Standard and Itemized Deductions

This self-study course discusses the standard deduction, itemized deduction, and the limit on some of the itemized deductions if your adjusted gross income exceeds certain amounts. After you have figured your adjusted gross income, you are ready to subtract the deductions used to figure taxable income. You can subtract either the standard deduction or itemized deductions, and, if you qualify, the qualified business income deduction. Itemized deductions are deductions for certain expenses that are listed on Schedule A (Form 1040). Though this basic tax course does not require any prerequisites, its recommended target audience is for existing Enrolled Agents, however anyone may take this course. This course provides 7 CE credits in the IRS Federal Tax Law category.

TABLE OF CONTENTS

Chapter 1: Standard Deduction

Chapter Objective
After completing this chapter, you should be able to:

- Recall the standard deduction amounts for the current year.

I. Important Changes

Increase in standard deduction. The standard deduction for some taxpayers who do not itemize deductions on Schedule A of Form 1040 has been increased for all filers. The amount depends on your filing status. The 2022 standard deduction is increased to:

- Single or married separate – $12,950
- Married joint or qualifying widow(er) – $25,900
- Head of household – $19,400

Changes to itemized deductions. For the years 2018 through 2025, your itemized deductions are no longer limited if your AGI is over a certain limit. However, your deduction for state and local income, sales, real estate, and property taxes is limited to a combined total deduction of $10,000 ($5,000 if married filing separately). Also, you can no longer deduct job-related expenses or other miscellaneous itemized deductions that were subject to the 2%-of-adjusted-gross-income floor. These changes will impact your choice of whether to take a standard deduction or to itemize deductions. There may be other changes that impact the amount of your itemized deductions.

II. Introduction

This chapter discusses:

- How to figure the amount of your standard deduction,
- The standard deduction for dependents, and
- Who should itemize deductions.

Most taxpayers have a choice of either taking a standard deduction or itemizing their deductions. If you have a choice, you can use the method that gives you the lower tax. The standard deduction is a dollar amount that reduces your taxable income. It is a benefit that eliminates the need for many taxpayers to itemize actual deductions, such as medical expenses, charitable contributions, and taxes, on Schedule A (Form 1040). The standard deduction is higher for taxpayers who:

- Are 65 or older, or
- Are blind.

Note
The additional standard deduction for age and/or blindness is $1,400 for married individuals, and $1,750 for singles and heads of household. If a taxpayer is both 65 or older and blind, he or she is eligible to double the additional amount.

Tip
You benefit from the standard deduction if your standard deduction is more than the total of your allowable itemized deductions.

Persons not eligible for the standard deduction. Your standard deduction is zero and you should itemize any deductions you have if:

- Your filing status is married filing separately, and your spouse itemizes deductions on his or her return;
- You are filing a tax return for a short tax year because of a change in your annual accounting period; or
- You are a nonresident or dual-status alien during the year. You are considered a dual-status alien if you were both a nonresident and resident alien during the year.

If you are a nonresident alien who is married to a U.S. citizen or resident alien at the end of the year, you can choose to be treated as a U.S. resident. If you make this choice, you can take the standard deduction.

Caution!
If you can be claimed as a dependent on another person's return (such as your parents' return), your standard deduction may be limited.

III. Standard Deduction Amount

The standard deduction amount depends on your filing status, whether you are 65 or older or blind, and whether another taxpayer can claim you as a dependent. Generally, the standard deduction amounts are adjusted each year for inflation.

Decedent's final return. The amount of the standard deduction for a decedent's final return is the same as it would have been had the decedent continued to live. However, if the decedent was not 65 or older at the time of death, the higher standard deduction for age cannot be claimed.

HIGHER STANDARD DEDUCTION FOR AGE (65 OR OLDER)

If you are age 65 or older on the last day of the year and do not itemize deductions, you are entitled to a higher standard deduction. You are considered 65 on the day before your 65th birthday. Therefore, you can take a higher standard deduction for 2022 if you were born before January 2, 1958.

HIGHER STANDARD DEDUCTION FOR BLINDNESS

If you are blind on the last day of the year and you do not itemize deductions, you are entitled to a higher standard deduction.

Not totally blind. If you are not totally blind, you must get a certified statement from an eye doctor (ophthalmologist or optometrist) that:

1. You cannot see better than 20/200 in the better eye with glasses or contact lenses, or
2. Your field of vision is 20 degrees or less.

If your eye condition is not likely to improve beyond these limits, the statement should include this fact. Keep the statement in your records.

If your vision can be corrected beyond these limits only by contact lenses that you can wear only briefly because of pain, infection, or ulcers, you can take the higher standard deduction for blindness if you otherwise qualify.

SPOUSE 65 OR OLDER OR BLIND

You can take the higher standard deduction if your spouse is age 65 or older or blind and:

1. You file a joint return, or
2. You file a separate return and can claim an exemption for your spouse because your spouse had no gross income and cannot be claimed as a dependent by another taxpayer.

Caution!

You cannot claim the higher standard deduction for an individual other than yourself and your spouse.

IV. Standard Deduction For Dependents

The standard deduction for an individual who can be claimed as a dependent on another person's tax return is generally limited to the greater of:

- $1,150, or
- The individual's earned income for the year plus $400 (but not more than the regular standard deduction amount, generally $12,950).

However, if the individual is 65 or older or blind, the standard deduction may be higher.

CHAPTER 1: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. Which of the following is correct regarding the standard deduction amount:

A. it is the same for all filing statuses
B. it is the same regardless of the taxpayer's age
C. the amount depends on the taxpayer's filing status
D. the amount was significantly reduced by the TCJA

2. The standard deduction for an individual who can be claimed as a dependent on another person's tax return is generally limited to which of the following:

A. $1,150
B. the individual's earned income for the year plus $400, but not more than the regular standard deduction amount
C. the greater of A and B above
D. the lesser of A and B above

CHAPTER 1: SOLUTION AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.

A. Incorrect. The standard deduction amount varies among the different filing statuses.
B. Incorrect. There is an additional deduction amount for taxpayers or their spouses over age 65.
C. **CORRECT**. The amounts vary by filing status and are set to adjust annually based on inflation.
D. Incorrect. The TCJA significantly increased the standard deduction amounts.

2.

A. Incorrect. This may be the limit, but there is a better answer.
B. Incorrect. This may be the limit, but there is a better answer.

C. **CORRECT**. If the individual is 65 or older or blind, the standard deduction may be higher.
D. Incorrect. The limit can be higher than the lesser of these two amounts.

Chapter 2: Medical And Dental Expenses

Chapter Objective
After completing this chapter, you should be able to:

- Recognize the deductibility characteristics of medical and dental expenses.

I. Important

Medical expense floor. In 2022, you can deduct only the part of your medical and dental expenses that exceed 7.5% of adjusted gross income (AGI).
Standard mileage rate. The standard mileage rate allowed for operating expenses for a car when you use it for medical reasons is 18.0 cents per mile for 2022 before July 1, and 22.0 cents per mile after June 30.

II. Introduction

This chapter will help you determine:

- What medical expenses are,
- What expenses you can include this year,
- How much of the expenses you can deduct,
- Whose medical expenses you can include,
- What medical expenses are includible,
- How to treat reimbursements,
- How to report the deduction on your tax return,
- How to report impairment-related work expenses, and
- How to report health insurance costs if you are self-employed.

III. What are medical expenses?

Medical expenses are the costs of diagnosis, cure, mitigation, treatment, or prevention of disease, and the cost for treatments affecting any part or function of the body. These expenses include payments for legal medical services rendered by physicians, surgeons, dentists, and other medical practitioners. They include the costs of equipment, supplies, and diagnostic devices needed for these purposes.

IV. What expenses can be included this year?

You can include only the medical and dental expenses you paid this year, but generally not payments for medical or dental care you will receive in a future year. If you pay medical expenses by check, the day you mail or deliver the check generally is the date of payment. If you use a “pay-by-phone” or “online” account to pay your medical expenses, the date reported on the statement of the financial institution showing when payment was made is the date of payment. You can include medical expenses you charge to your credit card in the year the charge is made, not when you actually pay the amount charged.

V. How much of the expenses can be deducted?

Generally, you can deduct on Schedule A (Form 1040) only the amount of your medical and dental expenses that is more than 7.5% of your adjusted gross income (AGI).

VI. Whose medical expenses can be included?

You can generally include medical expenses you pay for yourself, as well as those you pay for someone who was your spouse or your dependent either when the services were provided or when you paid for them. There are different rules for decedents and for individuals who are the subject of multiple support agreements.

Spouse. You can include medical expenses you paid for your spouse. To include these expenses, you must have been married either at the time your spouse received the medical services or at the time you paid the medical expenses.

Example 1

Mary received medical treatment before she married Bill. Bill paid for the treatment after they married. Bill can include these expenses in figuring his medical expense deduction even if Bill and Mary file separate returns.

If Mary had paid the expenses before she and Bill married, Bill could not include Mary's expenses in his separate return. Mary would include the amounts she paid during the year in her separate return. If they filed a joint return, the medical expenses both paid during the year would be used to figure their medical expense deduction.

Example 2

This year, John paid medical expenses for his wife, Louise, who died last year. John married Belle this year, and they file a joint return. Because John was married to Louise when she received the medical services, he can include those expenses in figuring his medical expense deduction for this year.

Dependent. You can include medical expenses you paid for your dependent. To claim these expenses, the person must have been your dependent either at the time the medical services were provided or at the time you paid the expenses. A person generally qualifies as your 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, and
2. The person was a U.S. citizen or national, or a resident of the United States, Canada, or Mexico.

You can include medical expenses you paid for an individual that would have been your dependent except that:

1. He or she received gross income of $4,400 or more in 2022;
2. He or she filed a joint return for 2022; or
3. You, or your spouse if filing jointly, could be claimed as a dependent on someone else's 2022 return.

Support claimed under a multiple support agreement. A multiple support agreement is used when two or more people provide more than half of a person's support, but no one alone provides more than half. If you are considered to have provided more than half of a qualifying relative's support under a multiple support agreement, you can include medical expenses you pay for that person.

Any medical expenses paid by others who joined you in the agreement cannot be included as medical expenses by anyone. However, you can include the entire unreimbursed amount you paid for medical expenses.

Example

You and your three brothers each provide one-fourth of your mother's total support. Under a multiple support agreement, you claim your mother as a dependent. You paid all of her medical expenses. Your

brothers repaid you for three-fourths of these expenses. In figuring your medical expense deduction, you can include only one-fourth of your mother's medical expenses. Your brothers cannot include any part of the expenses. However, if you and your brothers share the nonmedical support items and you separately pay all of your mother's medical expenses, you can include the amount you paid for her medical expenses in your medical expenses.

VII. What medical expenses are includible?

Use Table 2-1 in this chapter as a guide to determine which medical and dental expenses you can include on Schedule A (Form 1040).
This table does not include all possible medical expenses. To determine if an expense not listed can be included in figuring your medical expenses, see What Are Medical Expenses, earlier.

TABLE 2-1. MEDICAL AND DENTAL EXPENSES CHECKLIST

You can include:	You cannot include:

• Bandages
• Birth control pills prescribed by your doctor
• Body scan
• Braille books
• Breast pump and supplies
• Capital expenses for equipment or improvements to your home needed for medical care (see the worksheet in Publication 502)
• Diagnostic devices
• Expenses of an organ donor
• Eye surgery - to promote the correct function of the eye
• Fertility enhancement, certain procedures
• Guide dogs or other animals aiding the blind, deaf, and disabled.
• Hospital services fees (lab work, therapy, nursing services, surgery, etc.)
• Lead-based paint removal
• Legal abortion
• Legal operation to prevent having children such as a vasectomy or tubal ligation
• Long-term care contracts, qualified
• Meals and lodging provided by a hospital during medical treatment
• Medical services fees (from doctors, dentists, surgeons, specialists, and other medical practitioners)
• Medicare Part D premiums
• Medical and hospital insurance premiums
• Nursing services
	• Baby sitting and childcare
	• Bottled water
	• Contributions to Archer MSAs (see Publication 969)
	• Diaper service
	• Expenses for your general health (even if following your doctor's advice) such as -
	  • Health club dues
	  • Household help (even if recommended by a doctor)
	  • Social activities, such as dancing or swimming lessons
	  • Trip for general health improvement
	• Flexible spending account reimbursements for medical expenses (if contributions were on a pre-tax basis)
	• Funeral, burial, or cremation expenses
	• Health savings account payments for medical expenses
	• Operation, treatment, or medicine that is illegal under federal or state law
	• Life insurance or income protection policies, or policies providing payment for loss of life, limb, sight, etc.
	• Maternity clothes
	• Medical insurance included in a car insurance policy covering all persons injured in or by your car
	• Medicine you buy without a prescription
	• Nursing care for a healthy baby

• Oxygen equipment and oxygen • Part of life-care fee paid to retirement home designated for medical care • Physical examination • Pregnancy test kit • Prescription medicines (prescribed by a doctor) and insulin • Psychiatric and psychological treatment • Social security tax, Medicare tax, FUTA, and state employment tax for worker providing medical care (see Wages for nursing services, below) • Special items (artificial limbs, false teeth, eye-glasses, contact lenses, hearing aids, crutches, wheelchair, etc.) • Special education for mentally or physically disabled persons • Stop-smoking programs • Transportation for needed medical care • Treatment at a drug or alcohol center (includes meals and lodging provided by the center) • Wages for nursing services • Weight-loss, certain expenses for obesity	• Prescription drugs you brought in (or ordered shipped) from another country, in most cases • Nutritional supplements, vitamins, herbal supplements, "natural medicines," etc., unless recommended by a medical practitioner as a treatment for a specific medical condition diagnosed by a physician • Surgery for purely cosmetic reasons • Toothpaste, toiletries, cosmetics, etc. • Teeth whitening • Weight-loss expenses not for the treatment of obesity or other disease

INSURANCE PREMIUMS

You can include in medical expenses insurance premiums you pay for policies that cover medical care. Medical care policies can provide payment for treatment that includes:

- Hospitalization, surgical fees, X-rays,
- Prescription drugs and insulin,
- Dental care,
- Replacement of lost or damaged contact lenses, and
- Long-term care (subject to additional limitations).

If you have a policy that provides payments for other than medical care, you can include the premiums for the medical care part of the policy if the charge for the medical part is reasonable. The cost of the medical part must be separately stated in the insurance contract or given to you in a separate statement.

Long-term care services. Contributions made by your employer to provide coverage for qualified long-term care services under a flexible spending or similar arrangement must be included in your income. This amount will be reported as wages on your Form W-2.

Health reimbursement arrangement (HRA). If you have medical expenses that are reimbursed by a health reimbursement arrangement, you cannot include those expenses in your medical expenses. This is because an HRA is funded solely by the employer.

Medicare A. If you are covered under social security (or if you are a government employee who paid Medicare tax), you are enrolled in Medicare A. The payroll tax paid for Medicare A is not a medical expense. If you are not covered under social security (or were not a government employee who paid Medicare tax), you can voluntarily enroll in Medicare A. In this situation the premiums paid for Medicare A can be included as a medical expense.

Medicare B. Medicare B is a supplemental medical insurance. Premiums you pay for Medicare B are a medical expense. Check the information you received from the Social Security Administration to find out your premium.
Medicare D. Medicare D is a voluntary prescription drug insurance program for persons with Medicare A or B. You can include as a medical expense premiums you pay for Medicare D.

MEALS AND LODGING
You can include in medical expenses the cost of meals and lodging at a hospital or similar institution if a principal reason for being there is to receive medical care.

TRANSPORTATION
Include in medical expenses amounts paid for transportation primarily for, and essential to, medical care. You can include:

- Bus, taxi, train, or plane fares, or ambulance service,
- Transportation expenses of a parent who must go with a child who needs medical care,
- Transportation expenses of a nurse or other person who can give injections, medications, or other treatment required by a patient who is traveling to get medical care and is unable to travel alone, and
- Transportation expenses for regular visits to see a mentally ill dependent, if these visits are recommended as a part of treatment.

Car expenses. You can include out-of-pocket expenses for your car, such as gas and oil, when you use your car for medical reasons. You cannot include depreciation, insurance, general repair, or maintenance expenses.
If you do not want to use your actual expenses for 2022, you can use the standard medical mileage rate of 18.0 cents per mile for January 1 to June 30, 2022, and 22.0 cents per mile for July 1 to December 31, 2022.
You can also include the cost of parking fees and tolls. You can add these fees and tolls to your medical expenses whether you use actual expenses or use the standard mileage rate.

DISABLED DEPENDENT CARE EXPENSES
Some disabled dependent care expenses may qualify as either medical expenses or as work-related expenses for purposes of taking a credit for dependent care. You can choose to apply them either way as long as you do not use the same expenses to claim both a credit and a medical expense deduction.

VIII. How To Treat Reimbursements

You can include in medical expenses only those amounts paid during the taxable year for which you received no insurance or other reimbursement.

INSURANCE REIMBURSEMENT
You must reduce your total medical expenses for the year by all reimbursements for medical expenses that you receive from insurance or other sources during the year. This includes payments from Medicare. Even if a policy provides reimbursement for only certain specific medical expenses, you must use amounts you receive from that policy to reduce your total medical expenses, including those it does not reimburse.
Health reimbursement arrangement (HRA). A health reimbursement arrangement is an employer-funded plan that reimburses employees for medical care expenses and allows unused amounts to be carried forward. An HRA is funded solely by the employer and the reimbursements for medical expenses, up to a maximum dollar amount for a coverage period, are not included in your income.

Premiums paid by you. If you pay either the entire premium for your medical insurance or all of the costs of a plan similar to medical insurance and your insurance payments or other reimbursements are more than your total medical expenses for the year, you have an excess reimbursement. You generally do not include an excess reimbursement in your gross income.

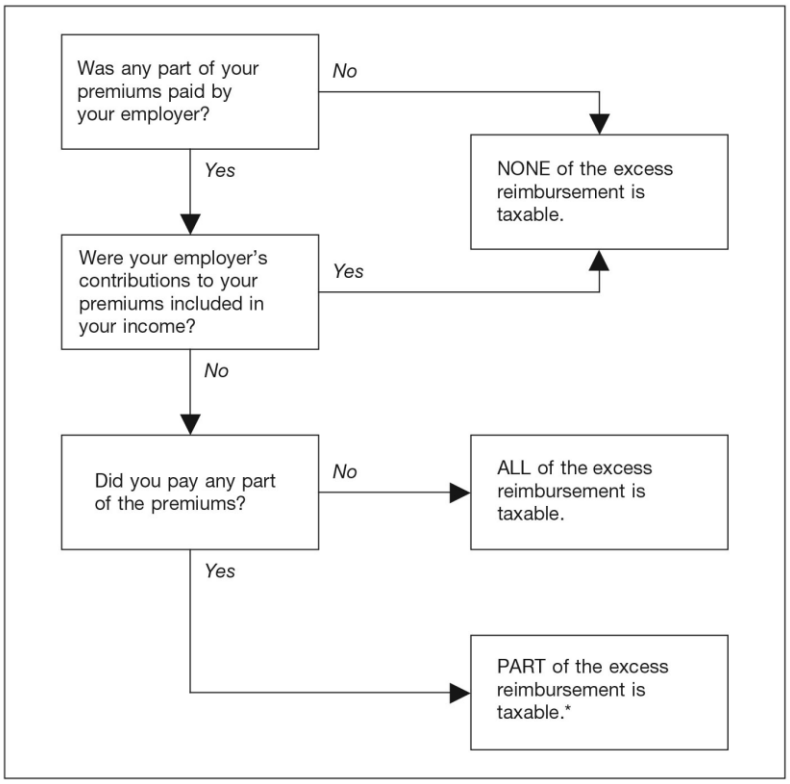
Medical expenses not deducted. If you did not deduct a medical expense in the year you paid it because your medical expenses were not more than 7.5% of your adjusted gross income, or because you did not itemize deductions, do not include the reimbursement up to the amount of the expense in income.

IX. Damages For Personal Injuries

If you receive an amount in settlement of a personal injury suit, part of that award may be for medical expenses that you deducted in an earlier year. If it is, you must include that part in your income in the year you receive it to the extent it reduced your taxable income in the earlier year.

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

FIGURE 2-A. IS YOUR EXCESS MEDICAL REIMBURSEMENT TAXABLE?



**See Premiums paid by you and your employer in this chapter.*

X. How To Figure And Report Deductions On A Tax Return

Once you have determined which medical care expenses you can include, you figure and report the deduction on your tax return.

WHAT TAX FORM DO YOU USE?
You figure your medical expense deduction on Schedule A (Form 1040).

XI. Impairment-Related Work Expenses (Business Or Medical)

If you are a person with a disability, you can take a business deduction for expenses that are necessary for you to be able to work. If you take a business deduction for these impairment-related work expenses, they are not subject to the 7.5% limit that applies to medical expenses.
You have a disability if you have:

- A physical or mental disability (for example, blindness or deafness) that functionally limits your being employed, or
- A physical or mental impairment (for example, a sight or hearing impairment) that substantially limits one or more of your major life activities, such as performing manual tasks, walking, speaking, breathing, learning, or working.

Impairment-related expenses defined. Impairment-related expenses are those ordinary and necessary business expenses that are:

- Necessary for you to do your work satisfactorily,
- For goods or services not required or used, other than incidentally, in your personal activities, and
- Not specifically covered under other income tax laws.

XII. Health Insurance Costs For Self-Employed Persons

If you were self-employed and had a net profit for the year, you may be able to deduct, as an adjustment to income, amounts paid for medical and qualified long-term care insurance on behalf of yourself, your spouse, your dependents, and your children who were under age 27 at the end of 2022.
For this purpose, you were self-employed if you were a general partner (or a limited partner receiving guaranteed payments) or you received wages from an S corporation in which you were more than a 2% shareholder.
The insurance plan must be established under your trade or business, and the deduction cannot be more than your earned income from that trade or business.
You cannot deduct payments for medical insurance for any month in which you were eligible to participate in a health plan subsidized by your employer, your spouse's employer, or an employer of your dependent child or your child under age 27 at the end of 2022. You cannot deduct payments for a qualified long-term care insurance contract for any month in which you were eligible to participate in a long-term care insurance plan subsidized by your employer or your spouse's employer.
If you qualify to take the deduction, use the Self-Employed Health Insurance Deduction Worksheet in the Form 1040 or 1040-SR instructions to figure the amount you can deduct. But if any of the following applies, do not use the worksheet.

- You had more than one source of income subject to self-employment tax.
- You file Form 2555, Foreign Earned Income.
- You are using amounts paid for qualified long-term care insurance to figure the deduction.

If you cannot use the worksheet in the instructions for Forms 1040 and 1040-SR, use the worksheet in Publication 535, Business Expenses, to figure your deduction.
Use Publication 974 instead of the worksheet in the Form 1040 or 1040-SR instructions if you, your spouse, or a dependent enrolled in health insurance through the Health Insurance Marketplace and you are claiming the premium tax credit.

CHAPTER 2: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. In 2022, if your AGI is $60,000, you are able to deduct medical expenses you paid that are more than what amount:

A. $3,000
B. $3,750
C. $4,500
D. $6,000

2. Payments that can be included as a medical and dental expense deduction <u>exclude</u> which of the following:

A. medical and hospital insurance premiums
B. long-term care contracts
C. stop-smoking programs
D. health club dues

CHAPTER 2: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.

A. Incorrect. You are only able to deduct medical expenses you incurred that are more than 7.5% of your AGI. 7.5% of $60,000 is greater than $3,000.
B. Incorrect. You are only able to deduct medical expenses that are more than 7.5% of your AGI. 7.5% of $60,000 is greater than $3,750.
C. **CORRECT**. If your AGI is $60,000, the first $4,500 of medical expenses are not deductible, which is equal to $60,000 x 7.5%.
D. Incorrect. You are only able to deduct medical expenses that are more than 7.5% of your AGI. 7.5% of $60,000 is less than $6,000.

2.

A. Incorrect. Payments made for medical and hospital insurance premiums are deductible expenses.
B. Incorrect. Payments made for long-term care contracts are deductible as medical expenses in the year that the payment was made.
C. Incorrect. Expenditures for stop-smoking programs are deductible medical expenses.
D. **CORRECT**. Health club dues are generally not deductible medical expenses because they do not meet the test for such expenses. Specifically, medical care expenses must be primarily to alleviate or prevent a physical or mental defect or illness.

Chapter 3: Taxes

Chapter Objective
After completing this chapter, you should be able to:
- Recognize what taxes you can deduct if you itemize deductions.

I. Important

Limitation on deduction for state and local taxes. The Tax Cuts and Jobs Act provides for the temporary limitation of deductions for state and local taxes. See Limitation on deduction for state and local taxes, later.
No deduction for foreign taxes paid for real estate. You can no longer deduct foreign taxes you paid on real estate.

II. Introduction

This chapter discusses which taxes you can deduct if you itemize deductions on Schedule A (Form 1040). It also explains which taxes you can deduct on other schedules or forms and which taxes you cannot deduct.
This chapter covers:
- Income taxes (federal, state, local, and foreign),
- General sales taxes (state and local),
- Real estate taxes (state, local, and foreign),
- Personal property taxes (state and local), and
- Taxes and fees you cannot deduct.

Use Table 3-1 as a guide to determine which taxes you can deduct.
At the end of the chapter is a section that explains which form you use to deduct the different types of taxes.
Business taxes. You can deduct certain taxes only if they are ordinary and necessary expenses of your trade or business or of producing income.
State or local taxes. These are taxes imposed by the 50 states, U.S. possessions, or any of their political subdivisions (such as a county or city), or by the District of Columbia.
Indian tribal government. An Indian tribal government that is recognized by the Secretary of the Treasury as performing substantial government functions will be treated as a state for purposes of claiming a deduction for taxes. Income taxes, real estate taxes, and personal property taxes imposed by that Indian tribal government (or by any of its subdivisions that are treated as political subdivisions of a state) are deductible.
General sales taxes. These are taxes imposed at one rate on retail sales of a broad range of classes of items.
Foreign taxes. These are taxes imposed by a foreign country or any of its political subdivisions.

III. Tests To Deduct Any Tax

The following two tests must be met for any tax to be deductible by you.
1. The tax must be imposed on you.
2. The tax must be paid during your tax year.

The tax must be imposed on you. Generally, you can deduct only taxes that are imposed on you.

Generally, you can deduct property taxes only if you are the owner of the property. If your spouse owns property and pays real estate taxes on it, the taxes are deductible on your spouse's separate return or on your joint return.

The tax must be paid during your tax year. If you are a cash basis taxpayer, you can deduct only those taxes actually paid during your tax year. If you pay your taxes by check, the day you mail or deliver the check is generally the date of payment. If you use a pay-by-phone account (such as a credit card or electronic funds withdrawal), the date reported on the statement of the financial institution showing when payment was made is the date of payment. If you contest a tax liability and are a cash basis taxpayer, you can deduct the tax only in the year you actually pay it (or transfer money or other property to provide for satisfaction of the contested liability).

TABLE 3-1. WHICH TAXES CAN YOU DEDUCT?

Type of Tax	You Can Deduct	You Cannot Deduct
Fees and Charges	Fees and charges that are expenses of your trade or business or of producing income.	Fees and charges that are not expenses of your trade or business or of producing income, such as fees for driver's licenses, car inspections, parking, or charges for water bills. Fines and penalties.
General Sales Taxes	State and local general sales taxes, including compensating use taxes.	State and local income taxes if you choose to deduct state and local general sales taxes.
Income Taxes	State and local income taxes. Foreign income taxes. Employee contributions to state funds listed under *Contributions to state benefit funds*.	Federal income taxes. Employee contributions to private or voluntary disability plans. State and local general sales taxes if you choose to deduct state and local income taxes.
Other Taxes	Taxes that are expenses of your trade or business. Taxes on property producing rent or royalty income. One-half of self-employment tax paid.	Federal excise taxes, such as tax on gasoline, that are not expenses of your trade or business or of producing income. Per capita taxes.
Personal Property Taxes	State and local personal property taxes.	Customs duties that are not expenses of your trade or business or of producing income
Real Estate Taxes	State and local real estate taxes. Tenant's share of real estate taxes paid by cooperative housing corporation.	Real estate taxes that are treated as imposed on someone else (see *Division of real estate taxes between buyers and sellers*).

		Foreign real estate taxes. Taxes for local benefits (with exceptions). Trash and garbage pick up fees (with exceptions). Rent increase due to higher real estate taxes. Homeowners' association charges.

IV. Income Taxes

This section discusses the deductibility of state and local income taxes (including employee contributions to state benefit funds) and foreign income taxes.

STATE AND LOCAL INCOME TAXES
You can deduct state and local income taxes.

Exception
You cannot deduct state and local income taxes you pay on income that is exempt from federal income tax, unless the exempt income is interest income. For example, you cannot deduct the part of a state's income tax that is on a cost-of-living allowance that is exempt from federal income tax.

What to Deduct
Your deduction may be for withheld taxes, estimated tax payments, or other tax payments as follows.
Withheld taxes. You can deduct state and local income taxes withheld from your salary in the year they are withheld. Your Form(s) W-2 will show these amounts. Forms W-2G, 1099-B, 1099-DIV, 1099-G, 1099-K, 1099-MISC, 1099-NEC, 1099-OID, and 1099-R may also show state and local income taxes withheld.
Estimated tax payments. You can deduct estimated tax payments you made during the year under a pay-as-you-go plan of a state or local government. However, you must have a reasonable basis for making the estimated tax payments. Any estimated state or local tax payments that are not made in good faith at the time of payment are not deductible.

Example
You made an estimated state income tax payment. However, the estimate of your state tax liability shows that you will get a refund of the full amount of your estimated payment. You had no reasonable basis to believe you had any additional liability for state income taxes and you cannot deduct the estimated tax payment.

Refund applied to taxes. You can deduct any part of a refund of prior-year state or local income taxes that you chose to have credited to your 2022 estimated state or local income taxes.
Do not reduce your deduction by either of the following items.

- Any state or local income tax refund (or credit) you expect to receive for 2022.
- Any refund of (or credit for) prior-year state and local income taxes you actually received in 2022.

However, part or all of this refund (or credit) may be taxable.
Separate federal returns. If you and your spouse file separate state, local, and federal income tax returns, you each can deduct on your federal return only the amount of your own state and local income tax that you paid during the tax year.

Joint state and local returns. If you and your spouse file joint state and local returns and separate federal returns, each of you can deduct on your separate federal return part of the state and local income taxes paid during the tax year. You can deduct only the amount of the total taxes that is proportionate to your gross income compared to the combined gross income of you and your spouse. However, you cannot deduct more than the amount you actually paid during the year. You can avoid this calculation if you and your spouse are jointly and individually liable for the full amount of the state and local income taxes. If so, you and your spouse can deduct on your separate federal returns the amount you each actually paid.
Joint federal return. If you file a joint federal return, you can deduct the total of the state and local income taxes both of you paid.
Contributions to state benefit funds. As an employee, you can deduct mandatory contributions to state benefit funds withheld from your wages that provide protection against loss of wages. Mandatory payments made to the following state benefit funds are deductible as state income taxes on Schedule A (Form 1040), line 5a.

- Alaska Unemployment Compensation Fund.
- California Nonoccupational Disability Benefit Fund.
- New Jersey Nonoccupational Disability Benefit Fund.
- New Jersey Unemployment Compensation Fund.
- New York Nonoccupational Disability Benefit Fund.
- Pennsylvania Unemployment Compensation Fund.
- Rhode Island Temporary Disability Benefit Fund.
- Washington State Supplemental Workmen's Compensation Fund.

FOREIGN INCOME TAXES
Generally, you take either a deduction or a credit for income taxes imposed on you by a foreign country or a U.S. possession. However, you cannot take a deduction or credit for foreign income taxes paid on income that is exempt from U.S. tax under the foreign earned income exclusion or the foreign housing exclusion.

V. State And Local General Sales Taxes

You can elect to deduct state and local general sales taxes instead of state and local income taxes, as an itemized deduction on Schedule A (Form 1040), line 5a. You can use either your actual expenses or the state and local sales tax tables to figure your sales tax deduction.
Actual expenses. Generally, you can deduct the actual state and local general sales taxes (including compensating use taxes) if the tax rate was the same as the general sales tax rate. However, sales taxes on food, clothing, medical supplies, and motor vehicles are deductible as a general sales tax even if the tax rate was less than the general sales tax rate. If you paid sales tax on a motor vehicle at a rate higher than the general sales tax rate, you can deduct only the amount of tax that you would have paid at the general sales tax rate on that vehicle. If you use the actual expenses method, you must have receipts to show the general sales taxes paid. Do not include sales taxes paid on items in your trade or business on Schedule A (Form 1040).
Optional sales tax tables. Instead of using your actual expenses, you can figure your state and local general sales tax deduction using the state and local sales tax tables in the Instructions for Schedule A (Form 1040). You may also be able to add the state and local general sales taxes paid on certain specified items.
Your applicable table amount is based on the state where you live, your income, and the number of dependents claimed on your tax return. Your income is your adjusted gross income plus any nontaxable items such as the following.

- Tax-exempt interest.
- Veterans' benefits.
- Nontaxable combat pay.
- Workers' compensation.
- Nontaxable part of social security and railroad retirement benefits.
- Nontaxable part of IRA, pension, or annuity distributions, excluding rollovers.
- Public assistance payments.

If you lived in different states during the same tax year, you must prorate your applicable table amount for each state based on the days you lived in each state. See the Instructions for Schedule A (Form 1040), line 5a, for details.

VI. State And Local Real Estate Taxes

Deductible real estate taxes are any state and local taxes on real property levied for the general public welfare. You can deduct these taxes only if they are assessed uniformly against all property under the jurisdiction of the taxing authority. The proceeds must be for general community or governmental purposes and not be payment for a special privilege granted or service rendered to you.

Deductible real estate taxes generally do not include taxes charged for local benefits and improvements that increase the value of the property. They also do not include itemized charges for services (such as trash collection) against specific property or certain people, even if the charge is paid to the taxing authority. For more information about taxes and charges that are not deductible, see Real Estate-Related Items You Cannot Deduct, later.

Tenant-shareholders in a cooperative housing corporation. Generally, if you are a tenant-stockholder in a cooperative housing corporation, you can deduct the amount paid to the corporation that represents your share of the real estate taxes the corporation paid or incurred for your dwelling unit. The corporation should provide you with a statement showing your share of the taxes.

Division of real estate taxes between buyers and sellers. If you bought or sold real estate during the year, the real estate taxes must be divided between the buyer and the seller.

The buyer and the seller must divide the real estate taxes according to the number of days in the real property tax year (the period to which the tax imposed relates) that each owned the property. The seller is treated as paying the taxes up to, but not including, the date of sale. The buyer is treated as paying the taxes beginning with the date of sale. This applies regardless of the lien dates under local law. Generally, this information is included on the settlement statement provided at the closing.

If you (the seller) cannot deduct taxes until they are paid because you use the cash method of accounting, and the buyer of your property is personally liable for the tax, you are considered to have paid your part of the tax at the time of the sale. This lets you deduct the part of the tax to the date of sale even though you did not actually pay it. However, you must also include the amount of that tax in the selling price of the property. The buyer must include the same amount in his or her cost of the property.

WORKSHEET 23-1. FIGURING YOUR STATE AND LOCAL REAL ESTATE TAX DEDUCTION

You figure your deduction for taxes on each property bought or sold during the real property tax year as follows:

1. Enter the total state and local real estate taxes for the real property tax year _____
2. Enter the number of days in the real property tax year that you owned the property… _____
3. Divide line 2 by 365 (for leap years, divide line 2 by 366) _____

4. Multiple line 1 by line 3. This is your deduction.
   Enter it on Schedule A (Form 1040), line 5b _____

Repeat steps 1 through 4 for each property you bought or sold during the real property tax year. Your total deduction is the sum of the line 4 amounts for all of the properties.

Real estate taxes for prior years. Do not divide delinquent taxes between the buyer and seller if the taxes are for any real property tax year before the one in which the property is sold. Even if the buyer agrees to pay the delinquent taxes, the buyer cannot deduct them. The buyer must add them to the cost of the property. The seller can deduct these taxes paid by the buyer. However, the seller must include them in the selling price.

Examples. The following examples illustrate how real estate taxes are divided between buyer and seller.

Example 1

Dennis and Beth White's real property tax year for both their old home and their new home is the calendar year, with payment due August 1. The tax on their old home, sold on May 7, was $620. The tax on their new home, bought on May 3, was $732. Dennis and Beth are considered to have paid a proportionate share of the real estate taxes on the old home even though they did not actually pay them to the taxing authority. On the other hand, they can claim only a proportionate share of the taxes they paid on their new property even though they paid the entire amount.

Dennis and Beth owned their old home during the real property tax year for 126 days (January 1 to May 6, the day before the sale). They figure their deduction for taxes on their old home as follows.

Taxes on Old Home

1.	Enter the total state and local real estate taxes for the real property tax year	$620
2.	Enter the number of days in the real property tax year that you owned the property	126
3.	Divide line 2 by 365 (for leap years, divide line 2 by 366)	.3452
4.	Multiple line 1 by line 3. This is your deduction. Enter it on Schedule A (Form 1040), line 5b	$214

Since the buyers of their old home paid all of the taxes, Dennis and Beth also include the $214 in the selling price of the old home. (The buyers add the $214 to their cost of the home.)

Dennis and Beth owned their new home during the real property tax year for 243 days (May 3 to December 31, including their date of purchase). They figure their deduction for taxes on their new home as follows:

Taxes on New Home

1.	Enter the total state and local real estate taxes for the real property tax year	$732
2.	Enter the number of days in the real property tax year that you owned the property	243
3.	Divide line 2 by 365 (for leap years, divide line 2 by 366)	.6658
4.	Multiple line 1 by line 3. This is your deduction. Enter it on Schedule A (Form 1040), line 5b	$487

Since Dennis and Beth paid all of the taxes on the new home, they add $245 ($732 paid less $487 deduction) to their cost of the new home. (The sellers add this $245 to their selling price and deduct the $245 as a real estate tax.)
Dennis and Beth's real estate tax deduction for their old and new homes is the sum of $214 and $487, or $701. They will enter this amount on Schedule A (Form 1040), line 5b.

Example 2
George and Helen Brown bought a new home on May 3, 2022. Their real property tax year for the new home is the calendar year. Real estate taxes for 2021 were assessed in their state on January 1, 2022. The taxes became due on May 31, 2022 and October 31, 2022.
The Browns agreed to pay all taxes due after the date of purchase. Real estate taxes for 2021 were $680. They paid $340 on May 31, 2022, and $340 on October 31, 2022. These taxes were for the 2021 real property tax year. The Browns cannot deduct them since they did not own the property until 2022. Instead, they must add $680 to the cost of their new home.
In January 2023, the Browns receive their 2022 property tax statement for $752, which they will pay in 2023. The Browns owned their new home during the 2022 real property tax year for 243 days (May 3 to December 31). They will figure their 2023 deduction for taxes as follows.

1.	Enter the total state and local real estate taxes for the real property tax year	$752
2.	Enter the number of days in the real property tax year that you owned the property	243
3.	Divide line 2 by 365 (for leap years, divide line 2 by 366)	.6658
4.	Multiple line 1 by line 3. This is your deduction. Enter it on Schedule A (Form 1040), line 5b	$501

The remaining $251 ($752 paid less $501 deduction) of taxes paid in 2023, along with the $680 paid in 2022, is added to the cost of their new home.
Because the taxes up to the date of sale are considered paid by the seller on the date of sale, the seller is entitled to a 2022 tax deduction of $931. This is the sum of the $680 for 2021 and the $251 for the 122 days the seller owned the home in 2022. The seller must also include the $931 in the selling price when he or she figures the gain or loss on the sale. The seller should contact the Browns in January 2023 to find out how much real estate tax is due for 2022.

Form 1099-S. For certain sales or exchanges of real estate, the person responsible for closing the sale (generally the settlement agent) prepares Form 1099-S, Proceeds From Real Estate Transactions, to report certain information to the IRS and to the seller of the property. Box 2 of Form 1099-S is for the gross proceeds of the sale and should include the portion of the seller's real estate tax liability that the buyer will pay after the date of sale. The buyer includes these taxes in the cost basis of the property, and the seller both deducts this amount as a tax paid and includes it in the sales price of the property.
For a real estate transaction that involves a home, any real estate tax the seller paid in advance but that is the liability of the buyer appears in box 6 of Form 1099-S. The buyer deducts this amount as a real estate tax, and the seller reduces his or her real estate tax deduction (or includes it in income) by the same amount. See Refund (or rebate), later.
Taxes placed in escrow. If your monthly mortgage payment includes an amount placed in escrow (put in the care of a third party) for real estate taxes, you may not be able to deduct the total amount placed in escrow. You can deduct only the real estate tax that the third party actually paid to the taxing authority.

If the third party does not notify you of the amount of real estate tax that was paid for you, contact the third party or the taxing authority to find the proper amount to show on your return.

Tenants by the entirety. If you and your spouse held property as tenants by the entirety and you file separate returns, each of you can deduct only the taxes each of you paid on the property.

Divorced individuals. If your divorce or separation agreement states that you must pay the real estate taxes for a home owned by you and your spouse, part of your payments may be deductible as alimony and part as real estate taxes.

Minister's and military personnel housing allowances. If you are a minister or a member of the uniformed services and receive a housing allowance that you can exclude from income, you still can deduct all of the real estate taxes you pay on your home.

Refund (or rebate). If you received a refund or rebate in 2022 of real estate taxes you paid in 2022, you must reduce your deduction by the amount refunded to you. If you received a refund or rebate in 2022 of real estate taxes you deducted in an earlier year, you generally must include the refund or rebate in income in the year you receive it. However, you only need to include the amount of the deduction that reduced your tax in the earlier year.

REAL ESTATE-RELATED ITEMS YOU CANNOT DEDUCT

Payments for the following items generally are not deductible as real estate taxes.

- Taxes for local benefits.
- Itemized charges for services (such as trash and garbage pickup fees).
- Transfer taxes (or stamp taxes).
- Rent increases due to higher real estate taxes.
- Homeowners' association charges.

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

Local benefit taxes are deductible only if they are for maintenance, repair, or interest charges related to those benefits. If only a part of the taxes is for maintenance, repair, or interest, you must be able to show the amount of that part to claim the deduction. If you cannot determine what part of the tax is for maintenance, repair, or interest, none of it is deductible.

Taxes for local benefits may be included in your real estate tax bill. If your taxing authority (or mortgage lender) does not furnish you a copy of your real estate tax bill, ask for it. You should use the rules above to determine if the local benefit tax is deductible.

Itemized charges for services. An itemized charge for services assessed against specific property or certain people is not a tax, even if the charge is paid to the taxing authority. For example, you cannot deduct the charge as a real estate tax if it is:

- A unit fee for the delivery of a service (such as a $5 fee charged for every 1,000 gallons of water you use),
- A periodic charge for a residential service (such as a $20 per month or $240 annual fee charged to each homeowner for trash collection), or
- A flat fee charged for a single service provided by your government (such as a $30 charge for mowing your lawn because it was allowed to grow higher than permitted under your local ordinance).

Caution!

You must look at your real estate tax bill to determine if any nondeductible itemized charges, such as those listed above, are included in the bill. If your taxing authority (or mortgage lender) does not furnish you a copy of your real estate tax bill, ask for it.

Exception
Service charges used to maintain or improve services (such as trash collection or police and fire protection) are deductible as real estate taxes if:

- The fees or charges are imposed at a like rate against all property in the taxing jurisdiction,
- The funds collected are not earmarked; instead, they are commingled with general revenue funds, and
- Funds used to maintain or improve services are not limited to or determined by the amount of these fees or charges collected.

Transfer taxes (or stamp taxes). Transfer taxes and similar taxes and charges on the sale of a personal home are not deductible. If they are paid by the seller, they are expenses of the sale and reduce the amount realized on the sale. If paid by the buyer, they are included in the cost basis of the property.
Rent increase due to higher real estate taxes. If your landlord increases your rent in the form of a tax surcharge because of increased real estate taxes, you cannot deduct the increase as taxes.
Homeowners' association charges. These charges are not deductible because they are imposed by the homeowners' association, rather than the state or local government.

VII. Personal Property Taxes

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

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 than once a year, or less 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.
If the tax is partly based on value and partly based on other criteria, it may qualify in part.

Example
Your state charges a yearly motor vehicle registration tax of 1% of value plus 50 cents per hundredweight. You paid $32 based on the value ($1,500) and weight (3,400 lbs.) of your car. You can deduct $15 (1% × $1,500) as a personal property tax, since it is based on the value. The remaining $17 ($.50 × 34), based on the weight, is not deductible.

VIII. Taxes And Fees That Cannot Be Deducted

Many federal, state, and local government taxes are not deductible because they do not fall within the categories discussed earlier. Other taxes and fees, such as federal income taxes, are not deductible because the tax law specifically prohibits a deduction for them.
Taxes and fees that are generally not deductible include the following items.

- ***Employment taxes***. This includes social security, Medicare, and railroad retirement taxes withheld from your pay. However, you can take a deduction for the deductible part of self-employment

tax. In addition, the social security and other employment taxes you pay on the wages of a household worker may be included in medical expenses that you can deduct or child care expenses that allow you to claim the child and dependent care credit.

- ***Estate, inheritance, legacy, or succession taxes***. You can deduct the estate tax attributable to income in respect of a decedent if you, as a beneficiary, must include that income in your gross income. In that case, deduct the estate tax on Schedule A (Form 1040), line 16.
- ***Federal income taxes***. This includes taxes withheld from your pay.
- ***Fines and penalties***. You cannot deduct fines and penalties paid to a government for violation of any law, including related amounts forfeited as collateral deposits.
- ***Foreign personal or real property taxes.***
- ***Gift taxes.***
- ***License fees***. You cannot deduct license fees for personal purposes (such as marriage, driver's, and pet license fees).
- ***Per capita taxes***. You cannot deduct state or local per capita taxes.

Many taxes and fees other than those listed above are also nondeductible, unless they are ordinary and necessary expenses of a business or income producing activity. For other nondeductible items, see Real Estate-Related Items You Cannot Deduct, earlier.

IX. Where To Deduct

You deduct taxes on the following schedules.

State and local income taxes. These taxes are deducted on Schedule A (Form 1040), line 5a even if your only source of income is from business, rents, or royalties.

Limitation on deduction for state and local taxes. The deduction for state and local taxes is limited to $10,000 ($5,000 if married filing married separately). State and local taxes are the taxes that you include on Schedule A (Form 1040), lines 5a, 5b, and 5c. Include taxes imposed by a U.S. possession with your state and local taxes on Schedule A (Form 1040), lines 5a, 5b, and 5c. However, do not include any U.S. possession taxes you paid that are allocable to excluded income.

Tip
You may want to take a credit for U.S. possession tax instead of a deduction. See the instructions for Schedule 3 (Form 1040), line 1, for details.

General sales taxes. Sales taxes are deducted on Schedule A (Form 1040), line 5a. You must check the box on line 5a. If you elect to deduct sales taxes, you cannot deduct state and local income taxes on Schedule A (Form 1040), line 5a.

Foreign income taxes. Generally, income taxes you pay to a foreign country or U.S. possession can be claimed as an itemized deduction on Schedule A (Form 1040), line 6, or as a credit against your U.S. income tax on Schedule 3 (Form 1040), line 1. To claim the credit, you may have to complete and attach Form 1116.

Real estate taxes and personal property taxes. These taxes are deducted on Schedule A (Form 1040), lines 5b and 5c, respectively, unless they are paid on property used in your business, in which case they are deducted on Schedule C (Form 1040) or Schedule F (Form 1040). Taxes on property that produces rent or royalty income are deducted on Schedule E (Form 1040).

Self-employment tax. Deduct one-half of the self-employment tax on Schedule 1 (Form 1040), line 15.

Other taxes. All other deductible taxes are deducted on Schedule A (Form 1040), line 6.

CHAPTER 3: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. Which of the following income taxes are not deductible:

A. federal income taxes
B. state income taxes
C. local income taxes
D. foreign income taxes

2. Which of the following taxes are generally not deductible:

A. federal excise taxes
B. taxes that are expenses of your trade or business
C. personal property taxes
D. taxes on property producing rental income

3. Deductible real estate taxes generally do not include taxes charged for local benefits and improvements that increase the value of your property.

A. true
B. false

CHAPTER 3: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.

A. **CORRECT**. Federal income taxes paid are not deductible on federal personal income tax returns – Form 1040 OR 1040-SR.
B. Incorrect. State income taxes, among other types of taxes and fees, are deductible for federal income tax purposes up to the SALT limitation.
C. Incorrect. Local income taxes can be deducted up to the SALT limitation.
D. Incorrect. Foreign income taxes are generally deductible on a U.S. Form 1040 return up to the SALT limitation. This deduction assumes that foreign income taxes were paid on income that is not already exempt from U.S. tax under the foreign earned income exclusion or the foreign housing exclusion.

2.

A. **CORRECT**. These would include taxes such as on gasoline that are not expenses of your trade or business or of producing income.
B. Incorrect. Taxes that are expenses of your trade or business are deductible.
C. Incorrect. Personal property taxes are deductible. They are lumped in with state and local taxes.
D. Incorrect. Taxes incurred on property that produces rent or royalty income is deductible.

3.

A. **CORRECT**. These include assessments for streets, sidewalks, water mains, sewer lines, public parking facilities, and similar improvements. You should increase the basis of your property by the amount of the assessment.
B. Incorrect. Local benefit taxes are deductible only if they are for maintenance, repair, or interest charges related to those benefits.

Chapter 4: Interest Expense

Chapter Objective
After completing this chapter, you should be able to:
- Recall what types of interest you can and cannot deduct.

I. Reminders

Home equity loan interest. No matter when the indebtedness was incurred, you can no longer deduct the interest from a loan secured by your home to the extent the loan proceeds were not used to buy, build, or substantially improve your home.
Home mortgage interest. You can deduct mortgage interest on the first $750,000 ($375,000 if married filing separately) of indebtedness. However, higher limitations ($1 million ($500,000 if filing separately)) apply if you are deducting mortgage interest from indebtedness incurred before December 16, 2017.
Mortgage insurance premiums. The itemized deduction for mortgage insurance premiums expired on December 31, 2021.

II. Introduction

This chapter discusses what interest expenses you can deduct. Interest is the amount you pay for the use of borrowed money.
The types of interest you can deduct as itemized deductions on Schedule A (Form 1040) are:
- Home mortgage interest, including certain points and mortgage insurance premiums, and
- Investment interest.

This chapter explains these deductions. It also explains where to deduct other types of interest and lists some types of interest you cannot deduct.
Use Table 4-1 to find out where to get more information on various types of interest, including investment interest.

III. Home Mortgage Interest

Generally, home mortgage interest is any interest you pay on a loan secured by your home (main home or a second home). The loan may be a mortgage to buy your home or a second mortgage.
You can deduct home mortgage interest only if you meet all the following conditions.
- You file Form 1040 or 1040-SR and itemize deductions on Schedule A (Form 1040).
- The mortgage is a secured debt on a qualified home in which you have an ownership interest. (Generally, your mortgage is a secured debt if you put your home up as collateral to protect the interests of the lender. The term “qualified home” means your main home or second home.)

Both you and the lender must intend that the loan be repaid.

AMOUNT DEDUCTIBLE

Note
Interest on home equity loans and lines of credit are deductible only if the borrowed funds are used to buy, build, or substantially improve the taxpayer’s home that secures the loan. The loan must be secured by the taxpayer’s main home or second home (qualified residence), not exceed the cost of the home, and meet other requirements.

In most cases, you will be able to deduct all of your home mortgage interest. How much you can deduct depends on the date of the mortgage, the amount of the mortgage, and how you use the mortgage proceeds.

Fully deductible interest. If all of your mortgages fit into one or more of the following three categories at all times during the year, you can deduct all of the interest on those mortgages. (If any one mortgage fits into more than one category, add the debt that fits in each category to your other debt in the same category.)

The three categories are as follows:

1. Mortgages you took out on or before October 13, 1987 (called grandfathered debt).
2. Mortgages you (or your spouse if married filing a joint return) took out after October 13, 1987, and prior to December 16, 2017 (but see binding contract exception below) to buy, build, or substantially improve your home (called home acquisition debt), but only if throughout 2022 these mortgages plus any grandfathered debt totaled $1 million or less ($500,000 or less if married filing separately).

   Exception. A taxpayer who enters into a written binding contract before December 15, 2017, to close on the purchase of a principal residence before January 1, 2018, and who purchases such residence before April 1, 2018, is considered to have incurred the home acquisition debt prior to December 16, 2017.
3. Mortgages you (or your spouse if married filing a joint return) took out after December 15, 2017, to buy, build, or substantially improve your home (called home acquisition debt), but only if throughout 2022 these mortgages plus any grandfathered debt totaled $750,000 or less ($375,000 or less if married filing separately).

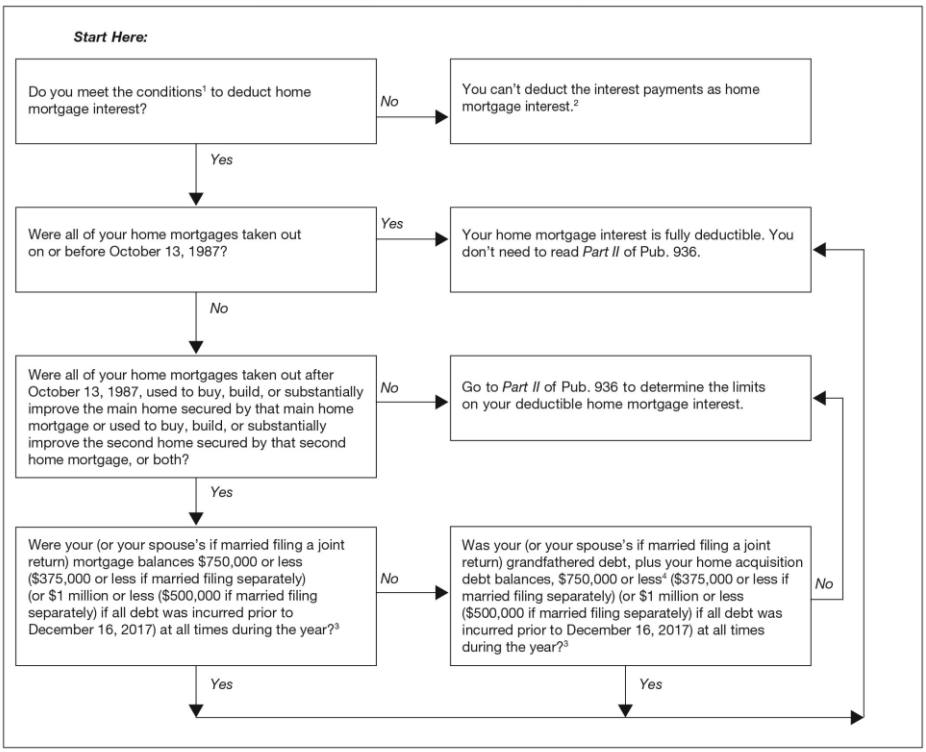
The dollar limits for the second and third categories apply to the combined mortgages on your main home and second home.

You can use Figure 4-A to check whether your home mortgage interest is fully deductible.

Limits on deduction. You cannot fully deduct interest on a mortgage that does not fit into any of the three categories listed above.

FIGURE 4-A. IS MY HOME MORTGAGE FULLY DEDUCTIBLE?

(Instructions: Include balances of ALL mortgages secured by your main home and second home.)



[1] You must itemize deductions on Schedule A (Form 1040 or 1040-SR). The loan must be a secured debt on a qualified home. See *Home Mortgage Interest* in *Part I* of Pub. 936.
[2] See Table 2 in *Part II* of Pub. 936 for where to deduct other types of interest payments.
[3] A taxpayer who enters into a written binding contract before December 15, 2017, to close on the purchase of a principal residence before January 1, 2018, and who purchases such residence before April 1, 2018, is considered to have incurred the home acquisition debt prior to December 16, 2017, and may use the 2017 threshold amounts of $1,000,000 ($500,000 if married filing separately).
[4] See *Part II* of Pub. 936 for more information about grandfathered debt and home acquisition debt.

Special Situations

This section describes certain items that can be included as home mortgage interest and others that cannot. It also describes certain special situations that may affect your deduction.

Late payment charge on mortgage payment. You can deduct as home mortgage interest a late payment charge if it was not for a specific service performed in connection with your mortgage loan.

Mortgage prepayment penalty. If you pay off your home mortgage early, you may have to pay a penalty. You can deduct that penalty as home mortgage interest provided the penalty is not for a specific service performed or cost incurred in connection with your mortgage loan.

Sale of home. If you sell your home, you can deduct your home mortgage interest (subject to any limits that apply) paid up to, but not including, the date of sale.

Example

John and Peggy Harris sold their home on May 7. Through April 30, they made home mortgage interest payments of $1,220. The settlement sheet for the sale of the home showed $50 interest for the 6-day period in May up to, but not including, the date of sale. Their mortgage interest deduction is $1,270 ($1,220 + $50).

Prepaid interest. If you pay interest in advance for a period that goes beyond the end of the tax year, you must spread this interest over the tax years to which it applies. You can deduct in each year only the interest that qualifies as home mortgage interest for that year. However, see Points, later.

Mortgage interest credit. You may be able to claim a mortgage interest credit if you were issued a mortgage credit certificate (MCC) by a state or local government. Figure the credit on Form 8396,

Mortgage Interest Credit. If you take this credit, you must reduce your mortgage interest deduction by the amount of the credit.

Ministers' and military housing allowance. If you are a minister or a member of the uniformed services and receive a housing allowance that is not taxable, you can still deduct your home mortgage interest.

Mortgage assistance payments. If you qualify for mortgage assistance payments for lower-income families under section 235 of the National Housing Act, part or all of the interest on your mortgage may be paid for you. You cannot deduct the interest that is paid for you.

No other effect on taxes. Do not include these mortgage assistance payments in your income. Also, do not use these payments to reduce other deductions, such as real estate taxes.

Divorced or separated individuals. If a divorce or separation agreement requires you or your spouse or former spouse to pay home mortgage interest on a home owned by both of you, the payment of interest may be alimony.

Redeemable ground rents. If you make annual or periodic rental payments on a redeemable ground rent, you can deduct them as mortgage interest.

Payments made to end the lease and to buy the lessor's entire interest in the land are not deductible as mortgage interest.

Nonredeemable ground rents. Payments on a nonredeemable ground rent are not mortgage interest. You can deduct them as rent if they are a business expense or if they are for rental property.

Reverse mortgages. A reverse mortgage is a loan where the lender pays you (in a lump sum, a monthly advance, a line of credit, or a combination of all three) while you continue to live in your home. With a reverse mortgage, you retain title to your home. Depending on the plan, your reverse mortgage becomes due with interest when you move, sell your home, reach the end of a pre-selected loan period, or die. Because reverse mortgages are considered loan advances and not income, the amount you receive is not taxable. Generally, any interest (including original issue discount) accrued on a reverse mortgage is considered home equity debt and is not deductible.

Rental payments. If you live in a house before final settlement on the purchase, any payments you make for that period are rent and not interest. This is true even if the settlement papers call them interest. You cannot deduct these payments as home mortgage interest.

Mortgage proceeds invested in tax-exempt securities. You cannot deduct the home mortgage interest on grandfathered debt or home equity debt if you used the proceeds of the mortgage to buy securities or certificates that produce tax-free income.

Refunds of interest. If you receive a refund of interest in the same tax year you paid it, you must reduce your interest expense by the amount refunded to you. If you receive a refund of interest you deducted in an earlier year, you generally must include the refund in income in the year you receive it. However, you need to include it only up to the amount of the deduction that reduced your tax in the earlier year. This is true whether the interest overcharge was refunded to you or was used to reduce the outstanding principal on your mortgage. If you need to include the refund in income, report it on Schedule 1 (Form 1040), line 8z.

If you received a refund of interest you overpaid in an earlier year, you generally will receive a Form 1098, Mortgage Interest Statement, showing the refund in box 4. For information about Form 1098, see Mortgage Interest Statement, later.

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 discount, or discount points.

A borrower is treated as paying any points that a home seller pays for the borrower's mortgage. See Points paid by the seller, later.

General rule. You generally cannot deduct the full amount of points in the year paid. Because they are prepaid interest, you generally must deduct them over the life (term) of the mortgage. If the loan is a home equity, line of credit, or credit card loan and the proceeds from the loan are not used to buy, build, or substantially improve the home, the points are not deductible.

Deduction Allowed in Year Paid

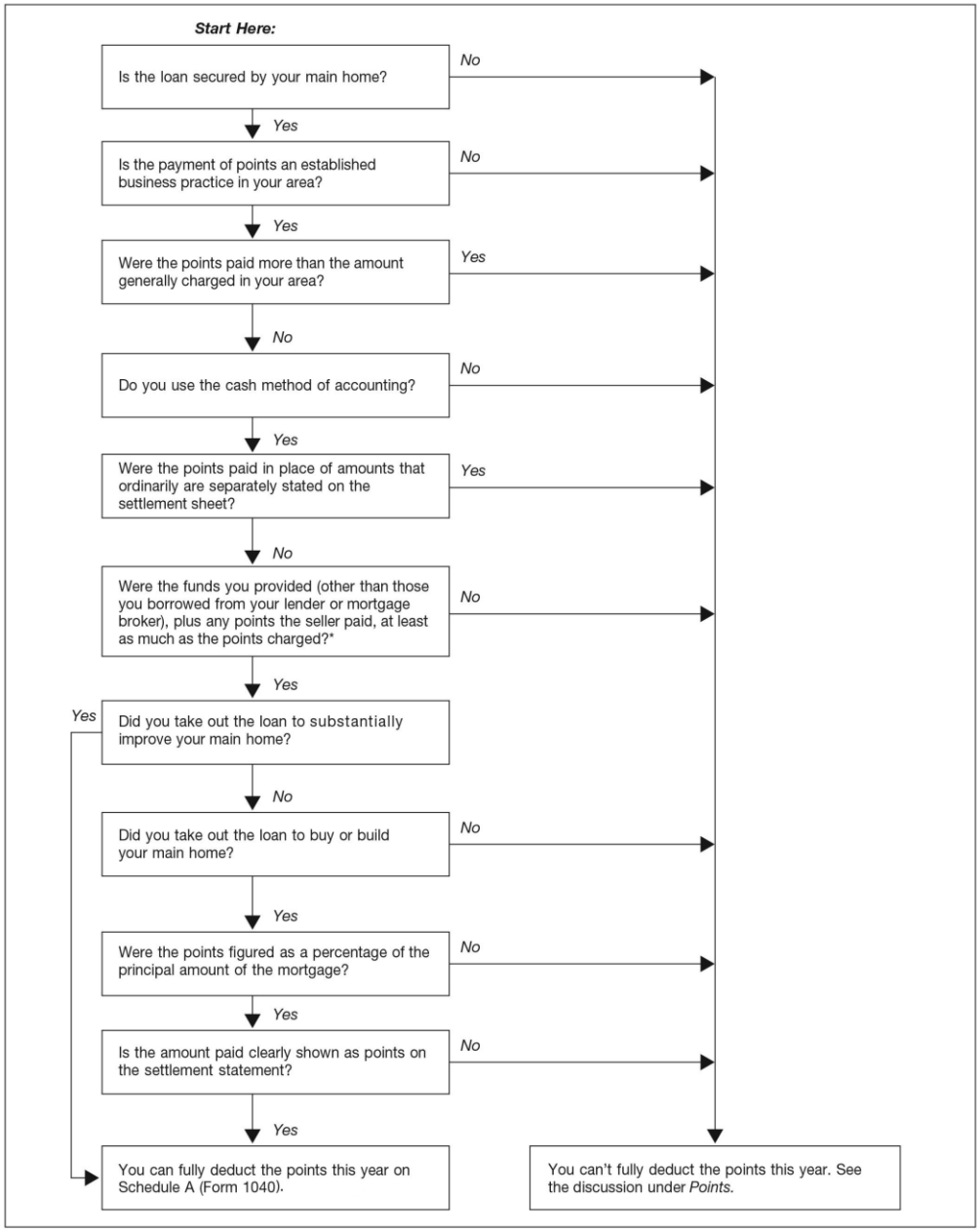
You can fully deduct points in the year paid if you meet all the following tests. (You can use Figure 4-B as a quick guide to see whether your points are fully deductible in the year paid.)

1. Your loan is secured by your main home. (Your main home is the one you ordinarily live in most of the time.)
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. You use the cash method of accounting. This means you report income in the year you receive it and deduct expenses in the year you pay them.
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 you provided at or before closing, plus any points the seller paid, were at least as much as the points charged. The funds you provided are not required to have been applied to the points. They can include a down payment, an escrow deposit, earnest money, and other funds you paid at or before closing for any purpose. You cannot have borrowed these funds from your lender or mortgage broker.
7. You use your loan to buy or build your main home.
8. The points were figured as a percentage of the principal amount of the mortgage.
9. The amount is clearly shown on the settlement statement (such as the Uniform Settlement Statement, Form HUD-1) as points charged for the mortgage. The points may be shown as paid from either your funds or the seller's.

Note

If you meet all of these tests, you can choose to either fully deduct the points in the year paid, or deduct them over the life of the loan.

FIGURE 4-B. ARE MY POINTS FULLY DEDUCTIBLE THIS YEAR?



* The funds you provided aren't required to have been applied to the points. They can include a down payment, an escrow deposit, earnest money, and other funds you paid at or before closing for any purpose.

Home improvement loan. You can also fully deduct in the year paid points paid on a loan to improve your main home, if tests (1) through (6) are met.

Caution!
Second home. You cannot fully deduct in the year paid points you pay on loans secured by your second home. You can deduct these points only over the life of the loan.

Refinancing. Generally, points you pay to refinance a mortgage are not deductible in full in the year you pay them. This is true even if the new mortgage is secured by your main home.
However, if you use part of the refinanced mortgage proceeds to improve your main home and you meet the first six tests listed under Deduction Allowed in Year Paid, earlier, you can fully deduct the part of the

points related to the improvement in the year you paid them with your own funds. You can deduct the rest of the points over the life of the loan.

Example 1
In 2000, Bill Fields got a mortgage to buy a home. In 2022, Bill refinanced that mortgage with a 15-year $100,000 mortgage loan. The mortgage is secured by his home. To get the new loan, he had to pay three points ($3,000). Two points ($2,000) were for prepaid interest, and one point ($1,000) was charged for services, in place of amounts that ordinarily are stated separately on the settlement statement. Bill paid the points out of his private funds, rather than out of the proceeds of the new loan. The payment of points is an established practice in the area, and the points charged are not more than the amount generally charged there. Bill's first payment on the new loan was due July 1. He made six payments on the loan in 2022 and is a cash-basis taxpayer.
Bill used the funds from the new mortgage to repay his existing mortgage. Although the new mortgage loan was for Bill's continued ownership of his main home, it was not for the purchase or improvement of that home. He cannot deduct all of the points in 2022. He can deduct two points ($2,000) ratably over the life of the loan. He deducts $67 [($2,000 ÷ 180 months) × 6 payments] of the points in 2022. The other point ($1,000) was a fee for services and is not deductible.

Example 2
The facts are the same as in Example 1, except that Bill used $25,000 of the loan proceeds to improve his home and $75,000 to repay his existing mortgage. Bill deducts 25% ($25,000 ÷ $100,000) of the points ($2,000) in 2022. His deduction is $500 ($2,000 × 25%).
Bill also deducts the ratable part of the remaining $1,500 ($2,000 - $500) that must be spread over the life of the loan. This is $50 [($1,500 ÷ 180 months) × 6 payments] in 2022. The total amount Bill deducts in 2022 is $550 ($500 + $50).

Deduction Allowed Ratably
If you do not meet the tests listed under Deduction Allowed in Year Paid, earlier, the loan is not a home improvement loan, or you choose not to deduct your points in full in the year paid, you can deduct the points ratably (equally) over the life of the loan if you meet all the following tests.

1. You use the cash method of accounting. This means you report income in the year you receive it and deduct expenses in the year you pay them. Most individuals use this method.
2. Your loan is secured by a home. (The home does not need to be your main home.)
3. Your loan period is not more than 30 years.
4. If your loan period is more than 10 years, the terms of your loan are the same as other loans offered in your area for the same or longer period.
5. Either your loan amount is $250,000 or less, or the number of points is not more than:
    a) 4, if your loan period is 15 years or less, or
    b) 6, if your loan period is more than 15 years.

Special Situations
This section describes certain special situations that may affect your deduction of points.
Original issue discount. If you do not qualify to either deduct the points in the year paid or deduct them ratably over the life of the loan, or if you choose not to use either of these methods, the points reduce the issue price of the loan. This reduction results in original issue discount.
Amounts charged for services. Amounts charged by the lender for specific services connected to the loan are not interest. Examples of these charges are:

1. Appraisal fees,
2. Notary fees,
3. Preparation costs for the mortgage note or deed of trust,
4. Mortgage insurance premiums, and
5. Department of Veterans Affairs (VA) funding fees.

You cannot deduct these amounts as points either in the year paid or over the life of the mortgage.

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. But 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 he or she had paid them. If all the tests under Deductible Allowed in Year Paid, earlier, are met, the buyer can deduct the points in the year paid. If any of those tests are not met, the buyer deducts the points over the life of the loan.

Funds provided are less than points. If you meet all the tests in Deduction Allowed in Year Paid, earlier, except that the funds you provided were less than the points charged to you (test 6), you can deduct the points in the year paid, up to the amount of funds you provided. In addition, you can deduct any points paid by the seller.

Example 1

When you took out a $100,000 mortgage loan to buy your home in December, you were charged one point ($1,000). You meet all the tests for deducting points in the year paid, except the only funds you provided were a $750 down payment. Of the $1,000 charged for points, you can deduct $750 in the year paid. You spread the remaining $250 over the life of the mortgage.

Example 2

The facts are the same as in Example 1, except that the person who sold you your home also paid one point ($1,000) to help you get your mortgage. In the year paid, you can deduct $1,750 ($750 of the amount you were charged plus the $1,000 paid by the seller). You spread the remaining $250 over the life of the mortgage. You must reduce the basis of your home by the $1,000 paid by the seller.

Excess points. If you meet all the tests in Deduction Allowed in Year Paid, earlier, except that the points paid were more than are generally paid in your area (test 3), you deduct in the year paid only the points that are generally charged. You must spread any additional points over the life of the mortgage.

Mortgage ending early. If you spread your deduction for points over the life of the mortgage, you can deduct any remaining balance in the year the mortgage ends. However, if you refinance the mortgage with the same lender, you cannot deduct any remaining balance of spread points. Instead, deduct the remaining balance over the term of the new loan.

A mortgage may end early due to a prepayment, refinancing, foreclosure, or similar event.

Example

Dan paid $3,000 in points in 2011 that he had to spread out over the 15-year life of the mortgage. He deducts $200 of the points per year. Through 2022, Dan has deducted $2,200 of the points.

Dan prepaid his mortgage in full in 2022. He can deduct the remaining $800 of points in 2022.

Limits on deduction. You cannot fully deduct points on a mortgage unless the mortgage fits into one of the categories listed earlier under Fully deductible interest.

FORM 1098, MORTGAGE INTEREST STATEMENT

If you paid $600 or more of mortgage interest (including certain points) during the year on any one mortgage, you generally will receive a Form 1098, Mortgage Interest Statement, or a similar statement from the mortgage holder. You will receive the statement if you pay interest to a person (including a financial institution or a cooperative housing corporation) in the course of that person's trade or business. A governmental unit is a person for purposes of furnishing the statement.

You should receive the statement for each year by January 31 of the following year. A copy of this form will also be sent to the IRS.

The statement will show the total interest you paid during the year, and if you purchased a principal residence during the year, it will also show the points paid during the year, including seller-paid points that are deductible as interest to the extent you do not exceed the home acquisition debt limit. However, it should not show any interest that was paid for you by a government agency.

As a general rule, Form 1098 will include only points that you can fully deduct in the year paid. However, it may report points that you cannot deduct, particularly if you are filing married filing separately or have mortgages for multiple properties. You must take care to deduct only those points legally allowable. Additionally, certain points not included on Form 1098 also may be deductible, either in the year paid or over the life of the loan. See Points, earlier, to determine whether you can deduct points not shown on Form 1098.

Prepaid interest on Form 1098. If you prepaid interest in 2022 that accrued in full by January 15, 2023, this prepaid interest may be included in box 1 of Form 1098. However, you cannot deduct the prepaid amount for January 2023 in 2022. (See Prepaid interest, earlier.) You will have to figure the interest that accrued for 2023 and subtract it from the amount in box 1. You will include the interest for January 2023 with the other interest you pay for 2023. See How to Report, later.

IV. Investment Interest

This section discusses the interest expenses you may be able to deduct as an investor.

If you borrow money to buy property you hold for investment, the interest you pay is investment interest. You can deduct investment interest subject to the limit discussed later. However, you cannot deduct interest you incurred to produce tax-exempt income. Nor can you 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 property that produces interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business. It also includes property that produces gain or loss (not derived in the ordinary course of a trade or business) from the sale or trade of property producing these types of income or held for investment (other than an interest in a passive activity). Investment property also includes an interest in a trade or business activity in which you did not materially participate (other than a passive activity).

Partners, shareholders, and beneficiaries. To determine your investment interest, combine your share of investment interest from a partnership, S corporation, estate, or trust with your other investment interest.

ALLOCATION OF INTEREST EXPENSE

If you borrow money for business or personal purposes as well as for investment, you must allocate the debt among those purposes. Only the interest expense on the part of the debt used for investment

purposes is treated as investment interest. The allocation is not affected by the use of property that secures the debt.

LIMIT ON DEDUCTION

Generally, your deduction for investment interest expense is limited to the amount of your net investment income.

You can carry over the amount of investment interest that you 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 that next year.

You can carry over disallowed investment interest to the next tax year even if it is more than your taxable income in the year the interest was paid or accrued.

Net Investment Income

Determine the amount of your net investment income by subtracting your investment expenses (other than interest expense) from your investment income.

Investment income. This generally includes your gross income from property held for investment (such as interest, dividends, annuities, and royalties). Investment income does not include Alaska Permanent Fund dividends. It also does not include qualified dividends or net capital gain unless you choose to include them.

Choosing to include qualified dividends. Investment income generally does not include qualified dividends. However, you can choose to include all or part of your qualified dividends in investment income.

You make this choice by completing Form 4952, line 4g, according to its instructions.

If you choose to include any amount of your qualified dividends in investment income, you must reduce your qualified dividends that are eligible for the lower capital gains tax rates by the same amount.

Choosing to include net capital gain. Investment income generally does not include net capital gain from disposing of investment property (including capital gain distributions from mutual funds). However, you can choose to include all or part of your net capital gain in investment income. You make this choice by completing line 4g of Form 4952 according to its instructions.

If you choose to include any amount of your net capital gain in investment income, you must reduce your net capital gain that is eligible for the lower capital gains tax rates by the same amount.

Tip

Before making either choice, consider the overall effect on your tax liability. Compare your tax if you make one or both of these choices with your tax if you do not make either choice.

Investment income of child reported on parent's return. Investment income includes the part of your child's interest and dividend income that you choose to report on your return. If the child does not have qualified dividends, Alaska Permanent Fund dividends, or capital gain distributions, this is the amount on line 6 of Form 8814, Parents' Election To Report Child's Interest and Dividends. Include it on line 4a of Form 4952.

Child's qualified dividends. If part of the amount you report is your child's qualified dividends, that part (which is reported on Form 1040, line 3a) generally does not count as investment income. However, you can choose to include all or part of it in investment income, as explained under Choosing to include qualified dividends, earlier.

Your investment income also includes the amount on Form 8814, line 12 (or, if applicable, the reduced amount figured next under Child's Alaska Permanent Fund dividends).

Child's Alaska Permanent Fund dividends. If part of the amount you report is your child's Alaska Permanent Fund dividends, that part does not count as investment income. To figure the amount of your child's income that you can consider your investment income, start with the amount on Form 8814, line 6. Multiply that amount by a percentage that is equal to the Alaska Permanent Fund dividends divided by the total amount on Form 8814, line 4. Subtract the result from the amount on Form 8814, line 12.
Child's capital gain distributions. If part of the amount you report is your child's capital gain distributions, that part (which is reported on Schedule D (Form 1040), line 13, or Form 1040, line 6) generally does not count as investment income. However, you can choose to include all or part of it in investment income. Your investment income also includes the amount on line 12 of Form 8814.

Form 4952
Use Form 4952, Investment Interest Expense Deduction, to figure your deduction for investment interest.
Exception to use of Form 4952. You do not have to complete Form 4952 or attach it to your return if you meet all of the following tests.

- Your investment income from interest and ordinary dividends minus any qualified dividends is more than your investment interest expense.
- You have no other deductible investment expenses.
- You have no carryover of investment interest expense from 2021.

If you meet all of these tests, you can deduct all of your investment interest.

V. Items You Cannot Deduct

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

- Personal interest (discussed later).
- Annual fees for credit cards.
- Loan fees.
- Credit investigation fees.
- VA funding fees.
- Interest to purchase or carry tax-exempt securities.

Penalties. You cannot deduct fines and penalties paid to a government for violations of law, regardless of their nature.

PERSONAL INTEREST
Personal interest is not deductible. Personal interest is any interest that is not home mortgage interest, investment interest, business interest, or other deductible interest. It includes the following items.

- Interest on car loans (unless you use the car for business).
- Interest on federal, state, or local income tax.
- Finance charges on credit cards, retail installment contracts, and revolving charge accounts incurred for personal expenses.
- Late payment charges by a public utility.

Tip
You may be able to deduct interest you pay on a qualified student loan.

VI. Allocation Of Interest

If you use the proceeds of a loan for more than one purpose (for example, personal and business), you must allocate the interest on the loan to each use. However, you do not have to allocate home mortgage interest if it is fully deductible, regardless of how the funds are used.
You allocate interest (other than fully deductible home mortgage interest) on a loan in the same way as the loan itself is allocated. You do this by tracing disbursements of the debt proceeds to specific uses.

VII. How To Report

You must file Form 1040 or 1040-SR to deduct any home mortgage interest expense on your tax return. Where you deduct your interest expense generally depends on how you use the loan proceeds. See Table 4-1 for a summary of where to deduct your interest expense.

TABLE 4-1. WHERE TO DEDUCT YOUR INTEREST EXPENSE

IF you have...	THEN deduct it on...
Deductible student loan interest	Schedule 1 (Form 1040), line 21
Deductible home mortgage interest and points reported on Form 1098	Schedule A (Form 1040), line 8a
Deductible home mortgage interest not reported on Form 1098	Schedule A (Form 1040), line 8b
Deductible points not reported on Form 1098	Schedule A (Form 1040), line 8c
Deductible investment interest (other than interest incurred to produce rents or royalties)	Schedule A (Form 1040), line 9
Deductible business interest (non-farm)	Schedule C (Form 1040)
Deductible farm business interest	Schedule F (Form 1040)
Deductible interest incurred to produce rents or royalties	Schedule E (Form 1040)
Personal interest	Not Deductible

Home mortgage interest and points. Generally, you can deduct the home mortgage interest and points reported to you on Form 1098 on Schedule A (Form 1040), line 8a. However, any interest showing in box 1 of Form 1098 from a home equity loan, or a line of credit or credit card loan secured by the property is not deductible if the proceeds were not used to buy, build, or substantially improve a qualified home. If you paid more deductible interest to the financial institution than the amount shown on Form 1098, show the portion of the deductible interest that was omitted from Form 1098 on line 8b. Attach a statement explaining the difference and enter “See attached” next to line 8b.
If you can take a deduction for points that were not reported to you on Form 1098, deduct those points on line 8c of Schedule A (Form 1040).
More than one borrower. If you and at least one other person (other than your spouse if you file a joint return) were liable for and paid interest on a mortgage that was for your home, and the other person received a Form 1098 showing the interest that was paid during the year, attach a statement to your return explaining this. Show how much of the interest each of you paid, and give the name and address of the person who received the form. Deduct your share of the interest on Schedule A (Form 1040), line 8b, and enter “See attached” next to the line.
Similarly, if you are the payer of record on a mortgage on which there are other borrowers entitled to a deduction for the interest shown on the Form 1098 you received, deduct only your share of the interest on Schedule A (Form 1040), line 8a. You should let each of the other borrowers know what his or her share is.

Mortgage proceeds used for business. If your home mortgage interest deduction is limited but all or part of the mortgage proceeds were used for business or other deductible activities, see Table 4-1. It shows where to deduct the part of your excess interest that is for those activities.

Investment interest. Deduct investment interest, subject to certain limits, on Schedule A (Form 1040), line 9.

Amortization of bond premium. There are various ways to treat the premium you pay to buy taxable bonds.

Income-producing rental or royalty interest. Deduct interest on a loan for income-producing rental or royalty property that is not used in your business in Part I of Schedule E (Form 1040).

Example

You rent out part of your home and borrow money to make repairs. You can deduct only the interest payment for the rented part in Part I of Schedule E (Form 1040). Deduct the rest of the interest payment on Schedule A (Form 1040) if it is deductible home mortgage interest.

CHAPTER 4: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. Home mortgage interest is fully deductible if all of the following conditions are met <u>except</u>:

A. you file Form 1040 or 1040-SR and itemize deductions on Schedule A
B. both you and the lender must intend that the loan be repaid
C. the mortgage must be a secured debt on a qualified home
D. the mortgage(s) have a combined balance exceeding $1 million

2. Why are points paid to obtain a home mortgage generally <u>not</u> deductible in the year paid:

A. because points are not an established business practice
B. because points are not computed as a percentage of the principal amount of the mortgage
C. because points are listed on the Uniform Settlement Statement
D. because points are prepaid interest and should be deducted over the life of the mortgage

3. Generally, what is your deduction for investment interest expense limited to:

A. your AGI
B. your taxable income
C. your net investment income
D. your net capital gain

CHAPTER 4: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.

A. Incorrect. You may be able to fully deduct home mortgage interest if certain conditions are met. Filing Form 1040 or 1040-SR with itemized deductions is one of the necessary conditions.
B. Incorrect. The condition of intention of repayment for the home mortgage loan is a necessary condition for claiming the home mortgage interest deduction.
C. Incorrect. The mortgage producing the intended interest expense to be deducted must be secured by a qualified home.
D. **CORRECT**. Mortgage interest paid resulting from mortgage balances exceeding $1 million ($500,000 for married filing separately) do not qualify for full deductibility. The $1 million was lowered to $750,000 ($375,000 for married filing separately) for new mortgages taken out after December 15, 2017.

2.
A. Incorrect. The deductibility of points is not directly related to a local business practice.
B. Incorrect. Points are computed as a percentage of the principal amount of the borrowed funds, or mortgage. This calculation however has no relationship to the deductibility of these costs on a federal tax return.
C. Incorrect. The listing of "points" on a standard closing statement (Form HUD-1) has no connection to their deductibility.
D. **CORRECT**. The general rule is that points represent prepaid interest and therefore must be claimed over the life of the mortgage. However, a nine-point exception test exists that upon meeting all such conditions will allow a taxpayer to fully deduct all points paid in the same year as they were paid.

3.
A. Incorrect. Generally, your deduction for investment interest expense is not limited to the amount of your AGI, but rather your net investment income.
B. Incorrect. Generally, your deduction for investment interest expense is not limited to the amount of your taxable income, but rather your net investment income.
C. **CORRECT**. Your deduction for investment interest expense is limited to the amount of your net investment income. You can carry over the amount of investment interest that you could not deduct in the current year because of this limit to the next tax year.
D. Incorrect. Generally, your deduction for investment interest expense is not limited to the amount of your net capital gain, but rather your net investment income.

Chapter 5: Contributions

Chapter Objective
After completing this chapter, you should be able to:
- Recall the types of charitable contributions you can deduct and the records you should keep.

I. Introduction

This chapter explains how to claim a deduction for your charitable contributions. It discusses:
- The types of organizations to which you can make deductible charitable contributions,
- The types of contributions you can deduct,
- How much you can deduct,
- What records to keep, and
- How to report your charitable 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 getting, or expecting to get, anything of equal value.
Schedule A (Form 1040) required. To deduct a charitable contribution, you must itemize deductions on Schedule A (Form 1040). The amount of your deduction may be limited if certain rules and limits explained in this chapter apply to you.

II. Organizations That Qualify To Receive Deductible Contributions

You can deduct your contributions only if you make them to a qualified organization. Most organizations, other than churches and governments, must apply to the IRS to become a qualified organization.

TYPES OF QUALIFIED ORGANIZATIONS
Generally, only the following types of organizations can be qualified organizations.
1. A community chest, corporation, trust, fund, or foundation organized or created in or under the laws of the United States, any state, the District of Columbia, or any possession of the United States (including Puerto Rico). It must, however, be organized and operated only for charitable, religious, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals. Certain organizations that foster national or international amateur sports competition also qualify.
2. War veterans' organizations, including posts, auxiliaries, trusts, or foundations, organized in the United States or any of its possessions (including Puerto Rico).
3. Domestic fraternal societies, orders, and associations operating under the lodge system.
4. Certain nonprofit cemetery companies or corporations.
5. The United States or any state, the District of Columbia, a U.S. possession (including Puerto Rico), a political subdivision of a state or U.S. possession, or an Indian tribal government or any of its subdivisions that perform substantial government functions.

Qualified organizations include:
- Churches, a convention or association of churches, temples, synagogues, mosques, and other religious organizations.
- Most nonprofit charitable organizations such as the American Red Cross and the United Way.
- Most nonprofit educational organizations, including the Boy Scouts of America, Girl Scouts of America, colleges, and museums. This also includes nonprofit daycare centers that provide childcare to the general public if substantially all the childcare is provided to enable parents and

guardians to be gainfully employed. However, if your contribution is a substitute for tuition or other enrollment fee, it is not deductible as a charitable contribution, as explained later under Contributions You Cannot Deduct.

- Nonprofit hospitals and medical research organizations.
- Utility company emergency energy programs, if the utility company is an agent for a charitable organization that assists individuals with emergency energy needs.
- Nonprofit volunteer fire companies.
- Nonprofit organizations that develop and maintain public parks and recreation facilities.
- Civil defense organizations.

III. Contributions You Can Deduct

Generally, you can deduct your contributions of money or property that you make to, or for the use of, a qualified organization. A 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.

If you give property to a qualified organization, you generally can deduct the fair market value of the property at the time of the contribution. See Contributions of Property, later in this chapter.

Your deduction for charitable contributions generally cannot be more than 60% of your adjusted gross income, but in some cases 20%, 30%, or 50% limits may apply.

Table 5-1 lists some examples of contributions you can deduct and some that you cannot deduct.

TABLE 5-1. EXAMPLES OF CHARITABLE CONTRIBUTIONS – A QUICK CHECK

Use the following lists for a quick check of contributions you can or cannot deduct. See the rest of this chapter for more information and additional rules and limits that may apply.

Deductible as Charitable Contributions	Not Deductible as Charitable Contributions
Money or property you give to: • Churches, synagogues, temples, mosques, and other religious organizations • Federal, state and local governments, if your contribution is solely for public purposes (for example, a gift to reduce the public debt or maintain a public park) • Nonprofit schools and hospitals • Salvation Army, American Red Cross, CARE, Goodwill Industries, United Way, Boy Scouts of America, Girl Scouts of America, Boys and Girls Clubs of America, etc. • War veterans groups Expenses paid for a student living with you, sponsored by a qualified organization Out-of-pocket expenses when you serve a qualified organization as a volunteer	Money or property you give to: • Civic leagues, social and sports clubs, labor unions, and chambers of commerce • Foreign organizations (except certain Canadian, Israeli, and Mexican charities) • Groups that are run for personal profit • Groups whose purpose is to lobby for law changes • Homeowners' associations • Individuals • Political groups or candidates for public office Cost of raffle, bingo, or lottery tickets Dues, fees, or bills paid to country clubs, lodges, fraternal orders, or similar groups Tuition Value of your time or services Value of blood given to a blood bank

CONTRIBUTIONS FROM WHICH YOU BENEFIT

If you receive a benefit as a result of making a contribution to a qualified organization, you can deduct only the amount of your contribution that is more than the value of the benefit you receive.

If you pay more than fair market value to a qualified organization for goods or services, the excess may be a charitable contribution. For the excess amount to qualify, you must pay it with the intent to make a charitable contribution.

Example 1

You pay $65 for a ticket to a dinner dance at a church. Your entire $65 payment goes to the church. The ticket to the dinner-dance has a fair market value of $25. When you buy your ticket, you know that its value is less than your payment. To figure the amount of your charitable contribution, you subtract the value of the benefit you receive ($25) from your total payment ($65). You can deduct $40 as a contribution to the church.

Example 2

At a fundraising auction conducted by a charity, you pay $600 for a week's stay at a beach house. The amount you pay is no more than the fair rental value. You have not made a deductible charitable contribution.

Charity benefit events. If you pay a qualified organization more than fair market value for the right to attend a charity ball, banquet, show, sporting event, or other benefit event, you can deduct only the amount that is more than the value of the privileges or other benefits you receive.

If there is an established charge for the event, that charge is the value of your benefit. If there is no established charge, the reasonable value of the right to attend the event is the value of your benefit. Whether you use the tickets or other privileges has no effect on the amount you can deduct. However, if you return the ticket to the qualified organization for resale, you can deduct the entire amount you paid for the ticket.

Example

You pay $40 to see a special showing of a movie for the benefit of a qualified organization. Printed on the ticket is "Contribution – $40." If the regular price for the movie is $8, your contribution is $32 ($40 payment - $8 regular price).

State or local tax credit or deduction. If you receive or expect to receive a state or local tax credit or a state or local tax deduction for a charitable contribution, then the amount treated as a charitable deduction may be reduced.

Membership fees or dues. You may be able to deduct membership fees or dues you pay to a qualified organization. However, you can deduct only the amount that is more than the value of the benefits you receive. You cannot deduct dues, fees, or assessments paid to country clubs and other social organizations. They are not qualified organizations.

Certain membership benefits can be disregarded. Both you and the organization can disregard the following membership benefits if you receive them in return for an annual payment of $75 or less:

1. Any rights or privileges that you can use frequently while you 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 you are a member, to events that are open only to members of the organization, if the organization reasonably projects that the cost per person (excluding any allocated overhead) is not more than $11.70.

Token items. You do not have to reduce your contribution by the value of any benefit you receive if both of the following are true.

1. You receive only a small item or other benefit of token value.
2. The qualified organization correctly determines that the value of the item or benefit you received is not substantial and informs you that you can deduct your payment in full.

Written statement. A qualified organization must give you a written statement if you make a payment of more than $75 that is partly for goods or services. The statement must say that you can deduct only the amount of your payment that is more than the value of the goods or services you received. It must also give you a good faith estimate of the value of those goods or services.

The organization can give you the statement either when it solicits or when it receives the payment from you.

Exception

An organization will not have to give you this statement if one of the following is true.

1. The organization is:
   - A governmental organization described in (5) under Types of Qualified Organizations, earlier, or
   - An organization formed only for religious purposes, and the only benefit you receive is an intangible religious benefit (such as admission to a religious ceremony) that generally is not sold in commercial transactions outside the donative context.
2. You receive only items whose value is not substantial. See Token items, earlier.
3. You receive only membership benefits that can be disregarded, as described earlier.

EXPENSES PAID FOR STUDENT LIVING WITH YOU

You may be able to deduct some expenses of having a student live with you. You can deduct qualifying expenses for a foreign or American student who:

4. Lives in your home under a written agreement between you and a qualified organization as part of a program of the organization to provide educational opportunities for the student,
5. Is not your dependent or relative, and
6. Is a full-time student in the twelfth or any lower grade at a school in the United States.

You can deduct up to $50 a month for each full calendar month the student lives with you. Any month when conditions (1) through (3) above are not met for 15 days or more counts as a full month.

Mutual exchange program. You cannot deduct the costs of a foreign student living in your home under a mutual exchange program through which your child will live with a family in a foreign country.

OUT-OF-POCKET EXPENSES IN GIVING SERVICES

Although you cannot deduct the value of your services given to a qualified organization, you may be able to deduct some amounts you pay in giving services to a qualified organization. The amounts must be:

- Unreimbursed,
- Directly connected with the services,
- Expenses you had only because of the services you gave, and
- Not personal, living, or family expenses.

Table 5-2 contains questions and answers that apply to some individuals who volunteer their services.

TABLE 5-2. VOLUNTEERS' QUESTIONS AND ANSWERS

If you volunteer for a qualified organization, the following questions and answers may apply to you. All of the rules explained in this chapter also apply. See, in particular, Out-of-Pocket Expenses in Giving Services.

Question	Answer
I volunteer 6 hours a week in the office of a qualified organization. The receptionist is paid $10 an hour to do the same work I do. Can I deduct $60 a week for my time?	No, you cannot deduct the value of your time or services.
The office is 30 miles from my home. Can I deduct any of my car expenses for these trips?	Yes, you can deduct the costs of gas and oil that are directly related to getting to and from the place where you are a volunteer. If you don't want to figure your actual costs, you can deduct 14 cents for each mile.
I volunteer as a Red Cross nurse's aide at a hospital. Can I deduct the cost of uniforms that I must wear?	Yes, you can deduct the cost of buying and cleaning your uniforms if the hospital is a qualified organization, the uniforms are not suitable for everyday use, and you must wear them when volunteering.
I pay a babysitter to watch my children while I do volunteer work for a qualified organization. Can I deduct these costs?	No, you cannot deduct payments for child care expenses as a charitable contribution, even if they are necessary so you can do volunteer work for a qualified organization.

Conventions. If a qualified organization selects you to attend a convention as its representative, you can deduct unreimbursed expenses for travel, including a reasonable amount for meals and lodging, while away from home overnight in connection with the convention. However, see Travel, later.

You cannot deduct personal expenses for sightseeing, fishing parties, theater tickets, or nightclubs. You also cannot deduct transportation, meals and lodging, and other expenses for your spouse or children.

You cannot deduct your expenses in attending a church convention if you go only as a member of your church rather than as a chosen representative. You can deduct unreimbursed expenses that are directly connected with giving services for your church during the convention.

Uniforms. You can deduct the cost and upkeep of uniforms that are not suitable for everyday use and that you must wear while performing donated services for a charitable organization.

Foster parents. You may be able to deduct as a charitable contribution some of the costs of being a foster parent (foster care provider) if you have no profit motive in providing the foster care and are not, in fact, making a profit. A qualified organization must designate the individuals you take into your home for foster care.

You can deduct expenses that meet both of the following requirements.

1. They are unreimbursed out-of-pocket expenses to feed, clothe, and care for the foster child.
2. They are incurred primarily to benefit the qualified organization.

Unreimbursed expenses that you cannot deduct as charitable contributions may be considered support provided by you in determining whether you can claim the foster child as a dependent.

Example

You cared for a foster child because you wanted to adopt her, not to benefit the agency that placed her in your home. Your unreimbursed expenses are not deductible as charitable contributions.

Car expenses. You can deduct as a charitable contribution any unreimbursed out-of-pocket expenses, such as the cost of gas and oil, that are directly related to the use of your car in giving services to a charitable organization. You cannot deduct any part of general repair and maintenance expenses, depreciation, registration fees, or the costs of tires or insurance.

If you do not want to deduct your actual expenses, you can use a standard mileage rate of 14 cents a mile to figure your contribution.

You can deduct parking fees and tolls whether you use your actual expenses or the standard mileage rate. You must keep reliable written records of your car expenses. For more information, see Car expenses under Records to Keep, later.

Travel. Generally, you can claim a charitable contribution deduction for travel expenses necessarily incurred while you 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 you pay the expenses directly or indirectly. You are paying the expenses indirectly if you make a payment to the charitable organization and the organization pays for your travel expenses.

The deduction for travel expenses will not be denied simply because you enjoy providing services to the charitable organization. Even if you enjoy the trip, you can take a charitable contribution deduction for your travel expenses if you are on duty in a genuine and substantial sense throughout the trip. However, if you have only nominal duties, or if for significant parts of the trip you do not have any duties, you cannot deduct your travel expenses.

Example 1

You are a troop leader for a tax-exempt youth group and take the group on a camping trip. You are responsible for overseeing the setup of the camp and for providing the adult supervision for the other activities during the entire trip. You participate in the activities of the group and really enjoy your time with them. You oversee the breaking of camp and you transport the group home. You can deduct your travel expenses.

Example 2

You sail from one island to another and spend 8 hours a day counting whales and other forms of marine life. The project is sponsored by a charitable organization. In most circumstances, you cannot deduct your expenses.

Example 3

You work for several hours each morning on an archaeological dig sponsored by a charitable organization. The rest of the day is free for recreation and sightseeing. You cannot take a charitable contribution deduction even though you work very hard during those few hours.

Example 4

You spend the entire day attending a charitable organization's regional meeting as a chosen representative. In the evening you go to the theater. You can claim your travel expenses as charitable contributions, but you cannot claim the cost of your evening at the theater.

Daily allowance (per diem). If you provide services for a charitable organization and receive a daily allowance to cover reasonable travel expenses, including meals and lodging while away from home overnight, you must include in income the amount of the allowance that is more than your deductible travel expenses. You may be able to deduct any necessary travel expenses that are more than the allowance.

Deductible travel expenses. These include:

- Air, rail, and bus transportation,
- Out-of-pocket expenses for your car,
- Taxi fares or other costs of transportation between the airport or station and your hotel,
- Lodging costs, and
- The cost of meals.

Because these travel expenses are not business related, they are not subject to the same limits as business-related expenses.

IV. Contributions You Cannot Deduct

There are some contributions that you cannot deduct, such as those made to individuals and those made to nonqualified organizations. (See Contributions to Individuals and Contributions to Nonqualified Organizations, next). There are others that you can deduct only part of, as discussed later under Contributions From Which You Benefit.

CONTRIBUTIONS TO INDIVIDUALS

You cannot deduct contributions to specific individuals, including the following.

- Contributions to fraternal societies made for the purpose of paying medical or burial expenses of deceased members.
- Contributions to individuals who are needy or worthy. This includes contributions to a qualified organization if you indicate that your contribution is for a specific person. But you can deduct a contribution that you give to a qualified organization that in turn helps needy or worthy individuals if you do not indicate that your contribution is for a specific person.
- Payments to a member of the clergy that can be spent as he or she wishes, such as for personal expenses.
- Expenses you paid for another person who provided services to a qualified organization.
- Payments to a hospital that are for services for a specific patient. You cannot deduct these payments even if the hospital is operated by a city, a state, or other qualified organization.

Example

Your son does missionary work. You pay his expenses. You cannot claim a deduction for your son's unreimbursed expenses related to his contribution of services.

CONTRIBUTIONS TO NONQUALIFIED ORGANIZATIONS

You cannot deduct contributions to organizations that are not qualified to receive tax-deductible contributions, including the following.

1. Certain state bar associations if:
    a) The state bar is not a political subdivision of a state,
    b) The bar has private, as well as public, purposes, such as promoting the professional interests of members, and
    c) Your contribution is unrestricted and can be used for private purposes.
2. Chambers of commerce and other business leagues or organizations.
3. Civic leagues and associations.
4. Country clubs and other social clubs.
5. Most foreign organizations.
6. Homeowners' associations.

7. Labor unions.
8. Political organizations and candidates.

CONTRIBUTIONS FROM WHICH YOU BENEFIT

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

- Contributions to a college or university if the amount paid is to (or for the benefit of) a college or university in exchange for tickets (or the right to buy tickets) to an athletic event in an athletic stadium of the college or university.
- Contributions from which you receive or expect to receive a credit or deduction against state or local taxes unless an exception applies.
- Contributions for lobbying. This includes amounts that you earmark for use in, or in connection with, influencing specific legislation.
- Contributions to a retirement home that are clearly for room, board, maintenance, or admittance. Also, if the amount of your contribution depends on the type or size of apartment you will occupy, it is not a charitable contribution.
- Costs of raffles, bingo, lottery, etc. You cannot deduct as a charitable contribution amounts you pay to buy raffle or lottery tickets or to play bingo or other games of chance.
- Dues to fraternal orders and similar groups. However, see Membership fees or dues, earlier, under Contributions You Can Deduct.
- Tuition, or amounts you pay instead of tuition. You also cannot deduct any fixed amount you may be required to pay in addition to the tuition to enroll in a private school, even if it is designated as a "donation."

QUALIFIED CHARITABLE DISTRIBUTIONS

A qualified charitable distribution (QCD) is a distribution made directly by the trustee of your individual retirement arrangement (IRA), other than a SEP or SIMPLE IRA, to certain qualified organizations. You must have been at least age 70½ when the distribution was made. Your total QCDs for the year cannot be more than $100,000. If all the requirements are met, a QCD is nontaxable, but you cannot claim a charitable contribution deduction for a QCD.

VALUE OF TIME OR SERVICES

You cannot deduct the value of your time or services, including:

- Blood donations to the American Red Cross or to blood banks, and
- The value of income lost while you work as an unpaid volunteer for a qualified organization.

PERSONAL EXPENSES

You cannot deduct personal, living, or family expenses, such as:

- The cost of meals you eat while you perform services for a qualified organization unless it is necessary for you to be away from home overnight while performing the services, or
- Adoption expenses, including fees paid to an adoption agency and the costs of keeping a child in your home before adoption is final.

V. Contributions Of Property

If you contribute property to a qualified organization, the amount of your charitable contribution is generally the fair market value of the property at the time of the contribution. However, if the property

has increased in value, you may have to make some adjustments to the amount of your deduction. See Giving Property That Has Increased in Value, later.

For information about the records you must keep and the information you must furnish with your return if you donate property, see Records To Keep and How To Report, later.

Clothing and household items. You cannot take a deduction for clothing or household items you donate, unless the clothing or household items are in good used condition or better.

Exception

You can take a deduction for a contribution of an item of clothing or household item that is not in good used condition or better if you deduct more than $500 for it and include a qualified appraisal of it with your return.

Household items. Household items include:

- Furniture,
- Furnishings,
- Electronics,
- Appliances,
- Linens, and
- Other similar items.

Household items do not include:

- Food,
- Paintings, antiques, and other objects of art,
- Jewelry and gems, and
- Collections.

Cars, boats, and airplanes. The following rules apply to any donation of a qualified vehicle. A qualified vehicle is:

- A car or any motor vehicle manufactured mainly for use on public streets, roads, and highways,
- A boat, or
- An airplane.

Deduction more than $500. If you donate a qualified vehicle to a qualified organization and you claim a deduction of more than $500, you can deduct the smaller of:

- The gross proceeds from the sale of the vehicle by the organization, or
- The vehicle's fair market value on the date of the contribution. If the vehicle's fair market value was more than your cost or other basis, you may have to reduce the fair market value to get the deductible amount, as described under Giving Property That Has Increased in Value, later.

Form 1098-C. You must attach to your return the copy of the Form 1098-C, Contributions of Motor Vehicles, Boats, and Airplanes, (or other statement containing the same information as Form 1098-C) you received from the organization. The Form 1098-C (or other statement) will show the gross proceeds from the sale of the vehicle.

If you e-file your return, you must: (a) attach Copy B of Form 1098-C to Form 8453 and mail the forms to the IRS, or (b) include Copy B of Form 1098-C as a PDF attachment if your software program allows it.

If you do not attach Form 1098-C (or other statement), you cannot deduct your contribution. You must get Form 1098-C (or other statement) within 30 days of the sale of the vehicle. But if exception 1 or 2 (described next) applies, you must get Form 1098-C (or other statement) within 30 days of your donation.

Exceptions. There are two exceptions to the rules just described for deductions of more than $500.

Exception 1

Vehicle used or improved by organization. If the qualified organization makes a significant intervening use of or material improvement to the vehicle before transferring it, you generally can deduct the vehicle's fair market value at the time of the contribution. But if the vehicle's fair market value was more than your cost or other basis, you may have to reduce the fair market value to get the deductible amount, as described under Giving Property That Has Increased in Value, later. The Form 1098-C (or other statement) will show whether this exception applies.

Exception 2
Vehicle given or sold to needy individual. If the qualified organization will give the vehicle, or sell it for a price well below fair market value, to a needy individual to further the organization's charitable purpose, you generally can deduct the vehicle's fair market value at the time of the contribution. But if the vehicle's fair market value was more than your cost or other basis, you may have to reduce the fair market value to get the deductible amount, as described under Giving Property That Has Increased in Value, later. The Form 1098-C (or other statement) will show whether this exception applies.
This exception does not apply if the organization sells the vehicle at auction. In that case, you cannot deduct the vehicle's fair market value.

Example
Anita donates a used car to a qualified organization. She bought it 3 years ago for $9,000. A used car guide shows the fair market value for this type of car is $6,000. However, Anita gets a Form 1098-C from the organization showing the car was sold for $2,900. Neither exception 1 nor exception 2 applies. If Anita itemizes her deductions, she can deduct $2,900 for her donation. She must attach the Form 1098-C and Form 8283 to her return.

Deduction $500 or less. If the qualified organization sells the vehicle for $500 or less and exceptions 1 and 2 do not apply, you can deduct the smaller of:

- $500, or
- The vehicle's fair market value on the date of the contribution. But if the vehicle's fair market value was more than your cost or other basis, you may have to reduce the fair market value to get the deductible amount, as described under Giving Property That Has Increased in Value, later.

If the vehicle's fair market value is at least $250 but not more than $500, you must have a written statement from the qualified organization acknowledging your donation. The statement must contain the information and meet the tests for an acknowledgment described under Deductions of At Least $250 But Not More Than $500 under Records to Keep, later.

DETERMINING FAIR MARKET VALUE
This section discusses general guidelines for determining the fair market value of various types of donated property. Fair market value 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.
Used clothing and household items. Generally, the fair market value of used clothing and household goods is far less than what you paid for them when they were new.
For used clothing, you should claim as the value the price that buyers of used items actually pay in used clothing stores, such as consignment or thrift shops.

Example

Dawn Greene donated a coat to a thrift store operated by her church. She paid $300 for the coat 3 years ago. Similar coats in the thrift store sell for $50. The fair market value of the coat is reasonably determined to be $50. Dawn's donation is limited to $50.

Cars, boats, and airplane. If you contribute a car, boat, or airplane to a charitable organization, you must determine its fair market value.

Certain commercial firms and trade organizations publish guides, commonly called "blue books," containing complete dealer sale prices or dealer average prices for recent model years. The guides may be published monthly or seasonally and for different regions of the country. These guides also provide estimates for adjusting for unusual equipment, unusual mileage, and physical condition. The prices are not "official" and these publications are not considered an appraisal of any specific donated property. But they do provide clues for making an appraisal and suggest relative prices for comparison with current sales and offerings in your area.

Large quantities. If you contribute a large number of the same item, fair market value is the price at which comparable numbers of the item are being sold.

GIVING PROPERTY THAT HAS DECREASED IN VALUE

If you contribute property with a fair market value that is less than your basis in it, your deduction is limited to its fair market value. You cannot claim a deduction for the difference between the property's basis and its fair market value.

GIVING PROPERTY THAT HAS INCREASED IN VALUE

If you contribute property with a fair market value that is more than your basis in it, you may have to reduce the fair market value by the amount of appreciation (increase in value) when you figure your deduction.

Your basis in property is generally what you paid for it.

Different rules apply to figuring your deduction, depending on whether the property is:

1. Ordinary income property, or
2. Capital gain property.

Ordinary income property. Property is ordinary income property if you would have recognized ordinary income or short-term capital gain had you sold it at fair market value on the date it was contributed. Examples of ordinary income property are inventory, works of art created by the donor, manuscripts prepared by the donor, and capital assets held 1 year or less.

Amount of deduction. The amount you can deduct for a contribution of ordinary income property is its fair market value minus the amount that would be ordinary income or short-term capital gain if you sold the property for its fair market value. Generally, this rule limits the deduction to your basis in the property.

Example

You donate stock that you held for 5 months to your church. The fair market value of the stock on the day you donate it is $1,000, but you paid only $800 (your basis). Because the $200 of appreciation would be short-term capital gain if you sold the stock, your deduction is limited to $800 (fair market value less the appreciation).

Capital gain property. Property is capital gain property if it would have resulted in long-term capital gain had you sold it at fair market value on the date of the contribution. It includes capital assets held more

than 1 year, as well as certain real property and depreciable property used in your trade or business and, generally, held more than 1 year.

Amount of deduction – general rule. When figuring your deduction for a contribution of capital gain property, you usually can use the fair market value of the property.

Exception
In certain situations, you must reduce the fair market value by any amount that would have been long-term capital gain if you had sold the property for its fair market value. Generally, this means reducing the fair market value to the property's cost or other basis.

Bargain sales. A bargain sale of property is a sale or exchange for less than the property's fair market value. A bargain sale to a qualified organization is partly a charitable contribution and partly a sale or exchange. A bargain sale may result in a taxable gain.

VI. When To Deduct

You can deduct your contributions only in the year you actually make them in cash or other property (or in a later carryover year, as explained later under Carryovers). This applies whether you use the cash or an accrual method of accounting.

Time of making contribution. Usually, you make a contribution at the time of its unconditional delivery.

Checks. A check that you mail to a charity is considered delivered on the date you mail it.

Text message. Contributions made by text message are deductible in the year you send the text message if the contribution is charged to your telephone or wireless account.

Credit card. Contributions charged on your bank credit card are deductible in the year you make the charge.

Pay-by-phone account. Contributions made through a pay-by-phone account are considered delivered on the date the financial institution pays the amount.

Stock certificate. A properly endorsed stock certificate is considered completed on the date of mailing or other delivery to the charity or to the charity's agent. However, if you give a stock certificate to your agent or to the issuing corporation for transfer to the name of the charity, your contribution is not delivered until the date the stock is transferred on the books of the corporation.

Promissory note. If you issue and deliver a promissory note to a charitable organization as a contribution, it is not a contribution until you make the note payments.

Option. If you grant a charity an option to buy real property at a bargain price, it is not a contribution until the organization exercises the option.

Borrowed funds. If you contribute borrowed funds, you can deduct the contribution in the year you deliver the funds to the charity, regardless of when you repay the loan.

VII. Limits On Deductions

Generally, the amount you can deduct for charitable contributions cannot be more than 60% of your adjusted gross income (AGI). Your deduction may be further limited to 50%, 30%, or 20% of your AGI, depending on the type of property you give and the type of organization you give it to. If your total contributions for the year are 20% or less of your AGI, these limits do not apply to you.

A higher limit applies to certain qualified contributions made for relief efforts in a qualified disaster area and qualified conservation contributions.

CARRYOVERS
You can carry over your contributions that you cannot deduct in the current year because they exceed your adjusted-gross-income limits. Except for qualified conservation contributions, you can deduct the excess in each of the next 5 years until it is used up, but not beyond that time.

VIII. Records To Keep

You must keep records to prove the amount of the contributions you make during the year. The kind of records you must keep depends on the amount of your contributions and whether they are:

- Cash contributions,
- Noncash contributions, or
- Out-of-pocket expenses when donating your services.

Note
An organization generally must give you a written statement if it receives a payment from you that is more than $75 and is partly a contribution and partly for goods or services. See Contributions From Which You Benefit under Contributions You Can Deduct, earlier). Keep the statement for your records. It may satisfy all or part of the recordkeeping and requirements explained in the following discussions.

CASH CONTRIBUTIONS
Cash contributions include those paid by cash, check, electronic funds transfer, online payment service, credit card, payroll deduction, or transfer of a gift card redeemable for cash.
You cannot deduct a cash contribution, regardless of the amount, unless you keep one of the following.

1. A bank record that shows the name of the qualified organization, the date of the contribution, and the amount of the contribution. Bank records may include:
    a) A canceled check,
    b) A bank or credit union statement,
    c) A credit card statement,
    d) An electronic fund transfer receipt, or
    e) A scanned image of both sides of a canceled check obtained from a bank or credit union website.
2. A receipt (or letter or other written communication) from the qualified organization showing the name of the organization, the date of the contribution, and the amount of the contribution.
3. The payroll deduction records described next.

Payroll deductions. If you can make a contribution by payroll deduction, you must keep:

1. A pay stub, Form W-2, or other document furnished by your employer that shows the date and amount of the contribution, and
2. A pledge or other document prepared by you for the qualified organization that shows the name of the organization and states the organization does not provide goods or services in return for any contribution made to it by payroll deduction.

If your employer withheld $250 or more from a single paycheck, see Contributions of $250 or More, next.

Contributions of $250 or More
You can claim a deduction for a contribution of $250 or more only if you have a contemporaneous written acknowledgment of your contribution from the qualified organization or certain payroll deduction records.

If you made more than one contribution of $250 or more, you must have either a separate acknowledgment for each or one acknowledgment that lists each contribution and the date of each contribution and shows your total contributions.

Amount of contribution. In figuring whether your contribution is $250 or more, do not combine separate contributions. For example, if you gave your church $25 each week, your weekly payments do not have to be combined. Each payment is a separate contribution.

If contributions are made by payroll deduction, the deduction from each paycheck is treated as a separate contribution.

If you made a payment that is partly for goods and services, as described earlier under Contributions From Which You Benefit, your contribution is the amount of the payment that is more than the value of the goods and services.

Acknowledgment. The acknowledgment must meet these tests.

1. It must be written.
2. It must include:
    a) The amount of cash you contributed,
    b) Whether the qualified organization gave you any goods or services as a result of your contribution (other than certain token items and membership benefits), and
    c) A description and good faith estimate of the value of any goods or services described in (b). If the only benefit you received was an intangible religious benefit (such as admission to a religious ceremony) that generally is not sold in a commercial transaction outside the donative context, the acknowledgment must say so and does not need to describe or estimate the value of the benefit.
3. You must get it on or before the earlier of:
    a) The date you file your return for the year you make the contribution, or
    b) The due date, including extensions, for filing the return.

If the acknowledgment does not show the date of the contribution, you must also have a bank record or receipt, as described earlier, that does show the date of the contribution. If the acknowledgment does show the date of the contribution and meets the other tests just described, you do not need any other records.

Payroll deductions. If you make a contribution by payroll deduction and your employer withheld $250 or more from a single paycheck, you must keep:

1. A pay stub, Form W-2, or other document furnished by your employer that shows the amount withheld as a contribution, and
2. A pledge card or other document prepared by or for the qualified organization that shows the name of the organization and states the organization does not provide goods or services in return for any contribution made to it by payroll deduction.

A single pledge card may be kept for all contributions made by payroll deduction regardless of amount as long as it contains all the required information.

If the pay stub, Form W-2, pledge card, or other document does not show the date of the contribution, you must also have another document that does show the date of the contribution. If the pay stub, Form W-2, pledge card, or other document does show the date of the contribution, you do not need any other records except those just described in (1) and (2).

NONCASH CONTRIBUTIONS

For a contribution not made in cash, the records you must keep depend on whether your deduction for the contribution is:

1. Less than $250,
2. At least $250 but not more than $500,

3. Over $500 but not more than $5,000, or
4. Over $5,000.

Amount of deduction. In figuring whether your deduction is $500 or more, combine your claimed deductions for all similar items of property donated to any charitable organization during the year. If you received goods or services in return, as described earlier in Contributions From Which You Benefit, reduce your contribution by the value of those goods or services. If you figure your deduction by reducing the fair market value of the donated property by its appreciation, as described earlier in Giving Property That Has Increased in Value, your contribution is the reduced amount.

Deductions of Less Than $250

If you make any noncash contribution, you must get and keep a receipt from the charitable organization showing:

1. The name and address of the charitable organization,
2. The date and location of the charitable contribution, and
3. A reasonably detailed description of the property.
4. For a security, the name of the issuer, the type of security, and whether it is publicly traded as of the date of the contribution. For example, a security is generally considered to be publicly traded if the security is (a) listed on a recognized stock exchange whose quotations are published daily, (b) regularly traded on a national or regional over-the-counter market, or (c) quoted daily in a national newspaper of general circulation in the case of mutual fund shares.

A letter or other written communication from the charitable organization acknowledging receipt of the contribution and containing the information in (1), (2), (3), and (4) will serve as a receipt.

You are not required to have a receipt where it is impractical to get one (for example, if you leave property at a charity's unattended drop site).

Additional records. You must also keep reliable written records for each item of donated property. Your written records must include the following information.

1. The information in (1), (2), (3), and (4) above.
2. If you claim a deduction for clothing or a household item, a description of the condition of the clothing or item.
3. The fair market value of the property at the time of the contribution and how you figured the fair market value. If it was determined by appraisal, keep a signed copy of the appraisal.

Deductions of at Least $250 but Not More Than $500

If you claim a deduction of at least $250 but not more than $500 for a noncash charitable contribution, you must get and keep a contemporaneous written acknowledgment of your contribution from the qualified organization. If you made more than one contribution of $250 or more, you must have either a separate acknowledgment for each or one acknowledgment that shows your total contributions.

The acknowledgment must contain the information in items (1) through (3) listed under Deductions of Less Than $250, earlier, and your written records must include the information listed in that discussion under Additional records.

The acknowledgment must also meet these tests.

1. It must be written.
2. It must include:
    a) A description (but not necessarily the value) of any property you contributed,
    b) Whether the qualified organization gave you any goods or services as a result of your contribution (other than certain token items and membership benefits), and
    c) A description and good faith estimate of the value of any goods or services described in (b). If the only benefit you received was an intangible religious benefit (such as admission

to a religious ceremony) that generally is not sold in a commercial transaction outside the donative context, the acknowledgment must say so and does not need to describe or estimate the value of the benefit.

3. You must get it on or before the earlier of:
    a) The date you file your return for the year you make the contribution, or
    b) The due date, including extensions, for filing the return.

Deductions Over $500
You are required to give additional information if you claim a deduction over $500 for noncash charitable contributions.

OUT-OF-POCKET EXPENSES
If you give services to a qualified organization and have unreimbursed out-of-pocket expenses, considered separately, of $250 or more, related to those services, the following two rules apply.

1. You must have adequate records to prove the amount of the expenses.
2. You must get an acknowledgment from the qualified organization that contains:
    a) A description of the services you provided,
    b) A statement of whether or not the organization provided you any goods or services to reimburse you for the expenses you incurred,
    c) A description and a good faith estimate of the value of any goods or services (other than intangible religious benefits) provided to reimburse you, and
    d) A statement that the only benefit you received was an intangible religious benefit, if that was the case. The acknowledgment does not need to describe or estimate the value of an intangible religious benefit (defined earlier under Acknowledgment).

You must get the acknowledgment on or before the earlier of:

1. The date you file your return for the year you make the contribution, or
2. The due date, including extensions, for filing the return.

Car expenses. If you claim expenses directly related to use of your car in giving services to a qualified organization, you must keep reliable written records of your expenses. Whether your records are considered reliable depends on all the facts and circumstances. Generally, they may be considered reliable if you made them regularly and at or near the time you had the expenses.
For example, your records might show the name of the organization you were serving and the date each time you used your car for a charitable purpose. If you use the standard mileage rate of 14 cents a mile, your records must show the miles you drove your car for the charitable purpose. If you deduct your actual expenses, your records must show the costs of operating the car that are directly related to a charitable purpose.
See Car expenses under Out-of-Pocket Expenses in Giving Services, earlier, for the expenses you can deduct.

IX. How To Report

Report your charitable contributions on Schedule A (Form 1040), lines 11 through 14. If your total deduction for all noncash contributions for the year is over $500, you must also file Form 8283.

CHAPTER 5: TEST YOUR KNOWLEDGE
The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. Claiming deductions for charitable contributions are generally limited to gifts given to qualifying organizations, such as which of the following:

A. country clubs and other social clubs
B. churches and religious organizations
C. homeowners' associations
D. political organizations and candidates

2. You can deduct dues paid to country clubs and other social organizations.

A. true
B. false

3. In regards to contributions of property to a qualified organization, household items include which of the following:

A. food
B. appliances
C. paintings
D. jewelry

CHAPTER 5: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.

A. Incorrect. You cannot deduct contributions to organizations that are not qualified to receive tax-deductible contributions such as country clubs or other social organizations.
B. **CORRECT**. Churches and religious organizations are generally qualified organizations for accepting tax-deductible charitable contributions.
C. Incorrect. Homeowners' associations are not qualified organizations with regard to accepting tax-deductible charitable contributions.
D. Incorrect. Political organizations and candidates are generally not recognized as charitable organizations for tax deductibility purposes.

2.

A. Incorrect. You may be able to deduct membership fees and dues you pay to certain qualified organizations, but country clubs and other social organizations are not qualified organizations.
B. **CORRECT**. You cannot deduct dues, fees, or assessments paid to country clubs and other social organizations.

3.

A. Incorrect. Household items do not include food.
B. **CORRECT**. Household items include appliances as well as furniture, furnishings, electronics, linens, and other similar items.
C. Incorrect. Paintings, antiques, and other objects of art are not included as household items.
D. Incorrect. Household items do not include jewelry and gems.

Chapter 6: Nonbusiness Casualty And Theft Losses

Chapter Objective
After completing this chapter, you should be able to:

- Recall the tax treatment of personal casualty and theft losses.

I. What's New/Reminders

Limitation on personal casualty and theft losses. As a result of the TCJA, personal casualty and theft losses of an individual, sustained in a tax year beginning after 2017, are deductible only to the extent that the losses are attributable to a federally declared disaster. Personal casualty and theft losses attributable to a federally declared disaster are subject to the $100 per casualty and 10% of your adjusted gross income (AGI) limitations unless they are attributable to a qualified disaster loss.
An exception to the rule above, limiting the personal casualty and theft loss deduction to losses attributable to a federally declared disaster, applies if you have personal casualty gains for the tax year.
Special rules and return procedures expanded for claiming qualified disaster-related personal casualty losses. The Taxpayer Certainty and Disaster Tax Relief Act of 2019 and the Taxpayer Certainty and Disaster Tax Relief Act of 2020 expanded the special rules and return procedures for personal casualty losses attributable to certain major federal disasters that were declared in 2018, 2019, and 2020.
Personal casualty losses sustained in those tax years as a result of qualified disaster losses may be claimed on Form 4684. See Qualified disaster loss, later, for more information.

Tip
You may have to file an amended return on Form 1040-X to claim these benefits on your 2018, 2019, and/or 2020 returns.

Special rules for capital gains invested in qualified opportunity funds (QOFs). If you have a capital gain for 2022, you can invest that gain into a qualified opportunity fund (QOF) and elect to defer part or all of the gain that you would otherwise include in income until December 31, 2026. You may also be able to permanently exclude gain from the sale or exchange of an investment in a QOF if the investment is held for at least 10 years. For information about how to elect to use these special rules, see the Instructions for Form 8949, Sales and Other Dispositions of Capital Assets. For additional information, see Opportunity Zones Frequently Asked Questions on IRS.gov.
Deferral of gain invested in a QOF. If you realize a gain from an actual, or deemed, sale or exchange with an unrelated person and during the 180-day period beginning on the date realizing the gain, invested an amount of the gain in a QOF, you may be able to elect to temporarily defer part or all of the gain that would otherwise be included in income. If you make the election, the gain is included in taxable income only to the extent, if any, that the amount of realized gain exceeds the aggregate amount invested in a QOF during the 180-day period beginning on the date the gain was realized.
How to report. Report the gain as it would otherwise be reported if you were not making the election. Report the election for the amount invested in a QOF on Form 8949. See the Instructions for Form 8949 for information on how to make the election. You will need to attach Form 8997 annually until you dispose of the QOF investment. See the Form 8997 instructions for more information.
QOF investment. If you held a qualified investment in a QOF at any time during the year, you must file your return with Form 8997 attached. See the Form 8997 instructions.

II. Introduction

This chapter explains the tax treatment of personal (not business related) casualty losses, theft losses, and losses on deposits.
The chapter also explains the following topics:

- How to figure the amount of your loss.
- How to treat insurance and other reimbursements you receive.
- The deduction limits.
- When and how to report a casualty or theft.
- The special rules for disaster area losses.

Forms to file. When you have a casualty or theft, you have to file Form 4684. You will also have to file one or more of the following forms:

- Schedule A (Form 1040).
- Schedule A (Form 1040-NR) (for nonresident aliens).
- Schedule D (Form 1040).
- Form 4797.

III. Casualty

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 you were engaged.

Casualty losses are deductible during the tax year that the loss is sustained. This is generally the tax year that the loss occurred. However, a casualty loss may be sustained in a year after the casualty occurred. See When To Report Gains and Losses, later.
Definitions. Three types of casualty losses are mentioned in this chapter:

1. Federal casualty losses,
2. Disaster losses, and
3. Qualified disaster losses.

All three types of losses refer to federally declared disasters, but the requirements for each loss vary. A federally declared disaster is a disaster determined by the President of the United States to warrant assistance by the federal government under the Stafford Act. A federally declared disaster includes (a) a major disaster declaration or (b) an emergency declaration under the Stafford Act.
Federal casualty loss. A federal casualty loss is an individual's casualty or theft loss of personal-use property that is attributable to a federally declared disaster. The casualty loss must occur in a state receiving a federal disaster declaration. If you suffered a federal casualty loss, you are eligible to claim a casualty loss deduction. If you suffered a casualty or theft loss of personal-use property that was not attributable to federally declared disaster, it is not a federal casualty loss, and you may not claim a casualty loss deduction unless the exception applies. See the Caution under Deductible losses, later.
Disaster loss. A disaster loss is a loss that is attributable to a federally declared disaster and that occurs in an area eligible for assistance pursuant to the Presidential declaration. The disaster loss must occur in a county eligible for public or individual assistance (or both). Disaster losses are not limited to individual personal-use property and may be claimed for individual business or income-producing property and by corporations, S corporations, and partnerships. If you suffered a disaster loss, you are eligible to claim a

casualty loss deduction and to elect to claim the loss in the preceding tax year. See Disaster Area Loss, later.

Qualified disaster loss. A qualified disaster loss is an individual's casualty or theft loss of personal-use property that is attributable to a major disaster declared by the President.

If you suffered a qualified disaster loss, you are eligible to claim a casualty loss deduction, to elect to claim the loss in the preceding tax year, and to deduct the loss without itemizing other deductions on Schedule A (Form 1040).

Deductible losses. For tax years 2018 through 2025, if you are an individual, casualty losses of personal-use property are deductible only if the loss is attributable to a federally declared disaster (federal casualty loss). If the event causing you to suffer a personal casualty loss occurred before January 1, 2018, but the casualty loss was not sustained until January 1, 2018, or later, the casualty loss is not deductible. See When To Report Gains and Losses, later, for more information on when a casualty loss is sustained.

Caution!
An exception to the rule limiting the deduction for personal casualty and theft losses to federal casualty losses applies where you have personal casualty gains. In this case, you may deduct personal casualty losses that are not attributable to a federally declared disaster to the extent they do not exceed your personal casualty gains.

Casualty losses can result from a number of different causes, including the following:

- Car accidents (but see Nondeductible losses next for exceptions).
- Earthquakes.
- Fires (but see Nondeductible losses next for exceptions).
- Floods.
- Government-ordered demolition or relocation of a home that is unsafe to use because of a disaster.
- Mine cave-ins.
- Shipwrecks.
- Sonic booms.
- Storms, including hurricanes and tornadoes.
- Terrorist attacks.
- Vandalism.
- Volcanic eruptions.

Nondeductible losses. A casualty loss is not deductible, even to the extent the loss does not exceed your personal casualty gains, if the damage or destruction is caused by the following:

- Accidentally breaking articles, such as glassware or china under normal conditions.
- A family pet (explained below).
- A fire if you willfully set it or pay someone else to set it.
- A car accident if your willful negligence or willful act caused it. The same is true if the willful act or willful negligence of someone acting for you caused the accident.
- Progressive deterioration (explained later).

Family pet. Loss of property due to damage by a family pet is not deductible as a casualty loss unless the requirements discussed earlier under Casualty are met.

Example
Your antique oriental rug was damaged by your new puppy before it was housebroken. Because the damage was not unexpected and unusual, the loss is not deductible as a casualty loss.

Progressive deterioration. Loss of property due to progressive deterioration is not deductible as a casualty loss. This is because 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:

- The steady weakening of a building due to normal wind and weather conditions.
- 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.
- 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.
- Termite or moth damage.
- 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.

IV. Theft

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 laws of the state where it occurred and it must have been done with criminal intent. You do not need to show a conviction for theft.

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

- Blackmail.
- Burglary.
- Embezzlement.
- Extortion.
- Kidnapping for ransom.
- Larceny.
- Robbery.

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

Theft loss deduction limited. For tax years 2018 through 2025, if you are an individual, casualty and theft losses of personal-use property are deductible only if the losses are attributable to a federally declared disaster (federal casualty loss).

Caution!
An exception to the rule limiting the deduction for personal casualty and theft losses to federal casualty losses applies where you have personal casualty gains. In this case, you may deduct personal casualty losses that are not attributable to a federally declared disaster to the extent they do not exceed your personal casualty gains.

Example
Martin and Grace experienced multiple personal casualties in 2022. Grace's diamond necklace was stolen, resulting in a $15,500 casualty loss. Martin and Grace also lost their camper as a result of a lightning strike. They have replacement-value insurance on the camper, so they have a $13,000 gain. Finally, they lost their car in a flood determined to be a federally declared disaster, resulting in a casualty loss of $25,000. Because Martin and Grace experienced a $13,000 personal casualty gain as a result of the replacement-value insurance, they can offset that gain with a portion of their loss attributable to the stolen necklace and claim the full federal casualty loss of $25,000 subject to the 10% of AGI and $100 limitations.

Decline in market value of stock. You cannot deduct as a theft loss the decline in market value of stock acquired on the open market for investment if the decline is caused by disclosure of accounting fraud or other illegal misconduct by the officers or directors of the corporation that issued the stock. However, you may be able to deduct it as a capital loss on Schedule D (Form 1040) if the stock is sold or exchanged or becomes completely worthless.

Mislaid or lost property. The simple disappearance of money or property is not a theft. However, an accidental loss or disappearance of property can qualify as a casualty if it results from an identifiable event that is sudden, unexpected, or unusual. Sudden, unexpected, and unusual events are defined earlier.

Example
A car door is accidentally slammed on your hand, breaking the setting of your diamond ring. The diamond falls from the ring and is never found. The loss of the diamond is a casualty.

Losses from Ponzi-type investment schemes. If you had a loss from a Ponzi-type investment scheme, see the following:

- Revenue Ruling 2009-9, 2009-14 I.R.B. 735.
- Revenue Procedure 2009-20, 2009-14 I.R.B. 749.
- Revenue Procedure 2011-58, 2011-50 I.R.B. 849.

If you qualify to use Revenue Procedure 2009-20, as modified by Revenue Procedure 2011-58, and you choose to follow the procedures in the guidance, first fill out Section C of Form 4684 to determine the amount to enter on Section B, line 28. Skip lines 19 through 27. Section C of Form 4684 replaces Appendix A in Revenue Procedure 2009-20. You do not need to complete Appendix A. For more information, see the above revenue ruling and revenue procedures, and the Instructions for Form 4684.

If you choose not to use the procedures in Revenue Procedure 2009-20, as modified by Revenue Procedure 2011-58, you may claim your theft loss by filling out Section B, lines 19 through 39, as appropriate.

V. Loss On Deposits

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

- As a casualty loss (to the extent the loss does not exceed your personal casualty gains).
- As a nonbusiness bad debt.

Caution!
You can no longer claim any miscellaneous itemized deductions, including the deduction for an ordinary loss on deposits in insolvent or bankrupt financial institutions.

Casualty loss. You can choose to deduct a loss on deposits as a casualty loss for any year in which you can reasonably estimate how much of your deposits you have lost in an insolvent or bankrupt financial institution. The choice is generally made on the return you file for that year and applies to all your losses on deposits for the year in that particular financial institution. If you treat the loss as a casualty loss, you cannot treat the same amount of the loss as a nonbusiness bad debt when it actually becomes worthless. However, you can take a nonbusiness bad debt deduction for any amount of loss that is more than the estimated amount you deducted as a casualty or ordinary loss. Once you make this choice, you cannot change it without permission from the IRS.

Casualty loss limitation. If you are an individual, casualty losses of personal-use property are deductible only if the loss is attributable to a federally declared disaster. An exception to the rule limiting the deduction for personal casualty and theft losses to federal casualty losses applies where you have personal casualty gains. Because a loss on deposits is not attributable to a federally declared disaster, you may deduct losses on deposits as personal casualty losses only to the extent they do not exceed your personal casualty gains.

Nonbusiness bad debt. If you do not choose to claim the loss as a casualty loss for purposes of offsetting gains, you must wait until the year the actual loss is determined and deduct the loss as a nonbusiness bad debt in that year.

How to report. The kind of deduction you choose for your loss on deposits determines how you report your loss:

- Casualty loss—report it on Form 4684 and Schedule A (Form 1040).
- Nonbusiness bad debt—report it on Form 8949 first and Schedule D (Form 1040).

VI. Proof Of Loss

To deduct a casualty or theft loss, you must be able to prove that you had a casualty or theft. You also must be able to support the amount you take as a deduction.

Casualty loss proof. For a casualty loss, your records should show all the following:

- That you were the owner of the property or, if you leased the property from someone else, that you were contractually liable to the owner for the damage.
- The type of casualty (car accident, fire, storm, etc.) and when it occurred.
- That the loss was a direct result of the casualty.
- Whether a claim for reimbursement exists for which there is a reasonable expectation of recovery.

Theft loss proof. For a theft loss, your records should show all the following:

- That you were the owner of the property.
- That your property was stolen.
- When you discovered that your property was missing.
- Whether a claim for reimbursement exists for which there is a reasonable expectation of recovery.

VII. Figuring A Loss

Figure the amount of your loss using the following steps:

1. Determine your adjusted basis in the property before the casualty or theft.
2. Determine the decrease in fair market value (FMV) of the property as a result of the casualty or theft.
3. From the smaller of the amounts you determined in (1) and (2), subtract any insurance or other reimbursement you received or expect to receive.

For personal-use property, apply the deduction limits, discussed later, to determine the amount of your deductible loss.

Gain from reimbursement. If your reimbursement is more than your adjusted basis in the property, you have a gain. This is true even if the decrease in the FMV of the property is smaller than your adjusted basis. If you have a gain, you may have to pay tax on it, or you may be able to postpone reporting the gain.

Leased property. If you are liable for casualty damage to property you lease, your loss is the amount you must pay to repair the property minus any insurance or other reimbursement you receive or expect to receive.

DECREASE IN FMV

FMV is the price for which you could sell your property to a willing buyer when neither of you has to sell or buy and both of you know all the relevant facts.

The decrease in FMV used to figure the amount of a casualty or theft loss is the difference between the property's FMV immediately before and immediately after the casualty or theft.

FMV of stolen property. The FMV of property immediately after a theft is considered to be zero because you no longer have the property.

Example

Several years ago, you purchased silver dollars at face value for $150. This is your adjusted basis in the property. Your silver dollars were stolen this year. The FMV of the coins was $1,000 just before they were stolen, and insurance did not cover them. Your theft loss is $150.

Recovered stolen property. Recovered stolen property is your property that was stolen and later returned to you. If you recovered property after you had already taken a theft loss deduction, you must refigure your loss using the smaller of the property's adjusted basis (explained later) or the decrease in FMV from the time just before it was stolen until the time it was recovered. Use this amount to refigure your total loss for the year in which the loss was deducted.

If your refigured loss is less than the loss you deducted, you generally have to report the difference as income in the recovery year. But report the difference only up to the amount of the loss that reduced our tax.

Figuring Decrease in FMV—Items To Consider

To figure the decrease in FMV because of a casualty or theft, you generally need a competent appraisal. However, other measures can also be used to establish certain decreases.

Appraisal. An appraisal to determine the difference between the FMV of the property immediately before a casualty or theft and immediately afterward should be made by a competent appraiser. The appraiser must recognize the effects of any general market decline that may occur along with the casualty. This information is needed to limit any deduction to the actual loss resulting from damage to the property.

Several factors are important in evaluating the accuracy of an appraisal, including the following:

- The appraiser's familiarity with your property before and after the casualty or theft.
- The appraiser's knowledge of sales of comparable property in the area.
- The appraiser's knowledge of conditions in the area of the casualty.
- The appraiser's method of appraisal.

Tip

You may be able to use an appraisal that you used to get a federal loan (or a federal loan guarantee) as the result of a federally declared disaster to establish the amount of your disaster loss.

Cost of cleaning up or making repairs. The cost of repairing damaged property is not part of a casualty loss. Neither is the cost of cleaning up after a casualty. But you can use the cost of cleaning up or making repairs after a casualty as a measure of the decrease in FMV if you meet all the following conditions:

- The repairs are actually made.
- The repairs are necessary to bring the property back to its condition before the casualty.
- The amount spent for repairs is not excessive.
- The repairs take care of the damage only.

- The value of the property after the repairs is not, due to the repairs, more than the value of the property before the casualty.

Landscaping. The cost of restoring landscaping to its original condition after a casualty may indicate the decrease in FMV. You may be able to measure your loss by what you spend on the following:

- Removing destroyed or damaged trees and shrubs minus any salvage you receive.
- Pruning and other measures taken to preserve damaged trees and shrubs.
- Replanting necessary to restore the property to its approximate value before the casualty.

Car value. Books issued by various automobile organizations that list the manufacturer and the model of your car may be useful in figuring the value of your car. You can use the retail value for your car listed in the book and modify it by such factors as mileage and the condition of your car to determine its value. The prices are not official, but they may be useful in determining value and suggesting relative prices for comparison with current sales and offerings in your area. If your car is not listed in the books, determine its value from other sources. A dealer's offer for your car as a trade-in on a new car is not usually a measure of its true value.

Safe harbor procedures to determine casualty and theft loss deduction. Safe harbor procedures allow filers to determine their casualty and theft loss deductions for personal-use residential real property and personal belongings resulting from a federally declared disaster without an appraisal.

Figuring Decrease in FMV—Items Not To Consider

You generally should not consider the following items when attempting to establish the decrease in FMV of your property.

Cost of protection. The cost of protecting your property against a casualty or theft is not part of a casualty or theft loss. The amount you spend on insurance or to board up your house against a storm is not part of your loss.

If you make permanent improvements to your property to protect it against a casualty or theft, add the cost of these improvements to your basis in the property. An example would be the cost of a dike to prevent flooding.

Exception. You cannot increase your basis in the property by, or deduct as a business expense, any expenditures you made with respect to qualified disaster mitigation payments.

Related expenses. Any incidental expenses 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 your casualty or theft loss.

Replacement cost. The cost of replacing stolen or destroyed property is not part of a casualty or theft loss.

Sentimental value. Do not consider sentimental value when determining your loss. If a family portrait, heirloom, or keepsake is damaged, destroyed, or stolen, you must base your loss on its FMV, as limited by your adjusted basis in the property.

Decline in market value of property in or near casualty area. A decrease in the value of your property because it is in or near an area that suffered a casualty, or that might again suffer a casualty, is not to be taken into consideration. You have a loss only for actual casualty damage to your property. However, if your home is in a federally declared disaster area, see Disaster Area Losses in Pub. 547.

Costs of photographs and appraisals. Photographs taken after a casualty will be helpful in establishing the condition and value of the property after it was damaged. Photographs showing the condition of the property after it was repaired, restored, or replaced may also be helpful.

Appraisals are used to figure the decrease in FMV because of a casualty or theft.

The costs of photographs and appraisals used as evidence of the value and condition of property damaged as a result of a casualty are not a part of the loss. They are expenses in determining your tax liability. For tax years 2018 through 2025, they can no longer be deducted as miscellaneous itemized deductions.

ADJUSTED BASIS

Adjusted basis is your basis in the property (usually cost) increased or decreased by various events, such as improvements and casualty losses.

INSURANCE AND OTHER REIMBURSEMENTS

If you receive an insurance payment or other type of reimbursement, you must subtract the reimbursement when you figure your loss. You do not have a casualty or theft loss to the extent you are reimbursed.

If in the year of the casualty there is a claim for reimbursement with a reasonable prospect of recovery, the loss is not sustained until you know with reasonable certainty whether such reimbursement will be received. If you expect to be reimbursed for part or all of your loss, you must subtract the expected reimbursement when you figure your loss. You must reduce your loss even if you do not receive payment until a later tax year.

Failure to file a claim for reimbursement. If your property is covered by insurance, you must file a timely insurance claim for reimbursement of your loss. Otherwise, you cannot deduct this loss as a casualty or theft loss. However, this rule does not apply to the portion of the loss not covered by insurance (for example, a deductible).

Example

Your car insurance policy includes comprehensive coverage with a $1,000 deductible. Because your insurance does not cover the first $1,000 of damages resulting from a storm, the $1,000 is deductible (subject to the deduction limits discussed later). This is true even if you do not file an insurance claim, because your insurance policy will not reimburse you for the deductible.

Types of Reimbursements

The most common type of reimbursement is an insurance payment for your stolen or damaged property. Other types of reimbursements are discussed next. Also see the Instructions for Form 4684.

Employer's emergency disaster fund. If you receive money from your employer's emergency disaster fund and you must use that money to rehabilitate or replace property on which you are claiming a casualty loss deduction, you must take that money into consideration in figuring the casualty loss deduction. Take into consideration only the amount you used to replace your destroyed or damaged property.

Example

Your home was extensively damaged by a tornado. Your loss after reimbursement from your insurance company was $10,000. Your employer set up a disaster relief fund for its employees. Employees receiving money from the fund had to use it to rehabilitate or replace their damaged or destroyed property. You received $4,000 from the fund and spent the entire amount on repairs to your home. In figuring your casualty loss, you must reduce your unreimbursed loss ($10,000) by the $4,000 you received from your employer's fund. Your casualty loss before applying the deduction limits is $6,000.

Cash gifts. If you receive excludable cash gifts as a disaster victim and there are no limits on how you can use the money, you do not reduce your casualty loss by these excludable cash gifts. This applies even if you use the money to pay for repairs to property damaged in the disaster.

Example

Your home was damaged by a hurricane. Relatives and neighbors made cash gifts to you that were excludable from your income. You used part of the cash gifts to pay for repairs to your home. There were

no limits or restrictions on how you could use the cash gifts. Because it was an excludable gift, the money you received and used to pay for repairs to your home does not reduce your casualty loss on the damaged home.

Insurance payments for living expenses. You do not reduce your casualty loss by insurance payments you receive to cover living expenses in either of the following situations:

- You lose the use of your main home because of a casualty.
- Government authorities do not allow you access to your main home because of a casualty or threat of one.

Inclusion in income. If these insurance payments are more than the temporary increase in your living expenses, you must include the excess in your income. Report this amount on Schedule 1 (Form 1040), line 8. However, if the casualty occurs in a federally declared disaster area, none of the insurance payments are taxable.

A temporary increase in your living expenses is the difference between the actual living expenses you and your family incurred during the period you could not use your home and your normal living expenses for that period. Actual living expenses are the reasonable and necessary expenses incurred because of the loss of your main home. Generally, these expenses include the amounts you pay for the following:

- Rent for suitable housing.
- Transportation.
- Food.
- Utilities.
- Miscellaneous services.

Normal living expenses consist of these same expenses that you would have incurred but did not because of the casualty or the threat of one.

Example

As a result of a hurricane, you vacated your apartment for a month and moved to a motel. You normally pay $525 a month for rent. None was charged for the month the apartment was vacated. Your motel rent for this month was $1,200. You normally pay $200 a month for food. Your food expenses for the month you lived in the motel were $400. You received $1,100 from your insurance company to cover your living expenses. You determine the payment you must include in income as follows:

1)	Insurance payment for living expenses		$1,100
2)	Actual expenses during the month you are unable to use your home because of the hurricane	1,600	
3)	Normal living expenses	725	
4)	Temporary increase in living expenses: Subtract line 3 from line 2		875
5)	**Amount of payment includible in income: Subtract line 4 from line 1**		**$225**

Tax year of inclusion. You include the taxable part of the insurance payment in income for the year you regain the use of your main home or, if later, for the year you receive the taxable part of the insurance payment.

Example

Your main home was destroyed by a tornado in June 2020. You regained use of your home in November 2021. The insurance payments you received in 2020 and 2021 were $1,500 more than the temporary

increase in your living expenses during those years. You include this amount in income on your 2021 Form 1040. If, in 2022, you receive further payments to cover the living expenses you had in 2020 and 2021, you must include those payments in income on your 2022 Form 1040 or 1040-SR.

Disaster relief. Food, medical supplies, and other forms of assistance you receive do not reduce your casualty loss unless they are replacements for lost or destroyed property.

Tip
Qualified disaster relief payments you receive for expenses you incurred as a result of a federally declared disaster are not taxable income to you.

Disaster unemployment assistance payments are unemployment benefits that are taxable.
Generally, disaster relief grants and qualified disaster mitigation payments made under the Stafford Act are not includible in your income.

Reimbursement Received After Deducting Loss
If you figured your casualty or theft loss using the amount of your expected reimbursement, you may have to adjust your tax return for the tax year in which you receive your actual reimbursement. This section explains the adjustment you may have to make.
Actual reimbursement less than expected. If you later receive less reimbursement than you expected, include that difference as a loss with your other losses (if any) on your return for the year in which you can reasonably expect no more reimbursement.

Example
Your personal car had an FMV of $2,000 when it was destroyed in a collision with another car in 2021. The accident was due to the negligence of the other driver. At the end of 2021, there was a reasonable prospect that the owner of the other car would reimburse you in full. You did not have a deductible loss in 2021.
In January 2022, the court awarded you a judgment of $2,000. However, in July it became apparent that you will be unable to collect any amount from the other driver. You can deduct the loss in 2022 (to the extent it does not exceed your 2022 personal casualty gains) subject to the deduction limits discussed later.

Actual reimbursement more than expected. If you later receive a larger reimbursement amount than you expected, after you claimed a deduction for the loss, you may have to include the extra reimbursement amount in your income for the year you receive it. However, if any part of the original deduction did not reduce your tax for the earlier year, do not include that part of the reimbursement amount in your income. You do not refigure your tax for the year you claimed the deduction.

Caution!
If the total of all the reimbursements you receive is more than your adjusted basis in the destroyed or stolen property, you will have a gain on the casualty or theft. If you have already taken a deduction for a loss and you receive the reimbursement in a later year, you may have to include the gain in your income for the later year. Include the gain as ordinary income up to the amount of your deduction that reduced your tax for the earlier year.

Actual reimbursement same as expected. If you later receive exactly the reimbursement you expected to receive, you do not have to include any of the reimbursement in your income and you cannot deduct any additional loss.

Example
In December 2022, your personal car was damaged in a flood that was a federally declared disaster. Repairs to the car cost $950. You had $100 deductible comprehensive insurance. Your insurance company agreed to reimburse you for the rest of the damage. Because you expected a reimbursement from the insurance company, you did not have a casualty loss deduction in 2022.
Due to the $100 rule (discussed later under Deduction Limits), you cannot deduct the $100 you paid as the deductible. When you receive the $850 from the insurance company in 2023, do not report it as income.

SINGLE CASUALTY ON MULTIPLE PROPERTIES
Personal property. Personal property is any property that is not real property. If your personal property is stolen or is damaged or destroyed by a casualty, you must figure your loss separately for each item of property. Then combine these separate losses to figure the total loss from that casualty or theft.

Example
A flood in your home damaged an upholstered chair, an oriental rug, and an antique table. You did not have flood insurance to cover your loss. (This was the only casualty or theft you had during the year.) You paid $750 for the chair and you established that it had an FMV of $500 just before the flood. The rug cost $3,000 and had an FMV of $2,500 just before the flood. You bought the table at an auction for $100 before discovering it was an antique. It had been appraised at $900 before the flood. You figure your loss on each of these items as follows:

		Chair	Rug	Table
1)	Basis (cost)	$750	$3,000	$100
2)	FMV before flood	$500	$2,500	$900
3)	FMV after flood	-0-	-0-	-0-
4)	Decrease in FMV	$500	$2,500	$900
5)	Loss (smaller of (1) or (4))	$500	$2,500	$100
6)	Total loss			**$3,100**

Real property. In figuring a casualty loss on personal-use real property, treat the entire property (including any improvements, such as buildings, trees, and shrubs) as one item. Figure the loss using the smaller of the adjusted basis or the decrease in FMV of the entire property.

Example
You bought your home a few years ago. You paid $160,000 ($20,000 for the land and $140,000 for the house). You also spent $2,000 for landscaping. This year a tornado destroyed your home. The tornado also damaged the shrubbery and trees in your yard. The tornado was your only casualty or theft loss this year. Competent appraisers valued the property as a whole at $200,000 before the tornado, but only $30,000 after the tornado. (The loss to your household furnishings is not shown in this example. It would be figured separately on each item, as explained earlier under Personal property.) Shortly after the tornado, the insurance company paid you $155,000 for the loss. You figure your casualty loss as follows:

1)	Adjusted basis of the entire property (land, building, and landscaping)	$162,000
2)	FMV of entire property before tornado	$200,000
3)	FMV of entire property after tornado	30,000
4)	Decrease in FMV of entire property	$170,000
5)	Loss (smaller of (1) or (4))	$162,000
6)	Subtract insurance	155,000
7)	**Amount of loss after reimbursement**	**$7,000**

VIII. Deduction Limits

After you have figured the amount of your casualty or theft loss, you must figure how much of the loss you can deduct.

The deduction for casualty and theft losses of personal-use property is limited. For tax years beginning after 2017 and before 2026, personal casualty and theft losses of an individual are deductible only to the extent they are attributable to a federally declared disaster. The loss deduction is subject to the $100 and 10% rules, discussed later.

An exception to the rule above limiting the personal casualty and theft loss deduction to losses attributable to a federally declared disaster applies if you have personal casualty gains for the tax year. In this case, you may reduce your personal casualty gains by any casualty losses not attributable to a federally declared disaster. Any excess gain is used to reduce losses from a federally declared disaster. The 10% rule is applied to any federal disaster losses that remain.

You make these reductions on Form 4684.

These rules are explained next and Table 6-1 summarizes how to apply the $100 rule and the 10% rule in various situations.

TABLE 6-1 HOW TO APPLY THE DEDUCTION LIMITS FOR PERSONAL-USE PROPERTY

		$100 Rule	**10% Rule**
General Application		You must reduce each casualty or theft loss by $100 when figuring your deduction. Apply this rule after you have figured the amount of your loss.*	You must reduce your total casualty or theft loss attributable to a federally declared disaster by 10% of your AGI. Apply this rule after you reduce each loss by $100 ($100 rule).**
Single Event		Apply this rule only once, even if many pieces of property are affected.	Apply this rule only once, even if many pieces of property are affected.
More Than One Event		Apply to the loss from each event.	Apply to the total of all your losses from all federally declared disasters.
More Than One Person- With Loss from the Same Event (other than a married couple filing jointly)		Apply separately to each person.	Apply separately to each person.
Married Couple- With	Filing Jointly	Apply as if you were one person.	Apply as if you were one person.

Loss From the Same Event	Filing Separately	Apply separately to each spouse.	Apply separately to each spouse.
More Than One Owner (other than a married couple filing jointly)		Apply separately to each owner of jointly owned property	Apply separately to each owner of jointly owned property
**Qualified disaster losses must be reduced by $500 when figuring your deduction.*			
***The 10% rule does not apply to qualified disaster losses.*			

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

$100 RULE

After you have figured your casualty or theft loss on personal-use property, you must reduce that loss by $100. This reduction applies to each total casualty or theft loss, including those losses not attributable to a federally declared disaster that are applied to reduce your personal casualty gains. It does not matter how many pieces of property are involved in an event. Only a single $100 reduction applies.

Example

A tornado damages your home and your car. Determine the amount of loss, as discussed earlier, for each of these items. Since the losses are due to a single event, you combine the losses and reduce the combined amount by $100.

Caution!

Qualified disaster losses must be reduced by $500 instead of $100. See Pub. 976 and the Instructions for Form 4684 for more information.

Single event. Generally, events closely related in origin cause a single casualty. It is a single casualty when the damage is from two or more closely related causes, such as wind and flood damage caused by the same storm.

10% RULE

You must reduce your total federal casualty losses by 10% of your AGI. Apply this rule after you reduce each loss by $100. If you have both gains and losses from casualties or thefts, see Gains and losses, later.

Example 1

In September, your house was damaged by a tropical storm that was a federally declared disaster. Your loss after insurance reimbursement was $2,000. Your AGI for the year the loss was sustained is $29,500. You first apply the $100 rule and then the 10% rule. Figure your casualty loss deduction as follows:

1)	Loss after insurance	$2,000
2)	Subtract $100	100
3)	Loss after $100 rule	$1,900
4)	Subtract 10% × $29,500 AGI	2,950
5)	Casualty loss deduction	-0-

You do not have a casualty loss deduction because your loss after you apply the $100 rule ($1,900) is less than 10% of your AGI ($2,950).

Caution!
The 10% rule does not apply to qualified disaster losses.

Example 2
In March, your car was destroyed in a flood that was a federally declared disaster. You did not have insurance on your car, so you did not receive any insurance reimbursement. Your loss on the car was $1,800. In November, another flood, which also was a federally declared disaster, damaged your basement and totally destroyed the furniture, washer, dryer, and other items stored there. Your loss on the basement items after reimbursement from your insurer was $2,100. Your AGI for the year that the floods occurred is $25,000. You figure your casualty loss deduction as follows:

		Car	Basement
1)	Loss	$1,800	$2,100
2)	Subtract $100 per incident	100	100
3)	Loss after $100 rule	$1,700	$2,000
4)	Total loss		$3,700
5)	Subtract 10% × $25,000 AGI		2,500
6)	**Casualty loss deduction**		**$1,200**

Gains and losses. If you had both gains and losses from casualties or thefts to your personal-use property, you must compare your total gains to your total losses. Do this after you have reduced each loss by any reimbursements and by $100, but before you have reduced the federal casualty losses by 10% of your AGI.

Caution!
Casualty or theft gains do not include gains you choose to postpone.

Losses more than gains. If your losses are more than your recognized gains, subtract your gains from your losses and reduce the result by 10% of your AGI. The rest, if any, is your deductible loss from personal-use property. If you have losses not attributable to a federally declared disaster, see Line 14 in the Instructions for Form 4684. Losses not attributable to a federally declared disaster can only be used to offset gains.
Gains more than losses. If your recognized gains are more than your losses, subtract your losses from your gains. The difference is treated as capital gain and must be reported on Schedule D (Form 1040). The 10% rule does not apply to your gains. If you have losses not attributable to a federally declared disaster, see Line 14 in the Instructions for Form 4684.

IX. When To Report Gains And Losses

Gains. If you receive an insurance or other reimbursement that is more than your adjusted basis in the destroyed or stolen property, you have a gain from the casualty or theft. You must include this gain in your income in the year you receive the reimbursement, unless you choose to postpone reporting the gain.

Losses. Generally, you can deduct a casualty loss that is not reimbursable only in the tax year in which the casualty occurred. This is true even if you do not repair or replace the damaged property until a later year. (However, see Disaster Area Loss, later, for an exception.)
You can deduct theft losses that are not reimbursable only in the year you discover your property was stolen.
If in the year of the casualty there is a claim for reimbursement with a reasonable prospect of recovery, the loss is not sustained until you know with reasonable certainty whether such reimbursement will be received. If you are not sure whether part of your casualty or theft loss will be reimbursed, do not deduct that part until the tax year when you become reasonably certain that it will not be reimbursed. This later tax year is when your loss is sustained.
If you have a loss, see Table 6-2.

TABLE 6-2. WHEN TO DEDUCT A LOSS

IF you have a loss...*	THEN deduct it in the...
from a casualty*	year the loss occurred.
in a federally declared disaster area	disaster year or the year immediately before the disaster year.
from a theft	year the theft was discovered.
on a deposit treated as a casualty	year a reasonable estimate can be made.
**If you are an individual, casualty and theft losses of personal-use property are deductible only if the loss is attributable to a federally declared disaster. An exception applies where you have personal casualty gains.*	

Loss on deposits. If your loss is a loss on deposits in an insolvent or bankrupt financial institution, see Loss on Deposits, earlier.

DISASTER AREA LOSS
A disaster loss is a loss that occurred in an area determined by the President of the United States to warrant assistance by the Federal government under the Stafford Act and that is attributable to a federally declared disaster. Disaster area includes areas warranting public or individual assistance (or both). A federally declared disaster includes a major disaster or emergency declaration.
You generally must deduct a casualty loss in the year it occurred. However, if you have a casualty loss from a federally declared disaster that occurred in an area warranting public or individual assistance (or both), you can elect to deduct the loss on your tax return or amended return for either of the following years:

- The year the loss was sustained (the disaster year).
- The year immediately preceding the disaster year.

You must make the election to take your casualty loss for the disaster in the preceding year on or before the date that is 6 months after the regular due date for filing your original return (without extensions) for the disaster year.
If you claimed a deduction for a disaster loss in the disaster year and you wish to deduct the loss in the preceding year, you must file an amended return to remove the previously deducted loss on or before you file the return or amended return for the preceding year that includes the disaster loss deduction.
Gains. Special rules apply if you choose to postpone reporting gain on property damaged or destroyed in a federally declared disaster area.
Postponed tax deadlines. The IRS may postpone for up to 1 year certain tax deadlines of taxpayers who are affected by a federally declared disaster. The tax deadlines the IRS may postpone include those for filing income and employment tax returns, paying income and employment taxes, and making contributions to a traditional IRA or Roth IRA.

If any tax deadline is postponed, the IRS will publicize the postponement in your area and publish a news release, and, where necessary, in a revenue ruling, revenue procedure, notice, announcement, or other guidance in the Internal Revenue Bulletin (IRB).

Who is eligible. If the IRS postpones a tax deadline, the following taxpayers are eligible for the postponement:

- Any individual whose main home is located in a covered disaster area (defined next).
- Any business entity or sole proprietor whose principal place of business is located in a covered disaster area.
- Any individual who is a relief worker affiliated with a recognized government or philanthropic organization who is assisting in a covered disaster area.
- Any individual, business entity, or sole proprietorship whose records are needed to meet a postponed tax deadline, provided those records are maintained in a covered disaster area. The main home or principal place of business does not have to be located in the covered disaster area.
- Any estate or trust that has tax records necessary to meet a postponed tax deadline, provided those records are maintained in a covered disaster area.
- The spouse on a joint return with a taxpayer who is eligible for postponements.
- Any individual, business entity, or sole proprietorship not located in a covered disaster area, but whose records necessary to meet a postponed tax deadline are located in the covered disaster area.
- Any individual visiting the covered disaster area who was killed or injured as a result of the disaster.
- Any other person determined by the IRS to be affected by a federally declared disaster.

Covered disaster area. This is an area of a federally declared disaster in which the IRS has decided to postpone tax deadlines for up to 1 year.

Abatement of interest and penalties. The IRS may abate the interest and penalties on underpaid income tax for the length of any postponement of tax deadlines.

X. How To Report Gains And Losses

Use Form 4684 to report a gain or a deductible loss from a casualty or theft. If you have more than one casualty or theft, use a separate Form 4684 to determine your gain or loss for each event. Combine the gains and losses on one Form 4684. Follow the form instructions as to which lines to fill out. In addition, you must use the appropriate schedule to report a gain or loss. The schedule you use depends on whether you have a gain or loss.

If you have a:	**Report it on:**
Gain	Schedule D (Form 1040)
Loss	Schedule A (Form 1040)

Adjustments to basis. If you have a casualty or theft loss, you must decrease your basis in the property by any insurance or other reimbursement you receive, and by any deductible loss. If you make either of the basis adjustments described above, amounts you spend on repairs to restore your property to its pre-casualty condition increase your adjusted basis.

Net operating loss (NOL). If your casualty or theft loss deduction causes your deductions for the year to be more than your income for the year, you may have an NOL. You do not have to be in business to have an NOL from a casualty or theft loss.

CHAPTER 6: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CE credit.
We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. Casualty and theft loss deductions were suspended for 2018-2025 unless in a federally declared disaster area or to the extent of a casualty gain.

A. true
B. false

2. Items to consider when figuring the decrease in FMV because of a casualty or theft include which of the following:

A. an appraisal
B. the cost of protection
C. the replacement cost
D. any sentimental value

CHAPTER 6: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.

A. **CORRECT**. This law change was a part of the TCJA of 2017.
B. Incorrect. The TCJA of 2017 eliminated many deductions, including all miscellaneous itemized deductions subject to the 2% of AGI limitation.

2.

A. **CORRECT**. An appraisal should be used to determine the difference between the FMV of the property immediately before a casualty or theft and immediately afterward. The appraiser must recognize the effects of any general market decline that may occur along with the casualty. This information is needed to limit any deduction to the actual loss resulting from damage to the property.
B. Incorrect. The cost of protecting your property against a casualty or theft is not part of a casualty or theft loss. For example, the amount you spend on insurance or to board up your house against a storm is not part of your loss.
C. Incorrect. The cost of replacing stolen or destroyed property is not part of a casualty or theft loss.
D. Incorrect. Do not consider sentimental value when determining your loss. You must base your loss only on an item's FMV.

Chapter 7: Other Itemized Deductions

Chapter Objective
After completing this chapter, you should be able to:

- Identify types of other itemized deductions allowable to reduce adjusted gross income.

I. What's New/Reminders

No miscellaneous itemized deductions allowed. You can no longer claim any miscellaneous itemized deductions. See Miscellaneous Itemized Deductions, later.
Standard mileage rate. The 2022 rate for business use of a vehicle is 58.5 cents per mile for January 1 to June 30, and the rate increases to 62.5 cents per mile for July 1 to December 31.

II. Introduction

This chapter explains that you can no longer claim any miscellaneous itemized deductions, unless you fall into one of the qualified categories of employment claiming a deduction relating to unreimbursed employee expenses. Miscellaneous itemized deductions are those deductions that would have been subject to the 2% of adjusted gross income limitation. You can still claim certain expenses as itemized deductions on Schedule A (Form 1040), Schedule A (Form 1040-NR), or as an adjustment to income on Form 1040 or 1040-SR. This chapter covers the following topics.

- Miscellaneous itemized deductions.
- Expenses you cannot deduct.
- Expenses you can deduct.
- How to report your deductions.

Tip
You must keep records to verify your deductions. You should keep receipts, canceled checks, substitute checks, financial account statements, and other documentary evidence.

III. Miscellaneous Itemized Deductions

You can no longer claim any miscellaneous itemized deductions that are subject to the 2% of adjusted gross income limitation, including unreimbursed employee expenses. However, you may be able to deduct certain unreimbursed employee business expenses if you fall into one of the following categories of employment listed under Unreimbursed Employee Expenses, next.

UNREIMBURSED EMPLOYEE EXPENSES
You can no longer claim a deduction for unreimbursed employee expenses unless you fall into one of the following categories of employment.

- Armed Forces reservists.
- Qualified performing artists.
- Fee-basis state or local government officials.
- Employees with impairment-related work expenses.

CATEGORIES OF EMPLOYMENT

You can deduct unreimbursed employee expenses only if you qualify as an Armed Forces reservist, qualified performing artist, fee-basis state or local government official, and employee with impairment-related work expenses.

Armed Forces reservist (member of a reserve component). You are a member of a reserve component of the Armed Forces of the United States if you are in the Army, Navy, Marine Corps, Air Force, or Coast Guard Reserve; the Army National Guard of the United States; or the Reserve Corps of the Public Health Service.

Qualified performing artist. You are a qualified performing artist if you:

1. Performed services in the performing arts as an employee for at least two employers during the tax year,
2. Received from at least two of the employers' wages of $200 or more per employer,
3. Had allowable business expenses attributable to the performing arts of more than 10% of gross income from the performing arts, and
4. Had adjusted gross income of $16,000 or less before deducting expenses as a performing artist.

Fee-basis state or local government official. You are a qualifying fee-basis official if you are employed by a state or political subdivision of a state and are compensated, in whole or in part, on a fee basis.

Employee with impairment-related work expenses. Impairment-related work expenses are the allowable expenses of an individual with physical or mental disabilities for attendant care at his or her place of employment. They also include other expenses in connection with the place of employment that enable the employee to work.

Allowable unreimbursed employee expenses. If you qualify as an employee in one of the categories mentioned above, you may be able to deduct the following items as unreimbursed employee expenses.

Unreimbursed employee expenses for individuals in these categories of employment are deducted as adjustments to gross income. Qualified employees listed in one of the categories above must complete Form 2106 to take the deduction.

You can deduct only unreimbursed employee expenses that are:

- Paid or incurred during your tax year,
- For carrying on your trade or business of being an employee, and
- Ordinary and necessary.

An expense is ordinary if it is common and accepted in your trade, business, or profession. An expense is necessary if it is appropriate and helpful to your business. An expense does not have to be required to be considered necessary.

EDUCATOR EXPENSES

If you were an eligible educator in 2022, you can deduct up to $300 of qualified expenses you paid in 2022 as an adjustment to gross income on Schedule 1 (Form 1040), line 11, rather than as a miscellaneous itemized deduction. If you and your spouse are filing jointly and both of you were eligible educators, the maximum deduction is $600. However, neither spouse can deduct more than $300 of his or her qualified expenses.

EXPENSES YOU CANNOT DEDUCT

Because of the suspension of miscellaneous itemized deductions, there are two categories of expenses you cannot deduct: Miscellaneous itemized deductions subject to the 2% AGI limitation, and those expenses that are traditionally nondeductible under the Internal Revenue Code. Both categories of deduction are discussed next.

Miscellaneous Deductions Subject to 2% AGI

Unless you fall into one of the qualified categories of employment under Unreimbursed Employee Expenses, earlier, miscellaneous itemized deductions that are subject to the 2% of adjusted gross income limitation can no longer be claimed. For expenses not related to unreimbursed employee expenses, you generally cannot deduct the following expenses, even if you fall into one of the qualified categories of employment listed earlier.

Appraisal Fees
Appraisal fees you pay to figure a casualty loss or the fair market value of donated property are miscellaneous itemized deductions and can no longer be deducted.

Casualty and Theft Losses
Damaged or stolen property used in performing services as an employee is a miscellaneous deduction and can no longer be deducted.

Clerical Help and Office Rent
Office expenses, such as rent and clerical help, you pay in connection with your investments and collecting taxable income on those investments are miscellaneous itemized deductions and are no longer deductible.

Credit or Debit Card Convenience Fees
The convenience fee charged by the card processor for paying your income tax (including estimated tax payments) by credit or debit card is a miscellaneous itemized deduction and is no longer deductible.

Depreciation on Home Computer
If you use your home computer to produce income (for example, to manage your investments that produce taxable income), the depreciation of the computer for that part of the usage of the computer is a miscellaneous itemized deduction and is no longer deductible.

Fees To Collect Interest and Dividends
Fees you pay to a broker, bank, trustee, or similar agent to collect your taxable bond interest or dividends on shares of stock are miscellaneous itemized deductions and can no longer be deducted.

Hobby Expenses
A hobby is not a business because it is not carried on to make a profit. Hobby expenses are miscellaneous itemized deductions and can no longer be deducted.

Indirect Deductions of Pass-Through Entities
Pass-through entities include partnerships, S corporations, and mutual funds that are not publicly offered. Deductions of pass-through entities are passed through to the partners or shareholders. The partners or shareholders share of passed-through deductions for investment expenses are miscellaneous itemized deductions and can no longer be deducted.
Nonpublicly offered mutual funds. These funds will send you a Form 1099-DIV, Dividends and Distributions, or a substitute form, showing your share of gross income and investment expenses. The investment expenses reported on Form 1099-DIV are a miscellaneous itemized deduction and are no longer deductible.

Investment Fees and Expenses

Investment fees, custodial fees, trust administration fees, and other expenses you paid for managing your investments that produce taxable income are miscellaneous itemized deductions and are no longer deductible.

Legal Expenses
You usually can deduct legal expenses that you incur in attempting to produce or collect taxable income or that you pay in connection with the determination, collection, or refund of any tax.
Legal expenses that you incur in attempting to produce or collect taxable income, or that you pay in connection with the determination, collection, or refund of any tax are miscellaneous itemized deductions and are no longer deductible.
You can deduct expenses of resolving tax issues relating to profit or loss from business (Schedule C), rentals or royalties (Schedule E), or farm income and expenses (Schedule F) on the appropriate schedule. Expenses for resolving nonbusiness tax issues are miscellaneous itemized deductions and are no longer deductible.

Loss on Deposits

Repayments of Income
Generally, repayments of amounts that you included in income in an earlier year is a miscellaneous itemized deduction and can no longer be deducted. If you had to repay more than $3,000 that you included in your income in an earlier year, you may be able to deduct the amount. See Repayments Under Claim of Right, later.

Safe Deposit Box Rent
Rent you pay for a safety deposit box you use to store taxable income-producing stocks, bonds, or investment related papers is a miscellaneous itemized deduction and can no longer be deducted. You cannot deduct the rent if you use the box only for jewelry, other personal items, or tax-exempt securities.

Service Charges on Dividend Reinvestment Plans
Service charges you pay as a subscriber in a dividend reinvestment plan are a miscellaneous itemized deduction and can no longer be deducted. These service charges include payments for:

- Holding shares acquired through a plan,
- Collecting and reinvesting cash dividends, and
- Keeping individual records and providing detailed statements of accounts.

Tax Preparation Fees
Tax preparation fees on the return for the year in which you pay them are a miscellaneous itemized deduction and can no longer be deducted. These fees include the cost of tax preparation software programs and tax publications. They also include any fee you paid for electronic filing of your return.

Trustee's Administrative Fees for IRA
Trustee's administrative fees that are billed separately and paid by you in connection with your IRA are a miscellaneous itemized deduction and can no longer be deducted.

IV. Nondeductible Expenses

In addition to the miscellaneous itemized deductions discussed earlier, you cannot deduct the following expenses.

LIST OF NONDEDUCTIBLE EXPENSES

- Adoption expenses.
- Broker's commissions.
- Burial or funeral expenses, including the cost of a cemetery lot.
- Campaign expenses.
- Capital expenses.
- Check-writing fees.
- Club dues.
- Commuting expenses.
- Fees and licenses, such as car licenses, marriage licenses, and dog tags.
- Fines or penalties.
- Health spa expenses.
- Hobby losses, but see Hobby Expenses, earlier.
- Home repairs, insurance, and rent.
- Home security system.
- Illegal bribes and kickbacks.
- Investment-related seminars.
- Life insurance premiums paid by the insured.
- Lobbying expenses.
- Losses from the sale of your home, furniture, personal car, etc.
- Lost or misplaced cash or property.
- Lunches with co-workers.
- Meals while working late.
- Medical expenses as business expenses other than medical examinations required by your employer.
- Personal disability insurance premiums.
- Personal legal expenses.
- Personal, living, or family expenses.
- Political contributions.
- Professional accreditation fees.
- Professional reputation improvement expense.
- Relief fund contributions.
- Residential telephone line.
- Stockholders' meeting attendance expenses.
- Tax-exempt income earning/collecting expenses.
- The value of wages never received or lost vacation time.
- Travel expenses for another individual.
- Voluntary unemployment benefit fund contributions.
- Wristwatches.

Adoption Expenses

You cannot deduct the expenses of adopting a child, but you may be able to take a credit for those expenses.

Campaign Expenses

You cannot deduct campaign expenses of a candidate for any office, even if the candidate is running for reelection to the office. These include qualification and registration fees for primary elections.

Legal fees. You cannot deduct legal fees paid to defend charges that arise from participation in a political campaign.

Check-Writing Fees on Personal Account
If you have a personal checking account, you cannot deduct fees charged by the bank for the privilege of writing checks, even if the account pays interest.

Club Dues
Generally, you cannot deduct the cost of membership in any club organized for business, pleasure, recreation, or other social purpose. This includes business, social, athletic, luncheon, sporting, airline, hotel, golf, and country clubs.
You cannot deduct dues paid to an organization if one of its main purposes is to:

- Conduct entertainment activities for members or their guests, or
- Provide members or their guests with access to entertainment facilities.

Dues paid to airline, hotel, and luncheon clubs are not deductible.

Commuting Expenses
You cannot deduct commuting expenses (the cost of transportation between your home and your main or regular place of work). If you haul tools, instruments, or other items in your car to and from work, you can deduct only the additional cost of hauling the items such as the rent on a trailer to carry the items.

Fines and Penalties
Generally, no deduction is allowed for fines and penalties paid to a government or specified nongovernmental entity for the violation of any law except in the following situations.

- Amounts that constitute restitution.
- Amounts paid to come into compliance with the law.
- Amounts paid or incurred as the result of certain court orders in which no government or specified nongovernmental agency is a party.
- Amounts paid or incurred for taxes due.

Nondeductible amounts include an amount paid in settlement of your actual or potential liability for a fine or penalty (civil or criminal). Fines or penalties include amounts paid such as parking tickets, tax penalties, and penalties deducted from teachers' paychecks after an illegal strike.
No deduction is allowed for the restitution amount or amount paid to come into compliance with the law unless the amounts are specifically identified in the settlement agreement or court order. Also, any amount paid or incurred as reimbursement to the government for the costs of any investigation or litigation are not eligible for the exceptions and are nondeductible.

Health Spa Expenses
You cannot deduct health spa expenses, even if there is a job requirement to stay in excellent physical condition, such as might be required of a law enforcement officer.

Home Security System
You cannot deduct the cost of a home security system as a miscellaneous deduction. However, you may be able to claim a deduction for a home security system as a business expense if you have a home office.

Investment-Related Seminars
You cannot deduct any expenses for attending a convention, seminar, or similar meeting for investment purposes.

Life Insurance Premiums
You cannot deduct premiums you pay on your life insurance. You may be able to deduct, as alimony, premiums you pay on life insurance policies assigned to your former spouse.

Lobbying Expenses
You generally cannot deduct amounts paid or in-curred for lobbying expenses. These include expenses to:

- Influence legislation;
- Participate or intervene in any political campaign for, or against, any candidate for public office;
- Attempt to influence the general public, or segments of the public, about elections, legislative matters, or referendums; or
- Communicate directly with covered executive branch officials in any 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.
Dues used for lobbying. If a tax-exempt organization notifies you that part of the dues or other amounts you pay to the organization are used to pay nondeductible lobbying expenses, you cannot deduct that part.

Lost or Mislaid Cash or Property
You cannot deduct a loss based on the mere disappearance of money or property. However, an accidental loss or disappearance of property can qualify as a casualty if it results from an identifiable event that is sudden, unexpected, or unusual.

Lunches With Co-workers
You cannot deduct the expenses of lunches with co-workers, except while traveling away from home on business.

Meals While Working Late
You cannot deduct the cost of meals while working late. However, you may be able to claim a deduction if the cost of meals is a deductible entertainment expense, or if you're traveling away from home.

Personal Legal Expenses
You cannot deduct personal legal expenses such as those for the following.

- Custody of children.
- Breach of promise to marry suit.
- Civil or criminal charges resulting from a personal relationship.
- Damages for personal injury, except for certain unlawful discrimination and whistle-blower claims.
- Preparation of a title (or defense or perfection of a title).
- Preparation of a will.
- Property claims or property settlement in a divorce.

You cannot deduct these expenses even if a result of the legal proceeding is the loss of income-producing property.

Political Contributions

You 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 aren't deductible.

Professional Accreditation Fees
You cannot deduct professional accreditation fees such as the following.

- Accounting certificate fees paid for the initial right to practice accounting.
- Bar exam fees and incidental expenses in securing initial admission to the bar.
- Medical and dental license fees paid to get initial licensing.

Professional Reputation
You cannot deduct expenses of radio and TV appearances to increase your personal prestige or establish your professional reputation.

Relief Fund Contributions
You cannot deduct contributions paid to a private plan that pays benefits to any covered employee who cannot work because of any injury or illness not related to the job.

Residential Telephone Service
You cannot deduct any charge (including taxes) for basic local telephone service for the first telephone line to your residence, even if it is used in a trade or business.

Stockholders' Meetings
You cannot deduct transportation and other expenses you pay to attend stockholders' meetings of companies in which you own stock but have no other interest. You cannot deduct these expenses even if you are attending the meeting to get information that would be useful in making further investments.

Tax-Exempt Income Expenses
You cannot deduct expenses to produce tax-exempt income. You cannot deduct interest on a debt incurred or continued to buy or carry tax-exempt securities.
If you have expenses to produce both taxable and tax-exempt income, but you cannot identify the expenses that produce each type of income, you must divide the expenses based on the amount of each type of income to determine the amount that you can deduct.

Travel Expenses for Another Individual
You generally cannot deduct travel expenses you pay or incur for a spouse, dependent, or other individual who accompanies you (or your employee) on business or personal travel unless the spouse, dependent, or other individual is an employee of the taxpayer, the travel is for a bona fide business purpose, and such expenses would otherwise be deductible by the spouse, dependent, or other individual.

Voluntary Unemployment Benefit Fund Contributions
You cannot deduct voluntary unemployment benefit fund contributions you make to a union fund or a private fund. However, you can deduct contributions as taxes if state law requires you to make them to a state unemployment fund that covers you for the loss of wages from unemployment caused by business conditions.

Wristwatches

You cannot deduct the cost of a wristwatch, even if there is a job requirement that you know the correct time to properly perform your duties.

V. Expenses You Can Deduct

You can deduct the items listed below as itemized deductions. Report these items on Schedule A (Form 1040), line 16, or Schedule A (Form 1040-NR), line 7.

LIST OF DEDUCTIONS
Each of the following items is discussed in detail after the list (except where indicated).

- Amortizable premium on taxable bonds.
- Casualty and theft losses from income-producing property.
- Excess deductions of an estate or trust.
- Federal estate tax on income in respect of a decedent.
- Gambling losses up to the amount of gambling winnings.
- Impairment-related work expenses of persons with disabilities.
- Losses from Ponzi-type investment schemes.
- Repayments of more than $3,000 under a claim of right.
- Unlawful discrimination claims.
- Unrecovered investment in an annuity.

Amortizable Premium on Taxable Bonds
In general, if the amount you pay for a bond is greater than its stated principal amount, the excess is bond premium. You can elect to amortize the premium on taxable bonds. The amortization of the premium is generally an offset to interest income on the bond rather than a separate deduction item.
Part of the premium on some bonds may be an itemized deduction on Schedule A (Form 1040).

Casualty and Theft Losses of Income-Producing Property
You can deduct a casualty or theft loss as an itemized deduction on Schedule A (Form 1040), line 16, if the damaged or stolen property was income-producing property (property held for investment, such as stocks, notes, bonds, gold, silver, vacant lots, and works of art). First, report the loss in Form 4684, Section B. You may also have to include the loss on Form 4797, if you are otherwise required to file that form. To figure your deduction, add all casualty or theft losses from this type of property included on Form 4684, lines 32 and 38b, or Form 4797, line 18a.

Excess Deductions of an Estate or Trust
Generally, if an estate or trust has an excess deduction resulting from total deductions being greater than its gross income, in the estate's or trust's last tax year, a beneficiary can deduct the excess deductions, depending on its character. The excess deductions retain their character as an adjustment to arrive at adjusted gross income on Schedule 1 (Form 1040), or as a miscellaneous itemized deduction. For more information on excess deductions of an estate or trust, see the Instructions for Schedule K-1 (Form 1041) for a Beneficiary Filing Form 1040.

Federal Estate Tax on Income in Respect of a Decedent
You can deduct the federal estate tax attributable to income in respect of a decedent that you as a beneficiary include in your gross income. Income in respect of the decedent is gross income that the decedent would have received had death not occurred and that was not properly includible in the decedent's final income tax return.

Gambling Losses up to the Amount of Gambling Winnings
You must report the full amount of your gambling winnings for the year on Schedule 1 (Form 1040), line 8. You deduct your gambling losses for the year on Schedule A (Form 1040), line 16. You cannot deduct gambling losses that are more than your winnings.

Caution!
You cannot reduce your gambling winnings by your gambling losses and report the difference. You must report the full amount of your winnings as income and claim your losses (up to the amount of winnings) as an itemized deduction. Therefore, your records should show your winnings separately from your losses.

Tip
Diary of winnings and losses. You must keep an accurate diary or similar record of your losses and winnings.
Your diary should contain at least the following information.

- The date and type of your specific wager or wagering activity.
- The name and address or location of the gambling establishment.
- The names of other persons present with you at the gambling establishment.
- The amount(s) you won or lost.

Impairment-Related Work Expenses
If you have a physical or mental disability that limits your being employed, or substantially limits one or more of your major life activities, such as performing manual tasks, walking, speaking, breathing, learning, and working, you can deduct your impairment-related work expenses.
Impairment-related work expenses are ordinary and necessary business expenses for attendant care services at your place of work and for other expenses in connection with your place of work that are necessary for you to be able to work.
Self-employed. If you are self-employed, enter your impairment-related work expenses on the appropriate form (Schedule C, E, or F) used to report your business income and expenses.

Repayments Under Claim of Right
If you had to repay more than $3,000 that you included in your income in an earlier year because at the time you thought you had an unrestricted right to it, you may be able to deduct the amount you repaid or take a credit against your tax.

Unlawful Discrimination Claims
You may be able to deduct, as an adjustment to income on Schedule 1 (Form 1040), line 24h, attorney fees and court costs for actions settled or decided after October 22, 2004, involving a claim of unlawful discrimination, a claim against the U.S. Government, or a claim made under section 1862(b)(3)(A) of the Social Security Act. However, the amount you can deduct on Schedule 1 (Form 1040), line 24h, is limited to the amount of the judgment or settlement you are including in income for the tax year.

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 investment is recovered tax free, any unrecovered investment can be deducted on the retiree's final income tax return.

CHAPTER 7: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. All of the following categories of employment can continue to claim a deduction for unreimbursed employee expenses post the passage of the TCJA <u>except</u>:

A. Armed Forces reservists
B. qualified performing artists
C. nonprofit organization employees
D. fee-basis state or local government officials

2. In order for employees in certain categories of employment to deduct unreimbursed employee expenses, the expenses must be which of the following:

A. ordinary
B. necessary
C. lavish
D. both A and B above

CHAPTER 7: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.

A. Incorrect. You are a member of a reserve component of the Armed Forces if you are in the Army, Navy, Marine Corps, Air Force, or Coast Guard Reserve; the Army National Guard; or the Reserve Corps of the Public Health Service.
B. Incorrect. You are a qualified performing artist if you performed services in the performing arts as an employee for at least two employers during the tax year, received at least two of the employer's wages of $200 or more per employer, had allowable business expenses attributable to the performing arts of more than 10% of gross income from the performing arts, and had adjusted gross income of $16,000 or less before deducting expenses as a performing artist.
C. **CORRECT**. Nonprofit organization employees are not among the categories listed by the IRS.
D. Incorrect. You are a qualifying fee-basis official if you are employed by a state or political subdivision of a state and are compensated, in whole or in part, on a fee basis.

2.

A. Incorrect. An expense is ordinary if it is common and accepted in your trade, business, or profession. However, this is not the best response.
B. Incorrect. An expense is necessary if it is appropriate and helpful to your business. However, this is not the best response.
C. Incorrect. Lavish expenses are not considered deductible.

D. **CORRECT**. Unreimbursed employee expenses can only be deducted if they are paid or incurred during the taxpayer's tax year, for carrying on the taxpayer's trade or business of being an employee, and ordinary and necessary.

Chapter 8: Section 199a Pass-Through Income Deduction

Chapter Objective
After completing this chapter, you should be able to:

- Identify the rules in the TCJA related to claiming a deduction for "qualified business income."

Note: This chapter has been updated with the Final Regulations and Other IRS Guidance issued by the IRS in January 2019 and inflation adjusted numbers for 2022.

I. ¶4.01 Qualified Business Income

Probably the most complex and far-reaching rule contained in the TCJA is the ability to claim a deduction for "qualified business income." This rule, contained in Code Section 199A, permits proprietors, partners and S corporation shareholders to claim a deduction for up to 20% of the taxable income from their enterprises. This new deduction is termed the "Section 199A deduction" or the "QBI deduction."
The American Jobs Creation Act of 2004 had added a deduction for Income Attributable to Domestic Production Activities. [Code Sec. 199] This rule allowed a deduction for certain income of various domestic production activities – up to 9% of taxable income. To allay some concerns about exportation of jobs, this deduction was limited to 50% of the W-2 wages paid in a taxable year. Thus, outsourcing of jobs could mean the loss of part of the base for the deduction. The Tax Cuts and Jobs Act repealed this deduction, but retained the 50% of W-2 wage rule for the QBI deduction. To accommodate real estate enterprises, which do not always have significant W-2 wage payments, Section 199A provides an alternate test using the basis of depreciable property.
As of 2018, two tax savings mechanisms replace the former Section 199, Domestic Production Activities Deduction:

1. Reduction of the C corporation rate to 21%; and
2. A special deduction for noncorporate taxpayers for qualified business income (QBI).

However, the Further Consolidated Appropriations Act, 2018 [P.L. 115-141] restored the rules of former Section 199 for cooperatives. [P.L. 115-141, Sec. 101(b)(2)(A), Div. T]

DEDUCTION FOR QUALIFIED BUSINESS INCOME (QBI)
Code Section 199A permits a deduction for 20% of certain income from partnerships, proprietorships and S corporations. It also applies to dividends from real estate investment trusts (REITs), income from publicly-traded partnerships (PTPs) and certain payments from cooperatives (COOPs) to their patrons.
The deduction is 20% of the qualifying income, but is limited to 20% of the individual's taxable income, reduced for items taxed as net capital gains (long-term capital gains and qualified dividends). [Code Sec. 199A(a)(1)(B)] The deduction is taken below AGI, although it is available in full for taxpayers who itemize or those who use the standard deduction. [Code Sec. 63(b)(3)]
The rules for income from Real Estate Investment Trusts (REITs) and Publicly Traded Partnerships (PTPs) are straightforward. Commercial businesses, professional service businesses and farms are subject to the most complex rules described below.

- The rules require separate computations for each separate trade or business;
- The income and other items must be effectively connected with a U.S. trade or business;
- There are special rules based on the taxpayer's taxable income (before the § 199A deduction);
- Wage, salary and retirement income are not components of QBI;
- Dividends, including qualified dividends, are not components of QBI;

- Capital gains and losses do not directly enter into the computation of QBI, but these items may affect the ultimate deduction.

Comment
The QBI deduction was written hastily, and was amended several times between its initial exposure in the Senate draft bill and the product that ultimately became law. The various drafters omitted detailed rules which may be necessary to apply the law in its intended manner. Some of these might take the form of technical corrections or other statutory changes down the road. However, the IRS has specific and broad regulatory authority to interpret Section 199A. [Code Sec. 199A(f)(4)] Therefore, its interpretations will have substantial weight of authority and will not be easy to challenge successfully. The Consolidated Appropriations Act, 2018 has already amended rules concerning cooperatives and their patrons.

INCOME FROM REITs AND PTPs
A REIT is a domestic corporation, or association treated as a corporation for federal tax purposes, which qualifies and elects to be treated as a REIT. [Code Sec. 856] Substantially all of its income and assets must be connected with real estate. It must have 100 or more owners and cannot be controlled by a small group. It must distribute at least 90% of its taxable income.
A REIT is taxable as a corporation, except that it deducts the dividends paid to its owners. The owners include the dividends from the REIT as gross income. Some of the dividends may be treated as capital gains and others as ordinary income. [Code Sec. 857]

Comment
REITs are subject to several complex rules as to permissible income, assets and activities. These rules are beyond the scope of this Guide, and are found in Code Sections 856–860.

A PTP exists when interests in the partnership are traded on an established securities market or secondary market. [Code Sec. 7704(b)] A PTP is treated as a corporation unless 90% or more of its gross income is from "passive-type" sources. [Code Sec. 7704(c)] These sources are interest, dividends, real property rents, gains from the disposition of real property, income from oil, gas, mineral and other natural resources, and gains from disposition of any assets used in these income-producing activities. [Code Sec. 7704(d)] There are special rules relating to commodities.
A distribution from a REIT to an individual is not QBI, per se. [Code Sec. 199A(c)(1)] However, a distribution from a REIT qualifies for the 20% deduction if it is not treated as a capital gain or qualified dividend. [Code Sec. 199A(b)(1)(B), 199A(e)(3)] Similarly, an individual's share of income from a PTP is not QBI, although it qualifies for the 20% deduction.
The shareholder deduction for QBI from a REIT or PTP does not depend on the W-2 wages or qualified property of the entity. However, a PTP must have qualifying income from a U.S. trade or business. A PTP may have items of income and gain that do not qualify for the QBI deduction. As a reporting entity, a PTP must inform its partners about the income items that do qualify for this deduction.
Gains from dispositions of interests in REITs and PTPs are generally capital gains. However, if a PTP has unrealized receivables or substantially appreciated inventory items, some or all of the gain on the disposition of an interest in a partnership may be ordinary income. [Code Sec. 751(a)] Ordinary income resulting from the disposition of a PTP qualifies for the QBI deduction.

Comment
Given the requirements for the income and assets of a qualifying PTP, it is unlikely that unrealized receivables and substantially appreciated inventory items would be a significant portion of the

partnership's assets. Therefore, it is unlikely that many gains from the disposition of interests in these entities will be treated as ordinary income.

The deduction for income from a REIT or PTP is the easiest to compute. There is no reference to W-2 wages, qualified property or the taxpayer's taxable income, except for the overall limit. The deduction is the lesser of 20% of the REIT or PTP income or 20% of the individual's taxable income (excluding gains and dividends taxed at capital gain rates).

Example 1
Jeannie, a single individual, has the following income in 2022:

Salary	$100,000
Dividends from REITs (ordinary income)	50,000
Income from PTPs	40,000
AGI	$190,000

Her itemized deductions are $31,000. Thus, her taxable income is $159,000, before any QBI deduction. She calculates her base for the QBI deduction as the lesser of:

Income from REITs and PTPs	$90,000	
Tentative deduction	20%	18,000
Taxable income:		
AGI	190,000	
Less itemized deductions	(31,000)	
Taxable income pre QBI	159,000	
Tentative deduction	20%	31,800
Lesser amount		18,000
199A Deduction		$18,000

When some of the taxable income is taxed as a net capital gain there is another limitation. Since capital gain tax rates already provide an advantage over ordinary income, this amount of taxable income reduces the base for the QBI deduction. [Code Sec. 199A(2)(B)]

Example 2
Merle, a single individual, has the following income in 2022:

Qualified dividends	$100,000
Dividends from REITs	50,000
Income from PTPs	40,000
AGI	$190,000

His itemized deductions are $31,000. Thus, his taxable income before the QBI deduction is $159,000, the same amount reported by Jeannie in Example 1. He calculates his base for the QBI deduction as the lesser of:

Income from REITs and PTPs	$90,000	
Tentative deduction	20%	18,000

Taxable income:		
AGI	190,000	
Less itemized deductions	(31,000)	
Taxable income pre QBI	159,000	
Less net capital gain	(100,000)	
Taxable income limitation	59,000	
Tentative deduction	20%	11,800
Lesser amount		11,800
199A Deduction		$11,800

INCOME FROM SOURCES OTHER THAN REITs AND PTPs

For business income other than from REITs and PTPs, there are several requirements, some of which depend upon the taxpayer's level of income. Rules that do not fluctuate with the taxpayer's income level include:

- The income must be effectively connected with a U.S. trade or business; [Code Sec. 199A(c)(3)(A)(i)]
- Certain income is not QBI, even if it is effectively connected with a U.S. trade or business; [Code Sec. 199A(c)(3)(B)]
- Each taxpayer must compute a separate deduction for each trade or business. [Code Sec. 199A(b)(2)]

Provisions that vary with the taxpayer's income are:

- The deduction is generally limited to 20% of the taxable income if taxable income is less than the taxpayer's QBI. [Code Sec. 199A(a)(1)(B)(i)]
- Income from a specified service business may or may not be part of the base for the QBI deduction, depending on the amount of taxable income and the taxpayer's filing status. [Code Sec. 199A(d)(1)(A), 199A(d)(3)]
- For a business other than specified service activity, the deduction may or may not depend on W-2 wages paid by the taxpayer or qualified property held by the taxpayer, depending on the amount of taxable income and the taxpayer's filing status. [Code Sec. 199A(b)(2)]

EFFECTIVELY CONNECTED WITH TRADE OR BUSINESS WITHIN U.S.

To be QBI, the income must be effectively connected with a U.S. trade or business. [Code Sec. 199A(c)(3)(A)(i)] This rule borrows from Code Section 864(c), in Subchapter N, Tax Based on Income from Sources Within or Without the United States.

The U.S. place of business is also a material factor if it is used for management of U.S. sales, rents or royalties. [Reg. § 1.864-6(b)(2)] Thus, rentals and royalties from U.S. property are clearly within this requirement. Any business conducted in Puerto Rico is treated as a U.S. trade or business for this purpose. [Code Sec. 199A(f)(1)(C)(i)]

Section 864(c) contains several rules applicable to foreign persons and entities and most of its language is concerned with what is not U.S. source income. The principal test is based on having an office or other fixed place of business within the U.S., if the place is a material factor in the realization of the income, gain, or loss, and if the income, gain, or loss is realized in the ordinary course of the trade or business carried on through that office or other fixed place of business. [Reg. § 1.864-6(b)(1)]

INCOME NOT TREATED AS QUALIFIED BUSINESS INCOME

Certain income is not QBI, even if it is effectively connected with a U.S. trade or business. [Code Sec. 199A(c)(3)(B)]

These items include:

- Long-term and short-term capital gains and losses;
- Dividends and equivalents (other than patronage dividends from cooperatives);
- Interest (other than that properly allocable to a trade or business); and
- Annuities (unless properly allocable to a trade or business).

In addition, wage or salary income received from the activity does not constitute QBI for an S corporation shareholder-employee. [Code Sec. 199A(c)(4)(A)] Similarly, guaranteed payments received by a partner, as well as any amounts received by a partner in a nonpartner capacity do not count as QBI. [Code Sec. 199A(c)(4)(B), (C)]

Example 3

Sandy and Paul are the sole and equal shareholders of Sapco, an S corporation. Sandy is the president and active manager of the corporation's business. Paul, her brother, lives in another state and is a passive investor. All of the business income in 2022 is QBI. The net income, after payment of Sandy's $200,000 salary, is $600,000. There are no other employees of Sapco. Sandy and Paul would each treat $300,000 as qualified business income and would each treat their portions of Sandy's salary as qualifying W-2 wages (see discussion below). Therefore, assuming that both shareholders had taxable income in excess of the threshold and phaseout limits, they could claim a QBI deduction of $50,000, the lesser of 20% of QBI or 50% of their allocable W-2 wages. Sandy cannot claim any of her salary as QBI.

Example 4

Assume the same facts in Example 3 except that Sapco is a limited liability company, treated as a partnership for federal income tax purposes. Sandy's compensation is a guaranteed payment for services. Since guaranteed payments are not reported on Form W-2, Sapco has no qualifying W-2 wages. If the partners are above the threshold and phaseout ranges, they cannot claim any QBI deduction.

These rules do not restrict QBI to ordinary income, per se. As a matter of fact, due to the incorporation of the Section 864 rules, gains from sales of property used in a U.S. trade or business are not excluded from QBI.

Example 5

Salty, an S corporation realized $85,000 of ordinary income in 2022. It also sold some business assets, resulting in a $25,000 depreciation recapture and $45,000 of Section 1231 gain from the sale of depreciated real estate. Salty also reported interest and dividend income of $10,000 from portfolio investments. Salty has no sources of income from outside the U.S.

The ordinary income and the depreciation recapture are taxable at ordinary income rates. Thus, if any shareholder is at the highest income bracket, and has sufficient taxable income to deduct the entire 20% from Salty, the effective tax rate on this income is 29.6% (80% x 37%). Assuming that the Section 1231 gain is not converted to ordinary income by the five-year lookback rule, it is not treated as part of QBI.

Sally, the sole shareholder of Salty, has no Section 1231 losses in the current or past five years. Her Section 1231 gain is not QBI. She computes her QBI from Salty as:

Ordinary income	$85,000
Depreciation recapture	25,000

QBI	$110,000

TAXABLE INCOME THRESHOLD RULES

Some of the most important tax planning needs to focus on increasing or decreasing taxable income to get certain results for the QBI deduction. Important limits apply to individual taxpayers, based on their level of taxable income.

- If taxable income is below a certain threshold, income from specified services constitutes qualified business income. If the income is above the threshold, this income does not qualify for the QBI deduction.
- If income is below the threshold, the deduction for income from a trade or business other than a specified service activity is not dependent upon the W-2 wages paid by the business or the qualified property held by the business. If the taxpayer's income exceeds the threshold, the deduction for QBI is limited by one or both of these factors.

When income exceeds the threshold, there is a phaseout range. When taxable income exceeds the threshold, but is within the phaseout range, the limits apply in part. When taxable income exceeds the threshold plus the phaseout range, the limits apply in full. The threshold rules depend on the taxpayer's filing status. [Code Sec. 199A(e)(2)]. The thresholds, but not the phaseout ranges, are indexed after 2018.

TABLE 8-1. THRESHOLDS FOR PHASE-IN OF LIMITATIONS (2022)

Filing Status	All Except Married Filing Joint	Married Filing Joint
Threshold	$170,050	$340,100
Phaseout for wage and property limit [Code Sec. 199A(b)(3)(B)] and service income [Code Sec. 199A(d)(3)]	50,000	100,000
End of phaseout	$220,050	$400,100

SEPARATE COMPUTATION FOR EACH TRADE OR BUSINESS

Code Section 199A requires a separate computation of the income and other limits for each qualified trade or business. [Code Sec. 199A(b)(1)(A), Code Sec. 199A(c)(1)] Accordingly, a taxpayer with more than one trade or business may not mix the income of one activity with the W-2 wages or qualified property of another.

Determination of what constitutes a separate trade or business will be problematic for planning and compliance with the new deduction. In some cases, taxpayers may want to separate certain activities, especially when one activity is a specified service business, and another is not.

In other cases, taxpayers will want to combine business ventures so that the income from one enterprise can draw upon the W-2 wages or qualified property of another.

Aggregation of Multiple Trades or Businesses

The Code does not specify rules for aggregation and separation. According to the regulations, each business activity must be treated as a separate trade or business unless aggregation is permitted. [Reg. §1.199A-4(a)] The regulations contain some specific aggregation rules. A pass-through entity that conducts more than one business may aggregate, if the businesses meet the ownership and business relationship rules and if none of the businesses to be aggregated are specified service trades or businesses (SSTBs). If a pass-through entity elects to aggregate businesses, each partner or shareholder is bound by the aggregation of those particular businesses.

Each partner or shareholder may also be allowed to aggregate activities. This aggregation could include businesses conducted by one or more S corporations or partnerships, even if the entities did not elect to aggregate. However, in order to aggregate, all of the owners' aggregate activities must meet the ownership and business relationship tests as discussed below.

The Ownership Tests

There are three basic rules governing the ownership tests.

1. In order to aggregate, a person, entity, or group must own at least 50% of each trade or business. [Reg. §1.199A-4(b)(1)(i)] The ownership must be outright ownership of the entire activity, stock (in S corporations) and capital or profits interest (in partnerships).
2. There must be common ownership for a majority of the taxable year in question. [Reg. §1.199A-4(b)(1)(ii)]
3. All of the businesses must use the same taxable year, not including short years. [Reg. §1.199A-4(b)(1)(iii)]

A taxpayer uses the rules of Code Sections 267(b) and 707(b) to determine constructive ownership for purposes of the aggregation rules. [Reg. §1.199A-4(b)(1)(i)]

The Business Relationship Tests

Each of the eligible businesses must share at least two of these attributes with the others:

1. The products or services must be the same or complementary;
2. The businesses must share the same facilities or business functions such as accounting, and payroll, advertising, etc.; and
3. There must be interdependence between (or among) the businesses. [Reg. §1.199A-4(b) (1)(v)]

Aggregation Election by Pass-Through Entity

The primary burdens on the pass-through entity in this situation are reporting income, deductions, gains, losses, etc., to shareholders and accounting for separate and combined lines of business. The burdens of disallowance, and the benefits of deducting suspended losses, fall entirely on the owners.

Once a pass-through entity makes a grouping election, the owners must group those activities with each other, with activities conducted directly by the taxpayer, or with activities conducted through other S corporations or partnerships, in accordance with the same criteria. [Reg. §1.199A-4(b)(2)(ii)]

Example 6

Green, LLC has several partners. Green owns and operates a highway center. The center has a gas and diesel station, a convenience store and a fast food franchise. Each of these businesses has separate books and records. If Green treats these enterprises as separate activities, each of the owners may group the income or loss from each enterprise with income or loss from other enterprises of a similar nature, assuming that the other activities meet all tests for aggregation with Green's businesses. If Green aggregates the three as a single business, no shareholder will be able to disaggregate the grouping.

Aggregation by Shareholder or Partner

A shareholder or partner may not treat activities owned by a pass-through entity as separate activities if the entity has grouped them together. However, the owners may group certain activities together. This could be useful when combining attributes of separate activities could match income with one venture with W-2 wages paid by another activity or with the qualified property owned by an enterprise under common control. See discussion of these limits below.

Example 7
Sally and Vic are married and file a joint return. Vic is the sole shareholder of Vic's Market, an S corporation that operates a grocery store. Sally is the sole shareholder of J Co., which owns a building and rents it to Vic's Market. This arrangement has been in effect for the entire taxable year. Under Code Section 267(b), Sally and Vic are each treated as the owner of each other's property. Therefore, the rental and grocery meet the ownership test required for aggregation. The store and the building are also interdependent. They are also at the same location. Therefore, Vic and Sally can aggregate the rental and the grocery operation.
The net income from the market and the net income from the rent would be treated as QBI from one business. Sally and Vic would also be able to use the qualified property limit from the rental as one of the factors determining the deduction for the income of the combined entity.

SPECIFIED SERVICE TRADE OR BUSINESS RULES
Any taxpayer whose taxable income exceeds the threshold plus phaseout is not able to claim a deduction for income from a "specified service trade or business." This rule begins by borrowing a definition from Code Section 1202(e)(3)(A), but then makes some modifications. Section 1202(e)(3)(A) lists the following activities as being service businesses:

- Health
- Law
- Engineering (but see below for Section 199A)
- Architecture (but see below for Section 199A)
- Accounting
- Actuarial Science
- Performing Arts
- Consulting
- Athletics
- Financial Services
- Brokerage Services, or
- Any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees.

The regulations treat the reputation of owners or employees as the principal asset of an SSTB only under the following limited circumstances: [Reg. §1.199A-5(b)(2)(xiv)]

- Fees, compensation, or other income is received for endorsing products or services;
- Licenses or fees, compensation, or other income for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity is received;
- Fees, compensation, or other income for appearing at an event or on radio, television, or another media format is received.

Example 8
Ed's Eatery, Inc., an S corporation, owns a gourmet restaurant in an out of the way location. Since Ed's Eatery hired Esther Epicurean, a widely-renowned chef, it is booked every night of the week, and customers need to reserve tables several days in advance. Ed's Eatery is not treated as an SSTB.

Section 199A adds investing and investment management, trading, or dealing in securities, partnership interests, or commodities to the list of specified services. [Code Sec. 199A(d)(2)(B)]

However, Section 199A specifically excludes engineering and architecture. Thus, these professions are governed by the commercial business rules.

TAXABLE INCOME DOES NOT EXCEED THRESHOLD

Taxpayers whose taxable income does not exceed the threshold described in Table 1 treat income from a specified service business as QBI. Thus, if a taxpayer's AGI less the standard deduction or itemized deductions does not exceed $170,050 ($340,100 for married filing joint returns), all of the specified service business income is QBI. [Code Sec. 199A(d)(3)(A)(i)]

Example 9

Dino, a single individual, has the following income in 2022:

Qualified dividends	$10,000
Income from law practice, sole practitioner	120,000
Other ordinary income, not from trade or business, rent or royalty	15,000
Self-employment tax deduction	(8,478)
AGI	$145,000

Dino does not itemize deductions. Subtracting the standard deduction of $12,950 from his AGI, his taxable income is $132,050. He must determine whether or not his taxable income (before the Section 199A deduction) is under the threshold of $170,050. [See
Table 1, above] Since his income is less than the threshold, he treats all of his law practice income as QBI. He calculates his base for the QBI deduction as the lesser of:

Income from law practice, net of self-employment tax deduction	$111,522	
Tentative deduction	20%	$22,304
Taxable income:		
AGI	145,000	
Less standard deduction	(12,950)	
Taxable income pre QBI	123,572	
Less net capital gain	(10,000)	
Taxable income limitation	113,572	
Tentative deduction	20%	22,714
Lesser amount		22,304
Deduction		$22,304

Dino's taxable income is:

Adjusted gross income	$136,522
Standard deduction	(12,950)
QBI deduction	(22,304)
Taxable income	$101,268

TAXABLE INCOME EXCEEDS THRESHOLD PLUS PHASEOUT

When a person's taxable income exceeds the threshold limit of $170,050 ($340,100 for married filing joint return) plus the phaseout range of $50,000 ($100,000 for married filing joint return), none of the income from a specified service business is QBI.

Example 10

Assume the same facts in Example 9, except that Dino's income from his law practice is $220,000. He has the following income in 2022:

Qualified dividends	$10,000
Income from law practice, sole practitioner	220,000
Other ordinary income, not from trade or business, rent or royalty	15,000
Self-employment tax deduction	11,186
AGI	$233,814

Dino does not itemize deductions. Subtracting the standard deduction of $12,950 from his AGI, his taxable income is $220,864. He must determine whether or not his taxable income (before the Section 199A deduction) is under the threshold of $170,050 plus the $50,000 phaseout, or $220,050. [See Table 1] Since his income exceeds the threshold plus the phaseout range, none of his law practice income is QBI. Dino's taxable income is:

Adjusted gross income	$233,814
Standard deduction	(12,950)
QBI deduction	0
Income	$220,864

In this case, the increase of $100,000 of gross income, when comparing Example 10 and Example 9, created $119,596 of additional taxable income ($220,864 - 101,268) resulting from the loss of the QBI deduction.

TAXABLE INCOME EXCEEDS THRESHOLD BUT IS WITHIN PHASEOUT RANGE

When a person's taxable income exceeds the threshold limit of $170,050 ($340,100 for married filing joint return,or $170,150 for married filing separate return)) but is within the phaseout range of $50,000 ($100,000 for married filing joint return), a portion of the income from a specified service business is QBI. To determine the percentage allowed as QBI, the taxpayer must back in from the amount disallowed. The amount disallowed is [Code Sec. 199A(d)(3)(B]:

$$\frac{\text{(Taxable income less threshold)}}{\text{(phaseout range)}}$$

Example 11

Assume the same facts in Example 9 except that Dino's income from his law practice is $180,000. He has the following income in 2022:

Dividends	$10,000
Income from law practice, sole practitioner	180,000
Other ordinary income, not from trade or business, rent or royalty	15,000
Self-employment tax deduction	(10,650)
AGI	$194,350

He does not itemize deductions. Thus, his taxable income is $181,400 ($194,350 – 12,950), before any allowable Section 199A deduction. His income from his law practice is subject to the specified service rules. Since his income exceeds the threshold but not the phaseout range he may treat a portion of his law practice income as QBI.

Taxable income before Section 199A deduction	$181,400
Threshold	(170,050)
Excess	11,350
Phaseout range	50,000
Excess as % of phaseout range ($21,450/50,000)	22.7%
Percent of deduction allowed	77.3%
Service before limit ($180,000 - 10,650)	169,350
QBI	130,907
QBI deduction (20% of permitted specified service business income)	26,182
20% of taxable income before Section 199A deduction (20% of $181,400)	36,280
Lesser of two: QBI deduction	$26,182

Thus, his taxable income is:

Adjusted gross income	$194,350
Standard deduction	(12,950)
QBI deduction	(26,182)
Income	$155,218

INAPPLICABILITY OF W-2 WAGE OR QUALIFIED PROPERTY LIMITS

Qualifying trade or business income, other than that from specified service businesses, is subject to deduction limits based on W-2 wages, and basis of qualified property. These limits are subject to the same threshold and phaseout limits and the same partial allowances that apply to specified service business income. Therefore, these limits only apply when the taxable income is above the threshold but below the full phase-out.

OTHER TRADE OR BUSINESS RULES

U.S. source business income other than specified service business income, is subject to the QBI deduction even for taxpayers whose incomes exceed the threshold. However, there are some special limitations that affect this deduction, which are dependent upon the relationship of the taxpayer's taxable income to the thresholds and phaseouts.

W-2 WAGE LIMITATION

A holdover rule from the now-repealed Domestic Production Activities Deduction is a limitation based on the W-2 wages paid by the business during the taxable year. In general, a taxpayer's QBI deduction is limited to 50% of W-2 wages paid. [Code Sec. 199A(b)(2)(i)]

However, there are some exceptions to this rule. First, the limit does not apply to any taxpayer whose taxable income (before the Section 199A deduction) is less than the threshold amount. [Code Sec. 199A(b)(3)(A)] The threshold and phase-ins are the same as those discussed above under specified service business income.

Moreover, a taxpayer with substantial depreciable property may qualify for the combined W-2 wage and property limitation. W-2 wages include any payment subject to either FICA or withholding. [Code Secs. 199A(b)(4)(A), 6051(a), 3401(a)] Thus, items included on Form W-2, such as health insurance for employees, including S corporation shareholder-employees, constitute part of the W-2 base. Wages paid in Puerto Rico also qualify as part of this base. [Code Sec. 199A(f)(1)(C)(ii)]

However, guaranteed payments to partners are not reported on Form W-2, but, rather, are reported on Form 1065, Schedule K-1. These payments are not part of the W-2 base. The W-2 wages are only those applicable to a qualified trade or business. [Code Sec. 199A(b)(4)(B)] Any wages allocable to foreign source income or to investment income that does not constitute trade or business income, would not be taken into account for this limit.
Moreover, the W-2 wages must be reported on a payroll tax return. This return, if not filed timely, must be filed no later than 60 days following the due date of the return. [Code Sec. 199A(b)(4)(C)]

LIMIT PER TRADE OR BUSINESS
This limitation applies to each separate trade or business. The grouping limitations discussed above may be important in this regard.

Example 12
Surpersoft, Inc, an S corporation, sells and installs specialized computer software. Surpersoft has a substantial payroll. Softmagic, LLC, is owned by the shareholders of Surpersoft, in equal proportions. Softmagic owns the intellectual property rights to the software sold by Surpersoft and receives royalties from Surpersoft on every copy of software it sells. Softmagic has no employees. All of the owners have taxable income in excess of the thresholds and phaseout ranges.
Since the two entities are functionally independent, in similar business lines and have identical ownership, the owners should be able to group income from both entities together and treat them as a unified business for purposes of the Section 199A deduction. Otherwise the income from Softmagic would not qualify for the deduction since it pays no W-2 wages.

TAXABLE INCOME EXCEEDS THRESHOLD PLUS PHASEOUT
When a person's taxable income exceeds the threshold limit of $170,050 ($340,100 for married filing joint return or $170,050 for married filing a separate return) plus the phaseout range of $50,000 ($100,000 for married filing joint return), the W-2 wage limit applies in full.

Example 13
Bryce and Josephine file a joint return in 2022. Their combined income items are:

Ordinary income	$50,000
Capital gains & qualified dividends	60,000
Qualified business income	750,000
AGI	860,000
Itemized deductions	(70,000)
Taxable income before 199A deduction	$790,000

Bryce's business reported $350,000 net income and paid $90,000 W-2 wages this year. Josephine's net income was $400,000 and her business paid $1,300,000 in W-2 wages. They compute each QBI deduction separately and then combine the two.

	Bryce	**Josephine**	**Total**
Net income	$350,000	$400,000	
20% QBI	70,000	80,000	
W-2 wages	90,000	1,300,000	
W-2 limit (50%)	45,000	650,000	
Lesser amount, 2 or 4	**$45,000**	**$80,000**	$125,000

Taxable income limitation (less capital gain)	730,000	20%	146,000
Section 199A deduction			$125,000

Their itemized deductions are $70,000. They compute their taxable income as follows:

AGI	$860,000
Itemized deductions	70,000
Taxable income before 199A deduction	790,000
199A deduction	125,000
Taxable income	$665,000

WAGE AND PROPERTY LIMITATION

As an alternative to the wage limitation, a taxpayer may claim a limit based on W-2 wages plus a percentage of basis of certain property. [Code Sec. 199A(b)(2)(ii)] The first component is 25 percent of the W-2 wage base. The second component is based on the unadjusted basis of certain qualified property held at the end of the year. [Code Sec. 199A(b)(6)] Qualified property has several requirements as described below:

- Only tangible and depreciable property qualifies (thus land and intangibles do not qualify); [Code Sec. 199A(b)(6)(A)]
- The property must be held and available for use at the end of the year; [Code Sec. 199A(b)(6)(A)(i)]
- The property must have been used for production of QBI during the year; [Code Sec. 199A(b)(6)(A)(ii)]
- The "depreciable period" of the property must not have ended at the close of the year; [Code Sec. 199A(b)(6)(A)(iii)]
- There are some special rules relating to the depreciable period, of property, as the term applies to Section 199A:
    - If the property's MACRS life exceeds 10 years, the depreciable period is the last full year MACRS life;
    - For other property, the depreciable period is 10 years.

The MACRS life is determined without regard to any required or elected alternative depreciation system period. The period ends with the last year in which the holder may claim an entire year of depreciation. For nonresidential property, that year would be 39 years, since the mid-month convention applies to real estate. For nonresidential property with a 27½ year, it would be the 27th or 28th year of ownership, depending upon the time of year the property was originally placed in service. For qualified improvement property, subject to the half-year convention or mid-quarter convention, the depreciable period ends with the 15th year.

Example 14

Assume the same facts in Example 13 except that Bryce's business holds $1,500,000 of qualified property at the end of the year and Josephine's business owns $1,000,000 of qualified property (unadjusted basis in both cases). They would compute the QBI deductions as:

	Bryce	**Josephine**	**Total**
Net income	$350,000	$400,000	
Wages paid	90,000	1,300,000	
W-2 limit (50%)	**45,000**	**650,000**	
W-2 + property limit Qualified property	1,500,000	1,000,000	
2.5%	37,500	25,000	

25% W-2 wages	22,500	325,000	
W-2 + property limit	**60,000**	350,000	
Limit, > of W-2 or W-2 + qualified property	60,000	650,000	
20% QBI	70,000	**80,000**	
20% of taxable income (less capital gain) before §199A, from Example 13			146,000
QBI deduction	60,000	80,000	$140,000

Again, their itemized deductions are $70,000. They compute their taxable income as follows:

AGI	$860,000
Itemized deductions	70,000
Taxable income before 199A deduction	790,000
199A deduction	140,000
Taxable income	$650,000

PHASE-IN OF W-2 AND QUALIFIED PROPERTY LIMITS

The limits concerning W-2 wages and qualified property do not apply to taxpayers whose taxable income does not exceed the threshold amount, described in Table 1. [Code Sec. 199A(b)(3)(B)] When taxable income exceeds the threshold, but is still within the phaseout range, the limits apply proportionately. [Code Sec. 199A(b)(3)(B)(i)]

Example 15

Assume the same facts in Example 14, except that Bryce and Josephine also incur a loss from an interest in a Mexican resort in which they materially participate. The loss is $400,000, which reduces their ordinary income from $50,000 to a loss of $350,000. Since this business is not located in the U.S., it has no effect on QBI, per se.

Their joint taxable income, before the Section 199A deduction is:

Ordinary income	($350,000)
Capital gains & qualified dividends	60,000
Qualified business income	750,000
AGI	460,000
Itemized deductions	(70,000)
Taxable income before 199A deduction	390,000

Since they file a joint return, their threshold is $340,100 and their phaseout range is $100,000. Their income is between the threshold and the end of the phaseout range, so they may claim deductions for a portion of QBI in excess of the W-2 or W-2 and qualified property limits.

Their taxable income before the Section 199A deduction of $390,000 exceeds their threshold amount of $340,100 by $49,900. This is 49.9% of the phaseout range. Accordingly, they can claim a Section 199A deduction for 50.1% (1-.499) of the amount by which the QBI exceeds the W-2 and property limits, in addition to the amount allowed by those limits. Their allowable Section 199A deduction, before considering the taxable income limitation, is:

	Bryce	**Josephine**	**Total**
Net income	$350,000	$400,000	
Wages paid	90,000	1,300,000	
W-2 limit (50%)	**45,000**	**650,000**	

W-2 + property limit Qualified property	1,500,000	1,000,000	
2.5%	37,500	25,000	
25% W-2 wages	22,500	325,000	
W-2 + property limit	**60,000**	**350,000**	
Limit, > of W-2 or W-2 + QP	**60,000**	650,000	
20% QBI	70,000	**80,000**	
Excess	10,000	0	
Excess amount/$100,000	49.9%	49.9%	
Excess disallowed	4,990	0	
Excess allowed	5,010	0	
Section 199A deduction	$65,010	$80,000	$145,010

However, in this situation, their taxable income, less capital gain, is only $330,000. Thus, their Section 199A deduction is limited to $66,000. Their taxable income is:

Taxable income before 199A deduction	$390,000
199A deduction	66,000
Taxable income	324,000

EFFECT OF QUALIFIED BUSINESS LOSS

The effect of a loss from a qualified business is to offset income from other qualified businesses. If the overall QBI is still positive, it reduces the QBI from each other business proportionately. [Reg. §1.199A-1(d)(2)(iii)(A)] If the overall QBI is negative, the result is a carryforward, which offsets QBI deductions in future years. [Reg. §1.199A-1(d)(2)(iii)(B)]

Example 16

Assume the same facts in Example 15 except that the resort was in Puerto Rico, rather than Mexico. This loss is an item of negative QBI since any business in Puerto Rico is a U.S. business for purposes of QBI. Their joint taxable income, before the Section 199A deduction is unchanged in total, but the composition is different.

Ordinary income	$50,000
Capital gains & qualified dividends	60,000
Qualified business income	350,000
AGI	460,000
Itemized deductions	(70,000)
Taxable income before 199A deduction	$390,000

The loss from the Puerto Rico activity reduces their Section 199A deduction.

	Bryce	**Josephine**	**Resort**	**Total**
Net income	$350,000	$400,000	($400,000)	
Offset proportionately	(186,667)	(213,333)	400,000	
Net after loss	163,333	186,667		
Wages paid	90,000	1,300,000	0	
W-2 limit (50%)	45,000	650,000	0	
W-2 + property limit Qualified property	1,500,000	1,000,000	0	
2.5%	37,500	25,000	0	

25% W-2 wages	22,500	325,000	0	
W-2 + property limit	60,000	350,000	0	
Limit, > of W-2 or W-2 + QP	60,000	650,000	0	
20% QBI	32,667	37,333		
199A deduction	32,667	37,333		$70,000

However, the taxable income before the QBI deduction, net of capital gains and qualified dividends, is $330,000 Their Section 199A deduction is limited to $66,000.

Taxable income before 199A deduction	$390,000
199A deduction	(66,000)
Taxable income	$324,000

OVERALL LOSS FROM QUALIFIED BUSINESS ACTIVITIES

When the overall result of the QBI rules is negative, the negative amount carries forward and offsets future QBI deductions. [Code Sec. 199A(c)(2)]

Example 17

Assume the same facts in Example 16, except that the loss from the Puerto Rico activity was $780,000. Their income is:

Ordinary income	$50,000
Capital gains & qualified dividends	60,000
Qualified business income	(30,000)
AGI	$80,000
Itemized deductions	(70,000)
Taxable income before 199A deduction	$10,000

Their Section 199A deduction is:

	Bryce	**Josephine**	**Resort**	**Total**
Net income	350,000	400,000	(780,000)	
Offset proportionately	(364,000)	(416,000)	780,000	
Net after loss	(14,000)	(16,000)		(30,000)

The $30,000 negative item is carried forward as a separate item of QBI in 2023. Their taxable income is:

Taxable income before 199A deduction	$10,000
199A deduction	0
Taxable income	$10,000

The qualified business loss carryforward becomes an offset to QBI deductions in the next taxable year. [Code Sec. 199A(c)(2)]

Example 18

Assume in 2023 Bryce and Josephine had the same losses on Bryce's business and Josephine's business, and their taxable income did not allow them any relief from the W-2 and W-2 plus qualified property limits. Now assume that the Puerto Rico resort produced a breakeven in 2023. Their 199A deduction

would be computed in the same manner as in Example 17, except that they would need to include their carryforward from 2022. Their computation would be:

	Bryce's business, 2023	Josephine's business, 2023	Carryforward from 2022	Total
Net income	$350,000	$400,000		
Offset proportionately	(14,000)	(16,000)	(30,000)	
Net after loss	336,000	384,000		
Wages paid	90,000	1,300,000		
W-2 limit (50%)	45,000	650,000		
Qualified property	1,500,000	1,000,000		
2.5%	37,500	25,000		
25% W-2 wages	22,500	325,000		
W-2 + QP limit	60,000	350,000		
Limit, > of W-2 or W-2 + QP	60,000	650,000		
20% QBI	67,200	76,800		
199A combined	60,000	76,800		136,800
20% of taxable income (less capital gain) before §199A				146,000
199A deduction				136,800

RULES FOR S CORPORATIONS AND PARTNERSHIPS

When the entity that actually conducts the business is not an individual, there are some special rules that apply. If the entity is a C corporation, there is no Section 199A deduction. If the entity is a partnership or S corporation, the deduction is claimed by the owners. [Code Sec. 199A(f)(1)(A)(i)]

In order for the partners or shareholders to calculate their QBI deductions, the partnership or S corporation must report the appropriate income and other items to each owner. The information needed is each partner or shareholder's portion of the necessary variables: [Code Sec. 199A(f)(1)(A)(ii)]

- Qualifying income and loss items from the qualifying business;
- W-2 wages paid by the qualifying business; and
- Qualified property owned by the business at the end of the taxable year.

PARTNERSHIPS

If the entity is a partnership, each partner receives a share of W-2 wages according to his or her share of partnership wage expense. [Code Sec. 199A(f)(1)(A)] If the partnership makes no special allocations of wage expense, this percentage will be the same as the partner's share of partnership income.

The partnership must allocate UBIA in accordance with its allocation of depreciation to the partners on the last day of the partnership's taxable year. [Reg. §1.199A-2(a)(3)(ii)] There is no allocation of UBIA to any person who has completely disposed of his or her partnership interest before the end of the partnership's taxable year.

Example 19

The Definer Partnership has four partners, David, Ellen, Floyd and Irene. David, the general partner, has an interest in 25% of the profits other than depreciation. David has a 10% share of partnership depreciation. The other three members each have a 25% interest in partnership income, except for depreciation and 30% of the depreciation deductions. In 2022, the partnership reports the following:

Interest income	$60,000
Rent income	250,000

W-2 wages to employees	(30,000)
Net rent before depreciation	220,000
Depreciation	(120,000)
Net rental income	100,000
Net income overall	$160,000

The partnership owns depreciable property with an unadjusted basis of $2,400,000 at year end. None of this property's depreciable period has expired.
The interest income is reported separately as portfolio income and does not become part of qualified business income. Each of the four partners receives $15,000 of interest income on Schedule K-1. The rent income is a bit more complicated.
The partners will be allocated the following:

	Total	David	Each other partner
Interest income	$60,000	$15,000	$15,000
Rent income	250,000	62,500	62,500
W-2 wages to employees	30,000	7,500	7,500
Net rent before depreciation	220,000	55,000	55,000
Depreciation	120,000	12,000	36,000
Net rental income	$100,000	$43,000	$19,000

Each partner determines his or her share of the income, W-2 and W-2 plus qualified property limits as follows:

	David	Each other partner
20% Net rent	$8,600	$3,800
50% W-2	3,750	3,750
25% W-2	1,875	1,875
2.5% QP	6,000	18,000
25% W-2 + 2.5% QP	7,875	19,875
199A deduction	$7,875	$3,800

S CORPORATIONS

When the entity is an S corporation, there will be no special allocations of any line item, such as depreciation. Therefore, if there are no changes in shareholdings during a taxable year, the qualifying income, W-2 wages, and qualified property limits will all be allocated per-share per day. However, if there is a complete termination of a shareholder's interest in the corporation, a substantial disposition of stock or a substantial issuance of new stock, there may be a split year. In this case, the corporation must allocate the income and W-2 wage information to each shareholder based on the income in each part of the year. The S corporation must allocate UBIA in proportion to the outstanding shares on the last day of the corporation's taxable year. [Reg. §1.199A-2(a)(3)(iii)] There is no allocation of UBIA to any person who has disposed of all of his or her stock before the end of the corporation's taxable year.

Example 20

Hamlet, Inc., an S corporation, sold a building in June 2022. It purchased another in that same month, and some equipment in December. At the beginning of the year, Ken and Linda each held half of the stock of Hamlet, Inc. On May 26, 2022, Ken sold all of his stock to Mel.
Hamlet's income and deduction items, according to each portion of the year, were:

	Total	Jan. 1 - May 26	May 27 - Dec. 31

Income before wages and depreciation	$817,750	$293,500	$524,250
Depreciation	(77,750)	(21,500)	(56,250)
Wages	(240,000)	(72,000)	(168,000)
Net ordinary income	500,000	200,000	300,000
Section 1231 Gain	185,000		185,000
Qualifying income	$685,000	$200,000	$485,000

As of December 31, Hamlet has $2,420,000 unadjusted basis of qualified property. All of it had been used for production of qualified business income and none of this property was older than its depreciable period.

Hamlet's default allocation among the three shareholders is the weighted average per share per day method. [Code Sec. 1377(a)(1)] These pro-rata allocations will be:

	Linda 50%	**Ken 20%**	**Mel 30%**
Net ordinary income	$250,000	$100,000	$150,000
Section 1231 gain	92,500	37,000	55,500
QBI	342,500	137,000	205,500
UBIA 50% to Linda, 50% to Mel	1,210,000	0	1,210,000

Based on these allocations, each shareholder computes the appropriate Section 199A deduction, assuming that each is above the applicable taxable income threshold, and each has sufficient taxable income to support the deduction. For all of the items except UBIA, the corporation must allocate among the three shareholders on a per-share per day formula. However, the corporation must allocate UBIA among the shareholders in proportion to the shares held on the last day of the year. In this case, Linda holds 50% and Mel holds 50%. The shareholders would each compute their Section 199A deductions as follows:

	Linda	**Ken**	**Mel**
20% Income	68,500	27,400	41,100
50% W-2 wages	60,000	24,000	36,000
2.5% Qualified property, 50% to Linda and 50% to Mel	30,250	0	30,250
25% W-2 wages	30,000	12,000	18,000
Combined W-2 & QP	60,250	12,000	48,250
Section 199A	60,250	24,000	41,100

Using the interim closing method to allocate income between Ken and Mel produces some different results.

Interim closing	**Linda 50% entire year**	**Ken 50% 1/1-5/26**	**Mel 50% 5/27-12/31**
Net ordinary income	$250,000	$100,000	$150,000
Section 1231 gain	92,500	0	92,500
QBI	342,500	100,000	242,500
W-2 wages	120,000	36,000	84,000
UBIA 50% to Linda, 50% to Mel	1,210,000		1,210,000

Each of the shareholders would then compute the QBI deduction.

	Linda	**Ken**	**Mel**
20% Income	68,500	20,000	48,500
50% W-2 wages	60,000	18,000	42,000

2.5% Qualified property, 50% to Linda and 50% to Mel	30,250		30,250
25% W-2 wages	30,000	9,000	21,000
Combined W-2 & QP	60,250	9,000	51,250
Section 199A	60,250	18,000	48,500

Since Linda did not exchange any shares during the year, her allocation using the interim closing method is the same as the pro-rata, and her Section 199A deduction is the combined W-2 wage and qualified property limit. However, Ken, who is allocated no UBIA for the year, uses the 50% of W-2 wage limit for his deduction. Mel, like Linda, has a slight advantage from the combined W-2 wage and qualified property limit.

APPLICATION TO COOPERATIVES AND PATRONS

Code Section 199A, after amendment by the Further Consolidated Appropriations Act, 2018, provides a special deduction for agricultural and horticultural cooperatives. In general, the deduction follows the rules for the Domestic Production Activities Deduction, prior to its repeal by the TCJA. The cooperative is allowed a deduction for 9% of its qualified production activities income of the year, or taxable income, whichever is less. [Code Sec. 199A(g)(1)(A)] The deduction is limited to 50% of the W-2 wages paid in connection with domestic production activities gross receipts. [Code Sec. 199A(g)(1)(B)]

Taxable dividends from cooperatives also qualify for the deduction by the patrons. However, the patron may be required to reduce the 20% deduction. As with the former DPAD, cooperatives may pass through a portion of this Code Section 199A(g) deduction to their patrons. Whether or not the cooperative passes through this deduction, a patron must reduce the QBI deduction attributable to patronage income by the lesser of 9% of the patron's income attributable to patronage income or 50% of wages paid by the patron in connection with the business that earned the income from the cooperative. [Code Sec. 199A(b)(7)]

EFFECT ON PARTNER OR SHAREHOLDER BASIS

The qualified business income passes through from the partnership or S corporation to the owner. Under the general basis rules, this income increases the owner's basis, thus making it available for tax-free distributions of cash, or deduction of future losses, or losses of a different character in the same year. However, the QBI deduction, computed at the owner level, does not affect basis in the partner's interest in the partnership or the shareholder's stock or debt basis.

Example 21

James and Meaghan are the two equal and only members in JAM, LLC. In 2022, JAM reports $200,000 of QBI, and $18,000 of cash charitable contributions. JAM distributes $50,000 to each member. James itemizes his deductions and Meaghan uses the standard deduction. Both are able to claim the Section 199A deduction in full.

The effects on each member's basis and taxable income are:

	James	**Meaghan**	**Total**
Ordinary income	$100,000	$100,000	$200,000
Distribution	(50,000)	(50,000)	(100,000)
Charitable contribution	(9,000)	(9,000)	(18,000)
Effect on basis $	41,000	$41,000	$82,000

	James	**Meaghan**
Ordinary income	$100,000	$100,000

Section 199A deduction	(20,000)	(20,000)
Charitable contribution	(9,000)	
Effect on taxable income	$71,000	$80,000

Comment
Although the statutory language on the effect of losses on the Section 199A deduction is scant, it seems almost certain that a loss would actually need to be allowable, and not blocked by the basis at-risk or passive activity limitations to result in a negative QBI amount.

Example 22
Evelyn is a shareholder in Evico, an S corporation. In 2022, her share of Evico's ordinary loss is $60,000. Evico's business qualifies for the Section 199A deduction. She has no other sources of QBI in 2022. Her basis in Evico stock is $40,000 and she has no debt basis in Evico. The amount she can potentially deduct on her 2022 income tax return is $40,000, and she must carry $20,000 of the loss forward to 2023. [Code Sec. 1366(d) (2)]
She must carry $40,000 forward to offset QBI in 2023 and future years, whether or not she is ever allowed to deduct the $20,000 loss in excess of basis. The $20,000 loss in excess of her basis has no effects on QBI until she can claim it on a return.

However, a loss carried forward from a year that began before 2018 does not affect QBI. The loss disallowance can be from basis, amount at risk, the passive activity loss limits, or a net operating loss. [Reg. §1.199A-3(b)(1)(iv)]

ACCURACY-RELATED PENALTIES ON UNDERPAYMENTS
Among the penalties of underpayment, or late payment of tax, is the Section 6662 penalty imposed in cases of negligence, disregard of rules, or "substantial understatement" of income tax. [Code Sec. 6662(b)]
The penalty is 20 percent of the offending amount of understatement. [Code Sec. 6662(a)]
In general, a substantial understatement exists when the understatement exceeds the greater of $5,000 or 10 percent of the correct tax for the year. [Code Sec. 6662(d)(1)(A)] However, for any taxpayer claiming the Section 199A deduction, the 10 percent threshold is reduced to 5 percent. [Code Sec. 6662(d)(1)(C)]

Comment
The reduction of the underpayment threshold applies to any taxpayer claiming the Section 199A deduction. The understatement need not be caused by the deduction, but could be related to any overstated deduction or understated income.

EFFECT OF QBI DEDUCTION ON OTHER TAXES
In addition to the income tax, partners and shareholders may be subject to other taxes as a result of income from the pass-through entity. The most important federal taxes, in addition to the income tax, are:

- The alternative minimum tax;
- The self-employment tax; and
- The net investment income tax.

Section 199A specifically states that the deduction is limited to "this chapter." To understand the scope, Section 199A is contained in:

CHAPTER 1: NORMAL TAXES AND SURTAXES [Secs. 1—1400Z-2]

Thus, it only applies to taxes imposed on noncorporate taxpayers within these sections. The most important of these are the regular income tax (Section 1) and the alternative minimum tax (Section 55). Although the alternative minimum tax requires recalculation of several items of income and deductions, there is no second calculation of the QBI deduction for purposes of the alternative minimum tax. [Code Sec. 199A(f)(2)]

The self-employment tax rules appear in Chapter 2:

TAX ON SELF-EMPLOYMENT INCOME.

The net investment income tax rules are in Chapter 3:

UNEARNED INCOME MEDICARE CONTRIBUTION.

Therefore, the QBI deduction cannot reduce either of these taxes.

II. ¶4.02 Alternative Minimum Tax

Although the House version of the TCJA would have repealed the alternative minimum tax, the final version did not go this far. The Act repealed the corporate alternative minimum tax, with a provision allowing the taxpayer to claim the alternative minimum tax credit between 2018 and 2021. [Code Sec. 53(c)]

The final version of the Tax Cuts and Jobs Act of 2017 did not repeal the alternative minimum tax for individuals. However, it substantially raised the exemption and phaseout. The 2017 through 2022 exemptions and phaseouts are:

	2017	2018	2019*	2020	2021	2022
Exemption, married joint	$78,750	$109,400	$111,700	$113,400	$114,600	$118,100
Exemption, single or head of household	50,600	70,300	71,700	72,900	73,600	75,900
Exemption, married filing separate	39,375	54,700	55,850	56,700	57,300	59,050
Exemption, estate or trust	22,500	22,500	25,000	25,400	25,700	26,500
Exemption phaseout begins, married joint	150,000	1,000,000	1,020,600	1,036,800	1,047,200	1,079,800
Exemption phaseout begins, single or head of household	112,500	500,000	510,300	518,400	523,600	539,900
Exemption phaseout begins, married filing separate	75,000	500,000	510,300	518,400	523,600	539,900
Exemption phaseout begins, estate or trust	75,000	75,000	83,500	84,800	85,650	88,300

** Rev. Proc. 2018-57, 2018-49 IRB 827 §3.12*

Pass-through entities must continue to report tax preferences and adjustments to their partners and shareholders. C corporations will need to determine their tentative alternative minimum tax for purposes of the alternative minimum tax credit. Individuals, estates and trusts will still need to determine tentative alternative minimum tax, although the imposition of the alternative minimum tax will undoubtedly apply in greatly reduced numbers.

III. ¶4.03 Repatriation Of Foreign Earnings

The United States has historically taxed its citizens and domestic corporations on their worldwide incomes. To alleviate the problems of multiple taxes on one income stream, the United States has offered a foreign tax credit.

Beginning in 2018, the U.S. approach shifted toward a territorial system, whereby domestic corporations are allowed to claim a deduction for dividends received attributable to foreign source income. [Code Sec. 245A] This deduction applies only to C corporations.

As part of the transition to the territorial system, there is a deemed repatriation of deferred foreign income for certain U.S. shareholders of foreign corporations. [Code Sec. 965] Under this rule, the U.S.

shareholder must include in its income its share of undistributed foreign income from corporations in which it owns at least 10 percent of the stock. In some cases, a U.S. shareholder can be a partnership or S corporation. Since partnerships and S corporations are pass-through entities, the repatriation tax applies at the partner or shareholder level. There are certain reduced tax rates, depending upon the U.S. shareholder's portion of the cash, cash equivalents and noncash assets held abroad.

IV. ¶4.04 Charitable Contributions And Foreign Taxes

One of the areas where there was a divergence between partnerships and S corporations was the relationship of charitable contributions and foreign taxes to shareholder basis. Since 1983, the Code has treated charitable contributions and foreign income taxes as items that are limited by shareholder basis [Code Sec. 1366(a)(1), flush language]

Example 23
Sharon and Barbara each own 50% of the stock in Sharbar, Inc., an S corporation. For 2017, the corporation sustained an ordinary loss of $80,000 and made qualifying cash contributions of $20,000. Neither shareholder received any distribution.
Sharon had basis of $60,000 at the beginning of 2017. She claims a deduction for $40,000 of ordinary loss and $10,000 of charitable contributions. She must reduce her basis by $50,000.
Barbara had no basis at the beginning of 2017. She would not be allowed any deduction for either the ordinary loss or the charitable contributions. Her basis would remain at zero.

In contrast, charitable contributions made by the partnership and foreign income taxes paid by the partnership had not been subject to the partner basis limit for deductibility. [Code Secs. 702(a)(4), 702(a)(6), 703(a)(2)(B), 703(a) (2)(C), Reg. § 1.704-1(d)(2); Ltr. Rul. 8405084]

Example 24
If Sharbar, from Example 23 had been a partnership, Sharon's deductible amounts would have been the same. However, Barbara, who had no basis in her partnership interest, would be able to claim her $10,000 charitable contribution. She would not have been allowed to deduct her share of ordinary loss and would have carried that amount forward. However, the charitable contribution would not reduce her basis in her partnership interest in 2017 or in any future year.

The TCJA removed this distinction. For taxable years beginning after 2017, both charitable contributions and foreign income tax of partnerships are now subject to the same limits as other losses. [Code Sec. 704(d)(3)(A)]

Example 25
Assume the same facts in Example 24 except that in the year 2022 Barbara would not be able to deduct any of the charitable contribution. She would need to carry it forward along with the ordinary loss from the year. Her total carryforward to 2023 would be:

Ordinary loss	$40,000
Charitable contributions	10,000
Total	$50,000

Assume that her share of income in 2023 was $30,000. She would be allowed to claim 60% ($30,000/$50,000) of each of the carryforwards on her 2023 tax return.

This rule does not apply to the excess of fair market value over the partnership's adjusted basis of capital gain property contributed to a qualifying organization. [Code Sec. 704(d)(3)(B), Conference Report to Accompany H.R. 1, December 15, 2017, p. 515] This also conforms to the treatment of S corporations and shareholders.

Example 26
Assume the same facts in Example 25, except that the contribution had been capital gain property with a FMV of $60,000 and adjusted basis of $20,000. Sharon and Barbara would each be allocated $30,000 of fair market value and $10,000 of basis in the contributed property. In 2022, Sharon would be able to claim a $30,000 charitable deduction and would only reduce her basis in her partnership interest by her allocated $10,000 of partnership basis of contributed property. Barbara would not be able to claim a $20,000 deduction in 2022 for her allocated basis in the contributed property but would be able to claim a 2022 deduction for her share of the contributed property's unrealized appreciation.

V. ¶4.05 Taxes Paid On Income From Pass-Through Entities

Before 2018, individuals were allowed to claim itemized deductions for state, local and foreign income taxes assessed on their taxable income, including income from partnerships and S corporations. [Code Sec. 164(a)(3)] This deduction was subject to an add-back adjustment for purposes of the alternative minimum tax. [Code Sec. 56(b)(1)(A)(ii)]
At least one attempt to treat state income tax imposed on S corporation income as a trade or business, "above the line" deduction was unsuccessful. [Cutler v. Comm'r, TC Memo 2015-73] Therefore the proper treatment of state, local and foreign income tax imposed on an individual is that of an itemized deduction. The Tax Cuts and Jobs Act of 2017 limits the deduction for all taxes allowed as itemized deductions to $10,000 per year. [Code Sec. 164(b)(6)] The legislative history indicates that the only exception is a business tax that is treated as an above the line deduction on Schedule C, Schedule E or Schedule F. [Conference Report to Accompany H.R. 1, December 15, 2017, p. 260]

CHAPTER 8: TEST YOUR KNOWLEDGE
The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CE credit.
We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. Which of the following would be treated as qualified business income (QBI) for an S corporation shareholder-employee:

A. wage or salary income
B. dividends (other than patronage dividends from cooperatives)
C. long-term and short-term capital gains and losses
D. none of the above

2. Which of the following deduction limits are unnecessary to compute when an activity's income is derived from a specified service business:

A. those based on W-2 wages
B. those based on the basis of qualified property
C. both A and B above
D. none of the above

3. The information needed for partners or shareholders of an S corporation to calculate their QBI deductions include all of the following <u>except</u>:

A. qualifying income and loss items from the qualifying business
B. W-2 wages paid by the qualifying business
C. qualified property owned by the business at the end of the taxable year
D. qualified property owned by the business at the beginning of the taxable year

4. For taxable years after 2017, the TCJA made which of the following subject to the same limits as other losses for partnerships:

A. charitable contributions made by the partnership
B. foreign income taxes paid by the partnership
C. both A and B above
D. none of the above

CHAPTER 8: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.

A. Incorrect. Wage or salary income received from the activity does not constitute QBI for an S corporation shareholder-employee.
B. Incorrect. Dividends and equivalents are not treated as QBI, even if effectively connected with a U.S. trade or business.
C. Incorrect. Long-term and short-term capital gains and losses are not treated as QBI.
D. **CORRECT**. None of the responses are items that are treated as QBI.

2.

A. Incorrect. These limits only apply when the taxable income is above the threshold but below the full phase-out.
B. Incorrect. These limits only apply when the taxable income is above the threshold but below the full phase-out.
C. **CORRECT**. These limits only apply when the taxable income is above the threshold but below the full phase-out.
D. Incorrect. At least one of the responses is correct.

3.

A. Incorrect. These income and loss items are among the necessary variables for each
A. partner or shareholder's portion.
B. Incorrect. W-2 wages paid for each partner or shareholder's portion is needed.
C. Incorrect. Qualified property at the end of the taxable year is a variable needed.

D. **CORRECT**. Qualified property owned by the business at the end of the taxable year is necessary, but not at the beginning of the taxable year.

4.

A. Incorrect. Due to changes made by the TCJA, charitable contributions are subject to the same limits as other losses, but this is not the best answer.
B. Incorrect. Due to changes made by the TCJA, foreign income taxes paid by the partnership are subject to the same limits as other losses, but this is not the best answer.
C. **CORRECT**. The TCJA removed the distinction between partnerships and S corporations related to charitable contributions and foreign income taxes.
D. Incorrect. At least one of the responses is correct.

Final Exam

Standard and Itemized Deductions

The following exam is attached only for your convenience. To access the official exam for this self-study course, please log into your account online and take the Final Exam from the course details page. A passing score of 70 percent or better will receive course credit and a Certificate of Completion.

1. What is the 2022 standard deduction for head of household under 65:

A. $12,950
B. $14,700
C. $19,400
D. $25,900

2. What does the standard deduction amount depend on:

A. your filing status
B. your age
C. your eyesight
D. all of the above

3. All of the following are correct regarding the medical expense deduction <u>except</u>:

A. you can include only the medical and dental expenses you paid this year
B. you can deduct medical expenses you prepay for the following year
C. if you pay by check, the day you mail or deliver the check generally is the date of payment
D. if you pay by credit card, the day the credit card is charged is the date of payment, and not when you actually pay the amount charged

4. Generally, medical and dental expenses that can be included on Schedule A (Form 1040) include which of the following:

A. herbal supplements
B. funeral, burial, or cremation services
C. contributions to Archer MSAs
D. diagnostic devices

5. Which of the following <u>cannot</u> be included in your medical expenses on Schedule A (Form 1040):

A. medical insurance premiums for hospitalization
B. medical insurance premiums for long-term care
C. medical expenses reimbursed by a health reimbursement arrangement
D. medical expense premiums paid for Medicare Part D

6. Generally, which of the following fees and charges can you deduct:

A. charges for water bills
B. fines and penalties paid to the government
C. fees and charges that are for your trade or business
D. license fees for personal use

7. Which of the following types of real estate taxes and charges are <u>not</u> deductible:

A. state real estate taxes
B. local real estate taxes
C. tenant's share of real estate taxes paid by a cooperative housing corporation
D. homeowners' association charges

8. Whether you can deduct all of your home mortgage interest depends on all of the following <u>except</u>:

A. the interest rate on the mortgage
B. your use of its proceeds
C. the date you took out the mortgage
D. the amount of the mortgage

9. Generally, which of the following can be deducted as home mortgage interest:

A. rental payments made prior to final settlement on the purchase
B. late payment charge on mortgage payment
C. payments on nonredeemable ground rents
D. interest portion of mortgage assistance payments

10. Which of the following is true regarding points paid on loans secured by a second home:

A. they are not deductible
B. they are fully deductible in the year paid
C. they can only be deducted over the life of the loan
D. they are only 50% deductible in the year paid

11. Which of the following interest expenses are deductible:

A. annual fees for credit cards
B. loan fees
C. personal interest
D. investment interest

12. To be able to deduct out-of-pocket expenses you pay when providing services to a qualified charitable organization, those expenses must be which of the following:

A. unreimbursed
B. directly connected with the services
C. not personal, living, or family expenses
D. all of the above

13. Which of the following is <u>not</u> deductible as a charitable contribution:

A. the value of services given to a qualified organization
B. any unreimbursed out-of-pocket car expenses for gas and oil
C. parking fees and tolls
D. travel expenses necessarily incurred while away from home specifically performing services for a charitable organization

14. If you donate a qualified vehicle with a fair market value less than your cost or other basis to a qualified organization and you claim a deduction of more than $500, how much can you deduct:

A. the gross proceeds from the sale of the vehicle by the organization
B. the vehicle's fair market value on the date of the contribution

C. the lesser of A or B above
D. the greater of A or B above

15. Which of the following is correct regarding your charitable deduction if you contribute property with a fair market value that is less than your basis in it:

A. it is limited to the property's fair market value
B. it is equal to your basis in the property
C. it is unlimited
D. it is limited to the difference between the fair market value and the basis in the property

16. Excess charitable contributions that cannot be deducted in the current year because the amount exceeds the taxpayer's AGI limit can generally be deducted in each of the next ____ years until it is all used up.

A. 2
B. 3
C. 4
D. 5

17. When can you claim a deduction for a cash contribution of $250 or more:

A. if you have a canceled check
B. if you have the check notarized
C. if you obtain a contemporaneous written acknowledgment from a qualified charitable organization or certain payroll deduction records
D. if you have a copy of the qualified organization's bank statement showing deposit of the funds

18. Per the TCJA, personal casualty and theft losses of an individual are generally only deductible under which of the following conditions:

A. if they are attributable to a federally declared disaster
B. if they are greater than 2% of AGI
C. if they are greater than $10,000
D. if they are the result of a fire or flood

19. For a casualty loss to occur, the decrease in value of an asset must be the result of an event described as any of the following <u>except</u>:

A. sudden
B. avoidable
C. unexpected
D. unusual

20. Which of the following should be considered when attempting to establish the decrease in FMV of property for purposes of a casualty or theft loss:

A. cost of cleanup
B. cost of protection
C. sentimental value
D. all of the above

21. An eligible educator can deduct up to how much of qualified expenses he or she paid in 2022:

A. $0

B. $300
C. $600
D. $1,000

22. All of the following can be deducted in 2022 on Schedule A, line 16, <u>except</u>:
A. federal estate tax on income in respect of a decedent
B. gambling losses up to the amount of gambling winnings
C. unlawful discrimination claims
D. fines and penalties

23. A REIT must distribute what percentage of its taxable income to its owners:
A. 50%
B. 75%
C. 90%
D. 100%

24. What is the taxable income threshold for a taxpayer with a filing status of single for the income from specified services to constitute qualified business income for 2022:
A. $50,000
B. $170,050
C. $340,100
D. $440,100

25. Which of the following is correct regarding the aggregation of multiple trades or businesses:
A. the Code specifies rules for the aggregation of multiple trades or businesses
B. each partner or shareholder may be allowed to aggregate activities
C. in order to aggregate, at least half of the owners' aggregate activities must meet specific ownership and business relationship tests
D. in order to aggregate, a person, entity, or group must own at least 33% of each trade or business

26. Which of the following type of service business was specifically excluded from the "Specified Service Business" limitation in Section 199A:
A. health
B. law
C. architecture
D. investment management

27. Which of the following is <u>not</u> included in the W-2 wage base for purposes of Section 199A:
A. wages paid in Puerto Rico
B. any payment subject to either FICA or withholding
C. guaranteed payments to partners
D. all of the above

28. In general, a substantial understatement of income tax exists when the understatement exceeds the greater of $5,000 or 10 percent of the correct tax for the year. If a taxpayer is claiming the Section 199A deduction, which of the following is correct regarding the 10 percent threshold:
A. it is reduced to 3 percent
B. it is reduced to 5 percent

C. it is increased to 15 percent
D. it is increased to 20 percent

29. Which of the following taxes can be reduced by the qualified business income (QBI) deduction:

A. regular income tax
B. self-employment tax
C. net investment income tax
D. all of the above

30. The TCJA limits the deduction for all taxes allowed as itemized deductions to how much per year:

A. $10,000
B. $20,000
C. $25,000
D. unlimited

31. Which of the following is correct regarding the standard deduction amount:

A. it is the same for all filing statuses
B. it is the same regardless of the taxpayer's age
C. the amount depends on the taxpayer's filing status
D. the amount was significantly reduced by the TCJA

32. Payments that can be included as a medical and dental expense deduction exclude which of the following:

A. medical and hospital insurance premiums
B. long-term care contracts
C. stop-smoking programs
D. health club dues

33. Which of the following income taxes are not deductible:

A. federal income taxes
B. state income taxes
C. local income taxes
D. foreign income taxes

34. In regards to contributions of property to a qualified organization, household items include which of the following:

A. food
B. appliances
C. paintings
D. jewelry

35. For taxable years after 2017, the TCJA made which of the following subject to the same limits as other losses for partnerships:

A. charitable contributions made by the partnership

B. foreign income taxes paid by the partnership
C. both A and B above
D. none of the above