

GROSS INCOME

Gross income includes all income items that must be reported on the federal income tax return and that are subject to the federal income tax. It includes all income as broadly defined, less exclusions. Gross income is discussed in more detail in Chapters 4 and 5. Some of the most common gross income items are listed in Exhibit 3.4.

EXHIBIT 3.4 ITEMS INCLUDED IN GROSS INCOME

- | | |
|---------------------------------------|---|
| • Gains from the sale of assets | • Compensation (salaries and wages, etc.) |
| • Distributions from retirement plans | • Interest income |
| • Rental income | • Dividend income |
| • Unemployment compensation benefits | • Alimony received |
| • Royalty income | • Gross income from self-employment |

DEDUCTIONS

Deductions are subtracted from gross income in arriving at taxable income. For individual taxpayers, deductions are divided into two categories: Deductions *for* (before) adjusted gross income and deductions *from* (after) adjusted gross income. Deductions for adjusted gross income are called **above-the-line deductions**, and deductions from adjusted gross income are called **below-the-line deductions**, itemized deductions, or Schedule A deductions. These types of deductions are discussed in more detail in Chapters 6 and 7. A small sample of deductions for adjusted gross income (above-the-line deductions) is listed in Exhibit 3.5.



Quick Quiz 3.1

Highlight the answer to these questions:

1. Income includes a return of invested capital.
 - a. True
 - b. False
2. Property obtained by inheritance is not included in gross income.
 - a. True
 - b. False

False, True.

EXHIBIT 3.5 PARTIAL LIST OF DEDUCTIONS FOR ADJUSTED GROSS INCOME

- | | |
|-------------------------------------|---|
| • Alimony paid | • Business expenses |
| • Contributions to traditional IRAs | • Rental or royalty income expenses |
| • Tuition for higher education | • Losses from the sale of business property |
| • Interest paid on student loans | • Moving expenses |

ADJUSTED GROSS INCOME (AGI)

Adjusted gross income (AGI) is gross income reduced by above-the-line deductions. When determining whether deductions are taken above the line (for AGI) or below the line (from AGI), “the line” is AGI. Adjusted gross income is also used to determine limitations on several below-the-line deductions, on several income tax credits (discussed later in this chapter), and on a few other items on the tax return. Adjusted gross income is a concept that applies to individual tax returns; it does not apply to corporate or other entity tax returns.

Deductions from Adjusted Gross Income

Deductions from adjusted gross income (below-the-line deductions) are those deductions that are subtracted from AGI. They consist of the greater of the standard deduction or certain allowable itemized deductions and the deduction for personal and dependency exemptions.

Standard Deduction

An individual taxpayer is allowed to deduct the greater of the standard deduction or allowable itemized deductions. In recent years, approximately 70 percent of individual taxpayers have used the standard deduction. The **standard deduction** is a standard amount used to offset AGI that is specified by Congress. The standard deduction is adjusted for inflation on an annual basis. The total standard deduction includes a basic standard deduction plus additional standard deduction amounts for taxpayers age 65 or older and for taxpayers who are blind. The basic standard deduction amounts depend on the taxpayer’s filing status (discussed below). The 2008 and 2009 standard deduction amounts for nondependents are listed in Exhibit 3.6. The standard deduction for a dependent is different and is discussed below.

STANDARD DEDUCTION

EXHIBIT 3.6

Filing Status	2008	2009
Married Filing Jointly	\$10,900	\$11,400
Married Filing Separately	\$5,450	\$5,700
Surviving Spouse	\$10,900	\$11,400
Head of Household	\$8,000	\$8,350
Single	\$5,450	\$5,700

Additional Standard Deduction

An additional standard deduction is allowed for a taxpayer or spouse (not for a dependent) who is 65 years of age or older or blind. The age of the taxpayer is determined as of the end of the year. It is therefore possible for an unmarried taxpayer to receive one or two additional standard



Key Concepts

Underline/highlight the answers to these questions as you read:

1. Define adjusted gross income.
2. Explain the difference between the standard deduction and itemized deductions.
3. Explain when a taxpayer is not permitted to use the standard deduction.

deductions and for a married couple to receive up to four additional standard deductions. The amounts allowed for each additional standard deduction are adjusted for inflation and depend upon the filing status of the taxpayer. The 2008 and 2009 additional standard deduction amounts are listed in Exhibit 3.7.

EXHIBIT 3.7 ADDITIONAL STANDARD DEDUCTION

Filing Status	2008	2009
Married Filing Jointly	\$1,050	\$1,100
Married Filing Separately	\$1,050	\$1,100
Surviving Spouse	\$1,050	\$1,100
Head of Household	\$1,350	\$1,400
Single	\$1,350	\$1,400

EXAMPLE 3.2

Trevor (age 66) and Susan (age 67) file a joint return for 2008. Their standard deduction is \$13,000 (basic standard deduction of \$10,900 plus two additional standard deductions of \$1,050 for age). If Susan were blind, their standard deduction would be \$14,050 (basic standard deduction plus three additional standard deductions). Note for 2009, the standard deduction is \$14,700 (basic standard deduction of \$11,400 plus three additional standard deductions of \$1,100 for age and blindness).

EXAMPLE 3.3

Alberto (age 65) and Stephanie (age 58) are raising their grandson, Jackson, who qualifies as their dependent. Jackson is blind. Their standard deduction on a joint return for 2008 is \$11,950 (basic standard deduction of \$10,900 plus one additional standard deduction of \$1,050 for Alberto's age). They do not receive an additional standard deduction for Jackson's blindness because additional standard deductions for age and blindness are allowed only for the taxpayer and spouse, and not for their dependents. It should be noted, however, that a dependent's additional standard deductions can be claimed on the dependent's own tax return. Note that for 2009, the standard deduction for Alberto and Stephanie is \$12,500 (basic standard deduction of \$11,400 plus one additional standard deduction of \$1,100 for Alberto's age).

EXAMPLE 3.4

Jessica is 34 years of age, blind, and unmarried as of the end of 2008. She uses the single filing status for her tax return. Her standard deduction is \$6,800 (basic standard deduction of \$5,450 plus an additional standard deduction of \$1,350 for blindness). Note that for 2009, the standard deduction is

\$7,100 (basic standard deduction of \$5,700 plus an additional standard deduction of \$1,400 for blindness).

Itemized Deductions

A taxpayer may choose to deduct specific allowable itemized deductions rather than the standard deduction. Below-the-line (“itemized”) deductions are claimed (on Schedule A) when they exceed the total standard deduction and thus reduce the AGI further than the standard deduction. Itemized deductions are explained in more detail in Chapter 7. A partial list of itemized deductions is presented in Exhibit 3.8.

PARTIAL LIST OF ITEMIZED DEDUCTIONS

EXHIBIT 3.8

- | | |
|--|--|
| • Miscellaneous expenses that exceed 2% of AGI | • Medical and dental expenses in excess of 7.5% of AGI |
| • Charitable contributions | • State and local income taxes |
| • Tax return preparation fees | • Real property taxes on home |
| • Home mortgage interest | • Property taxes based on the value of a car |
| • Unreimbursed employee expenses | • Certain investment expenses |
| • Investment interest expense | • Casualty losses in excess of 10% of AGI |

Michael (age 52) and Karen (age 50) have no dependents. During 2008, they paid \$5,000 in state income taxes, \$2,000 in charitable contributions, \$4,000 in home mortgage interest, and \$1,500 in property taxes on their home. The total of their itemized deductions is \$12,500. Their standard deduction is \$10,900. Therefore, they should itemize deductions rather than use the standard deduction. Note: For 2009, their standard deduction is \$11,400. Michael and Karen’s best option for 2009 is to itemize deductions if their total itemized deductions remain higher than the standard deduction.

EXAMPLE 3.5

In three situations, a taxpayer is not allowed to use the standard deduction and *must* itemize deductions:

1. A married individual who files a separate return (married filing separately filing status) cannot use a standard deduction if that person’s spouse itemizes deductions.
2. A nonresident alien and a dual-status alien is not allowed to use a standard deduction.
3. An individual who files a tax return for less than 12 months because of a change in annual accounting period is not allowed to use a standard deduction (not common for individual taxpayers).

Personal and Dependency Exemptions

Personal and dependency exemption amounts are also deductions from adjusted gross income. A **personal exemption** is allowed for the taxpayer and the taxpayer’s spouse on a tax return. A **dependency exemption** is allowed for each person who qualifies as a dependent of the taxpayer.

Normally, the child of a taxpayer qualifies as the taxpayer's dependent, but many other people may qualify as dependents and in some cases the taxpayer's own child does not qualify as a dependent. The inflation-adjusted amount allowed as a deduction for each personal and dependency exemption is \$3,500 for 2008 (\$3,650 for 2009).



Key Concepts

Underline/highlight the answers to these questions as you read:

1. Define personal and dependency exemptions.
2. Explain how the tax on taxable income is calculated.
3. Identify various tax credits.

TAXABLE INCOME

Taxable income is the tax base on which the income tax is calculated. It is calculated after reducing AGI by the greater of the standard deduction or itemized deductions and the allowable personal and dependency exemptions.

TAX ON TAXABLE INCOME

The income tax on taxable income is determined by applying certain tax rates to taxable income. The tax rates currently range from 10 percent to 35 percent. The amount of taxable income subject to tax at each rate (each tax bracket) depends on the filing status of the taxpayer. These rates are shown in Appendix A.

EXAMPLE 3.6

Scott is 32 years of age and unmarried. His taxable income for 2008 is \$80,000. Using Tax Rate Schedule X – Single, his tax on taxable income can be computed.

If taxable income is over--	But not over--	The tax is:
\$0	\$8,025	10% of the amount over \$0
\$8,025	\$32,550	\$802.50 plus 15% of the amount over \$8,025
\$32,550	\$78,850	\$4,481.25 plus 25% of the amount over \$32,550
\$78,850	\$164,550	\$16,056.25 plus 28% of the amount over \$78,850
\$164,550	\$357,700	\$40,052.25 plus 33% of the amount over \$164,550
\$357,700	no limit	\$103,791.75 plus 35% of the amount over \$357,700

For taxable income over \$78,850 but not over \$164,550, the income tax is \$16,056.25 plus 28% of the amount over \$78,850. $[(\$80,000 - \$78,850) \times 28\% = \$322]$. The tax is therefore \$16,378.25 or \$16,056.25 + \$322.

The total tax consists of:

1. \$8,025 taxed at 10%
 $\$8,025 \times 10\% = \802.50
2. \$24,525 taxed at 15%
 $[(\$32,550 - \$8,025) \times 15\% = \$3,678.75]$
3. \$46,300 taxed at 25%
 $[(\$78,850 - \$32,550) \times 25\% = \$11,575.00]$, and

4. \$1,150 taxed at 28%
 $[(\$80,000 - \$78,850) \times 28\% = \$322]$.

Scott's total tax is \$16,378.25.

Scott's marginal tax rate, the rate on the next dollar of taxable income, is 28%.

For 2009, Scott's total tax is \$16,187.50 and his marginal tax rate is 25%. The 2009 tax rate schedule is available in Appendix A.

Although the tax can be determined by directly applying the tax rates from the tax rate schedules to taxable income (as shown in the example above), taxpayers are required to determine the tax using tax tables provided by the Internal Revenue Service, if possible. These tax tables, published by the Internal Revenue Service in the instructions for individual income tax returns, show small ranges of taxable income and the amount of tax for taxable income within each range.

EXCERPT FROM 2008 AND 2009 TAX TABLES

EXHIBIT 3.9

Excerpt from 2008 Tax Table					
If taxable income is -		And you are -			
At least	But less than	Single	Married filing jointly	Married filing separately	Head of a household
Your tax is -					
80,000					
80,000	80,050	16,385	12,694	16,779	15,069
80,050	80,100	16,399	12,706	16,793	15,081
80,100	80,150	16,413	12,719	16,807	15,094
80,150	80,200	16,427	12,731	16,821	15,106
80,200	80,250	16,441	12,744	16,835	15,119
80,250	80,300	16,455	12,756	16,849	15,131
80,300	80,350	16,469	12,769	16,863	15,144
80,350	80,400	16,483	12,781	16,877	15,156
80,400	80,450	16,497	12,794	16,891	15,169
80,450	80,500	16,511	12,806	16,905	15,181
80,500	80,550	16,525	12,819	16,919	15,194
80,550	80,600	16,539	12,831	16,933	15,206
80,600	80,650	16,553	12,844	16,947	15,219
80,650	80,700	16,567	12,856	16,961	15,231
80,700	80,750	16,581	12,869	16,975	15,244
80,750	80,800	16,595	12,881	16,989	15,256
80,800	80,850	16,609	12,894	17,003	15,269
80,850	80,900	16,623	12,906	17,017	15,281
80,900	80,950	16,637	12,919	17,031	15,294
80,950	81,000	16,651	12,931	17,045	15,306

Excerpt from 2009 Tax Table					
If taxable income is -		And you are -			
At least	But less than	Single	Married filing jointly	Married filing separately	Head of a household
Your tax is -					
80,000					
80,000	80,050	16,194	12,381	16,539	14,859
80,050	80,100	16,206	12,394	16,553	14,871
80,100	80,150	16,219	12,406	16,567	14,884
80,150	80,200	16,231	12,419	16,581	14,896
80,200	80,250	16,244	12,431	16,595	14,909
80,250	80,300	16,256	12,444	16,609	14,921
80,300	80,350	16,269	12,456	16,623	14,934
80,350	80,400	16,281	12,469	16,637	14,946
80,400	80,450	16,294	12,481	16,651	14,959
80,450	80,500	16,306	12,494	16,665	14,971
80,500	80,550	16,319	12,506	16,679	14,984
80,550	80,600	16,331	12,519	16,693	14,996
80,600	80,650	16,344	12,531	16,707	15,009
80,650	80,700	16,356	12,544	16,721	15,021
80,700	80,750	16,369	12,556	16,735	15,034
80,750	80,800	16,381	12,569	16,749	15,046
80,800	80,850	16,394	12,581	16,763	15,059
80,850	80,900	16,406	12,594	16,777	15,071
80,900	80,950	16,419	12,606	16,791	15,084
80,950	81,000	16,431	12,619	16,805	15,096