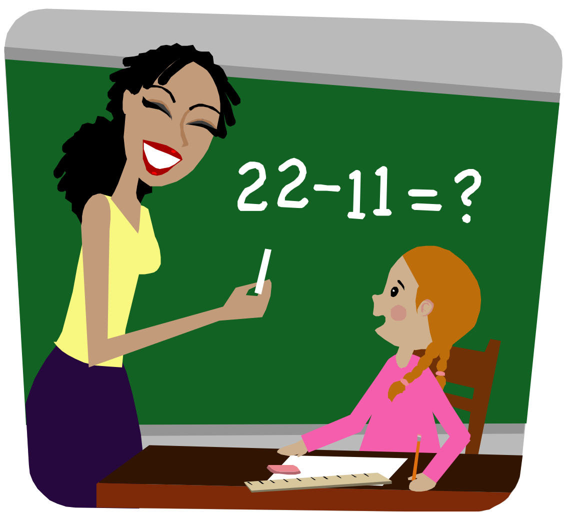
If you are truly serious about preparing your children for the future, don't teach them to subtract - teach them to deduct.

-- Fran Lebowitz



Unit06. Itemized Deductions (PAK Chapter 7)

This week's objective is to identify which personal expenses can be used as a tax deduction. Go to http://www.irs.gov/pub/irs-pdf/f1040sab.pdf and download a copy of Schedule A. Have this form beside you as you work though this chapter and locate where each tax deduction is to be reported on the form.

Our questions this week…

When can I deduct

- medical expenses
- taxes
- interest
- charitable contributions
- miscellaneous expenditures

What are the limits on what I can deduct?

Unit Outline

- This unit focuses on deductions from AGI, also referred to as itemized deductions. Below is the outline for this unit:
  1. Medical expenses
  2. Taxes
  3. Interest
  4. Charitable contributions
  5. Casualty and theft losses
  6. Miscellaneous itemized deductions
  7. Reduction of certain itemized deductions
  8. Tax planning considerations
  9. Compliance and procedural considerations

1. Medical Expenses

- Taxpayers may deduct medical expenses only to the extent the expenses exceed 7.5% of AGI. Three issues are covered under this topic
  1) Qualified individuals
  2) Qualified medical expenses
  3) Amount and timing of deduction

1. Medical Expenses

1) Qualified Individuals

- Medical expenses paid for the taxpayer, taxpayer's spouse, or taxpayer's dependent may qualify for a deduction.
- Medical expenses for dependents of the taxpayer who do not qualify for a dependency exemption solely due to the gross income or joint return tests will be allowed.
- Also, medical expenses for children of divorced parents are deductible by either parent paying such expenses, as long as one of the parents is entitled to the dependency exemption.
- Study PAK Example 7-1

1. Medical Expenses

2) Qualified Medical Expenses (1of 2)

- Qualifying expenses are those paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, including transportation, meals and lodging, certain capital expenditures, and medical insurance premiums.
  - EXAMPLE: Hospital, doctors, dentists, eyeglasses, and prescription drugs.
- Cosmetic surgery is not deductible unless it promotes the proper functioning of the body or prevents or treats an illness or disease.
- Deductible transportation costs include mileage, tolls, parking, taxis, airfare, etc. if the travel is primarily for and essential to qualified medical care.

1. Medical Expenses

2) Qualified Medical Expenses (2 of 2)

- Meals enroute to medical treatment are subject to a 50% disallowance and lodging is limited to $50/night per person (patient plus attendant). Lodging is available only if the patient is being treated at a licensed hospital or its equivalent.
- Qualified long-term care expenditures and long-term care insurance premiums are now deductible medical expenses. Deductible limit for such premiums vary with age of the covered individual.
- Capital expenditures that improve the residence (i.e. swimming pool for paraplegic) are deductible only to the extent that the cost of the improvement exceeds the increase in the FMV of the residence.
- Study PAK Examples 7-2, 7-3, 7-4, 7-5

1. Medical Expenses

3) Amount and Timing of Deduction

- A medical expense deduction is only allowed to the extent qualified medical expenses exceed 7.5% of AGI.
  - EXAMPLE: A taxpayer with $10,000 of qualifying medical expenses and a $100,000 AGI will be allowed only a $2,500 medical expense deduction [$10,000 minus (0.075 x $100,000) = $2,500].
- Reimbursements during the tax year reduce allowable deductions. Reimbursements received in subsequent tax years are included in gross income under the tax benefit rule.
- Study PAK Example 7-6, 7-7

2. Taxes

- Taxpayers can deduct specifically listed taxes paid or accrued during the taxable year.
  1) Definition of a tax
  2) Deductible taxes
  3) Nondeductible taxes
  4) State and local income taxes
  5) State and local sales taxes
  6) Personal property taxes
  7) Real estate taxes
  8) Self-employment tax

2. Taxes

1) Definition of a Tax

- The statutory definition of a tax is a mandatory assessment levied under the authority of a political entity for the purpose of raising revenue to be used for public or governmental purposes.
- The tax must be a liability of the taxpayer attempting to deduct the tax.

2. Taxes

2) Deductible Taxes

- Deductible taxes include state, local, and foreign real property taxes, state and local personal property taxes, foreign, state and local income taxes, and federal environment tax.
- Personal property taxes are deductible only to the extent the amount is based on the value of personal property.

2. Taxes

3) Nondeductible Taxes

- Nondeductible taxes include federal income tax, employee's social security tax, and federal estate and gift tax.

2. Taxes

4) State and Local Income Taxes

- Cash-basis taxpayers deduct state and/or local income tax paid or withheld, regardless of the tax year involved.
  - EXAMPLE: The last estimated state income tax payment for 2009 is due and paid on January 15, 2010. A cash-basis taxpayer cannot deduct this payment until 2010, even though it applies to the 2009 tax year.
  - Study PAK Example 7-8

2. Taxes

5) State and Local Sales Taxes

- Individuals may elect to deduct state and local sales taxes in lieu of state and local income taxes for tax years prior to January 1, 2010. Documented actual expenditures for sales taxes may be deducted or the amount allowed by Treasury tables.

"Could you make it a dollar and four cents, sir? — The Government says I have to collect sales tax."

2. Taxes

6) Personal Property Taxes

- In order to be deductible the tax must be an ad valorem tax on personal property imposed on an annual basis.
- Any portion of the tax which is a flat fee (i.e. registration fee the same for all vehicles) is not deductible.
- Study PAK Example 7-9

2. Taxes

(7) Real Estate Taxes

- Apportionment of taxes is necessary when real estate is sold during the year.
- Taxes assessed only against the property benefited (i.e. sewer improvement) are capitalizable costs, not deductions.
- For tax years 2008 and 2009, homeowners who do not itemize may take an additional standard deduction for real estate taxes limited to $500 ($1,000 for married filing jointly).
- Study PAK Example 7-10

2. Taxes

8) Self-Employment Tax

- Pay tax on self-employment income in lieu of payment of Social Security tax on salary
- ½ of SE tax deductible for AGI

3. Interest

1) Definition of interest
2) Classification of interest expense
3) Timing of the interest deduction

3. Interest

1) Definition of Interest

- Interest is the charge for the use or forbearance of money.
- Bank service charges and certain loan acquisition costs are not considered interest for tax purposes.

3. Interest

2) Classification of Interest Expense (1 of 2)

- Different rules exist for the deductibility of active trade or business interest, passive loss interest, investment interest, personal interest, and qualified residence interest.
- Business interest is deductible for AGI and personal interest (including investment interest), if deductible, is deductible from AGI.
- The investment interest deduction is limited to net investment income. Net investment income includes net long-term capital gain and qualified dividends only to the extent the taxpayer agrees to subject such income to ordinary tax rates.

3. Interest

3) Classification of Interest Expense (2 of 2)

- Most personal interest such as credit card interest, automobile loan interest, is not deductible.
- Qualified residence interest (mortgage) is deductible. Qualified residence interest is available on a maximum of two residences for acquisition indebtedness (maximum $1,000,000) and home equity indebtedness (maximum $100,000).
- The maximum amount of deductible interest on student loans is $2,500. The loans must be incurred to pay qualified higher education expenses. This interest deduction is taken "for" AGI and is subject to phase-out over certain AGI levels.
- Study PAK Examples 7-11, 7-12, 7-13, 7-14, 7-15, 7-16, 7-17, 7-18, 7-19, 7-20, 7-21.

3. Interest

3) Timing of the Interest Deduction

- The general rule is that cash-basis taxpayers deduct interest when paid.
- Exceptions exist (deduction is partially or fully deferred) for prepaid interest, interest paid with loan proceeds, discounted notes, and interest owed to a related party by an accrual-basis taxpayer.
- Study PAK Example 7-22, 7-23

4. Charitable Contributions

- Individuals who itemize their deductions and corporations can deduct charitable contributions to qualified organizations.
  1) Qualifying organization
  2) Type of property contributed
  3) Deduction limitations
  4) Application of carryovers
  5) Special rules for charitable contributions made by corporations

4. Charitable Contributions

1) Qualifying Organization

- Qualified organizations include the following:
  - The United States, the District of Columbia, state or possession of U.S.
  - Post or organization of war veterans
  - Domestic fraternal society, or order, or association
  - Public Charities
    - Churches, educational Institutions, hospitals, medical schools
- Only contributions to IRS-approved public and private charities qualify for the charitable contribution deduction.
- Organizations are added to and deleted from the IRS-approved list on a regular basis. Care must be exercised to determine that a purported qualified charitable organization is in fact qualified at the time of contribution.

4. Charitable Contributions

2) Type of Property Contributed

- The amount of the charitable contribution is affected by the type of property contributed:
  - Ordinary income property/Amount = Fair Market Value less potential ordinary income
  - Tangible personal property unrelated to the charitable function/ Amount = Adjusted basis of the property.
    - EXAMPLE: A painting held more than one year with a FMV of $5,000,000 and an adjusted basis of $500,000 is given to a charity. If the charity is the American Cancer Society the amount of the deduction is $500,000 (tangible personal property unrelated to the charitable function.) If the painting is given to an art museum, the amount of the deduction is $5,000,000 (related to the charitable function).
  - Long-term capital gain property (held more than 12 months)/Amount = Fair Market Value.
- Study PAK Examples 7-24, 7-25, 7-26, 7-27, 7-28, 7-29

4. Charitable Contributions

3) Deduction Limitations

- Annual limitations based on AGI are applicable to charitable contributions, including overall limitation (50%), capital gain property (30%), and certain private foundation contributions (20%).
  - EXAMPLE: The taxpayer contributed $100,000 cash to the Red Cross in a tax year when her AGI is $150,000. The taxpayer's current charitable contribution deduction is limited to $75,000 ($150,000 x 50%).
  - Study PAK Examples 7-30, 7-31

4. Charitable Contributions

4) Application of Carryovers

- Charitable contributions exceeding the annual percentage limitations may be carried over for five years.
  - EXAMPLE: In the example on previous slide, the taxpayer would have a $25,000 carryover ($100,000 contribution less $75,000 deduction) for five years.
  - Study PAK Example 7-32

4. Charitable Contributions

5) Special Rules for Contributions Made by Corporations

- Pledges made by accrual method corporations
  - Deductible in year pledged if paid by 15th day of 3rd month after year end
- Limitation applicable to corporations
  - Cannot exceed 10% of corporation's taxable income

"Today is financial Arbor Day. We're going to find some worthwhile charity and plant a money tree."

5. Casualty and Theft Losses

- Individuals can deduct casualty or theft loss on personal-use property as an itemized deduction
  - Subject to floor of $100 per item plus 10 % of AGI

6. Miscellaneous Itemized Deductions

- These items generally are deductable only to the extent that, in the aggregate, they exceed 2% of AGI (2% AGI floor).
  - Certain employee expenses
    - Unreimbursed employee business expenses are deductible as miscellaneous itemized deductions
  - Expenses to produce income
    - Examples: investment advice, safe deposit box holding investment property)
  - Cost of tax advice
    - tax return preparation, and any related fee (i.e. required appraisals)

7. Reduction of Certain Itemized Deductions

- In 2009, itemized deductions will be reduced by 1% of AGI exceeding $166,800 ($83,400-married/sep.).
- However, itemized deductions cannot be reduced by more than 80% of qualified residence interest, charitable contributions, taxes, and miscellaneous itemized deductions (other than gambling losses).
- Study PAK Examples 7-33, 7-34

8. Tax Planning Considerations

- Medical Expense Deduction (Example I7-35)
  - Elective medical treatment should be bunched in one tax year to alleviate the effect of the 7.5% of AGI limitation.
  - The year chosen to maximize the medical expense deduction should be different than the year for significant charitable contributions because medical expenses are subject to an AGI floor while charitable contributions are subject to an AGI cap.
  - Study PAK Examples 7-35, 7-36
- Interest expense deduction
  - May deduct residential interest on ***any*** two residences
    - If vacation home used > of 14 days or 10% of rental days personal portion qualifies as a residence
- Deduction for charitable contributions
  - Election to reduce amount of contribution
  - Donation of appreciated long-term capital gain property
  - Significant substantiation requirement
  - Study PAK Examples 7-37, 7-38

9. Compliance and Procedural Considerations

- Medical expenses
  - Dependent care credit vs. medical expense deduction
  - Compare dependent care credit rate with effective marginal tax rate for additional medical deductions
  - Study PAK Example 7-39
- Charitable contributions
  - >$500 must file Form 8283
  - Property > $5,000 should have appraisal
  - >$250 and quid pro quo > $75 require additional documentation
  - Study PAK Example 7-40
- Taxes
  - Schedule C - related to taxpayer's trade or business
  - Schedule E - related to the production of rents and/or royalties
  - Schedule A - if personal
  - Study PAK Example 7-41

Addition Things to Study

- Answers to Selected Textbook Problems:
  - http://www.fcs.utah.edu/~fan/fcs5530/Answers%20to%20Selected%20Problems/AnswersSelectedUnit06.pdf
- Self-study Quizzes on Publisher's website:
  - http://wps.prenhall.com/bp_pope_fedtax_2010/120/30827/7891879.cw/index.html
- Homework Assignment for Unit06 (Graded)
  - PAK Chapter 7 Problems: 7-39, 7-43, 7-45, 7-47, 7-51, 7-54
  - Please go to Week 6 folder on course Homepage to find the link. You can also access it directly through the "Assignments" link.
- Discussion Topic for Unit06(Graded)
  - Don't forget to post your thoughts on the discussion topic of the week.
  - Go to the Week 6 folder on course Homepage to find the link. You can also access it directly through the "Discussions" link.