Chapter **Five**

Itemized Deductions

This chapter provides a detailed investigation of Schedule A and itemized deductions. Specifically, we present the laws, rules, and complete tax authority encompassing the six basic categories of the primarily personal expenditures allowed as tax deductions. In addition to the law and rules for deductibility, we present the practical application of the law on Schedule A and related forms.

Learning Objectives

When you have completed this chapter, you should understand the following learning objectives (LO):

LO 5-1 Describe the deductibility and reporting of medical expenses.

LO 5-2 Be able to explain the state and local tax deductions.

LO 5-3 Apply the tax rules associated with the interest deduction.

LO 5-4 Explain the deductibility and reporting of charitable contributions.

LO 5-5 Discuss the casualty loss deduction.

LO 5-6 Know how to report miscellaneous expenditures.

LO 5-7 Apply the tax rules for the Pease limitations on total itemized deductions for high-income taxpayers in 2017.

INTRODUCTION

The Internal Revenue Code allows taxpayers to deduct certain items from gross income when determining taxable income. One type of permitted deduction is a *for* (or *above-the-line*) AGI deduction such as moving expenses, student loan interest, and Health Savings Accounts. We discussed these *for* AGI deductions in Chapter 4.

The other type of permitted deduction is a *from* (*below-the-line*) AGI deduction. You are already familiar with one *from* AGI deduction—the standard deduction, discussed in Chapter 2. We now introduce you to another *from* AGI deduction—the itemized deduction.

Itemized deductions are reported on Schedule A (see Exhibit 5-1). If you review Schedule A, you will see that itemized deductions are organized into six major categories:

1. Medical.
2. State and local taxes.
3. Interest.
4. Charitable gifts.
5. Casualty losses.
6. Miscellaneous deductions, including unreimbursed employee expenses.

The first six learning objectives of this chapter are tied to these six categories of itemized deductions.

Most itemized deductions are, in effect, personal living expenses: medical expenses, interest expenses, payments for taxes, and the like. Permitted personal living expenses can be deducted only if they are expressly permitted.

EXHIBIT 5-1

SCHEDULE A (Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Itemized Deductions

▶ Go to *www.irs.gov/ScheduleA* for instructions and the latest information.
▶ Attach to Form 1040.

OMB No. 1545-0074
2017
Attachment Sequence No. 07

Name(s) shown on Form 1040 | **Your social security number**

Medical and Dental Expenses		**Caution:** Do not include expenses reimbursed or paid by others.		
	1	Medical and dental expenses (see instructions)	1	
	2	Enter amount from Form 1040, line 38 [2]		
	3	Multiply line 2 by 10% (0.10)	3	
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-		4
Taxes You Paid	5	State and local **(check only one box):** a ☐ Income taxes, **or** b ☐ General sales taxes	5	
	6	Real estate taxes (see instructions)	6	
	7	Personal property taxes	7	
	8	Other taxes. List type and amount ▶	8	
	9	Add lines 5 through 8		9
Interest You Paid **Note:** Your mortgage interest deduction may be limited (see instructions).	10	Home mortgage interest and points reported to you on Form 1098	10	
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see instructions and show that person's name, identifying no., and address ▶	11	
	12	Points not reported to you on Form 1098. See instructions for special rules	12	
	13	Reserved	13	
	14	Investment interest. Attach Form 4952 if required. See instructions.	14	
	15	Add lines 10 through 14		15
Gifts to Charity If you made a gift and got a benefit for it, see instructions.	16	Gifts by cash or check. If you made any gift of $250 or more, see instructions	16	
	17	Other than by cash or check. If any gift of $250 or more, see instructions. You **must** attach Form 8283 if over $500	17	
	18	Carryover from prior year	18	
	19	Add lines 16 through 18		19
Casualty and Theft Losses	20	Casualty or theft loss(es). Attach Form 4684. See instructions		20
Job Expenses and Certain Miscellaneous Deductions	21	Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. See instructions. ▶	21	
	22	Tax preparation fees	22	
	23	Other expenses—investment, safe deposit box, etc. List type and amount ▶	23	
	24	Add lines 21 through 23	24	
	25	Enter amount from Form 1040, line 38 [25]		
	26	Multiply line 25 by 2% (0.02)	26	
	27	Subtract line 26 from line 24. If line 26 is more than line 24, enter -0-		27
Other Miscellaneous Deductions	28	Other—from list in instructions. List type and amount ▶		28
Total Itemized Deductions	29	Is Form 1040, line 38, over $156,900? ☐ **No.** Your deduction is not limited. Add the amounts in the far right column for lines 4 through 28. Also, enter this amount on Form 1040, line 40. ☐ **Yes.** Your deduction may be limited. See the Itemized Deductions Worksheet in the instructions to figure the amount to enter.		29
	30	If you elect to itemize deductions even though they are less than your standard deduction, check here ▶ ☐		

For Paperwork Reduction Act Notice, see the Instructions for Form 1040. Cat. No. 17145C **Schedule A (Form 1040) 2017**

Source: U.S. Department of the Treasury, Internal Revenue Service, Form 1040- Schedule A. Washington, DC: 2017.

Itemized deductions also include two other types of expenses: unreimbursed employee business expenses (part of miscellaneous deductions) and investment-related expenses (part of the interest category as well as miscellaneous deductions).

In practice, taxpayers determine their (1) standard deduction and (2) total itemized deductions and use the higher number. In other words, a taxpayer cannot take *both* the standard deduction *and* the itemized deduction but only the higher of the two. Recall, for example, that the standard deduction is $12,700 for a married couple.[1] Thus a married couple who has itemized deductions of $11,000 should claim the standard deduction, but if the itemized deductions total $13,500, the couple should choose to itemize the deductions.

DEDUCTIBLE MEDICAL EXPENSES (SCHEDULE A, LINE 4)

LO 5-1

Taxpayers can deduct an itemized deduction for medical expenses (net of insurance proceeds) for themselves, their spouse, and dependent(s). The qualifying relationship must exist at the date the taxpayer incurs or pays the expenses. Only the amount in excess of 7.5% of AGI is deductible.[2] Because the threshold is so high, medical expenditures usually must be substantial for the taxpayer(s) to benefit from a medical deduction. A formula for calculating the amount of deductible medical expense is shown in Table 5-1.

The Tax Cuts and Jobs Act, passed in December 2017, reduced the threshold to 7.5% for 2017 and 2018.

TABLE 5-1
Medical Expense Deduction Formula

Calculation of Deductible Medical Expenses

Allowable medical expenses
minus (insurance reimbursements)
Allowable net paid medical expenses
minus (10.0% of Adjusted Gross Income)
Deductible medical expenses

EXAMPLE 5-1

Alice and Bob are married taxpayers, with AGI of $100,000 in tax year 2017. To benefit from an itemized deduction for medical expenses, Alice and Bob must have medical costs in excess of $7,500 ($100,000 × 7.5% floor).

Two special rules apply for determining whether an individual qualifies as a dependent for purposes of the medical expense deduction:

1. The dependent child of divorced parents is treated as a dependent of both parents. The parent who pays the child's medical expenses may deduct the expenses even if the parent is not permitted to claim the child's dependency exemption.
2. The gross income and the joint return tests for the dependency exemption are waived. A taxpayer who pays the medical expenses of an individual who satisfies the relationship, citizenship, and support tests for the dependency exemption may deduct the medical expenses paid for that person.[3]

[1] The standard deduction for a qualifying widow(er) is $12,700, for head of household is $9,350, and for a single person as well as married filing separately is $6,350.

[2] IRC § 213.

[3] Reg. § 1.213-1(a)(3)(i).

A deduction may be claimed only for medical expenses actually paid during the taxable year regardless of when the care was provided and regardless of the taxpayer's method of accounting.[4] A medical expense charged to a credit card is considered paid.

The taxpayer may deduct costs for medical care, which includes the following:

1. The diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body.
2. Transportation primarily for and essential to medical care.
3. Qualified long-term care services.
4. Insurance for medical care or qualified long-term care services.

In most instances, medical expenses are relatively straightforward and include all costs for licensed medical treatment. Ambiguity occurs when expenditures for personal, living, and family purposes (generally not deductible) are incidental to medical care (generally deductible).

TAX YOUR BRAIN

A physician prescribes a special diet consisting of low-fat, high-fiber foods to lower cholesterol. The physician's bill is definitely deductible. However, is the cost of the food a deductible medical expense?

ANSWER

The mere fact that a physician prescribes or recommends a course of action does not automatically qualify the expenditure as a deduction.[5] If an expense item is ordinarily for personal purposes, the excess of the cost of the special items (excess over the ordinary-use goods) qualifies as a medical deduction. For example, the extra cost of a specially designed auto (above the normal cost of the auto) for a taxpayer confined to a wheelchair would qualify as a medical deduction.[6] Therefore, the special food would be deductible only to the extent the food costs exceeded normal food costs. This would be difficult to substantiate. Thus it is unlikely that the food would qualify as a deductible medical expense.

Taxpayers may *not* deduct expenditures that are merely for the benefit of the general health of an individual.[7] For example, expenditures for cosmetic surgery are normally not deductible. Clearly, any payments made for operations or treatments for any part of the body or function of the body are deductible if they serve a distinct medical need. Plastic surgery to repair a birth defect would be a deductible expense. This includes payments to virtually all health care providers, such as doctors, dentists, ophthalmologists, nurses, and physical therapists as well as many unconventional medical treatments, from acupuncture to treatments by Christian Science practitioners.[8]

TAX YOUR BRAIN

Can a capital expenditure such as an addition of a swimming pool to a house qualify as a deductible medical expense?

ANSWER

If the capital expenditure for the swimming pool is for the primary medical care of the taxpayer, his or her spouse, or his or her dependent(s), it may qualify for a deduction.[9] This area has been highly litigated by the IRS. To ensure the deduction for the pool, a physician must prescribe swimming and there can be no recreational element (such as a diving board or slide) to the pool. Other factors used in determining the deductibility of a swimming pool include the availability of other types of exercise and access to a community pool.[10]

[4] IRC § 213(a).

[5] *Atkinson, H.* (1965) 44 TC 39, acq. 1965-2 CB 4.

[6] Rev. Rul. 76-80, 1976-1 CB 71.

[7] Reg. § 1.213-1(e)(1)(ii).

[8] Rev. Rul. 72-593, 1972-2 CB 180; Rev. Rul. 55-261, 1955-1 CB 307. Payments to the following medical providers are specifically included as deductible charges: psychologists, physicians, surgeons, specialists or other medical practitioners, chiropractors, dentists, optometrists, osteopaths, psychiatrists, and Christian Science practitioners.

[9] Reg. § 1.213-1(e)(1)(iii).

[10] Rev. Rul. 83-33 (1983-1 CB 70) specially addresses the swimming pool issue.

For medical capital expenditures that improve the taxpayer's property, the deduction is available only to the extent that the medical expenditure exceeds the increase in the fair market value (FMV) of the residence. Thus if the cost of a swimming pool for medical purposes was $30,000 and the increase in FMV to the residence was $20,000, the medical deduction would be limited to $10,000 (the excess cost over the FMV increase).

EXAMPLE 5-2

Renaldo suffers from a severe knee condition and is unable to climb steps. Consequently, he installed an elevator in his home at a cost of $7,000. An appraiser indicates that the elevator increased the value of the home by $2,000. The cost of the elevator, $7,000, is a medical expense to the extent that it exceeds the increase in the value of the property, $2,000. Thus $5,000 of the cost of the elevator is included in the calculation of Renaldo's medical expense deduction.

Generally, deductible medical costs do not include cosmetic surgery unless the surgery is necessary to correct a deformity arising from a congenital abnormality, personal injury, or disfiguring disease.[11]

EXAMPLE 5-3

Tamara was riding her mountain bike on a trail and lost control. Her head and face hit a tree stump, causing damage to the right side of her face. The cost of the cosmetic surgery to repair the damage, the hospital stay, and all physician fees would qualify as a medical deduction.

Medical expenses are *not* deductible if they have been "compensated for by insurance or otherwise."[12] As a result, any insurance reimbursements or partial reimbursements reduce the deductible medical expenses subject to the 10.0% AGI limitation.

Medicine and Drugs

For the cost of a drug to be deductible, a physician must first prescribe it.[13] This would include payments for birth control pills or drugs to alleviate nicotine withdrawal as long as a prescription was required.[14]

One other limitation to the deductibility of medicine or drug costs is that the taxpayer must obtain the drug legally. Thus even if a physician prescribes an otherwise illegal drug for medicinal purposes, the cost of acquiring the illegal drug is not deductible.

Prescription drugs obtained from sources outside the United States, such as Canada, are deductible if they are prescribed by a physician for the treatment of a medical condition and the FDA has approved that they can be legally imported. Amounts paid for over-the-counter medications are not reimbursable from HSAs.

TAX YOUR BRAIN

A physician prescribes marijuana for pain control purposes for a terminally ill cancer patient. The use of marijuana for medicinal purposes is legal under state law. Can a taxpayer deduct the cost of marijuana?

ANSWER

Because marijuana cannot be legally procured under federal law, its cost is not deductible.[15]

[11] IRC § 213(d)(9).
[12] IRC § 213(a).
[13] IRC § 213(b).
[14] Rev. Rul. 73-200, 1973-1 CB 140; Rev. Rul. 99-28, 1999-25 IRB 6.
[15] Reg. § 1.213-1(e)(2); Rev. Rul. 97-9, 1997-1 CB 77.

Travel and Transportation for Medical Purposes

Transportation costs for medical purposes could include such items as cab, bus, or train fares, as well as expenses for a personal auto. The cost of the transportation must be primarily for, and essential to, deductible medical care.[16]

EXAMPLE 5-4

Jake Avery, who currently lives in New Orleans, must fly to Memphis to see a specialist concerning an inner ear condition. Mrs. Avery, a big Elvis fan, decides to go along to visit Graceland. The travel costs for Jake, but not Mrs. Avery, are deductible as a medical expense. If, on the other hand, Mrs. Avery accompanied Jake because her assistance was required because of problems stemming from the ear condition, her costs would also be deductible.[17]

There are two ways to calculate the deduction for the use of a personal auto for medical transportation: (1) the *actual cost* of operating the car for medical purposes or (2) the *standard mileage allowance*.[18]

When using the actual costs, the taxpayer must keep documentation for items such as gasoline, oil, repairs, and so on that are directly associated with transportation to and from medical care. However, the taxpayer gets no deduction for general repairs, maintenance, or insurance. The simpler approach for deducting personal auto expense is to use the standard mileage allowance, which in 2017 is 17 cents per mile. The taxpayer can deduct other supplemental costs such as parking and tolls in addition to the applicable mileage rate.

EXAMPLE 5-5

Maria has an inoperable brain tumor that requires treatment at University of Texas Medical Center in Houston twice a month. It is a 500-mile round trip. She pays a total of $10 in tolls, $20 in parking, and $80 for gasoline on each round trip. Assuming that Maria made the trip six times in the current tax year, what is the maximum transportation expense deduction for medical purposes (*disregarding* the 10% AGI floor)?

ANSWER

Actual costs follow:

Gasoline ($90 × 6)	$540
Tolls ($10 × 6)	60
Parking ($20 × 6)	120
Total deduction	$720

Use of the standard mileage rate in effect for the year gives this deduction:

Mileage (500 miles × $0.17/mile × 6)	$510
Tolls ($10 × 6)	60
Parking ($20 × 6)	120
Total deduction	$690

Maria would choose the standard mileage rate in this situation because it produces a higher deduction. This is not always the case, however. In reality, the convenience and the lack of receipt substantiation make the standard mileage rate more popular even though the deduction of actual costs could be higher.

[16] IRC § 213(d)(1)(B).

[17] *Kelly, Daniel,* TC Memo 1969-231 reversed on another issue (1971, CA-7), 440 F2d 307.

[18] Rev. Proc. 80-32, 1980-2 CB 767.

In addition to the mileage, the cost of meals and lodging at a hospital or similar institution is deductible if the principal reason for being there is to receive medical care.[19] Lodging near the related medical facility is deductible as long as no significant element of personal pleasure, recreation, or vacation is involved. The lodging expenditures are limited to $50 for each night for each individual, and meals are not deductible.[20]

Long-Term Care

As the population ages, more funds will be spent providing long-term care for senior citizens. *Qualified long-term care services* are medical, maintenance, and personal care services provided to a chronically ill individual pursuant to a plan of care prescribed by a licensed health care practitioner.

The general rule concerning the deductibility of nursing home or other long-term care institution costs provides that amounts spent are deductible if the principal reason for the individual's stay is medical care as opposed to enjoyment or convenience. The entire cost of the long-term institution is deductible as a medical expense if indeed that is the case. If full-time medical care is not required, only the fee allocable to actual medical care is deductible, and costs for food and lodging are nondeductible.[21]

Determining medical expenses is usually quite easy for the individual or client who keeps good records. Generally, medical care providers supply the necessary receipts to document the medical charges incurred in a hospital or doctor's office. Other source documents for medical charges include checkbook registers, bank records, and credit card statements. Be careful, however, in taking a medical deduction for a check made out to a local drugstore that sells items in addition to prescription drugs. The IRS may require an itemized receipt for the prescription drugs. Pharmacy departments usually provide this information. Another major item, which is easy to misclassify, is the payment of health insurance premiums. These are deductible only if the taxpayer pays the premiums with after-tax funds (not in an employer pretax plan).

Insurance for Medical Care or Long-Term Care

Premiums for medical insurance, such as major medical, hospitalization, dental, and vision insurance, are deductible. This includes Medicare B premiums for voluntary supplemental coverage, but it does not include Medicare A insurance payroll taxes withheld from the taxpayer's paycheck. Premiums for long-term care policies are deductible, subject to dollar limitations. Deductible amounts for 2017[22] follow:

Age at Close of Taxable Year	2017 Amount
40 and under	$ 410
More than 40, but not more than 50	770
More than 50, but not more than 60	1,530
More than 60, but not more than 70	4,090
Age 71 and over	5,110

In the event that the long-term insurance contract pays periodic payments to an individual who is chronically ill, any amount in excess of the per diem limit is in fact taxable. The per diem rate for 2017 is $360.

[19] *Montgomery, Morris v. Comm.* (1970, CA6), 428 F2d 243 affg (1968) 51 TC 410.
[20] IRC § 213(d)(2)(A)&(B).
[21] Reg. § 1.213-1(e)(1)(v).
[22] IRS Rev. Proc. 2014-61.

From Shoebox to Software

EXAMPLE 5-6

We will return to Maria and Jose Ramirez in terms of Example 5-5. In Chapter 4, you created and saved a tax file for Jose and Maria Ramirez. They had an AGI of $110,048. For this chapter, you will reopen their return and you will add the following medical costs:

Maria's hospital charges	$13,000
Maria's physician charges	8,000
Maria's prescription drugs	3,000
Jose's high blood pressure drugs	300
Jose's eye surgery	750
Regular dental visits (4 total)	280
Jose's regular physician charges	400
Transportation (from Example 5-5)	690
Lodging for trips to the University of Texas (for both Jose and Maria—Maria could not drive because the treatments affected her vision—6 nights at $127/night)	600
High-fiber health food recommended for Jose	450

Assuming that Jose and Maria do not have health insurance, how much is their medical deduction, and how is it presented on Form 1040, Schedule A?

Tax software: Retrieve the Ramirezes' file saved from Chapter 4. Because of the numerous types of medical expenses allowed, it is easier to go directly to Schedule A to enter the medical deductions.

To complete the form, you must understand tax law. All of the expenses qualify for a deduction with the exception of the high-fiber health food. Additionally, the lodging is limited to $50 per person per night. In this case, because Jose was required to drive Maria, expenses for both of them qualify, and lodging would be limited to $100 per night ($50 for Jose, $50 for Maria) for six nights. Thus the total medical deduction before the 7.5% AGI limitation is $27,020.

The $27,020 deduction could be placed on line 1 of Schedule A; or if you wished to list all of the deductions, you could right-click on line 1 and then list the expenses on the "add line item detail" provided. The taxpayer's AGI ($110,048) would automatically transfer to line 2, and the 7.5% limitation ($8,254) would be calculated. Any changes to other areas of the tax return would automatically update AGI and thus change the allowable medical deduction.

The medical expense presentation on Schedule A (Exhibit 5-2) is as follows:

EXHIBIT 5-2

Medical and Dental Expenses	**Caution:** Do not include expenses reimbursed or paid by others.			
	1 Medical and dental expenses (see instructions)	1	27,020	
	2 Enter amount from Form 1040, line 38 | 2 | 110,048			
	3 Multiply line 2 by 7.5% (0.075)	3	8,254	
	4 Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-		4	18,766

Source: U.S. Department of the Treasury, Internal Revenue Service, Form 1040- Schedule A. Washington, DC: 2017.

The net medical expense deduction would be $18,766.

If Jose and Maria had health insurance and received benefits of $14,000, the amount shown on line 1 would be $13,020 ($27,020 – $14,000). You could either directly enter $13,020 on line 1 or show the insurance benefits as a negative on the line item detail. The result would be a deduction of only $4,766 (see Exhibit 5-3). Save the file showing $4,766 in net medical expenses for use later in the text.

EXHIBIT 5-3

Medical and Dental Expenses	**Caution:** Do not include expenses reimbursed or paid by others.			
	1 Medical and dental expenses (see instructions)	1	13,020	
	2 Enter amount from Form 1040, line 38 | 2 | 110,048			
	3 Multiply line 2 by 7.5% (0.075)	3	8,254	
	4 Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-		4	4,766

Source: U.S. Department of the Treasury, Internal Revenue Service, Form 1040- Schedule A. Washington, DC: 2017.

TAX YOUR BRAIN

Sofia is an elderly woman who does not require any medical or nursing care. However, she has recently become legally blind and needs help with normal living activities such as cooking, cleaning, and bathing. Sofia enters an assisted living facility where she feels she will be happier and less of a burden to her children. Does the cost of the facility qualify as a medical deduction?

ANSWER

Because medical care is not the principal reason for the woman stay at the facility, there is no medical deduction.[23] Of course any actual medical costs, such as doctor visits, are still deductible.

Exhibit 5-3 assumes that Maria and Jose received a $14,000 insurance reimbursement in the year in which they paid the medical expenses. What happens if Maria and Jose receive the insurance benefits in the subsequent year? In this case, the insurance reimbursement would be included in income in the year received to the extent of the tax benefit received in the prior year.

EXAMPLE 5-7

Use the same facts as in Exhibit 5-3. If Jose and Maria received the $14,000 medical insurance benefits in the subsequent year, they must include the benefit amount in income to the extent of the tax benefit received. Their medical expense deduction would have been $16,015, so they would have received a tax benefit equal to the entire $14,000. In this case, they would report the $14,000 in income in the tax year received on line 21, Other Income, on Form 1040.

One common misconception is that the entire amount of an insurance reimbursement will always be included in income. If the insurance reimbursement caused the itemized deductions to be lower than the standard deduction, only a limited amount of the reimbursement would be included in income. The taxpayer would have to compare the taxable income in the deduction year tax return as it was reported to the taxable income that would have been reported had the insurance reimbursement been received in that year. The difference is the amount of income reported.

CONCEPT CHECK 5-1— LO 5-1

1. Medical expenses are generally deductible only to the extent that they exceed __________ of AGI.
2. Medical expenses can be deducted only in the year the expenses are __________.
3. The deductible amount of medical expense is reduced by __________ for those expenses.
4. The cost of long-term care insurance premiums is deductible, but the extent of the deduction depends on the taxpayer's __________.

DEDUCTIBLE STATE AND LOCAL TAXES (SCHEDULE A, LINE 9)

LO 5-2

Taxes are deductible in various places on a tax return. In this section, we discuss taxes that are personal; that is, they are not paid in connection with a trade or business or any other activity relating to the production of income. For example, if an individual taxpayer owns rental property, the property taxes relating to the rental property are a *for* AGI deduction and are deducted on Schedule E (see Chapter 8). Likewise, if an individual taxpayer operates a business as a sole proprietorship, any payroll or property taxes paid relating to the business are deductible on Schedule C (see Chapter 6) and thus reduce AGI (*for* AGI deductions).

There are four major categories of deductible taxes on individual returns:

1. Personal property taxes.
2. Local real estate property taxes.
3. Other state and local taxes.
4. Foreign taxes.

[23] *Robinson, John v. Comm.* (1968) 51 TC 520, affirmed, vacated, and remanded by (1970, CA9) 422 F2d 873.

The taxes that most individual taxpayers deduct on Schedule A are state and local income taxes and property taxes on real estate and personal property.[24] For cash method taxpayers, deductible taxes are generally deductible in the year paid. For accrual method taxpayers, taxes are generally deductible in the year in which the taxes are accrued. One important note is that federal taxes generally are not deductible on the federal tax return.

Personal Property Taxes

Personal property taxes paid on personal-use assets, such as the family car, are deductible on Schedule A. Personal property taxes paid on rental property are deducted on Schedule E. Personal property taxes paid on assets used in a proprietor's business are deducted on Schedule C.

State or local property taxes must meet three tests to be deductible:

- The tax must be levied on personal property.
- The tax must be an *ad valorem tax*; that is, it must be based on the value of the property.
- The tax must be imposed, at a minimum, on an annual basis with respect to personal property.

TAX YOUR BRAIN

David lives in Johnson County and his brother Joseph lives in Lee County. Johnson County imposes a property tax of 2% of the value of personal vehicles. Lee County, on the other hand, imposes a flat fee of $250 per personal auto. Both counties impose the tax on an annual basis. How should David and Joseph treat these taxes?

ANSWER

David may deduct the tax he pays because it is an annual tax based on the value of personal property. Joseph, on the other hand, cannot deduct the property tax because it is a flat fee that is not based on value.

Many counties and states have different names for the taxes they levy. For example, some counties levy vehicle registration fees, which are deductible if they meet the preceding three tests. Usually the primary determinant is whether the fee is based on the value of the vehicle. If it is, the fee is deductible (assuming that it passes the other two tests).

Property taxes on real estate must meet the three tests as well. Taxes on real property usually are much higher than personal property taxes and may create additional controversy. Problems may develop in the following situations:

1. Jointly owned real property.
2. Sale of property during the tax year.

Property Taxes on Property Owned Jointly

In most states and counties, joint owners of property are jointly and severally liable for property taxes. In other words, if an individual is a part owner of a parcel of real estate and the other owner does not pay the real estate property taxes, that individual is liable for the full payment. In this situation, the owner who pays the tax may deduct the tax amount.[25]

EXAMPLE 5-8

Two brothers, Jake and Stan, own a parcel of real estate with ownership interests of 30% to Jake and 70% to Stan. Jake pays the entire $2,300 county real estate tax. If Jake and Stan live in a state where all joint owners are jointly and severally liable for the tax, then Jake can deduct the entire $2,300 on Schedule A.[26]

[24] IRC § 164.

[25] Rev. Rul. 72-79, 1972-1 CB 51.

[26] This assumes the real estate is not business or "for the production of income" property. If the property were business use property, the taxes would be *for* AGI deductions and deducted on Schedule C (business), Schedule E (rental property), or Schedule F (farming property). See Chapters 6 and 8.

If local law mandates that co-owners of property do not have joint and several liability for a tax, then only the proportionate share of the taxes can be deducted.

EXAMPLE 5-9

Assume the same facts as in Example 5-8. However, Jake and Stan live in a state that does not have joint and several liability for the tax. In this case, Jake's deduction is $690 ($2,300 × 30%) even though he paid the entire amount.[27]

Property Taxes on Property Sold during the Year

When property is sold during the year, both the buyer and the seller receive a deduction for a portion of the real estate tax paid according to the number of days each owner held the property.[28]

EXAMPLE 5-10

On March 1, David sold some land to Marsha. The real estate tax of $3,300 was not due until August, and Marsha properly paid it. How much, if anything, can David and Marsha deduct? In this case, the buyer and seller prorate the real estate tax on a daily basis. Therefore, David would deduct $533 ($3,300 × 59/365), and Marsha would deduct the remainder of $2,767 ($3,300 × 306/365). Note that the day of sale is not included in David's holding period, and we are assuming a non–leap year event.

The previous example could raise a question. If Marsha paid the tax, how can David get a deduction? At the time of transfer of ownership, a closing agent (often an attorney) prepares a *closing agreement* that prorates, or divides, the taxes (and other items) between the seller and the buyer. The taxes owed by the seller are withheld from the amount otherwise due to the seller. In effect, David paid the tax at the time of sale instead of at the due date.

Real Estate Taxes

Real estate property taxes are deductible in the calculation of federal taxable income. If the tax is paid on personal-use real estate, such as the taxpayer's principal residence, it is an itemized deduction on Schedule A. If it is paid on rental real estate, it is deducted on Schedule E in the calculation of the taxpayer's net income or loss from the rental property. If it is paid on business real estate, such as an office building that the taxpayer owned and used as a proprietor, it is deducted on Schedule C in the calculation of net profit or loss from self-employment.

Many individuals make monthly mortgage payments that include real estate property taxes as well as mortgage principal and interest. Each month, the real estate tax payment is deposited into an escrow account that the mortgage company uses to pay the property taxes when they are due. In this case, the taxpayer deducts the actual amount of property taxes ultimately paid to the local taxing authority from the escrow account, not the amount paid to the mortgage holder. The mortgage company notifies the individual of the amount of the taxes paid on a year-end statement, normally a Form 1098.

EXAMPLE 5-11

Miriam's monthly mortgage payment for her principal residence is $1,500, of which $1,250 is mortgage principal and interest and $250 is for real estate property taxes. Every month the mortgage company deposits the $250 tax payment into an escrow account. In November 2017, the mortgage company paid the actual tax bill of $2,800 from the escrow account. Miriam can deduct $2,800 of real estate property taxes on her 2017 Schedule A.

State and Local Taxes

The deduction for state income taxes is one of the largest itemized deductions for many taxpayers. Only seven states in the United States do not have some form of state income tax.[29]

[27] *James, Joseph J.* (1995) TC Memo 1995-562.

[28] IRC § 164(d)(1).

[29] Currently the only states that do *not* have some form of income tax are Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming.

EXAMPLE 5-12

Elijah lives in South Carolina and has state taxable income of $120,000. His state income tax is $7,200. If he itemizes, Elijah gets a deduction on Schedule A for that amount in the year the tax is paid.

In any year, an individual taxpayer can deduct the amount of state income taxes paid, whether through withholding, estimated taxes, or filing the prior year's state tax return. However, if the state tax payments that were deducted result in the taxpayer receiving a refund in the following year, the state tax refund must be included as taxable income in the year of receipt. This is the *tax benefit rule,* which states that if a taxpayer receives a federal tax benefit from an expense when the expense is paid, that taxpayer is taxed on a refund of that expense when the refund is received. If the taxpayer does not receive a tax benefit from the expense when it is paid, he or she is not taxed on a refund of that expense when it is received.

EXAMPLE 5-13

In 2016 Richard had $4,700 in state income tax withheld from his paycheck. When he filed his 2016 federal tax return in April 2017, he was eligible to itemize and thus deducted the $4,700 in state income taxes paid, thus reducing his 2016 taxable income and federal tax liability. When he filed his 2016 state tax return (also in April 2017), he found that he had overpaid his state taxes and was due a refund of $800. He received the $800 state refund in June 2017. The $800 refund must be included in federal taxable income for the tax year 2017. The reasoning behind the inclusion is that Richard received a tax benefit for the entire $4,700 even though, in the end, he paid only $3,900 ($4,700 tax paid less the $800 refund). The inclusion of the $800 in income in the subsequent year corrects the excess deduction. The $800 is included on Form 1040, line 10, Taxable refunds, credits, or offsets of state and local taxes.

Taxpayers who do not itemize deductions (but claim the standard deduction) cannot deduct state income tax. Thus, if they get a refund, it is nontaxable income on their federal return because they received no tax benefit from a nondeductible expense. A refund of that expense is therefore not subject to tax. The same rules apply to taxpayers who are required to pay city or other local income taxes.

Employers may be required to withhold *state disability insurance* (SDI) from the paychecks of their employees in the state of California. California SDI is treated as state income tax for purposes of calculating federal taxable income.

Taxpayers may be able to elect to take an itemized deduction for the amount of either (1) state and local income taxes or (2) state and local general sales taxes paid during the tax year.[30] Taxpayers generally cannot deduct both. In general, taxpayers in states with an income tax will take the income tax deduction whereas taxpayers in states with no income tax will take the sales tax deduction. In states with both a state income tax and a state sales tax, the taxpayer will take the one with the greater benefit.

The amount of the sales tax deduction is determined by calculating actual sales taxes paid during the year. From a practical perspective, most taxpayers would find it difficult to determine and document actual sales tax payments. Thus a deduction is permitted using sales tax tables provided by the IRS in the instructions for Schedule A or by using the sales tax deduction calculator the IRS provides at http://apps.irs.gov/app/stdc/. To use the calculator, you can either copy and paste into your browser the URL just provided, or go to www.irs.gov and enter "sales tax deduction calculator" in the search box. When using the sales tax tables, taxpayers determine their sales tax deduction based on their income and number of exemptions. Income is defined as AGI plus any nontaxable items such as tax-exempt interest, workers' compensation, nontaxable social security or retirement income, and similar items. The number of exemptions is equal to the exemptions claimed on Form 1040, line 6d.

[30] IRC § 164(b)(5)

EXAMPLE 5-14

Lester and Charmaine live in Clearwater, FL 33755 with their two dependent children. Florida does not have a state income tax. The couple had AGI of $79,337 and interest income from a tax-exempt municipal bond of $2,190. Using the IRS sales tax deduction calculator tool for income between $80,000 and $90,000 with four exemptions and their zip code, you can calculate the itemized general sales tax deduction available to Lester and Charmaine.

Taxpayers who purchase an aircraft, boat, or in most cases a home or addition to a home, can add the amount of sales tax paid on those items to the amount of sales tax determined with reference to the IRS tables.[31]

Taxpayers claim the general sales tax deduction on Schedule A, line 5. The Schedule A instructions contain a worksheet for calculating the state and local sales tax deduction. The state and local sales tax tables are located in the appendix of the Schedule A instructions.

Foreign Taxes

Foreign taxes paid are deductible.[32] The taxpayer has the option of taking a credit (discussed in Chapter 9) for foreign taxes paid or deducting them on Schedule A. Individual taxpayers are usually better off utilizing the credit rather than the deduction because the credit is a dollar-for-dollar reduction in taxes, but the deduction reduces only taxable income, and the net tax effect depends on the taxpayer's tax rate.

EXAMPLE 5-15

Daniel, a U.S. citizen and resident, has several investments in England. The investments produced substantial income, and he had to pay $3,500 in English income taxes. Assume that Daniel's effective U.S. federal tax rate is 35%. He has a choice: File Form 1116 and take a $3,500 credit for the English tax, assuming that the foreign tax credit limitation does not apply, or deduct the taxes on Schedule A as an itemized deduction. The credit will reduce Daniel's net U.S. tax by $3,500. If he takes the deduction option, his net tax savings is only $1,225 ($3,500 × 35%). Clearly the better tax option is to file Form 1116 and take the credit.

A taxpayer cannot take both the credit and the deduction for the same foreign taxes paid. In most instances, the credit produces the better tax effect. However, if a taxpayer pays taxes to a country with which the United States has severed diplomatic relations or to a country that supports international terrorism, the credit is not allowed.[33] In this case, the deduction of the tax on Schedule A is the only option.

Documentation for State and Local Taxes

Generally the source document for property taxes (both personal and real property) is the receipt from the county or city tax collector. Other sources for property taxes are canceled checks. Many lending institutions escrow the property taxes along with the mortgage payment. If this is the case, the amount of property taxes is listed on the year-end mortgage interest statement (Form 1098) that the lending institution supplies. When real property is sold during the year, the allocation of the property taxes is usually shown on the closing statements signed when title changes hands.

For state income taxes, there are normally three source documents. For the majority of clients, the largest portion of state income taxes paid comes from the taxpayer's W-2 wage statement as state income tax withholding. Taxpayers who are self-employed or have considerable investment income could also pay quarterly estimated payments during the year. Usually, canceled checks to the state's department of revenue or other tax authority suffice as

[31] IRC § 164(b)(5)(H)(i) and IRS Publication 600.
[32] IRC § 164(a)(3).
[33] IRC § 901(j)(2).

documentation. The third source document is the prior year's state tax return. Reviewing the prior year return is crucial because it will show any tax paid with the prior year's return. If there was a refund, the tax preparer will know to include the refund in income for the current year (assuming the taxpayer itemized his or her return and deducted state taxes in the previous year).

Foreign taxes are sometimes more difficult to locate. The traditional source documents to locate foreign taxes paid include these:

1. The prior year's tax return from the foreign country.
2. Mutual fund or stock brokerage statements.
3. Canceled checks.

Some mutual funds or brokerage offices are required to withhold or pay foreign taxes on the sale of stock within the mutual fund. These taxes, in turn, pass through to investors. In addition, if a taxpayer invests in foreign stocks, taxes are often withheld from foreign dividends received. These withholdings are reported to the taxpayer on Form 1099-B.

Summary of Deductible Taxes

Type	**Potential Source Documents**
Personal property	County/city tax collector receipt Checkbook register/canceled check
Real estate property taxes	County/city tax collector receipt Checkbook register/canceled check Real estate closing statements Form 1098—Bank Mortgage Interest
State/local income tax	W-2 wage statement—State withholding box W-2 wage statement—Local withholding box Quarterly estimated tax payments Prior year's state/local tax return
Foreign	Prior year's foreign tax return Mutual fund/stock statements Canceled checks

CONCEPT CHECK 5-2—
LO 5-2

1. For personal property taxes to be deductible, they must be based on the value of the property. True or false?
2. When property is sold during the year, only the seller is allowed to take a deduction for taxes paid. True or false?
3. The tax benefit rule states that if a taxpayer receives a tax benefit when an expense is paid, no further action is required on the taxpayer's part if a refund is received in the future as a result of the previous expense deduction. True or false?
4. A taxpayer generally has the option to deduct foreign taxes paid either as a credit or as a deduction on Schedule A. True or false?

DEDUCTIBLE INTEREST (SCHEDULE A, LINE 15)
LO 5-3

Most taxpayers in the United States do not itemize deductions until they purchase their first residence. The main component of the interest deduction is the home mortgage deduction. In the past, almost all types of personal interest were deductible on Schedule A. However, consumer loan interest deductions (such as auto loan interest and credit card interest) have been virtually eliminated. The only types of personal interest still available as a deduction are mortgage interest on a personal residence and investment interest. Any interest connected with

From Shoebox to Software

EXAMPLE 5-16

Locate the saved tax file for Jose and Maria Ramirez from earlier in this chapter. They had the following additional information:

Property or Activity	Tax
Jose's state income tax withheld (per W-2)	$3,470
State estimated tax payments ($250 per quarter with the last payment on 12/31/17)	1,000
State taxes paid with prior year return	300
Foreign taxes paid on foreign stock investments	400
Personal residence real estate property tax	1,300
Truck	200
Van	250
Ski boat	200

Lines 5–9 on Schedule A are the appropriate lines to record deductible personal taxes. Go to Schedule A for the Ramirezes.

1. Note that the state withholding is already on line 5 from the W-2 you entered previously.
2. To enter the state estimated tax payments, double-click on the state and local estimates line. Enter the $250 per quarter payments and the dates they were paid.
3. Enter the $300 paid with last year's return (usually filed in April) on the Other state and local income taxes line.
4. Enter the personal residence property tax ($1,300) on the real estate tax line (line 6).
5. Enter the total of the taxes on the truck, van, and boat on line 7. You can use the line item detail by right-clicking on line 7 and entering each item individually. The total from the worksheet will then be carried forward to line 7.

When you have completed Schedule A for taxes, it will look like the one in Exhibit 5-4.

The total itemized deduction for taxes equals $6,720. The foreign taxes of $400 could have been placed on line 8, but the Ramirezes would most likely receive a higher tax benefit by filing Form 1116 and taking the $400 as a foreign tax credit.

EXHIBIT 5-4

Taxes You Paid	5	State and local **(check only one box):**				
		a ☑ Income taxes, **or** / b ☐ General sales taxes	5	4,770		
	6	Real estate taxes (see instructions)	6	1,300		
	7	Personal property taxes	7	650		
	8	Other taxes. List type and amount ▶	8			
	9	Add lines 5 through 8			9	6,720

Source: U.S. Department of the Treasury, Internal Revenue Service, Form 1040- Schedule A. Washington, DC: 2017.

a trade or business or for the production of income is still deductible. However, these amounts are *for* AGI deductions and are deducted on the appropriate form (Schedule C, Schedule E, or Schedule F).

Mortgage Interest and Home Equity Loans

Interest is the fee paid by a borrower to a lender for the use or forbearance of money. Congress encourages home ownership by granting an itemized deduction for qualified residence interest, better known as *home mortgage interest.* Qualified residence interest is *interest paid on acquisition indebtedness or a home equity loan secured by a qualified residence.* If the loan is not secured by a qualified residence, the interest is not qualified residence interest. *Acquisition indebtedness* means any debt incurred to acquire, construct, or substantially improve any qualified residence.[34]

[34] IRC § 163(h)(3)(B)(i).

TAX YOUR BRAIN

Suppose the taxpayer has a large unsecured personal line of credit with the local lending institution and borrows $15,000 to add a large closet to the existing residence. Does the interest charged by the institution on the $15,000 qualify as residence interest?

ANSWER

No. Because the debt was not secured by the residence, the interest would not be deductible. Had the line of credit been a home equity line, the interest would be deductible.

Taxpayers can deduct qualified residence interest on their principal residence and on a second residence selected by the taxpayer.[35] The aggregate amount treated as acquisition indebtedness for any period cannot exceed $1,000,000 ($500,000 for married individuals filing separate returns). The $1,000,000 limitation refers to the amount of *principal* of the debt, not the interest paid. Taxpayers may have more than one acquisition loan per residence (a first mortgage and a second mortgage).

If the taxpayer refinances an acquisition loan (for example, refinances a $260,000, 6% loan with a new $260,000, 4% loan), the new loan continues to qualify as acquisition debt to the extent that the principal does not increase. If the principal does increase as a result of the refinance, the interest related to that additional principal does not qualify for the deduction. There is a worksheet on page 9 of IRS Publication 936 that can be used to calculate the allowable mortgage deduction.

EXAMPLE 5-17

Cathy and Mark, who are married, incur debt of $580,000 to build their new personal residence. In the following year, they decide to build a vacation home at the beach and borrow an additional $500,000 to build it. Cathy and Mark's acquisition indebtedness is limited to $1,000,000. In this case, the additional interest on the excess $80,000 of indebtedness is allowed. However, it must be classified as home equity indebtedness. Home equity indebtedness may not exceed $100,000.[36] Thus the true debt limit to qualified residence interest is $1,100,000 for those filing MFJ.

The 9th Circuit Court of Appeals recently ruled that the mortgage interest deduction debt limits apply to unmarried co-owners *on a per-taxpayer basis, not on a per-residence basis* and the IRS, in AOD (Action on Decision) 2016-02, acquiesced to that decision.

The implication of this ruling is very important. Whereas a married couple filing jointly is seen as effectively being one taxpayer, and thus subject to the overall mortgage interest deduction limit of up to $1 million dollars in acquisition debt, an unmarried couple that owns a property together would be subject to a mortgage interest deduction of up to $1 million dollars in acquisition debt per individual.

This would also apply to the Home Equity interest deductions limitations as well. Assume that a non-married couple acquires a new house, owning the home as joint tenants. Also assume the total acquisition mortgage debt is $2,000,000 and the total home equity loan is $200,000, making the total debt $2,200,000. Under this new ruling, each person would be able to deduct the interest on their portion of the total debt which would be $1,100,000 per individual. This becomes another example of the "Marriage Penalty" that we see elsewhere in the tax code.

In Example 5-17, we noted that home equity indebtedness can increase the effective limit of the home mortgage deduction to interest on $1,100,000. What is *home equity indebtedness,* and how does it differ from acquisition indebtedness? *Home equity loans* are loans that are secured by a qualified residence in an amount that does not exceed the FMV of the residence less the acquisition debt.

[35] IRC § 163(h)(4)(A)(i)(II).

[36] IRC § 163(h)(3)(C)(ii).

EXAMPLE 5-18

Bryan purchased a house several years ago for $130,000. The acquisition debt still outstanding is $115,000. The house's FMV is now $150,000. Therefore, the net equity in the house is now $35,000 ($150,000 FMV − $115,000 debt). Bryan could borrow as home equity indebtedness up to $35,000, and the interest would still be deductible (most lending institutions, however, will lend only up to 80% or 90% of the net equity in the personal residence).

The aggregate amount treated as home equity indebtedness for any period cannot exceed $100,000 for MFJ ($50,000 for married filing separately) but, as pointed out in the previous paragraph, for unmarried co-owners of a property that interest limitation would be on $100,000 of home equity debt per person.[37] Interest on home equity debt is an adjustment for the Alternative Minimum Tax (AMT).

Mortgage Points

Points are amounts that borrowers pay to obtain a mortgage. The most common names of these charges are "loan origination fees" or "loan processing fees." Each point equals 1% of the loan principal. For example, Marisa pays 2 points on a $100,000 mortgage loan. The points equal $2,000 (0.01 × 2 × $100,000). Typically taxpayers deduct points ratably over the term of the loan. However, the law allows an exception for points paid in connection with a principal residence. Points are deductible by a cash basis taxpayer as mortgage interest if they meet the following "safe harbor" criteria:

1. The Uniform Settlement Statement must clearly designate the amounts as loan origination fees, loan discount, discount points, or points payable in connection with the loan.
2. The amounts must be computed as a percentage of the stated principal amount of the indebtedness incurred by the taxpayer.
3. The amounts paid must conform to an established business practice of charging points for loans for the acquisition of principal residences in the geographical area.
4. The amounts must be paid in connection with the acquisition of the taxpayer's principal residence, and that residence must secure the loan.
5. The amounts must be paid directly by the taxpayers.[38]

Generally the buyer of the home incurs points when obtaining a loan. As an inducement for the sale, the seller of the residence may actually pay the points for the buyer. If this is the case, the buyer receives the tax benefit if the point amount reduces the basis of the home when the property is sold. Taxpayers can take a deduction for the points paid only if the indebtedness is incurred in connection with the purchase or improvement of their principal residence. Points paid to refinance an existing mortgage are deducted ratably over the life of the loan. If the loan is paid off before it is due, the unamortized points are deductible in the year the debt is paid.

EXAMPLE 5-19

Jason and his wife purchased a home in 2003 for $230,000. They borrowed $184,000 with a 30-year, 6.5% note from a local lending institution. In 2017, Jason decided to make an addition to the house that would cost $75,000. He and his wife borrowed the $75,000 and paid a 1% loan origination fee. In 2017, the $750 in points could be deducted because the indebtedness was in connection with the improvement of their principal residence.

EXAMPLE 5-20

Assume the same initial facts as Example 5-19. However, instead of the $75,000 addition, Jason and his wife decided to refinance their loan (balance now at $175,000) because the interest rate was now 3.5% for a 30-year loan. The 1% origination fee of $1,750 cannot be fully deducted this year because the new loan was not for the original purchase or improvement of the residence. They can deduct the points ratably over the 30-year loan period or $58 per year ($1,750/30 years). If the refinancing had occurred on June 1, then the deduction for the current year would be $34 ($1,750/30 years × 7/12).[39]

[37] IRC § 163(h)(3)(C)(ii).

[38] Rev. Proc. 94-27, 1994-1 CB 613.

[39] Rev. Proc. 87-15, 1987-1 CB 624.

Mortgage Insurance Premium Deduction

Often individuals who purchase a home with a down payment of less than 20% are required to pay a mortgage insurance premium or, as it is sometimes referred to, *private mortgage insurance* (PMI). In effect, mortgage insurance protects the lender against a loan default. In the past, the mortgage insurance premium was not deductible. For mortgage insurance contracts issued in 2017, the taxpayer may take an itemized deduction for the amount of the premium paid in 2017 on line 13 of Schedule A.

The deductible amount is reduced by 10% for every $1,000 ($500 if married filing separately) by which AGI exceeds $100,000 ($50,000 if married filing separately). Thus the deduction is not allowed when AGI exceeds $110,000 ($55,000 if married filing separately).

Investment Interest

If a taxpayer borrows money to finance the purchase of investment assets—such as stocks, bonds, or land held strictly for investment—the interest expense is investment interest expense.

Investment interest expense is any interest that is paid or accrued on indebtedness properly allocable to property held for investment. The deduction of investment interest expense is limited to the net investment income for the year and is deductible as an itemized deduction on Schedule A.[40] Net investment income is gross investment income less deductible investment expenses. If the investment interest expense exceeds the taxpayer's net investment income, he or she can carry forward the excess expense to future tax years when net investment income is available. One common example of investment interest expense is interest from a loan whose proceeds the taxpayer uses to purchase stock.

EXAMPLE 5-21

Gayle purchased a tract of land that she felt would substantially appreciate over the next several years. She borrowed $20,000 from a local lending institution and signed a 7%, 15-year note. If Gayle's only investment income is interest of $1,000, she could deduct the interest on the lending institution loan up to a maximum of $1,000 in the current year (her net investment income). Any remaining amount of interest would be carried forward to future years and would be deducted when additional net investment income becomes available.

Typical items that qualify as investment income are interest income, ordinary dividends, and short-term capital gains. However, gains and losses from the disposition of several investment properties must first be netted to determine investment income. Income from passive activities and income from rental real estate with active participation are specifically excluded from the definition of investment income, as well as net long-term capital gains and qualified dividend income.[41] However, if a taxpayer elects to treat a portion of long-term capital gain or qualified dividend income as investment income, the long-term gain or dividend income is not eligible for the lower tax rate that would otherwise apply.[42] Generally taxpayers use Form 4952 to calculate and report the amount of deductible investment interest expense. However, Form 4952 does not have to be included with the return if all three of these circumstances apply:

1. Investment interest expense does not exceed investment income from interest and ordinary dividends minus qualified dividends.
2. The taxpayer has no other deductible investment expenses.
3. The taxpayer has no disallowed investment interest expense from 2016.

Net investment income may now be subject to a 3.8% Medicare tax for AGI over certain thresholds.

[40] IRC § 163(d)(1).

[41] IRC § 163(d)(4)(D). Passive activities and rental real estate are discussed in detail in Chapters 8 and 13, respectively.

[42] IRC § 163(d)(4)(B).

From Shoebox to Software

Determining the amount of the total interest deduction usually is not difficult. In most cases, a financial institution sends the taxpayer Form 1098 reporting the interest expense. See Exhibit 5-5 for an example of a common Form 1098 from a financial institution.[43]

EXAMPLE 5-22 Assume that the Form 1098 in Exhibit 5-5 was for Jose and Maria Ramirez and had $7,300 on line 1. To enter the $7,300 on line 10 of Schedule A, you must enter the amount on a Form 1098. Enter the $7,300 on line 1, and it will automatically be transferred to Schedule A. Save the Ramirezes' return for future use.

Difficulty can arise when a taxpayer has numerous loans outstanding. Typically the lending institution labels the interest as related to the principal residence (either acquisition indebtedness or home equity indebtedness). However, if the taxpayer has several loans, some of which are personal loans (like a car loan) and others are investment loans, the tax preparer must question the client to discover which loans are for what activities.

EXHIBIT 5-5

☐ CORRECTED (if checked)

RECIPIENT'S/LENDER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.

***Caution:** The amount shown may not be fully deductible by you. Limits based on the loan amount and the cost and value of the secured property may apply. Also, you may only deduct interest to the extent it was incurred by you, actually paid by you, and not reimbursed by another person.

OMB No. 1545-0901

2017

Form **1098**

Mortgage Interest Statement

RECIPIENT'S/LENDER'S federal identification number

PAYER'S/BORROWER'S taxpayer identification no.

PAYER'S/BORROWER'S name

Street address (including apt. no.)

City or town, state or province, country, and ZIP or foreign postal code

10 Number of mortgaged properties

11 Other

Account number (see instructions)

1 Mortgage interest received from payer(s)/borrower(s)*
$

2 Outstanding mortgage principal as of 1/1/2017
$

3 Mortgage origination date

4 Refund of overpaid interest
$

5 Mortgage insurance premiums
$

6 Points paid on purchase of principal residence
$

7 Is address of property securing mortgage same as PAYER'S/BORROWER'S address?
If "Yes," box is checked . . . . ☐
If "No," see box 8 or 9, below

8 Address of property securing mortgage

9 If property securing mortgage has no address, below is the description of the property

Copy B
For Payer/ Borrower

The information in boxes 1 through 10 is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if the IRS determines that an underpayment of tax results because you overstated a deduction for this mortgage interest or for these points, reported in boxes 1 and 6; or because you didn't report the refund of interest (box 4); or because you claimed a non-deductible item.

Form **1098** (Keep for your records) www.irs.gov/form1098 Department of the Treasury - Internal Revenue Service

Source: U.S. Department of the Treasury, Internal Revenue Service, Form 1098. Washington, DC: 2017.

[43] Many financial institutions develop their own Form 1098 (labeled Form 1098 Substitute). Therefore, the form may differ somewhat depending on the institution. The form, however, reports the same information.

CONCEPT CHECK 5-3—
LO 5-3

1. Acquisition indebtedness means any debt incurred to ____________________, ____________, or ____________ any qualified residence.
2. The aggregate amount treated as acquisition indebtedness, not home equity indebtedness, for any period cannot exceed $ ____________ for married filing jointly.
3. The deduction of investment interest expense is limited to the ________ ________ income for the year.
4. Each point paid to acquire a home loan equals ____________ of the loan principal.

DEDUCTIBLE GIFTS TO CHARITY (SCHEDULE A, LINE 19)

LO 5-4

The government encourages the private sector to support charitable organizations by granting individual taxpayers a charitable contribution deduction, which may be claimed as an itemized deduction on Schedule A. Contributions must be to one of the following five types of organizations:[44]

1. Any governmental unit or subdivision of the United States or its possession as long as the gift is for exclusively public purposes.
2. Any nonprofit organization that is organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes or to foster international amateur sports competition and is not disqualified from tax-exempt status under IRC § 501(c)(3).
3. A post or organization of war veterans for which no part of the net earnings benefits any private shareholder or individual.
4. A domestic fraternal society or association that uses the contribution only for religious, charitable, scientific, or educational purposes.
5. A cemetery company owned and operated exclusively for the benefit of its members.

If you are uncertain whether an organization is a qualified donee organization, check the IRS Exempt Organization on-line search tool at www.irs.gov/charities-non-profits/exempt-organizations-select-check.

The amount of the deduction depends on the type of donated property and is subject to AGI limitations. To be deductible, the donation must be cash or other property of value. The government imposes strict documentation requirements for both types of contributions.

A taxpayer receives no deduction for services rendered to a charitable organization.[45] The services do not give rise to taxable income to the taxpayer, so no deduction is permitted.

A taxpayer who travels away from home overnight to attend a convention as a representative of a charitable organization may deduct related transportation and travel expenses, including meals and lodging. If the taxpayer incurs travel expenses as a volunteer for a qualified charity, the expenses are deductible if he or she has significant duties throughout the course of the trip and no significant amount of personal recreation is attached to the trip.

EXAMPLE 5-23

Kathy, a local CPA, is an ardent supporter of the Boys Club in Hickory Hills, AL. Each year she compiles monthly financial statements and prepares the Form 990 tax return for the club. Kathy estimates that she spends 20 hours per year working for the Boys Club. Her normal rate is $100 per hour. Because Kathy's donation is her services and she has recorded no income for those services, she receives no charitable contribution deduction.

Kathy is able to deduct any out-of-pocket expenses she paid in connection with her service to the Boys Club. Actual expenditures are deductible for automotive travel, or the taxpayer has the option to deduct 14 cents per mile as a standard rate for charitable contributions.

Property Donations: Capital versus Ordinary Income Property

Not all donations to charity are in the form of cash. In fact, many large donations are made with capital gain property (such as stocks, bonds, land, and other investments). Still other donations

[44] IRC § 170(c).

[45] Reg. § 1.170A-1(g).

are made with ordinary income property (inventory and accounts receivable). Generally, if capital gain property is donated to a public charity, the deductible donation amount is the property's FMV.

Charitable Contribution of Personal Tangible Property Clarification

A key exception to this general rule concerns the contribution of tangible personal property. If the donated property is put to a use that is unrelated to the purpose or function of the charity's tax-exempt status, the contribution must be reduced by the amount of any long-term capital gain that would have been realized if the property had been sold at its FMV at the time of the contribution. For example, if a sculpture is donated to a museum and is put on display for the public, that would be a related purpose. If, however, the museum had simply sold the sculpture without displaying it and used the funds for museum operations, that would be an unrelated purpose and would require this exception. A second exception occurs if the investment property is short-term property (held one year or less). In this case, the deduction is limited to the tax basis of the asset (its cost). The donation of investment/capital gain property is also subject to additional limitations depending on the type of the recipient organization (see the following section on limitations).

EXAMPLE 5-24

Kimberly donated her old computer to Helping Hands Industries. She had purchased the computer for personal use several years ago at a cost of $1,500. The computer's FMV at the date of donation was $400. The computer is a capital asset held for more than one year, so Kimberly may deduct the $400 FMV as a charitable contribution, subject to the overall charitable contribution limits.

Generally, when ordinary income property (such as inventory and accounts receivable) is donated to charity, the deduction amount is limited to the tax basis of the property donated. The deduction does not depend on the type of recipient organization.

Percentage Limitations of Charitable Donations

There are three limitations concerning charitable contributions by individual taxpayers: 50%, 30%, and 20% limitations. The general limitation is the 50% limitation. All charitable contributions to public charities are limited to 50% of the individual taxpayer's AGI.[46] A contribution in excess of the limitation is carried forward for the next five tax years, subject to the overall 50% limitation in those years. For each category of contributions, the taxpayer must deduct carryover contributions only after deducting all allowable contributions in that same category for the current year. The deduction of amounts from previous years is done on a first-in, first-out, basis.

EXAMPLE 5-25

Doris is a wealthy widow and has $200,000 in AGI from various investments. If she makes a $150,000 cash donation to State University, her charitable deduction is limited to $100,000. The remaining $50,000 is carried forward for up to five years.

The 30% limitation applies to contributions of long-term tangible capital gain property. When long-term tangible capital gain property is contributed to a public charity, and the property is put to a related use by the charity, the taxpayer can take a deduction for the asset's FMV. However, the deduction is limited to 30% of the taxpayer's AGI.[47] Again, any excess is carried forward for five years.

EXAMPLE 5-26

Assume the same facts as in Example 5-25. However, instead of giving cash of $150,000, Doris contributed a vacation cottage that she has owned for many years. The cottage, which is in a marshland and could be used for research purposes, has an FMV of $150,000. The university uses the cottage as a research station for biology and zoology students, which would be a related use. In this case, Doris's deduction is limited to $60,000 for this year ($200,000 AGI × 30% limitation). The excess $90,000 of elgible deduction is carried forward for the next five years.

[46] IRC § 170(b)(1)(A).

[47] IRC § 170(b)(1)(C).

There is one exception to this rule: If the taxpayer elects to reduce the FMV of the contributed property by the amount of long-term capital gain that would have been recognized if the property had been sold at its FMV at the time of the contribution, the 50% limitation would apply to the contribution, rather than the 30% of AGI limitation.[48]

EXAMPLE 5-27

Assume the same facts as in Example 5-26. However, Doris elects to reduce the fair market value FMV of the cottage by the amount of long-term capital gain she would have recognized if she had sold the cottage. Her adjusted basis in the cottage is $70,000. Her charitable contribution would therefore be $70,000 because 50% of her AGI of $200,000 would be a $100,000 limitation on charitable contributions.

Another exception to this rule concerns the donation of long-term tangible capital gain property to a charity that the charity uses for purposes unrelated to the organization's function.

EXAMPLE 5-28

Assume the same facts as in Example 5-26, except that the university promptly sells the cottage. In this case, the deduction would be limited to Doris's adjusted basis in the cottage of $70,000 because the presumption is that the use of the property was unrelated to the university's tax-exempt purpose. In this exception the 30% limit does not apply, and the deduction would be based on 50% of AGI, as seen in Example 5-27.

The 30% limitation also applies to any contribution (cash or property) to charities that are not 50% limitation charities such as war veterans' organizations, fraternal orders, cemetery companies, and certain nonoperating private foundations.

The 20% limitation refers to the donation of capital gain property to a private foundation. The deduction for cash given to a private foundation is limited to 30% of AGI, whereas capital gain property given to the same organization is limited to 20% of AGI.[49]

One final limitation involves a charitable contribution to an educational institution that gives the taxpayer the right or benefit to preferential treatment at athletic events. The most common example is preferential seating rights at football and basketball games. If an otherwise deductible contribution to a university or college allows the taxpayer to get preferential seating, that donation is limited to 80% of the payment.[50] Any portion of the payment that is for tickets is nondeductible, and the excess is limited to 80%.

EXAMPLE 5-29

Samatha, a wealthy business owner, gave the following amounts to State College: $4,500 for 30 season tickets for woman's basketball and $10,000 to its athletic foundation for preferential seating location and parking. The $4,500 is not deductible at all because the taxpayer is buying a product; the $10,000 donation is limited to $8,000 (80% of $10,000).

Required Documentation of Charitable Gifts

Recently the substantiation requirements for charitable contributions have become more stringent. The nonprofit organizations themselves bear most of the increased requirements. They are now required to provide summary receipts to donors. From the taxpayer's perspective, when a gift to a charitable organization is less than $250 in cash, the contributor is required to keep a canceled check, a receipt from the organization, or other written records to substantiate the deduction.[51] If the donation is more than $250, the taxpayer must have written acknowledgment from the recipient organization stating (1) the date and amount of the contribution, (2) whether the taxpayer received any goods or services from the charity as a result of the

[48] IRC § 170(b)(1)(C)(iii).
[49] IRC § 170(b)(1)(D).
[50] IRC § 170(l)(2).
[51] Reg. § 1.170A-13(a)(1)(i)–(iii).

contribution, and (3) a description and good-faith estimate of the value of any goods and services that the taxpayer received. A canceled check does not meet the substantiation requirements for donations of more than $250.

EXAMPLE 5-30 John goes to a church function organized to raise funds for a new youth group building. He pays $500 for a painting that has a $100 FMV. John's charitable contribution to the church is $400. To substantiate the deduction, he must get a receipt from the church and keep his canceled check.

Taxpayers are not required to aggregate multiple contributions they make to a charity during the year for purposes of the $250 limit. The required documentation is based on the amount of each separate contribution.

EXAMPLE 5-31 Every week, Adina donates $50 to her synagogue. In October 2017, she made an additional $500 contribution to the temple building fund. Adina may document each weekly contribution with a canceled check. To take the $500 contribution as a deduction, she must receive a written acknowledgment from the synagogue. It must state the date and amount of the contribution and the fact that Adina received no goods or services from the temple as a result of her donation.

From Shoebox to Software

EXAMPLE 5-32 Jose and Maria Ramirez gave the following items to their church: (1) cash $1,000, no individual contribution greater than $250, (2) a painting with an FMV of $750, basis $500, and (3) three large bags of used clothing. The Ramirezes' charitable contribution would be calculated and placed on Schedule A and Form 8283 as follows:

Cash	$1,000
Painting	750
Clothes (thrift value)[52]	200
Total	$1,950

Open their tax return. Enter the cash contributions directly on line 16 of Schedule A. Form 8283 is required for noncash gifts in excess of $500. Double-click on line 17 or open a Form 8283. Enter the required information as shown on Form 8283 in Exhibit 5-6. Make sure you save your file when you have finished.

EXHIBIT 5-6

Gifts to Charity	16	Gifts by cash or check. If you made any gift of $250 or more, see instructions	16	1,000		
If you made a gift and got a benefit for it, see instructions.	17	Other than by cash or check. If any gift of $250 or more, see instructions. You **must** attach Form 8283 if over $500	17	950		
	18	Carryover from prior year	18			
	19	Add lines 16 through 18			19	1,950

Source: U.S. Department of the Treasury, Internal Revenue Service, Form 8283. Washington, DC: 2017.

(continued)

The substantiation requirements are the same for noncash gifts. A taxpayer who donates noncash property valued at less than $250 should obtain a receipt or letter from the charity showing the name of the charity, the date and location of the contribution, and a description of the donated property. The charity is not required to value the donated property, but the taxpayer should keep a record of the property's FMV at the date of the donation and how that FMV was determined.

However, if noncash gifts are worth more than $500, the taxpayer must file Form 8283 on which he or she must list the organization's name, a description of the property, the date acquired, the

[52] *Thrift value* is the value for which the clothes could be sold. In most cases, thrift value is a very subjective value.

EXHIBIT 5-6 *(concluded)*

Form **8283** (Rev. December 2014) Department of the Treasury Internal Revenue Service

Noncash Charitable Contributions

► **Attach to your tax return if you claimed a total deduction of over $500 for all contributed property.**

► **Information about Form 8283 and its separate instructions is at *www.irs.gov/form8283*.**

OMB No. 1545-0908

Attachment Sequence No. **155**

Name(s) shown on your income tax return | **Identifying number**

Note. Figure the amount of your contribution deduction before completing this form. See your tax return instructions.

Section A. Donated Property of $5,000 or Less and Publicly Traded Securities—List in this section **only** items (or groups of similar items) for which you claimed a deduction of $5,000 or less. Also list publicly traded securities even if the deduction is more than $5,000 (see instructions).

Part I **Information on Donated Property—**If you need more space, attach a statement.

1	**(a)** Name and address of the donee organization	**(b)** If donated property is a vehicle (see instructions), check the box. Also enter the vehicle identification number (unless Form 1098-C is attached).	**(c)** Description of donated property (For a vehicle, enter the year, make, model, and mileage. For securities, enter the company name and the number of shares.)
A		☐	
B		☐	
C		☐	
D		☐	
E		☐	

Note. If the amount you claimed as a deduction for an item is $500 or less, you do not have to complete columns (e), (f), and (g).

	(d) Date of the contribution	**(e)** Date acquired by donor (mo., yr.)	**(f)** How acquired by donor	**(g)** Donor's cost or adjusted basis	**(h)** Fair market value (see instructions)	**(i)** Method used to determine the fair market value
A						
B						
C						
D						
E						

Part II **Partial Interests and Restricted Use Property—**Complete lines 2a through 2e if you gave less than an entire interest in a property listed in Part I. Complete lines 3a through 3c if conditions were placed on a contribution listed in Part I; also attach the required statement (see instructions).

2a Enter the letter from Part I that identifies the property for which you gave less than an entire interest ► ________
If Part II applies to more than one property, attach a separate statement.

b Total amount claimed as a deduction for the property listed in Part I: **(1)** For this tax year ► ________
(2) For any prior tax years ► ________

c Name and address of each organization to which any such contribution was made in a prior year (complete only if different from the donee organization above):

Name of charitable organization (donee)

Address (number, street, and room or suite no.)

City or town, state, and ZIP code

d For tangible property, enter the place where the property is located or kept ► ________

e Name of any person, other than the donee organization, having actual possession of the property ► ________

		Yes	No
3a	Is there a restriction, either temporary or permanent, on the donee's right to use or dispose of the donated property?		
b	Did you give to anyone (other than the donee organization or another organization participating with the donee organization in cooperative fundraising) the right to the income from the donated property or to the possession of the property, including the right to vote donated securities, to acquire the property by purchase or otherwise, or to designate the person having such income, possession, or right to acquire?		
c	Is there a restriction limiting the donated property for a particular use?		

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 62299J Form **8283** (Rev. 12-2014)

Source: U.S. Department of the Treasury, Internal Revenue Service, Form 8283. Washington, DC: 2017.

acquisition method of the property, the cost or basis, and the FMV. If the value of the donated property is more than $5,000, an appraisal is required within 60 days prior to the date of contribution.

CONCEPT CHECK 5-4—
LO 5-4

1. Depending on the type and amount of a charitable donation, it can be claimed either as a *for* AGI deduction or as an itemized deduction on Schedule A. True or false?
2. The overall limitation on the deductibility of charitable contributions is 30% of AGI. True or false?
3. If noncash gifts are worth more than $500, the taxpayer must file Form 8283. True or false?

DEDUCTIBLE CASUALTY AND THEFT LOSSES (SCHEDULE A, LINE 20)

LO 5-5

The Internal Revenue Code notes three instances in which an individual taxpayer can deduct a loss of property.[53] The first two deal with business or "production of income" property. Such losses are *for* AGI deductions[54] and are treated differently than losses to personal-use property. Losses discussed in this section pertain to losses of personal-use property (such as a personal residence, personal auto, or vacation home).

What Is a Casualty?

Over the years, court cases and IRS administrative rulings have developed a generally accepted definition of *casualty:* an identifiable event of a sudden, unexpected , or unusual nature.[55] *Sudden* means the event is not gradual or progressive. If a loss is due to progressive deterioration, such as termite damage, it is not deductible as a casualty. A casualty is also an unusual event caused by external forces. Common household accidents, such as accidentally breaking furniture or damage caused by a pet, are not casualties. To claim a deduction, the taxpayer must own the damaged property.

EXAMPLE 5-33

Damage to walls and flooring from the progressive deterioration of a roof is a nondeductible casualty loss because the event was not sudden but gradual and progressive.[56] Likewise, when a patio porch collapses as a result of excessive dry rot, the casualty loss is disallowed.[57]

Unexpected refers to an event that is unanticipated and occurs without the intent of the taxpayer. An *unusual* event is one that is extraordinary and nonrecurring.[58]

TAX YOUR BRAIN

Since 1995 the North Carolina coast has been hit by a number of hurricanes, each of which caused substantial casualty losses. If a hurricane strikes the North Carolina coast in 2017, is the event still a casualty?

ANSWER

With a strict reading of the tax authority concerning casualty losses, the hurricane probably would not qualify as a casualty. The hurricane is not unexpected or unusual in recent history. However, the IRS is very unlikely to challenge a natural disaster if for no other reason than the negative public opinion that would result. A hurricane could provide a sudden loss even if it were not unusual. The Tax Court has held that even if an event is foreseeable, it does not preclude a casualty loss deduction.[59]

[53] IRC § 165(c).
[54] Casualty losses of business property are discussed in Chapter 6 and Chapter 8.
[55] Rev. Rul. 76-134,1976-1 CB 54.
[56] *Whiting, Laurin* (1975) 34 TCM 241.
[57] *Chipman* (1981) 41 TCM 1318.
[58] Rev. Rul. 72-592, 1972-2 CB 101.
[59] *Heyn, Harry* (1966) 46 TC 302, acq 1967-2 CB 2.

TABLE 5-2
Personal Casualty Expense Deduction Formula

Calculation of Deductible Casualty Loss

Determine:

FMV immediately before the casualty
minus (FMV immediately after the casualty)

Amount A: Decline in FMV

Amount B: Adjusted basis of the property

Select the smaller of Amount A or Amount B
minus (insurance recovery)

Allowable loss
minus ($100 per event)

Eligible loss
minus (10% of AGI)

Deductible casualty loss

The magnitude of the casualty is not the primary factor in deciding whether the event is a casualty. Thus a minor event could qualify as a casualty. A formula that can be used to determine the amount of deductible casualty loss is shown in Table 5-2.

The Amount of a Casualty Loss and the Year Deductible

The taxpayer may deduct uninsured loss or out-of-pocket loss subject to certain limits detailed here. The taxpayer's uninsured loss is calculated as follows:

Uninsured loss = Loss due to casualty or theft − Insurance recovery

In general, the casualty loss is the lower of the following:

1. The FMV immediately before the casualty reduced by the FMV immediately after the casualty.
2. The amount of the adjusted basis for determining the loss from the sale or other disposition of the property involved.[60]

The taxpayer is required to provide proof of the adjusted basis and FMV. *Adjusted basis* is the original cost or basis of the asset minus any depreciation or amortization and plus the cost of any capital improvements. The FMV is normally determined by an appraised value before and after the casualty event. Repair costs can also play an important role in determining the casualty loss. If the property is only partially destroyed, the casualty loss is its decline in value.

EXAMPLE 5-34

Tracy and Barbara purchased their personal residence in 1996 for $95,000. In March 2017, when the appraised value of the house was $250,000, it and most of their belongings in it were destroyed by fire. The amount of the casualty loss for the house is $95,000 (the lower of the adjusted basis of $95,000 or the decrease in FMV of $250,000) because Tracy and Barbara received no insurance reimbursement for the damage. Losses for the personal belongings would be calculated on an item-by-item basis (from an inventory list of everything in the house).

EXAMPLE 5-35

In 2016, Lee purchased an automobile (used for nonbusiness purposes) for $17,000. In April 2017, he had an accident with another automobile. Lee's auto had an FMV of $14,500 when the accident occurred. The FMV after the accident is difficult to determine. However, the cost to repair the auto to its precasualty condition was $5,000. The $5,000 would be a reasonable amount to deduct as a casualty loss. If Lee receives any insurance proceeds, he would reduce his loss accordingly.

[60] Reg § 1.167-7(b)(1).

Typically a taxpayer reports a casualty loss on the tax return in the tax year it took place. However, in three instances, casualty losses may be deducted in different tax years:

1. Theft losses.
2. Reimbursement by insurance or otherwise (such as from a negligence claim against an individual or company that caused the loss).
3. Disaster area losses.

Theft losses are deducted in the tax year in which the theft was discovered rather than the year of theft, if different.

EXAMPLE 5-36

As a hobby, Stefan collects rare coins. He had his collection appraised by an expert in October 2016. In January 2017, when Stefan was reviewing his collection, he noted that two extremely rare coins had been replaced with forgeries. Stefan would deduct the loss in 2017.[61]

In all cases, taxpayers must subtract any insurance reimbursement in determining their loss. Even when the insurance reimbursement has not yet been received, if a reasonable prospect of recovery exists with respect to a claim of insurance, the casualty loss should be adjusted for the anticipated recovery.[62] Should the loss be deducted and recovery occur in the subsequent tax year, the taxpayer must include the reimbursement in income in the year of reimbursement to the extent a tax benefit was gained from the casualty loss.

Individuals are required to file an insurance claim for *insured* personal casualty and theft losses to claim a deduction. If no insurance claim is filed, and there was insurance, then no deduction is permitted.

If the casualty loss occurred as the result of a major event (usually a natural disaster), and the president of the United States declares the area a national disaster area, the taxpayer can elect to deduct the casualty loss against the preceding year's taxable income. Congress added this provision to allow taxpayers suffering major disasters to get immediate assistance from a tax refund. The taxpayer files an amended return (Form 1040X) for the previous tax year including the casualty loss in the calculation. If the preceding year's tax return had not been filed at the time of the casualty, the loss can be deducted on the original return.

Limitation on Personal Casualty Losses

The tax law places two general limitations on personal casualty deductions. Each separate casualty is reduced by $100. It is important to note that this is $100 per *casualty,* not $100 per *item of property.*[63] For example, a taxpayer may lose his home, car, and other personal belongings in a tornado. This is one casualty, and only one $100 reduction is necessary. If the events are closely related, they are considered a single casualty. If the taxpayer had a theft loss early in the year and the tornado occurred later in the year, each loss would be reduced by $100.

The second and more substantial limitation is the 10% of AGI limitation. For the taxpayer to obtain any benefit from a casualty loss, the total losses for the year after the $100 per casualty deduction must exceed 10% of AGI. Because of the 10% limitation, most taxpayers do not benefit from casualty losses unless the loss was substantial.

For more information about specific issues related to casualty and theft losses, refer to IRS Publication 547—Casualties, Disasters, and Thefts.

EXAMPLE 5-37

Debra is a single taxpayer with an AGI of $75,000. For her to receive any tax benefit, a casualty loss must exceed $7,600 ($100 per casualty plus 10% of AGI). Recall that the $7,600 is net of any insurance recovery.

[61] This loss may be difficult to prove if Stefan did not have adequate documentation noting that he owned the rare coins prior to the theft.

[62] Reg. § 1.165-1(d)(2)(i).

[63] IRC § 165(h).

From Shoebox to Software

EXAMPLE 5-38

Jose and Maria Ramirez (see the saved file) had the following casualties from a large storm during the 2017 tax year. Recall that they had AGI of $110,048 in 2017. The area has not yet been declared a federal disaster area.

Asset	Cost or Basis	Decrease in FMV	Date Destroyed or Damaged	Insurance Proceeds
Furniture	$ 3,000	$ 3,000	04/11/2017	$ –0 –
Auto	15,500	9,500	04/11/2017	–0 –
Personal residence damaged by storm	225,000	55,000	04/11/2017	50,000

Casualty loss	
Residence (lower of cost or decrease in value)	$ 55,000
Insurance proceeds	(50,000)
Furniture	3,000
Auto (lower of cost or decrease in value)	9,500
Casualty before limitations	$ 17,500
$100 per event	(100)
10% AGI floor	(11,005)
Net casualty loss	$ 6,395

Jose and Maria would have a $6,395 casualty loss deduction for the year. If the area of the damage were declared a national disaster area, they could elect to take the deduction against their 2016 taxable income by filing an amended return.

Open the tax return file you previously saved for the Ramirezes. Report the casualty losses on line 20 of Schedule A. The taxpayers first report the losses on Form 4684. Double-click on line 20 of Schedule A to go to Form 4684 or open Form 4684 directly. Personal casualties are reported on lines 1 through 12. Click on Open Supporting Form and enter the data here. If you open Schedule A, you will see the net casualty loss of $6,395 on line 20.

The completed Form 4684 (Exhibit 5-7) follows on page 5-29.

TAX YOUR BRAIN

Binh suffered a $40,000 casualty loss in a nationally declared disaster in September 2017. Assuming that he had AGI of $110,000 in 2016 and $200,000 in 2017 (the disaster also affected business), what is the best way to treat the casualty loss?

ANSWER

Binh can elect to amend his 2016 tax return and get an immediate refund against her 2016 taxes or can wait until April 2018 and deduct the loss on his 2017 return.

An amendment to the 2016 return is as follows:

Disaster loss	$40,000
$100 per casualty	(100)
10% AGI floor	(11,000)
Casualty loss deduction	$28,900

If he files on her 2017 return, the deduction is as follows:

Disaster loss	$40,000
$100 per casualty	(100)
10% AGI floor	$20,000
Casualty loss deduction	$19,900

The advantage to filing an amended return for 2016 is that he will receive a larger refund and receive the funds more quickly.

EXHIBIT 5-7

Form **4684**

Department of the Treasury
Internal Revenue Service

Casualties and Thefts

▶ Go to *www.irs.gov/Form4684* for instructions and the latest information.
▶ Attach to your tax return.
▶ Use a separate Form 4684 for each casualty or theft.

OMB No. 1545-0177
2017
Attachment Sequence No. **26**

Name(s) shown on tax return: **Jose and Maria Ramirez**
Identifying number: **412-34-5670**

SECTION A—Personal Use Property (Use this section to report casualties and thefts of property **not** used in a trade or business or for income-producing purposes.)

1 Description of properties (show type, location, and date acquired for each property). Use a separate line for each property lost or damaged from the same casualty or theft.

Property **A** Furniture
Property **B** Automobile
Property **C** Personal Residence
Property **D**

	Line	Properties A	B	C	D
2 Cost or other basis of each property	2	3,000	15,500	225,000	
3 Insurance or other reimbursement (whether or not you filed a claim) (see instructions)	3			50,000	
Note: *If line 2 is **more** than line 3, skip line 4.*					
4 Gain from casualty or theft. If line 3 is **more** than line 2, enter the difference here and skip lines 5 through 9 for that column. See instructions if line 3 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year	4				
5 Fair market value **before** casualty or theft	5	3,000	15,500	225,000	
6 Fair market value **after** casualty or theft	6	0	6,000	170,000	
7 Subtract line 6 from line 5	7	3,000	9,500	55,000	
8 Enter the **smaller** of line 2 or line 7	8	3,000	9,500	55,000	
9 Subtract line 3 from line 8. If zero or less, enter -0-	9	3,000	9,500	5,000	

	Line	Amount
10 Casualty or theft loss. Add the amounts on line 9 in columns A through D	10	17,500
11 Enter the **smaller** of line 10 or $100	11	100
12 Subtract line 11 from line 10	12	17,400
Caution: *Use only one Form 4684 for lines 13 through 18.*		
13 Add the amounts on line 12 of all Forms 4684	13	17,400
14 Add the amounts on line 4 of all Forms 4684	14	0
15 • If line 14 is **more** than line 13, enter the difference here and on Schedule D. **Do not** complete the rest of this section (see instructions). • If line 14 is **less** than line 13, enter -0- here and go to line 16. • If line 14 is **equal** to line 13, enter -0- here. **Do not** complete the rest of this section.	15	0
16 If line 14 is **less** than line 13, enter the difference	16	17,400
17 Enter 10% of your adjusted gross income from Form 1040, line 38, or Form 1040NR, line 37. Estates and trusts, see instructions	17	11,005
18 Subtract line 17 from line 16. If zero or less, enter -0-. Also enter the result on Schedule A (Form 1040), line 20, or Form 1040NR, Schedule A, line 6. Estates and trusts, enter the result on the "Other deductions" line of your tax return	18	6,395

For Paperwork Reduction Act Notice, see instructions. Cat. No. 12997O Form **4684** (2017)

Source: U.S. Department of the Treasury, Internal Revenue Service, Form 4684. Washington, DC: 2017.

The taxpayer must be able to prove both the fact of the casualty or theft and the amount of the loss. Newspaper articles, photographs, and police reports are commonly used to document the fact of a casualty or theft. When a casualty results from a sudden, unexpected, or unusual event, the amount of the loss is not always easy to determine. In many instances, an appraisal of the property is required to calculate the loss. Casualty losses are first reported on Form 4684, and the net loss is carried to the appropriate form (Schedule A for personal casualties). If the insurance or other reimbursement is more than the basis in the property damaged or destroyed, the reimbursement is a gain. The gain is generally taxable if the taxpayer does not use the reimbursement proceeds to purchase replacement property that is related in service or use. However, there are several circumstances where the gain may be postponed; in the instance of gain realized on homes in declared disaster areas, the gain may escape taxation.

The IRS has previously issued guidance concerning the tax treatment of investment scam losses, similar to those in the infamous Bernie Madoff scandal, and the safe harbor options for deducting such losses.[64] In a situation where a taxpayer unknowingly invested in a brokerage activity that was in fact fraudulent, and the taxpayer experienced a loss as a result of the fraudulent activities, the loss is considered a theft loss, not a capital loss. However, the loss is not subject to the general deductibility limitations just outlined. It is entered on Form 4864 and carried to line 28 of Schedule A as a miscellaneous itemized deduction, not subject to the 2% of AGI limitation.

CONCEPT CHECK 5-5—
LO 5-5

1. A casualty is an identifiable event of a ______________, ______________, or ______________ nature.
2. Casualty losses are first reported on Form ________________.
3. Generally, the tax law places ________________ limitations on personal casualty deductions. First, each separate casualty event is reduced by ________________.
4. In general, to obtain any benefit from a casualty loss, the loss must be in excess of ________________ of AGI.

MISCELLANEOUS ITEMIZED DEDUCTIONS (SCHEDULE A, LINE 27)
LO 5-6

The final category of itemized deduction is the catch-all of miscellaneous itemized deductions. Typically miscellaneous itemized deductions are subject, in aggregate, to a 2% AGI floor. In other words, the sum of all miscellaneous deductions must exceed 2% of the taxpayer's AGI before any benefit is received. The most common miscellaneous deductions are for the following:

1. Unreimbursed employee business expenses.
2. Union or professional dues and subscriptions.
3. Expenses related to investment income or property.
4. Investment counsel and advisory fees.
5. Tax return preparation fees.
6. Safe deposit box fees.
7. Gambling losses to the extent of gambling income.[65]

Unreimbursed employee business expenses are usually the largest and are most likely to cause the total miscellaneous deduction to exceed the 2% floor. These expenses are costs

[64] Rev. Rul. 2009-9.

[65] Gambling losses are one miscellaneous deduction that is not subject to the 2% floor; instead they are limited to gambling income and are reported on line 28 of Schedule A.

incurred by the taxpayer as a part of his or her employment (as opposed to being self-employed) but not reimbursed. If any travel, transportation, meals, or entertainment expenses were incurred or some expenses were reimbursed, the taxpayer must complete Form 2106. Examples of unreimbursed employee business expenses include these:

1. Safety equipment needed on the taxpayer's job.
2. Uniforms required for employment that the taxpayer would not usually wear away from work.
3. Protective clothing such as hard hats, safety shoes or boots, and glasses.
4. Business dues and subscriptions.
5. Certain business use of the taxpayer's home.
6. Certain education expenses that do not qualify the taxpayer for a new job.[66]
7. Vehicle mileage not reimbursed by the employer.

EXAMPLE 5-39

Jane's AGI is $43,000. During the year, she had unreimbursed business expenses for supplies, a computer, and travel of $5,200. Jane's deduction would be limited to $4,340 ($5,200 – $860 [$43,000 × 0.02]).

If an employee is required as a condition of employment to wear special clothing that is not suitable for general street wear, the cost of the clothing and its upkeep (such as laundry) is generally a tax-deductible expense. The determination of whether clothing is suitable for general street wear is based on "general objective standards," not personal taste. Examples include uniforms worn by safety, transportation, and health care personnel and protective clothing such as hard hats, safety goggles, and steel-tipped shoes.

A taxpayer who is looking for a new job in the same business or profession in which he or she is already employed may deduct the costs of the job search, such as the cost of preparing and printing résumés, postage, employment agency fees, and long-distance telephone calls to prospective employers. The costs of looking for a new job are deductible whether or not the taxpayer accepts a new position. However, if the taxpayer is looking for a first job or for a job in a new field, his or her job-hunting expenses are generally nondeductible. This is so because to deduct the expense, it must be related to the current occupation. If a taxpayer has no occupation or is changing occupations, the expense is not related to current employment.

Many individuals purchase portfolio investments, such as stocks, bonds, and mutual funds. Expenses to manage, conserve, or maintain these income-producing investments are deductible on Schedule A. Examples include safety deposit box rental to store stock and bond certificates, investment advisory fees, subscriptions to investment publications, software to track investment portfolios, and depreciation on a home computer used to monitor personal investments. One element of these deductions that taxpayers often miss is investment advice. If a taxpayer has a large portfolio of stock or investments, the advisory cost can be substantial. Investment fees, however, are not deductible if they are added to the cost basis of the investment. Examples include brokerage commissions or items paid with tax-deferred funds.[67]

EXAMPLE 5-40

Jason has a $1 million investment portfolio and pays a flat fee of 2% of the FMV of the portfolio. The 2% fee would be deductible if Jason paid it directly. If the portfolio were a tax-deferred account or if the fee were paid on a commission basis that increased the basis of the investment, the investment fee would not be deductible.

[66] The deduction for education expenses is explained in detail in Chapter 6 (relating to a trade or business).

[67] For example, a 1% fee (on the outstanding value) paid to a custodian of an IRA that is paid from the IRA funds would not qualify as a miscellaneous itemized deduction.

If any of these expenses were related to a trade or business or rental property, the taxpayer would receive a higher tax benefit by taking the deduction as a *for* AGI deduction on Schedule C or Schedule E (discussed in Chapters 6 and 8, respectively).

CONCEPT CHECK 5-6—
LO 5-6

1. The sum of all miscellaneous deductions must exceed 3.5% of the taxpayer's AGI before receiving any benefit. True or false?
2. If a taxpayer as part of his or her employment incurs any travel, transportation, meals, and entertainment expenses or the employer reimburses him or her for some of the expenses, the taxpayer must complete Form 2106. True or false?
3. An example of deductible unreimbursed employee business expenses would include the blue suit needed by an accountant for his job. True or false?

LIMITATION OF TOTAL ITEMIZED DEDUCTIONS (SCHEDULE A, LINE 29)

LO 5-7

Individuals who are high-income taxpayers in the past have forfeited a part of their itemized deductions. This effectively increased the tax rate of high-income individuals by denying deductions rather than increasing rates. For 2017, this reduction, often referred to as the Pease limitation, is in effect.

If a taxpayer's AGI is above a certain amount, itemized deductions allowed for the year are reduced by the lessor of:

1. 3% of the excess of AGI over the applicable amount.
2. 80% of the itemized deductions otherwise allowable for the tax year.[68]

For tax year 2017, a high-income taxpayer is a person whose AGI exceeds $313,800 for married filing jointly ($156,900 for married filing separately). These amounts are adjusted for inflation in subsequent years.

The 3%/80% rule does not apply to medical expenses, investment interest, casualty or theft losses, or gambling losses. That is because most of these exempted deductions are somewhat uncommon or have high AGI qualifying hurdles.

EXAMPLE 5-41

Assume that a couple married filing jointly has AGI of $413,800. Their applicable itemized deductions total $30,000 and are as follows:

Mortgage interest deduction	$ 8,000
Real estate taxes	4,000
State income tax deduction	6,000
Charitable deduction	12,000

With a 2017 married filing jointly AGI threshold limitation of $313,800 for itemized deductions, the calculation for the limitation is as follows:

a. 3% × $100,000 ($413,800 − $313,800) = $3,000, which would reduce the taxpayers' itemized deduction by that amount.
b. 80% × $30,000 = $24,000, which would reduce the taxpayers' itemized deduction by that amount.

Because option (a) is the lesser, or lower, of the two amounts, the taxpayers' itemized deductions of $30,000 would be reduced to $27,000 ($30,000 − $3,000), which would be their deductible amount for 2017.

CONCEPT CHECK 5-7—
LO 5-7

1. For 2017, there is a ____________ on the amount of itemized deductions for high income taxpayers.
2. The applicable percentages for the limitation of itemized deductions for high-income taxpayers are the lesser of ____________ of AGI over the filing status threshold *or* ____________ of the applicable itemized deductions.

[68] IRC § 68(a).

From Shoebox to Software Comprehensive Example

In this example, you will create a new return for a high-income taxpayer. Open the tax software and create a new return.

Alan (SSN 412-34-5670) and Cherie (SSN 412-34-5671) Masters are married filing a joint return and reside at 1483 Tax Street, Highland, MO 63747. They have two children under the age of 17 who are eligible for the child tax credit on line 51 of the 1040:

Scotty (SSN 412-34-5672), born 7/12/2006.

Brittney (SSN 412-34-5673), born 9/16/2008.

The couple had the following 2017 income items that you need to enter in the tax software:

Alan's W-2	
Wages	$112,505
Federal withholding	14,056
Social security wages	112,505
Social security withholding	6,975
Medicare withholding	1,631
State withholding	5,456
Cherie's W-2	
Wages	$37,495
Federal withholding	5,499
Social security wages	37,495
Social security withholding	2,325
Medicare withholding	544
State withholding	3,123
Taxable amount on 1099-G from Missouri state tax refund ($7,560 deducted on federal 2016 return)	897
1099-INT, New Bank	2,300
1099-DIV, Shake Co, Inc. (qualified)	3,100

They also had the following additional itemized deductions:

Medical expenses	$6,400
Personal property taxes	2,000
Real estate property taxes	3,532
Mortgage interest from line 1 of Form 1098	10,052
Charitable contributions (cash) (no individual contribution was more than $250)	2,750
Unreimbursed employee business expenses (travel)	2,500
Tax preparation fee	410
Safety deposit box	75

See Exhibit 5-8 for the completed Schedule A for Alan and Cherie.

Notice the following in the tax software:

1. The medical expenses are entered directly on line 1. In Alan and Cherie's case, they get no benefit from their medical expenditures due to the 7.5% AGI floor.
2. Note that the state income tax paid flows through to line 5 when the amounts are entered on the W-2 input form.
3. The real estate property taxes and personal property taxes are entered directly on lines 6 and 7, respectively.
4. The mortgage interest is entered through the Documents Received section. To enter it, click on Form 1098 and enter $10,052 on line 1. The interest transfers to line 10 of Schedule A.
5. The charitable contributions are entered directly on line 16 of Schedule A.
6. The miscellaneous deductions are limited. The 2% AGI floor calculations are shown on Schedule A itself. Recall that a Form 2106 must be filed for employee business expenses if any portion of the expenses is reimbursed or if job-related vehicle, travel, transportation, meals, or entertainment expenses are involved. Because travel was involved in Alan and Cherie's case, Form 2106 is required to be filed (Form 2106 is not shown). To access Form 2106 through the tax software, double-click line 21 on Schedule A. Enter the unreimbursed business expenses on the appropriate lines of Form 2106, and the amount flows through to Schedule A. In this case, $2,500 is entered on line 3 of Form 2106.

Make sure you save the return for the Masters.

EXHIBIT 5-8

SCHEDULE A (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Itemized Deductions

▶ Go to *www.irs.gov/ScheduleA* for instructions and the latest information.
▶ Attach to Form 1040.
Caution: If you are claiming a net qualified disaster loss on Form 4684, see the instructions for line 28.

OMB No. 1545-0074
2017
Attachment Sequence No. 07

Name(s) shown on Form 1040: Alan and Cherie Masters

Your social security number: 412-34-5670

Medical and Dental Expenses		**Caution:** Do not include expenses reimbursed or paid by others.				
	1	Medical and dental expenses (see instructions)	1	6,400		
	2	Enter amount from Form 1040, line 38 [2] 156,297				
	3	Multiply line 2 by 7.5% (0.075)	3	11,722		
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-			4	0
Taxes You Paid	5	State and local **(check only one box):**				
		a ☑ Income taxes, **or** b ☐ General sales taxes	5	8,579		
	6	Real estate taxes (see instructions)	6	3,532		
	7	Personal property taxes	7	2,000		
	8	Other taxes. List type and amount ▶	8			
	9	Add lines 5 through 8			9	14,111
Interest You Paid **Note:** Your mortgage interest deduction may be limited (see instructions).	10	Home mortgage interest and points reported to you on Form 1098	10	10,052		
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see instructions and show that person's name, identifying no., and address ▶	11			
	12	Points not reported to you on Form 1098. See instructions for special rules	12			
	13	Reserved for future use	13			
	14	Investment interest. Attach Form 4952 if required. See instructions	14			
	15	Add lines 10 through 14			15	10,052
Gifts to Charity If you made a gift and got a benefit for it, see instructions.	16	Gifts by cash or check. If you made any gift of $250 or more, see instructions	16	2,750		
	17	Other than by cash or check. If any gift of $250 or more, see instructions. You **must** attach Form 8283 if over $500	17			
	18	Carryover from prior year	18			
	19	Add lines 16 through 18			19	2,750
Casualty and Theft Losses	20	Casualty or theft loss(es) other than net qualified disaster losses. Attach Form 4684 and enter the amount from line 18 of that form. See instructions			20	
Job Expenses and Certain Miscellaneous Deductions	21	Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. See instructions. ▶	21	2,500		
	22	Tax preparation fees	22	410		
	23	Other expenses—investment, safe deposit box, etc. List type and amount ▶ safe deposit box	23	75		
	24	Add lines 21 through 23	24	2,985		
	25	Enter amount from Form 1040, line 38 [25] 156,297				
	26	Multiply line 25 by 2% (0.02)	26	3,126		
	27	Subtract line 26 from line 24. If line 26 is more than line 24, enter -0-			27	0
Other Miscellaneous Deductions	28	Other—from list in instructions. List type and amount ▶			28	
Total Itemized Deductions	29	Is Form 1040, line 38, over $156,900? ☑ **No.** Your deduction is not limited. Add the amounts in the far right column for lines 4 through 28. Also, enter this amount on Form 1040, line 40. ☐ **Yes.** Your deduction may be limited. See the Itemized Deductions Worksheet in the instructions to figure the amount to enter.			29	26,9153
	30	If you elect to itemize deductions even though they are less than your standard deduction, check here ▶ ☐				

For Paperwork Reduction Act Notice, see the Instructions for Form 1040. Cat. No. 17145C **Schedule A (Form 1040) 2017**

Source: U.S. Department of the Treasury, Internal Revenue Service, Form 1040- Schedule A. Washington, DC: 2017.

Summary

LO 5-1: Describe the deductibility and reporting of medical expenses.

- Itemized, or below-the-line, deductions are taken in lieu of the standard deduction. They are reported on Schedule A.
- Medical expenses are deductible to the extent that they exceed 7.5% of AGI.
- Taxpayers may deduct just about all medical expenses that are doctor prescribed. Expenses related to the maintenance of general health are usually not deductible.
- Medical capital expenditures are deductible only to the extent that the expenditures exceed the increase in FMV of the property.
- Premiums for long-term care insurance are deductible, but the extent to which they are depends on the taxpayer's age.

LO 5-2: Be able to explain the state and local tax deductions.

- The four major categories of deductible taxes on individual returns are personal property taxes, local real estate taxes, other state and local taxes, and foreign taxes.
- For a property tax to be deductible, it must be based on the value of the property.
- An individual taxpayer can deduct the amount of state income taxes actually paid or has the option of deducting state and local sales taxes paid.
- Taxpayers have the option of taking a credit for foreign taxes or deducting the taxes as an itemized deduction on Schedule A.

LO 5-3: Apply the tax rules associated with the interest deduction.

- Interest paid on an acquisition loan or a home equity loan secured by a qualified residence is deductible up to certain limits.
- For acquisition indebtedness, the interest is generally deductible only on principal amounts up to $1,000,000. However, in the case of unmarried co-owners of a property, that limitation is extended to $1,000,000 per person.
- For home equity indebtedness, the interest is generally deductible only on principal amounts up to $100,000. However, in the case of unmarried co-owners of a property, that limitation is extended to $100,000 per person.
- Points are amounts paid by borrowers to obtain a mortgage. Typically taxpayers deduct points ratably over the term of the loan; however, there are some exceptions.

LO 5-4: Explain the deductibility and reporting of charitable contributions.

- All charitable contributions to public charities are limited to an overall 50% of the individual taxpayer's AGI.
- Depending on the nature of the item contributed, there are three deduction limitations for charitable contributions by individual taxpayers: 50%, 30%, and 20%.
- The substantiation requirements for charitable contributions have become more stringent, and the taxpayer is subject to more stringent reporting requirements.
- Contributions above the limitation amounts can be carried forward five years.

LO 5-5: Discuss the casualty loss deduction.

- *Casualty* is defined as an identifiable event of a sudden, unexpected, or unusual nature. *Sudden* means the event is not gradual or progressive.
- The taxpayer's uninsured loss is calculated as Uninsured loss = Loss due to casualty or theft − Insurance recovery
- Typically a taxpayer reports a casualty on the tax return in the tax year the casualty took place; however, there are exceptions.
- The deductible amount is generally limited. First, each separate casualty is reduced by $100. Second, the loss must be in excess of 10% of AGI.

LO 5-6: Know how to report miscellaneous expenditures.	• The sum of all miscellaneous deductions must exceed 2% of the taxpayer's AGI before the taxpayer receives any benefit. • Unreimbursed employee business expenses are usually the largest and are most likely to cause the total miscellaneous deduction to exceed the 2% floor. • One deduction often missed by taxpayers is investment advice. If a taxpayer has a large portfolio of stock or investments, the advisory cost can be substantial.

LO 5-7: Apply the tax rules for the Pease limitations on total itemized deductions for high-income taxpayers in 2017.	• "High-income" taxpayers' total itemized deductions are limited.
	• For 2017, a high-income taxpayer is a person whose AGI exceeds \$313,800 for married filing jointly (\$156,900 for married filing separately).
	• A high-income taxpayer's itemized deductions are reduced by the lower of:
	  • 3% of the excess of AGI over the applicable amount.
	  • 80% of the itemized deductions otherwise allowable for the tax year.

Discussion Questions

All applicable Discussion Questions are available with ***Connect***©

1. (Introduction) What is the difference between deductions *from* AGI and deductions *for* AGI?

2. (Introduction) What are the six types of personal expenses that can be classified as itemized deductions on Schedule A, Form 1040?

EA LO 5-1 3. Describe the concept of a 7.5% floor for medical deductions.

EA LO 5-1 4. Can an individual take a medical deduction for a capital improvement to his or her personal residence? If so, how is it calculated?

EA LO 5-1 5. What are the general requirements for a medical expense to be considered deductible?

LO 5-1 6. When are travel costs deductible as medical costs? How are medical travel costs calculated?

EA LO 5-1 7. What is the proper tax treatment for prescription drugs obtained outside the United States, such as from Canada?

EA LO 5-1 8. Can a taxpayer take a deduction for premiums paid for health insurance? How do reimbursements from health insurance policies affect the amount of the medical deduction? What happens if an insurance reimbursement for medical expenses is received in a subsequent tax year?

EA LO 5-2 9. What are the four major categories of deductible taxes on individual returns?

EA LO 5-2 10. For a tax to be deductible as an itemized deduction, what three tests are required?

EA LO 5-2 11. If state or local income taxes are deducted on the current year's tax return, what is required if the taxpayer receives a refund in the next year?

EA LO 5-2 12. For 2017, how can the amount of the sales tax deduction be determined?

EA LO 5-2 13. When using the IRS sales tax deduction calculator to assist in determining a sales tax deduction, what information is needed concerning the taxpayer do you need?

EA LO 5-2 14. What options does a taxpayer who paid foreign taxes have when considering his or her tax treatment? Which option is usually more tax beneficial?

EA LO 5-3 15. What is qualified residence interest? Are there any limits to the deductibility of acquisition loan interest?

EA LO 5-3 16. What is a home equity loan? Is the interest tax deductible? Are there any limits to the deductibility of home equity loan interest?

EA LO 5-3 17. What is investment interest expense? What are the limits to the deductibility of investment interest expense?

EA LO 5-4 18. Donations to what types of organizations are tax deductible?

EA LO 5-4 19. Distinguish between the tax treatment for donations to charitable organizations of cash, ordinary income property, and capital gain property.

EA LO 5-4 20. What happens to a charitable contribution that is in excess of the AGI limits?

EA LO 5-5 21. Define *personal casualty loss.* Include in your discussion the concepts of sudden, unexpected, and unusual.

EA LO 5-5 22. How is a personal casualty loss calculated? Include in your discussion how the determination of the loss is made and limits or floors that are placed on personal casualties as well as any exceptions to those limits.

EA LO 5-6 23. Give three examples of miscellaneous itemized deductions. How are miscellaneous itemized deductions limited?

EA LO 5-6 24. What is usually the largest miscellaneous deduction for individual taxpayers? Are any special reporting issues associated with it?

EA LO 5-7 25. Explain the treatment of itemized deduction limitations for high-income taxpayers in 2017.

____

____

____

Multiple-Choice Questions

All applicable multiple-choice questions are available with ***Connect***©

EA 26. (Introduction) Itemized deductions are taken when

a. The taxpayer wants to.
b. They are less than the standard deduction.
c. They are higher than the standard deduction.
d. The standard deduction is limited by high AGI.

EA 27. (Introduction) The majority of itemized deductions are

a. Business expenses.
b. Tax credits.
c. Personal living expenses.
d. None of the above.

EA LO 5-1 28. Generally, a taxpayer may deduct the cost of medical expenses for which of the following?

a. Marriage counseling.
b. Health club dues.
c. Doctor-prescribed birth control pills.
d. Trips for general health improvement.

EA LO 5-1 29. The threshold amount for the deductibility of allowable medical expenses ordinarily is:

a. 7.5% of AGI.
b. 10% of AGI.
c. 10% of taxable income.
d. 15% of taxable income.

EA LO 5-1 30. During 2017, Raul incurred and paid the following expenses:

Prescription drugs	$ 470
Vitamins and over-the-counter cold remedies	130
Doctors and dentist visits	700
Health club fee	250
Hair transplant surgery	2,400

What is the total amount of medical expenses (before considering the limitation based on AGI) that would enter into the calculation of itemized deductions for Raul's 2017 income tax return?

a. $1,170.
b. $1,300.
c. $1,550.
d. $3,950.

EA LO 5-1 31. Prescription drugs obtained from sources outside the United States, such as Canada, are

a. Always deductible no matter how they were obtained.

b. Deductible only for citizens of Canada living in the United States.

c. Deductible if prescribed by a physician and approved by the FDA for legal importation.

d. Never deductible.

EA LO 5-1 32. For 2017, Perla, who is single and 55 years of age, had AGI of $60,000. During the year, she incurred and paid the following medical costs:

Doctor and dentist fees	$3,350
Prescription medicines	625
Medical care insurance premiums	380
Long-term care insurance premiums	1,600
Hearing aid	150

What amount can Perla take as a medical expense deduction (after the AGI limitation) for her 2017 tax return?

a. $6,105.

b. $6,035.

c. $1,535.

d. $35.

EA LO 5-2 33. For 2017, the amount of the sales tax deduction is calculated by

a. Determining the actual sales tax paid during the year.

b. Using the IRS sales tax deduction calculator.

c. Using the sales worksheet and tax tables provided by the IRS in the Schedule A instructions.

d. All of the above.

EA LO 5-2 34. Daryl, who had significant itemized deductions for 2017 and therefore was eligible to use Schedule A, purchased a new vehicle in 2017 for $40,000 with a state sales tax of 10%. The allocated deduction amount for other purchases made by Daryl throughout the year, using the IRS state and local sales tax tables, would be $750. He also paid state income taxes of $4,500 for 2017. Daryl's best option to legally maximize his tax savings in 2017 would be to:

a. Deduct the amount of state sales tax for the vehicle purchase on Schedule A.

b. Take the standard deduction.

c. Take the deduction for the state income taxes paid on Schedule A.

d. Deduct his total amount of allowable state sales tax deduction on Schedule A.

EA LO 5-2 35. During 2017, Noriko paid the following taxes related to her home:

Real estate property taxes on residence (paid from escrow account)	$1,800
State personal property tax on her automobile (based on value)	600
Property taxes on land held for long-term appreciation	400

What amount can Noriko deduct as property taxes in calculating itemized deductions for 2017?

a. $400.

b. $1,000.

c. $2,400.

d. $2,800.

EA LO 5-3 36. What is the maximum amount of personal residence *acquisition* debt on which interest is fully deductible on Schedule A?

a. $1,000,000.
b. $500,000.
c. $250,000.
d. $0.

EA LO 5-3 37. For 2017, the deduction by a taxpayer for investment interest expense is

a. Not limited.
b. Limited to the taxpayer's net investment income for 2017.
c. Limited to the investment interest paid in 2017.
d. Limited to the taxpayer's gross investment income for 2017.

EA LO 5-3 38. For 2017, Thomas, a single parent, reported the following amounts relating to his investments:

Net investment income	$7,000
Interest expense on a loan to purchase stocks	2,000
Interest expense on funds borrowed to purchase land for investment	6,000

What is the maximum amount that Thomas can deduct in 2017 as investment interest expense?

a. $1,000.
b. $2,000.
c. $6,000.
d. $7,000.

EA LO 5-3 39. Referring to the previous question, what is the treatment for the interest expense that Thomas could not deduct in 2017?

a. It is lost.
b. It cannot be used except as a carryback to previous years.
c. It can be carried forward and deducted in succeeding years.
d. None of the above.

EA LO 5-4 40. Which of the following organizations qualifies for deductible charitable contributions?

a. A nonprofit educational institution.
b. The Salvation Army.
c. Churches.
d. All of the above.

EA LO 5-4 41. Which of the following statements is *not* true regarding documentation requirements for charitable contributions?

a. If the total deduction for all noncash contributions for the year is more than $500, Section A of Form 8283, Noncash Charitable Contributions, must be completed.
b. A noncash contribution of less than $250 must be supported by a receipt or other written acknowledgment from the charitable organization.
c. A contribution charged to a credit card is a noncash contribution for purposes of documentation requirements.
d. A deduction of more than $5,000 for one property item generally requires that a written appraisal be obtained and attached to the return.

EA LO 5-5 42. In 2017, the president of the United States declared a federal disaster due to brush fires in the Southwest. Lisa lives in that area and lost her home in the fires. What choice does she have regarding when she can claim the loss on her tax return?

a. It may be claimed in 2016 or 2017.

b. It must be claimed in 2016 if the loss is greater than her modified Adjusted Gross Income.

c. It may be claimed in 2018 if an election is filed with the 2017 return.

d. It must be claimed in 2016 if the return has not been filed by the date of the loss.

EA LO 5-5 43. In 2017, the Rinaldis' vacation cottage was severely damaged by an earthquake. They had an AGI of $110,000 in 2017, and following is information related to the cottage:

Cost basis	$ 95,000
FMV before casualty	135,000
FMV after casualty	20,000

The Rinaldis had insurance and received an $80,000 insurance settlement. What is the amount of allowable casualty loss deduction for the Rinaldis in 2017 *before* the AGI and event limitation?

a. $3,900.

b. $14,900.

c. $15,000.

d. $45,000.

EA LO 5-6 44. Which expense, incurred and paid in 2017, can be claimed as miscellaneous itemized deduction subject to the 2% of AGI floor?

a. Self-employed health insurance.

b. Unreimbursed moving expenses.

c. Employee's unreimbursed business car expense.

d. Self-employment taxes.

EA LO 5-6 45. Raquel, who works in medical sales, drives her own vehicle to various locations for client sales meetings. Her employer reimburses her $400 each month for various business expenses and does not expect Raquel to provide proof of her expenses. Her employer included this $4,800 reimbursement in Raquel's 2017 W-2 as part of her wages. In 2017, Raquel incurred $3,000 in transportation expense, $1,000 in parking and tolls expense, $1,800 in car repair expense, and $600 for expenses while attending a professional association convention. Assume that Raquel uses the vehicle for business purposes only and that she maintains adequate documentation to support all of these expenditures. What amount is Raquel entitled to deduct on her Schedule A for miscellaneous itemized deductions?

a. $6,400 of expenses subject to the 2% of AGI limitation.

b. $4,800 because her employer follows a nonaccountable plan.

c. $1,600, the difference between her expenditures and her reimbursement.

d. $0 because her employer follows a nonaccountable plan.

EA LO 5-6 46. Which of the following itemized deductions is *not* subject to the 2% limit on the Schedule A?

a. Tax preparation fees.

b. Safe deposit box fee.

c. Gambling losses.

d. Union dues and fees.

EA LO 5-6 47. All of the following would qualify as a deductible work or job-related expense *except:*

a. A doctor incurring expenses related to studying to become certified as a plastic surgeon.
b. An accountant taking a CPA exam review course.
c. A teacher taking courses to qualify for an educational administration position.
d. A CPA taking continuing education courses to be eligible to practice in another state.

EA LO 5-7 48. In 2017, high-income individuals are required to forfeit part of their itemized deductions. This effectively

a. Reduces their overall tax rate.
b. Does not affect their overall tax rate.
c. Increases their overall tax rate.
d. None of the above.

EA LO 5-7 49. For 2017, the high-income taxpayer limitation percent of the excess of AGI over the applicable threshold is

a. 3%.
b. 2%.
c. 1%.
d. 0%.

Problems

connect

All applicable problems are available with ***Connect***©

EA LO 5-1 50. Mickey is a 12-year-old dialysis patient. Three times a week for the entire year he and his mother, Sue, drive 20 miles one way to Mickey's dialysis clinic. On the way home, they go 10 miles out of their way to stop at Mickey's favorite restaurant. Their total round trip is 50 miles per day. How many of those miles, if any, can Sue use to calculate an itemized deduction for transportation? Use the mileage rate in effect for 2017. Explain your answer.

EA LO 5-1 51. Reggie, who is 55, had AGI of $32,000 in 2017. During the year, he paid the following medical expenses:

Drugs (prescribed by physicians)	$ 200
Marijuana (prescribed by physicians)	1,400
Health insurance premiums–after taxes	850
Doctors' fees	1,250
Eyeglasses	375
Over-the-counter drugs	200

Reggie received $500 in 2017 for a portion of the doctors' fees from his insurance. What is Reggie's medical expense deduction?

EA LO 5-1 52. Dante and Rosa, both under 65 and married, have a combined AGI of $45,000 in year 2017. Due to certain heart issues, Dante has been prescribed Lipitor by a physician. For year 2017, Dante spent a total of $3,100 on the medication and $750 on doctor's bills. Can Dante deduct the medical costs as an itemized deduction? Explain your answer.

EA LO 5-3 53. Leslie and Jason, who are married, paid the following expenses during 2017:

Interest on a car loan	$ 100
Interest on lending institution loan (used to purchase municipal bonds)	3,000
Interest on home mortgage (home mortgage principal is less than $1,000,000)	2,100

What is the maximum amount that they can use in calculating itemized deductions for 2017?

EA LO 5-2 54. On April 1, 2017, Paul sold a house to Amy. The property tax on the house, which is based on a calendar year, was due September 1, 2017. Amy paid the full amount of property tax of $2,500. Calculate both Paul and Amy's allowable deductions for the property tax. Assume a 365-day year.

EA LO 5-2 55. In 2016, Tomas, a single taxpayer, had $3,750 in state tax withheld from his paycheck. He properly deducted that amount on his 2016 tax return as an itemized deduction that he qualified for, thus reducing his tax liability. After filing his 2016 tax return, Tomas discovered that he had overpaid his state tax by $417. He received his refund in July 2017. What must Tomas do with the $417 refund? Explain your answer.

EA LO 5-3 56. Steve purchased a personal residence from Adam. To sell the residence, Adam agreed to pay $4,500 in points related to Steve's mortgage. Discuss the tax consequences from the perspectives of both Steve and Adam.

EA LO 5-3 57. Shelby has net investment income of $18,450 and wage income of $80,500. She paid investment interest expense of $19,000. What is Shelby's deduction for investment interest expense? Explain your answer.

EA **LO 5-3** 58. Tyrone and Akira, who are married, incurred and paid the following amounts of interest during 2017:

Home acquisition debt interest	$15,000
Credit card interest	5,000
Home equity loan interest	6,500
Investment interest expense	10,000

With 2017 net investment income of $2,000, calculate the amount of their allowable deduction for investment interest expense and their total deduction for allowable interest. Home acquisition principal is less than $1,000,000, and the home equity loan principal is less than $100,000.

EA **LO 5-4** 59. Jinhee purchased a ticket to a concert to raise money for the local university. The ticket cost $350, but the normal cost of a ticket to this concert is $100. How much is deductible as a charitable contribution?

EA **LO 5-4** 60. Jaylen made a charitable contribution to his church in the current year. He donated common stock valued at $33,000 (acquired as an investment in 1998 for $14,000). Jaylen's AGI in the current year is $75,000. What is his allowable charitable contribution deduction? How are any excess amounts treated?

EA **LO 5-4** 61. Adrian contributed an antique vase she had owned for 25 years to a museum. At the time of the donation, the vase had a value of $35,000. The museum displayed this vase in the art gallery.

a. Assume that Adrian's AGI is $80,000, and her basis in the vase is $15,000. How much may Adrian deduct?

b. How would your answer to Part a change if, instead of displaying the vase, the museum sold the vase to an antique dealer?

EA **LO 5-5** 62. In 2017, Arturo's pleasure boat that he purchased in 2012 for $48,500 was destroyed by a hurricane. His loss was not totally covered by his insurance. On what form(s) will Arturo report this loss?

EA LO 5-5 63. Reynaldo and Sonya, a married couple, had flood damage in their home due to a faulty water heater during 2017, which ruined the furniture that was stored in their garage. The following items were completely destroyed and not salvageable:

Damaged Items	FMV Just Prior to Damage	Original Item Cost
Antique poster bed	$6,000	$ 5,000
Pool table	7,000	11,000
Flat-screen TV	700	2,500

Their homeowner's insurance policy had a $10,000 deductible for the personal property, which was deducted from their insurance reimbursement of $12,700, resulting in a net payment of $2,700. Their AGI for 2017 was $50,000. What is the amount of casualty loss that Reynaldo and Sonya can claim on their joint return for 2017?

EA LO 5-6 64. During the year 2017, Ricki, who is not self-employed and does not receive employer reimbursement for business expenses, drove her car 5,000 miles to visit clients, 10,000 miles to get to her office, and 500 miles to attend business-related seminars. All of this mileage was incurred ratably throughout the year. She spent $300 for airfare to another business seminar and $200 for parking at her office. Using the automobile expense rates in effect for 2017, what is her deductible transportation expense?

EA LO 5-6 65. Hortencia is employed as an accountant for a large firm in San Diego. During 2017, she paid the following miscellaneous expenses:

Unreimbursed employee business expenses	$520
AICPA dues	400
Investment journal subscriptions	175
Student loan interest	450
Job-hunting expenses within the same profession	200

Hortencia plans to itemize her deductions in 2017 because she purchased a home this year and has mortgage interest expense; what amount could she claim as miscellaneous itemized deductions *before* the AGI limitations?

Tax Return Problems connect

All applicable tax return problems are available with ***Connect***©

Use your tax software to complete the following problems. If you are manually preparing the tax returns, you will need to prepare Form 1040 and Schedule A for each problem and a Form 8283 for the third problem and a Form 2106 for the fourth problem.

Tax Return Problem 1

Elise Dubois is single, has no dependents, and lives at 55855 Ridge Drive in Lafayette, LA 70593. His social security number is 412-34-5670 (date of birth 3/15/1976). Elise had qualifying health care coverage at all times during the tax year.

Her W-2 contained the following information:

Wages (box 1) = $48,965.25
Federal W/H (box 2) = $ 5,043.40
Social security wages (box 3) = $48,965.25
Social security W/H (box 4) = $ 3,035.85
Medicare wages (box 5) = $48,965.25
Medicare W/H (box 6) = $ 710.00

She has gambling winnings of $550 and the following expenses:

State income taxes	$2,200
Real estate property taxes	1,150
Medical expenses	5,400
Charitable cash contributions (no single contribution was more than $250)	450
Mortgage interest expense	4,605
Personal property taxes	220
Gambling losses	660
Job-hunting expenses within the same profession (she did not get the new position)	310

Prepare a Form 1040 and Schedule A for Elise using any appropriate worksheets.

Tax Return Problem 2

In 2017, John and Shannon O'Banion, who live at 3222 Pinon Drive, Mesa, CO 81643, file as married filing jointly. John's social security number is 412-34-5670 (date of birth 5/12/1979), and Shannon's is 412-34-5671 (date of birth 11/3/1981). John and Shannon had qualifying health care coverage at all times during the tax year.

John's W-2 contained the following information:

Wages (box 1) = $66,346.74
Federal W/H (box 2) = $ 6,583.85
Social security wages (box 3) = $66,346.74
Social security W/H (box 4) = $ 4,113.50
Medicare wages (box 5) = $66,346.74
Medicare W/H (box 6) = $ 962.03

Shannon did not work for the year due to a medical condition but did receive unemployment compensation of $2,711 for the year with no federal withholding. In the same year, they had the following medical costs:

Shannon's prescribed diabetes medication	$2,150
Shannon's hospital charges	8,350
Shannon's regular physician visits	835
Shannon's eye doctor	75
Shannon's diabetes blood testing supplies	185
Insurance reimbursements	1,910

In addition, they had the following other expenses:

State income taxes	$2,950
Real estate property taxes	1,170
Car loan interest	500
Personal property taxes	265
Cash charitable contributions (made ratably throughout the year to their church)	635
Mortgage interest expense	7,970
Union dues for John	575
Tax preparation fees	175

Prepare a Form 1040 and Schedule A for the O'Banions using any appropriate worksheets.

Tax Return Problem 3

Keisha Sanders, a divorced single taxpayer and practicing attorney, lives at 9551 Oak Lane in Menifee, CA 92584. Her social security number is 412-34-5670 (date of birth 2/27/1973). Keisha had qualifying health care coverage at all times during the tax year.

Her W-2 contained the following information:

Wages (box 1) = $84,601.55
Federal W/H (box 2) = $9,898.38
Social security wages (box 3) = $84,601.55
Social security W/H (box 4) = $ 5,245.30
Medicare wages (box 5) = $84,601.55
Medicare W/H (box 6) = $ 1,226.72

In addition, Keisha made alimony payments totaling $10,800 for the year to her former husband Alex, an unemployed mine worker, whose social security number is 412-34-5671. She also received a 1099 INT from Menifee Credit Union in the amount of $204.75.

Keisha also has the following information for her Schedule A itemized deductions:

Interest expense	
Home mortgage (qualified residence interest)	$8,100
MasterCard (used exclusively for personal expenses and purchases)	425
Car loan (personal use)	600
Student loan interest	1,750
Taxes paid	
State income tax withheld	2,950
State income tax deficiency (for 2015)	350
Real estate property taxes—principal residence	1,700
Personal property taxes—car	75
Registration fee—car	135
Medical expenses	
Doctors' fees	500
Prescription drugs	200
Vitamins and over-the-counter drugs	250
Dental implant to correct a bite problem	1,600
Health club fee	400
Charitable contributions (all required documentation is maintained)	
Cash:	
Church	3,100
(made ratably throughout the year)	
United Way	100
PBS annual campaign	200
Property:	
Pine Cove Goodwill—used clothing and household items	
Date of donation November 15, 2017	
Thrift shop value at date of donation	350
Purchase price of the items	1,300
Other	
Investment publications	150
Tax return preparation fee	275
Business dues and subscriptions	350
Safe deposit box	75

Prepare a Form 1040, a student loan worksheet, a Schedule A, and a Form 8283 for Keisha using any other appropriate worksheets.

We have provided selected filled-in source documents that are available in *Connect*.