

# **TAX TIPS FOR THE 2010 GRADUATE**

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## TAX TIPS FOR THE 2010 GRADUATE

Service is a watchword for the accountant who deals with and reacts to client needs in a variety of situations. One familiar scenario is depicted below.

*Accountant:* We filed the corporation's 1120 last month. Now, here's your completed 1040 and the 1040 EZ that your daughter, Julie, should sign before filing for her refund. By the way, how is Julie doing?

*Client:* Very well. She'll be graduating next month.

*Accountant:* Those four years really flew by. What are her plans for the future?

*Client:* She's accepted a position with a pharmaceutical company. That reminds me--she asked about her taxes. Do you have any materials that might help Julie better understand her tax situation?

This publication is an attempt to answer the question posed by the client. It recognizes that, as inexperienced preparers of Federal income tax returns, many 2010 graduates may find it difficult to file a return which will result in paying the lowest possible tax. Our effort involves introducing the 2010 graduate to some common tax considerations that could be beneficial in reducing the dreaded "tax-bite."

A set of basic facts will be assumed and worked with throughout. The assumptions are:

Current year = the year of graduation (i.e., 2010)  
Salary = \$3,500/month  
Commencement of Employment = July 1, 2010  
Filing Status = Single  
State and/or Local Tax Rate = 4%

Since the job will commence on July 1, the total salary earned during 2010 will be \$21,000 (i.e., \$3,500/month for 6 months).

### **"Take-Home" Pay**

A salary of \$3,500 per month doesn't mean that a newly-employed graduate will have this amount to spend each month. There are several tax-related items which will be deducted from each paycheck by the employer. These include federal withholding, Social Security/Medicare (also known as FICA) and, in most cases, a state income tax. As a single person, our assumed taxpayer will fill out a Form W-4 for the employer and probably claim one exemption. This will result in "take-home" pay of \$2,687 (see Table 1). Since income will only be earned for six months, this will create an "over-withholding" situation. In other words, too much will be deducted monthly from the paycheck since the paycheck is converted to an assumed annual salary (i.e., \$42,000) and total deductions are calculated based on this inflated figure. To alleviate this situation, the 2010 graduate should claim three dependents which will increase the "number of allowances" on the W-4 to four. This will increase "take-home" pay by \$156/month

(see Table 1) and generate a refund when filing the return for 2010. Early in 2011 fill out a new W-4, and list “number of allowances” as one.

### **TAX TIP #1**

**Avoid over-withholding in 2010 by increasing the “number of allowances” on Form W-4. Remember to change to the proper “number of allowances” at the beginning of 2011.**

### **Expected Refund**

If Tax Tip #1 is followed, there is an excellent chance that our taxpayer will qualify for a refund of Federal income taxes when filing a 2010 tax return. If all of the graduate’s income is from the job, the federal income tax liability will be approximately \$1,329<sup>1</sup>. Since his or her employer withheld \$1,494 (6 × \$249/month per Table 1), he or she will be eligible for a tax refund.

### **TAX TIP #2**

**Be prepared to file the 2010 Federal income tax return early to obtain a refund. In most regional centers, the refund can be hastened by labeling the envelope containing the return “REFUND” and/or using the appropriate post office box number. Alternatively, electronic filing will also shorten the time between filing and receiving a refund. Use of the direct deposit option is also recommended.**

### **Deductible Expenses**

Some graduates will be able to report and deduct expenses which are allowed if they itemize their deductions. This occurs when the total itemized deductions exceed the standard deduction amount (e.g., \$5,700 for “singles” and \$11,400 for “marrieds” are the 2010 figures). Taxpayers such as married graduates who own a home (and are paying mortgage interest and real estate taxes) and/or find themselves in states with high income tax rates (e.g., California, Massachusetts, New York, Wisconsin) would be the most likely candidates for itemizing. Other expenses that may be included in the itemized deduction category include employee expenses, such as unreimbursed overnight travel and meal expenses, and charitable contributions.

Out-of-pocket costs that can be deducted regardless of the taxpayer’s ability to itemize deductions are referred to as “above-the-line” deductions. The most likely “above-the-line” components for the 2010 graduate are the deduction for student loan interest and the moving expenses deduction. Also, if you decide to go back to graduate or professional school, up to \$4,000 of such costs (i.e., tuition, student activity fees and expenses for course related books, supplies and equipment that are required as a condition of enrollment or attendance, but not room and board) can be deducted in determining your adjusted gross income (AGI). These education costs (labeled as a tuition and fees deduction) qualify as “above-the-line” deductions.

## **Interest on a Student Loan**

Interest paid on a student loan is deductible. The interest must be on a “qualified education loan” which includes debt used to cover higher education expenses such as tuition, books, fees, room and board. If the 2010 graduate paid more than \$600 in student loan interest during the year, a Form 1098-E, Student Loan Interest Statement, will be provided by the payor. This deduction is also “above the line” (i.e., subtracted in computing Adjusting Gross Income) with a maximum figure of \$2,500 per tax return (even for a married couple who both have loan interest totaling more than \$2,500) applying to 2010. There are “phase out” rules that apply to the student loan interest deduction but these are unlikely to play a role in the 2010 graduate’s income tax reporting. But if the student is going to be claimed as a dependent on their parent’s 2010 tax return (see Tax Tip #9 below), this annual deduction would be reported for the first time on the recent grad’s 2011 tax return.

Since the 2010 graduate may have other types of interest expense (e.g., advance pay from employer, credit card, personal residence, vehicle loan), it is important that the source and reason for the interest is documented. Only the interest on a “qualified education loan” is deductible as the 2010 graduate determines his or her Adjusted Gross Income.

Example: Mariah, a single 2010 graduate, who will not be claimed as a dependent in 2010, is examining the interest she paid during 2010:

<u>Amount</u>	<u>Organization</u>	<u>Type of loan</u>
\$ 450	Beyonce Bank	New vehicle
1,680	Carey College	Tuition and fees
170	Damon Debit	Credit card
50	Eminem Enterprises	Pay advance
<u>1,050</u>	Cub Savings & Loan	Room and board
\$3,400		

Since the loans from Carey College and Cub Savings & Loan meet the “qualified education loan” criteria, Mariah may deduct the interest on those loans on her 2010 return. However, the deduction is limited to \$2,500 (the 2010 “cap”) even though the actual eligible interest payments were \$2,730 (i.e., \$1,680 +1,050)<sup>2</sup>.

### **TAX TIP #3**

**Determine and document the source and reason for all interest payments during 2010. Pay particular attention to loans used to pay qualified education expenses since up to \$2,500 is deductible when computing Adjusted Gross Income.**

## Moving Expenses

This special provision allows a taxpayer to deduct the costs involved in moving to his or her “first job” if specific distance-of-move and time-of-employment criteria are met. The distance-of-move test is a 50-mile factor while the time-of-employment requirement is met by working at least 39 weeks in the first 12 months after the move. The deductible expenses include those incurred for the transportation of the taxpayer to his or her new location, the cost of moving personal effects and household goods as well as any cost for lodging while traveling. These expenses are only limited by their “reasonableness.” However, the costs of temporary living expenses at the new job location once the move is completed are not deductible.

Example: Juan, a 2010 graduate, moves from Peoria to Milwaukee to start his career. He can deduct the following expenses on his federal tax return.

Transportation for self.....	\$260
Transportation for clothing, books, computer and compact disc player (his only possessions).....	500
10 days accommodations at Mecca Motel (i.e., temporary living expenses in Milwaukee while seeking a rental apartment) .....	<u>-0-</u>
Total moving deduction .....	<u>\$760</u>

Since employers may report the moving expense reimbursement to the Internal Revenue Service, 2010 graduates should maintain the necessary records to verify the amount spent on moving expenses.

### **TAX TIP #4**

**Prepare and maintain a record of the expenses involved in moving to the first place of employment. These include: the actual moving expenses; travel and lodging costs incurred en route to the place of employment.**

## Overnight Travel Expenses

When an individual’s employment calls for considerable travel away from their usual business place overnight, taxpayers may be entitled to deduct travel expenses from their Adjusted Gross Income (AGI) as an itemized deduction. The circumstances allowing this treatment occur when the out-of-pocket expenses exceed reimbursement, if any, from the employer. Since the costs are greater than the reimbursement, the unreimbursed costs would be possible deductions since they are included in the compilation of miscellaneous itemized deductions.<sup>3</sup> Specifically, amounts spent for lodging and meals while away from home on business are deductible. However, meal costs may be limited to 50% deductibility, if they are not reimbursed. Also deductible are such items as baggage charges, reasonable cleaning and laundry expenses, telephone, telegraph and fax machine expenses, and others. Any substantiated travel expenses

that are fully reimbursed by one's employer are treated as neither income nor a deduction and therefore these items would not appear on the individual's W-2 and tax return.

Example: Barbara is employed by BoSox Products. Since her job requires out-of-town travel, BoSox Products provides \$150 per month as a reimbursement allowance. Barbara is required to substantiate all expenses and must return all advances not spent on business expenses. From July through December, Barbara incurs \$1,500 of expenses while traveling (i.e., lodging costs of \$1,000 and \$500 for meals) and receives reimbursements of \$900 (\$600 for lodging and \$300 for meals). Barbara's treatment of the situation indicates:

	<u>Lodging</u>	<u>Meals</u>	<u>Total</u>
Actual Spending	<u>\$1,000</u>	<u>\$500</u>	<u>\$1,500</u>
Not reported (a)	\$ 600	\$300	\$ 900
Include in miscellaneous itemized deductions	400	100(b)	500(*)
Not deductible	<u>0</u>	<u>100(c)</u>	<u>100</u>
	<u>\$1,000</u>	<u>\$500</u>	<u>\$1,500</u>

- (a) As mentioned above, none of these amounts will appear on the W-2 or the tax return.
- (b) 50% of unreimbursed meal costs (i.e., 50% of \$200).
- (c) 50% of meal costs that are not reimbursed cannot be deducted.
- (\*) As a component of miscellaneous itemized deductions, the total of \$500 will be reduced by 2% of Adjusted Gross Income.

### **Other Business Expenses**

As part of one's job, it may be necessary to entertain a customer or client. In some instances, a miscellaneous itemized deduction will be generated to the extent that the expenses exceed any reimbursement. If the reimbursement equals the expenditures, neither is reported on the tax return as long as a proper accounting of the expenses was provided to the employer. In other instances, the comparison of actual expenses to the reimbursement can lead to income recognition (where the reimbursement exceeds the expense and the reimbursement is reported on the W-2) or a combination of a miscellaneous itemized deduction and a non-deductible portion (where the reimbursement is less than the expense). Those who qualify as "outside salespeople" (i.e., employees whose W-2 forms are marked with an "X" for "statutory employee") may be permitted special treatment since they are allowed to report all outside income and the related expenses on Schedule C. As a result of this provision, the "outside salesperson" may avoid the 2% of AGI hurdle that pertains to miscellaneous itemized deductions. Entertainment expenses include disbursements incurred at restaurants, cocktail lounges, country clubs, other similar establishments and sporting events. However, any club dues (including airline, country club and golf/athletic facility dues) are not deductible. Finally, any unreimbursed entertainment expense

deductions are limited to 50% of their total and must exceed 2% of AGI when totaled with other miscellaneous deductions to be included in total itemized deductions.

Example: Three 2010 graduates (Aaron, Alissa, and Amy) receive an entertainment allowance of \$200/month (i.e., a total of \$1,200 for 2010). The allowances are not reported on the Form W-2 by the employers since all expenses incurred must be substantiated and any excess advances must be returned. Aaron spends \$1,000, Alissa's expenditures are \$1,200, while Amy tallies \$1,600 of entertainment expenses. Proper treatment for each of the above if none of the taxpayers were an "outside salesperson":

Aaron--Reports \$200 (i.e., \$1,200-1,000) of other income based on Form 2106 instructions.<sup>4</sup>

Alissa--Since the allowance equals the expenses, there is no need to report either the allowance or the expenditures assuming that a proper accounting to the employer occurs.<sup>5</sup>

Amy--A deduction of \$200 is permitted (i.e., 50% of the unreimbursed \$400). The \$200 is included as a miscellaneous itemized deduction. Thus, it may not be deductible if (1) Amy is not able to itemize or (2) Amy's total miscellaneous itemized deductions do not exceed 2% of Adjusted Gross Income (AGI).

#### **TAX TIP #5**

**Familiarize yourself with the types of deductible expenses incurred as part of your employment. Prepare and maintain a record of these expenses which can include travel, meals, lodging, entertainment and educational costs. Also, if possible, insist on specific item reimbursement instead of a general allowance system.**

**Itemized Deductions**

Most graduates will not be itemizing deductions during their first years as wage-earners due to the substantial standard deduction which is available. To derive any tax benefit from itemizing deductions, the total of these deductions must exceed the following standard deduction amounts:

<u>Filing Status</u>	<u>Basic Standard Deduction for 2010</u>
Single	\$ 5,700
Head of Household	\$ 8,350
Married Filing Jointly	\$11,400

The possibility of itemizing deductions increases when a taxpayer resides in a high income tax state (e.g., California, Massachusetts, New York, Wisconsin), has had sizeable uninsured or unreimbursed medical expenses and/or when he or she owns a home and incurs interest on a mortgage and pays real estate taxes. Medical expenses (within percentage limitations), personal property taxes, and real estate property taxes are usually included in the list of itemized deductions along with state income taxes or state sales tax, charitable contributions and casualty losses. Teaching supplies, journal subscriptions and further educational costs are usually included in the miscellaneous itemized deduction category. An expanded discussion of educational expenses is included in a later section.

Example: Hannah, a single taxpayer, receives her MBA in May of 2010. She lists the potential following itemized deductions for 2010:

Interest paid on a car loan (amounts to \$400) .....	\$ 0 <sup>6</sup>
Interest paid on a home mortgage loan .....	3,500
State and local income taxes .....	1,280
Real estate taxes .....	1,500
Charitable contributions .....	600 <sup>7</sup>
Personal property taxes (included as a portion of automobile license plate cost) .....	<u>360</u>
<b>TOTAL ITEMIZED DEDUCTIONS .....</b>	<b><u>\$7,140</u></b>

Hannah will itemize deductions on her return since the total is greater than the \$5,700 standard deduction amount. If the total was less than the standard deduction, Hannah would not itemize.

## TAX TIP #6

**Don't attempt to itemize deductions unless you've incurred substantial unreimbursed medical costs, state and local income taxes, home mortgage interest, real estate and/or personal property taxes during 2010 and expect this total to surpass the 2010 standard deduction amount for your filing status.**

### Tax Credits

There are several tax credits that the 2010 graduate will be eligible for including the child and dependent care credit, the child tax credit, the Lifetime Learning Credit and the American Opportunity Tax Credit. However, unless the 2010 graduate has a child or is paying for the care of a child or other dependent (e.g., aging parent), the Lifetime Learning Credit or the American Opportunity Credit is the most likely candidate for inclusion on the 2010 return. One of these credits (but not both) may be reported by either the student (if not claimed as a dependent) or the parents.

The Lifetime Learning Credit is determined by multiplying 20% of the first \$10,000, spent in 2010, to take one or more courses (including graduate level offerings) at an "eligible educational institution." Thus, the 2010 diploma winner could reduce his or her taxes by up to \$2,000 as long as he or she paid as much as \$10,000 of tuition and fees during 2010. If one's parent(s) paid the education bills, the American Opportunity Credit will be reported on the tax return of the parent(s) subject to a phase-out rule that is triggered when modified AGI is above \$80,000 for a single or head of household taxpayer or \$160,000 when the return indicates a married filing jointly status. The American Opportunity Credit can reach \$2,500 and as much as 40 percent of the credit can be refundable if the taxpayer's tax liability is unable to cover the full amount of the American Opportunity Credit.

Example: Chandra graduated in May 2010 with a bachelor's degree. Her parents paid \$5,400 in tuition and fees for Chandra's final semester at an eligible educational institution. After starting her job, Chandra decided to take an evening course at an eligible educational institution paying \$1,200 of tuition and fees. She enjoyed the course and decided to enroll in the follow-up course. The \$1,400 tuition for the second course (which starts in late January of 2011) was paid in 2010.<sup>8</sup>

Based on the above, the following maximum credits could be listed for 2010:

\*\$2,500 on the 2010 tax return of Chandra's parents as an American Opportunity Credit assuming that their Adjusted Gross Income (AGI) was at or below \$160,000.

\*\$520 on Chandra's 2010 tax return (i.e., 20% of \$2,600 spent in 2010) assuming that her AGI was \$50,000 or below. Alternatively, a \$2,600 tuition and fees deduction could be claimed (as discussed above on page 2) in determining her AGI. The decision as to which would generate the largest tax savings (i.e., a tax credit or a deduction) would depend on Chandra's tax bracket in 2010.

## **TAX TIP #7**

**Claim the American Opportunity Tax Credit for 2010 tuition and fee payments (including prepayments) made to any “eligible educational institution.” Alert your parent(s) to the eligibility requirements that may allow the reporting of the American Opportunity Credit on their 2010 tax return.**

### **Tax Planning Considerations**

Many taxpayers feel that tax planning can only be carried out by taxpayers whose income is in the six-figure category. However, the 2010 graduate can also do some planning which will minimize his/her tax burden as well as that of the graduate’s parent(s). Two specific areas include the timing of income and the protection of the dependency exemption on the parental 2010 return.

#### **Timing of Income**

It is generally wise tax-planning to move as much income into 2010 (i.e., the year of graduation) as possible since the highest marginal tax rate (i.e., the highest tax bracket applied against those last dollars of income) will probably be lower in 2010 (when you will be earning an income for less than a full year) than in the next year (when you will most likely be employed during the entire year). Since the potential marginal rate in 2011 of 25%, 28% or 33% is significantly higher than the likely 2010 rate of 15%, this type of planning should not be taken lightly. The types of income that can be shifted include interest on U.S. Savings Bonds, capital gains, proceeds from an insurance policy that is redeemed, and overtime pay that certain organizations (e.g., CPA firms) allow employees to “bank.” For example, shifting \$500 into 2010 could create a tax savings of \$75 or more. Granted such activity would trim the refund discussed above in **Tax Tip #2** but such income movement might make a lot of tax sense.

## **TAX TIP #8**

**Examine situations that would enable you to recognize income in 2010, instead of 2011. Where possible, shift that income into 2010.**

#### **Dependency Exemption for Graduate’s Parent(s)**

For over twenty years, the tax returns filed by the parent(s) of the 2010 graduate included his or her name and a dependency exemption which reduced the parental tax liability. The graduation year return can continue to carry this tax benefit if the graduate is less than 24 years old at the end of 2010 and careful records are maintained. There are several criteria which must be met in order to qualify as a dependent on the parental return. In the year of graduation, four must be watched closely. First, the graduate cannot file a married filing joint return for any reason other than to garner a full refund. Second, the 2010 degree recipient must live with his/her parents for greater than six months. (Note: time lived away from home while a full-time student counts as “living with parents.”) Third, the 2010 graduate must be able to prove that his or her resources provided less than fifty percent of his or her support (i.e., parental funds and support from others must have been used for over half of the clothing, health care, education,

food and shelter costs). Proof of this type of spending will be based on records kept by the graduate and his or her parent(s) and other providers of support. Also, the graduate must have been a “full-time” student during at least all or part of five months of the tax year.<sup>9</sup>

Assuming that the graduate’s earnings, living away from his or her parent’s home and paying for upkeep starts in September, his or her 2010 expenditures can determine whether or not Mom and Dad will be able to claim the recent alum as a dependency exemption. For example, if the parents are paying all educational and other expenses until September 1, it would not be unreasonable to assume a spending level of \$8,000 for that eight-month period. If the graduate spends less than \$8,000 on support during the final four months of the year of graduation, the parents can claim him or her as a dependency exemption on their return. The resulting tax savings would be based on the highest marginal tax bracket applicable to the parents. The good news (for the parents) is that they will cut their tax bill based on their marginal tax bracket multiplied by the dependency deduction (e.g., \$3,650 for 2010). The bad news is that the graduate cannot claim the same dependency deduction on his or her return.<sup>10</sup> Referring to the example on page two, parental use of the exemption would impact the Form W-4 choice (i.e., graduating individual should claim 2 exemptions), take-home pay and the expected refund (see Table 2). Nonetheless, the overall result is a tax savings (assuming a 25% marginal rate for the parents and a 15% rate for the graduate while using a \$3,650 figure) as follows:

Parent savings 25% × \$3,650	=	\$ 912.50
Graduate’s cost 15% × \$3,650	=	(547.50)
Net result--Save		\$ <u>365.00</u>

### **TAX TIP #9**

**Protect the dependency exemption of your parent(s) by (a) documenting your support spending before and after you are employed and (b) spending less on your support from your funds than the amount spent by your parent(s) and others who provided resources for your support.**

### **Other Considerations**

There are several other situations which could be discussed, including the possible marriage penalty which is addressed in Appendix A. Let’s take a closer look at three areas-- education expenses, non-deductible expenses and Individual Retirement Accounts (IRAs).

### **Education Expenses**

Since a taxpayer cannot claim more than one type of tax benefit for the same expenditure, the taxpayer will want to explore which route (i.e., deductible expense or Lifetime Learning Credit) would be the most beneficial for 2010 education expenses incurred after graduating. Tuition and fees up to \$10,000 will qualify for the 20% Lifetime Learning Credit mentioned earlier. None of these costs would qualify for the American Opportunity Tax Credit since this is only available for the first four years of post-secondary education.

As a general rule, the pursuit of an advanced degree or law degree will NOT be allowed as a deductible education expense. However, if the advanced degree is a requirement to maintain

one's present position, the costs are included in miscellaneous itemized deductions (e.g., teacher seeking a master's degree based on a state requirement for retention of position). Other qualifying education expenses are those that maintain or improve skills required in one's present trade of business (e.g., salesperson enrolling in a course involving a better technical understanding of the product or service he/she sells; engineer studying various types of materials and their ability to withstand stress). Nevertheless, with the introduction of the \$4,000 for-AGI deduction permitted for tuition and fees (as discussed earlier), this distinction is not critical (at least for the first \$4,000 of such out-of-pocket spending). Now, only if the unreimbursed costs exceeded \$4,000, would the taxpayer have to meet the tests mentioned above in order to take a miscellaneous deduction for the amount in excess of \$4,000.

Disbursements included in the eligible education expenses category are those for tuition, books, fees and supplies.<sup>11</sup> In addition, transportation costs including the use of a personal vehicle to go to and from the place where the class and/or seminar is conducted are also allowed. (Note: in 2010 a rate of 50 cents/mile is permitted). Finally, 50% of the unreimbursed cost of meals of meals is an eligible education expense. Since these costs are categorized as miscellaneous itemized deductions, there is a chance that these expenses will not be included in the overall itemized deductions total. This occurs because these costs must exceed, when combined with all other miscellaneous itemized deductions, a 2% of AGI hurdle to be included in the final tally of overall itemized deductions. More importantly, the new grad must be able to itemize their deductions (vs. taking the standard deduction) and the excess portion of such expenses (i.e., above the \$4,000) was not incurred in order to qualify for a new trade or business.

Example Three recent graduates are enrolled in an MBA program and are each taking two courses during the current semester while working full-time. They are not receiving any reimbursement from their respective employers. CHET, a recent graduate (whose marginal tax bracket is 15%) is in the program to improve his skills for his present management position. URSULA, a taxpayer in the 25% marginal tax bracket, is maintaining skills by taking the course. BRAD (also in the 25% marginal tax bracket) is enrolled in the program because it is a prerequisite for an administrative position that he will seek. Without the MBA, he would not be eligible for the job.

NOTE: Assume that all three can itemize deductions and that their miscellaneous itemized deductions will exceed 2% of their AGI.

The following pertains to the current year:

	<u>CHET</u>	<u>URSULA</u>	<u>BRAD</u>
Tuition	\$5,400	\$5,400	\$5,400
Books	400	400	400
Required Supplies fee	<u>200</u>	<u>200</u>	<u>200</u>
Total Costs:	<u>\$6,000</u>	<u>\$6,000</u>	<u>\$6,000</u>
Tuition and Fees Deduction	<u>\$4,000</u>	<u>\$4,000</u>	<u>\$4,000</u>
Miscellaneous Itemized Deduction	\$2,000	\$2,000	\$ --0--
	or	or	or
Lifetime Learning Credit	\$1,200	\$1,200	\$1,200

CHET would choose to report the Lifetime Learning Credit since that would reduce his overall tax liability by \$1,200. The tax savings generated by listing the Tuition and Fees Deduction plus the Miscellaneous Itemized Deduction amounts to \$900 (i.e., 15% of \$6,000).

URSALA's choice would involve reporting the Tuition and Fees Deduction along with the Miscellaneous Itemized Deductions thereby generating an overall drop in tax liability of \$1,500 (i.e., 25% of \$6,000) as opposed to taking a \$1,200 Lifetime Learning Credit.

BRAD enrolled in the MBA program to enable him to qualify for a new position (i.e., a new trade or business). Thus, none of the costs listed above would be deductible as a miscellaneous itemized deduction but the \$4,000 Tuition and Fees Deduction would reduce his taxes by \$1,000. However, he would qualify for and report a Lifetime Learning credit of \$1,200 (i.e., 20% of \$6,000).

### **TAX TIP #10**

**Document the relationship of educational expenses to (a) requirement established by state or employer or (b) maintenance and/or improvement of skills required in your current trade or business. Following an up to \$4,000 Tuition and Fees Deduction, determine whether your tax liability is reduced more by treating the remaining eligible educational expenses as a miscellaneous itemized deduction or by using all of the educational expenses in computing the Lifetime Learning Credit.**

### **Non-Deductible Expenses**

Keeping correct and complete records can save a taxpayer a lot of time, trouble and "treasure" at tax time. Therefore, it is important to be aware of information that is not critical for tax return purposes since such activity does not generate any tax benefit. In keeping tax records, the following items are not critical since they are not deductible: non-prescription medicines, life insurance premiums, cost of a personal wardrobe, spending on personal entertainment, health club fees and spending on a personal vehicle (unless the vehicle is used for both personal and business purposes).

### **TAX TIP #11**

**Do not waste precious time and space maintaining information about spending that has no tax consequences. Furthermore, tax returns and the supporting data should be kept for at least three years.**

### **Individual Retirement Accounts**

Discussing retirement with a 2010 graduate seems to be a ludicrous exercise until you examine the potential benefits. Illustration A in Table 3 demonstrates how per year contributions<sup>12</sup> to an IRA for forty-six years--an overall investment of \$252,000--grow to over \$600,000. For the individual deciding to wait before starting to fund an IRA or similar arrangement, Illustration B in Table 3 shows that an extended delay followed by yearly contributions that amount to \$252,000 will build a retirement fund that is over \$250,000 less than the Illustration A results when the taxpayers reach age 70. In many instances, contributions to an IRA will be tax-

deductible if the employee is not eligible to be covered by an employer-provided retirement plan. Here, we ignore the tax savings that may occur since the results are so compelling.<sup>13</sup>

### **TAX TIP #12**

**Establish an IRA (Individual Retirement Account) or similar retirement arrangement -- such as a 401(k) Plan -- as soon as possible. Contribute the maximum amount to the IRA and allow it to grow until retirement.**

### **Conclusion**

Our tax laws are complex and constantly changing. This publication has highlighted several aspects of the Federal income tax law that are particularly applicable to the 2010 graduate and developed a list of twelve Tax Tips (see Table 4). Hopefully, the effort can provide this type of ending to the dialogue introduced earlier:

*Accountant:* Sure, here's something that might help Julie.

*Client:* Thanks! I knew you would have some good advice and information. See you soon.

**TABLE 1**

	<u>Number of Form W-4 Allowances</u>	
	<u>1</u>	<u>4</u>
Salary	\$3,500	\$3,500
Less:		
(a) Federal withholding tax	(405)	(249)
(b) FICA (Social Security/Medicare)	(268)	(268)
(c) State income tax	<u>(140)</u>	<u>(140)</u>
“Take-home” pay	<u>\$2,687</u>	<u>\$2,843</u>

- (a) Based on the 2010 withholding tables for Single Persons-Monthly Payroll Period Per Publication 15 (Circular E), Employer’s Tax Guide, page 53
- (b) Rate is 7.65% (6.2% Social Security; 1.45% Medicare).
- (c) Rate of 4% is used here.

NOTE: All numbers are rounded.

**TABLE 2**

Number of Form W-4 Allowance taken is 2

Salary	\$3,500
Less:	
(a) Federal withholding tax	(340)
FICA (Social Security/Medicare) - 7.65%	(268)
State income tax - 4%	<u>(140)</u>
“Take-home” pay	<u>\$2,752</u>

- (a) Based on the 2010 withholding tables for Single Persons-Monthly Payroll Period. Per Publication 15 (Circular E), Employer’s Tab Guide, page 53

Anticipated Refund

Federal tax withheld  $6 \times \$340 =$  \$2,040.00

Tax on a taxable income of \$15,300 (i.e., \$21,000 minus \$5,700) using a marginal rate of 10% on the first \$8,375 and 15% on the remaining \$6,925.\* (1,876.25)

Refund \$ 163.75

\*Parents are claiming an exemption for the graduate who is less than 24 years old by the end of 2010. Thus, the graduate’s taxable income is not reduced by a personal exemption.

**TABLE 3**

Assumptions – Yearly contribution; 4% simple interest compounded annually before yearly contribution.

Year	Illustration A			Illustration B	
	Age	Contribution	Cumulative Amount(*)	Contribution	Cumulative Amount(**)
2012	25	\$1,000	\$ 1,000	\$ -0-	\$ -0-
2013	26	\$2,000	\$ 3,040	\$ -0-	\$ -0-
2014	27	\$3,000	\$ 6,162	\$ -0-	\$ -0-
2015	28	\$4,000	\$ 10,408	\$ -0-	\$ -0-
2016	29	\$5,000	\$ 15,824	\$ -0-	\$ -0-
2017	30	\$5,000	\$ 21,457	\$ -0-	\$ -0-
2018	31	\$5,000	\$ 27,315	\$ -0-	\$ -0-
2019	32	\$5,000	\$ 33,408	\$ -0-	\$ -0-
2020	33	\$5,000	\$ 39,744	\$ -0-	\$ -0-
2021	34	\$5,000	\$ 46,334	\$ -0-	\$ -0-
2022	35	\$5,000	\$ 53,187	\$ -0-	\$ -0-
2023	36	\$5,000	\$ 60,314	\$ -0-	\$ -0-
2024	37	\$5,000	\$ 67,727	\$ -0-	\$ -0-
2025	38	\$5,000	\$ 75,436	\$ -0-	\$ -0-
2026	39	\$6,000	\$ 84,453	\$ -0-	\$ -0-
2027	40	\$6,000	\$ 93,831	\$ -0-	\$ -0-
2028	41	\$6,000	\$ 103,584	\$ -0-	\$ -0-
2029	42	\$6,000	\$ 113,727	\$ -0-	\$ -0-
2030	43	\$6,000	\$ 124,276	\$ -0-	\$ -0-
2031	44	\$6,000	\$ 135,247	\$ -0-	\$ -0-
2032	45	\$6,000	\$ 146,657	\$ -0-	\$ -0-
2033	46	\$6,000	\$ 158,523	\$ -0-	\$ -0-
2034	47	\$6,000	\$ 170,864	\$ -0-	\$ -0-
2035	48	\$6,000	\$ 183,699	\$ -0-	\$ -0-
2036	49	\$6,000	\$ 197,047	\$ -0-	\$ -0-
2037	50	\$6,000	\$ 210,929	\$ 12,000	\$ 12,000
2038	51	\$6,000	\$ 225,366	\$ 12,000	\$ 24,480
2039	52	\$6,000	\$ 240,381	\$ 12,000	\$ 37,459
2040	53	\$6,000	\$ 255,996	\$ 12,000	\$ 50,957
2041	54	\$6,000	\$ 272,236	\$ 12,000	\$ 64,995
2042	55	\$6,000	\$ 289,125	\$ 12,000	\$ 79,595
2043	56	\$6,000	\$ 306,690	\$ 12,000	\$ 94,779
2044	57	\$6,000	\$ 324,958	\$ 12,000	\$ 110,570
2045	58	\$6,000	\$ 343,956	\$ 12,000	\$ 126,993
2046	59	\$6,000	\$ 363,714	\$ 12,000	\$ 144,073
2047	60	\$6,000	\$ 384,263	\$ 12,000	\$ 161,836
2048	61	\$6,000	\$ 405,634	\$ 12,000	\$ 180,309
2049	62	\$6,000	\$ 427,859	\$ 12,000	\$ 199,521
2050	63	\$6,000	\$ 450,973	\$ 12,000	\$ 219,502
2051	64	\$6,000	\$ 475,012	\$ 12,000	\$ 240,282
2052	65	\$6,000	\$ 500,012	\$ 12,000	\$ 261,893
2053	66	\$6,000	\$ 526,012	\$ 12,000	\$ 284,369
2054	67	\$6,000	\$ 553,052	\$ 12,000	\$ 307,744
2055	68	\$6,000	\$ 581,174	\$ 12,000	\$ 332,054
2056	69	\$6,000	\$ 610,421	\$ 12,000	\$ 357,336
2057	70	\$6,000	\$ 640,838	\$ 12,000	\$ 383,629
	Total Investment	<u>\$252,000</u>		<u>\$252,000</u>	

(\*) Numbers are rounded. Illustration A reflects increasing payments starting in 2012 while payments begin in 2037 in Illustration B. Illustration A builds to a maximum contribution of \$6,000 per year while Illustration B works with a maximum contribution of \$12,000 per year. None of the payments reflect an adjustment for inflation.

(\*\*) Assumes that the 2010 graduate has married and he or she and his/her spouse contribute to an IRA account.

**TABLE 4**

Tax Tip

- #1 Avoid over-withholding in 2010 by increasing the “number of allowances” on Form W-4. Remember to change to the proper “number of allowances” at the beginning of 2011.
- #2 Be prepared to file the 2010 Federal income tax return early to obtain a refund. In most regional centers, the refund can be hastened further by labeling the envelope containing the return “REFUND” and/or using the appropriate post office box number. Alternatively, electronic filing will also shorten the time between filing and receiving a refund. Use of the direct deposit option is also recommended.
- #3 Determine and document the source and reason for all interest payments during 2010. Pay particular attention to loans used to pay qualified education expenses since up to \$2,500 is deductible when computing Adjusted Gross Income.
- #4 Prepare and maintain a record of the expenses involved in moving to the first place of employment. These include: the actual moving expenses; travel and lodging costs incurred en route to the place of employment.
- #5 Familiarize yourself with the types of deductible expense incurred as part of your employment. Prepare and maintain a record of these expenses which can include travel, meals, lodging, entertainment and educational costs. Also, if possible, insist on specific item reimbursement instead of a general allowance system.
- #6 Don’t attempt to itemize deductions unless you’ve incurred substantial unreimbursed medical costs, state and local income taxes, home mortgage interest, real estate and/or personal property taxes during 2010 and expect this total to surpass the 2010 standard deduction amount.
- #7 Claim the American Opportunity Tax Credit for 2010 tuition and fee payments (including prepayments) made to any “eligible educational institution.” Alert your parent(s) to the eligibility requirements that may allow the reporting of the American Opportunity Credit on their 2010 tax return.
- #8 Examine situations that would enable you to recognize income in 2010 instead of 2011. Where possible, shift that income into 2010.
- #9 Protect the dependency exemption of your parent(s) by (a) documenting your support spending before and after you are employed and (b) spending less on your support from your funds than the amount spent by your parent(s).
- #10 Document the relationship of educational expenses to (a) requirement established by state or employer or (b) maintenance and/or improvement of skills required in your current trade or business. Following an up to \$4,000 Tuition and Fees Deduction, determine whether your tax liability is reduced more by treating the remaining eligible educational expenses as a miscellaneous itemized deduction or by using all of the educational expenses in computing the Lifetime Learning Credit.
- #11 Do not waste precious time and space maintaining information about spending that has no tax consequences. Furthermore, tax returns and the supporting data should be kept for at least three years.
- #12 Establish an IRA (Individual Retirement Account) or similar retirement arrangement – such as a 401(k) plan -- as soon as possible. Contribute the maximum amount to the IRA and allow it to grow until retirement.

## APPENDIX A – POSSIBLE MARRIAGE PENALTY

Much is made of the supposed “marriage penalty” when two young graduates are considering this step in their future plans. What the term is referring to is that more overall tax might be paid on a joint return than if the young couple continued to report the same respective incomes on their individual tax returns (especially if they both make about the same amount). Nevertheless, this is hardly the reason to delay such an important decision.

To illustrate the impact (or, lack thereof) on the couple’s tax calculation, consider the following example:

Assume that the young couple are both making \$3,500 per month for an annual salary of \$42,000 each. Furthermore, they continue to take the standard deduction since neither one of them owns a home yet and this is more advantageous than itemizing their deductions (as discussed above). Here is a calculation of their taxes for 2010 if reported on two single returns versus a married filing joint return:

	<u>Single</u>	<u>Married Filing Jointly</u>
<b>Gross Income</b>	\$42,000	\$84,000
<b>Less:</b>		
<b>Personal Exemption</b>	(3,650)	(7,300)
<b>Standard Deduction</b>	(5,700)	(11,400)
<b>Taxable Income</b>	<u>\$32,650</u>	<u>\$65,300</u>
<b>Tax</b>	\$4,478.50	\$8,957
 <b>Combined Tax on Two Single Returns</b>	 \$ 8,957	

In fact, unless you expect your respective taxable incomes to exceed approximately \$65,000 each (or, \$130,000 on a joint return), there is not any type of “marriage penalty” from a tax standpoint. Furthermore, if one of the spouses is making more than the other, then getting married can actually result in an overall tax savings given the more favorable joint filing rates for couples.

## ENDNOTES

Based on a taxable income figure of \$11,650--\$21,000 reduced by 2010's standard deduction of \$5,700 and one personal exemption of \$3,650. Tax on \$11,650 is \$1,329 (rounded) as computed below:

$$\begin{array}{rcl} 10\% \text{ rate} \times \$8,375 & = & 837.50 \\ 15\% \times \$3,275 & = & \underline{491.25} \\ & & \underline{\$1,328.75} \end{array}$$

<sup>2</sup> A \$2,500 "cap" applies for all years after 2000.

<sup>3</sup> Miscellaneous deductions are included in total itemized deductions if they exceed two percent of a taxpayer's Adjusted Gross Income.

<sup>4</sup> Form 2106, Employee Business Expenses, is used to report entertainment expenses and to compare these expenses with reimbursements.

<sup>5</sup> Alternatively, if the allowance is included in Alissa's gross income, she will be allowed a \$1,200 deduction using Form 2106.

<sup>6</sup> No deduction is allowed in 2010 or later years for personal interest unless it is in connection with a home equity loan.

<sup>7</sup> Charitable contributions equal to or greater than \$250 must be supported by documentation provided by organization (e.g., church, community group, university) that received the cash or property contribution. Simply having a cancelled check for the donation is not sufficient for tax purposes. However, the charity should be aware of this rule and should supply a documented receipt.

<sup>8</sup> Payments in the current year for courses commencing within the first three months of the following year are eligible for the current year Lifetime Learning Credit. The HOPE credit is only allowed for the first two years of college.

<sup>9</sup> Full-time student status is based on the particular institution's criteria.

<sup>10</sup> The \$2,500 student loan interest deduction would also be lost due to the 2010 status as a dependent. If the 2010 graduate is in the 15% bracket, a maximum tax savings of \$375 (i.e., 15% × \$2,500) would be given up by the diploma winner but his/her parent(s) would generate a possible tax savings—assuming a 25% marginal tax rate—equal to \$625 (i.e., 25% × \$2,500).

<sup>11</sup> Not included as deductible education expenses are seminars unrelated to one's job or employment (e.g., physical fitness course, journalizing workshop).

<sup>12</sup> Legislation increased the yearly maximum contribution to an IRA to \$4,000 for 2005-2007, and \$5,000 for 2008. After 2008, the \$5,000 is adjusted for inflation. Individuals who are 50 or older are allowed an additional \$1,000/year starting in 2006.

<sup>13</sup> Any IRA contributions made which are not tax-deductible may require some detailed record keeping. In fact, if potential tax savings is not a major factor, especially for a 2010 graduate, consideration should be given to making the contribution to a Roth IRA where there is no tax deduction upfront and none of the money will be taxed upon retirement (as would be the case of money withdrawn from a regular IRA).