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1001 DEDUCTIONS & TAX BREAKS 2017

Your Complete Guide to Everything Deductible

BARBARA WELTMAN

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Introduction

Say the word "taxes" and most people groan. There are good reasons for this response: First of all, the cost of paying your taxes annually can be a financial burden. You may feel taken to the cleaners every time you view your paycheck *after* withholding for federal income taxes (not to mention state income taxes as well as Social Security and Medicare taxes). And taxes are time consuming—costing individuals 6 billion hours annually to file their returns.

Second, you may not even have to deal personally with taxes, other than paying them. The IRS says that about 60% of taxpayers use paid preparers for their returns.

Third, the tax law is very complicated and changing all the time. According to the Tax Foundation, the Internal Revenue Code (Tax Code) had 7.7 million words. There were only 11,400 words in the Tax Code in 1914, one year after the constitutional amendment authorizing the levy of an income tax. Between 2001 and 2012, there were 4,600 changes (which works out to more than one a day). Today the Tax Code is twice as long as it was in 1985. There have been major changes in the tax law nearly every year over the past 50 years—and this year is no exception! In addition, new court decisions and IRS rulings appear each day, providing guidance on how to interpret the law.

Fourth, you have to know what the tax rules are and can't claim ignorance to avoid taxes and penalties. Even if you use a tax professional or tax preparation software to prepare your return, you remain responsible for your taxes. The Tax Court has noted that using software is not an automatic excuse to avoid underpayment penalties.

How can you combat the feeling of dread when it comes to taxes? It helps to know that the tax law is peppered with many, many tax breaks to which you may be entitled. These breaks allow you to *not* report certain economic benefits you enjoy or to subtract certain expenses from your income or even directly from your tax bill. As the famous jurist Judge Learned Hand once stated (in the 1934 case of *Helvering v. Gregory* in the Court of Appeals for the Second Circuit):

> **Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one's taxes. Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike, and all do right, for nobody owes any public duty to pay more than the law demands.**

So get your tax affairs in order and reduce what you pay each year to Uncle Sam!

In getting a handle on how to do this by taking advantage of every tax break you may be entitled to without running afoul of the Internal Revenue Service (IRS), there are some simple rules to keep in mind. They include:

- You must report all of your income unless a specific law allows you to exclude or exempt it (so that it is never taxed) or defer it (so that it is taxed at a later time).
- You can claim deductions only when and to the extent the law allows. Deductions are referred to as a "matter of legislative grace;" Congress doesn't have to create them and does so only for some purpose (for example, to encourage economic activity or to balance some perceived inequity in the tax law).
- Tax credits are worth more than tax deductions. A credit reduces your tax payment on a dollar-for-dollar basis; a $1,000 credit saves you $1,000 in taxes. A deduction is worth only as much as the top tax bracket you are in. Suppose you are in the 28% tax bracket, which means this is the highest rate you pay on at least some of your income. If you have a $1,000 deduction, it is worth $280 (28% of $1,000) because it saves you $280 in taxes you would otherwise have to pay.
- Even if your income is modest, you may have to file Form 1040 (the so-called long form), rather than a simplified return (Form 1040A or 1040EZ), in order to claim certain tax benefits.
- In a number of cases, different deduction rules apply to the alternative minimum tax (AMT), a shadow tax system that ensures you pay at least some tax if your regular income tax is lower than it would have been without certain deductions.

Whether you prepare your return by hand (as 3% of filers do), use computer software or an online solution (37%), or rely on a professional (60%), this book is designed to tell you how to get every tax edge you're entitled to. Knowing what to look out for will help you plan ahead and organize your activities in such a way that you'll share less of your hard-earned money with Uncle Sam.

Tax-Favored Items

There are 5 types of tax-advantaged items receiving preferential or favorable treatment under the tax law:

1. *Tax-free income*—income you can receive without any current or future tax concerns. Tax-free income may be in the form of exclusions or exemptions from tax. In many cases, tax-free items do not even have to be reported in any way on your return.
2. *Capital gains*—profits on the sale or exchange of property held for more than one year (long-term). Long-term capital gains are subject to lower tax rates than the rates on other income, such as salary and interest income, and may even be tax free in some cases. Ordinary dividends on stocks and capital gain distributions from stock mutual funds are taxed at the same low rates as long-term capital gains.
3. *Tax-deferred income*—income that isn't currently taxed. Since the income builds up without any reduction for current tax, you may accumulate more over time. However, at some point the income becomes taxable.
4. *Deductions*—items you can subtract from your income to reduce the amount of income subject to tax. There are 2 classes of deductions: those "above the line," which are subtracted directly from gross income, and those "below the line," which can be claimed only if you itemize deductions instead of claiming the standard deduction (explained later).
5. *Credits*—items you can use to offset your tax on a dollar-for-dollar basis. There are 2 types of tax credits: one that can be used only to offset tax liability (called a "nonrefundable" credit) and one that can be claimed even if it exceeds tax liability and you receive a refund (called a "refundable" credit). Usually you must complete a special tax form for each credit you claim.

This book focuses on different types of tax-favored items: exclusions (tax-free income), above-the-line deductions that don't require itemizing, itemized deductions, tax credits, and other benefits, such as subtractions that reduce income. At the end of this Introduction you'll see symbols used to easily identify the type of benefit being explained.

Limits on Qualifying for Tax-Favored Items

In many cases, eligibility for a tax benefit, or the extent to which it can be claimed, depends on adjusted gross income (AGI) or modified adjusted gross income (MAGI).

Adjusted gross income is gross income (all the income you are required to report) minus certain deductions (called "adjustments to gross income"). Adjustments or subtractions you can make to your gross income to arrive at your adjusted gross income are limited to the following items:

Alimony payments

Archer Medical Savings Accounts (MSAs) (for accounts set up prior to 2008)

Business expenses

Capital loss deductions of up to $3,000

Domestic production activities deduction

Educator expenses up to $250

Employer-equivalent portion of self-employment tax

Forfeiture-of-interest penalties because of early withdrawals from certificates of deposit (CDs)

Health Savings Account (HSA) contributions

Individual Retirement Account (IRA) deductions

Jury duty pay turned over to your employer

Legal fees for unlawful discrimination claims

Moving expenses

Net operating losses (NOLs)

Performing artist's qualifying expenses

Qualified retirement plan contributions for self-employed individuals

Rent and royalty expenses

Repayment of supplemental unemployment benefits required because of the receipt of trade readjustment allowances

Self-employed health insurance deduction

Simplified employee pension (SEP) or savings incentive match plan for employees (SIMPLE) contributions for self-employed individuals

Student loan interest deduction up to $2,500

Travel expenses to attend National Guard or military reserve meetings more than 100 miles from home

Tuition and fees deduction up to $4,000

Figuring AGI may sound complicated, but in reality it's merely a number taken from a line on your tax return. For example, AGI is the figure you enter on line

TABLE I.1 Standard Deduction Amounts for 2016

Filing Status	Standard Deduction
Married filing jointly	$12,600
Head of household	9,300
Single (unmarried)	6,300
Qualifying widow(er) (surviving spouse)	12,600
Married filing separately	6,300

37 of the 2016 Form 1040, line 21 of the 2016 Form 1040A, or line 4 of 2016 Form 1040EZ.

Modified adjusted gross income is merely AGI increased by certain items that are excludable from income and/or certain adjustments to gross income. *Which* items are added back varies for different tax breaks. For example, the MAGI limit on eligibility to claim the student loan interest deduction is AGI (disregarding the student loan interest deduction) increased by the tuition and fees deduction as well as the exclusion for foreign earned income and certain other foreign income or expenses. All of these items are explained in this book.

Household income is a term in tax law used to determine eligibility for the premium tax credit under the Affordable Care Act, as well as whether a penalty applies to individuals who don't have minimum essential health coverage for 2016 and are not exempt from this requirement. Household income is explained further in this book in connection with these tax rules.

Standard Deduction versus Itemized Deductions

Every taxpayer, other than someone who can be claimed as a dependent on another taxpayer's return, is entitled to a standard deduction. This is a subtraction from your income, and the amount you claim is based on your filing status. Table I.1 shows the standard deduction amounts for 2016. In 2014, 69.3% of all filers used the standard deduction.

In addition to the basic standard deduction, certain taxpayers can increase these amounts. An additional standard deduction amount applies to those age 65 and older and for blindness. For 2016, the additional amount is $1,550 for individuals who are not married and are not a surviving spouse and $1,250 for those who are married or a surviving spouse.

Example

In 2016, you are single, age 68, and *not* blind (and do not own a house and did not buy a car this year). Your standard deduction is $7,850 ($6,300 + $1,550).

Instead of claiming the standard deduction, you can opt to list certain deductions separately (i.e., *itemize* them). Itemized deductions include:

Medical expenses
Taxes
Interest payments
Gifts to charity
Casualty and theft losses
Unreimbursed employee business expenses
Investment expenses
Legal fees to earn income
Gambling losses
Estate tax payments on income in respect of decedents

You cannot claim any additional standard deduction that applies to those 65 or older and/or blind if you choose to itemize deductions in lieu of claiming the basic standard deduction amount.

Generally, claim the standard deduction when it is greater than the total of your itemized deductions. However, it may save overall taxes to itemize, even when total deductions are less than the standard deduction, if you are subject to the alternative minimum tax (AMT). ***The reason:*** The standard deduction cannot be used to reduce income subject to the AMT, but certain itemized deductions can.

If a married couple files separate returns and one spouse itemizes deduction, the other must also itemize and cannot claim a standard deduction.

Overall Limit on Itemized Deductions

High-income taxpayers have an overall limit on the total amount of itemized deductions they can claim. Itemized deductions are reduced by the lesser of 3% of the amount that adjusted gross income (AGI) exceeds the applicable threshold amount (see Table I.2) or 80% of itemized deductions subject to the phaseout. Thus you cannot lose more than 80% of itemized deductions subject to the phaseout.

Itemized deductions subject to the phaseout include taxes, interest (other than investment interest), charitable contributions, and miscellaneous itemized deductions not subject to the 2%-of-adjusted-gross-income limit (other than gambling losses). Itemized deductions *not* subject to the phaseout are medical expenses, investment interest, casualty and theft losses, and gambling losses. These itemized deductions are already subject to special limitations.

TABLE I.2 2016 Thresholds for the Itemized Deduction Phaseout

Filing Status	MAGI Start of Phaseout
Married filing jointly	$311,300
Head of household	285,350
Single (unmarried)	259,400
Qualifying widow(er) (surviving spouse)	311,300
Married filing separately	155,650

Impact of Deductions on Your Chances of Being Audited

Did you know that the IRS collects statistics from taxpayers to create profiles of average deductions? If you claim more than the average for your income range, the computer *may* select your return for further examination.

Table I.3 shows the average itemized deductions for taxpayers in various adjusted gross income ranges.

Tax experts agree that you should claim every deduction you are entitled to, even if your write-offs exceed these statistical ranges. Just make sure to have the necessary proof of your eligibility and other records you are required to keep in case your return is examined.

How to Use This Book

The chapters in this book are organized by subject matter so you can browse through them to find the subjects that apply to you or those in which you have an interest.

TABLE I.3 Average Itemized Deductions for 2014*

AGI	Medical	Taxes	Interest	Donations
Under $15,000	$ 8,787	$ 3,566	$ 7,129	$ 1,427
$ 15,000 ≤ 30,000	8,477	3,376	6,619	2,339
$ 30,000 ≤ 50,000	8,209	4,098	6,511	2,594
$ 50,000 ≤ 100,000	9,614	6,679	7,553	3,147
$100,000 ≤ 200,000	11,123	10,983	9,147	4,130
$200,000 ≤ 250,000	18,092	17,763	11,698	5,786
$250,000 and over	38,992	50,679	16,982	21,596

*The latest year for which statistics are available.

Each tax benefit is denoted by an icon to help you spot the type of benefit involved:

Exclusion

Above-the-line deduction

Itemized deduction (a deduction taken *after* figuring adjusted gross income)

Credit

Other benefit (e.g., a subtraction other than an above-the-line or itemized deduction that reduces income)

For each tax benefit you will find an explanation of what it is, starting with the maximum benefit or benefits you can claim if you meet all eligibility requirements. You'll learn the conditions or eligibility requirements for claiming or qualifying for the benefit. You'll find both planning tips to help you make the most of the benefit opportunity as well as pitfalls to help you avoid problems that can prevent your eligibility. You'll see where to claim the benefit (if reporting is required) on your tax return and what records you must retain to support your tax position.

You'll find hundreds of examples to show you how other taxpayers have successfully taken advantage of the benefit. Over the years, taxpayers have been able to write off literally thousands of items; not every one is listed here because space does not allow it. And you'll learn what *isn't* allowed even though you might otherwise think so. There are references to free IRS publications on a variety of tax topics that you can download from the IRS web site (www.irs.gov) or obtain free of charge by calling 800-829-1040. Also included are titles of other J.K. Lasser books on various topics throughout this book.

In the appendices, you'll find a listing of items that can be adjusted each year to reflect cost-of-living changes so you can plan ahead, as well as a checklist of items that are tax free, and a checklist of items that are not deductible.

Throughout the book you will find alerts to possible changes to come. For a *free* update on tax developments, look for the Supplement to this book in February 2017, by going to www.jklasser.com, as well as to my website, www.barbaraweltman.com.

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You and Your Family

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Do the old clichés still ring true? Can two still live as cheaply as one? Are things really cheaper by the dozen? For tax purposes, there may be a penalty or bonus for being married versus single, but there are certain tax breaks for building a family.

This chapter explains family-related tax benefits, such as exemptions and tax credits related to your children and the consequences of marital dissolutions. For more information on these topics, see IRS Publication 501, *Exemptions, Standard Deduction, and Filing Information*; IRS Publication 503, *Child and Dependent Care Expenses*; IRS Publication 504, *Divorced or Separated Individuals*; IRS Publication 596, *Earned Income Credit*; and IRS Publication 972, *Child Tax Credit*.

Marital Status

Whether you are married or single has a significant impact on your taxes. In some cases, being married results in a "marriage bonus," such as effectively averaging taxes when one spouse works and the other does not. In other cases, being married results in a "marriage penalty," such as the fact that two working spouses earning about the same likely will pay higher total tax than if they were single. For some tax rules, a married couple has the identical tax break as a single individual, such as the $3,000 capital loss deduction against ordinary income, which is a distinct disadvantage for those who are married. For some tax rules, a married couple has double the tax break for singles, such as the ordinary loss deduction for so-called Section 1244 stock, so marital status makes no difference here.

Technically, there are a number of filing statuses that determine eligibility for various tax breaks:

- Married filing jointly
- Married filing separately
- Head of household
- Unmarried (single)
- Qualifying widow(er) with a dependent child

You need to know which term applies to you. The terms are not further defined here, so check IRS Publication 501 if you are unsure. Note that under federal tax law, the terms "husband," "wife," and "spouse" are gender neutral. The term "husband and wife" means two individuals lawfully married to each other. However, those in a civil union or domestic partnership are not married for federal income tax purposes.

Personal Exemption

Each taxpayer (other than someone who is another taxpayer's dependent) automatically is entitled to a deduction just for being a taxpayer. The amount of the deduction, called the exemption amount, is a fixed dollar amount ($4,050 in 2016).

Benefit

You can claim a deduction for yourself, called a personal exemption. In 2016, the exemption amount is $4,050 (each year it is indexed for inflation). Table 1.1 shows you the value of your personal exemption for your tax bracket in 2016 (the amount of taxes you save by claiming it).

TABLE 1.1 Value of Your Personal Exemption in 2016

Your Top Tax Bracket	Value of Your Exemption
10%	$ 405
15%	608
25%	1,013
28%	1,134
33%	1,337
35%	1,418
39.6%	1,604

Conditions

There are no conditions to claiming this deduction; it's yours because you are a taxpayer and the law says you are entitled to it.

Each spouse is entitled to his or her own personal exemption. On a joint return, 2 personal exemptions are claimed. If you are married but file a separate return, you can claim both deductions (an exemption for you and an exemption for your spouse) if your spouse has no income and is not the dependent of another taxpayer.

However, you *cannot* claim the personal exemption if you can be claimed as a dependent on another taxpayer's return. For example, a child who is the parent's dependent cannot claim a personal exemption on the child's own return.

Planning Tip

You cannot claim any personal or dependency exemption for alternative minimum tax (AMT) purposes, a shadow tax system designed to ensure that all taxpayers pay at least some tax. A large number of exemptions can substantially reduce or even eliminate any regular tax. So if you have a large number of exemptions, you may trigger or increase AMT liability. You may wish to engage in some tax planning to minimize or eliminate your AMT liability.

Pitfalls

The deduction for personal exemptions can be reduced or even eliminated entirely if your income is high enough. Personal exemptions are subject to a phaseout when adjusted gross income (AGI) exceeds a set amount based on filing status. Table 1.2 shows the AGI threshold for the start of the phaseout; it also shows the point at which the deduction for personal exemptions is completely eliminated. The phaseout is 2% of each $2,500 (or fraction of $2,500) of AGI over your threshold amount.