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
(slide 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 x 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 *FOR AGI* in 2003

Reimbursement by Medical Insurance

- If reimbursed in 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

Medical Savings Accounts
(slide 1 of 2)

- 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

Investment Interest (slide 2 of 5)

- 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 Interest (slide 4 of 5)

- 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

Interest Paid For Services (slide 1 of 2)

- "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 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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