

Itemized Deductions

Chapter 7

Itemized Deductions

- ▶ Below-the-Line Deductions
 - Reported on Schedule A
- ▶ Include
 - Medical Expenses
 - ★ ◦ Taxes
 - ★ ◦ Interest
 - ★ ◦ Charitable Contributions
 - Casualty Losses
 - Miscellaneous Itemized Deductions

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Medical Expenses

- ▶ Expenditures for
 - Diagnosis, cure, treatment, or prevention of disease affecting any structure or function of the body

Deductible	Nondeductible
Prescription Drugs	Elective Cosmetic Surgery
Expenses Related to Diagnosis, Cure, and Treatment	Dance Lessons
Health Insurance Premiums	Health Club Dues
Capital Expenditures	Marijuana
Nursing Home and Special Schools	Over-the-Counter Drugs
Travel and Lodging	General Health Items (e.g., vitamins)

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Medical Expense Deduction

- ▶ Deductible in year paid
- ▶ Must exceed 7.5% of AGI to achieve tax benefit
- ▶ Example
 - Amy has AGI of \$10,000 and medical expenses of \$1,000
 - Amy's medical deduction = \$250
 - $[\$1,000 - (\$10,000 \times 7.5\%)] = \250

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Capital Medical Expenses

- ▶ Includes
 - Wheelchairs
 - Medical beds
 - Seeing eye dogs
- ▶ Must be
 - Medical necessity
 - Advised by a physician
 - Used primarily by patient
 - Reasonable
- ▶ Maintenance on capital expenditures also deductible as medical expense

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Capital Improvement to Home

- ▶ Deductible to extent that the cost of improvement exceeds the increase in value to home
 - Exception: Removal of structural barriers to home of handicapped are deemed to add no value to home. Thus, full amount is a medical expense.
- ▶ Improvements for accessibility are always deductible
 - Handicapped entrance/exit ramps
 - Modifications to bathroom and kitchens

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Nursing Home and Special School Expenses

- ▶ If the primary purpose is medical treatment, all costs (including meals and lodging) qualify as medical expenses
- ▶ If the primary purpose is personal, only specific medical costs qualify (no meals or lodging)

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Transportation and Lodging

- ▶ Transportation to and from medical care is deductible
 - 23.5cents per mile for 2012
- ▶ Lodging while away from home for medical care
 - Allowable amount is \$50 per person per night
- ▶ If parent and/or aide needs to accompany patient, their expenses are also deductible

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Health Insurance Premiums

- ▶ Premiums paid for medical care insurance are deductible medical expenses
- ▶ For self-employed, 100% of insurance premiums are deductible above-the-line

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Reimbursed Expenses

- ▶ If reimbursed in same year as expense paid:
 - Reimbursement offsets deductible amount
- ▶ If reimbursed in the year after medical expenses were paid:
 - Reimbursement is income only to extent medical deduction was taken by taxpayer (tax benefit rule)

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Taxes

- ▶ Income Taxes or Sales Tax
 - Income Tax: State, Local and Foreign
- ▶ Property Taxes
 - State and Local
 - Must be based on value (ad valorem)
- ▶ *Fees and Fines are not deductible*

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Special Rules - Taxes

- ▶ State and local income taxes
 - Deduct amounts paid during year
 - Withheld amounts
 - Estimated tax payments
 - Amounts paid in year for prior year's liability
 - Refunds included in income in subsequent year (tax benefit rule)
- ▶ Foreign income taxes can be deducted or claimed as credit (FTC)

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Summary of Deductible and Nondeductible Taxes

<i>Deductible</i>	<i>Nondeductible</i>
State and Local Income Taxes	Fines or Fees
State Sales Tax (Alternative Income)	Excise Tax
Foreign Income Taxes	Gift Taxes
Property Taxes	Estate Taxes

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Interest

- ▶ **General Rule:** all interest paid or accrued within the taxable year on indebtedness is deductible
- ▶ Many exceptions apply, making the following types of interest deductible
 - Qualified residence interest
 - Interest incurred in a trade or business
 - Interest incurred for production of income

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"Interest" Includes

- ▶ Prepayment Penalties
- ▶ Points
- ▶ Late Payment Fees

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Paying Interest on the Obligation of Another

- ▶ Not deductible
- ▶ Commonly arises in situations where shareholder pays debt of a corporation
 - Treated as a capital contribution to the corporation, which can deduct the interest expense

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Qualified Residence Interest

- ▶ Can deduct interest on
 - Principal residence
 - One vacation home
 - Includes boat/vehicle with sleeping and eating accommodations
 - Vacation home treated as “qualified residence” if the home is not rented during the year or if the home does not meet the “rental use” exception of Section 280A.

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Qualified Residence Interest

- ▶ Acquisition Indebtedness
 - Acquire, construct improve principal residence
 - \$1 million maximum principal amount
 - \$500,000 for married filing separately
 - Once amortized, cannot be resurrected
- ▶ Home Equity Indebtedness
 - \$100,000 maximum principal amount
 - \$50,000 for married filing separately
 - Cannot exceed FMV of home less acquisition indebtedness

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Prepaid Interest (Points)

- ▶ Generally amortized over life of loan
- ▶ Exception: Points paid in the acquisition or improvement of principal residence
 - Entire amount is deductible in year paid
- ▶ Only points paid on the first \$1 million of acquisition indebtedness is deductible

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Investment Interest

- ▶ **Limited to Net Investment Income (NII)**
- ▶ Unlimited carryforward is allowed
- ▶ Not subject to the AGI phaseout for high income taxpayers

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Net Investment Income

- ▶ **NII** = Investment income - investment expenses other than interest
- ▶ **Investment income** includes
 - Interest
 - Dividends
 - Gains on property taxed at ordinary rates under depreciation recapture rules
 - Capital gains can be included if taxpayer elects to pay tax at ordinary rates
- ▶ **Investment expenses** other than interest
 - Those that are directly connected with the production of investment income
 - Expenses disallowed because of the 2% floor will not reduce net investment income

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Expenses & Interest to Generate Tax-Exempt Income

- ▶ Not deductible for regular tax purposes
 - If municipal bond interest is taxable when the AMT applies, the taxpayer may deduct interest expense incurred in purchasing the municipal bonds
- ▶ Other expenses associated with the purchase of tax-exempt securities are not deductible

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Interest Expense and Passive Activities

- ▶ If interest is incurred in acquiring a passive activity, the passive activity loss rules apply
 - These are covered in detail later

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Summary of Deductible & Nondeductible Interest Expense as Itemized Deduction

<i>Deductible</i>	<i>Nondeductible</i>
Qualified Residence Interest (Limit 2 houses and \$1,000,000 debt)	Personal Interest Including Credit Cards, Bank Loans, etc.
Home Equity Line of Credit (\$100,000 limit)	Interest Used to Buy Tax-Free Municipal Bonds
Investment Interest Expense (to extent of investment interest income)	

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Charitable Contributions

General Requirements for Income Tax Charitable Deduction

- ▶ Made to qualified organizations
- ▶ Subject of the gift is property (not services)
- ▶ Deductible portion must exceed value received by donor
- ▶ Paid in cash or property before close of tax year

Income Tax Deduction Depends on...

- ▶ Type of property given away
- ▶ Identity of
 - The donee
 - The contributor
- ▶ Amount of property given away
- ▶ Place where charity is organized

"Qualified Charity"

- ▶ Must be operated exclusively for
 - Religious, charitable, scientific, literary, or educational purposes
 - For the prevention of cruelty to animals or children
- ▶ No earnings may benefit a private party
- ▶ No substantial propaganda or lobbying
- ▶ For income tax purposes, must be a domestic charity

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Donations of Partial Interests

- ▶ Right to use property is not deductible
 - i.e., rent-free occupancy
- ▶ Gifts of less than entire interest are not deductible unless it is:
 - An undivided portion of donor's entire interest
 - A remainder interest in personal residence or farm
 - A partial interest if transferred in trust
 - A charitable gift annuity

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Gifts of Services

- ▶ Not deductible
 - Since the value of the gift was never brought into income, a deduction cannot result
- ▶ Unreimbursed expenses and travel expenses are deductible
- ▶ Mileage: 14¢ per mile for 2012

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Itemized Deduction Limitations

	<i>Cash or non-LTG Property</i>	<i>LTG Property</i>
Public Charity	50%	30%
Private Charity (Private Foundation & CLT)	30%	20%

Percentages Apply to *Contribution Base*

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Charitable Deduction Limitations

- ▶ Interaction of Limitations
 - When applying the yearly overall 50% limitation, allowable deductions come first from the 50% assets, then from the 30% assets if taxpayer makes donations to both 30% and 50% organizations
 - Deductions disallowed because of AGI limitations may be carried over for five years (in FIFO order)

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Charitable Deduction Limitations Example

- ▶ Taxpayer with \$100,000 in AGI, contributed \$40,000 cash and long-term stocks with a FMV of \$35,000 and a basis of \$8,000 to a University
- ▶ 50% limit = \$50,000 and 30% limit = \$30,000
 - Amount of deduction = \$50,000 (40,000 cash + 10,000 stock)
 - Contribution carryforward = \$25,000 stock (as 30% asset)

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Gifts of Cash

- ▶ Fully deductible subject to AGI limitations
- ▶ Excess contributions carryforward: 5 years
- ▶ Corporate deductions limited to 10% of AGI
 - Can move charitable deductions above-the-line
- ▶ 80% of the amount contributed is deductible if the contribution is made
 - To college or university
 - In return for the right to purchase tickets to athletic events

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Capital Gain Property

- ▶ Intangible Personal Property and Real Property
 - Subject to 30% limitation
 - Can qualify for 50% limitation by reducing the value of the gift by 100% of the gain
- ▶ Tangible Personal Property
 - Used by donee in tax-exempt purpose
 - Entire fair market value at the date of the gift is deductible
 - Subject to 30% AGI limitation
 - Not used by donee in tax-exempt purpose
 - The fair market value of the gift must be reduced by 100 percent of the potential gain
 - Subject to the 50% limitation

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Ordinary Income Property

- ▶ Includes
 - Short-term capital gain assets
 - Works of art, books, letters, and musical compositions if given by the person who created or prepared them
 - Business person's stock in trade and inventory
- ▶ Deduction limited to cost basis
 - These gifts should be avoided when the estate will not be subject to estate taxes

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Exhibit 7.5

Type of Property Donated	Valuation for Purposes of Charitable Deduction	Ceiling for Public Charities, Private Operating Foundations and Certain Private Nonoperating Foundations*	Ceiling for Other Private Nonoperating Foundations (PNOF)	
Cash	Fair Market Value	50%	30%	
Ordinary Income Property & Short-Term Capital Gain Property	Lesser of the Adjusted Basis or the Fair Market Value	50%	30%	
Long-Term Capital Gain Property: ➤ Intangible	Fair Market Value	30%*	Adjusted Basis	20%**
➤ Tangible Property	Fair Market Value – (a) Related use Adjusted Basis – (b) Unrelated use	30%*		20%
➤ Real Property	Fair Market Value	30%*		20%

* Taxpayer has the option to use the adjusted basis and the 50% of AGI ceiling for Regular Charities.
 ** Certain contributions of Qualified Appreciated Stock may use the fair market value.

Simple vs. Complex Trusts

- ▶ Simple Trust
 - Mandate the annual distribution of all trust income to beneficiaries
 - Beneficiaries pay income tax on trust income
- ▶ Complex Trust
 - Permitted to accumulate income, benefit a charity, or distribute principal
 - If complex trust accumulates income, it is taxed on that income at trust income tax rates

Trusts Personal Exemption

- ▶ For Simple Trusts (with realized income gains) and Complex Trusts
 - Simple Trust: \$300 Personal Exemption
 - Complex Trust: \$100 Personal Exemption
 - Note that estates are entitled to a personal exemption of \$600

Trust Income Tax Filing

- ▶ Form 1041
- ▶ Calendar Year Trusts: File on or before April 15th
- ▶ Fiscal Year Trusts: File by the 15th day of the 4th month following the close of the tax year
- ▶ Fiduciary of trust signs income tax form

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Gifts in Trust

- ▶ Deductible only if made in one of the following ways:
 - A fixed-annuity trust (CRAT)
 - A unitrust (CRUT)
 - A pooled-income fund (PIF)

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CRT Requirements

- ▶ Irrevocable Trust
- ▶ **Annual Payout:**
 - Not less than 5%
 - Not more than 50%
- ▶ **Term:**
 - Life of income beneficiary, or
 - Term of years not to exceed 20
- ▶ **Remainder Interest**
 - Value must be 10% on date of contribution

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Types of CRTs

- ▶ **Charitable Remainder Annuity Trust (CRAT)**
 - Payout is a fixed percentage of initial contribution
 - No additional contributions may be made
- ▶ **Charitable Remainder Unitrust (CRUT)**
 - Payout is a fixed percentage of the annual value
 - Additional contributions may be made to the trust

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Pooled Income Fund Requirements

- ▶ Contribution of irrevocable, vested remainder interest
- ▶ Property commingled with property of other donors
- ▶ Fund cannot invest in tax-exempt securities
- ▶ No donor or income beneficiary can be trustee
- ▶ Donor must retain life income interest
- ▶ Each income beneficiary entitled to annual pro rata share of income

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Charitable Gifts of Life Insurance

- ▶ **Benefits**
 - Death benefit is guaranteed
 - Amplifies the gift
 - Life insurance is a self-completing gift
 - Death proceeds are not subject to probate
 - Not subject to attack by disgruntled heirs
 - Privacy

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Taxation of Gifts of Life Insurance

- ▶ Considered a gift of ordinary income property
- ▶ Value limited to
 - Interpolated terminal reserve plus unearned premium,
 - Cost basis, or
 - Replacement cost (if paid up)
- ▶ Insurance company will issue value on Form 712
- ▶ Gifts of premium payments are gifts of cash and are fully deductible

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Charitable Deductions by Corporations

- ▶ C corporations can deduct up to 10% of their income
- ▶ S corporations pass through charitable gifts (Form K-1) to owners who deduct their portion on personal income tax return

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Casualty Loss Deduction

- ▶ One of few tax deductions allowed for personal losses
- ▶ Applies in extreme cases where the taxpayer has suffered a large loss due to
 - Fire
 - Storm
 - Shipwreck
 - Theft
 - Other sudden, unexpected events causing losses
- ▶ Classification of Casualty Loss:
 - Business Loss – Above-the-Line Deduction
 - Personal Loss – Schedule A Itemized Deduction

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Casualty Loss Deduction

- ▶ Amount of loss and its deductibility depends on whether:
 - Loss is from
 - Business or production of income property, or
 - Personal property
 - Loss is partial or complete

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Personal Casualty and Theft Losses

- ▶ **Deduction for personal losses is the lower of**
 - Decline in value of the asset less insurance proceeds received
 - Taxpayer's adjusted basis in property, less insurance proceeds received
- ▶ **Further Limitations**
 - \$100 is deducted from the loss caused by each occurrence
 - Only casualty losses in excess of 10% AGI are deductible

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Personal Casualty and Theft Gains

- ▶ If casualty gains exceed casualty losses,
 - Gain offsets any casualty losses suffered in the same year
 - Excess gains are treated as the sale of a capital asset
 - Can be short-term or long-term, depending on holding period of the asset
 - Deferral of gain provisions may apply, and will be discussed in the Non-taxable exchanges chapter.
 - Personal casualty and theft gains and losses are not netted with the gains and losses on business and income-producing property

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Personal Casualty Loss Example 1

- ▶ Beau owned a home in New Orleans that was severely damaged by a hurricane. Beau had purchased the home for \$200,000, and the fair market value of the home prior to the hurricane was \$400,000. His homeowners insurance policy had lapsed one month before the hurricane hit and Beau had not obtained any other insurance. After the hurricane, the property had a fair market value of \$90,000.
 - Beau's casualty loss is valued at \$200,000 which is his adjusted basis less insurance proceeds received (insurance proceeds in this case are zero).
 - His economic loss (the fair market value before the event, \$400,000 less the fair market value after the event, \$90,000) is \$310,000.
 - Since Beau had never paid tax on the \$200,000 gain in the property, however, he cannot take a tax deduction for the economic loss.
 - If Beau had the property fully insured, he would have received the full \$310,000 (less his deductible) from the insurance company.

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Personal Casualty Loss Example 2

- ▶ Continuing with the facts from the prior example, assume that Beau's AGI for the year is \$100,000.
 - Beau's casualty loss of \$200,000 must be reduced by \$100
 - The resulting loss is only deductible to the extent it exceeds 10% of AGI
 - The deductible portion of Beau's casualty loss is \$189,900 (\$200,000 - \$100 - \$10,000 [10% of AGI])

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Business Casualty and Theft Losses

- ▶ Above-the-line deduction
- ▶ Amount of deduction depends on whether the event caused
 - A **complete casualty** (FMV after the event = 0)
 - Loss = Adj. Basis in Property less insurance proceeds
 - A **partial casualty**
 - Loss is the lesser of
 - Decline in value, or
 - Adjusted basis in property, less insurance proceeds

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Business Casualty Loss Example

- ▶ No insurance proceeds received

Item	Adjusted Basis	FMV Before	FMV After	Loss
A	6,000	8,000	5,000	3,000
B	6,000	8,000	1,000	6,000
C	6,000	4,000	0	6,000

*Always limited to basis!

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Miscellaneous Itemized Deductions

Fully Deductible (Tier I) (Not Subject to 2% Hurdle)	Deductible (Tier II) (Subject to 2% Hurdle)
<ul style="list-style-type: none"> ▶ Gambling Losses to Extent of Gains ▶ Credit for Estate Tax on IRA Assets ▶ Loss of Disposition of Annuity Contracts ▶ Repayment of Income 	<ul style="list-style-type: none"> ▶ Unreimbursed Employee Business Expenses (travel, journals, uniforms, union dues) ▶ Hobby expenses to Extent of Hobby Income ▶ Investment Expenses (e.g., fees) ▶ Tax Advice and Preparation ▶ Losses on Terminated IRAs ▶ Educational Expenses to Maintain or Improve Taxpayer Competency ▶ Home Office Deduction

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Employee Business Expenses: Travel

- ▶ Typically include
 - Transportation
 - Primary purpose rule
 - Lodging
 - 50% of meals and entertainment
- ▶ Transportation for travel outside the U.S. is deductible if:
 - Taxpayer does not have control over timing/arrangements
 - Trip is for less than 7 days
 - Less than 25% of time was spent on personal activities
 - Vacation was not a primary consideration for the trip

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Employee Business Expenses: Travel

- ▶ Water travel limitations
 - Deduction limited to \$2,000
 - Requirements
 - Directly related to taxpayer's trade or business
 - Cruise ship is registered in the United States
 - Ship only docks at ports in the U.S. and its possessions

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Employee Business Expenses: Education

- ▶ Deductible if necessary to maintain or expand taxpayer's knowledge in current trade/profession
- ▶ Typical Expenses
 - Tuition
 - Books
 - Supplies
 - Transportation
 - Meals
 - Lodging
 - Fees

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Employee Business Expenses: Education

- ▶ Expenses incurred to meet minimum requirements to enter a profession are not deductible
 - Law school
 - Medical school

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Employee Business Expenses: Job Hunting

- ▶ Incurred to find new job in same trade or profession
- ▶ Deductible expenses
 - Travel
 - Printing resumes
 - Assembling portfolios of work
 - Phone calls
 - Fees paid to employment agencies/recruiters

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Employee Business Expenses: Job Hunting Example

Laura just graduated from law school, and passed the bar exam. She would like to try and find a job in California, so she flew to San Diego and San Francisco for a series of interviews with law firms. The primary purpose of the trip was to find a job, and her activities were substantiated with a detailed log that was kept by Laura.

Laura will not be able to claim any deduction for job hunting expenses, since she is not already in the trade or business of practicing law. She is seeking admission to practice, not seeking a new job in her current trade or profession, so no deduction will be allowed.

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Overall Limitation on Itemized Deductions

- ▶ For 2010, there was no phaseout of itemized deductions.
- ▶ TRA 2010 extends non-phaseout through December 31, 2012.

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Overall Limitation on Itemized Deductions

- ▶ Itemized deductions subject to reduction:
 - Taxes
 - Residential interest
 - Charitable deductions
 - Miscellaneous deductions

- ▶ Not subject to reduction
 - Medical
 - Investment interest
 - Casualties and thefts
 - Gambling losses
