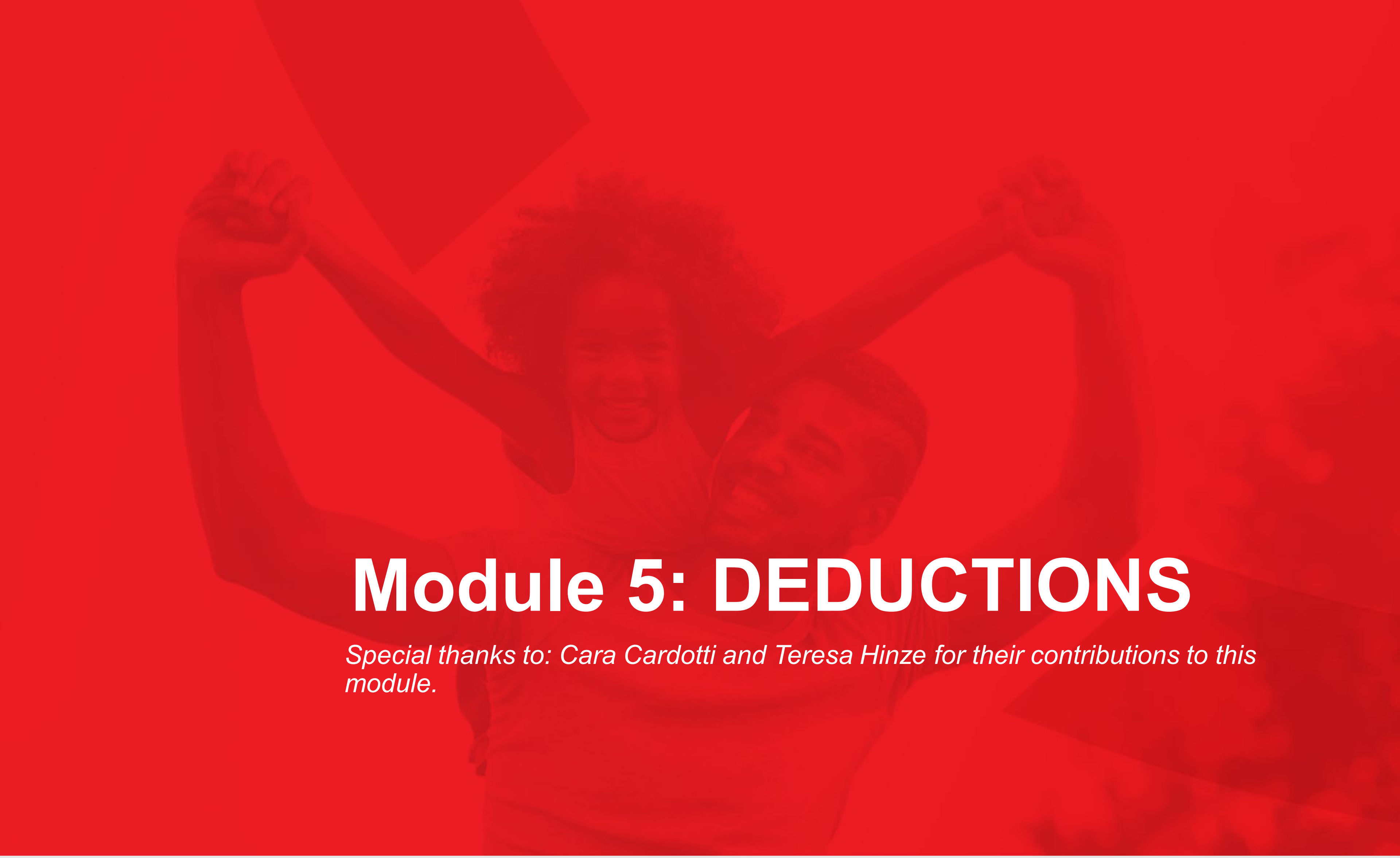

Module 5: DEDUCTIONS

Special thanks to: Cara Cardotti and Teresa Hinze for their contributions to this module.

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By the end of this module you will…

- Understand how the tax liability is calculated
- Understand the ways to lower one's taxable income and income taxes
- Understand the difference between the Standard and Itemized Deductions
- Understand how to determine which deduction should be applied to a client's return
- Understand what items/expenses are included with the Itemized Deduction

The Tax Computation

A general overview

The Tax Computation

- Tax filers are not taxed on all of their income.
- Income that is considered taxable (and certain non-taxable income) must be reported on the 1040 but that does not mean that the income will be taxed.

On the Form 1040, the lines for:

Total Income ≠ Taxable Income

- Total Income - Adjustments = **Adjusted Gross Income**
- Adjusted Gross Income - Deductions = **Taxable Income**

Determining Taxable Income

Step 1: Determine "Total Income" (this is not the same as "Taxable Income")

- Total Income = the taxable sum of the following:
  - Wages
  - Interest
  - Dividends
  - Capital gains
  - Business Income
  - Pensions
  - Social Security
  - Unemployment,
  - etc.

Total Income = line 9 = the sum of lines 1z + 2b + 3b + 4b + 5b + 6b + 7 + 8

Determining Taxable Income

Step 2: Reduce **Total Income** to determine **Taxable Income**

- There are two taxable income reducing categories:
  - **Adjustments** (Module 4):
    - IRA deductions
    - Student Loan Interest
    - Self-Employment tax, etc.
  - **Deductions**
    - Standard
    - Itemized

Total Income – Adjustments
=
Adjusted Gross Income (AGI)

Adjusted Gross Income – Deductions
=
Taxable Income

Note: Non-refundable **credits** (Module 6) can reduce income tax after it is calculated.

Deductions

Deductions Overview

- **<u>Deductions</u>** are subtracted from the Adjusted Gross Income (AGI) to result in the **Taxable Income**

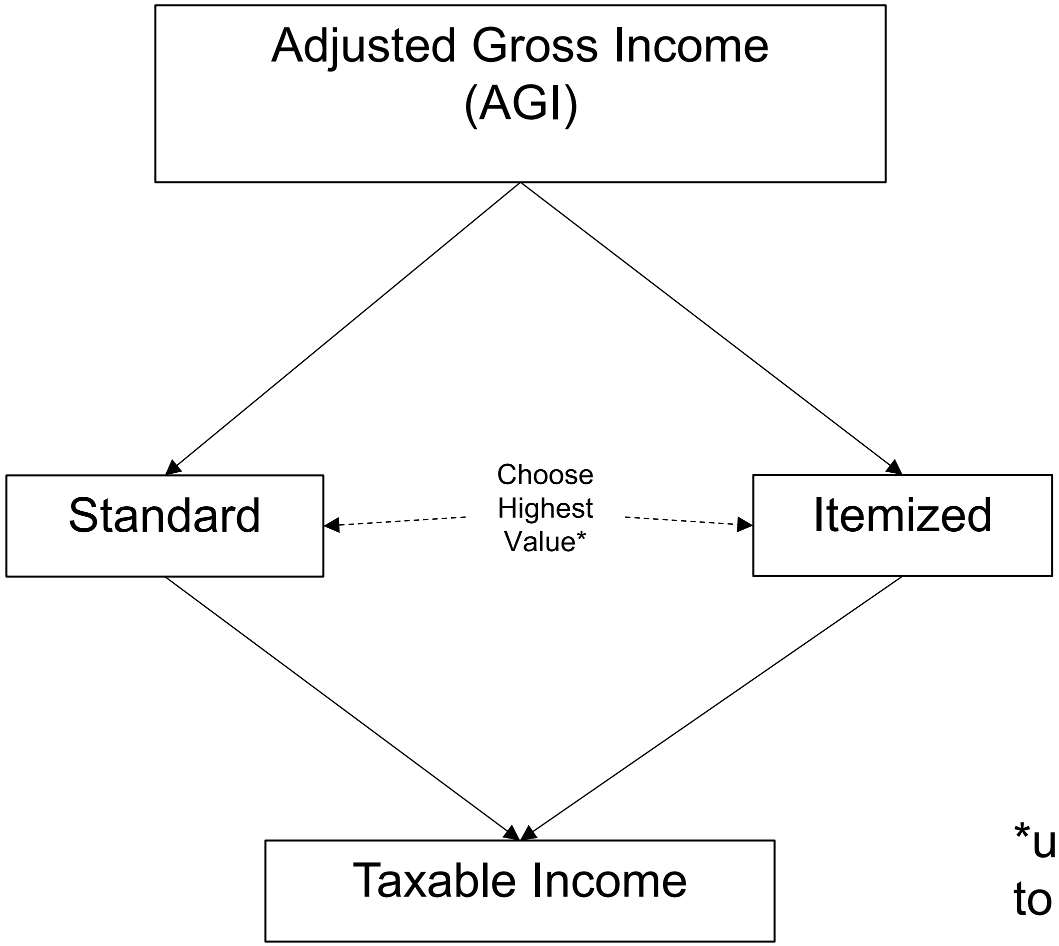
- The taxable income is used to determine the tax.

- There are 2 types of Deductions
  - Standard
  - Itemized

- **Only one** of these two can be applied to a return
  - **Use the one with the higher value**…. UNLESS you're required to itemize your deductions!
    - For example, MFS filers may be required to itemize
  - …. To obtain lowest **Taxable Income** value

- Don't sweat this! You got this!

Deductions → Taxable Income



*unless required to itemize

Standard Deduction

Standard Deduction

- **Standard Deduction** - A dollar amount that reduces the amount of taxable income
  - Varies according to filing status
  - Additional standard deduction for individuals who are blind or age 65 or over
  - You CANNOT take the standard deduction if you itemize deductions
  - Individuals that qualify as someone's dependent generally cannot take the full standard deduction

  - **NOTE:** *Not all clients are eligible to take the Standard deduction*
    - *If a married couple is filing separately and one spouse uses Itemized deductions then the other spouse must also use Itemized deductions*
    - *If you are a nonresident or dual-status alien during the year you cannot take the standard deduction. See 4012 for special circumstances for nonresident aliens married to a US citizen or resident.*
    - *See your 4012 for other less common cases.*

Standard Deduction Values (2024 returns)

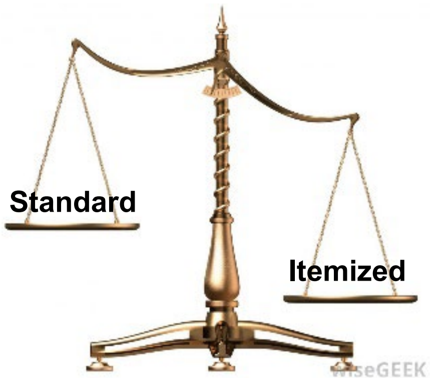
Filing Status	Standard Deduction Amount
Single and MFS	$14,600
MFJ and Qualifying Widow(er)	$29,200
Head of Household	$21,900

- Additional standard deduction for 65+ and blind
  - Filing Status: MFJ, Qualifying Widow(er) or MFS → $1,500 for each taxpayer
  - Filing Status: Single or Head of Household → $1,850
- An individual who qualifies as a dependent: Standard Deduction is the greater of
  - $1,250 (if all income is unearned income) *OR*
  - sum of $400 and individual's earned income (up to the standard deduction for their filing status)
  - *OR* the Standard Deduction for their Filing Status **if** earned income is greater than the Standard Deduction

Itemized Deductions

Itemized Deductions – Schedule A

- **Itemized Deductions**
  - Under current law, most VITA clients have lower **federal** taxable income using the standard deduction.
  - Taxpayers with higher incomes or high mortgage interest expenses are more likely to benefit from **federal** itemized deductions.
  - This training is focused on **federal** tax returns. Check with your VITA program, or state training resources to see if your state is one where clients can benefit from itemizing on the state return.
  - Common itemizable expenses include:
    - Medical and dental expenses
    - Taxes paid (state & local income taxes, & property taxes)
    - Home mortgage interest & points paid,
    - Gifts to charity
    - Certain miscellaneous deductions.
      - Can include gambling losses and casualty and theft losses
        - Check to make sure these are in scope!



If itemizable expenses are greater than the taxpayer's standard deduction it will probably be better to itemize.

Itemized Deduction Expenses

What to include?

- Medical
  - Expense Amount that is > 7.5% of AGI
  - Include medical & dental expenses paid for all members of the household:
    - Doctor & Dental bills
    - Prescriptions
    - Hospital bills
    - Insurance premiums (health and long-term care) **not** subsidized by employers or covered by the APTC
    - Mental health treatments
    - Transportation for medical treatments
    - And others (See 4012 and IRS Schedule A Instructions for limitations and additional allowable expenses)

- Taxes
  - State sales or income tax (whichever is larger)
    - Note: it is best practice to calculate the sales tax as it may be higher for low wage and non-working taxpayers (see 4012 or 1040 instructions for details on make the calculation)
  - Local or foreign income taxes
    - Foreign income taxes are generally out of scope – except those on 1099-INT and 1099-DIV
  - Real estate taxes
  - Personal property taxes

Beginning with tax year 2018, the total deduction for real estate tax, personal property taxes, and state income tax or sales tax is limited to $10,000.

Itemized Deduction Expenses

What to include?

- Home mortgage interest (Form 1098)
  - Limited to the 1st and 2nd home **only**
  - Private Mortgage Insurance*
  - For reverse mortgages, no interest until the loan is settled.

- Cash or non-cash donations to a qualified charitable organization
  - Charitable deductions are limited by VITA scope

- Miscellaneous Deductions
  - Gambling losses up to the amount of winnings
    - Be careful not to deduct more gambling losses than reported as gambling winnings! These winnings are reported on W-2G.
  - Since TY2018 many miscellaneous deductions including union dues, investment expenses and unreimbursed employee expenses were eliminated BUT some work related expenses are allowed for Disabled Persons.
  - Work related expenses are allowed for a Disabled Person only as well.
  - Casualty and Theft Losses are **Out of Scope** for VITA!
  - See your Publication 4012 for the complete list

- **NOTE: the ability to include Private Mortgage Insurance as a interest deduction changes from tax year to tax year. Make sure you check the tax law if you are not preparing a TY2023 return.*

Re-Cap

- **Taxable Income ≠ Total Income**

- Total Income – Adjustments = **Adjusted Gross Income**

- Adjusted Gross Income – Deductions = **Taxable Income**

- There are 2 types of Deductions
  - Standard
  - Itemized

- Only 1 of these two can be applied to a return
  - Standard vs Itemized Deduction
    How to choose??
  - Use the one with the higher value…
  - …. To obtain lowest "Taxable Income" value*
    - *Unless the taxpayer is required to itemized!

- If the sum of the individual expenses paid by the client results in an amount that is *greater than* the Standard deduction amount, Itemize Deductions (Schedule A), using the sum of the individual expenses to reduce taxable income. The software will help calculate for you!

Additional Resources

- Publication 4012
- IRS Tax Topic #551: Standard Deduction
- IRS Tax Topic #501: Should I Itemize?

Up Next…
Module 6: Non-refundable Credits