

Introduction to Deductions

Chapter 6



Deductions in General

- ▶ Deductions are not entitlements – they are a matter of legislative grace

- ▶ Substantiation requirements
 - Taxpayer has burden of proof
 - Adequate records of expenses must be maintained



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Classification of Deductible Expenses

- ▶ Above-the-line deductions
- ▶ Below-the-line deductions

<p>Gross Income</p> <ul style="list-style-type: none">- Exclusions- Adjustments (Above-the-line deductions) <p>= Adjusted Gross Income (AGI) ("The Line")</p> <ul style="list-style-type: none">- The greater of the Standard Deduction or Itemized Deductions (Below-the-line deductions)- Personal and Dependency Exemptions <p>= Taxable Income</p>



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Adjustments to Income

Adjusted Gross Income	23	Educator expenses (see page 29)	23	
	24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24	
	25	Health savings account deduction. Attach Form 8889	25	
	26	Moving expenses. Attach Form 3903	26	
	27	One-half of self-employment tax. Attach Schedule SE	27	
	28	Self-employed SEP, SIMPLE, and qualified plans	28	
	29	Self-employed health insurance deduction (see page 90)	29	
	30	Penalty on early withdrawal of savings	30	
	31a	Alimony paid to Recipient's SSN ▶	31a	
	32	IRA deduction (see page 81)	32	
	33	Student loan interest deduction (see page 54)	33	
	34	Tuition and fees deduction. Attach Form 9917	34	
	35	Domestic production activities deduction. Attach Form 9900	35	
	36	Add lines 23 through 31a and 32 through 35	36	
37	Subtract line 36 from line 22. This is your adjusted gross income	37		

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Comparison of Above and Below-the-Line Deduction

- ▶ Comparison of above and below-the-line deductions (**2012** tax year)
 - Single taxpayer has gross income of \$50,000 and a \$8,000 deduction.

	For AGI	From AGI
Gross Income	\$50,000	\$50,000
Less: for AGI Deduction	8,000	0
AGI	\$42,000	\$50,000
Less: from AGI Deduction (standard / itemized)	5,950	8,000
Less: Personal Exemption	3,800	3,800
Taxable Income	\$32,250	\$38,200

Difference: \$5,950

The single taxpayer with the \$8,000 above-the-line deductions will always be better off (by \$5,950) because he can also take the standard deduction for a single person.

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Trade or Business Expenses

- ▶ Only net profit (after expenses) is included in taxpayer's income
 - Above-the-line deduction
- ▶ Expenses must be
 - Ordinary
 - Necessary
 - Reasonable
- ▶ Additional expenses for Sole Proprietors, Partners, > 2% owners of S-Corporations
 - Half of self-employment tax paid
 - Self-employed pension contributions
 - Self-employed health insurance contributions

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Limitation on LTC Insurance

Age	2012 Deduction Limit	2011 Deduction Limit
40 or less	\$350	\$340
41-50	\$660	\$640
51-60	\$1,310	\$1,270
61-70	\$3,500	\$3,390
71 and over	\$4,370	\$4,240

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MSAs and HSAs

Deductible Limits for HDHPs

	Minimum Deductible	Maximum Deductible and Out of Pocket Expenses
	2012	2012
Individual	\$1,200	\$6,050
Family	\$2,400	\$12,100

Maximum HSA Contributions

	Maximum Contribution	Age 55 or older Catch-Up
	2012	2012
Individual	\$3,100	\$1,000
Family	\$6,250	\$1,000

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Who Can Deduct Contributions to a Traditional IRA

Taxpayer is not an active participant	Taxpayer(s) is an active participant	One spouse is an active participant, the other is not
No AGI Limit	Single	The spouse who is not an active participant may have a deductible traditional IRA contribution as long as their joint AGI does not exceed \$183,000. The deductible IRA contribution is phased out between \$173,000 - \$183,000 for 2012.
	MFJ	

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Other Above the Line Deductions

- ▶ Penalty on early withdrawal of savings
- ▶ Educator expenses
- ▶ Student loan interest
- ▶ Alimony paid

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Student Loan Interest

- ▶ Up to \$2,500
- ▶ Taxpayer must have primary obligation to repay debt

Loan Made By	Loan Repaid By	Is it Deductible?
Parent	Parent	Yes
	Student	No
Student	Parent	No
	Student	Yes

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Student Loan Interest

- ▶ Phaseout applies to MAGI

Filing Status	2012	2011
Single	\$60,000 - \$75,000	\$60,000 - \$75,000
MFJ	\$125,000 - \$155,000	\$120,000 - \$150,000
MFS	\$0	\$0

- ▶ MAGI = AGI plus
 - Foreign earned income exclusion
 - Income exclusion for U.S. possession and Puerto Rico
 - Deduction for tuition and fees
 - Deduction for qualified U.S. production activities

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Alimony Deduction Example

Charlie and Jane recently divorced. They had been married for 15 years, and had two children, Erin (14 years old) and Brian (12 years old). Under the terms of the divorce decree, Charlie is required to pay Jane \$2,000 per month in alimony for four years, \$1,500 for the next two years, and \$1,000 per month for the following two years.

Charlie's alimony deduction each month will be \$1,000. Even though the divorce decree classified the payment as alimony, the payment was reduced by \$500 when each child reached the age of 18, so \$1,000 of the payment (\$500 x 2) will be reclassified as child support for income tax purposes.

Year	Monthly Alimony	Event	Deductible Alimony Payment
Year 1	\$2,000		\$1,000
Year 2	\$2,000		\$1,000
Year 3	\$2,000		\$1,000
Year 4	\$2,000		\$1,000
Year 5	\$1,500	Erin turned 18	\$1,000
Year 6	\$1,500		\$1,000
Year 7	\$1,000	Brian turned 18	\$1,000
Year 8	\$1,000		\$1,000

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Summary of Above-the-Line Deductions

MSAs	Penalty or Early Withdrawal
HSAs	Educator Expenses
Trade or Business Expenses	Student Loan Interest
IRAs	Alimony Paid
Moving Expenses	

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Deduction Rules for Businesses

- ▶ **Corporations**
 - Ordinary, necessary and reasonable expenses deducted on corporate return
 - S-Corporations cannot deduct medical/pension benefits for owners
- ▶ **Partnership**
 - Expenses deducted on information return
 - Cannot deduct medical/pension benefits for owners
- ▶ **Sole Proprietorship**
 - Expenses deducted on Schedule C
 - Cannot deduct medical/pension benefits for owners

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Business Expense Requirements

- ▶ **Ordinary**
 - Incurred in the normal, usual conduct of business
- ▶ **Necessary**
 - One that a prudent business person would incur
- ▶ **Reasonable**
 - Question of fact
 - Overlaps ordinary and necessary requirements

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Common Deductions for Employers

- ▶ Fringe Benefits
- ▶ Self-Employed Retirement and Health Plan Contributions
- ▶ Social Security and Self-Employment Tax
- ▶ Investigation of Business Expenditures
- ▶ Home Office Expenses

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Investigation of Business Expenses

- ▶ Must purchase the business to qualify for a deduction
- ▶ New (unrelated) line of business
 - Up to \$5,000 of start up costs deducted
 - Costs beyond \$5,000 amortized ratably over 180 month period
- ▶ Same line of business
 - Expenses are deducted currently

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Home Office Deduction

- ▶ General Rules
 - Expenses are prorated
 - Depreciation on 39-year straight line basis
- ▶ Business Owner
 - Regular and exclusive use requirement
 - Exclusivity does not apply to
 - Storage of inventory or products
 - Day care facilities
 - Cannot deduct expenses to show loss
- ▶ Employee
 - Must be for convenience of employer

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Tax Planning with Deductions

- ▶ Employees
 - Most deductions are below-the-line
 - Timing of expenses can be important
- ▶ Business Owners
 - Deductions are above-the-line (no phase-out limitations)
 - Allocate as many expenses as possible to the business
- ▶ Investors
 - Real Estate Expenses – above-the-line deductions
 - Portfolio Expenses – below-the-line deductions, but the 2% floor does not apply

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