children do not have to be tax dependents to qualify.
- 4. Single Taxpayer
  - a. A taxpayer who does not qualify for any other filing status must file under the single status.
- 5. Married Filing Separately
  - a. Married individuals may choose to file separate returns rather than one joint return. Separate returns will seldom provide the best overall tax results due to the higher rates. However, every married couple's tax should be computed using both the joint return rules and the separate return rules to insure the lowest overall tax.
- 6. Abandoned Spouse (Examples I:2-32, I:2-33; Question I:2-18)
  - a. A legally married individual may file as head-of-household if the individual:
    - i. Lived apart from the spouse for the last 6 months of the year;

- ii. Pays over half of the cost of maintaining a household in which the taxpayer and a dependent child lived for over half the year; and
    - iii. Is a U.S. citizen or resident.
  - b. Without the abandoned spouse rule, the only alternative for the taxpayer would be to file married-separately (due to the unavailability of the absent spouse to prepare and sign a joint return). Head-of-household tax rates are significantly better than married-filing separately rates.
7. Children with Unearned Income (Example I:2-37; Problem I:2-56; Instructor Aid I:2-2)
- a. A dependent's standard deduction is the greater of \$1,050 or the dependent's earned income plus \$350.
  - b. For children under 18, unearned income in excess of \$2,100 is taxed in a special way. Between the ages of 18 and 23, this "kiddie tax" only applies under certain circumstances (e.g., the child's earned income represents less than half of his or her support).

#### **IV. Business Income and Business Entities**

Unlike for individuals, the tax rate schedule for C corporations is not progressive. Instead, a flat 21% tax rate applies.

#### **V. Treatment of Capital Gains and Losses (Question I:2-21; Instructor Aid I:2-3)**

- 1. Definition of Capital Assets
  - a. Capital assets are assets other than inventory; depreciable property used in a trade or business; real property used in a trade or business; patents; copyrights or literary, musical, or artistic compositions in the hands of the creator or a donee of the creator; letters or memoranda; accounts or notes receivable from the ordinary course of a trade or business; or certain U.S. Government publications.
  - b. The tax definition of capital assets is significantly different from the financial accounting definition of capital assets (i.e., property, plant, & equipment).
- 2. Tax Treatment of Gains and Losses
  - a. Net long-term capital gains (with a holding period greater than one year) are generally taxed at 0% if taxable income is not over \$38,600, 15% if taxable income is between \$38,600 and \$425,800, and 20% if taxable income is over



\$425,800. Different thresholds apply to other filings statuses (\$77,200 and \$479,000 for married filing jointly; \$51,700 and \$425,400 for head of household). Net short-term capital gains are taxed at ordinary income. Net capital losses offset a maximum of \$3,000 of other income, with an unlimited carryforward for individuals.

- b. A net investment income tax of 3.8% applies to certain high-income taxpayers.

## **VI. Tax Planning Considerations**

1. Shifting Income Between Family Members (Examples I:2-42 through I:2-44)
  - a. Shifting taxable income to family members to lower tax brackets will reduce the overall family tax burden.
  - b. Restrictions apply to transactions that only involve assignment, and not shifting, of income, as well as transactions that trigger the kiddie tax.
2. Splitting Income (Example I:2-45)
  - a. Creating additional taxpayers can reduce the overall tax burden, but administrative costs, especially of additional corporations, reduce the overall savings.
3. Maximizing Itemized Deductions (Examples I:2-46, I:2-47)
  - a. Itemized deductions only provide value to the extent that they exceed the standard deduction. Timing expenses and charitable contributions so that they fall in a single tax year can increase the value of the resulting deductions.
4. Filing Joint or Separate Returns (Example I:2-50)
  - a. Both tax and non-tax issues determine whether married couples should file jointly or separately.
  - b. Spouses who file jointly are jointly liable for income tax, including the tax on disallowed deductions or unreported income. The innocent spouse provision protects spouses who were not aware of the magnitude of the understated tax liability, and the separate liability election allows spouses or former spouses to elect to be separately liable for the tax.

## **VII. Compliance and Procedural Considerations**

1. Who Must File (Example I:2-51)

- a. Generally, the income limitation for filing is the standard deduction for a particular status. The limitation is zero for married filing separately. (See page I:2-35 for the gross income filing levels.)
  - i. EXAMPLE: For 2018, a single taxpayer (under 65, not blind, not a dependent on another return) must file a return when gross income exceeds \$12,000.

## 2. Due Dates and Extensions

- a. Tax returns for calendar-year individual taxpayers (Forms 1040, 1040EZ, 1040A) are due April 15 (or first business day thereafter if April 15 is not a business day) following the end of the taxable year, with an automatic six-month extension if Form 4868 is filed by the due date for the return.
- b. Forms 1040EZ and 1040A are used for taxpayers that have few complications in the tax year. Taxpayers with only salary, wages, and no more than \$1,500 of interest may file using Form 1040EZ. Taxpayers with only salary, wages, dividends, interest, pensions and annuities, and unemployment income can file using Form 1040A. Both forms also have restrictions on deductions and credits allowed. All taxpayers may file using Form 1040.
- c. Partnerships must file Form 1065 and S corporations must file Form 1120S by the fifteenth day of the third month following year end (i.e., March 15 for calendar-year-end taxpayers). C corporations must file Form 1120 and have the same due date as individual taxpayers. Any of these organizations can file Form 7004 to obtain a six-month extension.
- d. An extension to file is not an extension on paying taxes. Interest and penalties apply for underpayment even when filing an extension.

## 3. Systems for Reporting Income

- a. Payments made by certain entities are reported to the IRS for computer cross-checking that all income has been reported.
- b. Items reported include pensions, annuities, wages, dividends, interest, sales of securities, unemployment compensation, rents, royalties, and lump-sum distributions from retirement plans.

## Court Case Briefs

Kenneth Royce Boykin v. CIR, 1984 PH T.C. Memo & 84,297, 48 TCM 267.

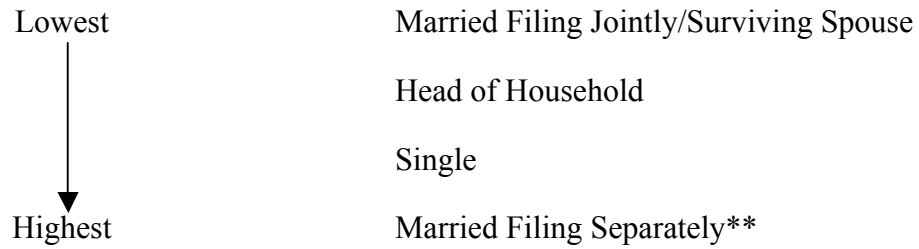
The taxpayer and his wife were divorced in February of 1979, but he continued to live with his former wife and their children after the divorce in 1979 and 1980. IRC Sec.143 provides that the “determination of whether an individual is married shall be made as of the close of his taxable year.” IRC Sec.143 further provides that an individual legally separated by divorce or a separate maintenance decree is not considered married. The taxpayer was denied the filing status of married, filing jointly because he was not married at the close of the tax years at issue. Texas (state of residence) recognizes common law marriages that have the elements of mutual agreement, cohabitation, and the holding out of themselves as married to the public. Their cohabitation did not qualify because they had not mutually agreed to be remarried. However, he was permitted “head of household” filing status because he met the requirements of Sec. 2(b). He was not married at the close of the tax year and he maintained a household for over half of the tax year for his dependent children.

Haynes, 119 AFTR 2d 2017-865.

Mr. and Mrs. Haynes hired Mr. Dunbar, a CPA, to prepare and file their 2010 individual tax return. In 2011, Dunbar filed for an extension to submit the Haynes’s 2010 income tax return, which was granted by IRS. On Oct. 17, 2011, Dunbar attempted to use the Lacerte software program to electronically file the Haynes’s 2010 tax return. The IRS rejected the filing because the return listed Mrs. Haynes’s social security number on the line designated for the employer identification number. Dunbar advised Mr. Haynes that the return had been filed, but eleven months later, the IRS notified the Haynes that it had not received their 2010 return. In December 2012, Dunbar filed the Haynes’s 2010 tax return on paper. IRS assessed a late-filing penalty, which the Haynes paid. They subsequently filed a refund suit in district court, but the court rejected their claim. The court stated that relying on a CPA’s erroneous word that the return had been filed was not reasonable cause for failing to file a tax return in a timely fashion.

## Instructor Aid I:2-1

### Relative Tax by Filing Status\*



\*Assuming the same amount of taxable income.

\*\*In the few cases where the married couple both has income and only one has substantial amounts of itemized deductions, the result may vary.

## **Instructor Aid I:2-2**

### **Kiddie Tax**

1. Compute the child's taxable income in the normal fashion for dependents.
2. Compute the child's net unearned income (investment income, including dividends, taxable interest, capital gains, rents, and royalties):

Unearned income

Less:            Statutory deduction of \$1,050

Less:            Greater of

- a. \$1,050 of standard deduction, or
- b. Itemized deductions directly connected with the production of the unearned income

Equals: Net unearned income (not less than zero)

3. Compute the child's earned taxable income (ETI) by subtracting net unearned income (Step 2) from taxable income (Step 1). ETI is not less than zero.
4. Determine tax rate:

10%: Portion of taxable income not over ETI + \$2,550

24%: Portion of taxable income over ETI + \$2,550

35%: Portion of taxable income over ETI + \$9,150

37%: Portion of taxable income over ETI + \$12,500

## Instructor Aid I:2-3

### Capital Assets

Capital assets are defined in a negative manner under the Internal Revenue Code. Capital assets are assets that are not:

- Inventory
  - Depreciable property used in a trade or business
  - Real Property used in a trade or business
  - Patents
  - Copyrights
  - Literary, musical, or artistic compositions
  - Letters or memorandums
  - Accounts or notes receivable from the ordinary course of a trade or business
  - Certain U.S. Government publications
- In the hands of the creator or a donee of the creator