Chapter 9

Deductions and Losses:
Certain Itemized Deductions

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Itemized Deductions
(slide 1 of 2)

• Personal expenditures that are deductible FROM AGI as itemized deductions include:
  – Medical expenses
  – Taxes
  – Interest
  – Charitable Contributions
  – Miscellaneous itemized deductions
Itemized Deductions
(slide 2 of 2)

- Itemized deductions provide a tax benefit only to extent that, in total, they exceed the standard deduction amount for the taxpayer.
Medical Expenses
(slide 1 of 6)

• Expenditures for the diagnosis, cure, mitigation, treatment, prevention of disease, or for purpose of affecting any structure or function of the body of the taxpayer, spouse, or dependents
  – Includes prescription drugs and insulin
Medical Expenses
(slide 2 of 6)

• Does not include the cost of items such as:
  – Elective cosmetic surgery
  – General health items
  – Nonprescription drugs
Medical Expenses
(slide 3 of 6)

- Medical expenditures are deductible in year paid
  - Includes payment by check or credit card
Medical Expenses
(slides 4 of 6)

- Medical expenses are deductible to the extent unreimbursed medical expenses, in total, exceed 7.5% of AGI
Medical Expenses
(slide 5 of 6)

• Example of medical expense deduction limitation:
  – Amy has AGI of $10,000 and medical expenses of $1,000
  – Amy’s medical expense deduction = $250
    [$1,000 - ($10,000 x 7.5%)]
Medical Expenses
(slide 6 of 6)

• Example of medical expense deduction limitation:
  – Bob has AGI of $4,000 and medical expenses of $1,000
  – Bob’s medical expense deduction = $700
    [$1,000 - ($4,000 \times 7.5\%)]
Nursing Home Expenditures

• If primary reason for being in nursing home is medical, costs (including meals and lodging) qualify

• If primary purpose of placement in home is personal, only specific medical costs qualify (no meals or lodging)
Special School Expenditures

- If primary purpose of placement in school is medical, costs (including meals, lodging, and tuition) qualify as medical expenses
- If primary purpose of placement in school is personal, only specific medical costs qualify (no meals or lodging)
Capital Medical Expenditures

- Includes wheelchairs, medical beds, dust elimination systems, etc.
- Must be medical necessity, advised by a physician, used primarily by patient, and expense is reasonable
- Full amount of cost is medical expense in year paid
- Maintenance on capital expenditures also medical expense
Capital Improvement to Home

- Deductible medical expense only to extent that cost of improvement exceeds increase in value of 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.
Medical Care of Spouse and Dependents

- Taxpayer may deduct cost of medical care for spouse and dependents
  - Dependents need not meet gross income or joint return tests
  - Medical expenses of children of divorced parents can be deducted by non-custodial parent even though child is dependent of custodial parent
Medical Transportation and Lodging

- Transportation to and from medical care is deductible
  - Mileage allowance of 12 cents per mile
- 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 medical
Health Insurance Premiums

• Premiums paid for medical care insurance are deductible medical expenses
• For self-employed, 100% of insurance premiums are deductible \textit{FOR AGI} in 2003
Reimbursement by Medical Insurance

- If reimbursed in the same year as expense paid:
  - Reimbursement offsets medical expense
  - Amount deductible is excess of expenses over reimbursement

- 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)
Example of Medical Reimbursements (slide 1 of 2)

- In 2003, taxpayer paid medical expenses = $1,200; In 2003, reimbursed $800 by insurance company
  - For 2003, deductible medical expense is $400 - (7.5% x AGI)
Example of Medical Reimbursements (slide 2 of 2)

- In 2003, taxpayer paid medical expenses of $1,200; In 2004, reimbursed $800 by insurance company
  - For 2003, deductible medical expense is $1,200 - (7.5% x AGI)
  - For 2004, reimbursement is income to extent taxpayer received a tax benefit from medical expense deduction in 2003
• Taxpayers with high deductible health insurance can make deductible (for AGI) contributions to MSA
  – Deduction limited to 65% (75% for family) of policy deductible
Medical Savings Accounts
(slide 2 of 2)

- Earnings of MSA not currently taxed
- MSA distributions used for unreimbursed medical costs are not taxed
  - Other distributions are taxable and subject to 15% penalty
Taxes (slide 1 of 4)

- State, local, and foreign income and real property taxes are deductible in the year paid.
- State and local personal property taxes based on value (ad valorem) are deductible in the year paid.
Taxes (slide 2 of 4)

- Other taxes such as sales, excise, etc., are not deductible
  - May be deductible if incurred in business or production of income activity
- Fees are not deductible as tax
Taxes (slide 3 of 4)

- Real estate taxes for year property is sold must be apportioned between the buyer and the seller
  - Failure to correctly apportion requires offsetting adjustments to seller’s amount realized and buyer’s adjusted basis
Taxes (slide 4 of 4)

- State and local income taxes
  - Deduct amounts paid during year
    - Withheld amounts
    - Estimated tax payments
    - Amounts paid in current year for prior year’s liability
- Foreign income taxes can be deducted or claimed as credit (FTC)
Interest Expense

• Deduction of interest expense is limited to:
  – Interest on qualified education loans
  – Investment interest
  – Qualified residence (home mortgage) interest

• Personal interest expense is not deductible
Interest on Qualified Education Loans

• Deductible *For AGI*, subject to limits
  – Maximum deduction is $2,500 per year
  – Deduction is phased out for taxpayers with modified AGI (MAGI) between $50,000 and $65,000 ($100,000 and $130,000 on joint returns)
  – Not allowed for those claimed as a dependent or for married filing separate returns
Investment Interest (slide 1 of 5)

- Definition: interest on loans whose proceeds are used to purchase investment property, e.g., stock, bonds, land
- Deduction of investment interest is limited to net investment income
• Net investment income:
  – Investment income less investment expenses
Investment Interest (slide 3 of 5)

• Investment income:
  – Gross income from interest, dividends, annuities, and royalties not derived from business
  – Net capital gains are treated as investment income only if elected
    • Amount elected as investment income is not eligible for preferential reduced tax on LTCG
• Investment expenses:
  – All expenses (other than interest) directly related to investment income that are allowed as a deduction
  – Application of 2% AGI floor for some investment expenses must be considered in computing amount of net investment income
Investment Interest (slide 5 of 5)

- Investment interest not used in current year due to limitation is carried forward to future years until ultimately used
  - Deductibility subject to net investment income limitation in carryover years
Qualified Residence Interest
(slide 1 of 4)

- Interest on indebtedness secured by the principal residence and one other residence (qualified residences)
- Interest must be on acquisition or home equity indebtedness
Qualified Residence Interest
(slide 2 of 4)

• Acquisition indebtedness: amounts incurred to acquire, construct, or substantially improve the qualified residences
  – Aggregate acquisition indebtedness for qualified residences cannot be greater than $1 million
Qualified Residence Interest
(slide 3 of 4)

• Home equity indebtedness: loans secured by qualified residences
• Interest is deductible only on portion of home equity loan that does not exceed the lesser of:
  – $100,000, or
  – FMV of home - acquisition indebtedness
Qualified Residence Interest

(slide 4 of 4)

- Thus, maximum loans on qualified residences that will produce qualified residence interest is $1.1 million.
- Interest on mortgage debt exceeding $1.1 million or on mortgage debt relating to nonqualified residence (e.g., second vacation home) is nondeductible personal interest.
“Points” paid for the use or forbearance of money qualify as deductible interest
  - Cannot be a service charge if they are to qualify as deductible interest

Points generally must be capitalized and amortized over the life of loan
Interest Paid For Services  (slide 2 of 2)

• Exception: Points paid in the acquisition or improvement of personal residence
  – Entire amount of such points are deductible in the year paid
  – Points paid to refinance an existing home mortgage must be capitalized and amortized over the life of the new loan
Charitable Contributions
(slide 1 of 3)

• Individuals and corporations may deduct contributions made to qualified domestic organizations

• Contributor must have donative intent and expect nothing in return
  – If contributor receives tangible benefit, the FMV of such benefit must be deducted from the amount of the contribution
Charitable Contributions
(slide 2 of 3)

- Exception to tangible benefit rule
  - Allows deduction of 80% of amount paid for the right to purchase athletic tickets from colleges and universities
Charitable Contributions
(slide 3 of 3)

• Contribution must be to qualified domestic nonprofit organization or state or possession of U.S. or any subdivisions thereof
  – Many (but not all) qualified domestic charities are listed in IRS Publication #78
Contribution of Services

- No deduction is allowed for the contribution of services
  - Unreimbursed expenses related to the services are deductible
  - Out-of-pocket transportation costs or a standard mileage rate of 14 cents per mile are also deductible
Record-Keeping Requirements

- No deduction is allowed for contributions of $250 or more without written substantiation from the charitable organization.
- Additional information is required if the value of property donated is > $500 but not over $5,000.
- An appraisal is required for contributions of property valued over $5,000.
Ordinary Income Property

• Defined: assets that would produce ordinary income or short-term capital gain if sold
• Contribution amount
  – FMV of asset less ordinary income (or STCG) potential; generally the lower of adjusted basis or FMV
Capital Gain Property

- Defined: assets that would produce long-term capital gain or Section 1231 gain if sold
- Contribution amount
  - Generally FMV of asset
Exceptions to FMV Deduction of Capital Gain Property (slide 1 of 2)

- Private nonoperating foundations
  - Deduction for contributions to private nonoperating foundations must be reduced by the amount of capital gain potential
  - Thus, the amount is limited to the adjusted basis
Exceptions to FMV Deduction of Capital Gain Property (slide 2 of 2)

• Tangible personalty
  – If asset contributed is not used in charity’s exempt function, the charitable deduction must be reduced by the amount of capital gain potential, thus, limiting the amount to the adjusted basis
Example of Contributions of Tangible Personalty

• Taxpayer contributes painting to local charity: FMV $100,000 and adjusted basis $10,000
  – If charitable organization is a local museum that hangs the painting for patrons to view, taxpayer has $100,000 contribution deduction
  – If charitable organization is a local church that sells the painting immediately to obtain funds for its operation, taxpayer has $10,000 contribution
Charitable Contribution Limitations (slide 1 of 4)

- 50% limit
  - In no case can the charitable contribution deduction for a year exceed 50% of the taxpayer’s AGI
  - Contributions of cash, ordinary income property, and certain capital gain property (where the contribution amount is adjusted basis) are subject to the 50% limit (50% assets)
Charitable Contribution Limitations (slide 2 of 4)

- 30% limit
  - Charitable contribution deduction for certain assets cannot exceed 30% of the taxpayer’s AGI
- Applies to 30% assets which are:
  - Capital gain property for which the contribution amount is FMV
  - Certain contributions to private nonoperating foundations
Charitable Contribution Limitations (slide 3 of 4)

• 30% limit
  – Taxpayer can elect to treat capital gain property as 50% assets by limiting the amount of such contributions to their adjusted bases
Charitable Contribution Limitations (slide 4 of 4)

- 20% limit
  - Certain contributions of capital gain property to private nonoperating foundations
Charitable Contributions Carryover

- Contributions that cannot be taken in current year due to limitations may be carried forward for 5 years
  - When using carryovers, current contributions are used first, then carryovers used on a FIFO basis
Example of Charitable Contribution AGI Limits

- Taxpayer, AGI $100,000, 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  30% limit = $30,000
  - Amount of deduction = $50,000 (40,000 cash + 10,000 stock)
  - Contribution carryforward = $25,000 stock (as 30% asset)
Miscellaneous Itemized Deductions

- Some expenditures are deductible only to the extent they exceed 2% of AGI
- Examples include:
  - Professional dues
  - Uniforms
  - Tax return prep fees
  - Job-hunting costs
  - Certain investment expenses
  - Hobby losses
  - Unreimbursed employee expenses
Misc. Itemized Deductions Not Subject to 2% of AGI Floor

• Examples include:
  – Gambling losses to the extent of gambling winnings
  – Impairment-related work expenses of a handicapped person
  – Deduction for repayment of amounts under a claim of right if more than $3,000
  – Unrecovered investment in a annuity contract when annuity ceases by reason of death
Overall Limitation on Itemized Deductions (slide 1 of 3)

• Taxpayers with AGI in excess of the specified threshold will lose part of their benefits from certain itemized deductions
  – Threshold amount in 2003 is $139,500 ($69,750 if married, filing separately)
Overall Limitation on Itemized Deductions (slide 2 of 3)

• Itemized deductions subject to possible reduction include:
  – Taxes, home mortgage interest, charitable contributions, and miscellaneous deductions
• Medical, investment interest, casualty & theft losses, and gambling losses are not subject to reduction
Overall Limitation on Itemized Deductions (slide 3 of 3)

• Amount of reduction
  – Reduction is lesser of:
    • (AGI - threshold) x 3%, or
    • 80% x total itemized deductions subject to reduction
If you have any comments or suggestions concerning this PowerPoint Presentation for West's Federal Taxation, please contact:

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