Chapters 6 Notes

Individual Deductions

**FOR AGI Deductions**

1. Deductions directly related to trade or business activities
2. Deductions directly related to investment activities
3. Deductions indirectly related to trade or business activities
4. Deductions that subsidize specific activities

***Deductions directly related to trade or business activities***

1. Trade or business expenses (discuss in Chapter 9)

1. Expenses and losses from flow-through entities
2. Generally deductible
3. Treat as though taxpayer incurred expenses/losses in course of business
4. Deduction corresponds to percentage ownership in the flow-through entity
5. Losses from the sale of business assets (discuss in Chapter 11)
6. Deductible for AGI

***Deductions directly related to investment activities***

1. Rent and royalty expenses
2. Deductible
3. Examples: advertising, maintenance, property taxes, insurance, etc.
4. Losses from sale of capital assets (e.g., stocks)
5. Deductible
6. Capital gains netting process (discuss in a later chapter)
7. Deduction on net capital losses (capital gains less capital losses) is limited to $3,000

***Deductions indirectly related to trade or business activities***

1. Moving expenses

- For tax years after 2017:

* no longer deductible; and
* employer reimbursements are taxable to employee
* exception: members of the military on active duty

1. Health insurance premiums paid by self-employed taxpayers

1. Deductible as long as the taxpayer or spouse is not eligible to participate in an employer-sponsored plan
2. If not deductible FOR AGI, then deductible FROM AGI (see medical expenses below)

3. Self-employment tax (discuss in Chapter 8)

4. Penalty on early withdrawal of savings

1. Deductible
2. Provided to prevent taxpayer from being taxed on income that was not received

***Deductions Subsidizing Specific Activities***

1. Interest on qualified educational loans –
2. Qualified educational expenses – no longer deductible for years after 2017.
3. Alimony payments

**FROM AGI Deductions** (Itemized Deductions)

***Medical Expenses***

- Qualified medical expense incurred related to health care for taxpayer (s) and dependents are deductible.

- Qualified medical expenses are payments for the care, prevention, diagnosis, or cure of injury, disease, or bodily function. Includes payments for prescription drugs, eyeglasses, contacts, dental work, etc.

- Qualified medical expenses (in total) are deductible to the extent they exceed 10% of AGI.

- Cost of travel (including meals and lodging) is deductible if traveling for medical purposes. If the taxpayer drives their personal vehicle, they can deduct actual expenses or mileage at a rate of 20 cents per mile.

- Meals and lodging at nursing homes (long-term care facilities) are deductible if they are for a medical necessity.

- Health insurance premiums: Deductible?

- Expenses reimbursed by health insurance or paid through a flexible spending account are not deductible.

**Example**: James is a single taxpayer under the age of 65 with an AGI of $75,000. James incurs the following expenses: $1,300 for a root canal, $250 for contact lenses, $350 for prescription drugs, $1,000 in doctors’ visits (office co-pay), and $8,500 for a medically necessary surgery. James drove 275 miles round-trip for his surgery. What is James’ medical expense deduction this year? What if his AGI was $90,000 instead?

***Taxes***

Individuals can deduct the following taxes paid or withheld during the year:

- State, local, and foreign income taxes withheld or paid during the year (includes overpayment on prior year state tax return that taxpayer applies to the current year)

- Real estate taxes on property held for personal or investment purposes

- Personal property taxes assessed on the *value* of the property

- Taxpayers can deduct state and local sales taxes *instead* of state and local income taxes

- Total itemized deduction for taxes is limited to $10,000 (applies to years after 2017).

***Interest***

Only two types are deductible:

1. Interest on residence-related loans (mortgage interest) acquired after December 15, 2017

- Interest on $750,000 of debt to acquire up to two residences

2. Investment interest (discuss in detail in chapter 7)

- Interest on loans used to purchase investment assets such as stock, bonds, or land

- Deduction is limited to net investment income, any excess interest can be carried forward to the next year

***Charitable Contributions***

- Contributions of money or property to qualified charitable organizations are deductible

- Qualified charitable organizations are organizations that engage in educational, religious, scientific, governmental, and other public activities

Examples: Church, Red Cross, UAB, hospitals, etc.

- Amount of deduction depends on the type of property contributed and the taxpayer’s AGI

- Broad categories of charitable contributions: cash, services, and property

- Cash contributions are deductible in year paid

- Value of services provided to a charitable organization are not deductible

- Out-of-pocket costs (i.e., transportation, lodging, etc.) of providing the services are deductible.

Mileage is deducted at a rate of 14 cents per mile (cannot deduct actual mileage costs).

- Contributions of property are deductible, but amount of deduction depends on the type of property donated:

1. Capital gain property – appreciated property that if sold would generate a long-term capital gain (i.e., property owned for more than one year)

2. Ordinary income property – property that if sold would generate ordinary income

- Examples: All assets other than capital gain property – stocks owned for less than one year, inventory from trade or business, assets with a fair market value below basis

***Casualty and Theft Losses on Personal-Use Assets***

- Generally, no longer deductible after 2017.

* Exception: if casualty on personal-use assets is attributable to a federally declared disaster
  + Examples: earthquake, hurricane, and flood

- Deductible amount from each casualty loss is the lesser of:

1. Decline in value of property damaged by the casualty, OR

2. Taxpayer’s basis in the damaged or stolen asset

- Excess loss after reimbursement is deductible, but subject to certain limitations.

- Limitations on the deduction

- $100 *per* event, **AND**

- Total casualty losses must exceed 10% of AGI

**Example**: Sarah’s entire home was destroyed during a hurricane, a federally declared disaster. She bought it a few years ago for $75,000 and her home was worth $100,000 before it was destroyed. In addition, Sarah’s car was flooded due to heavy rainfall from the hurricane. Sarah purchased her car last year for $15,000 and it was worth $12,000 before the hurricane. Sarah’s insurance reimbursed her for $60,000 for the home and $5,000 for her car. Her AGI was $115,000. What is Sarah’s casualty deduction?

***Miscellaneous Itemized Deductions***

- **no longer deductible after 2017**

- variety of expenses were deductible prior to 2018:

***Qualified Business Income Deduction***

- Applies to taxpayers with qualified business income from a partnership, S corporation or sole proprietorship.

- Deduct lesser of:

1) 20 percent of qualified business income from a qualified trade or business; **OR**

2) 20 percent of the excess of taxable income over net capital gains.

- Qualified trade or business: any trade or business other than a specified service trade or business

- performance of services in the fields of health, law, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset is the reputation or skill of one of more of its employees or owners.

- architecture and engineering services are not considered a specified service trade or business.

- Taxable income limitation

* if taxpayer’s taxable income (before QBI deduction) is less than $160,700 ($321,400 MFJ), the business will be deemed a qualified trade or business.

- Qualified business income: net amount of income, gain, deduction, and loss that applies to the taxpayer’s qualified trade or business conducted in the United States.

**Example:** Nina, a single taxpayer, decides to establish a sole proprietorship to perform consulting services. Her taxable income this year is $100,000 before the deduction for qualified business income. Will her income from consulting services be considered qualified business income?