J.K. LASSER'S™

1001 DEDUCTIONS & TAX BREAKS 2010

Your Complete Guide to Everything Deductible

BARBARA WELTMAN

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1001 DEDUCTIONS AND TAX BREAKS 2010

Your Complete Guide to Everything Deductible

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John Wiley & Sons, Inc.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
Published simultaneously in Canada.

ISBN 978-0-470-44548-8

Printed in the United States of America.

10 9 8 7 6 5 4 3 2 1

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Introduction

Say the word "taxes" and most people groan. There are good reasons for this response: First of all, the cost of paying your taxes annually can be a financial burden. You may feel taken to the cleaners every time you view your paycheck *after* withholding for federal income taxes (not to mention state income taxes as well as Social Security and Medicare taxes).

Second, the tax law is very complicated and changing all the time. The federal tax rules grew from 400 pages in 1913 to more than 80,000 in 2009. Congress changes the tax law to a greater or lesser extent every single year—and this year is no exception! In addition, new court decisions and IRS rulings appear each day, providing guidance on how to interpret the law.

How can you combat the feeling of dread when it comes to taxes? It helps to know that the tax law is peppered with many, many tax breaks to which you may be entitled. These breaks allow you to *not* report certain economic benefits you enjoy or to subtract certain expenses from your income or even directly from your tax bill. As the famous jurist Judge Learned Hand once stated (in the 1934 case of *Helvering v. Gregory* in the Court of Appeals for the Second Circuit):

> **Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one's taxes. Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike, and all do right it for nobody owes any public duty to pay more than the law demands.**

So get your tax affairs in order and reduce what you pay each year to Uncle Sam!

In getting a handle on how to do this by taking advantage of every tax break you may be entitled to without running afoul of the Internal Revenue Service (IRS), there are some simple rules to keep in mind. They include:

- You must report all of your income unless a specific law allows you to exclude or exempt it (so that it is never taxed) or defer it (so that it is taxed at a later time).
- You can claim deductions only when and to the extent the law allows. Deductions are referred to as a "matter of legislative grace"; Congress doesn't have to create them and does so only for some purpose (for example, to encourage economic activity or to balance some perceived inequity in the tax law).
- Tax credits are worth more than tax deductions. A credit reduces your tax payment on a dollar-for-dollar basis; a $1,000 credit saves you $1,000 in taxes. A deduction is worth only as much as the top tax bracket you are in. Suppose you are in the 28 percent tax bracket, which means this is the highest rate you pay on at least some of your income. If you have a $1,000 deduction, it is worth $280 (28 percent of $1,000) because it saves you $280 in taxes you would otherwise have to pay.
- Even if your income is modest, you may have to file Form 1040 (the so-called "long form"), rather than a simplified return (Form 1040A or 1040EZ), in order to claim certain tax benefits.
- In a number of cases, different deduction rules apply to the alternative minimum tax (AMT), a shadow tax system that ensures you pay at least some tax if your regular income tax is lower than it would have been without certain deductions.

Whether you prepare your return by hand, use computer software or an online solution, or rely on a professional, this book is designed to tell you how to get every tax edge you're entitled to. Knowing what to look out for will help you plan ahead and organize your activities in such a way that you'll share less of your hard-earned money with Uncle Sam.

Tax-Favored Items

There are five types of tax-advantaged items receiving preferential or favorable treatment under the tax law:

1. *Tax-free income*—income you can receive without any current or future tax concerns. Tax-free income may be in the form of exclusions or exemptions from tax. In many cases, tax-free items do not even have to be reported in any way on your return.

2. *Capital gains*—profits on the sale or exchange of property held for more than one year (long-term). Long-term capital gains are subject to lower tax rates than the rates on other income, such as salary and interest income. Ordinary dividends on stocks and capital gain distributions from stock mutual funds are taxed at the same low rates as long-term capital gains.
3. *Tax-deferred income*—income that isn't currently taxed. Since the income builds up without any reduction for current tax, you may accumulate more over time. However, at some point the income becomes taxable.
4. *Deductions*—items you can subtract from your income to reduce the amount of income subject to tax. There are two classes of deductions: those "above the line," which are subtracted directly from gross income, and those "below the line," which can be claimed only if you itemize deductions instead of claiming the standard deduction (explained later).
5. *Credits*—items you can use to offset your tax on a dollar-for-dollar basis. There are two types of tax credits: one that can be used only to offset tax liability (called a "nonrefundable" credit) and one that can be claimed even if it exceeds tax liability and you receive a refund (called a "refundable" credit). Usually you must complete a special tax form for each credit you claim.

This book focuses on three types of tax-favored items: exclusions (tax-free income), deductions, and credits.

Limits on Qualifying for Tax-Favored Items

In many cases, eligibility for a tax benefit, or the extent to which it can be claimed, depends on adjusted gross income (AGI) or modified adjusted gross income (MAGI).

Adjusted gross income is gross income (all the income you are required to report) minus certain deductions (called "adjustments to gross income"). Adjustments or subtractions you can make to your gross income to arrive at your adjusted gross income are limited to the following items:

Alimony payments

Archer Medical Savings Accounts (MSAs) (for accounts set up prior to 2008)

Business expenses

Capital loss deductions of up to $3,000

Domestic production activities deduction

Educator expenses up to $250

Forfeiture-of-interest penalties because of early withdrawals from certificates of deposit (CDs)

Health Savings Account (HSA) contributions

Individual Retirement Account (IRA) deductions

Jury duty pay turned over to your employer

Legal fees for unlawful discrimination claims

Moving expenses

Net operating losses (NOLs)

One-half of self-employment tax

Performing artist's qualifying expenses

Qualified retirement plan contributions for self-employed individuals

Rent and royalty expenses

Repayment of supplemental unemployment benefits required because of the receipt of trade readjustment allowances

Self-employed health insurance deductions

Simplified employee pension (SEP) or savings incentive match plan for employees (SIMPLE) contributions for self-employed individuals

Student loan interest deduction up to $2,500

Travel expenses to attend National Guard or military reserve meetings more than 100 miles from home

Tuition and fees deduction up to $4,000

Figuring AGI may sound complicated, but in reality it's merely a number taken from a line on your tax return. For example, AGI is the figure you enter on line 37 of the 2009 Form 1040, line 21 of the 2009 Form 1040A, or line 4 of 2009 Form 1040EZ.

Modified adjusted gross income is merely AGI increased by certain items that are excludable from income and/or certain adjustments to gross income. *Which* items are added back varies for different tax breaks. For example, the MAGI limit on eligibility to claim the student loan interest deduction is AGI (disregarding the student loan interest deduction) increased by the tuition and fees deduction as well as the exclusion for foreign earned income and certain other foreign income or expenses. All of these items are explained in this book.

Standard Deduction versus Itemized Deductions

Every taxpayer, other than someone who can be claimed as a dependent on another taxpayer's return, is entitled to a standard deduction. This is a subtraction from your income, and the amount you claim is based on your filing status. Table I.1 shows the standard deduction amounts for 2009.

In addition to the basic standard deduction, certain taxpayers can increase these amounts. An additional standard deduction amount applies to those age 65 and older and for blindness. For 2009, the additional amount is $1,400 for

TABLE I.1 **Standard Deduction Amounts for 2009**

Filing Status	Standard Deduction
Married filing jointly	$11,400
Head of household	8,350
Single (unmarried)	5,700
Qualifying widow(er) (surviving spouse)	11,400
Married filing separately	5,700

individuals who are not married and are not a surviving spouse and $1,100 for those who are married or a surviving spouse. Also, homeowners who do not itemize their deductions can add to their basis standard deduction $500 in property taxes ($1,000 on a joint return).

Example

In 2009, you are single, age 68, and *not* blind (and do not own a house and did not buy a car this year). Your standard deduction is $7,100 ($5,700 + $1,400).

You may also add to the basic standard deduction real estate taxes (up to $500, or $1,000 for joint filers), state and local sales and excise taxes on vehicles purchased on or after February 17, 2009, and before January 1, 2010, and net disaster losses. Instead of claiming the standard deduction, you can opt to list certain deductions separately (i.e., *itemize* them). Itemized deductions include:

Medical expenses

Taxes

Interest payments

Gifts to charity

Casualty and theft losses

Unreimbursed employee business expenses

Investment expenses

Legal fees to earn income

Gambling losses

Estate tax payments on income in respect of decedents

You cannot claim any additional standard deduction that applies to those 65 or older and/or blind if you choose to itemize deductions in lieu of claiming the basic standard deduction amount.

Generally, claim the standard deduction when it is greater than the total of your itemized deductions. However, it may save overall taxes to itemize, even when total deductions are less than the standard deduction, if you are subject to the alternative minimum tax (AMT). ***The reason:*** The standard deduction cannot be used to reduce income subject to the AMT, but certain itemized deductions can.

If a married couple files separate returns and one spouse itemizes deduction, the other must also itemize and cannot claim a standard deduction.

Overall Limit on Certain Itemized Deductions

Even if you meet all conditions for claiming certain itemized deductions, you may lose some of the benefit of claiming them because of a special rule currently in the law. If your income is more than a set limit, these itemized deductions are reduced by 3 percent of the excess income, subject to a two-thirds phaseout. More specifically, if your adjusted gross income (AGI) in 2009 is more than $166,800 (or $83,400 if you are married but file a separate return), your itemized deductions (other than certain ones) are reduced by 3 percent of your excess AGI. This reduction amount, however, is divided by three; only one-third of the reduction is taken into account in 2009.

Itemized deductions *not* subject to this reduction include deductions for:

- Medical expenses
- Investment interest
- Casualty and theft losses
- Gambling losses

You can use Worksheet I.1 to figure the reduction in your itemized deductions (*after* you have figured each and every one under the regular rules throughout this book).

Example

In 2009, you are single with adjusted gross income of $175,000. Your itemized deductions (after applying various limits for them) total $31,000:

Medical expenses (after the 7.5 percent floor)	$ 1,500
State and local income taxes	12,000
Real estate taxes	4,000
Home mortgage interest	6,000
Charitable donations	7,000
Miscellaneous itemized deductions (after 2 percent floor)	500
Total	$31,000

All of the deductions (except the one for medical expenses) are subject to the 3 percent reduction.

WORKSHEET I.1 Itemized Deductions Limit

1.	Enter the total itemized deductions for 2009 after applying any limits (such as the 7.5% limit on medical expenses)	1.__________
2.	Enter the amount included in line 1 for medical and dental expenses, investment interest, casualty and theft losses, and gambling losses	2.__________
3.	Subtract line 2 from line 1	3.__________
4.	Multiply the amount on line 3 by 80% (.80)	4.__________
5.	Enter the adjusted gross income	5.__________
6.	Enter $166,800 ($83,400 if married filing separately)	6.__________
7.	Subtract line 6 from line 5	7.__________
8.	Multiply the amount on line 7 by 3% (.03)	8.__________
9.	Enter the smaller of line 4 or line 8	9.__________
10.	Divide line 9 by 1.5	10.__________
11.	Subtract line 10 from line 9	11.__________
12.	Subtract line 11 from line 1. This is the net amount of itemized deductions for 2009.	12.__________

Itemized Deductions Limit

1.	Enter the total itemized deductions for 2009 after applying any limits (such as the 7.5% limit on medical expenses)	1.	31,000
2.	Enter the amount included in line 1 for medical and dental expenses, investment interest, casualty and theft losses, and gambling losses	2.	1,500
3.	Subtract line 2 from line 1	3.	29,500
4.	Multiply the amount on line 3 by 80% (.80)	4.	23,600
5.	Enter the adjusted gross income	5.	175,000
6.	Enter $166,800 ($83,400 if married filing separately)	6.	166,800
7.	Subtract line 6 from line 5	7.	8,200
8.	Multiply the amount on line 7 by 3% (.03)	8.	246
9.	Enter the smaller of line 4 or line 8	9.	246
10.	Divide line 9 by 1.5	10.	164
11.	Subtract line 10 from line 9	11.	82
12.	Subtract line 11 from line 1. This is the net amount of itemized deductions for 2009.	12.	30,918

If you use your computer to figure your taxes, your tax software or online program does this computation automatically. Still, it's useful to know that you may not fully realize the value of the deductions you are otherwise entitled to because of the 3 percent reduction in the law.

The good news is that this reduction started to be eliminated from the tax law in 2006. Unless this provision is reenacted into law, no one will have to go through this long computation to figure a reduction in allowable itemized deductions.

The bad news is that this elimination is phased in over a number of years (it is fully phased in by 2010). The reduction in itemized deductions was phased out by one-third in 2006 and 2007. In 2008 and 2009, only one-third of the reduction in itemized deductions is taken into account. In 2010, there may be no reduction in itemized deductions.

Impact of Deductions on Your Chances of Being Audited

Did you know that the IRS collects statistics from taxpayers to create profiles of average deductions? If you claim more than the average for your income range, the computer *may* select your return for further examination.

Table I.2 shows the average itemized deductions for taxpayers in various adjusted gross income (AGI) ranges.

Tax experts agree that you should claim every deduction you are entitled to, even if your write-offs exceed these statistical ranges. Just make sure to have the necessary proof of your eligibility and other records you are required to keep in case your return in examined.

How to Use This Book

The chapters in this book are organized by subject matter so you can browse through them to find the subjects that apply to you or those in which you have an interest.

TABLE I.2 Average Itemized Deductions for 2007*

AGI	Medical	Taxes	Interest	Donations
$ 15,000 ≤ 30,000	$ 6,849	$ 2,959	$ 9,102	$ 1,931
$ 30,000 ≤ 50,000	6,040	3,623	9,262	2,127
$ 50,000 ≤ 100,000	6,690	5,822	10,558	2,612
$100,000 ≤ 200,000	9,922	10,370	13,766	3,790
$200,000 ≤ 250,000	22,810	17,013	13,030	5,733
$250,000 and over	32,813	49,370	28,110	23,817

*The latest year for which statistics are available.

Each tax benefit is denoted by an icon to help you spot the type of benefit involved:

Exclusion

Above-the-line deduction

Itemized deduction (a deduction taken *after* figuring adjusted gross income)

Credit

Other benefit (e.g., a subtraction that reduces income)

For each tax benefit you will find an explanation of what it is, starting with the maximum benefit or benefits you can claim if you meet all eligibility requirements. You'll learn the conditions or eligibility requirements for claiming or qualifying for the benefit. You'll find both planning tips to help you make the most of the benefit opportunity as well as pitfalls to help you avoid problems that can prevent your eligibility. You'll see where to claim the benefit (if reporting is required) on your tax return and what records you must retain to support your tax position.

You'll find hundreds of examples to show you how other taxpayers have successfully taken advantage of the benefit. Over the years, taxpayers have been able to write off literally thousands of items; not every one is listed here because space does not allow it. And you'll learn what *isn't* allowed even though you might otherwise think so. There are references to free IRS publications on a variety of tax topics that you can download from the IRS web site (www.irs.gov) or obtain free of charge by calling 800-829-1040. Also included are titles of other J.K. Lasser books on various topics throughout this book.

In the appendices, you'll find a listing of items that can be adjusted each year to reflect cost-of-living changes so you can plan ahead, as well as a checklist of items that are tax free and a checklist of items that are not deductible.

At the time this book went to press, there were several tax bills before Congress. Throughout the book you will find notes to alert you to other possible changes to come. For a free update on tax developments, and a free download of the Supplement to this book in February 2010, go to www.jklasser.com, as well as to my web site, www.barbaraweltman.com (and click on "tax articles"). For more information, and to learn about the newest deductions and other tax breaks, visit www.jklasser.com, your 365-day-a-year tax resource.

Finally, I'd like to thank James Randall ("Randy") Gardner, CPA, CFP, professor of accountancy at the University of Missouri–Kansas City, for his thorough and helpful review of this edition.

You and Your Family

Do the old clichés still ring true? Can two still live as cheaply as one? Are things really cheaper by the dozen? For tax purposes, there are certain tax breaks for building a family.

This chapter explains family-related tax benefits, including:

- Personal exemption
- Dependency exemption
- Child tax credit
- Earned income credit
- Dependent care credit
- Adoption costs
- Foster care
- Child support
- Alimony

For more information on these topics, see IRS Publication 501, *Exemptions, Standard Deduction, and Filing Information*; IRS Publication 503, *Child and Dependent Care Expenses*; IRS Publication 504, *Divorced or Separated Individuals*; IRS Publication 596, *Earned Income Credit*; and IRS Publication 972, *Child Tax Credit*.

Personal Exemption

Each taxpayer (other than someone who is another taxpayer's dependent) automatically is entitled to a deduction just for being a taxpayer. The amount of the deduction, called the exemption amount, is a fixed dollar amount ($3,650 in 2009). However, if a taxpayer is considered to be a "high-income taxpayer," he or she loses some or all of this deduction.

Benefit

You can claim a deduction for yourself, called a personal exemption. In 2009, the exemption amount is $3,650 (each year it is indexed for inflation). Table 1.1 shows you the value of your personal exemption for your tax bracket in 2009 (the amount of taxes you save by claiming it).

Conditions

There are no conditions to claiming this deduction; it's yours because you are a taxpayer and the law says you are entitled to it.

Each spouse is entitled to his or her own personal exemption. On a joint return, two personal exemptions are claimed. If you are married but file a separate return, you can claim both deductions (an exemption for you and an exemption for your spouse) if your spouse has no income and is not the dependent of another taxpayer.

However, you *cannot* claim the personal exemption if you can be claimed as a dependent on another taxpayer's return. For example, a child who is the parent's dependent cannot claim a personal exemption on the child's own return.

Planning Tips

If a parent waives a dependency exemption for a child, the child can then claim the exemption on his or her own return (the child is no longer treated as a dependent). This may be advisable, for example, when the parent cannot use an education credit because the parent's income is too high, but the child can use the credit to offset his tax liability (see Chapter 3).

High-income taxpayers may lose some or all of their deduction for exemptions as explained below (see Pitfalls). But the phaseout of personal and dependency

TABLE 1.1 Value of Your Personal Exemption in 2009

Your Top Tax Bracket	Value of Your Exemption
10%	$ 365
15%	548
25%	913
28%	1,022
33%	1,205
35%	1,278

TABLE 1.2 Phaseout of Personal Exemption for 2009

Your Filing Status	AGI—Beginning of Phaseout	AGI above Which Exemption Is Fully Phased Out*
Married filing jointly	$250,200	$372,700
Head of household	208,500	331,000
Unmarried (single)	166,800	289,300
Married filing separately	125,100	186,350

*This is prior to the one-third cut explained above.

exemptions is being eliminated. The reduction of this phaseout, which started in 2006, is not fully in effect until 2010.

Pitfalls

You may lose some or all of the personal exemption (as well as dependency exemptions discussed later) if you are a high-income taxpayer. The write-off for exemptions is phased out for taxpayers with adjusted gross incomes above a set amount; once AGI reaches a set level, no write-offs are permitted. Table 1.2 shows where the phaseout of exemptions begins and the AGI level at which no exemptions can be claimed.

Once your AGI exceeds the beginning of the phaseout range, the deduction for personal and dependency exemptions is reduced by 2 percent for each $2,500 of AGI over the beginning phaseout number. However, the phaseout is reduced by one-third. Use the Worksheet 1.1 to figure your limitation, if any, on exemptions you can claim.

Example

In 2009, you are single and have AGI of $290,000. Since your AGI is over the limit of $289,300, you cannot use any of your personal exemption. If your AGI is $250,000, your net exemption amount is $2,840.

You cannot claim any personal or dependency exemption for alternative minimum tax (AMT) purposes, a shadow tax system designed to ensure that all taxpayers pay at least some tax. A large number of exemptions can substantially reduce or even eliminate any regular tax. So if you have a large number of exemptions, you may trigger or increase AMT liability. You may wish to engage in some tax planning to minimize or eliminate your AMT liability.

WORKSHEET 1.1 Reduction of Exemption Amount

Use this worksheet to figure the amount to enter on Worksheet 1, line 4.

1. Multiply $3,650 by the number of exemptions you plan to claim.	1. ________
2. Enter adjusted gross income.	2. ________
3. Enter: $166,800 if single $250,200 if married filing jointly or qualifying widow(er) $125,100 if married filing separately $208,500 if head of household	3. ________
4. Subtract line 3 from line 2 and enter here.	4. ________
5. Is line 4 more than $122,500 (more than $61,250 if married filing separately)? ☐ Yes. Multiply $2,333 by the number of exemptions you plan to claim and enter the result here and on Worksheet 1, line 4. Do not complete the rest of this worksheet. ☐ No. Divide line 4 by $2,500 ($1,250 if married filing separately). If the result is not a whole number, increase it to the next whole number.	5. ________
6. Multiply line 5 by 2% (.02). Enter the result as a decimal, but not more than 1.0.	6. ________
7. Multiply line 1 by the decimal on line 6.	7. ________
8. Divide line 7 by 3.0.	8. ________
9. Subtract line 8 from line 1. This is the net amount of the exemptions you can claim.	9. ________

Where to Claim the Personal Exemption

You claim the exemption directly on your tax return in the "Tax and Credits" section of Form 1040 or the "Tax, Credits and Payments" section of Form 1040A; no special form or schedule is required. If you are filing Form 1040EZ, the exemption amount is built into the tax table (you can file this return only if you are single or married filing jointly with no dependents); you don't have to subtract it anywhere on the return.

If your AGI exceeds the beginning of the phaseout range, use a worksheet in the instructions for the return to figure the phaseout of your exemption.

Dependency Exemption

A fixed deduction ($3,650 in 2009) is allowed to every taxpayer who supports another person and meets other tests described later. The deduction is called a dependency exemption. However, if a taxpayer is considered to be a "high-income taxpayer," he or she loses some or all of this deduction.

Benefit

You may be entitled to a dependency exemption for each person you support if certain conditions are met. Like the personal exemption, each dependency exemption in 2009 is a deduction of $3,650.

Conditions

There are two classes of dependents: qualifying children and all other qualifying individuals. Different conditions apply to each class of dependents.

For a qualifying child, there are four conditions:

1. Being your child
2. Modified support test
3. Citizenship test (see end of "Conditions" section)
4. Joint return test (see end of "Conditions" section)

BEING YOUR CHILD

For purposes of a qualifying child, your children include your natural children, stepchildren, adopted children (including those placed for adoption), and eligible foster children (those placed with you by an authorized adoption agency or court). A qualifying child also includes grandchildren and brothers and sisters (including stepsiblings) and children of siblings (nieces and nephews who are younger than you). The child must be under age 19, under age 24 and a full-time student, or permanently disabled (any age).

Your child must live in your household for more than half the year. A child kidnapped by someone other than a family member continues to be treated as a member of your household until the year in which he or she would have attained age 18.

MODIFIED SUPPORT TEST

A qualifying child must not have provided more than half of his or her own support (you do not have to show you paid more than half the child's support). Amounts received as scholarships are *not* counted as support. There is no gross income test for a qualifying child as there is for a qualifying relative explained later.

Special rule for divorced or separated parents: The exemption belongs to the noncustodial parent if these conditions are met:

- The child receives more than half of his/her support from the parents.
- A decree of divorce or separation agreement between the parents states that the noncustodial parent is entitled to claim the dependency exemption or the custodial parent signs a written declaration that he/she will not claim the exemption.

If there is no divorce decree or separation agreement with a statement on the dependency exemption for the noncustodial parent or the custodial parent fails to sign a written declaration waiving the exemption, then a so-called tiebreaker rule applies. Under this rule, the exemption belongs to the parent with whom the child resided for the greater amount of time, or if equal time, then to the parent with the higher adjusted gross income. Thus, the custodial parent will usually prevail because the child is a member of the custodial parent's household for more time during the year than the child is a member of the noncustodial parent's household.

There are five tests for claiming a dependency exemption for someone who is not a qualifiying child. You must satisfy *all* of them:

1. Relationship or member of the household test
2. Gross income test
3. Support test
4. Citizenship or residency test
5. Joint return test

RELATIONSHIP OR MEMBER OF THE HOUSEHOLD TEST

The person you claim as a dependent must either be a relative (whether or not they live with you) or a member of your household. Relatives who do not have to live with you in order to qualify as your dependent include:

- Child, adopted child, or stepchild (other than a qualifying child)
- Grandchild (other than a qualifying child)
- Great-grandchild (other than a qualifying child)
- In-law (son, daughter, father, mother, brother, or sister)
- Parent or stepparent
- Sibling, stepbrother or stepsister, half-brother or half-sister
- Uncle, aunt, nephew, or niece if related by blood

Any other individual, including, for example, a cousin, must be a member of your household for the entire year (not counting temporary absences).

GROSS INCOME TEST

The person you claim as a dependent must have gross income of less than the exemption amount—$3,650 in 2009.

Gross income means income that is subject to tax. It does not include tax-free or excluded items, such as municipal bond interest, employee fringe benefits, or gifts. Social Security benefits are gross income only to the extent they are taxable (which may be 50 percent or 85 percent, depending on the recipient's income and Social Security benefits).

SUPPORT TEST

You must provide more than half of the person's support for the year (or meet the multiple support rules discussed later). Generally, this test does not present a problem; you may be the person's only means of support.

But where the person pays some of his or her own support while receiving help from you and other sources, you need to look closely at whether you pay more than half of the person's support. "Support" is different from "income." You need to look at what is *spent* on personal living needs and not what the person *receives* in the way of income. Government benefits payable to the person, including Social Security benefits, are treated as the person's own payment of support (whether or not actually spent on personal living needs).

EXAMPLES OF SUPPORT ITEMS

Clothing

Education expenses (If your child takes out a student loan that he or she is primarily obligated to repay, the loan proceeds count as the child's own payment of support.)

Entertainment

Food

Lodging (If the person shares your home, support is based on the fair rental value of the room or apartment in your home, including a reasonable allowance for heat and other utilities.)

Medical expenses (for details see Chapter 2)

Recreation, including the cost of a television, summer camp, dance lessons, and a wedding

CITIZENSHIP OR RESIDENCY TEST

The person you claim as a dependent must be a U.S. citizen or national, or a resident of the United States, Canada, or Mexico.

JOINT RETURN TEST

If you are claiming an exemption for someone who is married, the person may not file a joint return with his or her spouse. However, this joint return test is not failed if a joint return is filed merely to claim a refund and both spouses have income under the exemption limit.

Example

You are supporting your married daughter. Both she and her husband are graduate students who each earned $3,000 as teaching assistants and file a joint return to claim a refund of taxes paid on these earnings. Even though your daughter files a joint return, you can still claim her as a dependent (assuming other tests are met).

Planning Tips

As described earlier in this chapter, elimination of the phaseout of the exemptions began in 2006; by 2010, high-income taxpayers will no longer lose the benefit of personal and dependency exemptions.

MULTIPLE SUPPORT AGREEMENTS

Even if you do not provide more than half the support of another person, you may still qualify for the deduction if you contribute more than 10 percent of the person's support and, together with others, contribute more than half the person's support. Then each of the other supporters who contribute more than 10 percent must agree among themselves who claims the exemption (it cannot be prorated among the supporters).

Example

You and your two sisters support your elderly mother. You contribute 40 percent, Ann contributes 35 percent, and Betty contributes 5 percent (your mother pays 20 percent of her own support). Since you and your sisters contribute more than half of your mother's support, a multiple support agreement is warranted.

However, only you and Ann qualify since you each contribute more than 10 percent of the support. You and Ann can decide who claims the exemption—it does not matter that you paid more than Ann.

In deciding which person should claim the exemption when more than one person qualifies, the decision should be based on who would benefit more. Factors to consider include:

- Which person is in the higher tax bracket
- Whether such person is a high-income taxpayer subject to the phaseout of personal and dependency exemptions

If all things are equal, then rotate from year to year who claims the exemption (for example, one year you claim the exemption for a parent and the following year your sibling claims it).

Pitfalls

For rules on the phaseout of the dependency exemption for high-income taxpayers as well as the impact of the AMT, see earlier sections of this chapter.

If you support a domestic partner or lover and meet all of the tests, you can claim a dependency exemption only if the relationship does not violate local law. For example, in North Carolina, a man was prohibited from claiming the exemption for his live-in girlfriend because under North Carolina law this cohabitation was a misdemeanor. In contrast, a man in Missouri was permitted to claim the exemption for his live-in girlfriend because the relationship there was not in violation of state law.

If you can claim an exemption for a partner, you may or may not be able to claim one for the partner's qualifying child. Usually, you do not qualify for an exemption for your partner's child because the child is not your qualifying relative (he or she is the qualifying child of your partner). Under an exception, however, the exemption for the child can be claimed if your partner (for whom the child is a qualifying child) is not required to file a tax return because of low income and does not file a return or files one only to get a refund of withheld income taxes. If, for example, your partner files a return to claim the earned income credit in addition to claiming a refund of withheld income taxes, then this exception to the general rule does not apply.

Where to Claim the Dependency Exemption

You claim the exemption directly on your tax return in the "Tax and Credits" section of Form 1040 or the "Tax, Credits and Payments" section of Form 1040A; no special form or schedule is required. You cannot claim a dependency exemption if you file Form 1040EZ.

If your AGI exceeds the beginning of the phaseout range, use a worksheet in the instructions for the return to figure the phaseout of your exemption.

In the case of divorced or separated parents, the noncustodial parent should attach to his or her return Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents, signed by the custodial parent.

Child Tax Credit

The U.S. Department of Agriculture estimates that it costs $279,000 for a Midwestern middle-class family to raise a child to age 17 (without adjustment for inflation). In recognition of this cost, you can claim a tax credit each year until your child reaches the age of 17. The credit is currently up to $1,000 per child. This credit is in addition to the dependency exemption for the child.

Benefit

You may claim a tax credit of up to $1,000 in 2009 for each child under the age of 17. If the credit you are entitled to claim is more than your tax liability, you may be entitled to a refund under certain conditions.

Generally, the credit is refundable to the extent of 15 percent of earned income over $3,000 in 2009.

If you have three or more children for whom you are claiming the credit, you are entitled to an additional child tax credit. In reality, the additional child tax credit is merely a larger refund of the credit you are ordinarily entitled to. There are two ways to figure your refundable amount (the additional child tax credit) and you can opt for the method that results in the larger refund:

1. Fifteen percent of earned income over $3,000 in 2009
2. Excess of your Social Security taxes (plus one-half of self-employment taxes if any) over your earned income credit for the year (the earned income credit is explained in the next main section)

Conditions

To claim the credit, you must meet two conditions:

1. You must have a qualifying child.
2. Your income must be below a set amount.

QUALIFYING CHILD

You can claim the credit only for a "qualifying child." This is a child who is under age 17 at the end of the year and meets the definition of a qualifying child explained earlier in this chapter.

MAGI LIMIT

You must have modified adjusted gross income (MAGI) below a set amount. The credit you are otherwise entitled to claim is reduced or eliminated if your MAGI exceeds a set amount. MAGI for purposes of the child tax credit means AGI increased by the foreign earned income exclusion, the foreign housing exclusion or deduction, or the possession exclusion for American Samoa residents.

The credit amount is reduced by $50 for each $1,000 of MAGI or a fraction thereof over the MAGI limit for your filing status. The phaseout begins if MAGI exceeds the limits found in Table 1.3.

TABLE 1.3 Phaseout of Child Tax Credit over MAGI Limits in 2009

Filing Status	MAGI Limit
Married filing jointly	$110,000
Head of household	75,000
Unmarried (single)	75,000
Qualifying widow(er)	75,000
Married filing separately	55,000

Example

In 2009 you are a head of household with two qualifying children. Your MAGI is $80,000. Your credit amount of $2,000 ($1,000 × 2) is reduced by $250 ($80,000 – $75,000 = $5,000 MAGI ÷ [$1,000 × $50]). Your credit is $1,750 ($2,000 – $250).

REFUNDABLE CREDIT

If the credit you are entitled to claim is more than your tax liability, you can receive the excess amount as a "refund." The refund is limited to 15 percent of your taxable earned income (such as wages, salary, tips, commissions, bonuses, and net earnings from self-employment) over $3,000 in 2009. If your earned income is not over $3,000, you may still qualify for the additional credit if you have three or more children.

If you have three or more children for whom you are claiming the credit, you may qualify for a larger refund, called the additional child tax credit. You can figure your refund in the usual manner as explained earlier, or, if more favorable, you can treat your refundable amount as the excess of the Social Security taxes you paid for the year (plus one-half of self-employment taxes, if any), over your earned income credit (explained later in this chapter).

Planning Tip

If you know you will become entitled to claim the credit (e.g., you are expecting the birth of a child in 2009), you may wish to adjust your withholding so that you don't have too much income tax withheld from your paycheck. Increase your withholding allowances so that less income tax is withheld from your pay by filing a new Form W-4, Employee's Withholding Allowance Certificate, with your employer.

Pitfall

There is no downside to claiming the credit. If you are entitled to it, be sure to claim it.

Where to Claim the Credit

You figure the credit on a worksheet included in the instructions for your return. You claim the credit in the "Tax and Credits" section of Form 1040 or the "Tax, Credits and Payments" section of Form 1040A; you cannot claim the credit if you file Form 1040EZ.

If you are eligible for the additional child tax credit, you figure this on Form 8812, Additional Child Tax Credit.

Earned Income Credit

Low-income taxpayers are encouraged to work and are rewarded for doing so by means of a special tax credit, called the earned income credit. The earned income credit is the second largest program, after Medicaid, that provides assistance to low-income people. The amount of the credit varies with income, filing status, and the number of dependents, if any. The credit may be viewed as a "negative income tax" because it can be paid to taxpayers even if it exceeds their tax liability. On 2006 returns, 23.4 million taxpayers claimed the earned income credit, totaling $45.4 billion.

Benefit

If you are a working taxpayer with low or moderate income, you may qualify for a special tax credit of up to $5,657 in 2009. The amount of the credit depends on several factors, including your adjusted gross income, earned income, and the number of qualifying children that you claim as dependents on your return. Table 1.4 shows the maximum credit you may claim based on the number of your qualifying children, if any.

The credit is "refundable" because it can be received in excess of the tax owed. What's more, in some cases the credit can be received on an advanced basis—included in your paycheck throughout the year.

Conditions

To be eligible for the credit, you must have earned income from being an employee or a self-employed individual. The amount of the credit you are entitled to claim depends on several factors.

QUALIFYING CHILDREN

You may claim the credit even if you have no qualifying child. But you are entitled to a larger credit if you have one qualifying child and a still larger credit for two or more qualifying children.

TABLE 1.4 Maximum Earned Income Credit for 2009

Number of Qualifying Children	Maximum Earned Income Credit
No qualifying child	$ 457
One qualifying child	3,043
Two qualifying children	5,028
Three or more qualifying children	5,657