Individual Tax Update, Part 1

PRESIDENT BUSH SIGNED THE JOB CREATION and Worker Assistance Act of 2002 (JCWAA) (P.L. 107-147) into law on March 9, 2002. Because this bill was intended as an economic stimulus package, prior tax columns have discussed the business provisions contained in the legislation. Now, however, it's time to address some of the individual taxpayer provisions. This month's column looks at two provisions that are relevant in 2002: exclusion of foster care payments and deductibility of teacher classroom expenses.

Foster Care Payments

IRC §131 provides an exclusion from gross income for qualified foster care payments and difficulty of care payments that are received for caring for a qualified foster care individual in the foster care provider's home. Prior to JCWAA, qualified foster care individuals were limited to those individuals who had to be placed by (1) an agency of the state or local government (regardless of the individual's age at the time of placement) or (2) a tax-exempt placement agency licensed by the state or local government (if such individual was under the age of 19 at the time of placement). Difficulty of care payments (§131(c)) are additional compensation payments that are determined by the state for providing the additional care of a qualified foster care individual with a physical, mental, or emotional handicap.

Beginning in the year 2002, Act §404 of JCWAA broadens two definitions in the foster care area. First, qualified foster care payments will now include payments received from any placement agency that is licensed or certified by a state or local government or an entity designated by a state or local government to make payments to providers of foster care. Second, the "under age 19" restriction is dropped for foster care placement agencies. These changes open the doors for placement by qualified for-profit organizations and for placement of individuals 19 and over by nonstate agencies.

There's still another age restriction that applies to the exclusion rule for qualified foster care payments. The qualified foster care payments are includible to the extent such payments are made for more than five qualified foster care individuals who are 19 years of age and over. For example, a household that is maintained for seven qualified foster care individuals who are all 19 and over can exclude the foster care payments for only five of the seven foster care individuals. But there is an exception to the above exception. The over-18 exception doesn't apply to difficulty of care payments. In other words, a difficulty of care payment made on behalf of a qualified foster care individual who is 19 or over is excluded from gross income, and the individual is not counted as a person over 18.

Teacher Classroom Expenses

Currently, any taxpayer is able to claim either the basic standard deduction or itemized deductions (subject to limitations) for certain personal expenses incurred during the taxable year. Unreimbursed medical expenses, investment interest, casualty and theft losses, charitable contributions, qualified residence interest, and unreimbursed employee business expenses are just some examples of itemized deductions.

Of course, not all itemized deductions are deductible.

Some are reduced initially by a percentage of adjusted gross income (AGI), such as medical expenses have a 7.5% floor, casualty and theft losses have a 10% floor, and miscellaneous deductions have a 2% floor. After a taxpayer adjusts for floor and other limitations, the total of the allowable itemized deductions is further reduced by 3% of the amount of the taxpayer's AGI in excess of a threshold amount of $100,000 ($50,000 for a married individual filing separately), adjusted for inflation. For the year 2002, the threshold amount is $137,300 ($68,650 for married spouses filing separate returns) (Rev. Proc. 2001-59), but not more than 80% of the AGI amount.

In general, §162 provides that ordinary and necessary business expenses are deductible against income. But in the case of an employee (or a teacher), unreimbursed employee business expenses are deductible only as miscellaneous itemized deductions and therefore only to the extent that the individual's total miscellaneous deductions exceed 2% of AGI and the individual does not have excess AGI for the year. If the above limitations for employees weren't tough enough, you must remember that miscellaneous itemized deductions are *not* allowable under the alternative minimum tax. It's easy to appreciate the fact that an employee is likely to lose most, if not all, of his or her miscellaneous deduction for unreimbursed business expenses after applying all these limitations. In this case, the employee is incurring out-of-pocket expenses.

Congress felt that some type of relief was needed for elementary and secondary school teachers who incur educational expenses for their class. As a result, Act §406(a) of JCWAA added new IRC §62(a)(2)(D), which provides an above-the-line deduction for up to $250 annually of expenses paid or incurred by an eligible educator for books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the eligible educator in the classroom.

To be eligible for this deduction, the expenses must be otherwise deductible under §162 as a trade or business expense and are only those qualified expenses that exceed the amount excludable under §135, 529(c)(1), or §530(d)(2). Moreover, new §62(d)(1)(A) defines an eligible educator as a kindergarten through grade 12 teacher, instructor, counselor, or principal in a school for at least 900 hours during a school year, and new §62(d)(1)(B) defines a school as any school that provides elementary education or secondary education, as determined under state law. Higher-education teachers, therefore, don't qualify under this provision.

Although most taxpayers would agree that this is a good tax provision, the deduction is limited to $250, which is a relatively small amount. The tax savings for a teacher spending $250 per year in the 15% tax bracket is $37.50; in the 27% tax bracket, it is $67.50; and in the 30% bracket, it is $75. On the other hand, this above-the-line deduction does reduce a person's AGI amount, which may increase his or her total itemized deductions. After all is said and done, the tax savings from this deduction are still insignificant.

There is one more limitation to this tax provision: It is effective for taxable years beginning after December 31, 2001, and before January 1, 2004. Put simply, it's a provision that is available only for tax years 2002 and 2003. Maybe the 108th Congress will revisit this issue during the coming year.

In next month's column, we will continue the individual taxpayer update. ■

The material for this article came, in part, from the MicroMash CPE course "Tax Legislation & Treasury Interpretations in 2002" by Tony Curatola.

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