Topic 1: Individual Tax Format and Filing Requirements

[IRS Materials: Publication 17 (1-2), Publication 501]

Priority of Subtopic	No. of Questions on 1996-2005 Exams
Green	0

A. Basic Tax Computation

Figure 1-1 provides a comprehensive example illustrating the tax formats for individual regular income tax computations. Review this format carefully, as we will return to the example throughout this part. *However, do not worry about* ***Figure 1-2*** *for now; we will address details of the AMT (****Figure 1-2****) much later in this part of the course.*

Note the key components of the individual formula for the regular income tax: gross income, deductions for adjusted gross income (AGI), AGI, deductions from AGI (consisting of the exemption deduction and the *larger* of itemized deductions or the standard deduction), taxable income, gross tax liability, additions to tax, tax credits, and net tax liability. We will analyze the differences between deductions *for* AGI and deductions *from* AGI later in this review course.

Example: M and N are filing a joint return in 2011. Their deductions consist of a $6,000 Keogh plan contribution, $4,000 interest, $2,000 contributions, and $3,000 state taxes. M and N will elect to use the standard deduction when filing their return, as the Keogh amount is a deduction for AGI and itemized deductions from AGI are only $9,000.

Review Question – Topic 1A – Basic Tax Computation

1. Which of the following items is not a deduction from adjusted gross income?

   a. personal exemptions
   b. one-half of self-employment tax paid
   c. personal casualty loss
   d. standard deduction

Priority of Subtopic	No. of Questions on 1996-2005 Exams
Green	0

B. The Standard Deduction

In lieu of itemizing deductions, a taxpayer may deduct an inflation-adjusted standard deduction that depends on the taxpayer's filing status.

Tax Tip: In 2009, a taxpayer could deduct state and local property taxes *in addition to the standard deduction*, limited to a maximum of $500 ($1,000 on a joint return). ***This provision was <u>not</u> extended in the 2009 year-end legislation, and therefore does NOT apply in 2011.***

The 2011 amounts are **$5,800** (single), **$11,600** (married filing jointly or surviving spouse), **$5,700** (married filing separately), and **$8,400** (head of household).

Figure 1-1 –
Howard and Martha Jones – Regular Tax Computation – 2011

Salaries		$ 162,000
Long-Term Capital Gain (stock investment)		20,000
Taxable Interest Income		15,000
Private Activity Bond Interest **(a)**		0
Incentive Stock Option (ISO) Exercise **(b)**		0
Sole Proprietorship Income **(c)**		58,000
Gross Income		255,000
Keogh and 1/2 Self-Emp. Tax Deductions		(5,000)
Adjusted Gross Income		250,000
Personal Exemptions (2 @ 3,750) **(d)**		(7,400)
Itemized Deductions (exceed standard deduction of $11,600):		
Medical ($25,000 less 7.5% of AGI)	6,250	
Interest – Qualified Acquisition Indebtedness	7,900	
Interest – Home Equity Indebtedness **(e)**	3,000	
Interest – Investment Activities **(f)**	15,000	
Taxes – State and Local	31,000	
Contributions – Cash and FMV of Property	41,600	
Casualty and Theft ($0 less 10% of AGI)	0	
Miscellaneous ($6,000 less 2% of AGI)	1,000	
Net Itemized Deductions		(105,750)
Regular Taxable Income – 2011		136,850
Regular Tax Liability (joint tax return):		
Regular Tax on ($136,850- $20,000 L/T Capital Gain)		21,463
Tax on L/T Capital Gain ($20,000 x .15)		3,000
Regular Tax Liability (**RT**)		24,463
Add: **Alternative Minimum Tax (see Figure 1-2)**		**24,716**
Self-Employment Tax on $58,000 Proprietorship Income		8,195
Less: Credits		(0)
Prepayments of Tax (Withholdings and Estimated Tax)		(55,000)
Net Tax Liability – 2011		$ 2,374

(a) Total received on 2011 private activity bond issue, $7,000.

(b) On 2/1/2011, Howard exercised an incentive stock option, purchasing 1,000 shares of his company's stock at $10 per share (FMV of $60 per share). No restrictions were placed on the stock.

(c) Includes the following cost recovery deductions for 2011:
$20,000 MACRS on post-86 property (AMT ADS is $15,000)
$15,000 ACRS on pre-87 realty (straight-line is $12,000)

(d) $7,400 total exemption is allowed in full, as there is no phaseout of the personal exemption deduction in 2011 (the phaseout computation returns in 2013; see Topic 1I).

(e) Loan on personal automobiles secured by personal residence.

(f) $18,000 investment interest paid, limit to $15,000 net investment income (interest income per above).

Figure 1-2 –
Howard and Martha Jones – Alternative Minimum Tax Computation – 2011

Items (T = timing, P = permanent)	**All**	**Permanent**
Taxable Income per Return (from Figure 1-1)	$136,850	$136,850
Less Disallowed Itemized Deductions (no phaseout in 2011)	(0)	(0)
Taxable Income as Adjusted	136,850	136,850
AMT Adjustments (may be positive or negative):		
[T] Post-86 Depreciation (MACRS – ADS)	5,000	- -
[T] Res. & Exp. Expenses (Ded. - 10-yr. amort.)	0	- -
[T] Amort. of Pollution Control (5-yr. – ADS recovery)	0	- -
[T] Mining Exploration & Develop (Exp. – 10-yr amort.)	0	- -
[T] Circulation Expenditures (Exp. – 3-yr. amort.)	0	- -
[T] Passive Losses (Recompute with AMT rules)	0	- -
[T] Pct. of Completion Method (PCM – Comp. Cont.)	0	- -
[T] Net Operating Loss Ded. (Reg. NOL – AMT NOL)	0	- -
[T] Adj. Gain (Loss) (Regular Tax – AMT Amount)	0	- -
[T] Incentive Stock Option Exercise (FMV – Ex. Price)	50,000	- -
[T] Adj. Expenses for AMT (Add'l Invest. Int. Expense)	(3,000)	- -
[P] Disallowed Standard Deduction (if taken)	0	0
Disallowed Itemized Deductions:		
[P] Medical (7.5% ded. - 10% ded.)	6,250	6,250
[P] Interest Expense (home equity disallowed)	3,000	3,000
[P] State and Local Taxes (none allowed)	31,000	31,000
[P] Miscellaneous Itemized (none allowed)	1,000	1,000
[P] Personal Exemption Deductions (none allowed)	7,400	7,400
Taxable Income as Adjusted	237,500	185,500
Preferences (Plus Only):		
[T] Pre-87 Deprec. (Excess - realty and leased per.)	3,000	- -
[P] Tax-Exempt Interest (Post 8/7/86 private act.)	7,000	7,000
[P] Excess Pct. Depletion (amount exceeding adj. basis)	0	0
Alternative Minimum Taxable Income (AMTI)	247,500	192,500
AMT Exemption*	(50,075)	(63,825)
Net Alternative Minimum Taxable Income	197,425	128,675
Tentative Minimum Tax (TMT):		
All [(175,000 x .26) + (2,425 x .28) + (20,000 x .15)]	49,179	
Permanent Only [($113,175 x .26) + (20,000 x .15)]		31,256
Less Regular Income Tax Liability (see **Figure 1-1**)	(24,463)	(24,463)
Alternative Minimum Tax Liability [AMT] (to **Figure 1-1**)	24,716	6,793
AMT Credit ("All" – "Permanent Only")	- -	17,923
	$ 24,716	$ 24,716

* Exemption amounts are:

Joint Ret. (M) – **$74,450**, less 25% x (AMTI - $150,000) [$447,800 phaseout is complete]
Single (or HH) – **$48,450**, less 25% x (AMTI - $112,500) [$306,300 phaseout is complete]
MS (or E&T) – **$37,225**, less 25% x (AMTI - $75,000) [$223,900 phaseout is complete]

** When considering only permanent adjustments and preferences ("exclusions"), those items that will *not* reverse in the future, there would be $6,793 AMT due in 2011. Thus, **$17,923** ($24,716 - $6,793) of AMT payable in 2011 is due solely to timing ("deferral") items; this **$17,923** may be carried over to 2012 as an **AMT credit**, reducing 2012 regular tax (but *not* below the 2012 computed TMT). Thus, if the 2012 regular tax (RT) is $32,000 and the TMT is $27,000, only $5,000 of the 2011 credit may be used to reduce 2012 RT to $27,000. The remaining AMT credit of $12,923 would then be carried forward to 2012.

An additional standard deduction of **$1,450** ($1,150 if married filing jointly or separately) in 2011 is available for each instance that the taxpayer or his or her spouse (but not dependents) is either age 65 or older or is legally blind at the end of the year.

Example: Jay and Joan Wentz, ages 68 and 63, respectively, file a joint return in 2011. Joan is legally blind. Jay and Joan's standard deduction for 2011 is $13,900, or $11,600 for a married couple, and two increases of $1,150 for age 65 or older (Jay) and blindness (Joan).

In two cases, the full standard deduction may not be available. First, if one spouse itemizes, the other must itemize (i.e., one may not itemize while the other claims the standard deduction). Secondly, a person who is eligible to be claimed as a dependent on another person's return will have a 2011 standard deduction limited to the greater of **$950** (the "minimum" standard deduction) or the taxpayer's earned income *plus* **$300**, not to exceed the normal maximum single standard deduction of $5,800).

Example: Al Johnson's wife Alice has already filed a separate return, claiming $7,400 of itemized deductions. Al's itemized deductions total $1,600. Al must itemize his deductions, even though the $1,600 is less than the normal 2011 standard deduction for married filing separately of $5,800.

Example: Mavis Williams, age 17, is claimed as a dependent on her parent's return. Her 2011 earnings consist of $1,200 interest and $400 wages from a paper route. Mavis's 2011 standard deduction is $950 (the minimum standard deduction).

Example: Assume the same facts as the previous example, except that Mavis has $980 itemized deductions in 2011. Mavis would itemize and deduct $980.

Example: Assume the same facts as the previous example, except that Mavis's paper route earnings were $1,300. In this case, the standard deduction would be $1,600 (the $1,300 earned income from the paper route *plus* $300). If paper route earnings were $5,980, the standard deduction would be limited to $5,800 (the maximum standard deduction for a single person in 2011).

Review Questions – Topic 1B – The Standard Deduction

1. Tom and Jean Akers, both age 68, provide all the support for their 34-year old dependent son Jeff, who is legally blind. Tom and Jean's standard deduction for 2011 is:

   a. $11,400
   b. $11,950
   c. $13,900
   d. $15,050

2. **Mary Allen, age 12, earned $800 from a paper route and received $1,200 of taxable interest during 2011. Mary is claimed as an exemption by her parents. Mary's standard deduction for 2011 is:**

   a. $850
   b. $950
   c. $1,100
   d. $5,450

3. Sam Spade, single and age 62, has itemized deductions of $6,000 in 2011, consisting of $4,000 home interest, $1,000 contributions, and $1,000 local real estate taxes. Other than his personal exemption deduction, Sam may subtract deductions from adjusted gross income of:
   a. $5,700
   b. $6,000
   c. $6,200
   d. $6,250

Priority of Subtopic	*No. of Questions on 1996-2005 Exams*
Green	0

C. Proper Tax Form to File

As a general rule, Form 1040 is the required return. Any taxpayer who itemizes deductions must file a Form 1040. Form 1040EZ may be used by non-itemizers (including married couples) with less than $100,000 of taxable income whose only income is salary and/or interest income. Form 1040A may be used by non-itemizers with less than $100,000 of taxable income who have certain other types of income (such as dividends) and who qualify for certain credits (such as the child credit and child and dependent care credit).

Example: M and N file a joint return and do not itemize deductions. Their only income consists of $30,000 salary, $800 interest, and $600 dividends. M and N may file either Form 1040A or Form 1040 for the tax year.

Review Question – Topic 1C – The Proper Tax Form to File

1. The child care credit can be claimed on
   a. Form 1040 only
   b. Form 1040 or 1040A
   c. Form 1040 or 1040EZ
   d. Form 1040, Form 1040A, or Form 1040EZ

Priority of Subtopic	*No. of Questions on 1996-2005 Exams*
Red	5

D. Requirements to File – General Rules

As a general rule, a tax return must be filed for taxpayers whose gross income exceeds the sum of the taxpayer's standard deduction and exemption deduction (including the taxpayer's spouse, but not dependents). Recall that gross income is gross receipts less exclusions, but not deductions.

Note: As is discussed later in this course, Social Security income is generally excludable unless the taxpayer's modified adjusted gross income exceeds $25,000 (single) or $32,000 (married filing jointly). This point keeps popping up in these questions.

Thus, a single taxpayer under age 65 with 2011 gross income exceeding $9,500 ($5,800 standard deduction plus $3,700 exemption) must file a return. You may want to review the standard deduction discussed earlier for these questions.

If the taxpayer is legally blind or age 65 or older, the minimum requirement is increased by the $1,450 or $1,150 supplemental standard deduction. Thus, the standard deduction used in determining the minimum filing requirement is adjusted upward for each instance of the taxpayer or spouse (but not dependents) meeting the blindness or age 65 or older tests.

Again, the upward adjustments are only for the taxpayer and spouse, and not for any dependents.

Review Questions – Topic 1D – Requirements to File – General Rules

1. In which of the following situations is no return required to be filed in 2011?

   a. single, filing status single, under age 65, gross income $10,000
   b. married, joint filing status, both spouses under age 65, gross income $23,000
   c. single, filing status single, age 70, gross income $9,000
   d. married, separate filing status, age 65, gross income $10,000

2. Mr. T. is age 21, single, and cannot be claimed as a dependent by another taxpayer. For 2011, he must file a federal income tax return if he had gross income of at least:

   a. $3,700
   b. $5,800
   c. $9,500
   d. $10,950

3. Ms. Maple, a single woman age 65, retired in 2011. Prior to her retirement she received a $3,000 bonus plus $1,500 in wages. After her retirement she received $9,000 in Social Security benefits. Which of the following is true?

   a. Ms. Maple does not have to file a 2011 income tax return.
   b. Ms. Maple has to file a 2011 income tax return.
   c. Ms. Maple has to file a 2011 income tax return, but may exclude the $3,000.
   d. Ms. Maple has to file an income tax return, but may exclude the $9,000 in Social Security benefits from income.

4. John is 19 years old and a full-time student. He works part time during school and full time during the summer. His earnings from work for the year are $3,150 and his savings account earned $175 interest income. John is claimed as a dependent on his parents' return because they provide more than half of his support. John is:

   a. not required to file a return
   b. required to file a return, but will owe no tax
   c. required to file a return, and will owe some tax
   d. required to file a joint return with his parents

5. Mr. Todd, who is 43 years old, has lived apart from his wife since May 2011. For 2011, his two children, whom he can claim as dependents, lived with him the entire year and he paid the entire cost of maintaining the household. Assuming that Mr. Todd cannot quality to file a joint return for 2011, he must, nevertheless, file a return if his gross income is at least:

- **a. $3,700**
- **b. $5,800**
- **c. $9,500**
- **d. $12,200**

Priority of Subtopic	*No. of Questions on 1996-2005 Exams*
Red	6

E. Requirements to File – Special Exceptions

Exceptions to the general rule, other than the additional standard deductions, are:

- Married filing separately taxpayers have a ***$3,700*** minimum filing requirement (the exemption amount), since they may not qualify for a standard deduction (if their spouse itemizes).
- Taxpayers claimed as a dependent by others have ***$950 unearned income*** minimum filing requirement (minimum standard deduction) since no exemption is available.
- Self-employed taxpayers with *net* self-employment income on Schedule C exceeding ***$400*** must file a return in order to pay the self-employment tax by filing Schedule SE. However, the *gross income* of such taxpayer for purposes of the filing requirements is Line 7, Schedule C (after cost of goods sold but *before* any deductions), and this number determines if the gross income limit is exceeded.
- Taxpayers with tip income not reported to their employer must file a return (filing is necessary to pay the Social Security and Medicare taxes).
- Taxpayers owing special taxes, such as the alternative minimum tax or taxes on retirement distributions, or reporting special tax recaptures, such as electric vehicle credits, must file a return.
- Taxpayers must file to obtain a refund of prepayments of taxes (through withholdings or estimated taxes), even though a return is otherwise not required.

Review Questions – Topic 1E – Requirements to File – Special Exceptions

1. April is age 18 and single. Her only income in 2011 was self-employment income from selling cosmetics. April is not required to file a return for 2011 if she has:

   a. $9,000 gross receipts and $300 net income
   b. $6,000 gross receipts and $700 net income
   c. $3,000 gross receipts and $850 net income
   d. April is required to file in every case above

2. **In 2011, Mr. Oak quit his job to start his own sole proprietorship. Prior to quitting his job he had earned $5,000 in wages. At the end of the year, his sole proprietorship showed $50,000 in sales. Mr. Oak will not have to file a return if his sole proprietorship expenses are at least:**

   a. **$49,601**
   b. **$50,000**
   c. **$50,400**
   d. **a return will be required in any case**

3. **Rosa, who turned 14 on December 1, 2011, received interest income of $1,000 during 2011. Rosa did not make any estimated tax payments or have any federal income tax withheld. She had no other income. Rosa is properly claimed as a dependent by her parents. For 2011, Rosa:**

   a. **is not required to file a federal return**
   b. **is required to file a federal return**
   c. **must file a return solely for purposes of the earned income credit**
   d. **none of the above**

Topic 2: Exemption Deductions

[IRS Materials: Publication 17 (3), Publication 501]

Priority of Subtopic	*No. of Questions on 1996-2005 Exams*
Green	2

A. Exemption Deductions – General Requirements

A taxpayer may take exemption deductions for himself or herself, his or her spouse, and any dependents that meet the five tests discussed below (filing status, relationship, gross income, support, and citizenship). A person eligible to be claimed as a dependent on another person's return may not claim an exemption for himself or herself. The 2011 amount is **$3,700** per exemption. A full exemption is allowed in the year of birth and the year of death. Each of the five tests is discussed below.

Example: Morris, age 16, is eligible to be claimed as a dependent by his parents. Believing that they could channel more income to their son in his low tax bracket by gifting income-yielding property to him, Morris's parents do not claim Morris as a dependent. Morris may not claim an exemption deduction on his own return, even though his parents did not claim him either.

Tip: The following discussion describes each of the five tests for dependency exemption. Although each test has at least one exception, the other four tests still apply.

Review Question – Topic 2A – Exemption Deductions – General Requirements

1. Tyler is single and is 18 years old. He works part time and is going to school. His total income for 2011 was $8,000. Tyler lives with his parents. He qualifies as their dependent.

   a. Tyler may not claim an exemption for himself under any circumstances.
   b. Tyler may claim an exemption for himself only if he files a return.
   c. Tyler may claim an exemption for himself only if his parents do not claim him as an exemption.
   d. Tyler may claim an exemption for himself, and his parents may claim him as well.