CHAPTER 5
Itemized Deductions & Other Incentives

Income Tax Fundamentals 2011

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Learning Objectives

- Understand nature/treatment of medical expenses
- Calculate itemized deduction for taxes, interest and charitable contributions
- Compute deduction for casualty/theft
- Identify miscellaneous itemized deductions
- Understand concepts behind deduction and exemption phase-outs for high-income taxpayers
- Understand tax implications of using educational savings vehicles

Medical Expenses

- First itemized deduction on Schedule A
- Medical expenses allowed
  - For spouse, self and dependents
  - For amounts spent that exceed 7.5% of AGI
  - Must be reduced by amount of insurance reimbursement
- See page 5-2 for list of health, dental, and optical expenditures that qualify
  - Medical insurance premiums deductible
  - Long-term care insurance premiums deductible
    - Specified limits that change each year based on taxpayer's age
    - If deducted *for* AGI, excluded from Schedule A calculations

Note: Health insurance for self employed is deduction for AGI

Medical Expenses

- Prescription medication is allowed
  - Drugs illegally purchased abroad nondeductible
  - Nonprescription drugs are not deductible
  - Medical marijuana is not deductible
- Special equipment purchased/installed in taxpayer's home is deductible all in one year
- Transportation/lodging for medical care is allowed
  - 2010 deduction per mile = $.165
  - $50 per night per person lodging deduction
    - Allowed for patient and one individual accompanying patient
    - No meal deduction allowed

Health Savings Accounts (HSA)

- HSA is an instrument that allows funds to be contributed to an account similar to an IRA
  - Employee must participate in ‘high-deductible’ medical insurance plan
  - Distributions to cover medical expenses are not taxed or penalized
  - Earnings on HSA not taxed
  - Employee contributions to an HSA is a deduction *for* AGI

- Medical Savings Accounts established in the past may be rolled into ‘new’ HSAs

Medical Expenses Example

Example

During the year, Frieda and José paid the following medical expenses:

Contact lenses	$ 120
Face lift for cosmetic purposes	2,900
Doctor bills	1,600
Health insurance premiums	4,800

They also traveled 260 miles to see a cardiologist in July. Their gross income = $31,200 and they were reimbursed $1,000 by their insurer. What are their deductible medical/dental expenses for the current year?

Solution

Example

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Face lift for cosmetic purposes	2,900
Doctor bills	1,600
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They also traveled 260 miles to see a cardiologist in July.

Their gross income = $31,200 and they were reimbursed $1,000 by their insurer. What are their deductible medical/dental expenses for the current year?

Solution

[120 + 1,600 + 4,800 + (.165)(260)] = $6,563

$6,563 less $1,000 reimbursement = $5,563.

They may deduct these expenses in excess of (7.5% x $31,200)

$5,563 – $2,340 = $3,223 medical expense as itemized deduction

Note: Face lift for cosmetic purposes is not deductible

Taxes

- Deductions for certain taxes are allowed
- Taxes are deductible, fees are not
  - Taxes are imposed by a government to raise revenue for general public purposes
  - Fees are charges with a direct benefit to person paying
- Examples of deductible taxes
  - State and local income taxes (deductible in year paid)
  - Sales/use tax
    - May use actual sales tax or from IRS-provided tables
    - If use actual, must keep receipts for all sales tax paid
  - Real property taxes
  - Personal property taxes
- Example of nondeductible taxes include estate taxes, gift taxes and excise taxes

Income Tax Deduction Example

Example

What amount is the itemized deduction for taxes in the following scenario?

- Colleen amends her 2008 state tax return and must pay an additional $843 state income tax (SIT) in 2010
  - Breakdown of amount due is: $93 in penalties/interest + $750 SIT
  - Her SIT withholding for the current year is $660
- She paid quarterly SIT estimates as follows
  - Paid $200 each on 4/15, 6/15, and 9/15 of current year and 1/15 of next year
  - 1/15 of current year paid 4th quarter estimate from prior year - $155

Solution

Example

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  - 1/15 of current year made 4th quarter estimate from prior year - $155

Solution

Colleen may deduct the actual amounts paid in 2010

Itemized deduction for SIT = $2,165 ($750 + 660 + 200 + 200 + 200 + 155)

Note: ***If taxpayer receives refund of SIT that was deducted in prior year, that refund is taxable income in year it is received !***

Real Estate Taxes

- Property taxes on real estate are deductible
  - Even on second home
  - Rental property real estate taxes are reported on Schedule E
  - If paid into escrow, taxes are deductible when paid
- When selling property, need to allocate real estate taxes based on number of days that each party owned
- Even if don't itemize, may take deduction for portion of property taxes paid (in addition to standard deduction). Should check web site to see if this provision extends to current year.
  - $500 (S) or $1000 (M) not to exceed actual property taxes
  - Must file Schedule L

Personal Property Taxes

- Tax on personal property
  - Amounts paid on autos, boats, trailer, etc. are an itemized deduction
  - Only amount that is based on the property's value is deductible
    - Fees calculated on basis of weight are not deductible

Tax Deduction Example

Example

Selma has AGI of $31,300 for 2010. She itemizes her deductions and therefore deducts the allowable amount of tax. Her FIT withholding for the year is $2,150, SIT withholding is $1,500, Social Security taxes are $2,394, real estate taxes on her home are $3,300 and she pays auto registration of $210 (of that $180 is based on value of auto).

How much may Selma show as an itemized deduction for taxes in 2010?

Solution

Example

Selma has AGI of $31,300 for 2010. She itemizes her deductions and therefore deducts the allowable amount of tax. Her FIT withholding for the year is $2,150, SIT withholding is $1,500, Social Security taxes are $2,394, real estate taxes on her home are $3,300 and she pays auto registration of $210 (of that $180 is based on value of auto).

How much may Selma show as an itemized deduction for taxes (in addition to her other itemized deduction) in 2010?

Solution

Itemized deduction for taxes = $4,980

($1,500 + 3,300 + 180)

Overview of Interest

- Interest is amount paid for use of borrowed funds
  - Borrower must be legally liable for note in order to deduct the interest
- Examples of deductible interest include
  - Qualified mortgage interest and points
  - Mortgage interest prepayment penalties
  - Investment interest*
  - Certain interest associated with passive activities
- Consumer (personal) interest is not deductible
- Private mortgage insurance (PMI) related to purchase of personal residence deductible (phase-outs apply)

Investment interest nondeductible if used to generate tax-exempt income

Mortgage Interest

- Qualified residence interest is mortgage interest that is deductible
  - Used to secure/construct first or second residence - limited to loans up to $1,000,000
  - Home equity loans - limited to loans up to $100,000
    - Deductible even if proceeds used for personal purposes
  - Interest limited to debt at or below fair market value of home
  - The taxpayer must be legally liable for debt to deduct mortgage interest*
- Loan origination fees
  - Called 'points' because they are quoted as percentage points of principal are deductible

Recent court case allowed relative, who essentially had ownership interest, to deduct even though not named on loan

Education Loan Interest

- Up to $2,500 per year
- Deduction *for* AGI
- This deduction phases out
  - AGI > $60,000 (S) or
  - AGI > $120,000 (M)
- Loan must be used for qualified higher education expenses
  - This includes tuition, room and board, and related expenses

Investment Interest

- Investment interest is incurred on debt to purchase investment property
  - Can only deduct up to the amount of net investment income (such as interest)
    - Special rules as to including dividends and capital gains in "net investment income" because of their preferential tax treatment
  - Carry forward any unused investment interest expense to next year
- Not allowed to deduct the following
  - Interest on loans to pay life insurance premiums
  - Consumer interest
  - Investment interest if funds used to generate tax-exempt income

Contributions

- Charitable contributions are allowed as a deduction
- Can contribute cash or property
  - Out of pocket expenses are deductible
  - $.14/mile for mileage deduction
  - Value of free use of taxpayer's property is not deductible
- To be deductible, donation must be made to a qualified recipient (see pages 5-12 and 5-13)
- IRS publishes *Cumulative List of Organizations*, Publication No. 78

Contributions - Property

- Gifts of household items/clothing subject to new requirements
  - Must be in good condition
  - Items with minimal value may not be deducted
- If contribute property, deduction is equal to fair market value (FMV) at time of donation
  - Exception occurs if property donated would have resulted in ordinary income or short-term capital gain (STCG)
    - Then, the deduction is equal to fair market value less the amount of ordinary income or STCG that would've resulted if property had been sold

Contributions – Property

- If taxpayer donates appreciated long-term capital gain (LTCG) property, such as appreciated stock, may deduct fair market value of the property, except if:
  - Donation is made to certain private nonoperating foundation (30% organization) – then can only deduct fair market value minus potential LTCG

    or
  - Donation is a contribution of tangible personal property to an organization that uses it for a purpose unrelated to the organization's primary purpose (such as artwork contributed to Humane Society)

LTCG Donation Example

Example

Bea donates an antique couch to a nonprofit that provides housing items to battered women. The couch cost $2,500 and is now worth $4,000. How much may Bea deduct for contributions? Would Bea's deduction change if she had donated the couch to an environmental organization?

Solution

Example

Bea donates an antique couch to a nonprofit that provides housing items to battered women. The couch cost $2,500 and is now worth $4,000. How much may Bea deduct for contributions? Would Bea's deduction change if she had donated the couch to an environmental organization?

Solution

If Bea had sold the antique, her LTCG would have been $1,500 ($4,000 – $2,500); since the couch is put to a use related to the organization's primary purposes. Deduction = $4,000.

If the antique was donated to an environmental organization, the purpose is unrelated and therefore she must reduce her deduction by the amount of the LTCG that would have resulted if the item had been sold. Deduction = $2,500 ($4,000 - $1,500 LTCG).

Contributions – Percentage Limitations

- Generally, deduction for charitable contributions limited to 50% of taxpayer's AGI – this applies to donations to:
  - All public charities
  - All private operating foundations

    and
  - Private nonoperating foundations, if distribute contributions to public charities within a specified time period
- Examples of "50% organizations" include churches and educational institutions and hospital/medical research organizations
- Contributions limited to 30% of taxpayer's AGI if donation made to certain private nonoperating foundations, fraternal societies and veterans' organizations

Contributions to a 50% Organization

Cash

50% of AGI

LTCG property

(see next slide)

STCG or ordinary income property

Can deduct FMV less amount of gain that would've been recognized (the basis), then limited to 50% of AGI

Contributions to a 30% Organization

Cash

30% of AGI

LTCG property

Cannot exceed 20% of AGI

STCG or ordinary income property

Can deduct FMV less amount of gain that would've been recognized (the basis), then limited to 30% of AGI

Contributions

Order of charitable contribution deductions

1. Deduct 50% contributions
2. Deduct 30% contributions
3. Deduct 20% contributions

*Total of all 3 types of deductions **still limited** to AGI x 50%*

Carryforward unused amounts to subsequent years

Contributions - Substantiation

- Charitable contributions are allowed as a deduction
- Can contribute cash or property
  - Out of pocket expenses are deductible
  - $.14/mile for mileage deduction
  - Value of free use of taxpayer's property is not deductible
- To be deductible, donation must be made to a qualified recipient (see pages 5-12 and 5-13)
- IRS publishes *Cumulative List of Organizations*, Publication No. 78

Donation of Vehicles

- Deduction for a donated vehicle limited to the amount for which the charity sells the vehicle
  - Same rule applies to boats and planes
- Charitable organization sends a Form 1098-C to taxpayer showing resale information
  - Or certifies that no resale amount may be provided as vehicle donated to needy individual
  - Taxpayer must attach 1098-C to tax return
  - Taxpayer may claim estimated value if charity uses donated auto rather than selling it

Contribution Example

Example

During the current year, Clem donates $1,260 to his synagogue's youth group, allows the church youth group to use his lake cabin (valued at $500), drives 1000 miles on behalf of the YWCA and donates a vehicle (valued at $950) to the United Way. United Way sells the auto for $750 and issues a 1098-C to Clem. What is Clem's charitable contribution deduction if his AGI = $33,200?

Solution

Example

During the current year, Clem donate $1,260 to his synagogue's youth group, allows the church youth group to use his lake cabin (valued at $500), drives 1000 miles on behalf of the YWCA and donates a vehicle (valued at $950) to the United Way. United Way sells the auto for $750 and issues a 1098-C to Clem. What is Clem's charitable contribution deduction if his AGI = $33,200?

Solution

Clem cannot deduct the value of his lake cabin; therefore his contribution deduction = $2,150

($1,260 + (1000 miles x .14) + 750)

Casualty and Theft Losses

- Deductions are allowed for casualty and theft losses
- To be classified as casualty loss, event needs to be sudden, unexpected or unusual
  - If theft, need to prove (for example, by police report)
  - Different calculations for deduction based on what type of property
- Casualty losses are deductible in year of occurrence
  - Exception for federally declared disaster area losses (can amend prior year return and deduct in that year and file for refund)

Casualty and Theft Losses

- Two rules governing casualty/theft losses:
  - Rule A is based on decrease of fair market value, not to exceed adjusted basis of property*
    - Used for partial/complete destruction of personal property or partial destruction of business or investment property
  - Rule B allows a deduction for the adjusted basis of the property
    - Used for complete destruction of business or investment property

Limit to personal casualty loss calculated as follows
Loss - $100 floor and only in excess of 10% of AGI

Miscellaneous Deductions

There are two types of miscellaneous deductions

"Those not limited to amounts over 2% of AGI"

- Handicapped "impairment related work expenses"
- Certain estate taxes
- Amortizable bond premiums purchased prior to 10/23/86
- Gambling losses to extent of gambling winnings
- Terminated annuity payments

Miscellaneous Deductions

"Those limited to amounts over 2% AGI"

- Unreimbursed employee expenses
- Reimbursed employee expenses made under a non-accountable plan
- Union dues
- Tax preparation fees
- Safety deposit box
- Professional journals/subscriptions
- Investment expenses
- Job-hunting fees

Miscellaneous Deductions

- Investment expenses
  - Deduction allowed if directly related to taxable income; however, no deduction for investment expenses related to tax-exempt income
  - Fees paid to broker to acquire stocks/bonds are not deductible
    - Instead, added to cost basis of stocks/bonds
- Tax Preparation Fees
- Job-Hunting Expenses
  - If seeking job in current trade, or if unemployed there is not lack of continuity since last job

Limitation on Itemized Deductions and Exemptions

- For many years, the ability to deduct total itemized deductions has been phased-out for high-income taxpayers
- Also, personal and dependency exemptions have been phased-out for high income taxpayers
- However, this is not applicable in 2010
- Phase-outs expected to return in 2011

Note: phase-out thresholds were different for itemized deductions and personal exemptions

Qualified Tuition Programs (QTP)

- Sometimes called §529 tuition plans
- Allows taxpayers to meet higher education expenses by
  - Buying in-kind tuition credits or certificates

    or
  - Contributing to an established account
- Distributions are generally not taxed if funds used for higher education
  - Tuition, fees, books, supplies, equipment plus reasonable amount for room and board
  - Computer technology primarily used for educational purposes
  - If not used for purposes outlined or the taxpayer withdraws early, then distributions are taxable plus 10% penalty

QTP

- Annual contribution amounts vary
  - Contribution is not deductible
  - High limits in most states
- May claim American Opportunity Education Credit or Lifetime Learning Credit in same year as distribution taken from a QTP
  - As long as distribution is not used for the same expenses for which the credit was claimed
  - Must also reduce qualified higher education expenses exclusion by scholarships, veterans' benefits, etc.

Note: plans vary by state – check out www.collegesavings.org or savingforcollege.com for overview

Education Savings Accounts

- Allows taxpayers to meet higher education expenses by contributing to an educational savings account
- Annual contributions are not deductible
  - Allowed until beneficiary reaches 18
  - Limited to $2,000/year per child
  - Can't make in same year as contribution to QTP
  - Phase-out when AGI exceeds $190,000 (MFJ) or $95,000 (S)

Education Savings Accounts

- Distributions are tax free if funds used for higher education or private elementary/secondary education
  - Tuition, fees, books, supplies, equipment
  - Room and board if at least ½ time student
- May claim educational credit in same year as distribution taken from an education savings account,
  - As long as distribution is not used for the same expenses for which the credit was claimed
- If distributions > qualified education expenses, part of distribution will be taxable income

Higher Education Expense Deduction

- Up to $4,000 above-the-line deduction for qualified tuition and related expenses with certain AGI limits (modified AGI < $65,000 (S) or < $130,000 (MFJ))

  or
- Up to $2000 deduction (modified AGI $65,000-$80,000 (S) or between $130,000-$160,000 (MFJ))
- Reduce deduction amount by
  - Excludible interest from higher education savings bonds
  - Excludible distributions from QTPs
  - Excludible distributions from Education Savings Accounts

The End