Chapter 3

Tax Formula and Tax Determination; An Overview of Property Transactions

CENGAGE

LEARNING OBJECTIVES (1 of 2)

LO.1 - Recognize and apply the components of the Federal income tax formula.

LO.2 - Explain the standard deduction and evaluate its choice in arriving at taxable income.

LO.3 - Describe the current status of the exemption deduction.

LO.4 - Explain the rules for determining whether someone is a dependent.

LO.5 - Choose the proper filing status and identify the related filing requirements.

LEARNING OBJECTIVES (2 of 2)

LO.6 - Demonstrate the proper procedures for determining the tax liability.

LO.7 - Identify and report the unearned income of dependent children (the kiddie tax).

LO.8 - Explain the fundamentals of property transactions.

LO.9 - Evaluate tax planning opportunities associated with the individual tax formula.

The Big Picture (1 of 2)

- Aleha maintains a household in which she lives with her:
  - Unemployed husband (Trevor)
  - Stepdaughter (Paige)
  - Family friend (Terrah)
- She provides more than half of the support for both Paige and Terrah
  - Terrah was fatally injured in an automobile accident in February
    - Aleha paid for her hospitalization and funeral expenses
  - Paige, an accomplished gymnast, graduated from high school last year
    - Paige has a part-time job but spends most of her time training and looking for an athletic scholarship to the "right" college

The Big Picture (2 of 2)

- In March, Trevor left for parts unknown and has not been seen or heard from since
- Aleha was more surprised than distressed over Trevor's unexpected departure
- One reaction, however, was to sell her wedding rings to a cousin who was getting married
  - The rings cost $11,800
  - The rings were sold for their approximate value of $9,000
- Based on these facts, what are Aleha's income tax concerns for the current year?
  - Read the chapter and formulate your response

Tax Formula for Individuals

		Text Discussion
Income (broadly defined)	$xx,xxx	Chs. 3, 4
Less: **Exclusions**	(x,xxx)	Ch. 5
Gross income	$xx,xxx	Chs. 4, 16, 17
Less: **Deductions *for*** adjusted gross income	(x,xxx)	Chs. 6–9, 11, 16, 17
Adjusted gross income	$xx,xxx	
Less: The greater of—		
Total **itemized deductions** *or* **standard deduction**	(x,xxx)	Chs. 6, 9, 10, 11 Ch. 3
Less: **Personal** and **dependency exemptions***	(x,xxx)	Ch. 3
Less: **Deduction for qualified business income****	(x,xxx)	Chs. 6 and 9
Taxable income	$xx,xxx	Chs. 3, 12, 13
Tax on taxable income	$ x,xxx	Chs. 3, 12, 13
Less: **Tax credits**	(xxx)	Ch. 13
Tax due (or refund)	$ xxx	Chs. 3, 12, 13

*Exemption deductions are not allowed from 2018 through 2025.
**Only applies from 2018 through 2025.

Income (Broadly Defined)

- Includes all of the taxpayer's income, both taxable and nontaxable
  - The courts have defined "income" as *any increase in wealth*
    - It does not include a return of capital or borrowed funds

Gross Income

- The Internal Revenue Code defines gross income broadly as "except as otherwise provided . . . , all income from whatever source derived"
- Gross income does not include *unrealized* gains
  - E.g., stock that has appreciated in value but has not been sold

Partial List of Exclusions from Gross Income

Partial List of Exclusions from Gross Income

Accident insurance proceeds	Life insurance paid upon death
Alimony (divorces after 2018)	Meals and lodging (if furnished for employer's convenience)
Annuities (cost element)	Military allowances
Bequests	Minister's dwelling rental value allowance
Child support payments	Railroad retirement benefits (to a limited extent)
Cost-of-living allowance (for military)	Scholarship grants (to a limited extent)
Damages for personal injury or sickness	Social Security benefits (to a limited extent)
Gifts received	Veterans' benefits
Group term life insurance, premium paid by employer (for coverage up to $50,000)	Welfare payments
Inheritances	Workers' compensation benefits
Interest from state and local (i.e., municipal) bonds	

Partial List of Gross Income Items (1 of 2)

Partial List of Gross Income Items

Alimony (divorces before 2019)	Group term life insurance, premium paid by employer (for coverage over $50,000)
Annuities (income element)	Hobby income
Awards	Interest
Back pay	Jury duty fees
Bargain purchase from employer	Living quarters, meals (unless furnished for employer’s convenience)
Bonuses	Mileage allowance (in certain cases)
Breach of contract damages	Military pay (unless combat pay)
Business income	Notary fees
Clergy fees	Partnership income
Commissions	Pension distributions
Compensation for services	Prizes
Death benefits	Professional fees
Debts forgiven	
Director’s fees	

Partial List of Gross Income Items (2 of 2)

Partial List of Gross Income Items

Dividends Embezzled funds Employee awards (in certain cases) Employee benefits (except certain fringe benefits) Estate and trust income Farm income Fees Gains from illegal activities Gains from sale of property Gambling winnings	Punitive damages Rents Rewards Royalties Salaries Severance pay Strike and lockout benefits Supplemental unemployment benefits Tips and gratuities Travel allowance (in certain cases) Treasure trove (found property) Wages

Deductions – Individual Taxpayers

- Individual taxpayers have two categories of deductions:
  - Deductions *for* adjusted gross income (AGI)
  - Deductions *from* adjusted gross income (AGI)

Deductions *for* Adjusted Gross Income (1 of 2)

- Sometimes called *above-the-line* deductions
  - On the tax return, they are taken before the “line” designating AGI

Deductions *for* Adjusted Gross Income (2 of 2)

- Deductions *for* AGI include:
  - Trade or business expenses
  - Part of the self-employment tax
  - Contributions to traditional Individual Retirement Accounts (IRAs) and other retirement plans
  - College tuition and related expenses
  - Contributions to Health Savings Accounts (HSAs)
  - Interest on student loans
  - Excess capital losses
  - Certain alimony payments

Deductions *from* Adjusted Gross Income (1 of 3)

- Some personal expenses as deductions from AGI
  - It is referred to as itemized deductions
  - Taxpayers are allowed itemized deductions for expenses related to
    - The production of collection of income
    - The management of property held for the production of income
  - These expenses, sometimes referred to as *nonbusiness expenses**

*The deductions for many of these expenses are suspended from 2018 through 2025

CENGAGE

Deductions *from* Adjusted Gross Income (2 of 3)

Partial List of Itemized Deductions

Medical expenses in excess of 7.5% of AGI (10% in 2021)

State and local income or sales taxes*

Real estate taxes*

Personal property taxes*

Interest on home mortgage (subject to certain limitations)

Investment interest (up to the amount of net investment income)

Charitable contributions (within specified percentage limitations)

Casualty and theft losses in excess of 10% of AGI

*Only $10,000 of combined state and local taxes is deductible

Deductions *From* Adjusted Gross Income (3 of 3)

Nondeductible expenses:

Personal living expenses

Employee business expenses (unless reimbursed by employer)*

Most investment expenses

Tax return preparation fees*

Losses on the sale of personal use property

Hobby expenses*

Life insurance premiums

Gambling losses

Child support payments

Fines and penalties

Political contributions

Funeral expenses

Capital expenditures

*Prior to 2018, these miscellaneous itemized deductions were allowed as from AGI deductions, subject to a 2%-of-AGI floor. These deductions are not allowed from 2018 through 2025

Standard Deduction (1 of 3)

- The standard deduction is the sum of two components:
  - Basic standard deduction
    - Amount allowed is based on taxpayer's filing status
  - Additional standard deductions of $1,300 or $1,650
    - Available for taxpayers who are
      - Age 65 or over in 2020, or
      - Blind in 2020
    - Two additional standard deductions are allowed for a taxpayer who is age 65 or over and blind
      - This provision also apply for a qualifying spouse who is age 65 or over or blind, but not for dependent
    - Amount allowed depends on filing status

Standard Deduction (2 of 3)

- The basic standard deduction amount depends on the filing status of the taxpayer

Basic Standard Deduction Amounts

Filing Status	Standard Deduction Amount in 2019	Standard Deduction Amount in 2020
Single	$ 12,200	$ 12,400
Married, filing jointly	24,400	24,800
Surviving spouse	24,400	24,800
Head of household	18,350	18,650
Married, filing separately	12,200	12,400

Standard Deduction (3 of 3)

- Additional standard deduction
  - For taxpayers age 65 or older and/or legally blind

Additional Standard Deduction Amounts

Filing Status	2019	2020
Single	$ 1,650	$ 1,650
Married, filing jointly	1,300	1,300
Surviving spouse	1,300	1,300
Head of household	1,650	1,650
Married, filing separately	1,300	1,300

Individuals Not Eligible for the Standard Deduction

- Some individuals are not allowed to use the standard deduction:
  - Married, filing separately, where either spouse itemizes deductions
  - Nonresident aliens (an individual who is neither a U.S. citizen nor a U.S resident)

CENGAGE

Special Limitations on the Standard Deduction for Dependents

- Individual claimed as a dependent has a basic standard deduction in 2020 is limited to the greater of:
  - $1,100, or
  - $350 plus earned income (but not exceeding the basic standard deduction)
- Additional standard deduction amount(s) still available

Exemptions

- Two types of exemptions
  - Personal exemptions
  - Dependency exemptions
- Deductions are suspended for exemptions from 2018 through 2025
- Personal exemptions are granted to the taxpayer and spouse
- Dependency exemptions are allowed for a qualifying child or a qualifying relative
- Exemption amount in 2020 is $4,300 ($4,200 in 2019)

Dependents (1 of 2)

- Under the Internal Revenue Code, there are two types of dependents—a qualifying child and a qualifying relative
  - Unique tests apply to each type of dependent
- A qualifying child must meet the following tests:
  - Relationship test
  - Residence test
  - Age test
  - Support test

Dependents (2 of 2)

- Congress has adopted a uniform definition of a qualifying child.
- This definition applies to the following tax provisions:
  - Head-of-household filing status
  - Earned income tax credit
  - Child tax credit
  - Credit for child and dependent care expenses

Relationship Test (1 of 2)

- The child must be the taxpayer's:
  - Son or daughter
  - Adopted child
  - Stepchild
  - Eligible foster child
  - Brother or sister
  - Stepbrother or stepsister
  - Half brother or half sister, or
  - A descendant of any of these parties (e.g., grandchild, nephew, niece)
- A child who has been adopted, or whose adoption is pending, qualifies
- An eligible foster child may also qualify

Relationship Test (2 of 2)

- Ancestors of any of these parties (e.g., uncles and aunts) and in-laws (e.g., son-in-law and brother-in-law) are not included
- An adopted child includes a child placed with the taxpayer even though the adoption is not final
- An eligible foster child is a child who is placed with the taxpayer by an authorized placement agency or by a court order

Residence Test

- A qualifying child must live with the taxpayer for more than half of the year
  - Temporary absences (e.g., school, vacation, medical care, military service, detention in a juvenile facility) are ignored
  - Special rules apply in the case of certain kidnapped children

Age Test

- The child must, by the end of the tax year, be (1) under age 19 or (2) under age 24 and a full-time student
  - A full-time student is a child who was in school during any part of five months of the year
  - Individuals who are disabled are not subject to the age test
  - A qualifying child must be younger than the taxpayer claiming him or her

CENGAGE

The Big Picture - Qualifying Child

- Return to the facts of The Big Picture
- Does Paige meet the requirements of a qualifying child as to Aleha?
  - Paige satisfies the relationship and residence tests, but the answer to the age test remains unclear
  - Because she is not a full-time student or disabled, she must be under 19 to meet the age test

CENGAGE

Support Test

- To be a qualifying child, the individual must not be self-supporting
  - Cannot provide more than one-half of his or her own support
  - In the case of a child who is a full-time student, scholarships are not considered to be support

CENGAGE

Tiebreaker Rules

- In situations where a child may be a qualifying child to more than one person
  - Tiebreaker rules specify which person has priority in claiming the child as a dependent

Tiebreaker Rules for Claiming Qualified Child

Persons Eligible to Claim Qualified Child as Dependent	Person Prevailing
One of the persons is the parent	Parent
Both persons are the parents, and the child lives longer with one parent	Parent with the longer period of residence
Both persons are the parents, and the child lives with each the same period of time	Parent with the higher adjusted gross income (AGI)
None of the persons is the parent	Person with highest AGI

Qualifying Relative

- A qualifying relative can be a dependent if the following tests are met:
  - Relationship
  - Gross income
  - Support

Relationship Test for Qualifying Relative

- The relationship test for a qualifying relative is more expansive than for a qualifying child. Also included are the following relatives:
  - Lineal ascendants (e.g., parents, grandparents)
  - Collateral ascendants (e.g., uncles, aunts)
  - Certain in-laws (e.g., son-, daughter-, father-, mother-, brother-, and sister-in-law)
- The relationship test also includes individuals who are “members of the household” (i.e., live with the taxpayer for the entire year)

The Big Picture - Qualifying Relative

- Return to the facts of The Big Picture
- Although Terrah is unrelated to Aleha, she qualifies as Aleha's dependent by being a member of the household
- Because Terrah is a dependent, Aleha can also claim the medical expenses she paid on Terrah's behalf
    - The funeral expenses are not deductible

Gross Income Test Qualifying Relative

- Dependent's gross income must be less than the exemption amount ($4,300 for 2020 and $4,200 for 2019)
- Gross income is determined by any income that is taxable

CENGAGE

The Big Picture - Dependency Exemptions

- Return to the facts of The Big Picture
- Assuming that Paige is not a qualifying child, can she be a qualifying relative?
  - She meets the relationship and support tests, but what about the gross income test?
  - If her income from her part-time job is less than $4,300 (the 2020 exemption amount), she does qualify and would be Aleha's dependent

Support Test Qualifying Relative

- Taxpayer must furnish over half of the qualifying relative's support
  - Scholarships are not considered in the support test
- Two exceptions to the support test:
  - Multiple support agreements
  - Children of divorced or separated parents

Multiple Support Agreements

- Allow to designate one member of a group to claim the individual as a dependent, even though no one person provides more than 50% support
  - Collectively, the group must provide more than 50% of the support
  - Eligible parties must provide more than 10% of the support
  - Each eligible party must meet all other dependency requirements

CENGAGE

Children of Divorced or Separated Parents

- Special rules apply if the parents meet the following conditions:
  - They would have been entitled to claim the individual(s) as a dependent had they been married and filed a joint return
  - They have custody (either jointly or singly) of the child (or children) for more than half of the year
- In general, the parent having custody of the child (or children) for the greater part of the year (i.e., the custodial parent) is entitled to claim the dependent(s)
  - General rule does not apply if
    - Custodial parent can sign a waiver that allows the noncustodial parent to claim the child as a dependent

Other Rules for Determining Dependents

- In addition to fitting into either the qualifying child or the qualifying relative category, a dependent must also meet:
  - The joint return test
  - The citizenship test

Joint Return Test

- Dependent cannot file a joint return with his or her spouse unless:
  - The reason to file is solely for claiming a refund of tax withheld
    - No tax liability exists

Citizenship Test

- Dependent must be a U.S. citizen, a U.S. resident, or a resident of Canada or Mexico for some part of the calendar year in which the taxpayer's tax year begins
  - 2018 through 2025, a taxpayer may not claim a dependent tax credit unless the individual is a U.S. citizen or a U.S. resident
  - An exception provides that an adopted child need not be a citizen or resident of the U.S. (or a contiguous country) as long as his or her principal residence is with a U.S. citizen

Tests for Dependents (Summary)

Tests for Dependents

Test	Qualifying Child	Qualifying Relative
Relationship:		
• Children (natural, step, or adopted) and their *descendants*, and siblings and stepsiblings and their *descendants*.	X	
• Children (natural, step, or adopted) and their *descendants*, siblings and their children, parents and their *ascendants*, uncles and aunts, stepparents and stepsiblings, and certain in-laws.		X
• Member of the household (live with taxpayer for *entire* year; relative or non-relative)		X
Residence	X	
Age	X	
Support:		
• Not self-supporting ("child" furnishes half or less of his or her support)	X	
• Taxpayer furnishes over half of the support of potential dependent		X
Gross income less than the exemption amount		X
Joint return (potential dependent cannot file joint return)	X	X
Citizenship (potential dependent must meet test)	X	X

CENGAGE

Child and Dependent Tax Credits (1 of 5)

- Child and dependent tax credits are provided to individual taxpayers based on the number of their qualifying children and dependents
  - A $2,000 child tax credit is allowed for each qualifying child (including stepchildren and foster children)
  - To be eligible for the credit, the child must be:
    - Under age 17,
    - A U.S. citizen, and
    - A dependent of the taxpayer
  - In addition, a Social Security number must be provided for any qualifying child

Child and Dependent Tax Credits (2 of 5)

- A $500 tax credit is allowed for each dependent of the taxpayer (other than a qualifying child)
  - Examples of qualifying relatives for purpose of the dependent tax credit include:
    - Children over age 16 (including full-time students under age 24),
    - Children without a Social Security number,
    - Parents of the taxpayer, and
    - “Members of the household”
  - For purposes of the dependent tax credit, these qualifying relatives must be a U.S. citizen, a U.S. national, or a U.S. resident
- The child and dependent tax credit are subject to a phaseout based on a taxpayer’s adjusted gross income

Child and Dependent Tax Credits (3 of 5)

- Child and Dependent Tax Credits Phaseout
  - The available child and dependent tax credits begin to phase out when AGI reached $400,000 for married taxpayers filing jointly ($200,000 for all other taxpayers)
  - The credit is phased out by $50 for each $1,000 (or part thereof) of AGI above the $400,000
  - If married taxpayers filing a joint return have one qualified child, the child tax credit is completely phased out if their AGI exceeds $440,000.
  - If those taxpayers have two qualifying children, the child tax credit is completely phased out if their AGI exceeds $480,000

Child and Dependent Tax Credits (4 of 5)

- Child and Dependent Tax Credits Phaseout
  - For all other taxpayers, these amounts would be $240,000 and $280,000, respectively

Child and Dependent Tax Credits (5 of 5)

- Refundable Portion of Child Tax Credit
  - For all taxpayers with qualifying children (regardless of how many), the child tax credit is refundable to the extent of the *lesser* of:
    - $1,400 of the child tax credit for each qualifying child, or
    - 15% of the taxpayer's earned income in excess of $2,500
- The $1,400 amount (which applies to 2020 and 2019) is adjusted for inflation each year
  - The $2,500 amount is not inflation adjusted
- The $500 dependent tax credit is *nonrefundable*

Filing Status

- There are 5 filing statuses:
  - Single
  - Married, filing jointly
  - Married, filing separately
  - Surviving spouse (qualifying widow or widower)
  - Head of household
- The amount of tax varies considerably depending on which filing status is used

Single Taxpayers

- A taxpayer who is unmarried (including a taxpayer who is legally separated or divorced) and does not qualify for head-of-household status will file as a single taxpayer

Married Filing Jointly

- A legally married same-sex couple is treated as married for Federal tax purposes no matter where they live
- Married status is determined as of the last day of the tax year, except when a spouse dies during the year
  - In that case, marital status is determined as of the date of death

Married Filing Separately (1 of 2)

- If married individuals file separate returns, each reports only his or her own income, deductions, and credits, and each must use the married, filing separately tax rates
- The Internal Revenue Code places some limitations o married persons who file separate returns
  - If either spouse itemizes deductions, the other spouse must also itemize
  - The earned income credit and the credit for child and dependent care expenses cannot be claimed

Married Filing Separately (2 of 2)

- No deduction is allowed for interest paid on qualified education loans
- Only $1,500 of excess capital losses can be claimed by each spouse

Surviving Spouse

- Joint filing status also applies for two years following the death of one spouse if the surviving spouse maintains a household for a dependent child
  - The child must be a son, stepson, daughter, or stepdaughter who qualifies as a dependent of the taxpayer

Head of Household

- Unmarried individuals who maintain a household for a dependent (or dependents) can use the head-of-household filing status
- Must pay more than half the cost of maintaining a household as his or her home
- The household must also be the principal home of a dependent
  - A dependent must satisfy either the qualifying child or the qualifying relative
    - A qualifying relative must also meet the relationship test

The Big Picture - Head-of-Household Filing Status

- Return to the facts of The Big Picture
- Assuming that Aleha can be treated as single (i.e., not married), can Terrah qualify Aleha for head-of-household filing status?
  - The answer is no
- Even though Terrah can be claimed as Aleha's dependent, she does not meet the relationship test for head-of-household status (Terrah qualified as a dependent under the member-of-the-household test)

CENGAGE

Abandoned Spouse Rules

- Allows a married taxpayer to file as head of household if the taxpayer:
  - The taxpayer does not file a joint return
  - The taxpayer paid more than half the cost of maintaining his or her home for the tax year
  - The taxpayer's spouse did not live in the home during the last six months of the tax year
  - The home was the principal residence of the taxpayer's son, daughter, stepson, stepdaughter, foster child, or adopted child for more than half the year
    - Can claim the child as a dependent

The Big Picture - Abandoned Spouse Filing Status

- Return to the facts of The Big Picture
- Can Aleha qualify as an abandoned spouse?
  - Yes, if she can claim Paige as a dependent—either as a qualifying child or as a qualifying relative
  - If so, Aleha can use head-of-household filing status
  - If not, her filing status is married, filing separately

Filing Requirements (1 of 2)

- **General Rules:** Tax return must be filed if gross income is equal to or exceeds the applicable standard deduction
  - The additional standard deduction for being age 65 or older is considered in determining the gross filing requirement
  - Except in the case of dependents, the additional standard deduction for blindness is not taken into account in determining whether a taxpayer must file a tax return
    - Special rules apply for dependents and self-employed taxpayers

Filing Requirements (2 of 2)

- Filing requirements for dependents
  - Dependent must file a return if he or she has any of the following
    - Earned income only and gross income that is more than the total standard deduction
    - Unearned income only and gross income of more than $1,100 plus any additional standard deduction
    - Both earned and unearned income and gross income of more than the larger of $1,100 or the sum of earned income plus $350 (but limited to the basic standard deduction) plus any additional standard deduction

Tax Rates

- Tax liability is computed using either the Tax Table method or the Tax Rate Schedule method
  - Tax Table Method
    - The Tax Table must be used if taxable income is below $100,000
    - An estate or a trust cannot use tax table method
  - Tax Rate Schedule Method
    - Taxpayer who do not use the tax tables use the Tax Rate Schedules

Kiddie Tax – Unearned Income of Dependent Children (1 of 3)

- Under the kiddie tax, the net unearned income (NUI) of a child is taxed using special rules
  - Child must be under age 19 at end of year (or under age 24 if a full-time student)
  - Unearned income of more than $2,200 (in 2020 and 2019)
- The kiddie tax does not apply:
  - If the child has earned income that exceeds half of his or her support,
  - If the child is married and files a joint return, or
  - If both parents are deceased

Kiddie Tax – Unearned Income of Dependent Children (2 of 3)

- Computing net unearned income in 2020:

	Unearned income
Less:	$1,100
Less:	The greater of: • $1,100 of the standard deduction, or • Amount of allowable itemized deductions directly connected with the production of unearned income
Equals:	Net unearned income

CENGAGE

Kiddie Tax – Unearned Income of Dependent Children (3 of 3)

- Tax Determination
  - If a child is subject to the kiddie tax, there are two options for computing the tax on the income
    - A separate return may be filed for the child
    - The parents may elect to report the child's income on their own return

Tax Return Filing Procedures

- Tax Return filing Procedures
  - Selecting the proper form
  - The E-File approach
  - When and where to file
  - Modes of payment

Gains and Losses from Property Transactions – In General (1 of 3)

- When a property is sold (or otherwise disposed of), a gain or loss results
- This gain or loss has a tax effect on the seller when the realized gain or loss is recognized for tax purpose
- The amount realized is the selling price of the property less any cost of disposition

Gains and Losses from Property Transactions – In General (2 of 3)

- All realized gains are recognized (taxable) unless a specific tax provision provides otherwise (example, nontaxable exchanges)
- Realized losses may or may not be recognized (deductible) for tax purposes
  - Generally, losses on the sale of personal use property are not recognized

Gains and Losses from Property Transactions – In General (3 of 3)

- Once recognized gains or losses have been determined, they must be classified as ordinary or capital
  - Ordinary gains are fully taxable
  - Ordinary losses are fully deductible
- Capital gains and losses are subject to special tax treatment

Gains and Losses from Property Transactions - Capital Gains and Losses (1 of 2)

- Capital assets are defined as any property other than:
  - Inventory,
  - Accounts Receivable, and
  - Depreciable property or real estate used in a business

Gains and Losses from Property Transactions - Capital Gains and Losses (2 of 2)

- Determination of Net Capital Gain
  - Gains and losses should be categorized based on their holding period
  - Gains and losses in each category are netted together
  - If excess losses result, they are applied to the category carrying the highest tax rate

Taxation of Net Capital Gain

Net capital gains are classified and taxed as follows:

Classification	Maximum Rate
Short-term gains (held for one year or less)	37%
Long-term gains (held for more than one year)—Collectibles	28%
Certain depreciable property used in a trade or business (known as unrecaptured § 1250 gain)	25%
All other long-term capital gains	20%, 15%, or 0%

Treatment of Net Capital Loss

- Net capital losses of individuals can be used to offset ordinary income of up to $3,000 ($1,500 for married persons filing separate return)
  - Excess capital losses are carried over to the next tax year
  - When carried over, excess capital losses retain their classification as short- or long-term

CENGAGE

The Big Picture - Treatment Of Net Capital Loss

- Return to the facts of The Big Picture
- Aleha's sale of her wedding rings resulted in a realized capital loss of $2,800 [$9,000 (selling price) − $11,800 (cost basis)]
- However, because they were personal use property, Aleha cannot deduct the loss

Refocus On The Big Picture (1 of 4)

- Of major concern to Aleha is her filing status
  - If she qualifies as an abandoned spouse, she is entitled to file as head of household
    - If not, she is considered to be a married person filing separately
  - Moreover, to be an abandoned spouse, Aleha must be able to claim Paige as a dependent

CENGAGE

Refocus On The Big Picture (2 of 4)

- To be a dependent, Paige must meet the requirements of a qualifying child or a qualifying relative
  - For qualifying child purposes, Paige must meet either
    - The age test (i.e., under age 19) or
    - The full-time student (under age 24) test
    - (A disabled child exception seems highly unlikely)
  - Because Paige currently is not a full-time student, is she under age 19?
    - If so, she is a qualifying child
  - If Paige is not a qualifying child, is she a qualifying relative?
    - Here, the answer depends on meeting the gross income test
    - How much did Paige earn from her part-time job?
      - If her earnings are under $4,300, she satisfies the gross income test

Refocus On The Big Picture (3 of 4)

- As a result, If Paige can be claimed as a dependent under either the qualifying child or the qualifying relative category, Aleha is an abandoned spouse entitled to head-of-household filing status
  - If not, she is a married person filing separately
- Terrah can be claimed as Aleha's dependent because she is a member of the household
  - It does not matter that she died in February
  - Because Terrah is her dependent, Aleha can claim the medical expenses she paid on Terrah's behalf
    - The funeral expenses, however, are not deductible

CENGAGE

Refocus On The Big Picture (4 of 4)

- Does Terrah qualify Aleha for head-of-household filing status?
  - No; although she is a dependent, Terrah does not meet the relationship test
- The sale of the wedding rings results in a capital loss of $2,800 ($9,000 − $11,800)
  - Because the loss is for personal use property, it cannot be claimed for tax purposes