

For Exams Scheduled After December 31, 2018



# CPA EXAM REVIEW REGULATION

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## REGULATION

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# Individual Taxation: Part 1

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## 1 Individual Income Tax Formula

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This module begins the discussion of individual income tax. The formula below provides a summary of the calculation of taxable income and federal income tax liability or refund for individuals. Ultimately, these items are reported on the individual income tax return, Form 1040.

$$\begin{array}{r}
 \text{Gross income} \\
 \text{< Adjustments >} \\
 \hline
 \text{Adjusted gross income} \\
 \left. \begin{array}{l} \text{< Standard deduction >} \\ \text{Or} \\ \text{< Itemized deductions >} \end{array} \right\} \\
 \hline
 \text{Taxable income before QBI deduction} \\
 \text{< QBI deduction >} \\
 \hline
 \text{Taxable income} \\
 \hline\hline
 \\
 \text{Federal income tax} \\
 \text{< Tax credits >} \\
 \text{Other taxes} \\
 \text{< Payments >} \\
 \hline
 \text{Tax due Or Refund} \\
 \hline\hline
 \end{array}$$

## 2 Taxable Income Formula for Individuals

Taxable income is the base for the individual income tax. The formula below demonstrates the calculation of taxable income for individual taxpayers.

<b>Gross income</b>	<ul style="list-style-type: none"> <li>Wages</li> <li>Interest</li> <li>Dividends</li> <li>State tax refunds</li> <li>Alimony received*</li> <li>Business income</li> <li>Capital gain/loss</li> <li>IRA income</li> <li>Pension and annuity</li> <li>Rental income/loss</li> <li>K-1 income/loss</li> <li>Unemployment compensation</li> <li>Social Security benefits</li> <li>Other income</li> </ul>
<b>&lt; Adjustments &gt;</b>	<ul style="list-style-type: none"> <li>Educator expenses</li> <li>IRA</li> <li>Student loan interest expenses</li> <li>Health savings account</li> <li>Moving expenses**</li> <li>One-half self-employment taxes</li> <li>Self-employed health insurance</li> <li>Self-employed retirement</li> <li>Interest withdrawal penalty</li> <li>Alimony paid*</li> </ul>
<b>Adjusted gross income</b>	
<b>&lt; Itemized deductions &gt;</b>	<ul style="list-style-type: none"> <li>Medical (in excess of 7.5 percent of AGI)</li> <li>Taxes—state/local (income/sales and property, up to \$10,000)</li> <li>Interest expense (Home and Investment)</li> <li>Charity (up to 60 percent of AGI)</li> <li>Casualty/theft attributable to federal disaster (in excess of 10 percent of AGI)</li> </ul>
<b>Taxable income before QBI deduction</b>	
<b>&lt; QBI deduction &gt;</b>	
<b>Taxable income</b>	

\*Under the Tax Cuts and Jobs Act (TCJA) for all divorce or separation agreements executed after 12/31/18, alimony received will not be included in gross income and alimony paid cannot be deducted.

\*\*Only for members of the armed forces moving pursuant to military order.

## 3 Filing Requirements for Individuals

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### 3.1 Who Must File?

The first consideration when thinking about individual taxation is who must file a tax return. Generally, a taxpayer must file a return if his or her income is equal to or greater than the sum of:

1. the regular standard deduction (except for married filing separately), plus
2. the additional standard deduction amount for taxpayers age 65 or older or blind (except for married persons filing separately).

### 3.2 When to File

#### 3.2.1 Due Date—April 15

Individual taxpayers must file on or before the 15th day of the fourth month following the close of the taxpayer's taxable year, which is April 15.

#### 3.2.2 Extension

- **Automatic Six-Month Extension to October 15:** An automatic six-month extension (until October 15) is available for those taxpayers who are unable to file by the April 15 due date. The automatic six-month extension is not an extension for the payment of any taxes owed. Although granted automatically, the six-month extension must be requested by the taxpayer by filing Form 4868 by April 15.
- **Payment of Tax:** Even with an extension, the due date for payment of taxes remains April 15.

## 4 Filing Status

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### 4.1 Single (Use the End-of-Year Test)

You are considered unmarried for the whole year if, on the last day of your tax year, you are either: unmarried or legally separated.

### 4.2 Joint Returns (Use the End-of-Year Test)

In order to file a joint return, the parties must be married at the end of the year, living together in a legally recognized common law marriage, or married and living apart (but not legally separated or divorced).

- If married during the year, a joint return may be filed, provided the parties are married at year-end. This includes same-sex couples legally married under state law (as a result of the Supreme Court case *Obergefell v. Hodges* (2015), same-sex couples have the right to marry in all states).
- If divorced during the year, a joint return may not be filed.
- If one spouse dies during the year, a joint return may be filed.

### 4.3 Married Filing Separately

A married taxpayer may file a separate return even if only one spouse has income for the year. In a separate property state, a husband and wife who elect to file using the married filing separately status must separately report their own income, credits, and deductions on their own individual income tax returns. In a community property state, most of the income, deductions, credits, etc., are split 50/50.

### 4.4 Qualifying Widow(er) With Dependent Child

- **Two Years After Spouse's Death:** A qualifying widow(er) is a taxpayer who may use the joint tax return standard deduction and rates for each of two taxable years following the year of death of his or her spouse, unless he or she remarries. In the event of a remarriage, the surviving spouse will file a tax return (joint or separate) with the new spouse.
- **Principal Residence for Dependent Child:** The surviving spouse must pay over half the cost of maintaining a household where a dependent child lives for the whole taxable year. The dependent child must be a child (including an adopted child but not a foster child) or stepchild of the surviving spouse.

### 4.5 Head of Household

Head of household status entitles certain taxpayers to pay lower taxes. The lower tax results from a larger standard deduction and "wider" tax brackets.

To qualify, the following conditions must be met:

1. The individual is unmarried, legally separated, or married and has lived apart from his or her spouse for the last six months of the year as of the close of the taxable year.
2. The individual is not a "qualifying widow(er)."
3. The individual is not a nonresident alien.
4. The individual maintains as his or her home a household that, for more than half the taxable year, is the principal residence of a qualifying person, including a dependent child, parent, or relative (as discussed below).

#### 4.5.1 A Qualifying Child

Child, stepchild, legally adopted child, foster child, brother or sister, or a descendant of one of these who meets the definition of a dependent under the qualifying children rules.

#### 4.5.2 Father or Mother (Not Required to Live With Taxpayer)

A dependent parent is not required to live with the taxpayer, provided the taxpayer maintains a home that was the principal residence of the parent for the entire year. Maintaining a home means contributing over half the cost of upkeep. This means rent, mortgage interest, property taxes, insurance, utility charges, repairs, and food consumed in the home.

#### 4.5.3 Dependent Relatives (Must Live With Taxpayer)

Grandparents, brothers, sisters, aunts, uncles, nephews, and nieces (as well as stepparents, parents-in-law, sisters-in-law, or brothers-in-law) qualify as relatives. A dependent relative (other than a father or mother) must live with the taxpayer. Note that cousins, foster parents, and unrelated dependents do not qualify.



#### 4.5.4 Summary of Who Meets Head-of-Household Qualifying Person Requirement

	Qualifying Dependent	Lives With Taxpayer
Child or descendant	Yes	Yes
Parents	Yes	No
Relative	Yes	Yes



### Pass Key

In order to avoid confusing the required time period for different filing statuses, just remember:

- **Widow/widower** = Must be principal residence for dependent child for **whole** year.
- **Head of household** = Must be principal residence for qualifying person for more than **half** a year.

## 5 Dependency Definitions

Certain tax benefits, such as an advantageous filing status or certain tax credits, require either a qualifying child or qualifying relative. Each category has requirements:

Qualifying Child	Or	Qualifying Relative
Close relative		Support test
Age limit		Under a specific amount of (taxable) gross income test
Residency and filing requirements		Precludes dependent filing a joint tax return test
Eliminate gross income test		Only citizens (residents of US/Canada or Mexico) test
Support test		Relative test
		Or
		Taxpayer lives with individual for whole year test

Taxpayers must obtain a Social Security number for any dependent who has attained the age of one as of the close of the tax year.