PART I: FEDERAL INCOME TAX FOR INDIVIDUALS AND SMALL BUSINESS

8501. Who must file a federal income tax return?

Taxpayers with annual income that equals or exceeds certain threshold amounts are required to file a federal income tax return for the year. The threshold amounts are indexed annually for inflation. In 2014, based on filing status, every taxpayer whose gross income equals or exceeds the following amounts must file a tax return:[1]

(1) Married persons filing jointly–$20,300 (if one spouse is blind or 65 or older–$21,500; if both spouses are blind or 65 or older–$22,700; if both spouses are blind and 65 or older–$25,100).

(2) Surviving spouse–$16,350 (if 65 or older or blind–$17,550; if 65 or older and blind–$18,750).

(3) Head-of-household–$13,050 (if blind or 65 or older–$14,600; if 65 or older and blind–$16,150).

(4) Single persons–$10,150 (if blind or 65 or older–$11,700; if blind and 65 or older–$13,250).

(5) Married filing separately–if neither spouse itemizes, a return must be filed if gross income equals or exceeds $10,150 in 2014 (if blind or 65 or older–$11,350; if blind and 65 or older–$12,550).

(6) Dependents–every individual who may be claimed as a dependent of another must file a return for 2014 if he has either (x) unearned income in excess of $1,000 (plus any additional standard deduction if the individual is blind or 65 or older) or (y) total gross income that exceeds the sum of any additional standard deduction if the individual is blind or 65 or older plus the greater of (a) $1,000 or (b) the lesser of (i) $350 plus earned income, or (ii) $6,200.

Taxpayers claiming the additional deduction for blindness may need to attach additional documents to a tax return to verify entitlement to the additional standard deduction.

Certain parents whose children are required to file a return may be permitted to include the child's income over $2,000 on their own return, thus avoiding the necessity of the child filing a return (see Q 8557).

A taxpayer with self-employment income must file a return if *net* self-employment income is $400 or more.

An individual who was subject to wage withholding but did not have gross income in excess of the threshold amounts described above may desire to file a return in order to receive a refund

1. IRC Secs. 6012(a), 63(c), 151; Rev. Proc. 2013-35, 2013-47 IRB 537.

of the withheld taxes. Similarly, an individual not required to file a return may desire to file a return in order to receive a refund resulting from a refundable credit (a tax credit or refund payable to the taxpayer even if she or she had paid no tax), such as the earned income credit.

8502. Who is allowed to file a joint federal income tax return? Who is eligible to file as a qualifying widow(er) with a dependent child?

Only legally married spouses may file joint returns. As a result of the Supreme Court's decision in the *Windsor* case, the federal government is compelled to recognize same-sex marriages that were legally executed in any U.S. state. As a result, the IRS must apply the tax laws to same-sex spouses in the same way as it is applied to all spouses.

Although the income and deductions of both spouses are reported, a joint return may be filed even if only one spouse has income. If one spouse dies during the tax year, the spouses are considered married for the entire year; and, thus, may file a joint return.

Qualifying Widow(er)

For 2 years following the death of a spouse, the surviving spouse may file as a "qualifying widow(er)" with a dependent (using the joint filer tax brackets), if he or she meets the following:

- Was entitled to file a joint return with the deceased spouse in the year of death, even if a joint return was not filed
- Has a child or stepchild (excludes a foster child) for whom an exemption can be claimed
- Child lived with the surviving spouse all year
- Paid more than half of the cost of keeping up the home[1]

Finally, if the surviving spouse remarries, he or she can no longer file as a qualifying widow(er); and, instead must file married filing separately or married filing jointly.

8503. Who is eligible to file a federal income tax return as head of household?

An individual who meets the following requirements may file as head of household:

- Not married or considered married (excluding a qualifying widow(er) with dependent child[2] see Q 8504)
- Paid more than half the cost of maintaining a home for the tax year
- A "qualifying person" lived with the individual more than half the year (except for temporary absences)
- Is not a nonresident alien[3]

1. IRC Sec. 2.
2. IRC Sec. 2(b)(1).
3. IRC Secs. 2(b), 2(d).

8504. Who is a "qualifying person?"

As stated above, in order to claim head of household filing status, an individual must maintain a home for a "qualifying person." A "qualifying person" is a:

1. A "qualifying child" (i.e., son, daughter, or grandchild) who is:

   Single (even if an exemption cannot be claimed for the person)

   Married and can be claimed as an exemption

2. A "qualifying relative" who is the individual father or mother and can be claimed as an exemption

3. A "qualifying relative" other than a parent, i.e., grandparent, brother, or sister and can be claimed as an exemption.[1]

8505. What does it mean to be considered unmarried?

An individual legally married may nonetheless be considered unmarried if all of the following requirements ~~are met~~:

- Filed a separate return
- Paid more than half the cost of maintaining the home for the tax year
- The other spouse did not live in the home during the last 6 months of the tax year
- The home was the main abode of the individual's child, stepchild, or foster child for more than half the year (except for temporary absences)
- Must be able to claim the child as an exemption or cannot claim the exemption because the exemption was transferred to the non-custodian spouse[2]

8506. What are the tax advantages of filing as head of household?

Filing as head of household is much more tax advantageous than filing separately. The main advantages are a higher standard deduction ($9,100 for 2014) and lower tax rates.[3]

8507. What is a taxable year for individual income tax purposes?

The basic period for computing income tax liability is one year, known as the *taxable year*. The taxable year may be either (a) the calendar year or (b) a fiscal year. A "calendar year" is a period of 12 months ending on December 31. A "fiscal year" is a period of 12 months ending on the last day of a month other than December.[4]

1. IRS Publication 17.
2. IRS Publication 17.
3. Rev. Proc. 2013-35, 2013-47 IRB 537.
4. IRC Secs. 441(a), 441(b), 441(d), 441(e).

Although most individuals report tax liability on a calendar year, it is possible to use a fiscal year. In any event, the year used for reporting tax liability must generally correspond to the taxpayer's accounting period.[1] Thus, if the taxpayer keeps books on a fiscal year basis the taxpayer cannot determine tax liability on a calendar year basis. If the taxpayer keeps no books, however, reporting on a calendar year basis is required.[2] Once the taxpayer has chosen a tax year, it cannot be changed without the permission of the Internal Revenue Service.[3] A principal partner cannot change to a taxable year other than that of the partnership unless the principal partner establishes, to the satisfaction of the IRS, a business purpose for doing so.[4]

A personal service corporation is required to use the calendar year for computing tax liability unless it can establish a valid business purpose for using a different period. The code specifically provides that deferral of income to shareholders does not constitute a valid business purpose.[5]

Under certain circumstances, partnerships and S corporations are required to use the calendar year for computing income tax liability.[6]

A short period (one that is less than 12 months) return is required where (1) the taxpayer changes the taxpayer's annual accounting period, and (2) a taxpayer has been in existence for only part of a taxable year.[7] A short period is treated in the law as a "taxable year."[8]

> *Example*: On June 1, 2014, ASK, Inc., a C corporation reporting its tax liability based on a calendar year began doing business. Since ASK was not operating for the entire calendar year, a short period return (June 1 through December 31) is required.

If the short period return is made because of a change in accounting period, the income during the short period must be annualized, and deductions and exemptions prorated.[9] But income for the short period is not required to be annualized if the taxpayer is not in existence for the entire taxable year.[10] For a discussion of the considerations applicable in determining a taxpayer's accounting period, see Q 8896 to Q 8902.

For the final regulations affecting taxpayers who want to adopt an annual accounting period (under IRC Section 441), or who must receive approval to adopt, change, or retain their annual accounting periods (under IRC Section 442), see Treasury Regulation Sections 1.441-0 to 1.441-4.

1. IRC Sec. 441(f)(1).
2. IRC Sec. 441(g).
3. IRC Sec. 442.
4. IRC Sec. 706(b)(2).
5. IRC Sec. 441(i).
6. See IRC Secs. 706(b), 1378.
7. IRC Sec. 443(a).
8. IRC Sec. 441(b)(3).
9. IRC Secs. 443(b), 443(c).
10. Treas. Reg. §1.443-1(a)(2).

For the general procedures for establishing a business purpose and obtaining approval to adopt, change, or retain an annual accounting period, see Revenue Procedure 2002-39.[1]

In Revenue Procedure 2003-62, the IRS has set forth the procedure under which IRC Section 442 allows individuals (e.g., sole proprietors) filing tax returns on a fiscal year basis to obtain automatic approval to change their annual accounting period to a calendar year.[2]

The exclusive procedures for (1) certain partnerships, (2) S corporations, (3) electing S corporations, (4) personal service corporations, and (5) trusts to obtain automatic approval to adopt, change, or retain their annual accounting period are set forth in Revenue Procedure 2006-46.[3]

8508. How does a taxpayer compute yearly tax liability?

A taxpayer computes the amount of tax owed using the following basic steps:

1. Gross income for the taxable year is determined (see Q 8512);
2. Certain deductions are subtracted from gross income (above the line deductions) to arrive at adjusted gross income (see Q 8519 to Q 8521);
3. The deduction for personal and dependency exemptions is determined (see Q 8515 to Q 8518);
4. Itemized deductions are totaled (see Q 8522), compared to the standard deduction and the additional standard deduction, if applicable (see Q 8519), and (generally) the greater amount, along with the deduction for exemptions, is deducted from adjusted gross income to arrive at taxable income;
5. The proper tax rate is applied to taxable income to determine the tax (see Q 8509);
6. The following amounts are subtracted from the tax to determine the net tax payable or overpayment refundable: (1) credits (see Q 8541 and Q 8542), and (2) prepayments toward the tax (e.g., overpayments or credits from a prior tax year carried over, tax withheld by an employer or estimated tax payments).

In some cases, there may be an alternative minimum tax liability. The steps in calculating the alternative minimum tax are explained in Q 8551.

1. 2002-1 CB 1046, *as modified by*, Notice 2002-72, 2002-2 CB 843, *and further modified by*, Rev. Proc. 2003-79, 2003-2 CB 1036.
2. 2003-2 CB 299, *modifying, amplifying, and superseding*, Rev. Proc. 66-50, 1966-2 CB 1260, and *modifying and superseding*, Rev. Proc. 81-40, 1981-2 CB 604. See also Ann. 2003-49, 2003-2 CB 339.
3. 2006-45 IRB 859.

8509. What are the current income tax rates for individuals?

Based on a taxpayer's filing status, the following individual income tax rates are applicable in 2014:[1]

	Taxable Income			
Tax Rate	Single	Married Filing Jointly Including Qualifying widow(er) with dependent child	Married Filing Separately	Head of Household
10%	$0-$9,075	$0-$18,150	$0-$9,075	$0-$12,950
15%	$9,075-$36,900	$18,150-$73,800	$9,075-$36,900	$12,950-$49,400
25%	$36,900-$89,350	$73,800-$148,850	$36,900-$74,425	$49,400-$127,550
28%	$89,350-$186,350	$148,850-$226,850	$74,425-$113,425	$127,550-$206,600
33%	$186,350-$405,100	$226,850-$405,100	$113,425-$202,550	$206,600-$405,100
35%	$405,100-$406,750	$405,100-$457,600	$202,550-$228,800	$405,100-$432,200
39.6%	Over $406,750	Over $457,600	Over $228,800	Over $432,200

8510. Why are many tax provisions indexed for inflation each year?

Many tax provisions are indexed annually for inflation so that increases in a taxpayer's income that result solely from inflation does not push them in a higher tax bracket or over thresholds that would reduce or eliminate certain tax benefits.

For example, Asher a single taxpayer earns $89,350 as the manager of a computer superstore. Assume at that income level, Asher is at the very end of the 25 percent tax bracket. At the end of the year, he receives a cost of living adjustment (another term for an adjustment for inflation) that increases his salary to $92,000. If tax brackets were not indexed for inflation, Asher's cost of living raise of $2,650 ($92,000 minus $89,350) would be taxed at 28 percent. Yet, based on inflation, $92,000 of today's dollars is the equivalent of $89,350 of yesterday's dollars. Thus, without indexing, Asher would experience a tax hike. However, by adjusting the tax brackets by inflation, i.e., increasing the 25 percent bracket to $92,000, Asher's tax liability essentially remains unchanged.

The following are examples of tax sensitive items indexed for inflation:

- Individual income tax brackets
- Basic standard deduction
- Additional standard deduction (taxpayers 65 or older)
- Exemptions
- Alternative minimum tax exemption amount

1. Rev. Proc. 2013-35, 2013-47 IRB 537.

- Maximum earned income credit
- Overall limitation on itemized deductions
- Education credits (Hope Scholarship, American Opportunity and Lifetime Learning Credits)
- Adoption credit
- Child tax credit
- Low income housing credit
- Phase out of exemptions
- Deductibility of interest on education loans[1]

8511. What indexing factor does the IRS use to make the adjustments for inflation?

The indexing factor (referred to in the IRC as the cost-of-living adjustment) is the percentage by which the Consumer Price Index (CPI) for the prior calendar year exceeds the CPI for a year designated as a reference point in each respective IRC Section. In all cases, the CPI is the average Consumer Price Index as of the close of the 12-month period ending on August 31 of the calendar year.[2] Thus, for example, in calculating the new tax rate schedules, the minimum and maximum dollar amounts for each rate bracket (except as described below) are increased by the applicable cost-of-living adjustment. The rates (percentages) themselves are not adjusted automatically for inflation. This method of increase explained above, however, does not apply to the phase out of the marriage penalty in the 15 percent bracket.[3]

The Secretary of the Treasury has until December 15 of each calendar year to publish new tax rate schedules (for joint returns, separate returns, single returns, head of household returns and for returns by estates and trusts) that will be effective for taxable years beginning in the subsequent calendar year.[4] As a practical matter the new numbers for the following tax year are often available as early as October of the preceding year. For a schedule of current tax rates, see Q 8509.

What Is Income?

8512. What is gross income?

Gross income is the starting point in the computation of taxable income upon which individuals are subject to income tax. Gross income is a broad concept that includes all income (whether derived from labor or capital) *excluding* those items that are specifically excluded;

1. Rev. Proc. 2013-35, 2013-47 IRB 537.
2. IRC Secs. 1(f)(3), 1(f)(4).
3. IRC Sec. 1(f)(2).
4. IRC Sec. 1(f)(1).

and, thus, not taxable. For example, gross income includes salary, fees, commissions, business profits, interest and dividends, rents, alimony received, and gains from the sale of property–but not the mere return of capital expended by the taxpayer to purchase or improve the property.[1]

The following is a non-exhaustive list of items that are *excluded* from gross income and received tax-free by an individual taxpayer:

1. gifts and inheritances;[2]
2. gain (within limits) from the sale of a personal residence (see Q 8587);
3. 50 percent of gain (within limits) from the sale of certain qualified small business stock held for more than five years (see Q 8563);
4. interest on many bonds of a state, city or other political subdivision;
5. Social Security and railroad retirement benefits (within limits–see Q 8545 to Q 8548); veterans' benefits (but retirement pay is taxable);[3]
6. Workers' Compensation Act payments (within limits);[4]
7. death proceeds of life insurance and, as to death proceeds of insurance on the life of an insured who died before October 23, 1986, up to $1,000 annually of interest received under a life income or installment option by a surviving spouse;[5]
8. amounts paid or expenses incurred by an employer for qualified adoption expenses in connection with the adoption of a child by an employee if the amounts are furnished pursuant to an adoption assistance program;[6]
9. contributions to a "Medicare Advantage MSA" by the Department of Health and Human Services;[7]
10. exempt-interest dividends from mutual funds;
11. interest on certain U.S. savings bonds purchased after 1989 and used to pay higher education expenses (within limits);[8]
12. contributions paid by an employer to Health Savings Accounts;[9]

1. IRC Sec. 61(a).
2. IRC Sec. 102.
3. IRC Sec. 104(a)(4).
4. IRC Sec. 104(a)(1).
5. IRC Secs. 101(a), 101(d).
6. IRC Sec. 137.
7. IRC Sec. 138.
8. See IRC Sec. 135.
9. IRC Sec. 106(d).

13. distributions from Health Savings Accounts (HSAs) used to pay qualified medical expenses;[1] and

14. federal subsidies for prescription drug plans.[2]

8513. What is adjusted gross income?

Adjusted gross income is broadly defined as gross income minus certain specifically deductible items allowed by the Code. Deductions from gross income also referred to as above the line deductions are the most tax beneficial type of deductions because they tend to be dollar per dollar with fewer limitations than what are known as below-the-line or itemized deductions. Additionally, as a measuring rod adjusted gross income is important because many thresholds upon which tax benefits phase out or taxes phase in are directly tied to adjusted gross income (for example, subject to the taxpayer being able to itemize, medical expenses are deductible only to the extent that they exceed 10 percent of adjusted gross income for the tax year).

The Code specifically designates which deductions are subtracted from adjusted gross income as above the line deductions. Following is a list of deductions permitted by the Code:

1. expenses directly incurred in carrying on a trade, business or profession (not as an employee – see Q 8522);

2. the deduction allowed for contributions made by a self-employed individual to a qualified pension, annuity, or profit sharing plan, or a simplified employee pension or SIMPLE IRA plan;

3. certain reimbursed expenses of an employee in connection with employment, provided the reimbursement is included in gross income (if the employee accounts to his employer and reimbursement does not exceed expenses, reporting is not required;

4. deductions related to property held for the production of rents and royalties (within limits);

5. deductions for depreciation and depletion by a life tenant, an income beneficiary of property held in trust, or an heir, legatee or devisee of an estate;

6. deductions for losses from the sale or exchange of property;

7. the deduction allowed for amounts paid in cash by an eligible individual to a traditional individual retirement account (IRA), or individual retirement annuity;

8. the deduction allowed for amounts forfeited as penalties because of premature withdrawal of funds from time savings accounts;

1. IRC Sec. 223(f)(1).
2. IRC Sec. 139A.

9. alimony payments made to the taxpayer's spouse;
10. certain reforestation expenses;
11. certain jury duty pay remitted to the taxpayer's employer;
12. moving expenses permitted by IRC Sec. 217;
13. the deduction for Archer Medical Savings Accounts under IRC Section 220(i);
14. the deduction for interest on education loans;
15. the deduction for qualified tuition and related expenses;
16. the deduction for contributions (within limits) to Health Savings Accounts;
17. the deduction for attorneys' fees involving discrimination suits; and
18. the deduction for certain expenses of elementary and secondary school teachers up to $250 (made retroactively effective for 2012 and 2013 by the American Taxpayer Relief Act of 2012, this provision has yet to be extended for 2014 and beyond).

8514. Is a taxpayer's discharge of indebtedness taxable?

If a creditor of a taxpayer discharges all or part of a debt for no consideration, the amount of debt discharged is potentially taxable to the taxpayer.[1] However, such debt discharge is excluded from gross income; and, thus not taxable, if the discharge: (1) occurs in a bankruptcy; (2) occurs when the taxpayer is insolvent and the discharge does not render the taxpayer solvent; (3) the indebtedness discharged is "qualified farm indebtedness;"[2] (4) in the case of a taxpayer other than a C corporation, the indebtedness discharged is "qualified real property business indebtedness;" or (5) the indebtedness discharged is "qualified principal residence indebtedness" (see "Mortgage Forgiveness Debt Relief Act of 2007," below) that is discharged before January 1, 2014.[3] So unless Congress reinstates the exclusion for the discharge of "qualified principal residence indebtedness," it would not apply.

Importantly, as stated above, "discharge of debt income" is triggered when a debt is forgiven for no consideration. So, if any consideration is involved, it would not be considered discharge of indebtedness income. Significantly, under those circumstances, the so-called discharge is completely taxable as none of the above exclusions would apply.

> *Example*: Asher borrows $10,000 from his employer. Instead of repaying the loan, his employer forgives the debt after Asher works 200 hours of overtime. In other words, it is as if the employer paid Asher $10,000 for his services; which, Asher, in turn used to repay the loan. Thus, the discharge of the loan is essentially compensation for services, or taxable wage income (not discharge of debt income).

1. IRC Sec. 61(a)(12).
2. See IRC Section 108(g)(2), as amended by ATRA.
3. IRC Sections 108(c)(3), 108(a)(1)(A), 108(a)(1)(B), 108(a)(1)(C), 108(a)(1)(D); IRC Sec. 108(a)(1)(E).

In some cases, even though consideration is involved, the discharge of debt may not necessarily be taxable. For example, suppose a shareholder of a corporation loans $10,000 to the corporation. Subsequently, the shareholder forgives the loan for no consideration. Because the loan comes from someone with shareholder status, the proceeds of the forgiven loan that remain in the corporation are essentially a capital contribution to the corporation. It is as if the corporation repaid the loan to the shareholder, who, in turn, made a capital contribution to the corporation. Contributions to a corporation are not taxable to the corporation. So in this case, discharge of debt that is the equivalent of a capital contribution does not trigger taxable income.[1]

Exemptions

8515. What is the personal exemption?

A personal exemption is essentially a fixed tax deduction adjusted for inflation each year. For tax year 2014, the exemption amount is $3,950.[2] With an exception discussed below, regardless of filing status, each individual taxpayer who files a return is entitled to claim a personal exemption.

Married couples filing joint returns are entitled to claim two personal exemptions (one for each spouse). In addition to a personal exemption, an additional exemption in the same amount (sometimes referred to as a "dependency exemption") is available for each individual a taxpayer may claim as a dependent.

There are several special rules that apply to claiming exemptions. A married spouse filing a separate return may claim an exemption for the spouse provided the other spouse has no gross income and is not claimed as a dependent by another taxpayer.[3] A child or other dependent (such as a parent) who files his or her own return may not claim a personal exemption.[4] Generally, the exemption will not be allowed unless the Social Security number of the individual for whom the personal or dependency exemption is being claimed is provided.[5]

8516. Are personal and dependency exemptions for high-income taxpayers subject to being phased out?

Yes. Beginning in 2013, the personal and dependency exemptions of taxpayers with income over certain defined threshold levels are subject to being reduced and potentially phased out completely. The dollar amount of personal and dependency exemptions of taxpayers with adjusted gross income above the threshold levels (adjusted annually for inflation[6]) is reduced by 2 percent for every $2,500 (or fraction thereof; $1,250 in the case of a married individual filing separately). Depending upon filing status, at certain adjusted gross income levels, the exemptions are phased out to zero.

1. Treas. Reg. §1.61-12(a).
2. IRC Sec. 151. Rev. Proc. 2013-35, 2013-47 IRB 537.
3. IRC Sec. 151.
4. IRC Sec. 151(d)(2).
5. IRC Sec. 151(e).
6. IRC Secs. 151(d)(3), 151(d)(4); Rev. Proc. 2013-35, 2013-47 IRB 537.

For 2014, the following chart illustrates the range of adjusted gross income in which the exemptions are gradually reduced until they are totally phased out:

Filing Status	AGI Threshold At Which Phase Out Begins	AGI Amount At Which Exemptions are Completely Phased Out
Married Joint and Surviving Spouse	$305.050	$427,550
Head of Household	$279,650	$402,150
Unmarried Individuals	$254,200	$376,700
Married Separate	$152,525	$213,775[1]

8517. When can a taxpayer claim a dependency exemption for a qualifying child and a qualifying relative?

In addition to the personal exemption, a taxpayer is entitled to an additional exemption (referred to as a dependency exemption) for each individual a taxpayer may claim as a dependent.[2] Under certain circumstances, the taxpayer may claim the exemption even though the dependent files a return. The taxpayer must include the Social Security number of any dependent claimed on the tax return.[3]

There are two categories of dependents 1) a "qualifying child" and 2) a "qualifying relative."[4]

Qualifying child. The term "qualifying child" means an individual who:

(1) is the taxpayer's "child" (see below) or a descendant of such a child, *or* the taxpayer's brother, sister, stepbrother, stepsister or a descendant of any such relative;

(2) has the same principal place of abode as the taxpayer for more than one-half of the taxable year;

(3) is younger than the taxpayer claiming the exemption and (i) has not turned age 19 as of the close of the calendar year in which the taxable year of the taxpayer begins, *or* (ii) is a student who has not turned age 24 as of the close of such calendar year;

(4) has not provided over one-half of his or her own support for the calendar year in which the claiming taxpayer's taxable year begins; *and*

(5) who has not filed a joint tax return (other than to claim a refund) for the taxable year.[5]

1. Rev. Proc. 2013-35, 2013-47 IRB 537.
2. IRC Sec. 151, 152.
3. IRC Sec. 151(e).
4. IRC Sec. 152(a).
5. IRC Sec. 152(c).

A "child" (including an adopted child) is an individual who is: (1) a son, daughter, stepson, or stepdaughter of the taxpayer; or (2) an "eligible foster child" of the taxpayer.[1] An "eligible foster child" means an individual who is placed with the taxpayer by an authorized placement agency or by judgment decree, or other order of any court of competent jurisdiction.[2]

Qualifying relative. The term "qualifying relative" means an individual:

(1) who is the taxpayer's:

  (i) child (who is not otherwise a "qualifying child") or a descendant of a child;

  (ii) brother, sister, stepbrother, or stepsister;

  (iii) father or mother or an ancestor of either, or stepfather or stepmother;

  (iv) son or daughter of a brother or sister of the taxpayer;

  (v) brother or sister of the father or mother of the taxpayer;

  (vi) son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law; or

  (vii) an individual (other than a spouse) who, for the taxable year of the taxpayer, has the same principal place of abode as the taxpayer and is a member of the taxpayer's household.

(2) whose gross income for the calendar year in which the taxable year begins is less than the exemption amount;

(3) for whom the taxpayer provides over one-half of the individual's support for the calendar year in which the taxable year begins; *and*

(4) who is not a qualifying child of the taxpayer or of any other taxpayer for any taxable year beginning in the calendar year in which the taxable year begins.[3]

8518. Who is entitled to the dependency exemption for qualifying children when the parents are divorced or have never been married?

For purposes of determining if a parent is entitled to the dependency exemption for qualifying children, it makes no difference whether the parents were divorced or had never been married.[4] As a general rule, the custodial parent is entitled to claim the dependency exemption. According to the Code, the parent having custody for the greater portion of the year is considered to be the "custodial parent."[5] However, if both parents have custody for equal amounts of

1. IRC Sec. 152(f).
2. IRC Sec. 152(f)(3).
3. IRC Sec. 152(d).
4. *King v. Comm.*, 121 TC 245 (2003). See also Preamble, REG-149856-03, 72 Fed. Reg. 24192, 24194 (5-2-2007).
5. IRC Sec. 152(e)(1)(B).

time during the taxable year, the parent with the highest adjusted gross income is entitled to claim the exemption.[1]

One the other hand the custodial parent may release the claim for exemption to allow the noncustodial parent to claim the exemption. In order to claim the exemption, the custodial spouse executes a Form 8332 that the noncustodial parent must attach to the tax return. As explained below, it is also possible for the custodial spouse to revoke the release of the exemption in order to claim it for himself or herself.

Post 2008 Rules for Release and Revocation of Release of Claim to Exemption

For tax years beginning after July 2, 2008, there are prescribed ways to release the claim to the exemption to the noncustodial parent as well as to revoke the release of the claim to the exemption from the noncustodial parent (effectively returning to the custodial parent).

- ***Releasing the Exemption to Noncustodial Spouse***

As mentioned above, the custodial spouse may release the claim to the exemption by executing a Form 8332 (Release/Revocation of Claim to Exemption for Child by Custodial Parent). Form 8332 provides the custodial parent with the option of releasing the right to claim the exemption for a single tax year or for multiple tax years. In the alternative, the custodial spouse may execute a conforming written document that includes the same information as it appears on a Form 8332. However, such written declaration must have been executed for the *sole purpose* of releasing the exemption to the noncustodial spouse for one or more tax years. Importantly, this means that attaching a court document such as a decree or a divorce or separation agreement would not be an acceptable written instrument even if it contains all of the required information.[2] Also, in order to claim the exemption, the noncustodial parent must attach the Form 8332 or written declaration to the tax return.

- ***Revoking the Release of the Exemption to Noncustodial Spouse***

According to the regulations, the custodial parent has the unilateral right to revoke the release of the exemption from the noncustodial spouse in order to claim it for himself or herself. To do so, the custodial parent is required to provide a noncustodial written notice of the intent to revoke and make reasonable efforts to deliver such notice to the noncustodial parent. The revocation is effective no earlier than the tax year *following* the calendar year in which the custodial parent delivered or made reasonable efforts to deliver the notice to the noncustodial spouse.[3]

> *Example*: Ashley and Asher are divorced parents with one child. Prior to tax year 2014, Ashley had executed a Form 8332 releasing the claim to the dependency exemption to Asher through tax year 2016. In February 2015, Ashley provides Asher written notice of her intent to revoke the release. Even though Asher received written notice of Ashley's intent to revoke the release, it would not be effective earlier than tax year 2015. Thus, for tax year 2014, Asher remains entitled to claim the dependency exemption.

1. IRC Sec. 152(c)(4)(B).
2. Treas. Reg. §1.152-4(e).
3. Treas. Reg. §1.152-4(e)(3).

Similar to the release, the revocation is made on Form 8332 or a separate conforming written document containing the same information contained on Form 8332. If a separate written document is used it must be executed for the sole purpose of revoking the release. Similar to the release, the revocation must specify the year or years in which it is to be in effect. To re-claim the exemption, the custodial spouse must attach the Form 8832 or conforming document to the return.[1]

Deductions

8519. What is the standard deduction?

The standard deduction is one of two "below-the-line" deduction options available to taxpayers. In other words, once a taxpayer determines adjusted gross income (gross income minus above the line deductions), the taxpayer may also deduct the sum of their exemptions and the greater of 1) the standard deduction; or 2) the sum of their itemized deductions (see Q 8522).[2]

The standard deduction for the 2014 tax year is $12,400 for married taxpayers filing jointly and surviving spouses, $9,100 for heads of households, and $6,200 for single taxpayers and married taxpayers filing separately.[3] The standard deduction is adjusted annually for inflation.[4]

Taxpayers who do not itemize and who are age 65 or older or blind are entitled to increase their standard deduction. In 2014, taxpayers who are married or are surviving spouses are each entitled to an additional deduction of $1,200, if age 65 or older as well as an additional $1,200 deduction if blind. The additional standard deduction is $1,550 for unmarried taxpayers age 65 or older as well as $1,550 for unmarried blind taxpayers.[5] The additional amounts for elderly and blind taxpayers are indexed for inflation.[6]

8520. What taxpayers are ineligible to use the standard deduction?

The following taxpayers are ineligible for the standard deduction and unless they have itemized deductions, there are no "below-the-line" deductions:

(1) married taxpayers filing separately, if either spouse itemizes[7],

(2) non-resident aliens,

(3) taxpayers filing a short year (less than 12 months) return because of a change in their annual accounting period, and

(4) estates or trusts, common trust funds, or partnerships.[8]

If a taxpayer dies within the tax year, his or her standard deduction is unaffected.

1. Treas. Reg. §1.152-4(e)(3).
2. IRC Sec. 63.
3. IRC Sec. 63(c); Rev. Proc. 2013-35, 2013-47 IRB 537.
4. IRC Sec. 63(c)(4).
5. IRC Sec. 63(f); Rev. Proc. 2013-35, 2013-47 IRB 537.
6. IRC Sec. 63(c)(4).
7. See, e.g., Legal Memorandum 200030023.
8. IRC Sec. 63(c)(6).

Example: Ashley an unmarried individual dies on February 1, 2014. As a result, her final tax year is only 32 days. However, even though Ashley died early in the tax year, in filing Ashley final Form 1040, the executor or administrator of Ashley's estate would deduct the entire standard deduction for a single filer.

8521. What is the standard deduction for a taxpayer who may be claimed as a dependent by another taxpayer?

For taxable years beginning in 2014, the standard deduction for an individual who may be claimed as a dependent by another taxpayer is the greater of $1,000 or the sum of $350 and the dependent's earned income.[1] These dollar amounts are adjusted for inflation.[2]

Planning Point: Self-employed and small business owners may be able to shift income taxable at their higher tax brackets to their lower tax bracket children by employing them in the business. This way the children's wage income would be taxed at their lower rates. The work must be legitimate and the pay must be reasonable, although it can be at the higher end of the reasonable scale.

8522. What are itemized deductions and how are they deducted?

As discussed in Q 8519, taxpayers are entitled to a "below-the-line" deduction, i.e., a deduction from adjusted gross income in arriving at taxable income, of the greater of 1) the applicable standard deduction (including the additional standard deduction for taxpayers who are blind and/or age 65 or older based on filing status); or, 2) the sum of their itemized deductions. So, in order to make a determination as to which amount to deduct, the taxpayer must total all deductible items that qualify as itemized deductions. If the total amount of itemized deductions exceeds the standard deduction, the taxpayer deducts that larger sum.

The following is a non-exhaustive list of the itemized deductions:

...Interest (including mortgage interest on a principal residence), within limits (see Q 8526);

...Personal expenses for the production or collection of taxable income, within limits, or in conjunction with the determination, collection or refund of any tax (but some of these expenses may be considered "miscellaneous itemized deductions" (see Q 8525)). However, certain business expenses and expenses for the production of rents and royalties are above the line deductions rather than itemized deductions;

...Personal taxes of the following types: state, local and foreign real property taxes; state and local personal property taxes; state, local and foreign income, war profits and excess profits taxes, and the generation-skipping tax imposed on income distributions. If taxes other than these are incurred in connection with the acquisition or disposition of property, they must be treated as part of the cost of such property (included in basis) or as a reduction in the amount realized on the disposition;[3]

1. IRC Sec. 63(c)(5); Rev. Proc. 2013-35, 2013-47 IRB 537.
2. IRC Sec. 63(c)(4).
3. IRC Sec. 164(a).

…Uncompensated personal casualty and theft losses. These are deductible only to the extent that the aggregate amount of uncompensated losses in excess of $100 (for each casualty or theft) exceeds 10 percent of adjusted gross income. The taxpayer must file a timely insurance claim for damage to property that is not business or investment property or else the deduction is disallowed to the extent that insurance would have provided compensation.[1] Uncompensated casualty and theft losses in connection with a taxpayer's business or in connection with the production of income are deductible in full. For more on casualty losses, see Q 8621 to Q 8641;

…Contributions to charitable organizations, within certain limitations (see Q 8534 to Q 8539);

…Unreimbursed medical and dental expenses, and expenses for the purchase of prescribed drugs or insulin incurred by the taxpayer for himself and his spouse and dependents, to the extent that such expenses exceed 10 percent of adjusted gross income (7.5 percent of adjusted gross income for taxpayers 65 or older) (see Q 8540);

…Unreimbursed expenses of an employee connected with his employment. Generally, such expenses are "miscellaneous itemized deductions" (see Q 8525);

…Federal estate taxes and generation-skipping transfer taxes paid on "income in respect of a decedent."

8523. Are state and local sales taxes deductible?

Under AJCA 2004, taxpayers could elect to deduct state and local general sales taxes instead of state and local income taxes when they itemized deductions.[2] This option was available for tax years 2004 through 2011.[3] ATRA extended this option through 2013, with retroactive application to the 2012 tax year. As of the date of this publication, Congress has not acted to extend this deduction for 2014 and beyond.

8524. What are miscellaneous itemized deductions? To what extent are they deductible?

"Miscellaneous itemized deductions" are a subset of itemized deductions *other than* the regular itemized deductions for (1) interest, (2) taxes, (3) non-business casualty losses and gambling losses, (4) charitable contributions, (5) medical and dental expenses, (6) impairment-related work expenses for handicapped employees, (7) estate taxes on income in respect of a decedent, (8) certain short sale expenses, (9) certain adjustments under the IRC claim of right provisions, (10) unrecovered investment in an annuity contract, (11) amortizable bond premium, and (12) certain expenses of cooperative housing corporations.[4]

1. IRC Sec. 165(h)(5)(E).
2. IRC Sec. 164(b)(5)(A).
3. IRC Sec. 164(b)(5)(I), as amended by TEAMTRA 2008.
4. IRC Sec. 67(b).

Examples of miscellaneous itemized deductions include unreimbursed employee business expenses, such as professional society dues or job hunting expenses, and expenses for the production of income, such as investment advisory fees or the cost for storage of taxable securities in a safe deposit box.[1]

"Miscellaneous itemized deductions" are included in the itemized deduction pool only to the extent that the aggregate of all miscellaneous itemized deductions for the tax year exceeds 2 percent of adjusted gross income.[2] Expenses that relate to both a trade or business activity (an above-the-line deduction) and a production of income or tax preparation activity must be allocated between the activities on a reasonable basis.[3]

> *Example*: In 2014, Asher a single taxpayer has adjusted gross income of $100,000. His deductible mortgage interest and property taxes (regular itemized deductions) total $4,000. In addition, Asher has unreimbursed employee business expenses of $2,500. Because unreimbursed employee business expenses are miscellaneous itemized deductions, they are deductible and added to the total of Asher's other regular itemized deductions only to extent they exceed 2 percent of his adjusted gross income. In this case, Asher's miscellaneous itemized deductions of $2,500 exceed $2,000 (2 percent of adjusted gross income) by $500. As a result, Asher's total itemized deductions would be $4,500 ($4,000 plus $500). However, because the standard deduction for a single filer is $6,200, Asher would deduct the higher standard deduction amount.

A taxpayer may not avoid the treatment of an item that would be a miscellaneous itemized deduction by virtue of it passing through to him or her through an entity such as a partnership or S corporation.[4]

> *Example*: Ashley is a 50 percent partner in a partnership engaging in an activity for the production of income. In 2014, Ashley's allocable share of section 212 production of income deductible expenses is $200. Even though Ashley did not directly incur that expense, she must treat the $200 deductible items as a miscellaneous itemized deduction. Thus, she must add the $200 to all her other miscellaneous deductions to determine whether the aggregate amount of those items exceed 2 percent of her adjusted gross income.[5]

8525. Are the itemized deductions of high-income taxpayers subject to phase-out?

Yes. The aggregate of most itemized deductions is reduced dollar-for-dollar by the lesser of (1) 3 percent of the individual's adjusted gross income that exceeds $254,200 for a single filer ($305,050 in the case of a married taxpayer filing jointly, $279,650 for heads of household, and $152,525 for married taxpayers filing separately) or (2) 80 percent of the amount of such itemized deductions otherwise allowable for the taxable year.[6] The threshold income levels for determining the phaseout are adjusted annually for inflation.[7]

1. Temp. Treas. Reg. §1.67-1T(a)(1).
2. IRC Sec. 67(a).
3. Temp. Treas. Reg. §1.67-1T(c).
4. IRC Sec. 67(c)(1); Temp. Treas. Reg. §1.67-2T.
5. Temp. Treas. Reg. §1.67-2T(b)(2) Example.
6. IRC Sec. 68(a).
7. IRC Sec. 68(b); as amended by ATRA, Sec. 101(2)(b); Rev. Proc. 2008-66, 2008-45 IRB 1107; Rev. Proc. 2013-35, 2013-47 IRB 537.

The phase-out of the value of itemized deductions is not applicable to medical expenses deductible under IRC Section 213, investment interest deductible under IRC Section 163(d), or certain casualty loss deductions.[1] The limitation also is not applicable to estates and trusts.[2] For purposes of certain other calculations, such as the limits on deduction of charitable contributions or the 2 percent floor on miscellaneous itemized deductions, the limitations on each separate category of deductions are applied *before* the overall ceiling on itemized deductions is applied.[3] The deduction limitation is not taken into account in the calculation of the alternative minimum tax.[4]

8526. What types of interest are deductible?

Whether or not interest is deductible depends on its classification as one of the following types of interest: (1) investment interest, (2) trade or business interest, (3) qualified residence interest, (4) interest relating to passive activities, (5) interest incurred on extended payment of estate tax, (6) interest on education loans or (7) personal interest. The deductibility of these seven types of interest is discussed in detail in Q 8527 to Q 8533.

The proper allocation of interest generally depends on the use to which the loan proceeds are put, except in the case of certain qualified residence interest. Detailed rules for classifying interest by tracing the use of loan proceeds are contained in temporary regulations.[5]

In some cases, the Code may specifically disallow the deductibility of interest. For example, no deduction is allowed for interest paid on a loan used to buy or carry tax-exempt securities.[6] The rationale for the disallowance is to prevent the taxpayer from receiving an unwarranted double tax benefit. (first, the exclusion of the interest from gross income; and, second, a deduction for the interest on a loan used to purchase the underlying tax-exempt security).

Interest expense that is deductible under the rules outlined in Q 8527 to Q 8533 may also be subject to the additional limitations on itemized deductions (unless it is investment interest, which is not subject to that provision). See Q 8524 for a discussion of the limits on itemized deductions.

8527. What are the rules for the deductibility of investment interest by an individual taxpayer?

Any interest expense on indebtedness properly allocable to property held for investment is classified as investment interest.[7] However, there is a limitation as investment is deductible to the extent of net investment income. Any excess is carried forward to subsequent tax years subject to the same terms and conditions. Net investment income is investment income less

1. IRC Sec. 68(c).
2. IRC Sec. 68(e).
3. IRC Sec. 68(d).
4. IRC Sec. 56(b)(1)(F).
5. See Temp. Treas. Reg. §1.163-8T.
6. IRC Sec. 265.
7. IRC Sec. 163(d)(3).

investment expenses (other than interest). Investment income is income from property held for investment such as interest, dividends, annuity income and royalties.[1]

> *Example*: In 2014, Asher has net investment income of $7,500 and investment interest of $10,000. Because the deductibility of investment interest is limited to net investment income, only $7,500 of the $10,000 of investment interest is deductible. The excess disallowed investment interest of $2,500 is carried forward to subsequent years.[2]

Excluded from the definition of investment income is net long-term capital gain and "qualified dividends." These types of income are taxed at a maximum rate of 15 percent or 20 percent depending on the taxpayer's overall income (i.e., the 20 percent rate applies to high income taxpayers). On the other hand, other types of investment income such as non-qualified dividends, interest income, etc. are taxed at ordinary income rates (up to 39.6 percent). However, if a taxpayer elects to treat long-term capital gains or qualified dividends as ordinary income (waives the application of the 15 percent and 20 percent maximum rates), that income does count as investment income.

> *Example*: Same as the above example, except that Asher has a combined $2,500 of qualified dividends and net long-term capital gain. If Asher makes an election waiving the 15 percent and 20 percent maximum rates with respect to that income (meaning it could be taxed to up to 39.6 percent), he may include it as investment income. If he does, Asher can deduct the full $10,000 of investment interest because adding the $2,500 of qualified dividends and net long-term capital gain to the $7,500 of other net investment income, there would be a total offset.[3]

8528. What is deductible trade or business interest?

Trade or business interest, as the name suggests, includes any interest incurred in the conduct of a trade or business. So for example, if a taxpayer borrows funds for working capital in a trade or business, the interest payments would be deductible.

8529. What is deductible qualified residence interest?

Qualified residence interest is interest paid or accrued during the taxable year on debt that is secured by the taxpayer's qualified residence and that is either (a) "acquisition indebtedness" (that is, debt incurred to acquire, construct or substantially improve the qualified residence, or any refinancing of such debt), or (b) "home equity indebtedness" (any other indebtedness secured by the qualified residence).

A "qualified residence" is the taxpayer's principal residence and one other residence that is essentially a second home.[4] A taxpayer may only treat an aggregate of $1,000,000 as acquisition indebtedness (spread over the two residences), *but* the amount of refinanced debt that may be treated as acquisition indebtedness is limited to the amount of debt being refinanced. The aggregate amount that may be treated as "home equity indebtedness" (that is, borrowing against the

1. IRS Publication 530 (2013).
2. IRC Sec. 163(d).
3. IRC Sec. 1(h)(11)(D)(i).
4. IRC Sec. 164(h)(4)(A).

fair market value of the home, less the acquisition indebtedness to borrow against the "equity" in the home) is $100,000,[1] or a combined maximum of $1,100,000 of indebtedness.

Example: In 2012, Ashley and Asher, a married couple, purchase a principal residence for $400,000 financed in part by a $300,000 home acquisition loan. In 2014, pursuant to a refinancing they borrow $350,000 to pay off the initial $300,000 loan and the other $50,000 to purchase two cars. Of the amount borrowed, only $300,000 (the amount necessary to pay off the initial acquisition loan) is treated as acquisition debt. The other $50,000 does not qualify as acquisition indebtedness. However, assuming the residence is worth $400,000 (meaning there is $100,000 of equity), the $50,000 additional indebtedness would qualify as home equity indebtedness. As a result, the interest on the total indebtedness would be deductible as qualified residence interest.

8530. To what extent is the deductibility of interest limited by the application of the passive activity loss rules?

A passive activity is generally an activity that involves the conduct of a trade or business in which the taxpayer does not materially participate, or any rental activity.[2] Generally, the deductibility of passive expenses is limited to the amount of passive income. The excess, passive loss, is not deductible. Instead, it is carried over to subsequent tax years for potential deductibility against passive income generated in those years. The same rules apply to the deductibility of interest related to a passive activity. So the extent that otherwise deductible interest is related to a passive activity, some or all of the interest deduction Interest deductions that are allocated to passive activities may be similarly disallowed.[3] See Q 8635 to Q 8644 for a detailed discussion of the passive loss rules.

8531. Is the interest on extended payments of estate tax deductible?

If an extension to pay Federal estate tax over a period of time is in effect, the interest portion of the payment is deductible.[4]

8532. Is the interest on education loans deductible?

An above-the-line deduction is available to certain taxpayers for interest paid on a "qualified education loan."[5] In 2014, the deduction is limited to $2,500 of such interest. However, the deduction is phased out for taxpayers with modified AGI between $65,000 and $80,000 ($130,000 and $160,000 for joint returns). Certain other requirements must be met for the deduction to be available.[6]

8533. Is personal interest deductible?

Pursuant to IRC section 163(h)(1), all personal interest is deductible. However, in defining personal interest, all of the types of interest described Q 8527 through Q 8532 are not considered personal interest, and, thus, are deductible subject to the limitations discussed therein.

1. IRC Sec. 164(h)(3).
2. IRC Sec. 469.
3. IRC Sec. 469, Treas. Reg. §1.163-8T.
4. IRC Sec. 163(h)(2).
5. IRC Secs. 163(h)(2)(F), 221.
6. See IRC Sec. 221; Treas. Reg. §1.221-1.

Generally, non-deductible personal interest includes but is not limited to consumer credit card interest, car loans and interest on tax deficiencies.

8534. How much of a charitable contribution is deductible?

An individual who itemizes may take a deduction for certain contributions "to" or "for the use of" charitable organizations. A gift is made "to" a charitable organization if it is a direct gift of property to the charitable organization. An indirect contribution of an interest in property to a charity that does not result in a complete gift of the property itself is considered to be a contribution "for the use of" the charity. For example, a gift of an income interest in property, but not the underlying property itself, to charity is considered to be a gift "for the use of" the charity.[1] The term "for the use of" does not refer to a gift of the right to use property such as office space. Such a gift would generally be a nondeductible gift.

The amount that may be deducted by the taxpayer in any tax year is subject to the income percentage ceilings explained below. The amount of the contribution depends on whether it is a gift of money or property; and, if the latter, the type of property. Also, for any charitable gift, the type of charity is also relevant. These rules are explained in Q 8537 and Q 8538.

Charitable giving is discussed in detail in Q 8916 to Q 8930.

8535. What are the income percentage ceilings that limit the income tax deduction for charitable contributions?

50 percent ceiling. For a charitable contribution of money, an individual is allowed a charitable deduction of up to 50 percent of his or her adjusted gross income if made to the following types of organizations: churches, schools, hospitals or medical research organizations, organizations that normally receive a substantial part of their support from federal, state, or local governments or from the general public and that aid any of the above organizations, and federal, state, and local governments. Also included in this list is a limited category of private foundations (private operating foundations and conduit foundations[2]) that generally direct their support to public charities.[3] The above organizations are often referred to as "public charities" or "50-percent-type charitable organizations."

Thus, a monetary contribution to a public charity is limited to 50 percent of adjusted gross income. The excess amount is carried over for a period of 5 years subject to the same limitations. Any amount of a charitable contribution not deducted within that time period is lost.[4]

> *Example*: In 2014, Asher made a monetary charitable contribution of $30,000 to a public charity. Asher's adjusted gross income is $50,000. Due to the 50 percent ceiling, Asher's contribution is limited to $25,000 (50 percent of $50,000). The remaining $5,000 is carried over to the next year subject to the same limitations for up to 5 years.

1. See Treas. Reg. §1.170A-8(a)(2).
2. See IRC Sec. 170(b)(1)(E).
3. IRC Sec. 170(b)(1)(A).
4. IRC Sec. 170(d).

30 percent ceiling. For a charitable contribution of money to a private foundation, the amount of the contribution is limited to 30 percent of the taxpayer's adjusted gross income. See Q 8538 for the definition of a private foundation.

8536. What are the rules to determine the income percentage ceilings for monetary charitable contributions to public charities and private foundations in the same tax year?

The combined monetary contributions to public charities and private foundations can never be more than 50 percent of adjusted gross income. Within the 50 percent ceiling the deductible charitable contribution to a private foundation cannot be more than 30 percent. The application of this rule by the following example:

> *Example*: In 2014, Asher contributes $70,000 to a public charity and $50,000 to a private foundation. His adjusted gross income is $180,000.
>
> Step 1 – Compute the limitation the charitable deduction to the public charity.
>
> If the charitable contribution to the public charity was equal or greater than 50 percent of adjusted gross income, this would be the end of the computation as the amount of the charitable contribution to the public charity in excess of 50 percent of adjusted gross income plus the full amount of the charitable contribution to the private foundation would not be deductible. Instead, those amounts would be carried forward into subsequent tax years.
>
> In this case, Asher's $70,000 charitable contribution to the public charity is less than $90,000, or 50 percent of his $180,000 of adjusted gross income. Thus, the entire $70,000 charitable contribution is deductible.
>
> Step 2 – Compute the charitable contribution deduction to the private foundation.
>
> Since the maximum amount deductible is 50 percent of adjusted gross income, after the Step 1 public charity deduction of $70,000 there remains only $20,000 of potentially deductible charitable contributions to the private foundation. So in computing how much of Asher's $50,000 contribution to a private foundation is deductible, it can be no greater than the lesser of $20,000 or 30 percent of his adjusted gross income of $54,000. Since $20,000 is the lesser amount, $20,000 of Asher's $50,000 private foundation charitable contribution is deductible. The remaining $30,000 is not currently deductible and must be carried over into the next tax year subject to the same rules for up to 5 subsequent tax years.[1]

8537. How does the character of property donated to charity (long-term capital gain property, tangible personal property, S corporation stock, partial interests in property) impact the income tax deduction allowed to the taxpayer?

If an individual makes a charitable contribution to a public charity (see Q 8534) of property that, if sold, would have resulted in long-term capital gain (other than certain tangible personal property, see below), the taxpayer is generally entitled to deduct the full fair market value of the property, but the deduction will be limited to 30 percent of adjusted gross income.[2]

1. IRC Sec. 170(b)(1)(B)(i).
2. IRC Sec. 170(b)(1)(C).

Long-term capital gain property. "Long-term capital gain" means "gain from the sale or exchange of a capital asset held for more than 1 year, if and to the extent such gain is taken into account in computing gross income."[1]

> *Example*: Asher owns raw land he purchased 5 years ago for $100,000. The fair market value of the land is $500,000. If Asher were to sell the land, he would recognize $400,000 long-term capital gain. Because the land is long-term capital gain property, if Asher contributes the land to a public charity, he would be entitled to a $500,000 charitable deduction. However, the amount deductible would be limited to 30 percent of his adjusted gross income.

If any portion of a gift of long-term capital gain property to a public charity is disallowed as a result of the adjusted gross income ceiling, the taxpayer may carry the deduction over for five years subject to the same 30 percent ceiling.[2]

In lieu of a full fair market value contribution of property subject to the 30 percent ceiling, a taxpayer may elect to take a lesser contribution of the property's basis subject to the 50 percent ceiling. Once made, such an election applies to all contributions of capital gain property during the taxable year (except unrelated use gifts of appreciated tangible personal property, as explained below). The election is generally irrevocable for the year in which it is made.[3]

> *Example*: Asher owns raw land he purchased 5 years ago for $100,000. The fair market value of the land is $500,000. If Asher were to sell the land, he would recognize $400,000 long-term capital gain. Because the land is long-term capital gain property, if Asher contributes the land to a public charity, he would be entitled to a $500,000 charitable deduction. However, if Asher elects to limit his charitable deduction to $100,000 (the land's basis), the amount deductible would be 50 percent of his adjusted gross income.

See Q 8538 for the rules regarding contribution of property to private foundations.

Tangible Personal Property. The treatment of a contribution of appreciated tangible personal property (i.e., property which, if sold, would generate long-term capital gain) depends on whether the use of the property is related or unrelated to the purpose or function of the (public or governmental) organization. If the property is related use property (e.g., a contribution of a painting to a museum), generally the full fair market value is deductible, subject to the 30 percent ceiling. However, if the property is unrelated to the purpose or function of the charity, the deduction is generally limited to the donor's adjusted basis.[4]

Other Gifts of Property. The deduction for any charitable contribution of property is reduced by the amount of gain that would *not* be long-term capital gain if the property were sold at its fair market value at the time of the contribution.[5] In other words, the amount of such gifts are limited to the basis in the property.

In the case of a gift of S corporation stock, special rules (similar to those relating to the treatment of unrealized receivables and inventory items under IRC Section 751) apply in

1. IRC Sec. 1222(3).
2. IRC Sec. 170(b)(1)(C)(ii).
3. IRC Sec. 170(b)(1)(C)(iii); *Woodbury v. Comm.*, TC Memo 1988-272, *aff'd*, 90-1 USTC ¶50,199 (10th Cir. 1990).
4. IRC Secs. 170(e)(1)(B), 170(b)(1)(C); Treas. Reg. §1.170A-4(b).
5. IRC Sec. 170(e)(1)(A).

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determining whether gain on such stock is long-term capital gain for purposes of determining the amount of a charitable contribution.[1]

8538. What income tax deduction may a taxpayer take for making a charitable donation to an organization classified as a private foundation?

Most private foundations are family foundations subject to restricted contribution limits. Certain other private foundations (i.e., conduit foundations and private *operating* foundations), which operate much like public charities, are treated as public charities (see Q 8534).[2] A private foundation is a charitable organization other than an organization described in IRC Sections 509(a)(1) through 509(a)(4). More specifically, a private foundation is usually a charitable organization that is 1) funded from a limited group such as an individual, family or company; 2) its expenses tend to be paid from investment earnings rather than regular charitable contributions; and 3) under certain circumstances it makes contributions to other charitable organizations. The term "private foundations" as used under this heading refers to standard private (e.g., family) foundations.

The amount of the deduction for a contribution of appreciated property (tangible or intangible) contributed *to* or *for the use of* private foundations generally is limited to the donor's adjusted basis. However, certain gifts of qualified appreciated stock made to a private foundation are deductible at their full fair market value.[3]

Qualified appreciated stock is generally publicly traded stock which, if sold on the date of contribution at its fair market value, would result in a long-term capital gain.[4] Such a contribution will not constitute qualified appreciated stock to the extent that it exceeds 10 percent of the value of all outstanding stock of the corporation. Family attribution rules apply in reaching the 10 percent level.[5] The IRS has determined that shares in a mutual fund can constitute qualified appreciated stock.[6]

Planning Point: Donor Advised Funds are an increasingly popular way for a donor to obtain more choice and control over how and when taxation occurs. A donor can wait to make a charitable contribution until the end of the calendar year, after the donor knows how much the donor wants (and is able) to deduct, make a gift to a public charity, and then decide the recipients of the donation at a future date.

Planning Point: From a tax perspective, it is not advisable to donate an investment with a taxable loss. This is because the transfer of loss property to a charity does not allow for the taxpayer to claim the loss. In this situation, the taxpayer should consider selling the investment in order to claim a taxable loss; and, then make a deductible charitable contribution of the proceeds from the sale.

1. IRC Sec. 170(e)(1).
2. See IRC Secs. 170(b)(1)(E), 170(b)(1)(A)(vii).
3. IRC Sec. 170(e)(5).
4. IRC Sec. 170(e)(5).
5. IRC Sec. 170(e)(5)(C).
6. Let. Rul. 199925029. See also Let. Rul. 200322005 (ADRs are qualified appreciated stock). Instruction for Form 8283 (Rev. December 2013).

8539. What substantiation requirements must a taxpayer satisfy in order to claim an income tax deduction for a charitable donation?

A taxpayer-donor is not entitled to a charitable deduction for a contribution of cash, check, or other monetary gift unless the donor maintains either a bank record or a written communication from the donee showing the name of the organization and the date and the amount of the contribution.[1]

A taxpayer must substantiate a charitable contribution of $250 or more (whether in cash or property) by a contemporaneous written acknowledgment of the contribution supplied by the charitable organization. The taxpayer is not required to provide substantiation if certain information is reported on a return filed by the charitable organization.[2] (An organization can provide the acknowledgement electronically, such as in an e-mail addressed to the donor).[3] Special rules apply to the substantiation and disclosure of quid pro quo contributions and contributions made by payroll deduction.[4] A taxpayer must generally obtain a qualified appraisal for contributions of property that is difficult to value if the taxpayer claims a deduction of more than $5,000 for the donation.[5]

A taxpayer is not entitled to a deduction for a contribution of clothing or household items unless the property is in new or good used condition. A deduction for a contribution of clothing or household items may be denied if the property has minimal monetary value. These rules do not apply to a contribution of a single item if the taxpayer claims a deduction of more than $500 and includes a qualified appraisal with the return. Household items include furniture, furnishings, electronics, linens, appliances, and similar items; but not food, art, jewelry, and collections.[6]

Special rules apply to certain types of gifts, including charitable donations of patents and intellectual property, and for donations of used motor vehicles, boats, and airplanes.[7]

8540. When is an individual taxpayer entitled to a deduction for medical expenses?

A taxpayer who itemizes deductions can deduct unreimbursed expenses for "medical care" (the term "medical care" includes dental care) and expenses for *prescribed* drugs or insulin for himself, spouse and dependents. The deduction is only allowed to the extent that such expenses exceed 10 percent of adjusted gross income for the tax year. (On a joint return, the 10 percent floor amount is based on the combined adjusted gross income of husband and wife).

To determine whether the taxpayer is entitled to a deduction, the taxpayer first determines net unreimbursed expenses by subtracting all reimbursements received during the year from

1. IRC Sec. 170(f)(17).
2. IRC Sec. 170(f)(8).
3. IRS Pub. 1771 (March 2008), p. 6.
4. Treas. Regs. §§1.170A-13(f), 1.6115-1.
5. IRC Sec. 170(f)(11).
6. IRC Sec. 170(f)(16).
7. See IRC Secs. 170(e)(1)(B), 170(f)(11), 170(f)(12), 170(m); Notice 2005-44, 2005-25 IRB 1287.

total expenses for medical care paid during the year. The taxpayer must then subtract 10 percent of the taxpayer's adjusted gross income from net unreimbursed medical expenses. Only the balance, if any, is deductible.[1] The deduction for medical expenses is not subject to the phase-out in itemized deductions for certain upper income taxpayers. (See Q 8524).

Though the 7.5 percent threshold increased to 10 percent in 2013, taxpayers can continue to use the 7.5 percent threshold through 2016 if the taxpayer or the taxpayer's spouse has attained age 65 before the end of the taxable year.

"Medical care" is defined as amounts paid: (a) for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body; (b) for transportation primarily for and essential to such medical care; (c) for qualified long-term services; or (d) for insurance covering such care or for any qualified long-term care insurance contract.[2]

The IRS has ruled that amounts paid for diagnostic and certain similar procedures and devices are deductible medical care expenses, provided that they are not compensated by insurance or otherwise, even though the individuals had no symptoms of illness prior to incurring the expense. According to the IRS, this includes an annual physical examination, a full-body electronic scan and a pregnancy test.[3]

The term "medical care" does not include cosmetic surgery or other similar procedures unless necessary to correct a deformity resulting from a congenital abnormality, a personal injury resulting from accident or trauma, or a disfiguring disease.[4] Despite this general rule, in *Al-Murshidi v. Comm.*,[5] the surgical removal of excess skin from a formerly obese individual was not found to be "cosmetic surgery" for purposes of IRC Section 213(d)(9)(A) because the procedures meaningfully promoted the proper function of the individual's body and treated her disease. Therefore, the costs of the surgical procedures were deductible despite the "cosmetic surgery" classification given to the procedures by the surgeon.

A taxpayer can deduct the medical expenses paid for a dependent (within the specified limits) even though the taxpayer is not entitled to a dependency exemption. The fact that the dependent's income for the year exceeds $3,950 is immaterial so long as the taxpayer has furnished over one-half of his support during that tax year. A child of parents who are divorced (or in some situations, separated) *and* who between them provide more than one-half of the child's support for the calendar year and have custody of the child for more than one-half of the calendar year will be treated as a dependent of both parents for purposes of this deduction.[6] In the case of a multiple support agreement, however, only the person designated to take the dependency exemption may deduct the dependent's medical expenses, and then only to the extent that he

1. IRC Sec. 213.
2. IRC Sec. 213(d)(1).
3. Rev. Rul. 2007-72, 2007-50 IRB 1154.
4. IRC Sec. 213(d)(9); see, e.g., Let. Rul. 200344010.
5. TC Summary Opinion 2001-185.
6. IRC Sec. 213(d)(5).

actually paid the expenses.[1] See Q 8518 for a discussion of which parent is entitled to take the dependency exemption.

Deductible medical expenses include amounts paid for lodging, up to $50 per individual per night, when being away from home is *primarily for and essential to* medical care if such care is provided by a physician in a licensed hospital (or similar medical care facility) and there is no element of personal pleasure, recreation or vacation in the travel away from home. No deduction is allowed if the lodgings are "lavish or extravagant."[2] A mother was permitted to deduct lodging expenses incurred when her child was receiving medical care away from home and her presence was essential to such care.[3] A parent's costs of attending a medical conference (i.e., registration fee, transportation costs) to obtain information about a chronic disease affecting the parent's child were deductible so long as the costs were primarily for and essential to the medical care of the dependent. However, the costs of meals and lodging incurred by the parent while attending the conference were not deductible.[4] The IRS has privately ruled that taxpayers could deduct special education tuition for their children as a medical care expense where the children attended a school primarily to receive medical care in the form of special education and each child had been diagnosed as having a medical condition that handicapped the child's ability to learn in the years in which tuition was paid.[5]

Generally, medical expenses are deductible only in the year they are paid, regardless of when the expenses are incurred. Despite this, in *Zipkin v. U.S.*, expenses incurred by a taxpayer to build a home to meet his wife's special health needs were properly deducted in the year the home became habitable, even though the costs had been paid in earlier years.[6] Costs paid by parents to modify a van used to transport their handicapped child were deductible in the year those costs were paid; however, the court held that depreciation was not a deductible medical expense.[7]

Medical expenses of a decedent paid out of the estate within one year from date of death are considered paid by the decedent at the time the expenses were incurred.[8] A decedent's medical expenses cannot be taken as an income tax deduction unless a statement is filed waiving the right to deduct them for estate tax purposes. Amounts that are not deductible under IRC Section 213 may not be treated as deductible medical expenses for estate tax purposes. Thus, expenses that do not exceed the 10 percent floor are not deductible.[9]

The Social Security hospital tax that an individual pays as an employee or self-employed person cannot be deducted as a medical expense.[10] Conversely, a 65-year-old who has signed up for the supplementary medical plan under Medicare can treat his monthly premiums as amounts

1. Treas. Reg. §1.213-1(a)(3)(i).
2. IRC Sec. 213(d)(2).
3. Let. Rul. 8516025.
4. Rev. Rul. 2000-24, 2000-19 IRB 963.
5. See Let. Rul. 200521003. See also Let. Rul. 200729019.
6. 2000-2 USTC ¶50,863 (D. Minn. 2000).
7. *Henderson v. Comm.*, TC Memo 2000-321.
8. IRC Sec. 213(c).
9. Rev. Rul. 77-357, 1977-2 CB 328.
10. See IRC Sec. 213(d).

paid for insurance covering medical care.[1] Premiums paid for Medicare Part D, the voluntary prescription drug insurance program that went into effect on January 1, 2006, are included in the definition of medical expenses.[2]

The unreimbursed portion of an entrance fee for life care in a residential retirement facility that is allocable to future medical care is also deductible as a medical expense in the year paid (but, if the resident leaves the facility and receives a refund, the refund is includable in gross income to the extent it is attributable to the deduction previously allowed).[3] Either the percentage method or the actuarial method may be used to calculate the portions of monthly service fees (paid for lifetime residence in a continuing care retirement community) allocable to medical care.[4] Despite this, a federal district court held that none of the entrance fee paid by married taxpayers to an assisted living facility was properly deductible as a medical expense because: (1) no portion of the entrance fee was attributable to the couple's medical care; and (2) the entrance fee was structured as a loan, which cannot serve as the basis for a deduction (the court cited *Comm. v. Tufts* in reaching this conclusion[5]).[6]

Amounts paid by an individual for medicines and drugs that can be purchased over-the-counter (without a doctor's prescription) are not deductible.[7] However, amounts paid by an individual for equipment (e.g., crutches), supplies (e.g., bandages), or diagnostic devices (e.g., blood sugar test kits) may qualify as amounts paid for medical care and may be deductible under IRC Section 213. The IRS has ruled privately that crutches used to mitigate the effect of the taxpayer's injured leg and blood sugar test kits used to monitor and assist in treating the taxpayer's diabetes were amounts paid for medical care and deductible.[8]

The costs of nutritional supplements, vitamins, herbal supplements, and "natural medicines" cannot be included in medical expenses unless they are recommended by a doctor as treatment for a specific medical condition diagnosed by a doctor.[9] Certain expenses for smoking cessation programs and products are deductible as a medical expense.[10]

Amounts paid by individuals for breast reconstruction surgery following a mastectomy for cancer and for vision correction surgery are medical care expenses and are deductible. Amounts paid by individuals to whiten teeth discolored as a result of age are not medical care expenses and are not deductible.[11]

Costs paid by individuals for participation in a weight-loss program as treatment for a specific disease or diseases (e.g., obesity, hypertension, or heart disease) diagnosed by a physician

1. Rev. Rul. 66-216, 1966-2 CB 100.
2. See IRS Pub. 502, Medical and Dental Expenses.
3. Rev. Rul. 76-481, 1976-2 CB 82, *as clarified by* Rev. Rul. 93-72, 1993-2 CB 77; Let. Rul. 8641037.
4. *Baker v. Comm.*, 122 TC 143 (2004).
5. 461 U.S. 300, 307 (1983).
6. *Finzer v. United States*, 496 F. Supp. 2d 954 (N.D. Ill. 2007).
7. Rev. Rul. 2003-58, 2003-22 IRB 959.
8. Rev. Rul. 2003-58, above; see also IRS Information Letter INFO-2003-169 (6-13-2003).
9. IRS Pub. 502, Medical and Dental Expenses.
10. See Rev. Rul. 99-28, 1999-25 IRB 6.
11. Rev. Rul. 2003-57, 2003-22 IRB 959.

are deductible as medical expenses. Conversely, the costs of diet food are not deductible.[1] According to IRS Publication 502, this includes fees paid by a taxpayer for membership in a weight reduction group and attendance at periodic meetings. Membership dues for a gym, health club, or spa cannot be included in medical expenses, but separate fees charged for weight loss activities can be included as medical expenses. In informational guidance, the IRS has also stated that taxpayers may deduct exercise expenses, including the cost of equipment to use in the home, if required to treat an illness (including obesity) diagnosed by a physician. For an exercise expense to be deductible, the taxpayer must establish the purpose of the expense is to treat a disease rather than to promote general health, and that the taxpayer would not have paid the expense but for this purpose.[2]

Expenses for childbirth classes were deductible as a medical expense to the extent that the class prepared the taxpayer for an active role in the process of childbirth.[3] Egg donor fees and expenses incurred in the process of obtaining a willing egg donor count as medical care expenses that are deductible.[4]

Finally, the cost of prescribed drugs brought in or shipped from another country is deductible only if imported legally. Additionally, the cost of prescribed drugs purchased and consumed in another country are also deductible provided the drug is legal in both the other country and the United States.[5]

Credits

8541. What is a refundable tax credit and what are some examples?

On Form 1040, after the amount of tax owed is computed, the taxpayer is entitled to subtract certain payments and credits from the tax to arrive at the amount of tax that is actually payable.

Refundable credit is a tax credit that can result in a refund or credit even if the taxpayer owes no tax or it exceeds the amount of tax owing. The refundable credits include:

...Taxes withheld from salaries and wages.[6]

...Overpayments of tax.[7]

...The excess of Social Security withheld (two or more employers).[8]

...The earned income credit.[9]

1. Rev. Rul. 2002-19, 2002-16 IRB 778.
2. Information Letter INFO 2003-0202.
3. Let. Rul. 8919009.
4. Let. Rul. 200318017; see also Information Letter INFO 2005-0102 (3-29-2005).
5. IRS Pububliсation. 502.
6. IRC Sec. 31(a).
7. IRC Sec. 35.
8. Treas. Reg. §1.31-2.
9. IRC Sec. 32.

…The 72.5 percent health care tax credit for uninsured workers displaced by trade competition.[1]

…The unused long-term minimum tax credit.

Example: In 2014, Ashley, a single mother is entitled to an earned income tax credit of $3,500. Her income tax liability before the application of the credit is $1,000. Other than the earned income tax credit, Ashley has no other credits. Because the earned income credit is a refundable credit, Ashley is entitled to a refund of $2,500 ($3,500 credit minus $1,000 tax liability).

8542. How does a nonrefundable tax credit work and what are some examples?

A nonrefundable credit is a credit that is limited by the amount of the taxpayer's tax liability for the year. A taxpayer is only entitled to claim nonrefundable tax credits to the extent that the combined amount of the credits does not exceed total income tax liability for the tax year. So unlike refundable credits (Q 8541), a nonrefundable credit can never result in a refund or credit.

However, because certain nonrefundable credits in excess of a taxpayer's tax liability for a tax year may be carried forward into future tax years (and others cannot be carried over), it is important to consider the order in which a taxpayer claims the nonrefundable credits.[2] The American Taxpayer Relief Act of 2012 (ATRA) extended many expiring credits for 2012 and 2013 (as indicated below). As of the date of this publication, however, Congress has yet to act in order to extend most of these credits for 2014 and beyond.

The following tax credits are classified as *nonrefundable credits*:

…Personal credits which consist of the child and dependent care credit;[3] the credit for the elderly and the permanently and totally disabled,[4] the qualified adoption credit,[5] the nonrefundable portion of the child tax credit,[6] the American Opportunity (extended under ATRA through 2017), Hope Scholarship, and Lifetime Learning credits,[7] the credit for elective deferrals and IRA contributions (the "saver's credit," which became permanent under PPA 2006);[8]

…The nonbusiness energy property credit (retroactively extended under ATRA for 2012 and 2013)[9]; and the residential energy efficient property credit;[10]

…Other nonbusiness credits;[11]

1. IRC Sec. 35.
2. See, for example, IRC Secs. 23 (adoption expense credit), 25 (mortgage interest credit) and 25D (residential energy efficient property credit) for examples of nonrefundable credits that may be carried over to succeeding tax years.
3. IRC Sec. 21.
4. IRC Sec. 22.
5. IRC Sec. 23.
6. See IRC Sec. 24.
7. IRC Sec. 25A, as amended by ATRA, Sec. 103.
8. IRC Sec. 25B.
9. IRC Sec. 25C, as amended by ATRA, Sec. 401.
10. IRC Sec. 25D.
11. See e.g., IRC Secs. 53, 901.

> . . . The general business credit is the sum of the following credits determined for the taxable year: (1) the investment credit determined under IRC Section 46) (including the rehabilitation credit); (2) the work opportunity credit determined under IRC Section 51(a) (retroactively extended under ATRA for 2012 and 2013); (3) the alcohol fuels credit determined under IRC Section 40(a); (4) the research credit (retroactively extended under ATRA for 2012 and 2013) determined under IRC Section 41(a); (5) the low-income housing credit determined under IRC Section 42(a); (6) the enhanced oil recovery credit under IRC Section 43(a); (7) in the case of an eligible small business, the disabled access credit determined under IRC Section 44(a); (8) the renewable electricity production credit under IRC Section 45(a) (extended only through 2009 under EIEA 2008); (9) the empowerment zone employment credit determined under IRC Section 1396(a) (retroactively extended under ATRA for 2012 and 2013); (10) the Indian employment credit as determined under IRC Section 45A(a) (retroactively extended under ATRA for 2012 and 2013); (11) the employer Social Security credit determined under IRC Section 45B(a); (12) the orphan drug credit determined under IRC Section 45C(a); (13) the new markets tax credit determined under IRC Section 45D(a) (retroactively extended under ATRA for 2012 and 2013); (14) in the case of an eligible employer (as defined in IRC Section 45E(c)); the small employer pension plan startup cost credit determined under IRC Section 45E(a); (15) the employer-provided child care credit determined under IRC Section 45F(a); (16) the railroad track maintenance credit determined under IRC Section 45G(a) (retroactively extended under ATRA for 2012 and 2013); (17) the biodiesel fuels credit determined under IRC Section 40A(a) (retroactively extended under ATRA for 2012 and 2013); (18) the low sulfur diesel fuel production credit determined under IRC Section 45H(a); (19) the marginal oil and gas well production credit determined under IRC Section 45I(a); (20) for tax years beginning after September 20, 2005, the distilled spirits credit determined under IRC Section 5011(a); (21) for tax year beginning after August 8, 2005, the advanced nuclear power facility production credit determined under IRC Section 45J(a); (22) for property placed in service after December 31, 2005, the nonconventional source production credit determined under IRC Section 45K(a); (23) the energy efficient home credit determined under IRC Section 45L(a) (extended through 2013); (24) the energy efficient appliance credit determined under IRC Section 45M(a) (extended through 2013); (25) the portion of the alternative motor vehicle credit to which IRC Section 30B(g)(1) applies; and (26) the portion of the alternative fuel vehicle refueling property credit to which IRC Section 30C(d)(1) applies (extended through 2013).[1]

A credit was also available for new qualified plug-in electric drive motor vehicles acquired and placed in service after 2009. The amount of the credit can vary from $2,500 to $7,500 depending on battery capacity (and subject to phase-out based on number of vehicles sold by the manufacturer). The portion of the credit attributable to property of a character subject to

1. IRC Sec. 38(b).

an allowance for depreciation is treated as part of the general business credit. The balance of the credit is generally treated as a nonrefundable personal credit.[1] An alternative credit is available for certain plug-in electric cars placed in service after February 17, 2009 and before 2014 (retroactively extended under ATRA for 2012 and 2013). This credit is equal to 10 percent of cost, up to $2,500.[2]

8543. Who qualifies for the tax credit for the elderly and the permanently and totally disabled and how is the credit computed?

The tax credit for the elderly and the permanently and totally disabled is a nonrefundable credit, meaning that it is available only to the extent that it does not exceed the taxpayer's tax liability (see Q 8542). The credit is available to taxpayers age 65 or older, *or* those who are under age 65, retired on disability, and were considered permanently and totally disabled when they retired.[3]

> "An individual is permanently and totally disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months. An individual shall not be considered to be permanently and totally disabled unless he furnishes proof of the existence thereof in such form and manner, and at such times, as the Secretary may require."[4]

The credit equals 15 percent of an individual's IRC Section 22 amount for the taxable year, but may not exceed the amount of tax. This IRC Section 22 base amount is $5,000 for a single taxpayer or married taxpayers filing jointly if only one spouse qualifies for the credit; $7,500 for married taxpayers filing jointly if both qualify; and $3,750 for a married taxpayer filing separately.[5] Married taxpayers must file a joint return to claim the credit, unless they lived apart for the entire taxable year.[6]

For individuals under age 65, this base figure is limited to the amount of the disability income (taxable amount an individual receives under an employer plan as wages or payments in lieu of wages for the period the individual is absent from work on account of permanent and total disability) received during the taxable year.[7] (The taxpayer may be required to provide proof of continuing permanent and total disability.)[8] For married taxpayers who are both qualified and who file jointly, the base figure cannot exceed the total of both spouses' disability income if both are under age 65. If only one spouse is under age 65, the base figure cannot exceed the sum of $5,000 plus the disability income of the spouse who is under 65.[9]

1. IRC Sec. 30D, as amended by ARRA 2009.
2. IRC Sec. 30, as amended by ARRA 2009 and ATRA.
3. IRC Sec. 22(b).
4. IRC Sec. 22(e)(3).
5. IRC Sec. 22(c).
6. IRC Sec. 22(e)(1).
7. IRC Sec. 22(c)(2)(B)(i).
8. GCM 39269 (8-2-84).
9. IRC Sec. 22(c)(2)(B)(ii).

The base figure (or the amount of disability income in the case of individuals under age 65, if lower) is reduced dollar-for-dollar by one-half of adjusted gross income in excess of $7,500 (single taxpayers), $10,000 (joint return), or $5,000 (married filing separately).[1] A reduction is also made for Social Security and railroad retirement benefits that are excluded from gross income, and certain other tax-exempt income.[2]

8544. Who qualifies for the child tax credit?

The child tax credit is generally a nonrefundable tax credit that is available for each "qualifying child" (defined below) of eligible taxpayers who meet certain income requirements. The child tax credit may be refundable to the extent that the taxpayer has three or more qualifying children or for a certain portion of the taxpayer's earned income (see below). The child tax credit is $1,000 per child.[3]

The term *qualifying child* means a "qualifying child" of the taxpayer (as defined under IRC Section 152(c) – see below) who has not attained the age of 17;[4] and

(1) who is the taxpayer's "child" (see below) or a descendant of such a child, *or* the taxpayer's brother, sister, stepbrother, or stepsister or a descendant of any such relative;

(2) who has the same principal place of abode as the taxpayer for more than one-half of the taxable year; *and*

(3) who has not provided over one-half of his or her own support for the calendar year in which the taxpayer's taxable year begins.[5]

Additionally, a qualifying child must be either a citizen or a resident of the United States.[6]

The term "child" means an individual who is: (1) a son, daughter, stepson, or stepdaughter of the taxpayer; or (2) an "eligible foster child" of the taxpayer.[7] An "eligible foster child" means an individual who is placed with the taxpayer by an authorized placement agency or by judgment decree, or other order of any court of competent jurisdiction.[8] Any adopted children of the taxpayer are treated the same as natural born children.[9]

The amount of the credit is reduced for taxpayers whose modified adjusted gross income (MAGI) exceeds certain levels. A taxpayer's MAGI is adjusted gross income without regard to the exclusions for income derived from certain foreign sources or sources within United States possessions. The credit amount is reduced by $50 for every $1,000 or fraction

1. IRC Sec. 22(d).
2. IRC Sec. 22(c)(3).
3. IRC Sec. 24(a).
4. IRC Sec. 24(c)(1).
5. IRC Sec. 152(c).
6. IRC Sec. 24(c)(2).
7. IRC Sec. 152(f)(1).
8. IRC Sec. 152(f)(1)(C).
9. IRC Sec. 152(f)(1)(B).

thereof, by which the taxpayer's MAGI exceeds the following threshold amounts: $110,000 for married taxpayers filing jointly, $75,000 for unmarried individuals, and $55,000 for married taxpayers filing separately.[1]

The child tax credit is also refundable. If the child tax credit exceeds the taxpayer's tax liability, a taxpayer with one or two children can receive a refund of the lesser of the unused amount of the credit or 15 percent of earned income in excess of $3,000.[2] For families with three or more qualifying children, the amount of the refundable credit is the greater of 15 percent of earned income over $3,000 or the sum of social security and Medicare taxes paid minus the earned income credit.

The nonrefundable child tax credit can be claimed against the individual's regular income tax *and* alternative minimum tax (see Q 8551 and Q 8553). The tax credit cannot exceed the excess of (i) the sum of the taxpayer's regular tax plus the alternative minimum tax over (ii) the sum of the taxpayer's nonrefundable personal credits (other than the child tax credit, adoption credit, and saver's credit) and the foreign tax credit for the taxable year.[3] Finally, the refundable child tax credit is not required to be reduced by the amount of the taxpayer's alternative minimum tax.[4]

Some additional restrictions applying to the child tax credit include: (1) an individual's tax return must identify the name and taxpayer identification number (Social Security number) of the child for whom the credit is claimed; and (2) the credit may be claimed only for a full taxable year, unless the taxable year is cut short by the death of the taxpayer.[5]

For purposes of applying a uniform method of determining when a child attains a specific age, the IRS has ruled that a child attains a given age on the anniversary of the date that the child was born (e.g., a child born on January 1, 1987, attains the age of 17 on January 1, 2004).[6]

Social Security

8545. Are social security and railroad retirement benefits taxable?

A taxpayer must include a portion of benefits in gross income if the taxpayer's modified adjusted gross income (in most cases the taxpayer's adjusted gross income) plus one-half of the Social Security benefits (including tier I railroad retirement benefits) received during the taxable year exceeds certain base amounts. The amounts that are required to be included in gross income are taxed as ordinary income. The more income the taxpayer has in addition to Social Security benefits, the greater the amount of those benefits are taxable. However, the amount of benefits taxable can never exceed 85 percent of the total benefits.

To calculate the extent to which social security benefits are taxable, add one half of Social Security benefits received during the tax year to all other income including wages, interest

1. IRC Sec. 24(b)(2).
2. IRC Sec. 24(d).
3. IRC Sec. 24(b)(3).
4. IRC Sec. 24(d)(1).
5. IRC Secs. 24(e), 24(f).
6. Rev. Rul. 2003-72, 2003-2 CB 346.

(including tax exempt interest), dividends, taxable pension distributions, etc. (modified adjusted gross income).[1] Next, compare that amount with the base amount which are the following:

- $25,000 for single, head of household or qualifying widow
- $25,000 for married filing separately and living apart from other spouse for the entire tax year
- $32,000 for married filing jointly
- $0 for married filing separately and living with his or her spouse any time during the tax year[2]

If the modified adjusted gross income plus one half of Social Security benefits is equal or less than the base amount, no portion of the Social Security benefits are taxable.

On the other hand, if the sum of modified adjusted gross income plus one half of Social Security benefits exceeds the base amount, then a portion of those benefits are potentially taxable. The computation, however, involves the "adjusted base amount" which is the following:

- $34,000 for all filers with the exception of joint filers and a married taxpayer filing separately and living with his or her spouse any time during the tax year.
- $44,000 for joint filers.
- $0 for married taxpayer filing separately and living with his or her spouse any time during the taxable year.[3]

If the sum of modified adjusted gross income plus one half of Social Security benefits is *greater than* the base amount but *less than* the adjusted base amount, the amount included in gross income is the lesser of 1) one-half of the Social Security benefits received during the tax year; or 2) one-half of the excess of the sum of modified adjusted gross income plus one half of Social Security benefits exceeds the base amount (referred to as the "Section 86(a)(1) Amount").[4]

> *Example*: Married couple files a joint return. During the taxable year, they received $12,000 in Social Security benefits and have a modified adjusted gross income of $35,000. Their modified adjusted gross income plus one-half of their Social Security benefits [$35,000 + (½ of $12,000) = $41,000] is greater than the *base amount* of $32,000 but less than the *adjusted base amount* of $44,000.

So in computing the taxable amount of Social Security benefits, consider the following: The taxpayers' Social Security benefits are $12,000 and the excess between modified adjusted gross income plus one-half of their Social Security benefits over the base amount is

1. IRC Sec. 86(b)(2).
2. IRC Sec. 86(c)(1).
3. IRC Sec. 86(c)(2).
4. IRC Sec. 86(a)(1).

$9,000 ($41,000 minus $32,000). However, referring back to the formula, the amount includible is one-half of the lesser amount. Therefore, the amount of Social Security benefits included in gross income is $4,500 (one half of $9,000) because it is less than one 6,000 (one-half of the $12,000 total Social Security benefits).

If the sum of modified adjusted gross income plus one half of Social Security benefits is *greater than* the adjusted base amount, the amount included in gross income is the lesser of the sum of 1) 85 percent of the amount of modified adjusted gross income over the adjusted base amount plus the lesser of (a) the Section 86(a)(1) Amount or b) one half of the difference between the adjusted base amount and the base amount) or 2) 85 percent of the Social Security benefits received during the tax year.

> *Example*: During the taxable year, a single individual had a modified adjusted gross income of $33,000 and received $8,000 in Social Security benefits. His modified adjusted gross income plus one-half of his Social Security benefits [$33,000 + (½ of $8,000) = $37,000] is greater than the applicable *adjusted base amount* of $34,000.
>
> So tracking the formula above: The lesser of
>
> 1) 85 percent of the amount of modified adjusted gross income over the adjusted base amount $3,000 ($37,000 modified adjusted gross income minus $34,000 the adjusted base amount), or **$2,550** plus the lesser of a) the Section 86(a)(1) Amount $6,500 (which is one half of $13,000, i.e., the excess of $37,000 modified adjusted gross income over the base amount $24,000) or b) **$4,500** (which is one half of $9,000, the difference between $34,000 adjusted base amount and $25,000 base amount; or
>
> 2) 85 percent of total Social Security benefits of $8,000, or **$6,800**.
>
> So consolidating the above formula, 85 percent of $3,000, or $2,550 plus $4,500 equals $6,550 which is less than 85 percent of $8,000, or $6,800. So, the amount included in gross income is $6,500.

8546. What other issues relate to the taxation of social security and railroad retirement benefits?

Railroad retirement benefits (other than Tier I benefits) are taxed like benefits received under a qualified pension or profit sharing plan. For this purpose, the Tier II portion of the taxes imposed on employees and employee representatives is treated as an employee contribution, while the Tier II portion of the taxes imposed on employers is treated as an employer contribution.[1]

As mentioned above, the base amount and adjusted base amount of a married taxpayer filing separately who lives with his or her spouse anytime during the tax year is zero. This means it is much more likely that 85 percent of his or her Social Security benefits will be taxable even if the other income is on the low end. So the issue of whether separated taxpayers are living apart is significant.

To this point, the Tax Court held that the term "live apart" means living in separate residences for purposes of IRC Section 86(c)(1)(C)(ii). Thus, where the taxpayer lived in the same residence as his spouse for at least 30 days during the tax year in question (even though maintaining

1. See IRC Sec. 72(r)(1).

separate bedrooms), the Tax Court ruled that he did not "live apart" from his spouse at all times during the year; therefore, the taxpayer's base amount was zero.[1]

A taxpayer may elect to treat a lump sum payment of benefits as received in the year in which the benefits are attributable.[2]

Any workers' compensation pay that reduced the amount of Social Security received and any amounts withheld to pay Medicare insurance premiums are included in the figure for Social Security benefits.[3]

Another issue that has arisen is whether Social Security disability payments should be lumped in with regular Social Security benefits. In *Green v. Comm.*,[4] the taxpayer argued that his Social Security disability benefits were excludable from gross income[5] because they had been paid in lieu of workers' compensation. The Tax Court determined, however, that Title II of the Social Security Act is *not* comparable to workers' compensation, which provides benefits based on a taxpayer's employment. Instead, the Act allows for disability payments to individuals regardless of employment. Consequently, the taxpayer's Social Security disability benefits were includable in gross income.

In a case of first impression, the Tax Court held that a taxpayer's Social Security disability insurance benefits (payable as a result of the taxpayer's disability due to lung cancer that resulted from exposure to Agent Orange during his Vietnam combat service) were includable in gross income under IRC Section 86 and were not excludable under IRC Section 104(a)(4). The court reasoned that Social Security disability insurance benefits do not take into consideration the nature or cause of the individual's disability. Furthermore, the Social Security Act does not consider whether the disability arose from service in the Armed Forces or was attributable to combat-related injuries. Eligibility for purposes of Social Security disability benefits is determined on the basis of the individual's prior work record, not on the cause of disability. Moreover, the amount of Social Security disability payments is computed under a formula that does not consider the nature or extent of the injury. Consequently, because the taxpayer's Social Security disability insurance benefits were not paid for personal injury or sickness in military service within the meaning of IRC Section 104(a)(4), the benefits were not eligible for exclusion under IRC Section 104(a)(4).[6]

8547. What are the social security tax and Medicare rates for self-employed taxpayers?

Similar to the FICA tax imposed on wage income, the social security and Medicare taxes are imposed on self-employment income pursuant to the Self-Employment Contributions Act of 1954 (collectively the two taxes are more formally referred to as the "SECA tax").[7]

1. *McAdams v. Comm.*, 118 TC 373 (2002).
2. IRC Sec. 86(e).
3. Rev. Rul. 84-173, 1984-2 CB 16.
4. TC Memo 2006-39.
5. Under IRC Section 104(a)(1).
6. *Reimels v. Comm.*, 123 TC 245 (2004), affi'd, 436 F.3d 344 (2d Cir. 2006); *Haar v. Comm.*, 78 TC 864, 866 (1982), aff'd, 709 F.2d 1206 (8th Cir. 1983), followed.
7. SECA is codified as Chapter 2 of the Internal Revenue Code.

Unlike a wage earner whose liability is limited to ½ of the FICA tax, a self-employed individual is obligated to pay the entire amount of the 15.3 percent SECA tax, or 12.4 percent social security tax and 2.9 percent Medicare tax. Similar to FICA, the social security tax cap for self-employment income is the same dollar amount as the social security wage cap. Indexed for inflation, for 2014, the social security cap for self-employment income is $117,000.[1]

On the other hand, there is no cap on the amount of self-employment income subject to the Medicare tax. Moreover, effective for tax years beginning after December 31, 2012, subject to filing status thresholds, there is an Additional Medicare Surtax of 0.9 percent added to the 2.9 percent Medicare tax rate.

8548. What are the social security and Medicare tax rates for traditional employees and employers?

The social security tax and Medicare tax rates are the same on the wage income of a wage earner and as they are on the self-employment income of a self-employed individual. However, the operative statute for the imposition of payroll taxes on wage earners is the Federal Insurance Contributions Act (the "FICA tax").[2] Unlike the self-employed, the liability for FICA tax imposed on the wages of a wage earner is split equally between the employee and the employer. In other words, the employee and the employer are each responsible for 6.2 percent of the 12.4 percent of social security tax and for 1.45 percent of the 2.9 percent of Medicare tax.[3]

Although the social security tax rate is much higher than the Medicare tax rate, it is capped at a certain amount of wages as adjusted annually for inflation. So, wages in excess of the cap amount are no longer subject to social security tax. For 2014, the social security tax caps at wages of $117,000.[4] Thus, the maximum amount of social security tax liability for the employee and employee shares would be $14,508 (12.4 % * $117,000), or $7,254 each.

On the other hand, there is no cap on the Medicare tax. This means the combined employer/employee 2.9 percent tax rate will be imposed on all wages without limit. So, for 2014, although the imposition of social security tax ceases on wages in excess of $117,000, the imposition of Medicare tax continues to be imposed on all excess wages. Moreover, effective for tax years beginning after December 31, 2012, subject to filing status thresholds, there is an Additional Medicare Surtax of 0.9 percent added to the 1.45 percent rate on the employee portion of the Medicare tax.

Estimated Tax and Self-Employment Tax

8549. Who must pay the estimated tax and are penalties imposed for underpayment of the tax?

Subject to the potential imposition of penalties, any taxpayer who expects to owe tax of $1,000 or more is required to make estimated tax payments.[5] In other words, a taxpayer should

1. IRS Publication 517 (2013).
2. Codified as Chapter 21 of the Internal Revenue Code, IRC Secs. 3101-3128.
3. IRC Secs. 3101(a), 3111(a), 3101(b) and 3111(b).
4. Press Release, Social Security Administration (October 13, 2013).
5. http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Estimated-Taxes.

project the current year's taxable income, tax and credits based on expected income, deductions, etc. Based on "a pay as you go" method, estimated tax payments are payable periodically throughout the year. For this purpose, tax liability includes regular income tax, alternative minimum tax as well as self-employment tax (Social Security and Medicare tax).[1]

For self-employed taxpayers, the requirement to make estimated payments is more problematic than for employees. Unlike employees, no part of a self-employed individual's compensation is withheld by the payor and paid over to the IRS for taxes. Moreover, in addition to regular income tax, these taxpayers are required to pay the full 15.3 percent of the Social Security and Medicare tax. For this reason, a self-employed with even a modest amount of income who may owe little or no income tax, may, nonetheless have a significant Social Security and Medicare tax liability.

However, even employed individuals who are subject to withholding should consider making estimated payments under the following circumstances:

- The amount being withheld by the employer is insufficient.
- The taxpayer has a significant amount of other income such as dividends, interest, alimony, rent, etc. that is not subject to withholding.

On the other hand, an individual need not make estimated payments if all three of the following conditions are met:

- The individual had no tax liability for the prior tax year.
- The individual was a U.S. citizen for the entire tax year.
- The prior tax year was a 12 month period.[2]

Although estimated payments can be made at any time during the tax year, there is a "required annual payment" that is payable in "required installments" with specific due dates. For that purpose, the tax year is divided into four unequal quarters with the following due dates:

First Quarter January through March	April 15th
Second Quarter April through June	June 15th
Third Quarter June through August	September 15th
Fourth Quarter September through December	January 15th of following tax year[3]

The "required annual payment" is a) 90 percent of the taxpayer's expected tax liability for the tax year or b) 100 percent of the tax owing for the prior tax year (assuming the prior

1. IRC Sec. 6654(a).
2. http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Estimated-Taxes.
3. IRC Sec. 6654(c).

tax year spanned 12 months).[1] However, if the taxpayer's adjusted gross income exceeded $150,000 ($75,000 for filing married filing separately), the percentage in b), above is 110 percent.[2]

If the taxpayer fails to make timely estimated installment payments, the taxpayer is subject to penalties. Although the taxpayer can compute the penalty on Form 2210, the IRS will compute the penalty if the taxpayer does not complete the form.

8550. Who must pay the self-employment tax?

An individual who has annual net earnings from self-employment of $400 or more is subject to self-employment tax.[3] Generally, the income of sole proprietors, single member LLCs treated as a disregarded entity and general partners are considered to be self-employed. Self-employment tax is reported on Schedule SE attached to Form 1040. However, a self-employed taxpayer is entitled to an above-the-line deduction equal to one-half of the self-employment tax paid.[4]

In essence, self-employment tax is the combination of Social Security tax and Medicare tax. The Social Security tax is 12.4 percent and the Medicare tax is 2.9 percent.[5] For 2014, the cap on Social Security taxes on up to $117,000 of self-employment income. If the taxpayer has wages and self-employment income, the amount of self-employment income subject to the Social Security tax part is the difference between the cap amount and the amount of the taxpayer's wages.

> *Example*: In 2014, Asher has wages of $90,000. In addition, Asher has self-employment income of $30,000. Since the Social Security wage base is $117,000, only $27,000 of Asher's $30,000 of self-employment ($117,000 minus $90,000).

On the other hand, with regard to Medicare tax, there is no cap on self-employment income. Also, for self-employment over certain threshold amounts, there is an Additional Medicare Surtax of 0.9 percent added to the 2.9 percent Medicare rate, or a total of 3.8 percent. The threshold amounts are self-employment income in excess of $250,000 for joint filers, $125,000 for married filing separately and $200,000 for all other filing status.[6]

Alternative Minimum Tax

8551. What is the alternative minimum tax and how is it calculated?

In addition to regular income tax, the *alternative minimum tax* (AMT) is an additional tax that certain taxpayers must pay. In theory, the purpose of AMT is prevent high income taxpayers from taking advantage of tax benefits (such as exclusions, deductions and credits) to substantially reduce or even eliminate their tax liability. However, in reality, due to complex rules, many relatively low income taxpayers are often subject to AMT.

1. IRC Sec. 6654(d)(1)(A).
2. IRC Sec, 6654(d)(1)(C).
3. IRC Sec. 6017
4. IRC Sec. 164(f).
5. IRC Sec. 1401.
6. IRC Sec. 1401(b)(2).

The AMT is calculated as follows:

(1) compute alternative minimum taxable income (AMTI, see Q 8553);

(2) subtract the exemption amount from AMTI; and

(3) multiply the remaining AMTI (step (2), above), by the applicable AMT rate.

For purposes of sheltering lower income taxpayers from being subject to AMT, the Code allows exemption amounts. Only AMTI in excess of the exemption amount is subject to AMT. The 2014 exemption amounts are as follows:[1]

Filing Status	AMT Exemption
Married filing jointly or qualifying widow(er)	$82,100
Single or Head of Household	$52,800
Married filing separately	$41,050

There are two AMT rates. For 2014, those rates are as follows:

AMT Rates	26%	28%
Married filing separately	Up to $91,250	Over $91,250
All other filing status	Up to $182,500	Over $182,500

For purposes of computing AMT, the taxpayer is allowed to take the foreign tax credit.[2] After computing AMT, it is compared with the taxpayer's regular income tax. If the regular tax is lower than AMT, the difference is AMT owing in addition to the tax. Stated differently, the taxpayer must pay the higher of AMT or the regular tax.[3]

Example: For 2014, Asher's regular income tax liability is $75,000 but his AMT tax liability is $92,000, or $17,000 more than his regular income tax liability. Asher's liability is $92,000 ($75,000 regular income tax and $17,000 AMT).

8552. Are personal tax credits allowed as an offset against AMT liability?

Several refundable tax credits such as the earned income credit and the refundable portion of the child tax credit are allowed as an offset against AMT liability. Other personal nonrefundable credits also allowed as an offset include:

- Adoption tax credit
- Child and dependent care credit
- Nonrefundable portion of the child tax credit
- Certain learning credits

1. IRC Sec. 55(d)(1), Rev. Proc. 2013-35, IRB 2013-47 537.
2. IRC Sec. 55(b)(1)(A).
3. IRC Sec. 55(a).

- Tax credit for IRAs and retirement plans
- Energy saving credits[1]

8553. How is alternative minimum taxable income (AMTI) computed?

Alternative minimum taxable income (AMTI) is taxable income, with adjustments made in the way certain items are treated for AMT purposes and increased by tax preference items.[2]

Except as otherwise provided below and in Q 8554 and Q 8555, the provisions that apply in determining the regular taxable income of a taxpayer also generally apply in determining the AMTI of the taxpayer.[3] In addition, references to a non-corporate taxpayer's adjusted gross income (AGI) or modified AGI in determining the amount of items of income, exclusion, or deduction must be treated as references to the taxpayer's AGI or modified AGI as determined for regular tax purposes.[4]

The following chart is a non-exclusive comparison of the different treatment of certain items in the computation of regular income tax as compared to the computation of AMT:[5]

Item	Regular Income Tax Computation	AMT Computation
Standard deduction (taxpayer does not itemize)	Allowed	Not allowed
Phase out of itemized deductions	Phased out if AGI exceeds applicable thresholds	No phase out
Medical Expenses	Allowed as itemized deductions to the extent they exceed 10% of AGI	Same.
Taxes	State income taxes, property taxes, etc. allowed as itemized deduction	Not allowed
Home Mortgage Interest	Allowed	Allows only acquisition indebtedness including loan to improve principal residence or second home. Interest attributed to refinanced amounts in excess of original loan not allowed.
State Tax Refund	Included in gross income if previously deducted as itemized deduction	Since state taxes are not allowed as a deduction, refunds are not included in income. Amount of regular income entered as a negative amount.

1. IRC Sec. 26(a)(2).
2. IRC Sec. 55(b)(2).
3. Treas. Reg. §1.55-1(a).
4. Treas. Reg. §1.55-1(b).
5. IRC Secs. 56, 58.

Item	Regular Income Tax Computation	AMT Computation
Interest expense related to tax-exempt interest income	Not allowed	Allowed if interest expense is related to tax-exempt private activity bonds
Miscellaneous itemized deductions	Allowed to the extent they exceed 2% of AGI assuming the taxpayer itemizes	Not allowed
Qualified stock options	Exercise of a qualified stock option not taxable	Difference between amount paid to acquire the stock and the FMV of the stock is included as AMTI income
Tax-exempt income	Not included in gross income	Included in AMTI income

8554. Is there an AMT credit for an AMT liability in a prior tax year?

There are two factors that contribute to the imposition of AMT. There are "exclusion items" and "deferral items." An example of an exclusion item are miscellaneous itemized deductions or state or local taxes that are deductible for regular income tax purposes but never for AMT purposes. For this reason, there is never a credit for an exclusion item.

Conversely, for AMT purposes, a deferral item is simply a matter of a timing difference. For example, certain property depreciated using the accelerated depreciation method must be depreciated under the straight line method for AMT purposes. Thus, for regular income tax purposes, in the early years of property depreciated under the accelerated method will be higher than under the straight line method. For that reason, it will cause AMTI to be higher than regular taxable income. However, in the later years of property depreciated und the accelerated method, the amount of depreciation will be lower than amount of straight line depreciation.

Therefore, in the absence of an AMT credit for a deferral item, the taxpayer would be whipsawed with double negative tax consequences with respect to one item.

Example: In 2014, Asher is subject to AMT. Although for regular income tax purposes, based on the accelerated depreciation method, Asher is entitled to a $2,500 depreciation deduction, for AMT purposes the straight line depreciate deduction is $1,750. As a result, Asher's depreciation deduction is the lesser $1,750.

In 2015, Asher is not subject to AMT. However, based on the accelerated depreciation method, his regular income tax depreciation deduction is $1,500 (it would have been $1,750 if depreciated under the straight line method.

So, in the AMT year, Asher was not allowed to take the higher accelerated depreciation deduction. Then, in the non-AMT year, Asher was compelled to take the lower accelerated depreciation deduction.

Fortunately, there is an AMT credit to allow an adjustment in the non-AMT year. Using Form 8801, the AMT from the prior year is recalculated based on what it would have been but for the deferral item.[1] So in the above example, Asher's AMT would be refigured using the accelerated depreciation deduction. The difference between the actual AMT tax and the recomputed AMT tax is the AMT credit. Although the AMT credit is nonrefundable, it is cumulative so it can be carried forward to subsequent tax years until it is fully used.[2]

8555. Is there a phase out of the alternative minimum tax exemption?

The purpose of the AMT exemption is to prevent its imposition on lower income taxpayers. The exemption amounts are: $52,800 for single and head of household filers, $82,100 for joint filers and $41,050 for married separately filers.

However, the AMT exemption does phase out when AMTI reaches certain threshold levels.[3] The phase out is a reduction of the exemption by 25 percent of each dollar over the applicable threshold. The following chart sets forth the applicable 2014 AMTI thresholds as well as the total phase out amount.

Filing Status	AMTI Exemption Phase Out Threshold Amount	AMTI Total Phase Out Amount
Married filing jointly or qualifying widow(er)	$156,500	$484,900
Single or Head of Household	$117,300	$328,500
Married filing separately	$78,250	$242,450

Example: In 2014, Asher and Ashley, a married couple have AMTI of $200,000. Their AMT exemption without considering the phase out is $82,100. However, the couple's AMTI is $200,000 and the AMTI exemption phase out threshold amount is $156,500. As a result, their AMT exceeds the threshold amount by $43,500. Applying the phase out, the couple's 2014 exemption amount is reduced from $82,100 to $71,225 (a reduction of $10.875, or 25 percent * $43,500).

8556. Are there special AMT exemption rules that apply to a child subject to the kiddie tax?

If a child is subject to the kiddie tax, it is possible that he or she may be subject to AMT. Under special rules, the AMT exemption of a child subject to the kiddie tax is the lesser of the AMT exemption for a single taxpayer ($52,800) or the total of the child's earned income plus $7,250.[4]

Minors

8557. What is the "kiddie tax"?

This so-called "kiddie tax" prevents parents from shifting unearned income taxed at their higher rates to their children to be taxed at lower rates. So to prevent this type of income

1. IRC Sec. 53(d).
2. IRC Sec. 53(b).
3. IRC Sec. 55(d)(3).
4. IRC Sec. 59(j); Rev. Proc. 2013-35, 2013-47 IRB 537.

shifting, the kiddie tax subjects a child's unearned income in excess of $2,000 to being taxed at the parents' highest marginal tax rate.

For the kiddie tax to apply, at least one parent must be alive at the close of the taxable year. The parent whose taxable income is taken into account is (a) in the case of parents who are not married, the custodial parent of the child (determined by using the support test for the dependency exemption) and (b) in the case of married individuals filing separately, the individual with the greater taxable income.[1] If the custodial parent files a joint return with a spouse who is not a parent of the child, the total joint income is applicable in determining the child's rate.

If there is an adjustment to the parent's tax, the child's resulting liability must also be recomputed. In the event of an underpayment, interest, but not penalties, will be assessed against the child.[2]

The kiddie tax applies only to "net unearned income." "Net unearned income" is defined as adjusted gross income that is not attributable to earned income, and that exceeds (1) the $1,000 standard deduction for a dependent child in 2014, *plus* (2) the greater of $1,000 or (if the child itemizes) the amount of allowable itemized deductions that are directly connected with the production of his unearned income.[3] The source of the assets that produce unearned income need not be the child's parents.[4]

"Earned income" means all compensation for personal services actually rendered.[5] A child is therefore taxed at his own rate on reasonable compensation for services that he or she performs.

Regulations specify that "unearned income" includes any Social Security or pension payments received by the child, income resulting from a gift under the Uniform Gifts to Minors Act, and interest on both earned and unearned income.[6]

As to which children are subject to the kiddie tax, it applies to:

(1) a child under age 18; *or*

(2) a child age 18 whose earned income does not exceed one-half of his or her support; *or*

(3) a child age 19 to 23 who is a fulltime student with earned income that does not exceed one-half of his or her support.[7]

Whether a child is under the threshold ages listed above is determined at the end of the tax year. "Child," for purposes of the kiddie tax, includes children who are adopted, related by

1. Temp. Treas. Reg. §1.1(i)-1T, A-11, A-12.
2. Temp. Treas. Reg. §1.1(i)-1T, A-17, A-19.
3. IRC Sec. 1(g)(4); Rev. Proc. 2013-35, 2013-47 IRB 537.
4. Temp. Treas. Reg. §1.1(i)-1T, A-8.
5. IRC Secs. 911(d)(2), 1(g)(4)(A)(i).
6. Temp. Treas. Reg. §1.1(i)-1T, A-8, A-9, A-15.
7. IRC Sec. 1(g)(2).

half-blood, or from a prior marriage of either spouse.[1] The kiddie tax applies without regard to whether the child is considered a dependent for tax purposes.

Example: In 2014, Pete is 16 with both parents alive. During 2014, Pete has $1,400 of interest income from a bank savings account and $1,700 he earned from a paper route. Some of the interest income is attributable to Pete's paper route earnings that were deposited in the account. The balance of the interest was generated from cash gifts Pete received from his parents and grandparents. Pete has no itemized deductions and can be claimed as a dependent on his parent's return.

Therefore, for the taxable year 2014, Pete's standard deduction is $2,050, the amount of Pete's earned income, $1,700 from the paper route, plus $350. Of this standard deduction amount, $1,000 is allocated against unearned income, and $1,050 is allocated against earned income.

Although some of Pete's $1,400 of interest income is attributable to some of his paper route income deposited into his bank account, it is all treated as unearned income. Of that amount, $1,000 is taxed at Pete's own tax rate (10%). The remaining taxable unearned income of $400 will be taxed at his parents' highest marginal tax rate.

8558. Can parents include the amount of their child's unearned income subject to kiddie tax on their own income tax return?

Under certain circumstances, parents may elect to include their child's unearned income subject to the kiddie tax on their own income tax return, thus avoiding the necessity of the child filing a return. The election is available to parents whose child has gross income of more than $1,000 and less than $10,000 (in 2014), all of which is from interest and dividends.[2] However, by doing so, the parents would increase their adjusted gross income and be subject to potential phase outs or other tax benefits that decrease as a result of certain threshold amounts of adjusted gross income.

The election is unavailable if there has been backup withholding under the child's Social Security number or if estimated tax payments have been made in the name and Social Security number of the child.

8559. Who is taxed on the income from property that is transferred to a minor under a uniform "Gifts to Minors" act?

As a general rule, the income is taxable to the minor. However, as discussed in Q 8557, unearned income of children (even potentially up to age 23), may be subject to the kiddie tax.

To the extent that income from the transferred property is used for the minor's support, it may be taxed to the person who is legally obligated to support the minor.[3] State laws differ as to a parent's obligation to support. The income will be taxable to the parent only to the extent that it is actually used to discharge or satisfy the parent's obligation under state law.[4]

1. Temp. Treas. Reg. §1.1(i)-1T, A-13, A-14.
2. IRC Sec. 1(g)(7); Rev. Proc. 2008-66, 2008-45 IRB 107.
3. Rev. Rul. 56-484, 1956-2 CB 23; Rev. Rul. 59-357, 1959-2 CB 212.
4. IRC Sec. 677(b).