**Chapter Five**

**Itemized Deductions and Other Incentives**

**Learning Objective 5.1 Medical Expenses**

Medical expenses are the first itemized deductions on the Schedule A. Medical expenses include those amounts paid for the taxpayer, spouse or dependents. Qualifying medical expenses include prescription medications, visits to doctors, dentists and hospitals, medical insurance premiums, lodging and transportation expenses for medical care, hearing aids, dentures, eyeglasses and contact lenses. This amount must be decreased by any insurance reimbursements. The deductible amount is the amount greater than 10 percent of AGI for taxpayers under age 65 at year-end. The 7.5% threshold remains in effect through 2016 for taxpayers who reach the age of 65 by year-end. (MFJ only one taxpayer must be 65.) Certain medical expenditures are not deductible and need special consideration.

**Learning Objective 5.2 Taxes**

Certain state, local and foreign taxes paid during the year are deductible. Taxpayers may deduct state and local income taxes paid during the year. Taxes that are levied on real property are deductible. Property taxes based on the value of the property (ad valorem) are deductible.

**Learning Objective 5.3 Interest**

Interest paid on a qualified residence, investment interest and certain interest associated with a passive activity are deductible. Consumer interest (such as the interest on credit cards) is not deductible. A deduction for education loan interest is limited to $2,500 and phased-out if an individual taxpayer’s modified AGI is $65,000 to $80,000 and for married taxpayers with modified AGI of $130,000 to $160,000. The investment interest deduction is limited to the net investment income of the taxpayer.

**Learning Objective 5.4 Contributions**

Taxpayers may deduct charitable contributions. The donation must be either cash or property. If the donation is made in cash, the deduction is equal to the amount of cash. If property is donated, the deduction is equal to the fair market value of the property. The IRS maintains a list of organizations that are considered to be charitable. The limit of contributions to public charities and private foundations is 50 percent of AGI. Other contribution limits are established for long-term capital gain property. However, usually the amount over the contribution limit may be carried forward for five years. Taxpayers should keep all receipts, cancelled checks or other proof of contributions. Form 8283 should be completed if the individual made a contribution of property over $500.

**Learning Objective 5.5 Casualty and Theft Losses**

Taxpayers are allowed deductions for losses due to casualties or thefts. A casualty is defined as a complete or partial destruction of property resulting from an identifiable event of a sudden, unexpected, or unusual nature. Most casualties are natural occurrences, such as damages caused by floods or storms. For damages to be considered casualties, the condition must be unusual for the area. Deductions for theft losses occur in the year the theft is discovered, not when the theft actually occurred. There are two ways to establish the amount of losses. The first is Rule A that allows a loss based on the decrease in fair market value of the property. The second method is Rule B that uses the adjusted basis of the property. A $100 floor per occurrence limits the overall amount of the deduction. Also, the total loss must exceed 10 percent of AGI.

**Learning Objective 5.6 Miscellaneous Deductions**

Taxpayers are allowed to take several miscellaneous deductions. These deductions are either limited by 2% of AGI or are not limited. Examples of deductions limited by 2% of AGI include unreimbursed employee business expenses and employee business expenses reimbursed under a nonaccountable plan, investment expenses and other expenses such as tax preparation fee, union dues, job hunting expenses, and professional subscriptions. Examples of those not limited include certain estate taxes, amortizable bond premiums, unrecovered annuity costs at death, handicapped “impairment related work expenses” and gambling losses to extent of gambling winnings.

**Learning Objective 5.7 Classification of Deductions-Employees**

Business expense incurred by an employee in performing services for his or her employer are generally considered miscellaneous itemized deductions, subject to the 2 percent of adjusted gross income limitation. In some cases, however, reimbursed employee business expenses may be treated as deductions in arriving at adjusted gross income. The reimbursement is not included in gross income if the employee business expense is under an accountable plan.

**Learning Objective 5.8 Educational Incentives**

Qualified Tuition Programs (QTP) allow taxpayers to buy in-kind tuition credits or certificates for qualified higher education expenses or to contribute to an account established to meet qualified higher education expenses. A state government or private institutions of higher learning sponsor the programs. Qualified higher education expenses include tuition, fees, books, supplies, and equipment required for the enrollment or attendance at an eligible education intuition. There is no income limit on the amount of contributions to the QTP, however, the contributions are not tax deductible. The contributions are considered gifts, thus subject to gift tax rules.

Educational savings accounts are established to pay for qualified higher education expenses. The maximum annual contribution to these plans is $2,000. Contributions can be made until the designated beneficiary reaches 18. Additionally, contributions cannot be made to educational savings accounts in the same year a contribution is made to a Qualified Tuition Program. Contributions to educational savings accounts are phased out between AGIs of $95,000 and $110,000 for single taxpayers and $190,000 and $220,000 for married couples filing a joint return.

**Learning Objective 5.9 Phase-Out of Itemized Deductions and Exemptions for High-Income Taxpayers**

Taxpayers with AGI over certain threshold amounts are subject to both itemized deduction and exemption phase-outs. The thresholds are; single - $254,200, head of household - $279,650, married filing joint - $305,050, and married filing separately - $152,525.

Itemized deductions are reduced by the lesser of 3 percent of the excess of AGI over the threshold amount or 80 percent of itemized deductions. Medical expenses, investment interest expense, casualty and theft losses, and gambling losses to the extent of gambling winnings are not subject to phase-out.

Personal and dependency exemptions are reduced by 2 percent for each $2,500 ($1,250 – married filing separately) or fraction thereof by which AGI exceeds the threshold amount.