

Tax Planning 101: Step Four

Step Four in the Tax Planning Process begins with examining the **ITEMIZED DEDUCTIONS** from last year's tax return (Form 1040 Line 40)(Schedule A). The decision to "itemize your deductions" should be based on whether your qualified itemized deductions, when totaled, are greater than what the IRS allows for the Standard Deduction, based on your filing status. Itemized deductions are eligible deductions that Congress has permitted the individual taxpayer to use to reduce his/her taxable income. These deductions are detailed on Form 1040 Schedule A. The primary deductions in which savings can be found are:

- Medical Expenses
- Certain Taxes
- Mortgage Interest
- Investment Interest
- Charitable Contributions
- Casualty and Theft Losses
- Miscellaneous Deductions

Medical Expenses (Schedule A) (Lines 1-4)

Qualified medical expenses, when totaled, that exceed 7.5% of Adjusted Gross Income (AGI) are eligible for deduction against taxable income. For example, if your AGI (Form 1040) (Line 37) is \$100,000 then your qualified medical expenses that exceed \$7500 can be deducted. The first \$7500 is not deductible. Therefore, unless you have some serious medical expenses, it is highly unlikely that you will be able to deduct any of your medical expenses. Qualified medical expenses include your out of pocket expenses (above what your medical insurance pays) for the costs of diagnosis, cure, mitigation, treatment, or prevention affecting any part or function of the body. They also include cost of equipment, supplies, and diagnostic devices needed for these purposes. They must be primarily to alleviate or prevent a physical or mental defect or illness. Please consult your tax advisor for a complete list of examples of deductible medical expenses as well a list of nondeductible expenses. The key to maximizing your medical expenses is to keep of all your expenses throughout the year as well as mileage to and from medical facilities, pharmacies, and doctors/dentists that you make seeking medical treatment. All too often people wait to the end of the year to try to compile their medical expenses. As a result many deductions are overlooked in this area. Medical expenses are deductible even if you pay your bill with a credit card. If it looks like you may be able to take the medical deduction for a given year, one tax planning tip is to pay any outstanding medical expenses prior to the end of the year, even if you have to charge them on a credit card. Carrying them forward to the next year may prevent you from claiming the medical expense deduction because of lower medical expenses in the following year.

Certain Taxes (Schedule A) (Lines 5-9)

State and Local – A taxpayer can elect to deduct either state and local sales taxes or state and local income taxes, but not both. In most cases, if you have state income tax withheld from your salary or pay estimated state income taxes, you will get a larger deduction for state and local income tax than the calculated amount from the optional state sales tax tables provided in your tax booklet. If however, you live in a state that does not have state income taxes you can deduct the state and local sales taxes for that state.

Real Estate Taxes – Real estate taxes are deductible as an itemized deduction only if the taxpayer owns the real estate and the taxes are based on the assessed value of the property. This includes all real property that you own, i.e. homes, land, etc. Unlike the mortgage interest deduction which is limited to your first and second home, real estate taxes are deductible regardless of the number of properties you own. If your mortgage company pays the taxes from an escrow account, deduct the taxes actually paid on behalf of the taxpayer, not the amount the taxpayer paid into escrow.

Personal Property – Personal property taxes are deductible if based on value alone (Ad Valorem) and are charged on a yearly basis. Vehicles are the primary properties in which taxes are based on the value of the property. Arbitrary tag fees are not deductible.

Mortgage Interest (Schedule A) (Lines 10-13)

Mortgage Interest (acquisition debt, refinanced debt, and home equity debt) on a home mortgage that is secured by the taxpayer's main or second home are deductible in the year paid.

Points paid to purchase a home are generally fully deductible in the year paid. Points paid on a refinance, however, must be amortized over the life of the refinanced loan.

Mortgage Insurance premiums paid for acquisition indebtedness for insurance contracts after December 31, 2006 are treated as deductible mortgage insurance. The deduction is phased out ratably by 10% for each \$1,000 by which the taxpayer's AGI exceeds \$100,000. The deduction is not allowed when AGI exceeds \$109,000 (\$54,000 Married Filing Separately).

One method of increasing your mortgage interest deduction for the year is to pay your mortgage payment (due at the first of January) just prior to the end of the current tax year. Doing so will yield one additional mortgage interest deduction.

In addition, if you happen to be late on a mortgage payment, the late charges are deductible as mortgage interest in the year the late charges are paid.

Investment Interest (Schedule A) (Line 14)

Interest paid on money borrowed to purchase investment property is investment interest. The deduction for investment interest expense is limited to net investment income. Investment interest not allowed due to the investment limit may be carried forward the following year. There is no limit on how many years it can be carried forward.

Property held for investment includes property that produces income that is not trade or business income. This includes interest income, dividend income, annuity income, or royalty income.

It also includes property that produces gain or loss, not derived in the ordinary course of a trade or business, from the disposition of property that produces the above types of income, or is held for investment.

Charitable Contributions (Schedule A) (Lines 16-18)

Cash Contributions

Contributions made by cash, check or credit card to a qualifying organization are deductible against taxable income. Out of pocket expenses incurred in performing volunteer work for a charitable organization (including the charitable mileage deduction) (14¢ per mile in 2010) are also considered cash contributions.

If, however, the taxpayer receives a benefit in exchange for a charitable contribution, the deduction is reduced by the value of the benefit received.

One contribution that many people tend to overlook is the charitable mileage deduction for service to a charitable organization. A good example would be the service of a church officer, Sunday School teacher, committee member, volunteer to Red Cross, Salvation Army, Pregnancy Support Clinic, etc. Keeping up with the mileage to and from your service participation to a charitable organization can yield a pretty nice additional cash charitable contribution.

Property Contributions

Contributions of property are deductible for the Fair Market Price (FMV) of the property at the time of contribution, not the amount that you paid for the property.

Total property contributions of over \$500 must be reported on Form 8283 (Non-cash Charitable Contributions). Total property contributions of over \$5000 may require an appraisal of the property contributed.

Non-cash Charitable Contributions are great ways to come up with additional deductions without having to pay additional money out of pocket. A good practice would be to go through property items that you seldom, if ever, use and contribute those to a qualified charitable organization, i.e. church, Salvation Army, Goodwill, Red Cross, etc.

Because of the complexity associated with contributing a vehicle to a qualified charitable organization, vehicle contributions will not be discussed here. Please consult your tax advisor concerning the decision to contribute a vehicle.

The total deduction for all charitable contributions is limited to 50% of the taxpayers AGI. Contributions in excess of 50% are carried forward to the next and subsequent tax years.

Casualty and Theft Loss Deductions (Schedule A) (Line 20)

A casualty loss is the damage, destruction, or loss of property resulting from an identifiable event. The identifiable event must be:

- Sudden, not gradual or progressive
- Unexpected, not ordinarily anticipated or intended
- Unusual, not a day-to-day occurrence or typical of the taxpayer's activity

A theft is the taking and removing of money or property with the intent to deprive the owner of it. The taking of property must be:

- Illegal under the law of the state where it occurred

- Done with a criminal intent

Losses are not deductible to the extent they are reimbursed by insurance. If property is covered by insurance, a timely insurance claim for reimbursement must be filed or the deduction is not allowed.

Casualty losses are similar to medical expense deductions in that the allowable deduction is a loss that is greater than 10% (vs. 7.5% of medical expense deduction) of AGI. In addition, losses are further reduced by \$100 per occurrence. If multiple items are lost for one event, the \$100 reduction is based on the entire loss, instead of each individual item.

A business loss, on the other hand, is not subject to the 10% of AGI floor or the \$100 reduction per occurrence. All casualty losses, subject to the deduction must be reported on Form 4684.

Because of the high AGI floor restriction, minor losses would not qualify for the Casualty and Theft Loss deduction. A quick calculation should determine whether it worth investigating the possibility of going through the additional work of completing the complex Form 4684. Please consult your tax advisor to determine whether it would be worth subjecting yourself to the possible scrutiny of claiming a Casualty and Theft Loss deduction.

Miscellaneous Itemized Deductions (Schedule A) (Lines 21-28)

Deductions Not Subject to 2% AGI Limitation

The following expenses are not limited by 2% of AGI:

- **Gambling Losses.** The full amount of gambling winnings for the year are reported as income on Line 21 (Form 1040). Gambling losses, up to the total amount reported as income, are deducted on line (Schedule A) (Line 28).
- **Impairment-related work expenses.** Taxpayers with physical or mental disabilities that limit employment can claim a deduction for impairment-related work expenses.
- **Unrecovered investment in an 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.

Some additional obscure deductions that are also not subject to the 2% of AGI limitation are reported on (Schedule A) (Line 28):

- Casualty and theft losses of income-producing property from Form 4684 or Form 4797.
- Deduction for Federal Estate Tax paid on income in respect of the decedent.
- Amortizable bond premium on taxable bonds acquired before October 23, 1986.
- Deduction for repayment of amounts under a claim of right if over \$3,000.
- Deduction for unrecovered investment in a pension or annuity contract.

Miscellaneous Itemized Deductions Subject to the 2% AGI Limitation

Most miscellaneous itemized deductions are deductible to the extent they exceed 2% of AGI. In other words, the first 2% of these deductions are not deductible. There is a whole litany of deductions that are subject to 2% of AGI. Some of the key ones that many people can capitalize on are:

- Education expenses required for your job
- Tax preparation fees
- Unreimbursed employee job expenses
- Legal fees for advice concerning income producing property
- Licenses and regulatory fees
- Safety equipment needed for work
- Subscriptions to professional journals and trade magazines related to work
- Job search expenses
- Hobby expenses (limited to hobby income)
- Employee Home Office expenses

Because the list of possible Miscellaneous Itemized Deductions are long and winding, it is highly advisable to seek the services of an experienced tax professional to determine which deductions may be applicable to you.

While there are many miscellaneous itemized deductions that are legitimately deductible, there are also many miscellaneous expenses that are absolutely not deductible. Some of the ones that many taxpayers get confused with are:

- Club dues
- Commuting expenses
- Funeral expenses
- Life Insurance premiums
- Personal legal, living, or family expenses
- Political contributions and lobbying expenses
- Residential or first telephone line into a home
- Seminar or convention fees, unless related to a taxpayer's employment
- Fines and penalties to a government entity
- Clothing purchased for your job that can be worn as personal attire as well

As you can see from the long list of possible Itemized Deductions, good record keeping is a must in order to prevent you from missing possible deductions you may be eligible for. This is why tax planning is critical to keep you from handing over many dollars each year to the Federal and State Government. If you have not been doing so, now is the time to develop habits that will help you tremendously by the time you get to tax season.

Till Next Time,

Charles W. Register, EA, CPB
CWR Financial Services, LLC

Disclaimer

The information presented in this newsletter is provided as a public service to provide clients and other visitors with general financial information. Every effort is made to provide accurate information; however, errors may occur due to the nature of the subject matter and interpretation of

any laws and regulations involved. The information provided on this site should not be construed as legal, tax, accounting or investment advice. You should consult with a legal or financial professional familiar with your circumstances for appropriate financial advice before making any decision. CWR does not warrant the completeness, accuracy or timeliness of the information provided and offers no warranties regarding the content of this site, either expressed or implied.