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1040 Preparation and Planning 1: Fundamentals (2010 Edition)

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Welcome

Welcome to **Fundamentals**, Part 1 of the 2010 1040 Preparation and Planning series.

This CPE course, developed by **CCH**, in cooperation with [Sidney Kess and Barbara Weltman](#), brings the tax preparer "up-to-speed" in the most efficient way possible for the tax preparation season.

It offers quick answers and hands-on help for tax return preparation that has become increasingly complex by several recently passed tax Acts.

To help you further research this topic, links from cited documents (e.g., Code and Regulation sections, IRS releases and publications, cases, etc.) to the full text of such documents are provided within **CCH Learning Center** courses.

You must be a subscriber to **CCH IntelliConnect** to take advantage of this powerful content integration functionality.

Visit the [CCH Group](#) for more information about **CCH IntelliConnect** and how to subscribe.

Note: When this course was completed, some of the final versions of the 2009 tax forms, schedules, and other publications had not been released. We have used the most current versions available at the time this course was posted to the Learning Center. Additional tax legislation, court decisions and IRS pronouncements could affect 2009 returns.

Course Structure

How the Course is Organized

This course is designed to provide you with an engaging learning experience. It consists of self-paced reading materials, study questions, and graphics.

1040 Preparation and Planning Part 1: Fundamentals is divided into the following chapters:

- Fundamentals
- Filing Status
- Exemptions

When you have completed the course, you will take the **Final Exam**. Your **Certificate of Completion** will be available after you successfully complete the course.



Why Do I Need to Complete Learning Activities

Integrated throughout the course are self-check questions. These learning activities give you the opportunity to test your understanding of the material presented and to prepare you for the Final Exam. Completing the exercises and answering the study questions encourages interactivity and reinforces the course objectives stated previously.

What Do I Find in the Glossary

A glossary section provides definitions of the terms used in the text. It is universal for all **CCH Learning Center** online courses. Terms are listed in alphabetical order.

How to Navigate the Site

The Back arrow () and Next arrow () allow you to navigate linearly through the course. The drop down list in the upper left allows you to select which lesson you want to view. When you select a lesson, the topics and pages within that lesson appear in the left navigation frame. After you have visited a page, the title in the left navigation frame will be grayed out. Furthermore, the Course Outline in the menu bar lists all lessons, topics, and subtopics in a comprehensive outline, allowing you to link directly to any page in the course.

CCH IntelliConnect

Most sections in this course include links to the **CCH IntelliConnect**, providing access to relevant sections of the internal revenue code and Treasury regulations. Direct links to the selections are provided. You will need to use your personal **CCH IntelliConnect** User ID and Password.

There are different ways you can use **CCH IntelliConnect** in this course:

- Read online when directed
- Access the **CCH IntelliConnect**, print the pages, read the hard copy, and take notes
- Keep the **CCH IntelliConnect** open during the course and toggle back to it when necessary

NOTE: If you selected the option "Log me in automatically" from the IntelliConnect Login Screen, you will be directed to a link without any additional registration. Each time you click on a link, a new Internet browser window will open. You can have several code sections and regulations open at once, each in its own window.

Course Objectives

Learning Objectives

This first course of the series provides a quick overview of Federal income taxes, explains filing status, and outlines exemptions.

More specifically, upon completion, you will be able to:

- Describe the basic federal income tax structure.
- Identify who is required to file a return, as well as which status applies to each individual.
- Explain what exemptions are available and the amounts of each.
- Determine eligibility for exemptions and the phase-out of exemptions for high-income taxpayers.

Tools and Resources

In addition to helpful planning pointers and citations linked throughout this course, Tools and Resources are provided to:

- Facilitate understanding of the course topic
- Keep you abreast of developments in tax return preparation and planning
- Help you actively utilize the knowledge gained in this course in your practice

Subscribers to **CCH IntelliConnect** also have the option of receiving news headlines and summaries related to tax preparation issues directly to their desktop through e-mail or RSS reader. Coverage includes daily news stories, full text of primary source documents cited, and an optional daily e-mail or RSS feed.

Sign up for customized news feeds from the [CCH Tax Tracker](#)

You will need Acrobat Reader to view or print the following articles and forms in Portable Documents (PDF). If you need to install it, download the free plugin from [Adobe's website](#). The client letter is in Rich Text Format (.rtf) and can be opened in most word processing programs.

Download:

[Client Letter: 2009 Planning: Maximizing Itemized Deductions](#)

Use this letter to notify clients of some opportunities that are available to maximize itemized deductions, in order to assist them in achieving the greatest tax savings possible.

[Client Letter: 2009 Year-end Tax Planning for Individuals](#)

This letter can inform clients about the ways in which year-end tax planning for 2009 presents a unique chance to lower their tax liability, especially in light of the significant tax law changes that were enacted in response to the struggling economy.

IRS Forms

[Form 1040](#)

[Form 1040A](#)

[Form 1040EZ](#)

[Instructions to Form 1040](#)

Fundamentals

Learning Objectives

This chapter was prepared to enable participants to gain a quick overview of Federal income taxes.

More specifically, upon completion, you will be able to:

- Describe the basic federal income tax structure
- Identify who is required to file a return

New This Year

Indexing. To reflect cost-of-living increases, changes have been made to all tax brackets, standard deduction amounts, personal and dependency exemptions, and gross income thresholds for filing income tax returns.

Basic Federal Income Tax Structure

This section introduces the fundamentals of federal income tax and gives a bird's-eye view of the general income tax structure. For this reason, some of the topics presented in this initial section are discussed only in general terms, and they will be covered at length in later portions of this series of courses.

It is essential, however, to clearly and thoroughly understand these basic principles. Even though much of the subject matter may be familiar, take advantage of these introductory pages for a quick brush-up.

Classification of Taxpayers

For purposes of the federal income tax, all taxpayers (other than not-for-profit taxpayers) are classified into three groups:

Taxpayer Classification	Applicable Form
Individuals	1040, 1040A, 1040EZ
Corporations	1120
Estates and trusts	1041

Partnerships are not separate taxpayers and, therefore, their income is not taxed at the federal level to the partnership directly. Each partner reports his share of the partnership income or losses on his individual tax return, along with other income or losses. However, the partnership itself is required to file an information return (Form 1065) computing the partnership's net income or loss and listing each partner's share.

A limited liability company (LLC) taxed as a partnership must also file Form 1065, computing the company's net income or loss and listing each member's share of these items. A similar procedure is followed by an S corporation. The S corporation files a return (Form 1120S) computing each shareholder's share of the corporation's net income plus the share of each item that would require separate treatment on a shareholder's individual return.

However, unlike the partnership, the S corporation is sometimes required to pay tax at the corporate level, that is, for the tax imposed on built-in gains.

The following discussions, except where otherwise indicated, pertain to the income tax of individuals.

Purpose of the Income Tax Return and Tax Return Forms

Our system of taxation is a *pay-as-you-go* plan of collecting individual income taxes. Employers are required to *withhold* a part of their employees' wages or salaries and pay the amount withheld to the government. As a result, most of the taxes due the federal government from wage earners are collected as the income is earned. Withholding is also required on certain pension distributions.

There is another, perhaps less well-known, method of collecting income taxes during the year. This is the payment of *estimated tax*. Many taxpayers who are in business for themselves (self-employed), independent contractors or other workers who do not have earnings subject to withholding, or those who have income from sources other than wages, such as tips, interest, or dividends, may be required to pay an estimated tax. They estimate what their tax will be for the current year. At least one-fourth of this estimated tax is paid in each of quarterly installments.

Remember, the estimated tax (just like the withholding tax) is *not* an additional tax. It is merely a device to enable the Treasury to collect all, or part, of the tax due for the income earned, instead of postponing the collection of the tax until after the end of the year.

Example

In April 2009, Abel Davis estimated that his total taxable income for 2009 would amount to \$58,000. Tax of \$9,000 will be deducted by his employer for withholding tax. He also estimated that his total tax liability for 2009 will be \$11,165. His estimated tax is \$2,164—the difference between the total projected tax liability and the estimated amount to be withheld by his employer.

To make sure Abel would not owe any tax when he filed his 2009 return, he also makes estimated tax payments. One-fourth of the estimated tax, or \$541, was payable in April 2009. The remainder was payable in three quarterly installments of \$541 each.

Most taxpayers are required to file an annual tax return after the close of the year to determine the exact tax due. If taxpayers owe more than they have paid throughout the year via withholding and/or estimated tax payments, they must pay the difference. If they have overpaid, they will either receive a refund or have the overpayment credited toward the current year's estimated tax.

Thus, withholding and estimated tax payments are merely *payments on account*, not actual payments of tax.

Example

In April 2010, Abel Davis prepares his 2009 federal income tax return and determines that his actual tax liability for 2009 was \$12,150. The total amount withheld by his employer was \$9,000.

Because he had already paid \$11,165 (\$9,000 through withholding and \$2,164 through estimated tax) toward his 2009 tax liability, he now merely remits the remaining balance of \$986 when he files his income tax return.

Planning Pointer:



Individuals generally are required to pay at least 90% of the total owed (through withholding and estimated tax payments) in order to avoid penalty. Because estimating the exact amount owed may be difficult, safe harbor rules allow individuals to avoid penalty by basing current tax payments on the prior year's liability.

The basic tax return for individuals is Form 1040. It may be used by any individual taxpayer. In addition, there is the so-called short form (Form 1040A) and a form for certain single taxpayers (Form 1040EZ).

Form 1040

The basic Form 1040 is a two-page form, but there are various supporting schedules. The schedules to be used depend on the types of income that taxpayers receive, their deductions, and the credits and other benefits for which they may be eligible.

The major schedules include:

- [Schedule A](#) for itemized deductions
- [Schedule B](#) for interest and dividends received
- [Schedule C](#) or [Schedule C-EZ](#) for non-farm business income or loss
- [Schedule D](#) for capital gains and losses
- [Schedule E](#) for income from rents or royalties; partnerships, estates, and trusts; and S corporations
- [Schedule EIC](#) for the earned income credit
- [Schedule F](#) for farm income and expenses
- [Schedule H](#) for employment taxes of household employees
- [Schedule J](#) for income averaging for farmers and fishermen
- [Schedule L](#) for the additional standard deduction
- [Schedule M](#) for the making work pay credit
- [Schedule R](#) for credit for the elderly and the permanently and totally disabled
- [Schedule SE](#) for self-employment tax


Pitfall: The IRS has noted as a common error the failure to submit all required forms and schedules. Taxpayers can help avoid having a return questioned by submitting a complete return.

Form 1040A

The short form (Form 1040A) generally may be used by a taxpayer if all income was from wages, salaries, tips, other employee compensation, taxable scholarships and fellowships, capital gain distributions, IRA and pension distributions, unemployment compensation, Alaska Permanent Fund dividends, Social Security benefits, dividends, and interest; and if the taxpayer does not itemize deductions.

In addition, the educator deduction, the making work pay credit, the IRA contributions deduction, the student loan interest deduction, the tuition and fees deduction, the dependent care credit, the credit for the elderly or disabled, the earned income credit, the American opportunity credit, the lifetime learning credit, the child tax credit, the retirement savings contributions credit, and estimated tax payments can be reported on Form 1040A.

Basically, Form 1040A is for taxpayers who do not itemize deductions, who have any business interests, or who sell any capital assets.

Planning Pointer:	
	The use of Form 1040A is never required, but, for those taxpayers eligible to use it, its use will simplify the task of return preparation.

Form 1040EZ

This form can be used only by a single taxpayer or by married persons filing a joint return, who are under age 65, who are not blind, who have taxable income from wages, unemployment compensation, and Alaska Permanent Fund dividends, who receive no more than \$1,500 in interest, and who have taxable income of less than \$100,000.

Only a personal exemption can be claimed; no additional dependents may be claimed. No credits other than the earned income credit (EIC) may be claimed (and the EIC only if it was not received on an advanced basis). Form 1040EZ cannot be used if there is *any* dividend income.

Who Must File a Return

Whether U.S. citizens or residents must file tax returns depends on their gross income, filing status, and age ([Sec. 6012](#)).

Generally, U.S. citizens or residents will have to file tax returns for 2009 if their *gross income* is at least as much as the amount shown for their situation in the table below. For most individuals, the filing threshold is the sum of their applicable exemption and standard deduction amounts.

Unmarried persons under 65	\$9,350
Unmarried persons 65 or over	10,750
Married persons filing jointly both under 65	18,700
Married persons filing jointly, one 65 or over	19,800
Married persons filing jointly, both 65 or over	20,900
Head of household under 65	12,000
Head of household 65 or over	13,400
Married persons filing separately	3,650
Surviving spouse	15,050
Surviving spouse 65 or over	16,150

Dependent

Different filing thresholds apply to single versus married dependents.

Single Dependents

A single dependent who is not either age 65 or older or blind must file a return if (1) unearned income is over \$950, (2) earned income is over \$5,700, or (3) gross income is more than the greater of \$950 or earned income (up to \$5,400), plus \$300.

A single dependent who is either 65 or older or blind must file a return if (1) earned income is over \$7,100 (\$8,500 if 65 or older *and* blind); (2) unearned income is over \$2,350 (\$3,750 if 65 or older *and* blind); or (3) gross income is more than the greater of \$950 or earned income up to \$5,400, plus \$300 (plus \$1,400 and another \$1,400 if also blind).

Married Dependents

A married dependent who is not either age 65 or older or blind must file a return if (1) gross income is at least \$5 and the spouse itemizes deductions on a separate return, (2) unearned income over \$950, (3) earned income is over \$5,700, or (4) gross income more than the greater of \$950 or earned income (up to \$5,400) plus \$300.

A married dependent who is 65 or older or blind must file a return if (1) unearned income is over \$2,050 (\$3,000 if 65 or older *and* blind); (2) earned income is over \$6,800 (\$7,900 if 65 or older *and* blind); (3) gross income is more than the larger of: (a) \$950 or (b) earned income (up to \$5,400) plus \$300 (plus \$1,100 and another \$1,100 if also blind), or (4) gross income of a least \$5 and his spouse itemizes deductions on a separate return.

Pitfall: A return does not have to be filed for a dependent under the kiddie tax age *if* the parent elects to report the child's unearned income on the parent's return.

Planning Pointer:



Even though a return is not *required*, it may be advisable to file one if individuals have tax withheld from their pay or paid estimated tax. A return must be filed to obtain any refund of such tax payments.

Example

Sam Perkins, a 50-year-old unmarried taxpayer, worked for 20 weeks at \$400 per week, out of which his employer withheld \$38 every week.

Technically, he is not required to file a 2009 return because his total gross income (\$8,000) is less than the \$9,350 filing threshold.

However, he should file a return in order to obtain a refund of the \$760 (\$38 x 20) withheld from his pay.

To qualify for the higher filing threshold available for older persons, taxpayers need not have been age 65 for the entire year. It is sufficient that they attain age 65 at any time during the year, even on December 31. Furthermore, persons are considered as attaining age 65 on the day preceding their 65th birthday. Hence, an individual whose 65th birthday is on January 1 is considered to be age 65 on December 31 of the previous year and thus qualifies for the higher limit.

Example

Jim Brown, an unmarried taxpayer, has his 65th birthday on January 1, 2010. He is considered as having attained age 65 in 2009 and, hence need not file a return unless his gross income was \$10,750 or more during 2009.

Notwithstanding the above, individuals, whether married or single, are required to file if they have \$400 or more of net earnings (essentially "profits") from self-employment, even though gross income is less than the amounts previously mentioned.

Test Your Understanding

- 1. In 2009, Adam Scott is an employee who pays \$7,500 in withholding taxes. He is single and under age 65. His gross income for the year exceeds \$9,350. His withholding amount exactly equals his tax liability for the year. Which statement is correct?**
 - Adam must pay an additional \$7,500.
 - Adam does not have to file a return.
 - Adam must file a return even though he owes no taxes.
- 2. Shirley Jones, who is single and under age 65, has income from wages of \$35,000, dividends of \$500, and interest income of \$1,000. She claims the standard deduction. Which type of income tax form can she file?**
 - Form 1040EZ, Form 1040A, or Form 1040
 - Form 1040A or Form 1040
 - Form 1040 only
- 3. Carlos and Anne Miller are married and both under age 65. They do not have to file a return in 2009 if their gross income is under:**
 - \$9,350
 - \$12,000
 - \$18,700
- 4. Christopher Smith is 16 years old and has interest and dividend income only. His parents claim him as their dependent. He must file a return if his income in 2009 exceeds:**
 - \$1
 - \$950
 - \$5,700
- 5. Emma Anderson is 17 years old and has a Web site design business. In 2008, her net earnings are \$500. Which statement is correct?**
 - Emma must file a return because her net earnings from self-employment exceed \$400.
 - Emma does not have to file a return because her income does not exceed \$950.
 - Emma does not have to file a return because her income does not exceed \$5,700.

Getting Started on Preparing a Return

Preparing a return is really a year-round process. Good recordkeeping of expenses throughout the year will make it easier to complete the return at tax time. Certain techniques for recordkeeping can be helpful:

- *Diary, log book, or electronic device.* Some individuals may find it helpful to keep track of expenses as they occur on a daily basis in a diary, log book, or electronic device such as a personal digital assistant (PDA). This is particularly important for certain types of expenses for which substantiation is required, such as business use of an automobile. Even if records are kept in a diary, log book, or an electronic device, receipts and other proof of expenses should also be retained.

- *Checkbook notations.* Some individuals highlight checks written that relate to deductible expenses. Many standard checkbooks have a special column for this purpose.
- *Shoebox or file folders.* Some individuals prefer to collect tax receipts and other items throughout the year in a shoebox or file folder. Receipts should then be organized according to category (e.g., acknowledgments for charitable contributions).
- *Home computer recordkeeping.* Some individuals use specially designed software programs to keep track of tax-related expenditures on a computer throughout the year.

Whatever recordkeeping method works best for a particular individual is the best method to use. All taxpayers should use *some* method to simplify return preparation and to have proof available in case a return is examined.

It is important to begin assembling required documents and other information before starting to fill in a return. Refer to tax returns from prior years to bring to mind forgotten items, such as carryovers of certain deductions and credits. If prior returns are not available, copies can be obtained from the IRS at a small charge.

Also, obtain all tax forms and schedules needed to complete the return. Common forms and schedules generally are available at local banks, libraries, and post offices, or they can be downloaded from the IRS Web site at www.irs.gov. Other forms and schedules are available directly from the IRS. Stop in at any local IRS office or call 1-800-829-FORM.

Further, collect all statements and information returns for the current year. These include 1099s issued for interest, dividends, state income tax refunds, pension and IRA distributions, and other income items. These also include Schedule K-1s from partnerships, S corporations, trusts, or estates in which a taxpayer has an interest.

If a taxpayer has worked for more than one employer during the year, and, particularly if the taxpayer has changed residences, it may be advisable for the taxpayer to keep a record of all his employers. Although employers are required to mail a W-2 showing wages and income tax withholding, they may lose track of an employee after termination of employment. A taxpayer's pay stubs can serve as a double check on employer W-2s.

Finally, it may be advisable to review the various forms and schedules, and the instructions for each, before beginning to complete the return.

Gross Income

The balance of this section is devoted to a brief explanation of how the tax is computed and the various methods used. Remember that the purpose of this discussion is merely to explain this subject in general terms; no attempt will be made to go into detail about any of the items discussed here.

The starting point in any tax computation is "gross income" ([Sec. 61](#)). For income tax purposes, this is all income from whatever source derived. The law enumerates specific items of income as "exclusions" that are not taxable and, therefore, are not included in gross income.

All other income, such as income received as salary, wages, tips, fees, commissions, interest, rents, dividends, profits from a business or profession, and gain from the sale or exchange of property, is taxable and is included in gross income.

Deductions from Gross Income

Deductions are amounts that may be subtracted from income at some stage of the tax computation. Because the amount of the tax ultimately depends upon the amount of taxable income, it follows that deductions will reduce the tax liability.

The law divides all allowable deductions into two groups: (a) those deducted from *gross income* to compute the *adjusted gross income* and (b) those deducted from *adjusted gross income*.

The more common deductions from gross income (called "above the line deductions") include:

- Deductions in connection with a trade or business
- Deductions (such as depreciation and depletion) in connection with property held for the production of rents or royalties
- Allowable losses from a sale or exchange of property
- 100% health insurance deduction for self-employed individuals and more-than-2% S corporation shareholders
- Alimony payments

- Contributions to IRAs and contributions to SEP, SIMPLE, or other qualified retirement plans on behalf of self-employed individuals
- One-half of the self-employment tax
- Moving expenses
- Contributions to health savings accounts (HSAs)
- Student loan interest
- Educator deduction up to \$250
- Tuition and fees deduction
- Contributions to Archer MSAs set up prior to 2008
- Penalty on early withdrawal of savings
- Certain business expenses of reservists, performing artists, and fee-based government officials
- Legal fees incurred to obtain an award for a discrimination action
- Domestic production activities deduction

Adjusted Gross Income

The income remaining after subtracting the foregoing deductions from gross income is called adjusted gross income (AGI) (Sec. 62). The AGI is a vital factor in preparing income tax returns and should be clearly understood.

AGI is the figure upon which numerous tax limitations are based. For example, there are now more than two dozen items keyed to AGI. Limitations based on AGI include:

- Exclusions (interest on EE and I bonds used for higher education; adoption assistance; COBRA assistance)
- Taxation of Social Security benefits
- Phase-out of personal exemptions
- \$25,000 rental loss allowance for rental real estate
- Conversion of traditional IRAs to Roth IRAs
- IRA deductions for active participants
- Roth IRA contributions
- Contributions to Coverdell education savings accounts
- Tuition and fees deduction
- Domestic production activities deduction
- Additional standard deduction for state and local sales and excise taxes on the purchase of a vehicle
- Itemized deductions (medical expense, mortgage insurance, casualty and theft losses, charitable contributions, miscellaneous itemized expenses), and the overall reduction in itemized deductions
- Tax credits (making work pay credit, child tax credit, adoption assistance, dependent care credit, American recovery credit, lifetime learning credit, credit for the elderly, retirement savers credit, health coverage tax credit, earned income credit, first-time homebuyer credit, and the refundable long-term unused minimum tax credit).

Planning Pointer:



In view of the many limitations tied to AGI, it is important for tax planning purposes to try to minimize AGI as much as possible.

In addition to taking full advantage of the deductions from gross income which serve to reduce AGI, other key ways include, where possible, making 401(k) plan contributions under salary reduction arrangements and using flexible spending accounts (FSAs) offered by employers as a way of paying for medical expenses and dependent care costs on a pretax basis.

Taking advantage of these measures now will translate into tax savings when next year's return is prepared.

Test Your Understanding

1. The threshold for filing a return generally is based on:

- Gross income
- Adjusted gross income
- Taxable income

2. Deductions from gross income include all of the following items *except*:

- Alimony payments
- Medical expenses
- Deductions in connection with a trade or business

3. All of the following tax items have limitations based on adjusted gross income *except*:

- Taxation of Social Security benefits
- Conversion of traditional IRAs to Roth IRAs
- Itemized deduction for real estate taxes

Deductions from Adjusted Gross Income

In the next step, all allowable deductions not deductible directly from gross income are deducted from adjusted gross income. These are the standard deduction or “itemized deductions.” Included in itemized deductions are the so-called “nonbusiness” or “personal” deductions. Typical examples of nonbusiness or personal deductions that are deductible from adjusted gross income are:

- Medical expenses, charitable contributions, mortgage interest, property taxes, state and local income taxes, and casualty and theft losses
- Expenses incurred by employees in connection with their employment that are not reimbursed (“unreimbursed expenses”)
- Most deductions in connection with income-producing activities *not* constituting a trade or business and *not* involving rents and royalties

The above deductions are commonly referred to as “itemized deductions” because the taxpayer must “itemize” or list them on Schedule A of the return.

Most miscellaneous itemized deductions are subject to a 2%-of-adjusted-gross-income limit. The amount deductible is limited to the total of these miscellaneous deductions that exceed 2% of adjusted gross income. The 2% limit is applied after all other deduction limits are considered. Typical examples of miscellaneous expenses subject to the 2% limit are:

- Employment-related educational expenses of employees
- Employee home office expenses
- Union dues
- Safe deposit box rental
- Fees paid to an IRA custodian
- Tax preparation fees
- Expenses of hobby activities

Pitfall: Itemized deductions for “high-income” taxpayers are reduced when AGI exceeds certain threshold amounts.

Exemptions

Exemptions (Secs. 151 and 152) may be claimed for the taxpayer, the taxpayer's spouse, and the taxpayer's dependents.

The amount of each personal exemption for 2009 is \$3,650.

Taxable Income

The amount of income remaining after deducting itemized deductions and exemptions from adjusted gross income is called taxable income.

Example		
Gross income		\$75,000
Less deductions from gross income (IRA contribution)		5,000
Adjusted gross income		\$70,000
Less deductions from adjusted gross income:		
Personal expense deductions:		
Contributions	\$1,500	
Mortgage interest	9,000	
Taxes	<u>6,000</u>	
Total	\$16,500	
Personal exemption	3,650	<u>20,150</u>
Taxable income		\$49,850

For taxpayers who do not itemize deductions, taxable income is defined as adjusted gross income reduced by the standard deduction and personal exemptions.

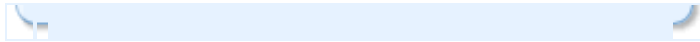
For taxpayers who itemize deductions, taxable income means adjusted gross income less total itemized deductions and personal exemptions.

The Standard Deduction

The standard deduction is made up of two parts: the basic standard deduction and the additional standard deduction. The standard deduction is taken on the tax return in lieu of itemized deductions.

The amount of the 2009 basic standard deduction for each filing status is listed below.

Filing Status	Standard Deduction
Single	\$5,700
Married filing jointly	11,400
Married filing separately	5,700
Head of household	8,350
Surviving spouse	11,400



An additional standard deduction is allowed for those age 65 or over and for those who are blind. The additional standard deduction is the total of additional amounts allowed for age and blindness. The additional amount is allowed if the taxpayer is age 65 or older by the last day of the tax year. An additional amount is allowed for blindness if the taxpayer is blind on the last day of the tax year.

If a joint return is filed, an additional amount will be allowed if the spouse is age 65 or over and an additional amount will be allowed if the spouse is blind.

A married taxpayer who files a separate return will be allowed the additional amounts for his spouse if the spouse had no gross income and was not the dependent of another taxpayer.

The additional standard deduction is not available for dependents.

The dollar value of the additional amount will depend on a taxpayer's filing status, as shown below.

Filing Status	Additional Standard Deduction
Single	\$1,400
Married filing jointly	1,100
Married filing separately	1,100
Head of household	1,400
Surviving spouse	1,100

Example

Bob Eubanks, 46, and Dina Eubanks, 41, are filing a joint return for 2009. Neither is blind. Their basic standard deduction for 2009 is \$11,400. They are not entitled to an additional standard deduction because neither spouse is blind or age 65.

Example

Assume the same facts as in the previous example, except that Bob is blind at the end of 2009. Bob and Dina's basic standard deduction for 2009 is \$11,400. However, they also receive an additional standard deduction of \$1,100 for Bob's blindness. Their total standard deduction is \$12,500.

Those who are age 65 or over and/or blind do not realize any benefit from the additional standard deduction if they claim itemized deductions.

Standard Deduction for Single Dependents

The standard deduction is the *lesser* of:

- \$5,700 or
- The greater of \$950, or earned income plus \$300.

Example

In 2009, Ann Palmer, age 19 and a full-time student who is claimed as a dependent on her parents' return, earns \$3,000 on a summer job and \$500 from bank interest. Her standard deduction is \$3,300 (earned

income of \$3,000 plus \$300), which is less than \$5,700.

Taxpayers generally have a choice between using the standard deduction and itemizing deductions. Where an elderly taxpayer itemizes deductions, he loses any benefit from the additional standard deduction.

Real Estate Taxes

For 2009, home owners who claim the basic standard deduction may also claim an additional standard deduction for state and local real property taxes, up to \$500 (\$1,000 for joint returns) as provided in the [Housing Assistance Tax Act of 2008](#).

Some individuals are required to itemize deductions. If a married couple files separate returns, and one spouse itemizes, the other spouse must also itemize deductions and cannot use the standard deduction.

State and Local Sales Taxes

Taxpayers claiming the standard deduction can add state and local sales taxes paid on vehicles purchased on or after February 17, 2009, and before January 1, 2010, on a cost up to \$49,500. The additional standard deduction amount, however, can only be used if modified adjusted gross income (MAGI) does not exceed \$125,000 for singles, or \$250,000 for joint filers.

The deduction phases out for those with MAGI between \$125,000 and \$135,000 for singles, and \$250,000 to \$260,000 for joint filers; no additional standard deduction can be claimed if MAGI exceeds \$135,000 for singles, and \$260,000 for joint filers.

Planning Pointer:



Weigh carefully a decision to claim an additional standard deduction amount for these taxes. If this option is used, then the taxpayer may not itemize deductions.

Net Disaster Losses

Taxpayers who suffer losses in federal disaster areas can opt to deduct the losses as an additional standard deduction amount rather than itemizing this write-off. The deduction is not subject to the usual 10%-of-adjusted-gross-income floor. However, each disaster loss must be reduced by \$500.

Planning Pointer:



New Schedule L is used to figure the total standard deduction when additional amounts are claimed for real estate taxes, state and local sales taxes, and disaster losses.

Test Your Understanding

1. Deductions from adjusted gross income include all of the following *except*:

- Student loan interest deduction
- Charitable contribution deduction
- Deduction for tax return preparation fees

2. Deductions that are part of miscellaneous itemized deductions subject to the 2%-of-adjusted gross income floor include all of the following *except*:

- Fees paid to an IRA custodian
- Unreimbursed employee business expenses
- Casualty losses

3. In 2009, Matthew Miller has income from wages of \$50,000 and claims a \$5,000 IRA deduction. He paid real estate and state income taxes of \$5,000 and mortgage interest of \$4,000, and he made charitable contributions of \$1,500. His personal exemption amount is \$3,650. His gross income is:

- \$31,000
- \$46,000
- \$50,000

4. In 2009, the standard deduction for a married taxpayer filing a joint return where one spouse is age 65 or older and the other is under age 65 is:

- \$11,400
- \$12,500
- \$13,600

Tax Liability

The actual amount of tax due for the year (the tax liability) is based on taxable income. If taxable income is less than \$100,000, the Tax Table must be used. For taxable income of \$100,000 or more, the tax must be figured on the Tax Computation Worksheet.

Taxpayers with net capital gains and/or dividends must use the Qualified Dividends and Capital Gain Tax Worksheet from the instructions to Form 1040 to figure their tax, regardless of the amount of taxable income. Use of the worksheet ensures that net capital gains and dividends are taxed at no more than the top tax rate of 15% (5% for those in the 10% or 15% tax bracket).


The tax derived from the Tax Table or Tax Computation Worksheet may not be the final tax due because that amount may be increased by other taxes, such as the alternative minimum tax and self-employment tax, or it may be reduced by tax credits.

Pointers on Filing the Return

Be sure the return has been signed by the taxpayer. If a couple files a joint return, each spouse must sign it. Date the return and be sure the correct Social Security numbers have been included.

If a taxpayer wants a third party (a relative, friend, or paid preparer) to be able to talk with the IRS about processing the return, the taxpayer must complete the third party designee information. Check the box to indicate this authorization, which allows communication through the end of the year in which the return is prepared.

Then the taxpayer enters the name and telephone number of the third party and a five-digit personal identification number selected by the taxpayer, which this party can use when talking to the IRS to prove he has authorization.

Planning Pointer:	
	To enable a paid preparer or anyone else to deal with the IRS after the end of the year in which the return was prepared, the taxpayer must complete Form 2848 , Power of Attorney and Declaration of Representative.

Check and recheck the math on the return. Incorrect addition and subtraction are common errors noted by the IRS. The taxpayer should ensure that if the Tax Table was used, the tax was taken from the column appropriate for the filing status. Make sure all required forms and schedules are attached.


Make a copy of the return. This will help the taxpayer in case the return is questioned in the future. It will also serve as a reminder of key items when the taxpayer is completing next year's return. If a taxpayer failed to keep a copy and later wants one, a copy can be obtained from the IRS. To obtain a copy of a return, send [Form 4506](#), *Request for Copy or Transcript of Tax Form*, to the IRS. Include the user fee.

If a payment is due, the taxpayer should make the check payable to the United States Treasury (not the IRS) and write his Social Security number, daytime phone number, and the form number (e.g., "2009 Form 1040") on the front of the check. To ensure prompt crediting of the payment, the taxpayer should place the check and Form 1040-V, *Payment Voucher*, into the envelope with the return. The taxpayer should *not* attach the check or Form 1040-V to the return.

If a payment is due and is not made by check, it can be made by major credit card: American Express, Discover, Master Card, or Visa. This may be done through Official Payments Corporation (800-2PAYTAX or www.officialpayments.com) or LINK2GOV Corporation (888-PAY1040 or www.PAY1040.com). There is a "convenience fee" charged by the credit card companies for making payment in this manner; the IRS does not charge a fee for this payment method.

Alternatively, the balance can also be paid using EFTPS Online, a federal tax payment system over the Internet that effectively pays the tax from a bank account (www.eftps.gov). There is no convenience fee for this payment method.


If a refund is due, it can be credited directly to the taxpayer's bank account if the taxpayer provides the required information on page 2 of Form 1040: account number, type of account (checking or savings), and routing number (ask the bank for its number).

Planning Pointer:	
	Use of Form 8888 permits the refund to be direct deposited into up to three different accounts, including checking, savings, IRAs, and health savings accounts (HSAs), or for the purchase of U.S. savings bonds.

For paper returns, send the return to the appropriate IRS Service Center using certified or registered mail. Alternatively, consider using a certificate of mailing, which is a receipt that provides evidence of the date that return was presented to the U.S. Postal Service for mailing (this is less costly than certified mail).

Although certified or registered mail is not required, it is the best way a taxpayer can prove what day a return was mailed. If the return is sent by regular mail, be sure to include the proper postage (the return will not be delivered with inadequate postage).

Alternatively, use a designated private carrier to mail the return, or file electronically from your personal computer (retain the IRS acknowledgment for an electronically filed return to prove it was received). Refer to IRS.gov/efile for more information on e-filing.

Planning Pointer:	
	Using a certificate of mailing, certified or registered mail or a designated private carrier means that the return is treated as filed on the date it is mailed.

Recent Developments Affecting Fundamentals

The IRS has provided tips on splitting tax refunds to be deposited directly into certain accounts of the taxpayer's choosing. (IRS FS-2008-5, January 2008, at www.irs.gov/newsroom/article/0,,id=177058,00.html).

Tax refunds can be used to buy U.S. savings bonds (see Retirement and Savings Initiatives at www.irs.gov/retirement/article/0,,id=212061,00.html).

See [IRS Publication 17: Your Federal Income Tax](#) for the IRS explanation of the rules for individual income taxation.

See [IRS Publication 553: Highlights of 2008 Tax Changes](#) for the IRS overview of what is new in 2008 and 2009.

Filing Status

Learning Objectives

This chapter was prepared to enable participants to learn about filing status.

More specifically, upon completion, you will be able to:

- Identify which status applies to each individual
- Determine when innocent spouse relief may be appropriate

Introduction

An individual's actual tax liability is determined by (1) gross income less deductions, (2) the respective tax rate or percentage, and (3) tax credits, if any. The tax rate, or percentage, by which the gross income less deductions is multiplied, is not the same for all taxpayers but depends on the taxpayer's filing status (i.e., whether single, married filing jointly, a surviving spouse, head of household, or married filing separately).

Selecting Filing Status

One of the errors most frequently committed by taxpayers and by the preparers of tax returns is selecting the wrong filing status.

Married Persons Filing Joint Returns

Married couples can file a joint return on which they report their combined income and deductions ([Sec. 6013](#)). They can file a joint return even if only one spouse has income.

Marital status is determined as of the last day of the tax year ([Sec. 7703](#)). Thus, for tax purposes, taxpayers are considered to be married for the entire calendar year if they are husband and wife on December 31, regardless of the date of marriage.

A person divorced or legally separated on or before December 31 is single or unmarried for the entire calendar year for income tax purposes. However, a joint return may be filed by a husband and wife who are living apart but are not legally separated by decree of divorce or of separate maintenance.

Example

John Eaton and Jane Eaton were married on May 20, 2009, and were divorced on January 2, 2010. They can file a joint return for the entire year 2009, because they were husband and wife as of December 31, 2009.

Pitfall: Couples in same-sex marriages (which are legal in California, Connecticut, Iowa, Maine [starting mid-September 2009], New Hampshire [starting January 1, 2010], Massachusetts, and Vermont [as of September]) cannot file a joint federal income tax return.

The federal Defense of Marriage Act bans the recognition of same-sex marriages for federal tax purposes. They have to file as single taxpayers (although one taxpayer may qualify as head of household).

If either spouse of a married couple dies during the year, the survivor is considered as having been married for the entire year. Thus, if the survivor did not remarry before the close of the year, he may file a joint return with the deceased spouse.

If the survivor remarries during the year, he can file a joint return with the new spouse but not with the deceased spouse. The return should be signed by the survivor in his own name, followed by the words "taxpayer and surviving spouse."

A joint return for the taxpayer and the deceased spouse generally should be filed by the taxpayer and the executor or administrator of the spouse's estate.

As mentioned previously, married persons filing separately are subject not only to different tax brackets, but also to special rules and restrictions.

The different tax brackets and special rules and restrictions apply only to those taxpayers who are considered "married" but who file separate returns. A taxpayer who is legally separated by a decree of divorce or of separate maintenance before the end of the year or who is married to a nonresident alien is considered "unmarried."

Furthermore, "unmarried" status goes to a spouse who, though not legally separated, lives apart from his spouse, provided the following conditions are met:

- The taxpayer files a separate return.
- He maintains as his home a household that, for more than half of the tax year, is the principal home of a *dependent* son or daughter (including a stepson or a stepdaughter).

Note: A custodial spouse can still qualify as "unmarried" and claim head of household status even though the noncustodial spouse claims a dependency exemption for the child because the custodial parent has waived it.

- He furnishes over half of the cost of maintaining the household.
- The other spouse has not been a member of the household during the last 6 months of the tax year.

Example

Sarah Green was deserted by her husband several years ago. She and her child live in a small apartment, and she provides more than half of the household costs and claims the child as a dependent.

Sarah is considered to be “unmarried” even though still legally married, and may be able to use head of household status.

“Cost of maintaining a household” includes such expenses as rent, mortgage interest, property taxes, property insurance, upkeep and repairs, utilities, domestic help, and food consumed in the home.

Joint filing is advantageous when one spouse has substantially more income than the other. In effect, it allows the couple to average the income between them, resulting in less tax on the total income.

Community Property

In some states, state law provides that most income earned by husband and wife (so-called “community income”) belongs one-half to the husband and one-half to the wife, regardless of who actually earned it.

These “community property states” are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington. Wisconsin has adopted a marital property law similar to community property.

Example

Mr. and Mrs. Steve Lennox, both employed, reside in California. Mr. Lennox earned a salary of \$60,000 during the year. His wife's earnings were \$8,000.

Under California community property law, salaries and wages are community income. Thus, half of the \$68,000 total income belongs to the husband and half belongs to the wife.

Marriage Penalty

When one spouse has high income, and the other has little or no income, joint returns can prove advantageous. However, when couples have incomes that are more or less equal, then a “marriage penalty” results.

This is not a separate tax. Rather, it is the difference between what the couple pays because they are married (and file a joint return) versus what they would have paid had they been single and filed as such.

However, there is some relief from the marriage penalty. Married couples filing joint returns enjoy an increased 15% tax bracket and standard deduction amount. These amounts are twice the amount for single taxpayers. There is also some relief in 2009 and 2010 in the earned income credit.

Planning Pointer:



Although marriage penalty relief is designed to alleviate the problem for two-earner couples, it helps all joint filers in a tax bracket of 15% or higher.

Pitfall: Married couples filing jointly who itemize their deductions do not benefit from the increased standard deduction amount.

On a joint return, each spouse is jointly and individually liable for the entire tax owed unless “innocent spouse” relief applies.

Joint Return Required

In order to claim certain tax benefits, married persons who live together at any time during the year *must* file joint returns.

Some of the tax benefits that married persons can claim only by filing jointly include an IRA deduction for a nonworking spouse, the dependent care credit, the earned income credit, the credit for the elderly, and the \$25,000 rental loss allowance under the passive loss rules.

Further, a married person who receives Social Security benefits and who does not file jointly must automatically include in income 85% of those benefits as the base amount for a married person filing separately.

Bear in mind that the filing of a joint return by a husband and wife is *optional*; they may file separate returns specifically for married persons if they prefer. Alternatively, one spouse may file a separate return and the other, because he has less than \$3,650 of gross income in 2009, will not file a return.

Joint Return Requirements

No joint return can be filed if one spouse reports income using a different taxable year from the other. Because almost all individuals use a calendar year, this seldom presents a problem.

If one spouse is or was a nonresident alien at any time during the taxable year, a joint return may be filed only if the nonresident spouse includes all income, including that from foreign sources, in the return.

Signing a Joint Return

In general, both spouses must sign a joint return. If one spouse is unable to sign because of illness or absence, the other spouse may sign for both if proper authorization to do so is filed with the return. Authorization may be in the form of a letter containing a statement similar to the following:

"I, Anna Dean, residing at 100 Riverside Drive, New York, N.Y., hereby authorize Charles Dean, my husband, to prepare, sign, and file a joint income tax return elected to be filed by us under the Internal Revenue Code for the taxable year 2009.

Dated at New York, New York,

January 20, 2010 (signed by) Anna Dean"

In some cases, a joint return is considered valid even if only one spouse signs the return, and there is no special authorization to do so.

This is true when the return includes the income and expenses of both spouses, neither spouse files a separate return, and there is a history of filing jointly.

Test Your Understanding

1. On November 1, 2009, Andrew Smith weds Olivia Jones. For 2009:

- They are considered married for the entire year and can file a joint return.
- They can choose to file as single or married because they were not married for the entire year.
- They can file a joint return for the portion of the year in which they were married.

2. Married persons must file joint returns to claim all of the following benefits *except*:

- The \$25,000 rental loss allowance.
- The dependent care credit.
- Medical deductions.

Innocent Spouse Relief

Generally, each spouse is jointly and individually liable for the entire tax owed on a joint return. However, a spouse may be entitled to “innocent spouse” relief under certain circumstances. Under this relief, the spouse may avoid liability for the entire amount except the amount relating to the innocent spouse.

An executor may make a request for innocent spouse relief on behalf of a deceased spouse, even if the claim was not initiated by that spouse prior to death. There are three ways to obtain innocent spouse relief.

General Innocent Spouse Relief

Innocent spouse relief can be claimed for *any* understatements of tax attributable to erroneous items of the other spouse. The spouse claiming this relief must have no knowledge (or reason to know) of the understatement.

If this is proven, then the innocent spouse is subject to proportional liability (the spouse is relieved of liability to the extent it is attributable to the portion of the understatement that the spouse did not know or have reason to know).

Separate Liability Relief for Spouses Who Are Divorced, Legally Separated, or Living Apart for at Least Twelve Months

A spouse in this case may elect separate liability. This means the spouse is liable for tax as if he had filed separately. The election must be made within 2 years after the date the IRS begins collection activities.

The election cannot be made if the spouse had actual knowledge of an incorrect item on a joint return that was intended to avoid tax or is fraudulent.

Equitable Relief

The IRS is authorized to provide equitable relief in cases where automatic relief is not available. This relief will be granted, for example, where the spouse did not know, or did not have any reason to know, that funds intended for paying tax were taken by the other spouse for the other spouse’s benefit.

A request for innocent spouse relief is made on [Form 8857](#), *Request for Innocent Spouse Relief*. A separate form must be filed for each year for which relief is sought. The form is *not* filed with the income tax return. Instead, it is filed with the Internal Revenue Service, Stop 840F, P.O. Box 120053, Covington, KY 41012.

Planning Pointer:



To protect the privacy of taxpayers claiming innocent spouse relief, those who have been victims of domestic violence, or those who fear retaliation should write "Potential Domestic Abuse Case" at the top of Form 8857.

Spouses who want to check on their eligibility for innocent spouse relief can do so on the IRS web site at www.irs.gov (click on "Tax Information for Innocent Spouses" under "Individuals").

Tax Court Jurisdiction

The Tax Court can review cases for innocent spouse relief. However, this jurisdiction does not include review of the timeliness of the underlying deficiency in an innocent spouse case. It does not include jurisdiction over a "stand alone" petition to challenge a denial of innocent spouse relief in community property states.

Further, based on a recent Tax Court case, taxpayers now have only a single choice of forum, federal district court, for nondeficiency stand-alone innocent spouse cases.

Test Your Understanding

1. Which of the following statements with respect to innocent spouse relief is correct?

- The IRS is required to grant equitable relief if a request is made.
- The maximum relief is limited to a set dollar amount.
- Innocent spouse relief—whether general relief, separate liability relief, or equitable relief—will not be granted if the requesting spouse had actual knowledge of the understatement.

Married Persons Filing Separately

In a few cases, separate returns will result in a lower tax than would a joint return. It is advisable to figure the tax using both a joint return and separate returns.

Separate filing may provide a benefit where one spouse has large medical expenses, casualty or theft losses, or miscellaneous itemized deductions. This is because the percentage floor for these deductions will be lower when based on separate income.

In the great majority of cases, married persons filing separate returns are at a distinct disadvantage. For one, while the tax brackets on the joint return result in the lowest tax of all, the tax brackets for separate returns result in the highest tax, higher even than for single persons.

Also, the standard deduction is not available to one spouse when the other spouse itemizes. Further, certain tax benefits are denied or curtailed to married persons who file separate returns.

Because the tax liability generally rests on both spouses equally if they file jointly, regardless of who earned the income, some married individuals do insist on filing separate returns to avoid being held liable for the other spouse's tax.

Planning Pointer:



An individual who is experiencing marital difficulties may want to file a separate return to avoid liability for his spouse's taxes.

An innocent spouse may in some cases be relieved of tax liability and penalties attributable to income omitted from or expenses inflated on a joint return by the other spouse.

If husband and wife residing in other than a community property state file separate returns, each spouse reports his actual income.

In a community property state, on the other hand, each spouse must report one-half of the combined community income because that portion legally belongs to him under state law. The various community property states also recognize certain types of income as non-community income. Such income, therefore, belongs entirely to one spouse or the other.

In some states, interest or dividends received on bank deposits made by one of the spouses before the marriage is non-community income and belongs to that spouse alone.

The same is true in some states in the case of interest and dividends on securities purchased before marriage. Such non-community income would be shown on that spouse's separate return. For this reason, joint returns are frequently advantageous to community property state taxpayers as well, because they provide for income splitting of *all* income, whether community income or not.

Changing Filing Status

Married persons who qualify to file a joint return, but choose to file separate returns, may nevertheless change their minds and file an "amended" joint return within 3 years from the regular due date for filing the original return, without paying the full joint tax liability.

Form 1040X is used to file an amended return. However, they cannot change their minds the other way: if they file a joint return, they may not, after the due date, amend the return and file separately.

Heads of Households

Congress realized that many unmarried individuals provide a home for their children or other relatives, and that they should therefore be granted some measure of tax relief.

Accordingly, the head of household classification was established ([Sec. 2](#)), and individuals qualifying as heads of household became entitled to use special reduced tax rates, a higher standard deduction than other singles, and more favorable AGI limitations than singles (these limits are applicable to a number of breaks).

A head of household is an unmarried taxpayer (but not a surviving spouse), who maintains as his home a household that is the principal residence of one or more qualifying person(s) (in most cases, you do not have to be eligible to claim that person as a dependent). A qualifying person includes:

- Qualifying child
- Qualifying relative

Pitfall: A married child is a qualifying relative for purposes of head of household status only if the taxpayer can claim the child as a dependent.

For purposes of determining whether a child is qualifying, the child (unless permanently and totally disabled) must be younger than the person claiming head of household status (Fostering Connections to Success and Increasing Adoptions Act of 2008 ([P.L. 110-351](#))).

Note: A married child's divorced or separated custodial parent can qualify as a head of household although the parent allows the noncustodial parent to claim the dependency exemption for the child.

Social Security Number for Dependent

Head of household status will be denied if the required tax identification number is not provided for the dependent. In the case of a child placed with a taxpayer for adoption, apply for an Adoption Taxpayer Identification Number (ATIN) on [Form W-7A, Application for Taxpayer Identification Number for Pending U.S. Adoptions](#).

Once the adoption is final, apply for a Social Security number on Form SS-5, *Application for a Social Security Card*.

Planning Pointer:



A taxpayer who has not received a dependent's tax identification number by the filing due date should request a filing extension, gaining 6 more months to have the required number when the return is filed. Returns filed electronically will not be accepted without the taxpayer identification number.

Support Requirement

In addition, the taxpayer qualifying as head of household must have furnished over half the cost of maintaining that household.

The household in which the relative (other than dependent parent) lives must be the taxpayer's home as well. In other words, the taxpayer and the qualifying relative must have lived in the same household for more than half of the year. (If the qualifying relative was born or dies during the year, the tests are applied to the portion of the year the relative was alive.)

Temporary absences for vacation, sickness, school, etc. are disregarded in determining whether a related person actually lived in the household. However, there is one exception to the joint residence requirement: A parent who is the taxpayer's dependent *need not* live in the taxpayer's home.

If the taxpayer furnishes more than half of the cost of maintaining the parent's home for the *entire year*, the taxpayer will qualify as head of household, even though the parent, or parents, do not live in the same home as the taxpayer.

Example

Ray Kramer's dependent mother lived with his sister in a separate apartment. It cost \$14,000 to maintain that home for the year. Ray contributed \$9,000, and his sister paid \$5,000. The mother had no income and contributed nothing toward maintaining the home.

Because Ray paid over half the cost of maintaining the home for his mother for the year, he qualifies as a head of household.

Example

Jessica Crenshaw pays over half of the cost of keeping her mother in a rest home. This is considered as maintaining a home for her. Therefore, Jessica may claim head of household status.

If one spouse was a nonresident alien during any part of the year, the other spouse will qualify as head of household if the other tests are met. If one spouse died during the year, the other spouse is entitled to file a joint return with the deceased spouse (or with the new one, if he remarried during the year) and, thus, cannot qualify as head of household.

Also considered as "unmarried," and thus entitled to head of household status, is a married taxpayer living apart from his spouse who qualifies under the special provision discussed earlier, that is:

- He files a separate return,
- He maintains a household that for more than half of the year was the principal residence of the taxpayer's dependent child, and
- The other spouse was not a member of the household during the last 6 months of the year.

Any other married taxpayer who files a separate return does not qualify as head of household and must use the tax rates for married persons filing separately.

Test Your Understanding

1. Which is *not* a requirement for head of household status?

- The taxpayer must provide over half the cost of maintaining the household for the qualifying relative.
- The taxpayer's parent, who qualifies as a dependent, must live in the same home as the taxpayer.
- The taxpayer must provide a Social Security number for the qualifying relative.

Surviving Spouses

The law grants a special tax consideration to certain recently widowed individuals by permitting them to use the tax rates normally reserved for married couples filing a joint return ([Sec. 2](#)). A "surviving spouse," called a qualifying widow or widower on the tax return, is a widow or widower who meets the following requirements:

- The taxpayer's husband or wife died in either of the 2 preceding tax years.
- The taxpayer was *entitled* to file a joint return with the deceased spouse for the year of death. (It is not required that they actually filed jointly.)
- The taxpayer has not remarried.
- The taxpayer furnishes over half the maintenance of his home, which is the principal residence of the taxpayer's son, daughter, stepson, or stepdaughter for whom the taxpayer may claim an exemption.

Example

Russ Eaton's wife died January 15, 2009. Russ continues to live in their home with their dependent child. Assuming that he has not remarried, he is considered "married" for the entire year of 2009 and can file a joint return for that year, claiming his deceased wife's exemption.

For 2010 and 2011, Russ is considered to be a "surviving spouse" (assuming the child continues to be a dependent). Being a surviving spouse entitles him to use the joint return rates but does not entitle him to an exemption for his deceased wife.

Recent Developments Affecting Filing Status

- The Tax Court has held that the two-year limitation on equitable relief claims is invalid ([Lantz, 132 TC No. 8 \(2009\)](#)).
- An innocent spouse cannot recoup payments made from community property ([Ordlock, CA-9, 2008-2 USTC ¶50,457](#)).
- Equitable relief was denied to a spouse who had community property income attributed to him because the couple did not file a joint return ([Christensen, CA-9, 2008-1 USTC ¶50,312](#)).
- The IRS can reverse the grant of innocent spouse relief if, upon further review, it determines that the relief was unwarranted ([Chief Counsel Memorandum 200802030](#)).

See [IRS Publication 501: Exemptions, Standard Deduction, and Filing Information](#) for the IRS explanation of filing status.

See [IRS Publication 971: Innocent Spouse Relief](#) for rules on claiming such relief.

Exemptions

Learning Objectives

This chapter was prepared to enable participants to learn about personal exemptions.

More specifically, upon completion, you will be able to:

- Identify the amount of each exemption
- Determine eligibility for a dependency exemption
- Determine the phaseout of exemptions for high-income taxpayers

New This Year

Exemption indexed for inflation: As a result of cost-of-living adjustments, the amount of the exemption in 2009 is \$3,650.

Introduction

As previously stated, taxpayers are allowed one or more exemptions in computing taxable income. Inasmuch as each exemption legally claimed reduces taxable income by a significant amount, the rules governing this subject are of great importance. For 2009, each personal exemption is \$3,650.

The exemption amount is phased out for higher-income taxpayers. The phaseout (or reduction) is based on adjusted gross income.

New for 2010

In 2010, there will be no phaseout of exemptions for high-income taxpayers.

Exemptions for Taxpayer's Spouse

If taxpayers are married at the end of the year and file *separate* returns, they may claim similar exemptions for their spouse, but only if the spouse had no gross income for the year and is not claimed as a dependent by another taxpayer.

If husband and wife file a joint return, the personal deductions of both are combined on the return because both are considered as "taxpayers," regardless of whether each spouse had income. (A husband and wife may file a joint return even though one of them has no income.)

On a separate return, in contrast, the wife's exemption may be taken by the husband (or vice versa) *only if she has no gross income* and is not a dependent of another taxpayer and does not file her own return. If the wife also files a return, she will, of course, claim her own exemption on her return; neither spouse may use any part of the exemption to which the other is entitled.

If a taxpayer's spouse dies during the year, the taxpayer may claim the deceased spouse's exemption in full on a separate return if the deceased spouse had no income and if the taxpayer has not remarried by the end of the year. If the deceased spouse had gross income, the taxpayer may file a joint return and claim the deceased spouse's exemptions.

If the couple were legally separated by decree of divorce or of separate maintenance at the close of the year (or on the date of death if one died during the year), neither spouse may claim the other's exemptions.

Exemptions for Dependents

Although the rules governing personal exemptions are brief and relatively simple, the rules governing the exemption for dependents are somewhat more involved and require greater explanation.

One exemption deduction is allowed for each dependent that taxpayers are legally permitted to claim on their returns.

There are two classes of dependents: qualifying children and other qualifying relatives.


Ordinarily, an individual cannot be claimed as a dependent unless all of the following conditions, or tests, are met. However, as indicated, there are exceptions to some of these tests.

Tests for qualifying children:


- **Qualifying child test.** This is based on a relationship and living arrangement. For purposes of a qualifying child, the term “children” includes natural children, stepchildren, adopted children (including those placed for adoption), and eligible foster children (those placed with a taxpayer by an authorized adoption agency or court). A qualifying child also includes grandchildren and brothers and sisters (including stepsiblings).

The child must be under age 19, under age 24 and a full-time student, or permanently disabled (any age). The child must live in the taxpayer’s household for more than half the year. (There is an exception for a child of divorced parents, explained more fully later in this course). The child must be younger than the person claiming the exemption (unless the child is permanently and totally disabled).

A child kidnapped by someone other than a family member continues to be treated as a member of the household until the year in which he would have attained age 18. A child who is older than the age limit and not disabled can still be a dependent but would have to meet the rules for a qualifying relative; these rules are explained later.

Planning Pointer:	
	If a child does not live with the taxpayer, then the child may still qualify as the taxpayer’s dependent if the following tests for qualifying relative are met; the child is not treated as a qualifying child and may prevent a taxpayer from claiming other tax breaks (e.g., child tax credit).

- **Modified support test.** A qualifying child must not have provided more than half of his own support. Amounts received as scholarships are *not* counted as support.

Planning Pointer:	
	In the past, a taxpayer had to provide more than half a child’s support in order to claim a dependency exemption. Now all that is required is that the child does not provide more than half of his own support. Also, the gross income test that applies to a qualifying relative (below) does not apply to a qualifying child.

- The citizenship or residence test (discussed below).
- The joint return test (discussed below).
- Social Security numbers (discussed below).

Qualifying relative tests. If an individual does not meet the tests for qualifying child, then that individual may still be claimed as a dependent if he/she meets the tests for qualifying relative:

- **The support test.** The taxpayer must have furnished more than one-half of the dependent’s support during the year. There are two exceptions: (1) multiple support agreements and (2) children of divorced or separated parents.
- **The gross income test.** The dependent’s gross income must be less than the amount of one exemption deduction (i.e., \$3,650 for 2009).
- **The relationship or member of household test.** The dependent must be a qualifying relative of the taxpayer *or*, if not related, must be a member of the taxpayer’s household for the entire year.
- **The citizenship or residence test.** The dependent must be a U.S. citizen or a resident of the United States, Canada, or Mexico.
- **The joint return test.** The dependent must not have filed a joint return for the same year with his spouse.
- **Social Security number.** The Social Security number (or appropriate taxpayer identification number) for each dependent must be provided.

Example

Sam Allen completely supports his daughter Beatrice (who is married to a doctor interning at a hospital for a small salary) and her baby son Charles. Beatrice has no income. Beatrice, her husband, and Charles live with Sam.

Sam can claim an exemption for Beatrice, his child, because she meets all the tests for a qualifying dependent. He cannot claim an exemption for Beatrice's son Charles; only his parents (Beatrice and her husband) can.

Note: A taxpayer's wife (or husband) is never a dependent. For this reason, the taxpayer need not furnish his wife's support to claim her exemptions, even though he files a separate return.

By the same token, if the wife has any gross income, the husband (filing separately) cannot claim her exemption, even though she is a member of his household and receives more than one-half of her support from him.

Following is a review of the requirements that must be met before an individual can qualify as a dependent. A taxpayer is not required to detail each of the following requirements on the return; he simply claims the dependency exemption to which the taxpayer is entitled.

The Support Test

During the calendar year, the taxpayer must furnish *more than one-half of the total support* of the dependent who is not a qualifying child. In determining whether an individual received over half his support from the taxpayer, it is necessary to compare the amount of support provided by the taxpayer with the entire amount of support the individual received from all sources, including support provided by the dependent's own funds.

"Total support" is generally the total expenditures incurred in furnishing food, shelter, clothing, education, medical and dental care, entertainment, transportation, and similar necessities to the dependent. Property and lodging furnished as a part of total support are measured by their fair market and rental values.

One who receives Social Security benefits (although these benefits are not taxable) provides his own support to the extent the funds are spent for support items. Income taxes—whether federal, state, or local—are not a part of total support.

Neither are life insurance premium payments, medical reimbursements (including coverage from Medicare or Medicaid), or funeral expenses. However, the amount spent for clothing is part of total support.

Example

Ira Bell had the following expenditures during the year:

1. Food and lodging	\$12,000
2. Clothing	700
3. Medical expenses	1,400
4. Life insurance premiums	<u>1,500</u>
Total	\$15,600

Ira had no income during the year. However, he had \$6,000 in his savings account, of which he used \$1,500 to pay his insurance premiums and the remaining \$4,500 to pay his other expenses. The balance was provided by his sister.

Ira's total support was \$14,100 (items 1, 2, and 3), of which \$4,500 was provided by Ira himself and \$9,600 by his sister. Because the sister furnished more than half of his support, she can claim the exemption because Ira is her dependent.

Amounts received as scholarships for study at an educational institution by a taxpayer's child, stepchild, or legally adopted child are not taken into account in determining total support. However, amounts received by veterans for tuition payments and allowances while attending school are not considered as scholarships and do count toward total support.

Example

Jamie Davis's son receives a college scholarship valued at \$8,000. In the same year, Jamie provides her son's only other support: \$7,000. Jamie may claim her son as a dependent because the scholarship is not counted in determining total support.

If a dependent lives in a house owned by the taxpayer claiming him as such, total support is the sum of (1) the fair rental value of the lodging furnished to the dependent, (2) all items of expense spent directly by or upon the dependent (such as for clothing and health care), and (3) a proportionate share of the expenses incurred in supporting the whole household that cannot be directly attributed to each individual (such as for food).

Example

Sean Baron's mother, Beth Baron, lives with him, his wife, and their two children. Beth received \$10,000 in Social Security benefits, which she spent for clothing, entertainment, and so on. Sean's total expense in providing food for the household is \$6,000.

He also paid his mother's medical expenses of \$7,000. The fair rental value of the room furnished to the mother is \$6,000 per year, based on the cost of comparable rooming facilities. Under these facts, Beth's total support is computed as follows:

1. Fair rental value of lodging		\$6,000
2. Direct expenses paid by dependent	\$10,000	
Direct expenses paid by taxpayer (medical)	7,000	
3. Total direct expenses		17,000
4. Pro rata expenses for food (1/5 of \$6,000)		<u>1,200</u>
Total support		\$24,200

Because the support furnished by Sean (\$6,000 lodging + \$7,000 medical expenses + \$1,200 food = \$14,200) exceeds one-half of the \$24,200 total support, he may claim his mother as a dependent.

If the dependent lives in a rented home, the value of lodging furnished in support is a proportionate share of the rental expense.

Example

Dave Duncan's mother lives with him, his wife, and their two children. The yearly rental expense for all five is \$9,600. The value of lodging furnished to the dependent (to be considered with other items of support) is one-fifth of \$9,600, or \$1,920.

If the dependent lives in his own home, the fair rental value of the home is considered as being contributed by the dependent to his own support.

Example

Carol Ramos contributes \$10,000 to support her father. The father lives alone in a house he owns. It has a fair rental value of \$9,000. Carol can claim an exemption for her father because she furnished more than one-half of the \$19,000 (\$10,000 + \$9,000) total support.

The dependent need not have been living the entire year. Thus, if a child is born alive (not stillborn) at any time during the year, a *full* exemption may be claimed for the child. The same is true of a dependent who died during the year. As long as the taxpayer furnished more than one-half of the dependent's support during the period of the year that the latter was living, the taxpayer may claim the full exemption.

A dependency exemption may not be divided between spouses filing separate returns but should be claimed in full by the taxpayer entitled to the deduction.

Test Your Understanding

1. All of the following are requirements to claim an exemption for a dependent (other than a qualifying child) *except*:

- The dependent does not file a tax return.
- The taxpayer furnishes over half the dependent's support (disregarding multiple support agreements and divorced parents).
- The dependent is a U.S. citizen or resident of the United States, Canada, or Mexico.

Exceptions to the Support Test

There are two exceptions to the general more-than-one-half-of-the-support test requirement. One deals with taxpayers filing multiple support agreements, and the other concerns children of separated or divorced parents.

Multiple Support Agreements

This provision was enacted to alleviate hardship where, as is frequently the case, several persons combine to support a relative or other individual, but no one person alone furnishes more than one-half of the support.

Under this provision, if more than one-half of the support of a qualifying relative during the calendar year was furnished by two or more persons, each of whom would be entitled to claim the exemption except for the fact that he or she did not furnish more than one-half of the support, one of this group may claim the exemption if:

- He or she furnished more than 10% of the support, and
- Each of the others who contributed more than 10% of the support signs a [Form 2120](#), *Multiple Support Declaration*, stating that he or she will not claim the individual as a dependent for the taxable year.

The statements should be filed with the return of the person who claims the exemption.

Example

Jake Westbrook, his brother, and his two sisters furnished the entire support of their mother. Jake furnished 45%, the brother furnished 35%, and the sisters each furnished 10%.

Either Jake or his brother may claim an exemption for their mother, provided that the other files a written statement that he will not claim an exemption for her.

Because neither of the sisters furnished more than 10% of the mother's support, neither of them qualifies for the exemption. Consequently, the sisters need not file the statement.

Example

Janet Brown and her brother each furnished 20% of their mother's support. The remaining 60% of her support was furnished in equal shares by two persons not related to her and with whom she does not live.

Because over one-half of the mother's support was not furnished by persons who, but for the support test, would have been entitled to claim an exemption for her, the exemption for a dependent may not be claimed by anyone.

Planning Pointer:



In deciding which of the support contributors should claim the exemption under a multiple support agreement, be sure to take into account the impact, if any, of the partial phaseout of personal exemptions.

For example, it would be foolish for a high-income individual subject to the phaseout to be the person designated to claim the exemption when the exemption would provide greater tax savings for another support contributor.

Planning Pointer:



Medical expenses paid by a taxpayer for a parent (or other potential dependent) who is claimed as a dependent by another taxpayer under a multiple support agreement are not deductible.

Only the taxpayer claiming the exemption is entitled to deduct medical expenses paid on behalf of the dependent. Therefore, it is advisable that he or she pay as much of these expenses as possible.

Test Your Understanding

1. Amy, Beth, and Carol James all contribute to the support of their mother. Amy pays 5%, Beth pays 20%, and Carol pays 30%. Who can claim a dependency exemption for the mother under a multiple support agreement (assuming other requirements are met)?

- Amy, Beth or Carol
- Beth or Carol
- Carol only

Special Rules for Children of Divorced Parents

Special rules apply in determining which parent can claim an exemption for a child when the parents are not married. The exemption usually belongs to the custodial parent. The noncustodial parent can claim the exemption if these conditions are met:

- The child receives more than half of his or her support from the parents.
- A decree of divorce or separation agreement between the parents states that the noncustodial parent is entitled to claim the dependency exemption or the custodial parent signs a written declaration that he or she will not claim the exemption. (Under proposed regulations, the release of the right to claim the exemption can be revoked by providing written notice to the other parent.)

If there is no divorce decree or separation agreement with a statement on the dependency exemption for the noncustodial parent or the custodial parent fails to sign a written declaration waiving the exemption, then a "tiebreaker" rule applies.

Under this rule, the exemption belongs to the parent with whom the child resided for the greater amount of time, or if equal time, the parent with the higher adjusted gross income is treated as the custodial parent.

Thus, the custodial parent will usually prevail because the child is a member of the custodial parent's household for more time during the year than the child is a member of the noncustodial parent's household.

Planning Pointer:



The noncustodial parent must attach to his or her return the written declaration by the custodial parent waiving the right to claim the exemption. [Form 8332](#), Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent, can be used.

It is usually advisable for the custodial parent to sign the waiver each year rather than provide a permanent waiver to provide flexibility for changes in the parents' respective circumstances, unless so ordered by the terms of a divorce decree or written separation agreement to execute a permanent waiver.

Planning Pointer:



The IRS has explained the circumstances in which a child of divorced or separated parents is treated as a dependent of both (without any signed waiver by the custodial parent) ([Rev. Proc. 2008-48](#)). These situations include:

- The exclusion from gross income of:
 - Certain employer reimbursements of medical care expenses incurred for the employee's child;
 - Employer contributions to an accident or health plan on behalf of the employee's children; and
 - Fringe benefits qualifying as no-additional-cost services or qualified employee discounts that are treated as used by the employee due to use by an employee's child;
- The deduction of medical expenses of the taxpayer's child; and
- The exclusions for distributions from Archer Medical Savings Accounts and Health Savings Accounts if the distributions are used to pay qualified medical expenses of the account beneficiary's child.

Pre-1985 Decrees or Agreements

In the case of a child whose parents divorced before 1985, the dependency exemption can be claimed by the noncustodial parent as long as he or she provides at least \$600 for the support of the child during the year.

The fact that the noncustodial parent is behind in child support payments has no impact on claiming the exemption (as long as the \$600 threshold is met).

Test Your Understanding

1. **Susan Eaton's parents divorce in 2009. Under the terms of the divorce decree, the couple has joint custody. Susan, who is 10 years old, resides with the mother but has generous visitation with the father. The father pays about 60% of her support; the mother about 40%. The divorce decree is silent on the question of the exemption for Susan. Form 8332 is not signed. Which statement is correct?**

- The mother may claim a dependency exemption for Susan.
- The father may claim a dependency exemption for Susan.
- Both the mother and the father must apportion the exemption 60/40.

The Gross Income Test

The second requirement for the dependency exemption of a qualifying relative is that the dependent's gross income (if any) must be less than the amount of one exemption deduction. Thus, if he or she earned gross income of \$3,650 for 2009, that person could not qualify as a dependent for that year.

Although the dependent's tax-exempt (or nontaxable) income is not included for the gross income test, it must be taken into consideration in meeting the support test.

When excludable Social Security benefits, welfare payments, armed forces family allotments, life insurance proceeds (all tax-exempt income items, as explained later), and other nontaxable income provide part of the support of a dependent, these amounts are included in total support in determining whether the taxpayer has provided over one-half of the support.

Example

David Mann contributed \$5,000 to his mother for her support during the calendar year. In addition, his mother had interest income of \$1,200 and received Social Security benefit payments of \$12,000. All of these receipts were used for her support.

Although his mother's gross income is only \$1,200 (Social Security payments that are not taxed are excluded), David may not claim his mother as a dependent because his contribution of \$5,000 is not more than half of her total support of \$18,200 (\$5,000 + \$1,200 + \$12,000).

Had David contributed more than \$9,100 to her support during the year, he would have been able to claim her as a dependent (assuming the other tests were met), as he would have contributed more than half of the total support.

The gross income test does not apply to a dependent who is a qualifying child of the taxpayer.

The Relationship or Member of Household Test for Qualifying Relatives

Another requirement that must be met before a dependency exemption can be claimed is that the dependent must *either* be related to the taxpayer *or* be a member of the taxpayer's household *for the entire year*.

An individual is considered a member of a taxpayer's household for the entire year even if he or she is temporarily absent for vacation, school, business, sickness, and so on.

The fact that the dependent died during the year will not deprive the taxpayer of the deduction if the dependent lived in the household for the entire part of the year preceding death.

Likewise, if a child is born during the year and becomes a member of the taxpayer's household immediately after birth (or after release from the hospital), he or she will be considered a member of the taxpayer's household for the entire year.

Example

Chris Danken agreed to take a Romanian orphan into his home for two years, starting February 1, 2009. In September 2009, Chris enrolled the child in a boarding school away from home, where he is to remain until January 2011. Chris provided more than one-half of the support during both years.

He can claim a dependency exemption for 2010, even though the child was temporarily away from his home.

However, he does not qualify for 2009 because the child did not become a member of the household until February.

Remember that the dependent must be a member of the taxpayer's household only if he or she is *not related* to the taxpayer. If the dependent is a relative by blood, marriage, or adoption, it is immaterial whether or not he or she is a household member.


Only the following individuals are considered "relatives":

- Child (including a legally adopted child), grandchild, or great-grandchild
- Stepchild, but not the stepchild's children or grandchildren
- Brother or sister, half brother or half sister, or stepbrother or stepsister
- Parent, grandparent, or great-grandparent (but not foster parent)
- Stepfather or stepmother
- A brother or sister of the taxpayer's father or mother
- A son or daughter of the taxpayer's brother or sister
- Father-in-law, mother-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law

Once any of these relationships is established, it will not be terminated by death or divorce. For instance, a taxpayer may continue to claim an exemption for supporting his mother-in-law even though death or divorce has dissolved the marriage.

If a taxpayer and his wife file a joint return, it is not necessary to show that the dependent is related to both. Thus, on a joint return, an exemption may be claimed for the wife's uncle.

However, if they file separate returns, the husband cannot claim his wife's uncle unless the uncle is a member of the taxpayer's household and lives with him for the entire taxable year.

Planning Pointer:	
	If two people each claim an exemption for a dependent, the exemption belongs to the person who is the dependent's parent. If neither of these people are the dependent's parent, the exemption belongs to the one with the higher adjusted gross income.

A taxpayer's housekeeper, maid, or other employee is not considered the taxpayer's dependent, even if a member of his or her household for the entire year.

The Citizenship or Residence Test

Another requirement for the dependency exemption is that the dependent be a citizen or resident of the United States or a resident of Canada or Mexico. A taxpayer may not claim anyone living in any other part of the world as a dependent unless that person (1) is a citizen or a resident of the United States or (2) was a resident of the United States, Canada, or Mexico for some part of the taxable year.

The Joint Return Test

The final requirement is that the dependent, if married, must not have filed, for the same year, a joint return with his or her spouse.

Example
Steve Shields supported his daughter while her husband served with the U.S. Army in Europe. She had no income. Steve can claim her as a dependent only if her husband filed a separate return.

However, this rule will not disqualify a dependent if neither spouse was required to file a return and a joint return was filed only to obtain a refund of tax withheld.


Social Security Numbers for Dependents

Social Security numbers are required for all individuals who are claimed as dependents or as qualifying children for purposes of the earned income credit. There are no exceptions. To obtain a Social Security number for a child, contact the local Social Security Administration office to obtain Form SS-5, *Application for a Social Security Card*. Usually, hospitals provide this form to parents of newborns.

Children placed for adoption cannot receive Social Security numbers until the adoption is final. In the case of a U.S. adoption, obtain an Adoption Taxpayer Identification Number (ATIN) for the child by filing [Form W-7A, Application for Taxpayer Identification Number for Pending U.S. Adoptions](#). Once the adoption is final, then apply for a Social Security number.

Pitfall: Failure to include the Social Security number or applicable taxpayer identification number can result in the loss of the exemption.

Planning Pointer:

 If the tax identification number for the dependent is not available by the due date of the return, the person claiming the dependency exemption should request a filing extension to gain six months in which to obtain the needed tax identification number.

Recent Developments Affecting the Dependency Exemption

- For tax years beginning after July 2, 2008 (i.e., 2009 and subsequent tax years), a custodial parent must release a claim of dependency exemption on Form 8332 or on a separate release document that has as its only purpose the release of a claim to exemption ([Chief Counsel Advice Memorandum 200925041](#)).
- Dependency exemptions allowed for nieces who each met the definition of qualifying child ([Pavia, TC Memo 2008-270](#)).
- There is a unified definition of a qualifying child (Fostering Connections to Success and Increasing Adoptions Act of 2008, (P.L. 110-351)).
- A noncustodial parent awarded the right to a dependency exemption by a divorce court cannot claim the exemption without a written waiver from the custodial parent ([Walker, TC Memo 2008-194](#)).
- Final regulations clarify the dependency exemption for separated and divorced parents (T.D. 9408, 7/1/08, corrected 7/23/08).
- A dependency exemption is allowed for an unrelated child if (1) the child's parent is not required to file a return and (2) the parent does not file a return or only files one to obtain a refund ([Notice 2008-5, IRB 2008-2, 256](#)).
- Although an exemption for an unrelated child may be allowed, this does not mean the taxpayer is eligible for other family tax breaks, such as the child tax credit, earned income credit, or dependent care credit, because these credits require the child to be the taxpayer's qualifying child (not merely a qualifying relative) ([Chief Counsel Advice Memorandum 200812024](#)).

See [IRS Publication 501: Exemptions, Standard Deduction, and Filing Information](#) for the IRS explanation of exemptions and dependents.

Example of Filled-In Form 1040

Note: On all of the following forms, bracketed numbers reference the paragraph numbers below as the source for the line's entry.

1. Reproduced below is an illustrative Form 1040 for the calendar year 2009 and worksheets (not filed with the return). The taxpayers are John C. Scott and Mabel A. Scott, his wife, who file a joint return and report on the cash basis.

2. John Scott (SS# 611-19-5023), a U.S. citizen, lives at 145 Oakview Lane, Pittsburgh, PA 15218. He is 66 years old, and his wife, Mabel (SS# 658-01-6253), is 56. Both have good vision. Their son, Howard (SS# 711-12-5501), age 27, is in his third year of full-time graduate study at the University of Pittsburgh. Howard was supported during the year as follows:

By earnings from a part-time job	\$2,000
By father	12,000
Total	\$14,000

Their daughter Ann (SS # 543-21-9876), is a 16-year-old high school student who does not work.

3. Mr. Scott received \$6,000 of Social Security benefits.

4. The Scotts entirely supported Mr. Robert R. Smith (SS# 130-12-1089), age 80, whose wife (who died five years ago) was Mr. Scott's aunt. R. R. Smith had no gross income, and he has lived in the Scott residence for the past five years.

5. Mrs. Scott has been controller of the Johnson Manufacturing Company in Pittsburgh, Pa., since May 1, 2009. Her gross salary for the eight months was \$43,000 (\$5,375 per month). Her payroll deductions were \$8,592 federal withholding tax and \$3,289.50 FICA tax. While away from home on company business, she spent \$1,000 for travel and \$500 for lodging. To cover these kinds of expenses, Scott received an expense allowance of \$375 per month for six months that her employer did not report on her Form W-2. She accounted to her employer for her expenses, but she was not required to return the extra \$750 of allowances over her expenses. Thus, this surplus allowance was reported on her W-2. In addition, while away from home on company business, Scott also incurred \$750 of meals and entertainment expenses, which her employer reimbursed in full. Schedule M must be completed so that the Scotts receive the making work pay credit with respect to her wages.

6. Before her employment with the Johnson Manufacturing Company, Mrs. Scott had been assistant controller with the Elaborate Foundry Company in St. Louis. Her gross salary there for 2009 totaled \$8,400 (four months at \$2,100 per month). Among her payroll deductions were \$1,108 Federal withholding tax and \$642.60 FICA tax.

7. The Scotts paid \$1,025 for moving expenses from St. Louis to Pittsburgh, which is a distance of 852 miles. When they resided in St. Louis, Mrs. Scott had lived 10 miles from the Elaborate Foundry Company.

8. Mr. Scott operates a television repair shop as a sole proprietorship under the name of Scott Electronics Shop. The books are kept on the accrual basis, and net income before taxes for 2009 was \$3,000. This income is determined on Schedule C.

9. The Scotts held the following bonds during the entire year. All were purchased at par and are in joint name.

Description	Date Issued	Principal	Interest Rate	Interest Received
AB Corporation Bonds	7/1/98	\$10,000	5%	\$500
CD Corporation Bonds	1/1/04	6,000	7%	420
Borough of Bellevue Bonds	6/1/84	10,000	4½%	450
AE Corporation Bonds	5/1/99	9,000	7½%	675

10. Mr. Scott received ordinary dividends of \$692 on an investment in La Vie, a corporation in a foreign country (which is not traded on a U.S. exchange), and that income is also subject to U.S. income tax. Mr. Scott is entitled to a \$50 credit for tax paid to the foreign country. Show the income on the appropriate line on Form 1040.

11. Mr. and Mrs. Scott received ordinary cash dividends from ABC Corp. of \$2,800 during the year and capital gain distributions in December from ABC Corp. of \$1,000.

12. In 2009, the Scotts received \$2,100 as a refund of state income taxes paid in 2008. In 2008, they had itemized their deductions. (Assume the refund is fully taxable).

13. While Mr. Scott was making a speech on the evening of June 14 at Soldiers and Sailors Memorial Hall, his personal automobile, which he had purchased only five months before for \$12,000 cash, was stolen. The automobile was never recovered, and the insurance company paid him \$11,300 in full settlement on December 14, 2009. Fair market value of the automobile immediately before the theft was \$11,500. Mr. Scott received an honorarium of \$25 for the speech.

14. Mr. Scott served on jury duty, receiving payment of \$375.

15. The Scotts' *stock holdings and transactions* were as shown below.

Kind of Stock	Date Acquired or Basis Date	Date of Sale	Cost or Other Basis	Selling Price	Expense of Sale
FF Co., Common (see Note (a), below)	2/5/87	6/12/09	\$4,000	\$31,000	\$90
ZZ Co., Common (see Note (b), below)	7/2/09	---	500	---	---
HH Co., Preferred (see Note (c), below)	3/1/03	3/15/09	4,000	25,000	50
GG Co., Common (see Note (d), below, and (16–17))	10/11/86	8/31/09	800	1,100	40

Notes on stock holdings and transactions:

a. FF stock purchased for cash on February 5, 1987.

b. ZZ stock purchased for cash on July 2, 2009. On November 15, 2009, the ZZ Corporation was adjudicated bankrupt, and the stock was worthless.

c. The stock of HH Company was inherited from Mrs. Scott's father, who purchased it in 1941 for \$6,000. The father died on March 1, 2003, at which date the stock was worth \$4,000, and its fair market value when distributed by the executor on July 1, 2004, was \$4,200. The executor made no election to use alternate valuation for estate tax purposes.

d. One hundred shares of GG Company common stock (certificate No. 18523) purchased on October 11, 1986, for \$80 a share.

16. On July 24, 2009, Mr. Scott received certificate No. 29431 for 10 shares of GG Company common stock as a 10 percent stock dividend on the common stock. Fair market value per share on this date was \$95.

17. On August 31, 2009, Mr. Scott sold 10 shares of GG Co. (certificate No. 29431) at \$110 per share.

18. Mr. Scott made a \$1,000 loan to A. Blade on December 8, 1994. On September 1, 2009, the loan was deemed worthless as Blade died after a long illness and left no estate.

19. The Scotts have a \$20,000 short-term capital loss carryover from 2008.

20. In addition to any allowable itemized deductions in the preceding information, Mr. and Mrs. Scott had

the following allowable other itemized deductions: contributions by check, \$1,850; mortgage interest, \$4,440; state and local income taxes, \$5,200 (their state and local sales taxes were less than their income taxes and they did not purchase a vehicle on or after February 17, 2009); real estate taxes, \$6,100.

21. Mr. and Mrs. Scott have made payments totaling \$1,000 on their 2009 estimated taxes (Form 1040-ES). Neither one owes any prior years' taxes, nor did they have any interest in or connection with foreign trusts or bank accounts. To the Presidential election fund check-off, both answer "yes."

Download Filled-In Forms:

[Form 1040](#)

[Schedule A](#)

[Schedule B](#)

[Schedule SE](#)

[Schedule C](#)

[Schedule D](#)

[Form 2106, Employee Business Expenses](#)

[Form 3903, Moving Expenses](#)

[Schedule M](#)

[Qualified Dividends and Capital Gain Tax Worksheet—Line 44](#)

JOHN C. and MABEL A. SCOTT: #611-19-5023; #658-01-6253				
2009				
	FICA Tax	Federal Income Tax Withheld	Wages, Etc.	Appendix Par. No.
Schedule 1—Wages, Etc.				
(H) Johnson Mfg. Co., Pittsburgh, PA	\$3,289.50	\$8,592	\$43,750*	[5]
(H) Elaborate Foundry Co., St. Louis, MO	642.60	1,108	8,400	[6]
Total FICA Tax Withheld	\$3,932.10			
Totals		\$9,700	\$52,150	

**Includes \$750 excess reimbursement over expenses (\$2,250 less \$1,500) reported on Form 2106.*

Schedule 2—Other Income	
Speech honorarium	\$25 [13]
Jury duty pay	375 [14]
Schedule 3—Casualty Loss	
Scott is not entitled to a casualty loss deduction on the loss of his personal automobile because the loss does not exceed 10% of his adjusted gross income.	

Final Exam

Exam Instructions: Choose the best answer for each question below based upon the information provided in the course content. Then submit your answers.

You can change your answers any time prior to clicking the submit test button.

You have three (3) chances to submit the exam for a passing grade. Each time you click the Submit button is considered an attempt.

You must pass the Final Exam with a score of 70% or higher in order to receive Continuing Professional Education (CPE) credit for completing the course.

Your Certificate of Completion will be available after you successfully complete the course.

Users of JAWS accessibility software may use the "P" key to navigate the screens containing Study Questions or the Final Exam.

Expiration: This course must be completed within one year of enrollment.

1. Which of the following tax forms *cannot* be used by individuals?

- Form 1040A
- Form 1040EZ
- Form 1040
- Form 1041

2. A head of household who is under age 65 (and not someone's dependent) must file a return in 2009 if gross income exceeds (assume no self-employment income):

- \$9,350
- \$12,000
- \$13,400
- \$18,700

3. In 2009, a married couple, one of whom is age 65, must file a return if their combined gross income exceeds:

- \$18,700
- \$19,800
- \$20,900

4. Regardless of income, a return must be filed if the taxpayer:

- Received any advance earned income credit
- Owed any penalty taxes with respect to an IRA
- Has liability for household employees
- All of the above

5. Which of the following expenses is *not* deductible from gross income?

- Medical expenses
- Alimony payments
- One-half of self-employment tax
- Moving expenses

6. Assuming spouses do not live apart for the entire year, joint filing is *not* a prerequisite to claiming:

- Deduction for spousal IRA contributions
- Dependent care credit
- Earned income credit
- Net operating losses

7. A taxpayer seeking innocent spouse relief must do all of the following *except*:

- Show that he did not know or have reason to know that there was an understatement of tax.
- Meet one of three ways to obtain relief.
- Prove that the understatement was substantial.
- File for relief.

8. Which of the following is *not* a requirement in determining whether a taxpayer who is legally married can be considered unmarried for head of household filing-status purposes?

- An individual must file a separate return.
- An individual must maintain a household that, for more than one-half the year, was the principal residence of the taxpayer's dependent child.
- An individual's home must be, for the entire year, the main home of his child, stepchild, or adopted child whom he, or the noncustodial parent, can properly claim as a dependent.
- An individual's spouse must not have lived in his home for the last six months of the tax year.

9. Malcolm and Glenda Jackson divorced on June 1, 2009. Their one minor child lived with Glenda all of 2009. Glenda worked all year to keep the home for herself and her minor child. The divorce decree awarded the exemption for the child to Malcolm. Glenda's proper filing status is:

- Single
- Head of household
- Married filing separately
- Married filing jointly

10. John and Linda Smith, a childless married couple, lived apart for all of 2009. On December 31, 2009, they were legally separated under a decree of separate maintenance. Based on these facts, which of the following is the only filing status choice available to them for 2009?

- Single
- Head of household
- Married filing jointly
- Married filing separately

11. A married couple has two minor children. What is the maximum amount they can claim as a deduction for their exemptions in 2009?

- \$3,650
- \$7,300
- \$10,950
- \$14,600

12. In figuring the support test for a dependent who is a qualifying relative, which item is *not* taken into account?

- Life insurance premiums
- Clothing
- Dental care
- Entertainment costs

13. Three sisters contribute to the support of their elderly father as follows: Abigail, 5%; Betty, 30%; and Christine, 45%. Because they, in total, contribute more than half their father's support, they can sign a multiple support obligation to assign one sister the right to claim the exemption for the father. Which statement is correct?

- Any of the three sisters can claim the exemption.
- Only Christine, who contributed the most, can claim the exemption.
- Only Betty or Christine can claim the exemption.
- None of the sisters can claim the exemption, because none contributed more than 50% of the father's support.

14. A qualifying child includes all of the following people *except*:

- Taxpayer's natural child who is age 15
- Taxpayer's natural child who is age 26 and not permanently disabled
- Taxpayer's stepchild who is age 12
- Taxpayer's adopted child who is age 3

15. Under the definition of a qualifying child, which test differs from the tests applied for a dependent who is not a qualifying child?

- Citizenship or residency test
 - Joint return test
 - Gross income test
 - Social Security number
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