Chapter 3: Schedule A

Corrections were made to this workbook through January of 2013. No subsequent modifications were made.

According to preliminary data from the IRS, over 140 million tax returns were filed for the 2009 tax year. Of those returns, nearly one-third used Schedule A, *Itemized Deductions*, in lieu of taking the standard deduction.[1] It is reasonable to assume that taxpayers who use tax professionals to complete their returns are more likely to itemize than taxpayers who prepare their own returns.

Each type of itemized deduction is distinctive. Tax practitioners should be well versed in the requirements for each type. This chapter reviews the following deductions reported on Schedule A.

1. Medical and dental expenses
2. Taxes paid
3. Interest paid
4. Gifts to charity
5. Casualty and theft losses
6. Job expenses and certain miscellaneous deductions
7. Other miscellaneous deductions

Schedule A, which follows, provides a separate category for each of the above types of deductions.

Note. In this chapter, 2011 forms are frequently used rather than draft 2012 IRS forms because many of the draft forms were not available as of the date of publication.

1. IRS Statistics of Income Bulletin (Winter 2011).

SCHEDULE A (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Itemized Deductions

▶ Attach to Form 1040. ▶ See Instructions for Schedule A (Form 1040).

OMB No. 1545-0074
2011
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 7.5% (.075)	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	10	Home mortgage interest and points reported to you on Form 1098	10			
Note. Your mortgage interest deduction may be limited (see instructions).	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	Mortgage insurance premiums (see instructions)	13			
	14	Investment interest. Attach Form 4952 if required. (See instructions.)	14			
	15	Add lines 10 through 14			15	
Gifts to Charity	16	Gifts by cash or check. If you made any gift of $250 or more, see instructions	16			
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	
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% (.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	Add the amounts in the far right column for lines 4 through 28. Also, enter this amount on Form 1040, line 40			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 Form 1040 instructions. Cat. No. 17145C **Schedule A (Form 1040) 2011**

WHO SHOULD ITEMIZE

Most taxpayers can choose whether to itemize deductions or use the standard deduction. However, there are some taxpayers who must itemize deductions even when it is not advantageous for them to do so. The following taxpayers **must** itemize deductions because they **cannot** use the standard deduction.

- Taxpayers who are nonresident aliens or dual-status aliens during the year
- Taxpayers who are filing a short-year tax return because of a change in their annual accounting method
- Taxpayers who are married filing separately (MFS) and whose spouse itemizes deductions

A taxpayer's standard deduction is zero when their filing status is MFS and their spouse itemizes deductions. **This does not apply to taxpayers who file using the head of household (HoH) filing status, because they are considered unmarried for tax purposes.** Therefore, taxpayers filing HoH are **not** subject to the zero standard deduction, even if they are legally married to someone who files a return using the MFS status and itemizes.

However, the reverse is not true. The taxpayer filing MFS must use the zero standard deduction if their spouse itemizes, whether that spouse files as MFS or HoH.

Example 1. Tula and Claude Popp separated in June 2012. Their son Hu lives with Tula after the separation. They do not file for divorce or legal separation during the year. Tula incurs significant travel expenses related to her employment. These expenses coupled with her other allowable deductions makes her itemized deductions for 2012 more than the standard deduction of $8,700[2] for HoH filers. Therefore, she completes Schedule A for her 2012 return.

Claude has been living in an apartment and his only deductible expense is the state income taxes withheld from his wages of $2,500. Because Tula itemizes, he must itemize for 2012 even though the standard deduction of $5,950 for MFS taxpayers is higher than his itemized deductions.

Example 2. Use the same facts as **Example 1,** except Tula does not have any deductible expenses, and Claude's itemized deductions are greater than his standard deduction. Claude chooses to itemize on his 2012 return. Tula does **not** have to itemize; she may use the standard deduction for HoH filers.

In some situations, it is beneficial for a taxpayer to use the standard deduction even though their total itemized deductions are greater because itemizing can create an alternative minimum tax (AMT).

> **Note.** A thorough discussion of the AMT is outside the scope of this chapter. For more information, see Chapter 6, Alternative Minimum Tax, in the 2011 *University of Illinois Federal Tax Workbook.*

The decision to itemize or take the standard deduction may be changed by filing an amended return within three years of the due date of the return or two years from the date the tax is paid, whichever is later. This deadline applies regardless of extensions.[3] However, married persons who filed separate returns can change methods **only** if both spouses make the same changes. Both must file a consent to assessment for any additional tax that either one may owe as a result of the change.

2. Rev. Proc. 2011-52, 2011-45 IRB 701.

3. IRC §6013(b)(2)(A).

MEDICAL AND DENTAL EXPENSES

Medical expenses are the costs of diagnosis, cure, mitigation, treatment, or prevention of disease, and the costs for treatments affecting any part or function of the body.[4] Medical care expenses must be primarily to alleviate or prevent a physical or mental defect or illness. Expenses that are merely beneficial to general health, such as vitamins or a vacation, are not deductible.

Only the medical and dental expenses **paid** during the tax year are deductible, regardless of when the services were provided.[5] If the taxpayer uses a credit card, the expense is deductible in the year the charge is made, not when the credit card bill is actually paid.

The total amount of deductible medical expenses on Schedule A is reduced by 7.5% of the taxpayer's adjusted gross income (AGI). Under the Patient Protection and Affordable Care Act, this percentage is scheduled to increase to **10% in 2013** for taxpayers under age 65. However, taxpayers age 65 or over may generally continue to use the 7.5% AGI threshold through the 2016 tax year.

MEDICAL EXPENSES OF SPOUSES AND DEPENDENTS

Taxpayers can generally include medical expenses that they paid for themselves as well as those expenses they paid for someone who was their spouse or their dependent **either** when the services were provided **or** when they paid for the services. There are different rules for adopted children, decedents, and individuals who are the subject of multiple support agreements.

A person generally qualifies as the taxpayer's dependent for purposes of the medical expense deduction if **both** of the following requirements are met.

1. The person was a qualifying child or a qualifying relative.

> **Note.** See Chapter 3, Filing Status and Dependency Exemption, of the 2011 *University of Illinois Federal Tax Fundamentals* workbook for more information on the definitions of qualifying child and qualifying relative.

2. The person was a U.S. citizen or national, or a resident of the United States, Canada, or Mexico. However, there are exceptions to this requirement for qualifying children who were adopted.

> **Note.** See IRS Pub. 502, *Medical and Dental Expenses*, for more information on exceptions.

Taxpayers can also include medical expenses they paid for an individual who is **not** their dependent **if** that person would have been their dependent **except** that:

1. The individual received gross income in excess of the personal exemption amount ($3,800 in 2012),[6]
2. The individual filed a joint return for the tax year, or
3. The taxpayer, or their spouse if filing jointly, could be claimed as a dependent on someone else's return.

Example 3. Warren Hatfield supports his 25-year-old son, Renfield, who lives with him. Renfield works seasonally picking pumpkins and earned $4,000 in 2012. Renfield meets all of the other requirements to be claimed as Warren's dependent for 2012. Warren may include the medical costs that he paid on Renfield's behalf with his own medical expenses if he itemizes even though Renfield is not Warren's dependent.

4. IRS Pub. 502, *Medical and Dental Expenses.*
5. Treas. Reg. §1.213-1(a)(3)(i).
6. Rev. Proc. 2011-52, 2011-45 IRB 701.

Child of Divorced or Separated Parents

For purposes of the medical and dental expenses deduction, a child of divorced or separated parents can be treated as a dependent of **both** parents. Each parent can include the medical expenses that they pay for the child, even if the other parent claims the child's dependency exemption, if:

1. The child is in the custody of one or both parents for more than half the year;
2. Over half of the support the child receives during the year is from their parents; and
3. The child's parents:
   a. Are divorced or legally separated under a decree of divorce or separate maintenance,
   b. Are separated under a written separation agreement, or
   c. Lived apart at all times during the last six months of the year.

This does not apply if the child's exemption is being claimed under a multiple support agreement.

Support Claimed under a Multiple Support Agreement

If taxpayers are considered to have provided more than half of a qualifying relative's support under a multiple support agreement, they may include the medical expenses that **they paid for that person.** Any medical expenses paid by others who joined in the agreement cannot be deducted as medical expenses by anyone.

Decedents

Medical expenses paid before death by the decedent are included in figuring any deduction for medical and dental expenses on the decedent's final income tax return. This includes expenses for the decedent's spouse and dependents as well as for the decedent.

> **Note.** The survivor or personal representative of a decedent can choose to treat certain expenses that were paid by the decedent's estate for the decedent's medical care as paid by the decedent at the time the medical services were provided. These expenses must be paid within the 1-year period beginning with the day after the date of death. The survivor or personal representative making this choice must attach a statement to the decedent's tax return that says that the expenses have not been and will not be claimed on Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*.

Medical expenses paid by the taxpayer for their deceased spouse or dependent are deductible in the year paid, whether the expenses are paid before or after the decedent's death.

SEPARATE RETURNS

If married taxpayers live in a **noncommunity property state** and file separate returns, each of the taxpayers may deduct only the medical expenses that they actually paid. Any medical expenses paid out of a joint checking account in which both spouses have the same interest are considered to have been paid equally by each of them, unless they can show otherwise.

If married taxpayers live in a **community property state** and file separate returns, any medical expenses paid out of community funds are divided equally. Each spouse should include half of the expenses. If medical expenses are paid out of the separate funds of one spouse, only the spouse who paid the medical expenses can include them. The source of the funds determines who receives the deduction. For more information, see IRS Pub. 555, *Community Property*.

DEDUCTIBLE MEDICAL EXPENSES

Generally, most medical expenses are deductible. However, some expenses are for both medical and personal purposes and the tax treatment may not be obvious. For medical expenses not covered in this material, practitioners may want to consult IRS Pub. 502, which provides detailed information about various medical deductions.

> **Note.** Rather than deducting impairment-related **work** expenses as medical expenses, disabled taxpayers may take a **business** deduction for expenses that are necessary for them to be able to work.[7] Disabled employees use Form 2106, *Employee Business Expenses,* to report these expenses.
>
> Impairment-related work expenses are **not** subject to the 2%-of-AGI limit that applies to other employee business expenses,[8] nor are they subject to the 7.5% limit that applies to medical expenses.

Insurance Premiums

Insurance policies that cover medical care are generally deductible as a medical expense. However, there are some limitations for certain types of insurance. In addition, tax preparers should verify that clients are not including costs that were paid on a pre-tax basis through employer-provided plans.

Long-Term Care Insurance. The allowed deduction for premiums paid for qualified long-term care insurance contracts is limited by the taxpayer's age. A qualified long-term care insurance contract is one that provides only coverage of long-term care services. The contract must meet the following criteria.[9]

- Be guaranteed renewable
- Not provide for a cash surrender value or other money that can be paid, assigned, pledged, or borrowed
- Provide that refunds and dividends under the contract must be used only to reduce future premiums or increase future benefits (This does not include refunds made due to the death of the insured, or due to a complete surrender or cancellation of the contract.)
- Generally not pay or reimburse expenses incurred for services or items that would be reimbursed under Medicare, except when Medicare is a secondary payor, or the contract makes per diem or other periodic payments without regard to expenses

The following limits apply for 2012:[10]

Taxpayer's Age at End of Tax Year	Maximum Deduction
Age 40 or under	$ 350
Age 41–50	660
Age 51–60	1,310
Age 61–70	3,500
Age 71 or over	4,370

7. IRC §162.
8. IRC §67(b)(6).
9. IRS Pub. 502, *Medical and Dental Expenses.*
10. Rev. Proc. 2011-52, 2011-45 IRB 701.

Medicare Part A. Taxpayers who are covered under social security (and government employees who pay Medicare tax) may not deduct the payroll tax paid for Medicare. **However, taxpayers not covered under social security who voluntarily enroll in Medicare Part A** can include the premiums that they pay as a medical expense.[11]

Medicare Part B. Medicare Part B is supplemental medical insurance. Premiums that taxpayers pay for Medicare Part B are considered a medical expense.[12]

Medicare Part D. Medicare Part D is a voluntary prescription drug insurance program for persons with Medicare Part A or Part B. Premiums for Medicare Part D can be included as a medical expense.[13]

Capital Expenses

Taxpayers may deduct amounts paid for special equipment installed in their homes and for home improvements if the expense was incurred because of the medical needs of the taxpayer, their spouse, or dependent. If the equipment or improvement increases the value of the home, only the excess of the cost over the increase in value is deductible. If the value of the home is not increased by the improvement, the entire cost qualifies as a medical expense.

> **Example 4.** Cliff Hanger has a debilitating disease that makes it difficult for him to walk. He lives alone in a 2-story home where all the bedrooms are on the second floor. Fearing Cliff will fall on the stairs, his doctor advises Cliff to either move or to install an elevator. Cliff decides to install an elevator at a cost of $15,000. He has the home appraised and finds the elevator only increases the value of the home by $5,000. Therefore, Cliff has a $10,000 medical deduction.

As outlined in Rev. Rul. 2003-58, amounts paid by an individual for equipment, supplies, or diagnostic devices that may be purchased without a prescription from a physician, may be deductible under §213, which allows specifically for medical care for the diagnosis, cure, mitigation, treatment, or prevention of disease. It specifically states that the recommendation of a physician is important.[14] However, the recommendation is unnecessary in the case of expenses for items that are wholly medical in nature and serve no other function in everyday life.[15]

Meals and Lodging

Only meals provided to patients during their stay at a hospital, nursing home, or similar institution are deductible as medical expenses. Meals incurred by family members while traveling with the patient are **not** deductible.

Taxpayers may deduct lodging expenses. The amount they include in medical expenses for lodging cannot be more than $50 per night for each person. Taxpayers may also include lodging for a person traveling with the person receiving the medical care. For example, if a parent is traveling with a sick child, up to $100 per night can be included as a medical expense for lodging while receiving medical treatment.

Transportation

Transportation expenses are deductible only if the primary reason they are incurred is to obtain medical care. For travel by vehicle, taxpayers may use the actual expense method or **standard medical mileage rate (23 cents for travel during 2012).[16]** Expenses for parking fees and tolls are deductible in addition to the standard medical mileage rate.

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11. IRS Pub. 17, *Your Federal Income Tax (for Individuals)*, p. 148. (2011).
12. Ibid.
13. Ibid.
14. *Harvey v. Comm'r,* 12 TC 409 (1949).
15. *Stringham v. Comm'r,* 12 TC 580 (1949), *aff'd* 183 F.2d 579 (6th Cir. 1950).
16. IRS News Rel. IR-2011-116 (Dec. 9, 2011).

Long-Term Care Services

Qualified long-term care services are necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, rehabilitative services, and maintenance and personal care services that meet the following criteria.

- Required by a chronically ill individual
- Provided under a plan of care prescribed by a licensed healthcare professional.

> **Note.** See the 2011 *University of Illinois Federal Tax Workbook,* Chapter 2, Long-Term Care, for more information on home care and nursing home expenses.

Wages and Employment Taxes for Household Employees[17]

Taxpayers who pay household employees to provide personal care services for a chronically ill individual may deduct both the wages paid and any employment taxes paid on those wages as medical expenses. To qualify as chronically ill, the individual must **either:**

1. Be unable to perform at least two activities of daily living[18] without substantial assistance from another individual for at least 90 days due to a loss of functional capacity, or
2. Require substantial supervision to be protected from threats to health and safety due to severe cognitive impairment.

Personal care services are defined as care whose primary purpose is to provide needed assistance (including protection from threats to health and safety due to severe cognitive impairment) to a chronically ill individual. If the individual qualifies as chronically ill, the cost of the services does not have to be prorated between nursing care and household assistance.

If a person does not qualify as chronically ill, only payments for nursing services qualify as a medical expense. If the attendant also provides personal and household services, compensation paid to the attendant must be divided between the time spent performing household and personal services and the time spent for nursing services.

REIMBURSEMENTS

Medical expenses must be reduced by reimbursements received from insurance policies, employer plans, health savings accounts (HSAs), or other sources. However, deductible medical expenses are **not** reduced by payments received due to:

1. Permanent loss of, or loss of use of, a member or function of the body (loss of limb, sight, hearing, etc.) or disfigurement to the extent the payment is based on the nature of the injury without regard to the length of time lost from work; or
2. Loss of earnings.

An exception applies if any part of these payments is **designated** for medical costs. In this instance, deductible medical expenses are reduced by the amount so designated.

17. IRS Pub. 502, *Medical and Dental Expenses.*

18. Activities of daily living are eating, toileting, transferring, bathing, dressing, and continence.

Reimbursements in Excess of Medical Expenses

If taxpayers are reimbursed more than their out-of-pocket medical expenses, they may have to include the excess in income, depending on who paid for the health insurance premiums.

> **Caution.** Reimbursements from long-term care contracts should be reviewed as to their taxability.

Premiums Paid by the Taxpayer. Generally, taxpayers do **not** include excess reimbursements in their gross income **if** they paid the entire premium for their medical insurance.

Premiums Paid by the Taxpayer and Employer. If both the taxpayer and their employer contribute to the medical insurance plan and the employer's contributions are not included in the taxpayer's gross income, the taxpayer must include in their gross income the part of the excess reimbursement that is due to their employer's contribution.

> **Note.** IRS Pub. 502 contains more information on excess reimbursements.

Reimbursement of Previously Deducted Expenses

If the taxpayers are reimbursed in a later year for medical expenses they deducted in an earlier year, they generally must report the reimbursements as income up to the amount they previously deducted as medical expenses. However, the reimbursements are not included in income if the medical deductions did not reduce their tax for the earlier year.

> **Note.** More information about the recovery of an amount that was claimed as an itemized deduction in an earlier year can be found in "Itemized Deduction Recoveries" in IRS Pub. 525, *Taxable and Nontaxable Income.*

Damages for Personal Injuries

When taxpayers receive an amount in settlement of a personal injury lawsuit, part of the award may be for medical expenses incurred in an **earlier year.** If this is the case, the taxpayer must include that part as income in the year they receive it to the extent that deducting those medical expenses reduced their taxable income in the earlier year.

If they receive an amount in settlement of a damage suit for personal injuries, part of the award may be for **future medical expenses.** If it is, the taxpayer must reduce any future medical expenses claimed for these injuries until the amount they received has been completely used.

Example 5. In 2011 while swimming with the dolphins at the Ultimate Byway, Marina Bolt was attacked by a shark that had been let into the dolphin sanctuary by a careless employee. Marina's injuries were substantial and she will require significant medical treatments for the rest of her life.

In 2011, she paid $10,000 for associated medical costs. Her 2011 AGI was $90,000. After the reduction for 7.5% of her AGI ($6,750), only **$3,250 of her medical expenses were included in her itemized deductions.** Her total itemized deductions for 2011 exceeded the standard deduction for her filing status by more than that amount.

In 2012, Marina receives a settlement of $1.5 million for the personal injuries she incurred. The settlement papers indicate that $1 million of the settlement is for lost wages and $500,000 of the settlement is to cover past and future medical costs related to her injuries. Also in 2012, Marina paid $50,000 in medical bills related to her injuries.

Tax Result. On Marina's 2012 return, she must report $3,250 as income from the reimbursement she received for her 2011 medical expenses. None of the 2012 payments she made for her medical bills related to the injuries is includible in her deductible medical expenses for 2012, because the settlement reimbursed those expenses.

At the beginning of 2013, the remaining balance of her medical cost reimbursement is $440,000, as calculated below:

Settlement	$500,000
Less: costs paid in 2011	(10,000)
Less: costs paid in 2012	(50,000)
Remaining amount to apply to future expenses	$440,000

Marina cannot deduct any medical expenses related to her injuries until after she has spent another $440,000.

Form 1099-MISC for Personal Injury Damage Awards. A taxpayer may receive a Form 1099-MISC, *Miscellaneous Income,* reporting an entire settlement as other income, even though not all of the damages are subject to tax.

Caution. Practitioners are advised to review the terms of the settlement before reporting any amounts awarded as taxable.

IRC §104(a) specifically excludes from income damages received because of personal injury or physical sickness except to the extent the amounts attributable to medical expenses were previously deducted. However, related punitive damages are included in income.

If the taxpayer receives a reporting statement that does not properly report the taxable amount of the award, there are several possible remedies.

1. Have the issuer submit a corrected Form 1099-MISC.
2. Report only the taxable amount on line 21 (other income) of Form 1040. Attach a statement explaining how the taxable amount was determined that includes documentation supporting the classification of the proceeds. This method may give IRS personnel enough information to determine that the income was properly reported after the income-matching software flags the return. However, a notice from the IRS stating that income was underreported may be automatically issued without human review. The taxpayer should be alerted to the possibility of such a notice, and if one is received, advised to consult with the practitioner.
3. Report the entire amount of the award on line 21 of Form 1040, and report the nontaxable amount on line 36. (The instructions for Form 1040 explain that the total on line 36 includes any write-in adjustments.) A detailed statement explaining the calculation of the nontaxable amount and documents supporting that determination should also be attached to the return. Using this method may allow the taxpayer to avoid having their return flagged by the IRS income-matching program.

If the return is **electronically filed,** the practitioner may be able to submit the documents supporting the classification of the proceeds in PDF format. If not, most tax preparation software programs allow preparer notes to be created within the return, which transmit with the electronically filed returns. The detailed explanations under options 1 and 2 above should be created using that feature, and the note should indicate that the documents are available upon request.

Form 8453, *U.S. Individual Income Tax Transmittal for an IRS e-file Return,* can no longer be used to transmit the documentation to the IRS because this form is only for transmittal of specific documents listed on the form. Furthermore, the attachment is not required by the IRS; therefore, the return is not exempt from the electronic filing requirement imposed on most practitioners. However, the taxpayer may direct the practitioner to prepare a paper return with the supporting documentation attached. If the taxpayer so chooses, the practitioner must attach Form 8948, *Preparer Explanation for Not Filing Electronically*, to the paper-filed return.

TAXES

STATE AND LOCAL INCOME TAXES

State and local income taxes are deductible. However, taxpayers cannot deduct state and local income taxes paid on income that is exempt from federal income tax except when the exempt income is interest income. For example, a taxpayer cannot deduct the portion of state income tax attributable to a cost-of-living allowance that is exempt from federal income tax.[19]

SALES AND USE TAXES

At the time this chapter was written, Congress had not approved an extension of the option to deduct state sales and use taxes in lieu of state and local income taxes for tax years beginning after 2011.

CONTRIBUTIONS TO STATE BENEFIT FUNDS

Taxpayers may deduct **mandatory** contributions to state benefit funds that are withheld from their wages to provide protection against loss of wages. For example, certain states require employees to make contributions to state funds providing disability or unemployment insurance benefits.

REAL ESTATE TAXES

Deductible real estate taxes are any state, local, or foreign taxes on real property levied for the general public welfare. Taxpayers may deduct these taxes only if the taxes are based on the assessed value of the real property and charged uniformly against all property under the jurisdiction of the taxing authority.

Taxpayers must be the equitable and beneficial owners of the property in question to deduct the real estate taxes they pay. Even if the taxpayers do not own legal title to the property, they may qualify as equitable and beneficial owners based on the facts and circumstances involved.[20]

Deductible real estate taxes generally do not include taxes charged for local benefits and improvements that increase the value of the property. These include assessments for streets, sidewalks, water mains, sewer lines, public parking facilities, and similar improvements. Taxpayers should increase the basis of their property by the amount of the assessment.

Deductible real estate taxes also do not include itemized charges for services (such as trash collection) assessed against specific property or certain people, even if the charge is paid to the taxing authority. However, local benefit taxes are deductible if they are only for maintenance, repair, or interest charges related to **public** property. If only a part of the taxes is for maintenance, repair, or interest, taxpayers may only claim the amount so related. If the taxpayer cannot determine what part of the tax is for maintenance, repair, or interest, none of it is deductible.

Generally, taxpayers who are tenant-stockholders in a **cooperative housing** corporation can deduct the amount paid to the corporation that represents their share of the real estate taxes that the corporation paid or incurred for their dwelling unit. The corporation should provide the tenant-stockholders with a statement showing their share of the taxes. For more information, see "Special Rules for Cooperatives" in IRS Pub. 530, *Tax Information for Homeowners.*

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19. IRS Pub. 17, *Your Federal Income Tax (for Individuals).*

20. *Ndile Njenge and Ekinde Rachel v. Comm'r,* TC Summ. Op. 2008-84 (July 15, 2008).

Proration of Real Estate Taxes

Taxpayers who bought or sold real estate during the year must prorate the real estate taxes paid between the buyer and the seller. The proration is based on the number of days each party owned the property over the period of time that the real estate taxes are imposed. The buyer is treated as paying the taxes beginning with the date of sale. Generally, this information is included on the settlement statement provided at the closing.

The seller's portion of real estate taxes due is usually withheld from the proceeds of the sale. The amount withheld is deductible by the seller in the year of the sale even if the taxes would normally not be paid until the following year.

Caution. When the buyer receives a credit against the net amount payable for the purchase, the buyer must reduce their property tax deduction for the year the taxes are paid to the taxing agency.

When the seller receives a refund for prepaid property tax, they must reduce their property tax deduction in the year the refund is received.

The taxpayer and tax practitioners should remember to make these adjustments.

Real Estate Taxes Placed in Escrow

For many homeowners, their monthly mortgage payments include an amount placed in escrow for real estate taxes. The taxpayers may only deduct the real estate taxes that the third party actually paid to the taxing authority during the tax year.

Divorced Individuals

If the divorce or separation agreement states that the taxpayer must pay the real estate taxes for a home owned by the taxpayer and their ex-spouse, the type of deduction allowed depends on how the home is titled. If the home is held by the parties as tenants in common, one-half of the payments is deductible on Schedule A as real estate taxes and one-half is deductible as alimony. If the home is held by the taxpayer and spouse as joint tenants or tenants by the entirety, none of the payments are alimony and the entire amount is deductible on Schedule A as real estate taxes.

Ministers' and Military Housing Allowances

Many ministers and members of the uniformed services receive tax-free housing allowances. Even though the money used to pay the taxes is excluded from income, taxpayers may **still deduct all of the real estate taxes they pay on their home.**

Homeowners' Association Fees

Homeowners' association fees are not deductible because they are imposed by the homeowners' association, rather than a state or local government.

PERSONAL PROPERTY TAXES

Personal property tax is deductible if it is a state or local tax that is:[21]

1. Charged on personal property,
2. Based only on the value of the personal property, and
3. Charged on a yearly basis, even if it is collected more or less often than once a year.

A tax that meets the above requirements can be considered charged on personal property even if it is for the exercise of a privilege. For example, a yearly tax **based on value** qualifies as a personal property tax even if it is called a registration fee and is for the privilege of registering motor vehicles or using them on the highways.

21. IRS Pub. 17, *Your Federal Income Tax (for Individuals).*

INTEREST EXPENSE

HOME MORTGAGE INTEREST

Generally, home mortgage interest is any interest that taxpayers pay on a loan secured by their principal residence or a second home. The loan may be a mortgage to buy their home, a second mortgage, a line of credit, or a home equity loan.

Taxpayers must be the equitable and beneficial owners of the property in question to deduct the mortgage interest they pay. Even if the taxpayers do not own legal title to the property, they may qualify as equitable and beneficial owners based on the facts and circumstances involved.[22]

Amount Deductible

In most cases, taxpayers may deduct all of their home mortgage interest. However, the amount of the deduction may be limited based on the date of the mortgage, the amount of the mortgage, and how the mortgage proceeds are used.

Fully Deductible Interest. If all of the taxpayer's mortgages fit into one or more of the following three categories at all times during the year, they may deduct all of the interest on those mortgages.[23]

1. Mortgages originated on or before October 13, 1987
2. Mortgages originated after October 13, 1987, to buy, build, or improve the taxpayer's home but only if throughout the tax year these mortgages plus any grandfathered debt totaled $1 million or less ($500,000 or less if MFS)
3. Mortgages originated after October 13, 1987, other than to buy, build, or improve the taxpayer's home (home equity debt), but only if throughout the tax year these mortgages totaled $100,000 or less ($50,000 or less if MFS) and totaled no more than the fair market value (FMV) of the home reduced by the amounts of the mortgages from the two preceding categories

The dollar limits for the second and third categories apply to the combined mortgages on the taxpayer's principal residence and second home.

Not Fully Deductible. If the taxpayer's mortgages do not qualify under the above three categories, the interest deduction is limited. See IRS Pub. 936, *Home Mortgage Interest Deduction,* for instructions on calculating the amount of deductible interest.

More Than One Borrower

If the taxpayer and another person are liable for the mortgage, the Form 1098, *Mortgage Interest Statement*, issued by the lender will report the interest paid under only one tax identification number. If the tax identification number used by the lender is not that of the taxpayer who paid the mortgage interest, the payor may still deduct the mortgage interest they paid. The taxpayer must attach a statement to their return explaining the situation. The statement must include:[24]

1. The amount of interest paid by the taxpayer and the other party, and
2. The name and address of the person who received the form.

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22. *Ndile Njenge and Ekinde Rachel v. Comm'r,* TC Summ. Op. 2008-84 (Jul. 15, 2008).

23. IRS Pub. 17, *Your Federal Income Tax (for Individuals).*

24. IRS Pub. 936, *Home Mortgage Interest Deduction.*

Similarly, the taxpayer may be the payor of record on a mortgage on which there are other borrowers entitled to a deduction for the interest shown on the Form 1098 the taxpayer receives. The taxpayer must limit their deduction to only their share of the interest. However, the taxpayer is **not** required to attach a statement or to issue a Form 1098 to the other borrowers.

Example 6. Don K. Kong co-signs a mortgage with his niece, Candy, so that she can purchase her first home. Candy makes all of the mortgage payments in 2012. Don's banker listed him as the primary borrower on the loan, so the Form 1098 issued by the bank for 2012 shows his name, address, and social security number.

Candy may still claim the mortgage interest on her 2012 Schedule A. She should attach a statement explaining that she paid 100% of the mortgage interest but that the bank issued the Form 1098 to Don K. Kong. Candy includes Don's address on the attachment.

Don may not claim any of the interest because he did not pay any of it. He is not required to issue a statement to Candy.

Observation. In lieu of Candy attaching a statement to her return, Don K. Kong has the option to file a nominee Form 1098. This form would show the same financial information as the form Don received. However, Candy would be identified as the borrower and Don would be identified in the recipient box as Don K. Kong, Nominee.

Late Payment Charge

Taxpayers may deduct late payment charges as home mortgage interest if the charges were not for a specific service performed in connection with the mortgage loan.

Mortgage Prepayment Penalty

Taxpayers who pay off their home mortgage early may have to pay a penalty. They may deduct that penalty as home mortgage interest provided the penalty is not for a specific service performed or cost incurred in connection with the mortgage loan.

Prepaid Interest

Taxpayers who pay interest in advance for a period that goes beyond the end of the tax year must spread this interest over the tax years to which it applies. They may deduct only the interest that qualifies as home mortgage interest for that year. However, there is an exception that applies to points, which is discussed later.

Ministers' and Military Housing Allowance

Ministers and members of the uniformed services who receive housing allowances that are not taxable **may** still deduct their home mortgage interest.

Mortgage Assistance Payments

Mortgage interest paid by the mortgage assistance program for lower-income families under section 235 of the National Housing Act is not deductible.

Divorced or Separated Individuals

If a divorce or separation agreement requires a taxpayer to pay a home mortgage on a **jointly owned home,** one-half of the mortgage interest may be alimony. The other half may be deducted as mortgage interest expense on Schedule A. Unlike the provision for deductible real estate taxes, the mortgage interest is deductible 50/50 regardless of whether the title is held as tenants in common or joint tenants.

If the home is not jointly owned, the treatment of the payments is based on which party is the owner. If it is owned by the taxpayer, the taxpayer may not deduct any of the mortgage payments as alimony. This is true even if the other party lives in the home and the payments are court ordered. However, the taxpayer may be able to deduct 100% of the mortgage interest on Schedule A if the home qualifies.

If the home is owned solely by the other party, all of the payments required by the court may be deducted as alimony. In that case, none of the interest is deductible on Schedule A.

Reverse Mortgages

A reverse mortgage is a loan in which the lender pays the homeowner a lump sum, a monthly advance, a line of credit, or a combination of all three. Depending on the plan, the reverse mortgage and interest become due when the borrowers move, sell their home, reach the end of a pre-selected loan period, or die. Any interest accrued on a reverse mortgage is not deductible until the loan is paid in full. This deduction is subject to the $100,000 limit on home equity loans.

Mortgage Insurance Premiums

The deduction for mortgage insurance premiums expired December 31, 2011.

Points

The term "points" is used to describe certain charges paid, or treated as paid, by a borrower to obtain a home mortgage. Points may also be called loan origination fees, maximum loan charges, loan discounts, or discount points.

Generally, taxpayers may **not** deduct the full amount of points in the year paid. Because the points are prepaid interest, they generally must be deducted **ratably over the term of the mortgage.** However, taxpayers may **fully deduct points in the year paid** if they meet **all** the following tests.[25]

1. The loan is secured by the taxpayer's **principal residence.**
2. Paying points is an established business practice in the area where the loan was made.
3. The points paid were not more than the points generally charged in that area.
4. The taxpayer uses the cash method of accounting.
5. The points were not paid in place of amounts that ordinarily are stated separately on the settlement statement, such as appraisal fees, inspection fees, title fees, attorney fees, and property taxes.
6. The funds the taxpayer provided at or before closing, plus any points the seller paid, were at least as much as the points charged. It is **not** necessary that the funds provided were applied to the points. The funds provided by the taxpayer may include a down payment, an escrow deposit, earnest money, and other funds paid at or before closing for any purpose. They cannot have borrowed these funds from their lender or mortgage broker.
7. The taxpayer uses the loan to **buy, build, or improve their principal residence.**
8. The points were computed as a percentage of the principal amount of the mortgage. (This does not apply to home improvement loans.)
9. The amount is clearly shown on the settlement statement as points charged for the mortgage. The points may be shown as paid from either the taxpayer's or the seller's funds. (This does not apply to home improvement loans.)

If the taxpayer meets all of these tests, they may choose to either fully deduct the points in the year paid or deduct them over the life of the loan.

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25. IRS Pub. 936, *Home Mortgage Interest Deduction.*

Generally, points the taxpayer pays to refinance a mortgage are **not** deductible in full in the year they are paid. This is true even if the new mortgage is secured by the principal residence. However, if the taxpayer uses part of the refinanced mortgage proceeds to improve their principal residence, they may deduct the points related to the proceeds used for the home improvement.

Points Paid by the Seller. The term "points" includes loan placement fees that the seller pays to the lender to arrange financing for the buyer.

Treatment by Seller. The seller cannot deduct these fees as interest. However, they are a selling expense that reduces the amount realized by the seller.

Treatment by Buyer. The buyer reduces the basis of the home by the amount of the seller-paid points and treats the points as if they paid them. If all the above tests are met, the buyer can deduct the points in the year paid. If any of those tests are not met, the buyer must deduct the points over the life of the loan.

If the buyer meets all the tests except that the funds they provided were less than the points charged to them, they may deduct the points up to the amount of funds they provided in the year paid. In addition, the buyer may deduct any points paid by the seller.

Mortgage Ending Early. If the taxpayers spread their deduction for points over the life of the mortgage, they may deduct any remaining balance in the year the mortgage ends. However, if the taxpayers refinance the mortgage with the **same lender,** they cannot deduct any remaining balance of spread points. Instead, the remaining balance is deducted over the term of the **new loan.**

MIXED-USE DEBT

Mixed-use debt is a debt in which part of the proceeds is used to repay the existing acquisition debt and the remainder is used for an unrelated purpose. The amount used to repay the existing acquisition debt is considered acquisition debt and is limited to the original acquisition debt rules discussed earlier. Any of the new debt used for improvements to the principal residence is also considered acquisition debt. The remainder is considered home equity debt. The home equity interest deduction is limited to the interest on the first $100,000 of refinanced debt. If the additional refinanced debt is used for trade or business purposes or investment property, the interest on this portion may be trade or business interest or investment interest.

INVESTMENT INTEREST

Taxpayers may deduct investment interest subject to certain limits. However, the taxpayer cannot deduct interest they incurred to produce tax-exempt income, nor can they deduct interest expenses on straddles. Investment interest does **not** include any qualified home mortgage interest or any interest taken into account in computing income or loss from a passive activity.

Investment Property

Property held for investment includes the following.[26]

1. Property that produces interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business
2. Property that produces gain or loss from the sale or trade of property producing these types of income or held for investment
3. An interest in a trade or business activity in which the taxpayers did not materially participate but which is not considered a passive activity (See IRS Pub. 925, *Passive Activity and At-Risk Rules*, for information on passive activities.)

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26. IRS Pub. 17, *Your Federal Income Tax (for Individuals).*

To determine the investment interest of partners, shareholders, and beneficiaries, their share of investment interest from a partnership, S corporation, estate, or trust should be combined with their other investment interest.

Limit on Deduction

Generally, the deduction for investment interest expense is limited to the amount of the taxpayer's net investment income. Taxpayers may carry over the amount of investment interest that they could not deduct because of this limit to the next tax year. The interest carried over is treated as investment interest paid or accrued in the subsequent year.

Net Investment Income. Net investment income equals the amount of investment income less investment expenses.

Investment Income. Investment income generally includes gross income from property held for investment, such as interest, dividends, annuities, and royalties. It also includes any interest or dividend income that parents elect to include on behalf of their children. Investment income does not include Alaska Permanent Fund dividends.

Investment income does not include qualified dividends or net capital gains unless the taxpayer elects to include them. The election is made by completing line 4g of Form 4952, *Investment Interest Expense Deduction,* according to its instructions. If the taxpayer chooses to include any amount of their qualified dividends in investment income, they must reduce their qualified dividends and net capital gains that are eligible for the lower capital gains tax rates by the same amount.

Investment Expenses. Investment expenses are the allowed deductions (other than interest expense) directly connected with the production of investment income. Investment expenses that are included as a miscellaneous itemized deduction on Schedule A are considered allowable deductions after applying the 2% limit that applies to miscellaneous itemized deductions. The allowable amount is the smaller of:

1. The investment expenses included on Schedule A, line 23, or
2. The amount on Schedule A, line 27.

For more information on investment interest, see "Interest Expenses" in Chapter 3 of IRS Pub. 550, *Investment Income and Expenses*.

see instru…	19	… through …		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% (.02)	26	
	27	Subtract line 26 from line 24. If line 26 is more than line 24, enter -0-		27
	28	Other—from list in instructions. List type and amount ▶		

NONDEDUCTIBLE INTEREST EXPENSES

Some interest payments are not deductible. Certain expenses similar to interest also are not deductible. Nondeductible expenses include the following items.[27]

1. Personal interest, such as interest on car loans and credit cards
2. Interest on federal, state, or local income taxes
3. Service charges
4. Annual fees for credit cards
5. Loan fees
6. Credit investigation fees
7. Interest to purchase or carry tax-exempt securities

CONTRIBUTIONS

A charitable contribution is a donation or gift to, or for the use of, a qualified organization. It is voluntary and is made without receiving, or expecting to receive, anything of equal value. The deductible amount may be limited.

QUALIFIED ORGANIZATIONS

Taxpayers may only deduct contributions made to a qualified organization. Most organizations other than churches and governments must apply to the IRS to be considered a qualified organization. The IRS provides a database of qualified exempt organizations. This database can be accessed at **www.irs.gov/Charities-&-Non-Profits/Exempt-Organizations-Select-Check.**

DEDUCTIBLE CONTRIBUTIONS

Generally, taxpayers can deduct contributions of money or property to, or for the use of, a qualified organization. A gift or contribution is "for the use of" a qualified organization when it is held in a legally enforceable trust for the qualified organization or in a similar legal arrangement. The contributions must be made to a qualified organization and not set aside for use by a specific person.

A donor must have a contemporaneous written acknowledgement of any contribution of $250 or more. The statement must contain the following.

1. Name of organization
2. Amount of cash contribution
3. Description (not value) of noncash contributions
4. Statement indicating one of the following:
   - **a.** No goods or services were provided by the organization
   - **b.** A good faith estimate of any goods or services received (if any)
   - **c.** Good or services received were entirely intangible

> **Note.** See the *Durden* case in 2012 Volume B, Chapter 6: Rulings and Cases, for a discussion of deductions lost due to incomplete documentation.

27. Ibid.

CONTRIBUTIONS FROM WHICH THE TAXPAYER BENEFITS

If the taxpayer receives a benefit as a result of making a contribution to a qualified organization, they may deduct only the amount of the contribution that exceeds the value of the benefit they receive.

If the taxpayer pays more than FMV to a qualified organization for merchandise, goods, or services, the amount they pay that is more than the item's value can be a charitable contribution. For the excess amount to qualify, the taxpayer must pay it with the intent to make a charitable contribution.

Athletic Events

If the taxpayer makes a payment to, or for the benefit of, a college or university and, as a result, they receive the right to buy tickets to an athletic event in the athletic stadium of the college or university, taxpayers may deduct 80% of the payment as a charitable contribution. If any part of their payment is considered payment for tickets (rather than the right to buy tickets), that part is not deductible. In that case, the price of the tickets must be subtracted from the taxpayer's payment and the result multiplied by 80% to determine the charitable contribution.

Membership Fees or Dues

Taxpayers may be able to deduct membership fees or dues they pay to a qualified organization. However, they may deduct only the amount that is more than the value of the benefits they receive. The taxpayer cannot deduct dues, fees, or assessments paid to country clubs and other social organizations, because these are not qualified organizations.

Certain membership benefits the taxpayers get in return for an annual payment of **$75 or less** to a qualified organization may be disregarded in determining the amount of the deduction. These benefits include the following.

1. Any rights or privileges that the taxpayers may use frequently while they are a member, such as:
    a. Free or discounted admission to the organization's facilities or events,
    b. Free or discounted parking,
    c. Preferred access to goods or services, and
    d. Discounts on the purchase of goods and services
2. Admission, while they are a member, to events that are open only to members of the organization, if the organization reasonably projects that the direct cost per person is not more than $9.90[28]
3. Token items (The qualified organization must determine that the value of the token benefit is not substantial and must inform the taxpayer that the full payment is deductible.)

A qualified organization must give the taxpayer a written statement for a payment of more than $75 that is partly a contribution and partly for goods or services. The statement must state that the donor can deduct only the amount of the payment that is more than the value of the goods or services they received. It must also give the donor a good faith estimate of the value of those goods or services.

28. Rev. Proc. 2011-52, 2011-45 IRB 701.

Other Benefits

If the taxpayers receive or expect to receive a financial or economic benefit as a result of making a contribution to a qualified organization, they cannot deduct the part of the contribution that represents the value of the benefit they receive. These contributions include the following.

1. Contributions for lobbying (This includes amounts that the taxpayer earmarks for use in, or in connection with, influencing specific legislation.)
2. Contributions to a retirement home that are clearly for room, board, maintenance, or admittance (Also, if the amount of their contribution depends on the type or size of the apartment the taxpayer will occupy, it is not a charitable contribution.)
3. Costs of raffles, bingo, lottery, etc.
4. Tuition, or amounts paid instead of tuition, even if the taxpayers pay them for children to attend parochial schools or qualifying nonprofit daycare centers (They also cannot deduct any fixed amount they may be required to pay in addition to the tuition fee to enroll in a private school, even if it is designated as a "donation.")

OUT-OF-POCKET EXPENSES

Although taxpayers cannot deduct the value of their **services** given to a qualified organization, they may be able to deduct some of the expenses incurred in giving services to a qualified organization. The amounts must be:

1. Unreimbursed;
2. Directly connected with the services;
3. Expenses they incurred only because of the services they gave; and
4. Not personal, living, or family expenses.

Car Expenses

Taxpayers may deduct unreimbursed out-of-pocket expenses, such as the cost of gas and oil, which are directly related to the use of their car in providing services to a charitable organization. They cannot deduct general repair and maintenance expenses, depreciation, registration fees, or the costs of tires or insurance.

Instead of deducting actual expenses, taxpayers may use a standard mileage rate of 14 cents per mile to calculate their contribution.[29] Taxpayers may deduct parking fees and tolls under either method.

Travel

Generally, taxpayers may claim a charitable contribution deduction for travel expenses incurred while they are away from home performing services for a charitable organization **only if there is no significant element of personal pleasure**, recreation, or vacation in the travel. This applies whether they pay the expenses directly or indirectly. The taxpayer pays the expenses indirectly if they make a payment to the charitable organization and the organization pays for their travel expenses.

The deduction for travel expenses will not be denied simply because the taxpayer enjoys providing services to the charitable organization. Even if they enjoy the trip, taxpayers may deduct their travel expenses if they are on duty in a genuine and substantial sense throughout the trip. However, if the taxpayer has only nominal duties, or if for significant parts of the trip they do not have any duties, they cannot deduct their travel expenses.

29. IRS News Rel. IR-2011-116 (Dec. 9, 2011).

If the taxpayer provides services for a charitable organization and receives a daily allowance to cover reasonable travel expenses, including meals and lodging while away from home overnight, the taxpayer must include in income the amount of the allowance that is more than their deductible travel expenses. They may deduct their necessary travel expenses that are more than the allowance.

Because these travel expenses are not business-related, they are not subject to the same limits as business-related expenses. For example, the deduction for the cost of meals incurred while traveling for charitable purposes is not limited to 50% of the expense.

NONDEDUCTIBLE CONTRIBUTIONS

There are some contributions that taxpayers may not deduct, such as those made to specific individuals and those made to nonqualified organizations.

A taxpayer cannot deduct contributions to specific individuals, including the following.[30]

1. Contributions to fraternal societies made for purposes of paying medical or burial expenses of deceased members
2. Contributions to individuals who are needy or worthy (This includes contributions to a qualified organization if the taxpayer indicates that their contribution is for a specific person. But taxpayers may deduct a contribution that they give to a qualified organization that in turn helps needy or worthy individuals if they do not indicate that their contribution is for a specific person.)
3. Payments to a member of the clergy that can be spent as he or she wishes, such as for personal expenses
4. Expenses the taxpayer paid for another person who provided services to a qualified organization

Example 7. Joe Saint does missionary work. His parents pay his expenses. Mr. and Mrs. Saint cannot claim a deduction for Joe's unreimbursed expenses related to his missionary services.

5. Payments to a hospital that are for a specific patient's care or for services for a specific patient. The taxpayer cannot deduct these payments even if the hospital is operated by a city, a state, or other qualified organization.

CONTRIBUTIONS OF PROPERTY

When taxpayers contribute property to a qualified organization, the amount of the charitable contribution is generally the FMV of the property at the time of the contribution.

Contributions of Vehicles

In the past, taxpayers could donate vehicles to charities and base the deductible value of the contribution on the blue book value, even if the recipient organizations sold the vehicles at auction for significantly less than the claimed value. To curb this abuse, Congress revised the law to limit the deductible value of donated vehicles to the lesser of the auction price or the FMV on the date of the contribution.

There are two exceptions to the limit.

1. The vehicle is used or improved by the recipient organization. If the qualified organization makes a significant intervening use of, or material improvement to, the vehicle before transferring it, the taxpayer may generally deduct the vehicle's FMV at the time of the contribution.
2. The vehicle is given or sold to a needy individual. If the qualified organization gives the vehicle, or sells it for a price well below FMV to a needy individual to further the organization's charitable purpose, the taxpayer can generally deduct the vehicle's FMV at the time of the contribution. This exception does not apply if the organization sells the vehicle at auction.

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30. IRS Pub. 526, *Charitable Contributions.*

Charitable organizations that receive vehicles as contributions must issue Form 1098-C, *Contributions of Motor Vehicles, Boats, and Airplanes*, to the donors of vehicles valued at more than $500. Taxpayers must attach copy B of Form 1098-C to their tax returns. For e-filed returns, copy B must be attached to Form 8453 and submitted by mail. If the taxpayer does not attach Form 1098-C, they cannot deduct their contribution.

Determining FMV

FMV is the price at which property would change hands between a willing buyer and a willing seller, neither having to buy or sell, and both having reasonable knowledge of all the relevant facts. Generally, appraisals are required when the value of donated property exceeds $5,000. The appraisal must be performed by a qualified independent professional. Even when it is not required, taxpayers may wish to obtain an appraisal for items that do not have an easily identifiable market value.

Generally, the FMV of used clothing and household goods is far less than its original cost. For used clothing, taxpayers should claim the price that buyers actually pay in used clothing stores, such as consignment or thrift shops. Determining this value can be very difficult for the taxpayer.

The following websites are among those that provide free valuation guides.

1. **www.goodwill.org**
2. **www.salvationarmyusa.org**
3. **www.bankrate.com**

Some companies offer software that can help in valuing donated items and calculating the totals. These products include the following.

- Intuit: ItsDeductible
- H&R Block: DeductionPro
- CharityDeductions.com

Note. For more information, see IRS Pub. 561, *Determining the Value of Donated Property*.

LIMITS ON DEDUCTIONS

The amount of the deduction for charitable contributions is generally limited to 50% of the taxpayer's AGI. The deduction may also be further limited to 30% or 20% of AGI, based on the type of property given and the type of donee organization. If the taxpayer's contributions are more than any of the applicable limits, the excess is carried forward to future years.

50% Limit

This limit applies to the total of all charitable contributions that taxpayers make during the year. Generally, the 50% limit is the only limit that applies to gifts to the following types of organizations.

1. Churches and conventions or associations of churches
2. Educational organizations with a regular faculty and curriculum that normally have a regularly enrolled student body attending classes on site
3. Hospitals and certain medical research organizations associated with these hospitals
4. Publicly supported charities

These organizations are often referred to as **"50% limit organizations."**

30% Limits

A 30% limit applies to the following gifts.

1. Gifts to all qualified organizations other than 50% limit organizations (This includes gifts to veterans' organizations, fraternal societies, nonprofit cemeteries, and certain private nonoperating foundations.)
2. Gifts for the **use** of any organization (However, if these gifts are of capital gain property, the deduction is further limited.)
3. Amounts taxpayers spend on behalf of an exchange student living with them (These amounts are considered a contribution for the use of a qualified organization.)

> **Note.** The deduction is limited to $50 for each month the student lives with the host family. The host family must have a written agreement with the sponsoring organization.[31]

Another 30% limit may apply to gifts of capital gain property, if the gifts are made to 50% limit organizations.

1. If the taxpayers choose to deduct the full FMV of the appreciated capital gain property, their deduction is limited to 30% of their AGI.
2. If the taxpayers choose to deduct only the value (basis) remaining after subtracting the amount that would have been long-term capital gain (if they had sold the property) from the full FMV, the 30% limit does not apply.

The two 30% limits are considered independently. Therefore, the deduction of a contribution subject to one 30% limit does not reduce the amount taxpayers may deduct for contributions subject to the other 30% limit. However, the total they deduct cannot be more than 50% of their AGI.

20% Limit

This limit applies to all gifts of capital gain property to, or for the use of, 30% limit organizations.

Carryovers

A taxpayer may carry over contributions that cannot be deducted in the current year because they exceed the taxpayer's AGI limits. However, the taxpayer's total contributions deduction for the year to which the contributions are carried cannot exceed 50% of the taxpayer's AGI for that year.[32] The carryforward period is limited to five years.

31. IRC §170(g)(2)(A).
32. IRS Pub. 526, *Charitable Contributions.*

Example 8. After a personal epiphany on Christmas Eve the year before, Ebenezer Scrooge donates significant sums and his most prized possessions to various charities in 2012, as shown in the following table.

Donation	FMV	Charity	Type of Organization	AGI Limit
$60,000	$60,000	Children's Hospital	50%	50%
$50,000	50,000	Amazing Grace Cemetery Association	30%	30%
Brass doorknocker (for use on the main entrance: original cost $2,000)	20,000	Children's Hospital	50%	30%
Ten acres of bare land (for use as future burial sites: original cost $4,000)	40,000	Amazing Grace Cemetery Association	30%	20%

Ebenezer's 2012 income is lower than usual because he devoted a substantial number of hours to philanthropic causes during the year. His 2012 AGI is $150,000. The maximum amount of each gift that he can deduct on his 2012 tax return is shown in the following table.

Gift	FMV	Calculation of Limit	Maximum Deduction	Lesser of FMV or Maximum
$60,000	$60,000	($150,000 × 50%)	$75,000	$60,000
$50,000	50,000	(150,000 × 30%)	45,000	45,000
Door knocker	20,000	(150,000 × 30%)	45,000	20,000
Land	40,000	(150,000 × 20%)	30,000	30,000

Ebenezer's total charitable gift deduction for 2012 is limited to 50% of his AGI, or $75,000. For purposes of calculating his carryover to 2013, his deduction is applied first against the cash donation to the hospital (50% organization, 50% donation), then to the property gift (50% organization, 30% donation) made to the hospital. His carryovers are calculated as shown below.

Deductible Gift/Value	Amount Deducted in 2012	Carryover to 2013
$60,000	$60,000	$ 0
$50,000	0	50,000
Door knocker/$20,000	15,000	5,000
Land/$40,000	0	40,000

These 2012 carryforwards will expire after 2017. Current year contributions are deducted before carryover contributions from previous years. If Ebenezer continues with these levels of earning and gifting, his remaining 2012 contributions may never be deducted.

Note. Making smaller charitable contributions in future years can allow the carryforwards to be utilized before their expiration year.

NONBUSINESS CASUALTY AND THEFT LOSSES

CASUALTY

Note. For a detailed discussion of casualty losses, see Chapter 8, Small Business Issues, in the 2011 *University of Illinois Federal Tax Workbook*.

A casualty is the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual. A sudden event is one that is swift, not gradual or progressive. An unexpected event is one that is ordinarily unanticipated and unintended. An unusual event is one that is not a day-to-day occurrence and that is not typical of the activity in which the property was used.

A casualty loss is not deductible if the damage or destruction is caused by the following.

1. Accidental breakage of articles such as glassware or china under normal conditions
2. A family pet, unless so unusual as to be unexpected by a reasonable person
3. A fire that the taxpayer willfully set or paid someone else to set
4. A car accident caused by the taxpayer's willful negligence or willful act (The same is true if the willful act or willful negligence of someone acting for them caused the accident.)
5. Progressive deterioration (The damage results from a steadily operating cause or a normal process, rather than from a sudden event.) The following are examples of damage due to progressive deterioration.
   a. The steady weakening of a building due to normal wind and weather conditions
   b. The deterioration and damage to a water heater that bursts (However, the rust and water damage to rugs and drapes caused by the bursting of a water heater does qualify as a casualty.)
   c. Most losses of property caused by droughts (To be deductible, a drought-related loss generally must be incurred in a trade or business or in a transaction entered into for profit.)
   d. Termite or moth damage
   e. The damage or destruction of trees, shrubs, or other plants by a fungus, disease, insects, worms, or similar pests (However, a sudden destruction due to an unexpected or unusual infestation of beetles or other insects may result in a casualty loss.)

THEFT

Theft includes the taking of money or property by the following means.

1. Blackmail
2. Burglary
3. Embezzlement
4. Extortion
5. Kidnapping for ransom
6. Larceny
7. Robbery

The taking of money or property through fraud or misrepresentation is considered theft if it is illegal under state or local law.

> **Note.** Mislaid or lost property does not qualify as a theft loss. **Mislaid** property is property intentionally left in a place and later forgotten. **Lost** property is property in a place where the owner did not likely intend to leave it and will not likely find it.

SPECIFIC LOSSES WITH SPECIAL TAX TREATMENT

Losses from Ponzi-Type Investment Schemes

Losses from Ponzi-type investment schemes are deductible as theft losses of income-producing property on the tax return for the year in which the loss was discovered.

For more information, see the following.

1. Rev. Rul. 2009-9, 2009-14 IRB 735 (available at **www.irs.gov/irb/2009-14_IRB/ar07.html**)
2. Rev. Proc. 2009-20, 2009-14 IRB 749 (available at **www.irs.gov/irb/2009-14_IRB/ar11.html**)

> **Note.** For additional information on losses from Ponzi-type investment schemes, see pages 136–144 in the 2009 *University of Illinois Federal Tax Workbook.* This can be found at **www.taxschool.illinois.edu/taxbookarchive.**

Loss on Deposits

A loss on deposits can occur when a bank, credit union, or other financial institution becomes insolvent or bankrupt. If taxpayers incur this type of loss, they may choose one of the following ways to deduct the loss.

1. As a casualty loss
2. As an ordinary loss
3. As a nonbusiness bad debt

> **Note**. For more information, see the instructions for Form 4684, *Casualties and Thefts*, or IRS Pub. 550, *Investment Income and Expenses*.

PROOF OF LOSS

To deduct a casualty or theft loss, the taxpayer must be able to prove that they had a casualty or theft. They also must be able to support the amount taken as a deduction.

Casualty Loss Proof

For a casualty loss, the taxpayer's records should show **all** the following.

1. The type of casualty (car accident, fire, storm, etc.) and when it occurred
2. That the loss was a direct result of the casualty
3. That they were the owner of the property or, if they leased the property from someone else, that they were contractually liable to the owner for the damage
4. Whether a claim for reimbursement exists that has a reasonable expectation of receipt

Theft Loss Proof

For a theft loss, the taxpayer's records should show **all** the following.

1. When they discovered that the property was missing
2. That the property was stolen
3. That they owned the property
4. Whether a claim for reimbursement exists that has a reasonable expectation of receipt

CALCULATING A LOSS

The loss is calculated using the following steps.[33]

1. Determine the adjusted basis in the property before the casualty or theft.
2. Determine the difference between the property's FMV immediately before and immediately after the casualty or theft.

> **Note.** The FMV of property immediately after a theft is considered zero because the taxpayer no longer has the property.

3. From the smaller of the amounts calculated in steps 1 and 2, subtract any insurance or other reimbursement the taxpayer received or expects to receive.

If the reimbursement is more than the taxpayer's adjusted basis in the property, there is a gain. If the taxpayer has a gain, they may have to pay tax on it or they may be able to postpone reporting the gain.

> **Note.** See IRS Pub 547, *Casualties, Disasters, and Thefts (Business and Nonbusiness)*, for more information on how to treat a gain from a reimbursement for a casualty or theft.

Cost of Cleaning or Making Repairs

Neither the cost of repairing damaged property nor the cost of cleaning up after a casualty is considered part of a casualty loss. However, taxpayers may use the cost of cleaning up or making repairs after a casualty as a measure of the decrease in FMV if they meet all the following conditions.

1. The repairs are actually made.
2. The repairs are necessary to bring the property back to its condition before the casualty.
3. The amount spent for repairs is not excessive.
4. The repairs take care of the damage only.
5. The value of the property after the repairs is not, due to the repairs, more than the value of the property before the casualty.

Calculating the Decrease in FMV

Any incidental expenses that the taxpayers have due to a casualty or theft, such as expenses for the treatment of personal injuries, for temporary housing, or for a rental car, are not part of the casualty or theft loss. The cost of replacing stolen or destroyed property is not part of a casualty or theft loss.

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33. IRS Pub. 584, *Casualty, Disaster, and Theft Loss Workbook.*

A decrease in the value of property because it is in or near an area that suffered a casualty, or that might again suffer a casualty, is not a casualty loss. Only actual damage to the taxpayers' property qualifies.

The costs of photographs and appraisals used as evidence of the value and condition of property after the casualty are not a part of the loss. However, taxpayers may claim these costs as a miscellaneous itemized deduction subject to the 2%-of-AGI limit.

Insurance and Other Reimbursements

If the taxpayers receive an insurance payment or other type of reimbursement, they must subtract the reimbursement when they calculate the loss. They do not have a casualty or theft loss to the extent that they are reimbursed.

If the taxpayers expect to be reimbursed for part of their loss, they must subtract the expected reimbursement when they calculate the loss. If their property is covered by insurance, they must file a timely insurance claim for reimbursement of their loss. Otherwise, they cannot deduct this loss as a casualty or theft.

Taxpayers should not reduce their casualty loss by insurance payments they receive to cover living expenses in either of the following situations.

1. They lose the use of their principal residence because of a casualty.
2. Government authorities do not allow the taxpayers access to their principal residence because of a casualty or threat of one.

If the insurance payments are more than the temporary increase in the taxpayers' living expenses, they must include the excess in their income. This amount is reported on Form 1040, line 21. However, if the casualty occurs in a federally declared disaster area, none of the insurance payments for living expenses are taxable.

Reimbursement Received After Deducting Loss

The actual amount of reimbursement may be different than the expected amount reported by the taxpayers for the year of loss. The treatment of the difference is determined by whether the projected amount is more or less than expected.

Actual Reimbursement Less Than Expected. If the reimbursement is less than expected, the difference is reported as a loss on the return for the year in which the taxpayers reasonably expect no more reimbursement.

Actual Reimbursement More Than Expected. If the reimbursement is more than expected, the taxpayers may have to include the extra reimbursement in their income the year they receive it. However, if any part of the original deduction did not reduce their tax for the earlier year, the reimbursement is not included in income.

DEDUCTION LIMITS

After the taxpayer has calculated their casualty or theft loss, they must calculate how much of the loss they may deduct. If the loss was to property for their personal use or their family's use, there are two limits on the amount they may deduct for the casualty or theft loss.

1. The taxpayer must reduce each casualty or theft loss by $100 ($100 rule). This reduction applies to the total casualty or theft loss, not to each item of personal property.
2. The taxpayer must further reduce the total of all their casualty or theft losses by 10% of their AGI (10% rule).

The $100 rule and the 10% rule apply only to the loss on the **personal-use part** of the property. When property is used partly for personal purposes and partly for business or income-producing purposes, the casualty or theft loss deduction must be calculated separately for each part.

GAINS AND LOSSES

If the taxpayer has both gains and losses from casualties or thefts to personal-use property, they must net their total gains and total losses. This is done after the losses are reduced by any reimbursements and by applying the $100 rule, but before applying the 10% rule. Gains that the taxpayer elects to postpone are not included in the total.

Net Loss

3

If the taxpayer's losses are more than their recognized gains, the net loss is reduced by 10% of their AGI. The result is their deductible loss from personal-use property.

Net Gain

If the taxpayer's recognized gains are more than their losses, the net gain is treated as a capital gain and must be reported on Form 4684, *Casualties and Thefts,* and carried to Schedule D, *Capital Gains and Losses*. The 10% rule does not apply to the gains.

WHEN TO REPORT GAINS AND LOSSES

If the taxpayer receives reimbursements that are more than their adjusted basis in the destroyed or stolen property, they have a gain from the casualty or theft. They must include this gain in their income in the year they receive the reimbursement, unless they choose to postpone reporting the gain.

Note. See IRS Pub. 547, *Casualties, Disasters, and Thefts,* for information about postponing gains.

If the taxpayer has a net loss from the casualty or theft, the year in which the loss is deducted depends on the type of loss. The following table from IRS Pub. 17, *Your Federal Income Tax,* shows which year applies to which types of losses.

IF You Have A Loss . . .	THEN Deduct It in the Year . . .
From a casualty,	The loss occured.
In a federally declared disaster area,	The disaster occurred or the year immediately before the disaster.
From a theft,	The theft was discovered.
On a deposit treated as a . . .	
Casualty,	A reasonable estimate can be made.
Bad debt,	Deposits are totally worthless.
Ordinary loss,	A reasonable estimate can be made.

Net Operating Loss (NOL)

If the taxpayers' casualty or theft loss deduction causes their deductions for the year to be more than their income for the year, they may have an NOL. The taxpayer does not have to be in business to have an NOL from a casualty or theft loss.

Note. For more information, see IRS Pub. 536, *Net Operating Losses (NOLs) for Individuals, Estates, and Trusts*.

EMPLOYEE BUSINESS EXPENSES

Taxpayers may deduct the ordinary and necessary business-related expenses that they incur in their employment. The following is a general list of some of the expenses that are deductible.

1. Tools used in work
2. Education that is work related
3. Legal fees related to the job
4. Licenses and regulatory fees
5. Malpractice insurance premiums
6. Medical examinations required by an employer
7. Occupational taxes
8. Passport for a business trip
9. Subscriptions to professional journals and trade magazines related to work
10. Business bad debt of an employee
11. Damages for breach of employment contract
12. Depreciation on computers; taxpayers may claim a depreciation deduction for a computer that they use in their work as an employee if its use is:
    a. For the convenience of their employer, and
    b. Required as a condition of their employment
13. Dues to chambers of commerce and professional societies (However, employees may not deduct any part of their dues that is for certain lobbying and political activities.)
14. Union dues and expenses

    Taxpayers may deduct dues and initiation fees that they pay for union membership. Taxpayers may also deduct assessments for benefit payments to unemployed union members. However, they **cannot** deduct the part of the assessments or contributions that provides funds for the payment of sick, accident, or death benefits. Also, they **cannot** deduct contributions to a pension fund, even if the union requires them to make the contributions. They **may not** deduct amounts that they pay to the union that are related to certain lobbying and political activities.
15. Work clothes and uniforms; taxpayers may deduct the cost and upkeep of work clothes if:
    a. They must wear them as a condition of their employment, and
    b. The clothes are not suitable for everyday wear

    It is not enough that they wear distinctive clothing. The clothing must be specifically required by the employer. Additionally, it is not enough that they do not, in fact, wear their work clothes away from work. The clothing must not be suitable for taking the place of their regular clothing.

    Examples of workers who may be able to deduct the cost and upkeep of work clothes are delivery workers, firefighters, healthcare workers, law enforcement officers, letter carriers, professional athletes, and transportation workers (air, rail, bus, etc.).

Musicians and entertainers can deduct the cost of theatrical clothing and accessories that are not suitable for everyday wear.

Work clothing consisting of standard work shoes and a white cap, shirt, jacket, and white bib overalls — which some painters are required by their unions to wear on the job — is not distinctive in character or in the nature of a uniform. Similarly, the costs of buying and maintaining blue work clothes worn by a welder at the request of a foreman are not deductible.

16. Protective clothing

Taxpayers may deduct the cost of protective clothing required in their work, such as safety shoes or boots, safety glasses, hard hats, and work gloves. Examples of workers who may be required to wear safety items are carpenters, cement workers, chemical workers, electricians, fishing boat crew members, machinists, oil field workers, pipefitters, steamfitters, and truck drivers.

17. Military uniforms

Members of the armed services **cannot** deduct the cost of their uniforms if they are on **full-time active duty** in the armed forces. However, **armed forces reservists may deduct** the unreimbursed cost of their uniforms if military regulations restrict them from wearing it except while on duty as a reservist. In calculating the deduction, the reservist must reduce the cost by any nontaxable allowance they receive for these expenses.

If local military rules do not allow them to wear fatigue uniforms when they are off duty, taxpayers may deduct the cost of buying and keeping up these uniforms in excess of the uniform allowance that they receive. Taxpayers may also deduct the cost of their uniforms if they are a civilian faculty or staff member of a military installation.

Meals and entertainment, office-in-the-home, travel, transportation, and vehicle expenses are also deductible. Because they often receive extra scrutiny by the IRS during an audit, the requirements related to these deductions are discussed in more detail in Chapters 6 and 7 of this book. Tax practitioners are advised to have a complete understanding of the restrictions on these deductions.

Employees are required to complete Form 2106, *Employee Business Expenses*, to deduct their meals and entertainment, travel, transportation, and vehicle expenses. Even when Form 2106 is not required, reporting high amounts of unreimbursed employee expenses directly on Schedule A without filing Form 2106 may trigger an audit.

Note. Meals and entertainment expenses are discussed in detail in 2012 Volume C, Chapter 6: Travel, Meals, and Entertainment.

HOME OFFICE

If taxpayers use part of their home for business purposes, they may be able to deduct part of the operating expenses and depreciation of their home. To qualify for the deduction, they must use the home office:

1. Exclusively and regularly as the principal place of business for any trade or business;
2. Exclusively and regularly as a place to meet or deal with patients, clients, or customers in the normal course of the trade or business;
3. In the case of a separate structure not attached to the home, in connection with the trade or business; or
4. On a regular basis as a storage unit for the taxpayer's inventory, but only if the dwelling unit is the sole fixed location of that trade or business.[34]

[34] Prop. Treas. Reg. §1.280A-2(e).

The regular and exclusive business use **must be for the convenience of the employer** and not just appropriate and helpful in the taxpayer's job. A home office is deemed for the convenience of the employer if it is:

1. Required as a condition of employment,
2. Necessary for the employer's business to function, and
3. Necessary for the employee to perform their duties.

Note. See the *Cadwallader* 7th Circuit Appeals Court case for a thorough analysis of the convenience-of-the-employer rule.[35]

Note. Additional information about the home office deduction is available in 2012 Volume C, Chapter 7: Home Office Deduction.

MISCELLANEOUS DEDUCTIONS SUBJECT TO THE 2% THRESHOLD

UNREIMBURSED EMPLOYEE EXPENSES

Unreimbursed job-related expenses of employees are discussed in the previous section and in the Schedule C chapter of this book. If Form 2106 is not required, the expenses are reported on line 21 of Schedule A. Other business expenses that a taxpayer may incur, such as job search expenses, are also deductible on this line, even though the expenses were not incurred as an employee.

TAX PREPARATION FEES

Taxpayers may deduct costs related to preparation of their taxes on line 22 of Schedule A. These costs include amounts they pay for do-it-yourself software and electronic filing fees. Penalties and interest that the taxpayer pays for mistakes made using "do-it-yourself" resources are not deductible.

In many cases, a significant portion of the tax preparation fee is incurred for the preparation of business and investment schedules for the return, such as Schedules C or E. Therefore, that portion of the expense can be deducted on the appropriate schedule rather than on Schedule A.

OTHER EXPENSES

Taxpayers may deduct certain other expenses as miscellaneous itemized deductions subject to the 2%-of-AGI threshold. Types of expenses included on line 23 are those paid:

1. To produce or collect income that must be included in the taxpayer's gross income;
2. To manage, conserve, or maintain property held for producing such income; or
3. To determine, contest, pay, or claim a refund of any tax.

Taxpayers may deduct expenses that they pay for the purposes stated in 1 and 2 above only if they are reasonably and closely related to these purposes. Some of these expenses include the following.

1. **Appraisal fees**. Taxpayers may deduct appraisal fees if they pay them to calculate a casualty loss or the FMV of donated property.
2. **Clerical help and office rent.** Taxpayers may deduct office expenses, such as rent and clerical help, which they incur in connection with their investments and collecting the taxable income on them. Both the wages and the employment taxes of the clerical help are deductible. However, taxpayers must be careful not to include wages paid for personal services performed by the clerical help.

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35. *Cadwallader v. Comm'r*, No. 89-3429, 7th Cir. (Dec. 11, 1990), *aff'g* TC Memo 1989-356, 57 TCM 1030 (July 24, 1989).

3. **Credit or debit card convenience fees.** Taxpayers may deduct the convenience fee charged by the card processor for **paying their income tax** (including estimated tax payments) by credit or debit card. The fees are deductible in the year in which they are charged to the taxpayer.

4. **Depreciation on home computer.** Taxpayers may deduct depreciation on their home computer if they use it to produce income (for example, to **manage their investments** that produce taxable income). They generally must depreciate the computer using the straight-line method over the alternative depreciation system (ADS) recovery period. The personal-use portion of the computer costs is not deductible.

5. **Fees to collect interest and dividends.** Taxpayers may deduct fees that they pay to a broker, bank, trustee, or similar agent to collect their taxable bond interest or dividends on shares of stock.

6. **Investment fees and expenses.** Taxpayers may deduct investment fees, custodial fees, trust administration fees, and other expenses they paid for managing their investments that produce taxable income.

7. **Trustee's administrative fees for IRA.** Trustee's administrative fees that are billed separately and paid by taxpayers in connection with their IRAs are deductible, if the fees are ordinary and necessary.

8. **Service charges on dividend reinvestment plans.** Taxpayers may deduct service charges that they pay as a subscriber in a dividend reinvestment plan. These service charges include payments for:

   a. Holding shares acquired through a plan,

   b. Collecting and reinvesting cash dividends, and

   c. Keeping individual records and providing detailed statements of accounts.

9. **Safe deposit box rent.** Taxpayers may deduct safe deposit box rent if they use the box to store taxable income-producing stocks, bonds, or investment-related papers and documents. They cannot deduct the rent if they use the box only for jewelry, other personal items, or tax-exempt securities.

10. **Repayments of income.** If a taxpayer has to repay an amount that they included in income in an earlier year, they may be able to deduct the amount repaid. If the amount they have to repay is ordinary income of **$3,000 or less, the deduction is subject to the 2%-of-AGI threshold.** If it is more than $3,000, see the "Repayments under Claim of Right" section later in this chapter.

11. **Legal expenses.** Taxpayers may usually deduct legal expenses that they incur in attempting to produce or collect taxable income or that they pay in connection with the determination, collection, or refund of any tax. Taxpayers may also deduct legal expenses that are:

    a. Related to either doing or keeping their job, such as those they paid to defend themselves against criminal charges arising out of their trade or business;

    b. For tax advice related to a divorce, if the bill specifies how much is for tax advice and it is determined in a reasonable way; or

    c. To collect taxable alimony.

> **Note.** Taxpayers should ask their attorneys to use specific language on the invoices that clearly identifies which charges are tax deductible.

12. Hobby expenses. Taxpayers may generally deduct hobby expenses, but only up to the amount of hobby income. The U.S. Supreme Court has identified a 2-prong test to determine whether an activity is engaged in as a business.[36] To meet this test, the taxpayer must:

a. Be involved in the activity with continuity and regularity, **and**

b. Intend to generate a profit.

A sporadic activity, hobby, or amusement diversion does not qualify as a business, and the expenses related to these activities are only deductible on Schedule A.

> **Note.** See "Issue 2: Not-for-Profit Activities" in Chapter 10 of the 2008 *University of Illinois Federal Tax Workbook* for a comprehensive discussion of profit motive. This is available at **www.TaxSchool.illinois.edu/taxbookarchive.**

Treasury regulations[37] specify the order in which deductions for these expenses must be taken by categorizing them into three tiers.

1. **Tier 1** expenses are those related to the hobby and also qualify as deductible under other provisions of the Code. This includes home mortgage interest, taxes, and casualty losses. These are normally Schedule A deductions. These deductions are not limited to the income from the hobby. However, if Tier 1 expenses exceed the hobby income, no further deductions for hobby expenses are allowed.

2. **Tier 2** expenses are those that do not result in an adjustment to the basis of property. Examples include advertising, supplies, and travel. Deductions for Tier 2 expenses cannot exceed gross income minus Tier 1 expenses.

3. **Tier 3** expenses are those that reduce the basis of property, such as depreciation. Deductions for Tier 3 expenses cannot exceed gross income minus the previous tiers. The expenses in Tiers 2 and 3 are subject to the 2%-of-AGI threshold. Expenses in excess of income do not carry forward. However, disallowed Tier 3 expenses do not reduce the asset's basis.

Example 9. Professor Bjorn Peggle competes in amateur pinball tournaments. Although he enjoys winning occasional prizes, his primary motive is to relax the left side of his brain. In fact, he spends more on his hobby than he wins each year.

In 2012, the professor purchases a computerized pinball simulator for $20,000. This apparatus allows him to practice on over 50 pinball machine configurations. He borrows the money to buy the simulator using his home equity line of credit and pays $1,000 in qualified interest for the year. He also spends $6,000 traveling to competitions.

Bjorn wins $7,500 in prize money during 2012. He reports this income on line 21 of Form 1040. His allowed hobby expenses are deducted on Schedule A in the following manner.

Income from hobby	$7,500	
Tier 1: home equity interest	(1,000)	Included on line 10
Remaining profit for Tier 2 and 3 expenses	$6,500	
Tier 2: travel expense	(6,000)	Included on line 23
Remaining profit for Tier 3 expenses	$ 500	
Tier 3: allowed depreciation expense	(500)	Included on line 23
Remaining profit	$ 0	

36. *Comm'r v. Robert P. Groetzinger,* 480 U.S. 23 (1987).

37. Treas. Reg. §1.183-1.

Observations:

1. Using the MACRS half-year convention for this asset with a 5-year class life, the potential depreciation on the simulator is $4,000. However, the professor can only claim depreciation expense up to the amount of profit remaining after Tier 1 and Tier 2 expenses, so his deduction is limited to $500.

2. The professor's basis in the simulator is reduced by the $500 of allowed depreciation expense.

MISCELLANEOUS DEDUCTIONS NOT SUBJECT TO THE 2% THRESHOLD

There are only eight miscellaneous itemized deductions that are not subject to the 2%-of-AGI threshold. Following is a description of each.

AMORTIZABLE PREMIUM ON TAXABLE BONDS

This deduction only applies to bonds acquired **before** October 23, 1986. The amortization of bond premiums acquired subsequent to that date is generally an offset to interest income on the bond rather than a separate deduction item.

CASUALTY AND THEFT LOSSES FROM INCOME PRODUCING PROPERTY

A loss is not subject to the 2%-of-AGI threshold if the property was income-producing. This includes property held for investment such as stocks, notes, bonds, gold, vacant lots, art work, etc. The loss is first reported in Section B of Form 4684, *Casualties and Thefts.* If Form 4797, *Sale of Business Property,* is required, the loss is included there. All losses from this type of property are included. This includes losses from Ponzi-type investment schemes.

FEDERAL ESTATE TAX ON INCOME IN RESPECT OF A DECEDENT

Income in respect of a decedent (IRD) is gross income that:

- The decedent would have received had death not occurred, and
- Was not includible in the decedent's final income tax return.

The value of the underlying asset, including the previously untaxed income, is included in the decedent's estate for federal estate tax purposes. If federal estate tax is due on this amount, the beneficiary of the IRD may deduct the portion of the federal estate tax that is attributable to this income.

GAMBLING LOSSES UP TO THE AMOUNT OF GAMBLING WINNINGS

Taxpayers must report the full amount of their gambling winnings for the year on Form 1040, line 21 (other income). They can deduct their gambling losses for the year as a miscellaneous itemized deduction. However, they cannot deduct gambling losses that are more than their winnings.

> **Note.** According to advice issued by the IRS, slot machine players should log their net gains or losses by day instead of by machine.[38] See Problem 4 of Chapter 4 in the 2009 *University of Illinois Federal Tax Workbook* for information about winnings and losses from slot machine gambling. This is available at **www.TaxSchool.illinois.edu/taxbookarchive.**

[38] Chief Counsel Advice AM 2008-011 (Dec. 12, 2008).

IMPAIRMENT-RELATED WORK EXPENSES

Taxpayers who have a physical or mental disability that limits their employment or substantially limits one or more of their major life activities may deduct their impairment-related work expenses. Major life activities include performing manual tasks, walking, speaking, breathing, learning, and working. Impairment-related work expenses include ordinary and necessary business expenses for attendant care services at the taxpayer's place of work and other expenses that are necessary for them to be able to work.

LOSS FROM OTHER ACTIVITIES

If the amount reported on box 2 of Schedule K-1 of Form 1065-B, *U.S. Return of Income for Electing Large Partnerships,* is a loss, it is deducted as a miscellaneous itemized deduction that is not subject to the 2% limit. This loss is not subject to the passive activity limitations.

REPAYMENTS UNDER CLAIM OF RIGHT

If taxpayers have to repay **more than $3,000** that was included in income in an earlier year, they may claim the repayment as a miscellaneous itemized deduction not subject to the 2% floor. However, the taxpayer may **instead** take a credit against their tax for the amount of tax previously paid. They may use whichever method is most beneficial.

> **Example 10.** In 2011, Jimmy Lightening suffered a disabling injury while teaching skateboarding for the local public park district. His disability insurance paid him a total of $12,000 during 2011 while he was waiting for his social security benefits to be approved. In 2012, he is awarded social security benefits, including a lump sum amount of $4,000 for 2011. Jimmy's insurance company requires him to repay the $4,000 to them for the 2011 benefits.
>
> Jimmy calculates his 2012 tax return using the $4,000 as a miscellaneous itemized deduction on Schedule A. However, because he has no other expenses deductible on Schedule A, his total itemized deductions are only $4,000, which is less than his standard deduction amount of $5,950.[39]
>
> In 2011, Jimmy's taxable income was $8,000, which is all in the 10% income tax bracket. He recalculates his 2011 return as if he had not received the $4,000 that was subsequently repaid. This recalculation shows that his 2011 taxes would have been $400 lower without that income. Jimmy claims the $400 as a refundable credit on his 2012 return in the payment section of Form 1040, citing IRC §1341 as the source of the credit.

UNRECOVERED INVESTMENT IN ANNUITY

A retiree who contributed to the cost of an annuity can exclude from income a part of each payment received as a tax-free return of the retiree's investment. If the retiree dies before the entire tax-free investment is excluded, any unrecovered investment can be deducted on the retiree's final income tax return.

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39. Rev. Proc. 2011-52, 2011-45 IRB 701.

NONDEDUCTIBLE EXPENSES

PERSONAL EXPENSES

Taxpayers often have expenses that they believe should be deductible despite the inherent personal nature of the expense. The following is a general list of personal expenses that are **not deductible.**

1. Burial or funeral expenses, including the cost of a cemetery lot
2. Fees and licenses, such as car licenses, marriage licenses, and dog tags
3. Home repairs, insurance, rent, or a home security system, except as related to a qualified home office
4. Illegal bribes and kickbacks
5. Losses from the sale of their personal assets, such as home, furniture, and personal car
6. Personal disability insurance premiums
7. Personal, living, or family expenses
8. The value of wages never received or lost vacation time
9. Check-writing fees on personal account
10. Health spa expenses
11. Membership dues in any club organized for business, pleasure, recreation, or other social purpose
12. Life insurance premiums
13. Personal legal expenses such as the following (even when the legal proceeding results in the loss of income-producing property)
    a. Custody of children
    b. Breach of promise to marry suit
    c. Civil or criminal charges resulting from a personal relationship
    d. Damages for personal injury, except for certain unlawful discrimination and whistleblower claims
    e. Preparation of a title (or defense or perfection of a title)
    f. Preparation of a will
    g. Property claims or property settlement in a divorce

NONDEDUCTIBLE JOB-RELATED EXPENSES

Certain expenses that an employee incurs in the course of their employment or profession are not deductible despite being job related. Such expenses include the following.

1. Lunches with co-workers, except while traveling away from home on business
2. Meals while working late, except if the meals are qualified entertainment or travel expenses
3. Professional accreditation fees such as the following
   a. Accounting certificate fees paid for the **initial** right to practice accounting
   b. Bar exam fees and incidental expenses in securing **initial** admission to the bar
   c. Medical and dental license fees paid to get **initial** licensing
4. Professional reputation enhancement, such as the costs of radio and television appearances to increase personal prestige or establish professional reputation
5. Residential telephone service for the first telephone line to a residence even if it is used in a trade or business
6. Wristwatches, even if there is a job requirement that the employee know the correct time to properly perform their duties
7. Business attire, jewelry, and status symbols, unless the items are not suitable for ordinary wear

NONDEDUCTIBLE INVESTMENT EXPENSES

Although many investment-related expenses are deductible, the following are specifically excluded.

1. Broker's commissions paid in connection with an IRA or other investment property
2. Investment-related seminars or conventions
3. Attending stockholders' meetings
4. Expenses related to tax-exempt income

OTHER TYPES OF NONDEDUCTIBLE EXPENSES

Fines or Penalties

Taxpayers may not deduct fines or penalties they pay to a governmental unit for violating a law. This includes an amount paid in settlement of an actual or potential liability for a fine or penalty (civil or criminal). Fines or penalties include parking tickets, tax penalties, and penalties deducted from teachers' paychecks after an illegal strike.

Campaign Expenses

Taxpayers may not deduct campaign expenses of a candidate for any office, even if the taxpayer is running for re-election to the office. These include qualification and registration fees for primary elections. They also cannot deduct legal fees paid to defend charges that arise from participation in a political campaign.

Political Contributions

Taxpayers cannot deduct contributions made to a political candidate, a campaign committee, or a newsletter fund. Advertisements in convention bulletins and admissions to dinners or programs that benefit a political party or political candidate are not deductible.

Lobbying Expenses

Taxpayers cannot deduct amounts paid or incurred for lobbying expenses. These include expenses to:

1. Influence legislation;
2. Participate or intervene in any political campaign for, or against, any candidate for public office;
3. Attempt to influence the general public, or segments of the public, about elections, legislative matters, or referendums; or
4. Communicate directly with covered executive branch officials in an attempt to influence the official actions or positions of those officials.

Lobbying expenses also include any amounts paid or incurred for research, preparation, planning, or coordination of any of these activities. If a tax-exempt organization notifies its members that part of the dues or other amounts they pay to the organization are used to pay nondeductible lobbying expenses, the members cannot deduct that part.

There are **exceptions** to this prohibition for professional lobbyists, which include de minimis in-house expenditures and direct communications with local governing bodies.

Note. See "Lobbying Expenses" in IRS Pub. 529, *Miscellaneous Deductions*, for more information on these exceptions.

Relief Fund Contributions

Taxpayers may not deduct contributions paid to a private plan that pays benefits to any covered employee who cannot work because of an injury or illness not related to the job.

Voluntary Unemployment Benefit Fund Contributions

Taxpayers may not deduct voluntary unemployment benefit fund contributions they make to a union fund or a private fund. However, taxpayers may deduct contributions as taxes if state law **requires** them to pay into a state unemployment fund that covers them for the loss of wages from unemployment caused by business conditions.