6

Itemized Deductions

OVERVIEW

This chapter covers common itemized deductions that a taxpayer may be eligible to claim on Schedule A. These types of itemized deductions include medical and dental expenses, taxes, interest expenses, charitable contributions, and prior-year tax preparation fees. A taxpayer who wishes to itemize their deductions on a Schedule A may do so only by filing Form 1040. It is important to be aware of these types of itemized deductions so that, when you encounter them at the tax desk, you can properly hand the taxpayer's return off to a more experienced Tax Professional.

OBJECTIVES

At the conclusion of this chapter, you will be able to:

- Determine when it is advantageous for a taxpayer to itemize deductions.
- Identify deductible medical and dental expenses reported on Schedule A.
- Identify deductible taxes reported on Schedule A.
- Identify deductible qualified home mortgage interest expenses reported on Schedule A.
- Identify deductible charitable contributions reported on Schedule A.

TAX TERMS

Look up the definitions of the following terms in the glossary:

- Acquisition debt.
- Charitable contributions.
- Contribution.
- General sales tax.
- Itemized deductions.
- Medicare Part A.
- Medicare Part B.
- Medicare Part D.
- Personal property tax.
- Points.
- Prepaid interest.
- Qualified charitable organization.
- Standard deduction.

ITEMIZING VS. STANDARD DEDUCTIONS

The Tax Code allows certain personal expenses to be deducted from gross income as an itemized deduction on Schedule A. Some of the expenses taxpayers may deduct depend on their adjusted gross income (AGI). In other words, before taxpayers will see any tax benefits from these types of deductions, they will have to cross a threshold amount. The dollar amount of the threshold is different for every taxpayer, but the percentages (2%, 7½%, and 10%) of AGI are the same. It is not uncommon for a taxpayer to have several thousand dollars of one type of expense, but see no tax benefit from it. Other types of deductions may be deducted regardless of AGI.

Every taxpayer must decide whether or not to itemize deductions. Generally, taxpayers choose to deduct the larger of their total itemized deductions or their standard deduction. It is important to note that a taxpayer who wishes to itemize their deductions on a Schedule A must file a Form 1040. The Form 1040EZ or Form 1040A only allows a taxpayer to claim their standard deduction, and does not provide the taxpayer the ability to itemize their deductions. You studied the standard deductions for various categories of taxpayers in previous chapters. The following table shows a taxpayer's standard deduction based on their filing status, age, and if they are legally blind. This table can also be found on the KJ Briceño Desk Card reference guide located on pages A.3–A.4 of the Appendix.

2016 STANDARD DEDUCTION	
Single	$6,300
Age 65 or older or blind (each)	+1,550
Married filing jointly	$12,600
Age 65 or older or blind (each)	+1,250
Married filing separately	$6,300
Age 65 or older or blind (each)	+1,250
Head of household	$9,300
Age 65 or older or blind (each)	+1,550
Qualifying widow(er)	$12,600
Age 65 or older or blind (each)	+1,250
Dependent	Greater of earned income +$350 or $1,050.

When married taxpayers choose to use the married filing separately status and one spouse itemizes deductions, the other spouse should itemize deductions as well, because their standard deduction is reduced to $0. Such a taxpayer, while not required to itemize, benefits from doing so—unless the taxpayer has nothing to deduct, which almost never happens. After all, even a small deduction is better than none. For more information, see IRS Publication 17, page 22.

In certain states and under certain circumstances, it may be advantageous for some taxpayers to itemize deductions on the federal return, even if their federal itemized deductions total less than their standard deductions. The reason? Itemizing on their federal returns allows them to itemize on their state returns, thus saving overall tax dollars. Such taxpayers should mark the box on Schedule A, line 30. Your instructor will tell you if this is a consideration in your state.

Schedule A in Illustration 6.1 on page 6.4 is completed for taxpayers who itemize deductions. This schedule contains the following sections:

- Medical and Dental Expenses.
- Taxes You Paid.
- Interest You Paid.
- Gifts to Charity.
- Casualty and Theft Losses.
- Job Expenses and Certain Miscellaneous Deductions.
- Other Miscellaneous Deductions.

This chapter is devoted to a discussion of deductions for medical expenses, taxes paid, interest paid, charitable contributions, and prior-year tax preparation fees, because these deductions are the most common types of itemized deductions on the Schedule A.

STOP **Complete Exercise 6.1 before continuing to read.**

MEDICAL AND DENTAL EXPENSES

Deductible medical expenses include payments made for the diagnosis, cure, mitigation, treatment, or prevention of disease, and the costs for treatments affecting any part or function of the body. Deductible medical expenses may also include equipment, supplies, transportation related to medical care, and certain health insurance coverage for the taxpayer, spouse, and dependents. General deductible medical expense payments are made by the taxpayer with after-tax dollars. Payments of medical expenses with pre-tax dollars are nondeductible on the Schedule A. When determining what medical or dental expenses are deductible on Schedule A, IRS Publication 502, *Medical and Dental Expenses*, is an excellent resource.

Medical expenses are deductible in the year paid. If expenses are charged to a credit card, they are considered to be paid on the date charged.

Medical expenses paid by a taxpayer for his spouse are deductible if they were married at the time the expenses were incurred *or* at the time the expenses were paid. To be able to deduct medical expenses paid for a dependent, the individual generally must have been a dependent at the time the expenses were incurred *or* at the time they were paid. An exception is allowed if the medical expenses were paid for an individual who the taxpayer could claim as a dependent, except that the dependent failed the gross income or joint return test.

Illustration 6.1

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

Itemized Deductions

▶ Information about Schedule A and its separate instructions is at www.irs.gov/schedulea.
▶ Attach to Form 1040.

OMB No. 1545-0074
2016
Attachment Sequence No. **07**

Name(s) shown on Form 1040: MARK H LUJAN
Your social security no. 747-69-7235

Section	Line	Description	Box	Amount	Box	Amount
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] 59,870				
	3	Multiply line 2 by 10% (0.10). But if either you or your spouse was born before January 2, 1952, multiply line 2 by 7.5% (0.075) instead	3	5,987		
	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 [X] Income taxes, **or** b [ ] General sales taxes	5	1,796		
	6	Real estate taxes (see instructions)	6	2,798		
	7	Personal property taxes	7	425		
	8	Other taxes. List type and amount ▶	8			
	9	Add lines 5 through 8			9	5,019
Interest You Paid	10	Home mortgage interest and points reported to you on Form 1098	10	7,632		
	11	Home mortgage int. not reported to you on Form 1098. If paid to the person from whom you bought the home, see inst. and show that person's name, identifying no., and address ▶	11	0		
Note: Your mortgage interest deduction may be limited (see instructions).	12	Points not reported to you on Form 1098. See inst. for special rules	12			
	13	Mortgage insurance premiums (see instructions)	13			
	14	Investment interest. Attach Form 4952 if required. (See instructions.)	14			
	15	Add lines 10 through 14			15	7,632
Gifts to Charity	16	Gifts by cash or check. If you made any gift of $250 or more, see instructions	16	2,000		
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			
	18	Carryover from prior year	18			
	19	Add lines 16 through 18			19	2,000
Casualty and Theft Losses	20	Casualty or theft loss(es). Attach Form 4684. (See instructions.)			20	0
Job Expenses and Certain Miscellaneous Deductions	21	Unreimbursed empl. exp. -- job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See inst.) ▶	21			
	22	Tax preparation fees	22			
	23	Other expenses -- investment, safe deposit box, etc. List type and amt. ▶	23			
	24	Add lines 21 through 23	24			
	25	Enter amount from Form 1040, line 38 . . [25] 59,870				
	26	Multiply line 25 by 2% (0.02)	26	1,197		
	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 $155,650? [X] **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	14,651
	30	If you elect to itemize deductions even though they are less than your standard deduction, check here ▶ [ ]				

For Paperwork Reduction Act Notice, see Form 1040 instructions. **Schedule A (Form 1040) 2016**

A taxpayer may also deduct medical expenses paid for a dependent claimed under a multiple-support agreement. The persons who waive the exemption may not deduct medical expenses paid for the dependent.

If divorced or separated parents who lived apart during the last six months of the year supported a child together, each parent, whether custodial or noncustodial, is allowed to deduct the medical expenses actually paid for the child during the year. The deduction may be taken even if the other parent is allowed to claim the exemption for the child.

Medicine and Drugs

Prescription drugs and insulin are deductible if the expense has not been reimbursed by insurance. Generally, taxpayers are not allowed to deduct the cost of prescription drugs purchased in or imported from another country, unless the drug is legal in the United States and the Food and Drug Administration allows importing of the drug by individuals. Expenses for nonprescription medicines and vitamin and mineral supplements are *not* deductible. However, certain over-the-counter drugs may be paid for using tax-free dollars. See Cafeteria Plans on page 6.10.

Medical Insurance Premiums

Taxpayers may include insurance premiums they paid for policies that cover medical care if the insurance provides reimbursement for hospitalization, surgical fees, other medical or dental expenses, prescription drugs, or lost or damaged contact lenses as medical expenses.

A taxpayer cannot include any insurance premiums or other medical or dental expenses paid by an employer-sponsored health insurance plan (unless the premium or other expense amounts are included in box 1 of the taxpayer's Form W-2 or paid with after-tax dollars) as medical and dental expenses on Schedule A.

Medicare

The portion of payroll tax allocated to pay for Medicare Part A is *not* deductible. A taxpayer who is not covered under the social security program and who is not a government employee paying medicare tax, may deduct the premiums voluntarily paid for Medicare Part A coverage.

Medicare Part B premiums (the premiums paid or withheld from social security benefits for supplemental medicare coverage) are deductible as a medical expense. Medicare Part D prescription premiums are also deductible.

Long-Term Care Services and Insurance

If the taxpayer paid for qualified long-term care services during the year, they may be eligible to deduct these costs. If the taxpayer paid premiums for a qualified long-term care insurance contract, they may be able to deduct all or part of these premiums based on their age. To see the amount a taxpayer may deduct for qualified long-term care insurance contract premiums, see IRS Publication 502, *Medical and Dental Expenses*, page 11.

Qualified long-term care services are services prescribed by licensed health care practitioners for chronically ill individuals. These services must be:

- Necessary diagnostic, preventative, therapeutic, curing, treating, mitigating, or rehabilitative services.
- Maintenance or personal care services.

A qualified long-term care insurance contract is an insurance contract that provides coverage only for qualified long-term care services. The contract must:

- Be guaranteed renewable.
- Not provide for a cash surrender value.
- Not pay or reimburse expenses that would be covered under medicare.
- Provide that refunds and dividends under the contract must be used only to reduce future premiums or increase future benefits.
- Not apply to refunds on the death of the insured or upon surrender or cancellation of the contract.

Ineligible Insurance

Premiums paid for the following types of insurance policies are *not* deductible:

- Policies covering loss of earnings while injured.
- Policies covering loss of life, limb, or sight.
- Policies paying a guaranteed amount for each day (or week) for a given period of time while the taxpayer is hospitalized for sickness or injury. However, if the policy also provides for medical care, and the amounts for each are stated separately, the portion of the premium allocable to medical care is deductible.
- Policies paying for medical care from a portion of automobile insurance premiums.

Medical and Dental Expenses

Deductible medical expenses include most fees paid to medical doctors, dentists, psychologists, psychiatrists, chiropractors, and Christian Science practitioners. Most fees paid for hospital services, therapy, nursing services, laboratory tests, and payments for acupuncture treatments are deductible.

Stop-Smoking Programs

The cost of a smoking cessation program is deductible as a medical expense. The deduction may include the cost of treatment and prescription drugs designed to alleviate the effects of nicotine withdrawal. Costs for nicotine gum and patches not requiring prescriptions are *not* deductible.

Weight-Loss Programs and Surgery

The government and the health care profession recognize obesity as a disease in and of itself. If a physician has diagnosed a taxpayer as being obese, the cost of a weight-loss program or weight-loss surgery is deductible as a medical expense.

A deduction is also allowed in cases where the weight-loss program or surgery is used to treat other diagnosed diseases, such as arthritis, diabetes, high cholesterol, or hypertension (high blood pressure). However, the cost of such a weight-loss program undertaken for general health purposes or without a doctor's diagnosis of obesity is not deductible. In no case is the cost of diet food deductible.

m**Example:** Sandy, Roxanne, and Alice joined a well-known national weight-loss program that sells portion-controlled packaged food to its members. Sandy was diagnosed as obese by her physician. Roxanne's doctor told her that losing weight would help her lower her high blood pressure. Alice is not obese and does not suffer from any weight-related health problems — she just wants to lose a few pounds.

Both Sandy and Roxanne may deduct the cost of the weight-loss program; Alice may not. None of them may deduct the cost of the food.

After this attempt at weight loss failed, Sandy had obesity surgery at the recommendation of her doctor. She may deduct the medical expenses connected with the surgery.m

Cosmetic Surgery

While most legal medical services are deductible, the cost of cosmetic surgery (face-lifts and the like) generally is not. *Cosmetic surgery* is any procedure directed at improving appearance and does not meaningfully promote the proper function of the body or prevent illness or disease.

There is an exception to the nondeductibility of expenses for cosmetic surgery. If the surgery or procedure is necessary to correct or improve a deformity arising from a congenital abnormality, an accident or other trauma, or a disfiguring disease, the cost is deductible.

Medical Aid Items and Equipment

The costs of medical aid items and equipment, such as bandages, blood glucose meters, eyeglasses, contact lenses, hearing aids, prosthetic devices, crutches, and wheelchairs are deductible. The cost of related supplies, batteries, cleaning, and maintenance of medical items and equipment is deductible.

The cost of purchasing and maintaining a service animal to assist individuals with any kind of physical disability is deductible. The most common example of a service animal is a seeing-eye dog.

Costs to purchase and maintain TTY/TDD (telecommunications devices for the deaf) equipment, which allows hearing-impaired persons to communicate by text over the telephone, are deductible. Costs to purchase Braille books and magazines for the blind are deductible to the extent they exceed the costs of the same printed materials.

m**Example:** Steve Henderson, a hearing-impaired individual, purchased a TDD unit for $500. He also purchased some Braille books for his dependent daughter, who is blind. The books cost $350, but the same printed books would cost $190. Steve may deduct $660 for these items [$500 + ($350 – $190)].m

Medical Capital Expenditures

The cost of special equipment and structural improvements installed in a residence for medical purposes is deductible as a medical expense. If the taxpayer rents the residence, these costs are deductible in full. If the taxpayer owns the residence, the part of the cost that exceeds any increase in the value of the property is deductible.

m**Example:** On a doctor's advice, a taxpayer who owns his home installs central air conditioning to alleviate his son's severe allergies. The unit cost plus installation equals $5,000 but the unit increased the value of the home by $5,300. The cost and installation are not deductible, because it did not exceed the increase in property value [$5,000 cost – $5,300 increased value = –300 cost less home value].m

The cost of operating and maintaining special equipment and structural improvements is deductible for as long as there is a medical purpose for its use. Therefore, although the cost of the air conditioner in the example above is not deductible, the increase in utility bills from running the air conditioner, as well as maintenance costs, are deductible as long as the taxpayer's son remains his dependent and resides in his home.

The IRS has ruled that the following capital expenditures undertaken to remove structural barriers for handicapped individuals will not increase the value of the residence, and hence are fully deductible:

- Constructing exit or entrance ramps.
- Widening hallways and doorways, including entrances and exits to the home.
- Installing lifts, but generally not elevators.
- Installing railings, support bars, and other modifications in bathrooms.
- Lowering counters and cabinets.
- Adjusting electrical outlets and fixtures.
- Modifying fire alarms, smoke detectors, and other warning systems.
- Modifying stairs.
- Adding handrails or grab bars, whether or not in bathrooms.
- Modifying hardware on doors.
- Modifying areas in front of entrance and exit doorways.
- Grading of ground to ease access to the residence.

Medical Transportation

Deductible transportation expenses incurred in connection with medical care include fares for buses, taxis, planes, trains, and ambulance hire. Taxpayers using their own cars for medical transportation may deduct out-of-pocket expenses for gas and oil. In lieu of actual gas and oil expenses, a standard mileage rate may be used. For 2016, the rate is 19¢ per mile.

Regardless of which method is used to calculate medical transportation, add to the deduction any medically-related parking fees and tolls paid. The transportation expenses of a parent who must take a child to receive medical care or for a nurse who must travel with a patient to get medical care are deductible. Transportation expenses for regular visits to see a mentally ill dependent are deductible if the visits are recommended as a part of the treatment.

Medical Meals and Lodging

If a person is in a hospital, nursing home, or similar institution primarily for medical care, the cost of the meals and lodging the institution provides is a deductible medical expense.

The cost of non-hospital lodging while away from home, primarily for medical care provided by a physician in a licensed hospital, or in a medical facility that is related to or equivalent to a licensed hospital, is deductible. The deduction is limited to $50 per night per person. Meals are *not* deductible.

Lodging expenses for a person accompanying the patient are deductible if the patient's expenses are deductible and the patient is unable to travel alone. No deduction is allowed for either the patient or the companion if the accommodations are lavish or there is a significant element of pleasure involved.

m**Example:** Janice Rawlins accompanied her ten-year-old dependent daughter, Rachel, to Rochester, Minnesota, for some medical tests that Rachel needed to undergo at the Mayo Clinic. While in Rochester, Janice and Rachel stayed for three nights at a motel near the clinic while the tests were conducted. They spent $90 per night for the motel and a total of $130 for meals. Janice may deduct $270 [$90 2 3 nights] for lodging, because the mother and daughter have separate $50-per-night limits. Janice cannot deduct the $130 for meals.m

Special Care

Payments for special care necessitated by a physical or mental handicap or disorder are deductible medical expenses. Such special care includes care furnished by a special school for the physically or mentally handicapped, advance payments to an institution for lifetime care, treatment and training of a mentally or physically handicapped dependent, and tutoring provided for an individual who has severe learning disabilities caused by mental or physical impairments. Alleviating the handicap or disorder must be the primary reason for obtaining this special care in order for its cost to be deductible.

Wages paid to individuals who provide nursing care, including meals provided and payroll taxes paid on their behalf, may be deducted as a medical expense. The care need not be provided by a nurse, but the services must be of a kind generally performed by a nurse. These include caring for the patient's medical condition, administering medications, and assisting with bathing, grooming, and the like.

Certain expenses of handicapped individuals to assist them in their employment are deductible as an Other Miscellaneous Deduction on line 28 of Schedule A.

Cafeteria Plans

Some employers allow employees to defer some of their earnings before tax (i.e., pre-tax earnings) into a flexible spending account (FSA) or health savings account (HSA). Funds from the FSA or HSA may be used to pay medical expenses after they have been incurred. These plans also may allow employees to pay for their medical or dental insurance or bills with these pre-tax account funds. These plans are often referred to as cafeteria plans (or §125 plans, referring to the section of the Internal Revenue Code that defines them) because the employee can choose from a "menu" of available qualified benefits, usually before taxable wages are computed.

No deduction may be taken for any medical expense that is paid for with pre-tax money. The logic is simple: You cannot deduct from taxable income something that was never included in the first place.

Non-prescription drugs and medicines, although non-deductible, may qualify for reimbursement under a §125 plan if they were prescribed by a doctor and used to treat a specifically diagnosed disease or condition.

m**Example:** Lisa Curcio had her employer deposit $10 of her salary per week into her §125 plan. Lisa is under the care of a doctor to treat her arthritis. Her medical expenses for the year include $300 for four doctor visits and $220 for over-the-counter pain relievers prescribed by her doctor. Lisa may receive reimbursement from her §125 plan to cover the cost of the doctor visits and the pain relievers. If she did not have the §125 plan, she could deduct the doctor bills but not the cost of the pain relievers.m

Reimbursement for Medical Expenses

Medical expenses that are reimbursed by an insurance plan or paid with pre-tax money from a §125 plan are not deductible. Expenses that are paid directly by insurance are not entered on the return. Reduce total medical expenses by any reimbursements received (or expected to be received) before entering the net amount on Schedule A. Any reimbursement received in excess of an actual expense must be used to reduce other medical expenses.

Excess Reimbursements

If a taxpayer receives reimbursement in excess of medical expenses from an insurance policy for which they paid the entire premium, the excess reimbursement is not taxable. The section titled, "How Do You Treat Reimbursements?" in Chapter 21 of IRS Publication 17, explains the taxability of excess reimbursements if the employer paid a portion of the insurance premium.

MEDICAL AND DENTAL EXPENSE AGI THRESHOLD

For a taxpayer to deduct their qualified medical and dental expenses on the Schedule A, the taxpayer's medical and dental expenses must first exceed their AGI threshold for the tax year. Their AGI threshold is based on the taxpayer's age and AGI. Only the amount of expenses that exceed the taxpayer's AGI threshold can be deducted on Schedule A. For 2016, medical and dental expenses are deductible to the extent they exceed 10% (7½% if either the taxpayer or their spouse is age 65 or older) of the taxpayer's AGI. In short, for these medical and dental expenses to be deductible as an itemized deduction, only the total amount of these expenses that exceeds 10% (7½% if either the taxpayer or their spouse is age 65 or older) of the taxpayer's AGI are deductible on the Schedule A.

Tax Tip: When preparing taxes, you may hear other Tax Professionals refer to an AGI floor. For example, the taxpayer's deductible medical or dental expenses are the amounts that exceed their 10% AGI floor. In short, a floor represents the minimum amount of expense the taxpayer must incur before they can deduct the excess expense, that exceeds the floor, on their return.

STOP **Complete Exercises 6.2 and 6.3 before continuing to read.**

TAXES YOU PAID

In general, taxes that fall into the following categories are deductible on a Schedule A:

- State and local taxes (income or general sales).
- Real property taxes (state, local, and foreign).
- Personal property taxes (state and local).
- Foreign income taxes.

To be deductible, these taxes must be imposed on, and paid by, the taxpayer. Taxes are generally deducted the year they are paid. Most taxes are deductible only on Schedule A. However, the taxes incurred in the operation of a business or farm or in producing rental or royalty income must be deducted from that income.

Tax Tip: For a taxpayer to deduct taxes on their Form 1040, Schedule A, the taxpayer must meet the following two requirements:

- The tax must be imposed on the taxpayer.
- The taxpayer must pay the tax during the tax year.

State and Local Taxes

Taxpayers have the option of deducting either (1) state and local income taxes paid during the year or (2) state and local general sales taxes paid during the year, but not both.

Income Taxes

Deductible income taxes include all of the following:

- State and local income taxes withheld from income (normally shown on Forms W-2).
- Mandatory employee contributions to the Alaska, New Jersey, or Pennsylvania Unemployment Compensation Fund; California, New Jersey, or New York Nonoccupational Disability Benefit Fund; Rhode Island Temporary Disability Benefit Fund; or Washington State Supplemental Workmen's Compensation Fund.
- Payments of state and local estimated taxes, including any portion of a prior-year refund the taxpayer chose to have credited to their 2016 state or local income taxes.
- Any balances paid on prior years' state and local returns.

When considering the amount of state and local income taxes to deduct on Schedule A, be careful to include only payments *made* during the tax year, regardless of the year to which the payments apply.

m**Example:** Maggie Colt is a resident of Nebraska in 2016. For the 2016 tax year, she made four state estimated tax payments of $45 to Nebraska on April 30, 2016; July 31, 2016; October 31, 2016; and January 31, 2017. Maggie made no state estimated tax payments for the 2015 tax year. When determining the amount of state income taxes Maggie may deduct on her Schedule A, she is only allowed to include three of the four $45 state estimated tax payments, because these payments were made during the 2016 tax year. The $45 payment made on January 31, 2017 would be deductible on her 2017 return, because the payment was made in 2017.m

Sales Taxes

Instead of state and local income taxes paid, individual taxpayers may choose to deduct state and local general sales taxes. Sales taxes paid on items used in a trade or business may *not* be deducted on Schedule A, but are included as part of the cost of the items and are potentially deductible as an expense of the trade or business.

A *general sales tax* is a sales tax imposed on retail sales of a broad range of items at a single rate. However, sales taxes imposed at different rates may also be fully or partially deductible. Certain economically depressed areas impose sales taxes at rates lower than the general sales tax rate. Also, some areas tax food, clothing, medical supplies, or motor vehicles at reduced rates. If sales tax was imposed at a rate less than the general sales tax rate, the actual amount of tax paid is deductible.

Sales taxes on items (generally motor vehicles) that are imposed at rates higher than the general sales tax rate are deductible only up to the amount of tax that would have been imposed on an item of the same cost taxed at the general rate. For this purpose, *motor vehicles* include cars, trucks, vans, SUVs, recreational vehicles, motor homes, motorcycles, and off-road vehicles. This also includes any state and local general sales taxes paid for a leased motor vehicle.

In order to deduct the actual amount of sales tax paid, the taxpayer must keep receipts supporting his deduction amount. However, many taxpayers do not bother saving all those receipts. Instead, Schedule A filers may calculate their sale tax deduction amount by completing the *State and Local General Sales Tax Deduction Worksheet*—Line 5b provided in the 2016 *Instructions for Schedule A (Form 1040)*. This worksheet uses the Optional State Sales Tax Table to determine the amount of the taxpayer's sales tax deduction based on their state of residence, locality, total available income, and number of personal and dependent exemptions claimed. In addition to the amount found in the table, the worksheet allows taxpayers to add any local general sales taxes paid (limited to the general sales tax rate) on certain specified items. These items include motor vehicles, any aircraft, boats, homes (including mobile and manufactured homes), and home-building materials.

If married taxpayers file separately, and both spouses choose to deduct state and local sales taxes instead of income taxes, both spouses must use the same method to compute their sales tax deductions. Thus, if one spouse uses the Optional State Sales Tax Table, the other spouse also must use the table.

Real Estate Taxes

Real estate taxes are state, local, or foreign taxes levied on real property for the general public welfare. They usually do not include local assessments for improvements that increase the value of the assessed property. However, any portion of a local assessment specifically allocated to repairs, maintenance, or related interest is deductible.

It is common for taxpayers with a mortgage on their home to pay their real estate taxes in monthly installments to the mortgage financial institution when they make their mortgage payment. The financial institution will remit the real estate tax to the county and report the taxpayer's real estate taxes paid for the year on Form 1098, box 5 (shown in Illustration 6.2 on page 6.17).

Real estate tax paid into an escrow account (sometimes called an impound account) is deductible in the year the tax is paid from the account to the taxing authority, as opposed to the year the money is paid into the account. Usually, the account trustee sends the owner a statement of taxes paid during the year.

The taxes imposed on real estate sold must be apportioned between the buyer and the seller. The seller may deduct the taxes from the beginning of the year up to (but not including) the date of sale. The buyer may deduct the taxes from the date of purchase to the end of the year. This proration is usually shown on the closing statement.

Personal Property Taxes

A *personal property tax* is similar to a real estate tax, except that it is imposed on personal property. Examples of personal property are clothing, jewelry, cameras, and automobiles. The most common personal property tax is the tax certain states impose annually on the value of automobiles and other vehicles registered in the state.

To be deductible, personal property tax must be based on the value of the property and imposed on an annual basis, even if collected more (or less) frequently. A tax meeting these requirements is deductible even if it is labeled as a fee. If only a portion of the fee meets these requirements, that portion is deductible.

m**Example:** Your state imposes an annual registration fee on motor vehicles. The fee is equal to $25 plus 2% of the assessed value of the vehicle and $1 for every 100 pounds of the vehicle's weight.

Your registration fee for 2016 is $175 [$25 + ($6,000 value 2 2%) + (3,000 pounds 3 100 2 $1) = $175]. You may deduct $120 of the fee as personal property tax [$6,000 value 2 2% = $120]. The remaining $55 is not deductible because it is not based on the value of the vehicle.m

Foreign Taxes

You may include on Schedule A, line 8, any income taxes paid to a foreign country or U.S. possession. These taxes may be claimed either as an itemized deduction or as a credit. A full discussion of the foreign tax credit, which is generally more favorable than this deduction, can be found in the instructions for Form 1040, line 45.

Nondeductible Taxes

Federal taxes, including the taxpayer's federal income taxes, social security and medicare taxes, excise taxes, customs duties, and gift taxes, are not deductible on Schedule A. State and local taxes that are not deductible on Schedule A include inheritance taxes, gift taxes, taxes on utilities, gasoline, tobacco, and alcohol, and taxes that are fines or fees for services.

Federal estate taxes attributable to taxable income received in respect of a decedent may be deductible as a miscellaneous expense. We discuss such deductions later in the next chapter.

STOP **Complete Exercise 6.4 before continuing to read.**

INTEREST YOU PAID

There are several kinds of loans on which taxpayers may pay interest. Among them are personal loans, business loans, loans to purchase investments, and home mortgage loans.

Interest paid on personal loans, such as car loans, credit card finance charges, and installment plans, is not deductible at all. Interest on business loans is deductible from business income on the appropriate schedule. Qualified home mortgage interest and investment loan interest may be deductible on Schedule A. For either of these types of interest to be deductible, the taxpayer must be legally liable for repayment of the loan. Generally, it is very common for taxpayers who own a home to have qualified home mortgage interest. Let's take a look at this type of interest now.

Qualified Home Mortgage Interest

Generally, taxpayers are allowed to deduct qualified home mortgage interest from their first and second home (the taxpayer's primary residence and one other residence) on a Schedule A. There are two categories of qualified home mortgage interest (interest on debt secured by a principal residence or second residence):

1. Acquisition debt.
2. Home equity debt.

Acquisition debt is debt incurred to buy, build, or improve the home. This type of debt is generally secured through a financial institution in the form of a mortgage loan. Generally, a taxpayer would secure this form of debt through a cash down payment and pledge of property. Interest on acquisition debt is fully deductible, as long as the debt amount does not exceed $1 million ($500,000 MFS) at any time during the tax year.

m**Example:** In 2012, Lisa Wilcox purchased her principal residence for $250,000. In 2016, when she owed $180,000 on the original mortgage, she borrowed an additional $60,000 secured by the home and used the proceeds to build a sunroom and install an indoor pool. On her 2016 return, Mary may deduct, as qualified home mortgage interest, the interest she pays on her original mortgage as well as the additional $60,000 loan. Both loans are considered acquisition debt, because the loan funds are used to buy, build, or improve Lisa's primary residence.m

Home equity debt is debt incurred for any purpose other than buying, building, or improving the home. This type of debt is generally issued to a taxpayer by a financial institution in the form of a home equity loan. A taxpayer would use the equity in their home as collateral for securing the home equity loan. Interest on home equity debt is fully deductible, as long as the debt does not exceed $100,000 ($50,000 MFS) at any time during the tax year, or the difference between the fair market value of the home and the remaining acquisition debt, whichever is less. It is important to note that if a taxpayer used the funds from a home equity loan to buy, build, or improve their first or second primary residence, the loan is not classified as home equity debt, but instead is classified as acquisition debt, and the debt limitations are increased to $1 million ($500,000 MFS).

m**Example:** In 2013, Jim Myers purchased his home for $180,000. In 2016, his debt remaining on his original mortgage used to acquire the house is $70,000, and the fair market value of the house is $185,000. Jim decides to open a home equity line of credit in 2016 to borrow $25,000 to purchase a new car. All of the interest paid in 2016 on the original mortgage (acquisition debt) and on the $25,000 car loan (home equity debt) are deductible as qualified home mortgage interest.m

Prepaid Interest

Interest paid in advance (for a period extending beyond the current tax year) generally is deductible in the tax years to which the payments apply. The taxpayer may deduct in each year only the interest for that year.

Points

Points (also called loan origination fees, maximum loan charges, or loan discounts) are mortgage interest paid "up front," when the mortgage is granted. One point equals 1% of the mortgage loan amount. To be deductible as mortgage interest, points must be paid solely for the use of money. Fees paid to cover services, such as the lender's appraisal fee, notary fees, or the preparation of the mortgage note, are *not* deductible.

Because points represent interest paid in advance, they generally must be deducted over the life of the loan. However, points incurred to finance the purchase or improvement of the taxpayer's main home may qualify to be deducted in full in the year they were paid.

Seller-Paid Points. Points paid by the seller in connection with a loan to the buyer are usually considered for tax purposes to be paid by the buyer, and are deductible by the buyer. The taxpayer must reduce the basis of the home by the amount of points paid by the seller.

Reporting Home Mortgage Interest on Schedule A

Financial institutions must report, to the borrower and the IRS, mortgage interest of $600 or more received during the year. Form 1098 (a copy of the standard form is shown in Illustration 6.2 on page 6.17) is used for this purpose. Box 1 shows the interest received from the payer, exclusive of deductible points. Box 6 shows points received for the purchase of the taxpayer's main home, only for the year acquired.

Box 4 shows any refund of interest made because the taxpayer overpaid the amount actually owed. Entries in this box are fairly rare. If you are interested, you may find more information about taxable recoveries of previously-deducted amounts in Chapter 12 of IRS Publication 17.

Box 10 can show various information, such as the address of the property financed or amounts paid out of escrow, including real estate taxes and insurance premiums.

On Schedule A, line 10, enter deductible interest and points reported on Form 1098. Keep in mind that the amounts shown on Form 1098 may or may not be deductible, depending on how they fit the guidelines discussed earlier.

Deductible home mortgage interest and points paid by the taxpayer, but *not* reported on Form 1098, are entered on Schedule A, lines 11 and 12, respectively. If the recipient of the interest is an individual, the recipient's information needs to be reported on the Schedule A.

Qualified Mortgage Insurance Premiums

Taxpayers who were required to purchase mortgage insurance for a mortgage issued after 2006 can deduct the premiums they paid if the mortgage was secured by their first or second home. The amount of premiums paid for this insurance can usually be found in box 5 of Form 1098, and it should be entered on line 13 of Schedule A. This deduction may phase out depending on the taxpayer's AGI. See IRS Publication 936, *Home Mortgage Interest Deduction,* for a detailed explanation of mortgage insurance premiums.

STOP **Complete Exercise 6.5 before continuing to read.**

Illustration 6.2

☐ 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.
MOUNTAINSIDE MORTGAGE
121 S GLEN AVE
YOUR CITY, YS XXXXX

*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
2016
(Rev. July 2016)
Form 1098

Mortgage Interest Statement

RECIPIENT'S/LENDER'S federal identification number: 39-1234466	PAYER'S/BORROWER'S taxpayer identification no.: 744-11-5789
PAYER'S/BORROWER'S name: SANDY BRIGGS	
Street address (including apt. no.): 2636 W RUSTY LANE	
City or town, state or province, country, and ZIP or foreign postal code: YOUR CITY, YS XXXXX	
10 Other: REAL ESTATE TAX: $1,274.00	
Account number (see instructions)	

1 Mortgage interest received from payer(s)/borrower(s)* $ 5,446.38	
2 Outstanding mortgage principal as of 1/1/2016 $ 169,412.00	3 Mortgage origination date 06/01/2017
4 Refund of overpaid interest $	5 Mortgage insurance premiums $ 1,834.00
6 Points paid on purchase of principal residence $ 3,000.00	
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 9 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

CHARITABLE CONTRIBUTIONS

The amount of money contributed and the value or cost of property donated to qualified U.S. charities are deductible. Donations must be made voluntarily and without receiving (or the expectation of receiving) anything of equal or greater value in return.

To be deductible, a charitable contribution must be made to a qualified organization and actually be paid in cash or property during the tax year, regardless of when pledged. *Qualified organizations* generally are nonprofit groups that are charitable, religious, educational, scientific, or literary in purpose, or that work to prevent cruelty to children or animals.

Examples of qualified organizations include:

- Religious organizations, such as churches, mosques, temples, and synagogues.
- Most nonprofit charitable organizations, schools, museums, hospitals, medical research organizations, volunteer fire companies, civil defense organizations, and war veterans' groups.
- The United States government, governments of U.S. states and possessions and political subdivisions thereof (counties, municipalities, etc.), the District of Columbia, and Native American tribal governments that perform governmental functions.
- Certain nonprofit cemeteries and fraternal organizations.

Most organizations, other than religious organizations and governments, must apply to the IRS to become qualified organizations. If you do not know whether an organization qualifies, the IRS has provided an online search tool that allows users to search for and select an exempt organization and check certain information about its federal tax status and filings. This search tool is available online at <http://www.irs.gov/Charities-&-Non-Profits/Exempt-Organizations-Select-Check>.

Cash Donations

If the taxpayer contributes cash, the deduction is usually the amount of cash contributed. However, sometimes amounts that appear at first glance to be charitable contributions do not qualify as deductions. A few examples follow:

- Amounts paid to charitable organizations primarily for personal benefit, such as educational or club activities for the taxpayer's child, are not deductible.
- Amounts paid to a charitable organization for raffle tickets or to play games of chance, such as bingo, are not deductible as contributions.
- Contributions made for the benefit of an individual; to Chambers of Commerce and other business, civic, political, and social clubs or organizations; and to foreign and international organizations (except certain Canadian, Israeli, and Mexican charitable organizations) are not deductible.
- If amounts paid to a qualified organization for merchandise, goods, or services is less than the fair market value (FMV) of the item or service received, the amounts paid are not deductible.

Fair market value is the price at which property would be sold in a transaction between a willing buyer and a willing seller, both of whom have full knowledge of the relevant facts.

You cannot deduct a cash contribution, regardless of the amount, unless you keep a record of the contribution. An example would be a bank record (such as a canceled check, copy of a canceled check, or a bank statement containing the name of the charity, the date, and the amount) or a written communication from the charity that includes the charity's name, the date, and the amount contributed.

Contributions of $250 or more made at any one time to a qualified charitable organization are deductible only if the taxpayer obtains written substantiation from the donee organization. Canceled checks do not suffice to document such donations. Written substantiation is required for both cash and property donations.

m**Example:** James Dean donated $400 to Habitat for Humanity on March 20. He must have written substantiation of the contribution from Habitat for Humanity in order to deduct it. However, if James made two separate donations of $200 to Habitat for Humanity on different dates, the canceled checks or other written documentation would substantiate his charitable deduction.m

A charitable contribution to a qualified organization in which goods or services are received by the donor are only deductible when the following two requirements are met:

1. The contribution exceeds the FMV of the goods or services received.
2. The donor intended to make a charitable contribution.

For contributions of more than $75 for which the taxpayer receives goods or services, the donee organization must specify that the contribution is only partly deductible and must furnish the taxpayer with a good faith estimate of the value of the goods or services. A detailed discussion of records to keep can be found in IRS Publication 526, *Charitable Contributions*.

Contributions of Property

Generally, the FMV of property at the time it is donated to a charitable organization is deductible. In every case in which the FMV of donated property is less than the cost of the property, the allowable deduction is FMV. A common example is a donation of clothes, home furnishings, or automobiles made to various charitable organizations or thrift shops operated by such organizations. The FMV of these items is generally less than the cost; therefore, the deduction usually is the FMV.

Note: You cannot take a deduction for clothing or household items you donate after August 17, 2006, unless the clothing or household items are in good used condition or better.

There is no deduction allowed for a donation of the use of property. For example, a taxpayer allows a scout camp to use his property as a parking lot, but retains title to the land. The taxpayer is not allowed a deduction for the use of his land.

Appreciated property. If donated property has appreciated in value (FMV is more than cost), the allowable deduction is the FMV minus the amount of the value that would have been ordinary income if the property was sold. In most cases, if the property donated was owned by the donor for personal or investment purposes, this means that:

- If the taxpayer owned the property one year or less, the deduction is the cost of the property.
- If the taxpayer owned the property for more than one year, the deduction is the FMV of the property—there are some exceptions, so do some research in IRS Publication 526, *Charitable Contributions*, if you encounter this type of donation.

m**Example:** In 2011, George Harris purchased 100 shares of XYZ stock for $2,000. In 2016, when he gave the stock to his church, the stock was worth $2,500. George may deduct the full $2,500, because he held the stock for more than one year.m

m**Example:** In January 2016, Bessie Philips purchased 100 shares of ADC stock for $500. In October, when she gave the stock to United Way, it was worth $1,000. Bessie may deduct only $500 because she did not own the property more than one year.m

Tax Tip: If a taxpayer donates a car worth more than $500 to a qualified organization after December 31, 2004, and the organization sells the car, the taxpayer's deduction is limited to the gross proceeds of the sale or the car's FMV, whichever is less. However, if the organization improves the car or makes significant use of it before selling it, the taxpayer may deduct the fair market value at the time of the donation.

Reporting Contributions of Property

When total property contributions of more than $500 are deducted, Form 8283, *Noncash Charitable Contributions*, must be completed. If a single item of donated property (or aggregate of similar items) has a value of more than $5,000, the recipient organization is required to sign Form 8283, page 2. The taxpayer must also obtain a written appraisal. Generally, the appraisal does not need to be attached to the return.

For donated art with an aggregate value of $20,000 or more, the donor must attach a copy of the qualified appraisal to his return. The taxpayer must also be able to provide upon IRS request an 8210-inch color photograph or transparency of any individual objects valued at $20,000 or more. For purposes of these rules, art includes paintings, sculptures, watercolors, prints, drawings, ceramics, antique furniture, decorative arts, textiles, carpets, silver, rare manuscripts, historical memorabilia, and similar objects.

The taxpayer must keep a record of each cash or property contribution they made. Records of property donations should include a description of the property, its cost and fair market value, the date of the contribution, and the name and address of the charity.

Contribution Limitations

There are limitations on deductions for charitable contributions. The majority of contributions by taxpayers are given to qualified charitable organizations. Donations to most of these organizations are deductible up to 50% of AGI. However, the value of gifts to veterans' organizations, fraternal societies, and nonprofit cemeteries may not exceed 30% of AGI. Gifts of certain types of property may be further limited. The majority of taxpayers do not approach these limits. If you are interested, you may find a discussion of these limits and carryover provisions in the section titled "Limits on Deductions" in Chapter 24 of IRS Publication 17.

Volunteer Work

The value of time or service donated is not deductible as a charitable contribution.

m**Example:** Charles Yates is an attorney. Without charge, he drew up a trust agreement for his church. The work took him five hours. He normally charges $200 per hour for such work. Charles may take no charitable deduction, because the value of his time is not deductible.m

Out-of-pocket expenses incurred in rendering volunteer services to charitable organizations are deductible. Examples of these expenses include:

- The cost and upkeep of uniforms, equipment, and supplies used when performing services.
- Actual vehicle expenses, such as the cost of parking, tolls, gas, and oil if the volunteer uses his car, or 14¢ per mile (for 2016), plus parking and tolls, if the taxpayer doesn't wish to deduct actual vehicle expenses.
- The cost of public transportation if the taxpayer uses public transportation.

The cost of transportation to attend meetings of charitable organizations as a member or observer (rather than to perform volunteer services) is *not* deductible. The cost of driving one or several people to an activity is not deductible, unless the driving is volunteer service to a charitable organization and the volunteer would not otherwise attend the activity.

A chosen representative attending a convention of a qualified organization and others whose volunteer work takes them away from home overnight may deduct food, lodging, and other unreimbursed expenses directly related to the volunteer services.

> **Tax Tip:** Recent tax law changes have attempted to eliminate deductions for "charitable" trips that are really disguised vacations. Thus, expenses for volunteer travel are deductible only if there is "no significant element of personal pleasure, recreation, or vacation" involved. This does not mean that the volunteer is forbidden to enjoy himself while performing the volunteer service, but it does mean that volunteer service must be the main motivation for the trip.

m**Example:** Ken Adams accompanies a group of Boy Scouts on a camping trip. During the trip, he is on duty as a supervisor of the scouts, in a real and substantive sense, most of the time. Ken may deduct his travel expenses for this excursion. The fact that he enjoys this type of activity does not disqualify his deduction.m

STOP **Complete Exercise 6.6 before continuing to read.**

MISCELLANEOUS DEDUCTIONS

Miscellaneous itemized deductions generally encompass expenses necessary for the production of income. Thus, unreimbursed ordinary and necessary employment expenses, gambling losses to the extent of gambling winnings, hobby losses to the extent of hobby income, tax advice and preparation fees, investment expenses, and similar expenses are deductible as miscellaneous itemized deductions.

Recall how medical expenses are generally deductible only to the extent they exceed 10% of AGI. The total of most, but not all, miscellaneous itemized deductions deductible on a Schedule A is subject to a similar 2% AGI threshold or 2% AGI floor. The total of the itemized deductions reported on lines 21 through 23 are subject to the 2% AGI floor. In short, for these expenses to be deductible as an itemized deduction, only the total amount of these expenses that exceeds 2% of the taxpayer's AGI are deductible on the Schedule A.

One of the most common of these miscellaneous itemized deductions is tax preparation fees. Let's take a closer look at this deduction, because almost every taxpayer who has their prior-year return prepared in a tax office or online should have incurred a tax preparation fee.

Tax Preparation Fees

If the taxpayer paid someone to prepare and/or electronically file their income tax return(s), the fees are deductible. These amounts are entered on Schedule A, line 22. Also, include the cost of tax preparation software and publications. Bank fees or finance charges paid to financial institutions in connection with applying for or obtaining a refund transfer or a similar product are not deductible.

If the taxpayer is self-employed or owns rental property, the portion of tax preparation fees directly associated with their business or rental property should be deducted on the appropriate form (Schedules C, E, or F or Form 4835) and the remainder deducted on Schedule A, line 22.

The fees are deducted in the year paid. Thus, the amount entered on the 2016 return will usually reflect the preparation of the 2015 return(s).

m**Example:** In 2016, Kyle Rollins paid $54 to prepare and electronically file his 2015 federal and state return himself using online software. When Kyle prepares his 2016 return, he can include the $54 he paid to prepare his 2015 returns on his Schedule A, line 22. However, Kyle will only be allowed to deduct as an itemized deduction the total of miscellaneous deductions reported on lines 21 through 23 that exceed 2% of his AGI.m

CHAPTER SUMMARY

In this chapter, you learned:

- Generally, taxpayers may deduct the larger of their total itemized deductions or their standard deduction.
- Most medical and dental expenses are deductible to the extent they exceed 10% (7½% if either the taxpayer or their spouse is age 65 or older) of the taxpayer's adjusted gross income.
- A taxpayer may deduct the following taxes:
  - State and local taxes (income or general sales).
  - Real property tax.
  - Personal property tax.
  - Foreign income taxes.
- A taxpayer may deduct interest paid on qualified home mortgages. However, personal interest is not deductible.
- Cash and property donated to qualified U.S. charities is deductible. The taxpayer should always keep a record of their donations with the organization's name, date, and the amount of cash or FMV of property. Based on the amount of the donation, a taxpayer may also be required to substantiate their charitable contributions to the IRS.
- A taxpayer may deduct expenses incurred when providing volunteer charitable work or services. The FMV of volunteering time or services provided is not deductible.
- Miscellaneous itemized deductions reported on Schedule A, lines 21 through 23, are subject to a 2%-of-AGI threshold. The total of these expenses that exceed 2% of the taxpayer's AGI may be deducted as an itemized deduction.

Suggested Reading

For further information on the topics discussed in this chapter, you may wish to read the following in IRS Publication 17:

- Chapter 21, Medical and Dental Expenses.
- Chapter 22, Taxes.
- Chapter 23, Interest.
- Chapter 24, Contributions.