

In Chapter 6, we describe the deductions allowed in the computation of taxable income. It is important to emphasize that taxpayers are only allowed to deduct expenditures if there is a specific tax law authorizing the deductions. Of course, Congress grants many deductions for taxpayers for a variety of reasons, and these deductions appear in one of two places in the individual income tax formula. Deductions “*for* AGI” are subtracted directly from gross income. In contrast, deductions “*from* AGI” are subtracted from AGI.

Deductions *for* AGI are preferred over deductions *from* AGI because these deductions reduce taxable income dollar for dollar. An indirect benefit of deductions *for* AGI is that these deductions reduce AGI. Because many of the limitations on tax benefits for higher-income taxpayers are based upon AGI, deductions *for* AGI reduce these limitations, thereby increasing potential tax benefits. In contrast to deductions *for* AGI, itemized deductions will have no effect on taxable income unless the total exceeds the standard deduction. Students often confuse the location of the deduction with the deduction rule. So, a good rule is to emphasize the order of the questions. First, determine if the expense is deductible. Next, determine the location of the deduction (*for* or *from*).

## Lecture Notes

- 1) Deductions *for* AGI
  - a) Congress allows taxpayers to claim a variety of deductions *for* AGI.
  - b) Deductions directly related to business activities
    - i) Work through Example 6-1.
    - ii) Refer to Exhibit 6-1 for Individual Business and Investment-Related Expense Deductions *for* AGI, *from* AGI, and Not Deductible.
    - iii) Trade or business expenses
    - iv) Refer to Exhibit 6-2 for Parts I and II from Schedule C Profit or Loss from Business.
    - v) Work through Example 6-2.
    - vi) Rental and royalty expenses
      - (1) Taxpayers are allowed to deduct their expenses associated with generating rental or royalty income *for* AGI.
      - (2) Refer to Exhibit 6-3 for Page 1 of Schedule E Rental or Royalty Income.
      - (3) Work through Example 6-3.
    - vii) Losses on dispositions
      - (1) Taxpayers disposing of business assets at a loss are allowed to deduct the losses *for* AGI deductions.
    - viii) Flow-through entities
      - (1) Income from flow-through entities such as partnerships, LLCs, and S corporations passes through to the owners of those entities, with the related net business income reported on Schedule E of the tax returns of the owners.
      - (2) Expenses and losses incurred by the entity pass through to the entity owners, who typically treat them as deductions *for* AGI.
    - ix) Excess business loss limitation
      - (1) An excess business loss for the year is the excess of aggregate business deductions for the year over the sum of business gross income or gain of the taxpayer plus a threshold amount.
      - (2) The threshold amount for 2025 is \$626,000 for married taxpayers filing jointly and \$313,000 for other taxpayers.
      - (3) Excess business loss is not deductible but is carried forward.
      - (4) Work through Example 6-4.
  - c) Deductions indirectly related to business activities

- i) Taxpayers are allowed to deduct several expenses that are indirectly related to business activities as deductions *for* AGI.
- ii) Moving expenses
  - (1) Generally are not deductible.
  - (2) Employer reimbursements are taxable.
  - (3) Exception for active-duty military.
  - (4) Work through Example 6-5.
- iii) Health insurance deduction by self-employed taxpayers
  - (1) Intended to help self-employed taxpayers who must pay their own insurance premiums.
- iv) Self-employment tax deduction
  - (1) Work through Example 6-6.
- v) Deductions for individual retirement accounts (IRAs)
  - (1) Deductible contributions to traditional IRAs are *for* AGI deductions
  - (2) The deductible amount of the contribution depends on a number of factors (filing status, whether the taxpayer is an active participant in an employer-sponsored retirement plan, and the taxpayer's modified AGI).
  - (3) Distributions from traditional IRAs are taxed as ordinary income to the taxpayer, and early distributions (before age 59 ½) are generally subject to a 10 percent penalty.
  - (4) Taxpayers with earned income that are not eligible to make deductible contributions can make nondeductible contributions. On distribution, the taxpayer is taxed on the earnings generated by nondeductible contributions but not on the actual nondeductible contributions.
- vi) Deduction for health savings accounts (HSAs)
  - (1) HSAs allow individuals covered by a high deductible health plan with no other health coverage to set aside amounts for payment of qualified medical and dental expenses for the taxpayer, spouse, and dependents.
  - (2) For 2025, high deductible health plans have a minimum annual deductible of \$1,650 for self-only coverage (\$3,300 for family coverage) and their maximum annual deductible and other out-of-pocket expenses cannot exceed \$8,300 for self-only coverage (\$16,600 for family coverage).
  - (3) For 2025, individuals can contribute up to \$4,300 for self-only coverage (\$8,550 for family coverage) to an HSA and deduct these contributions for AGI. Individuals age 55 or older at the end of the tax year may contribute and deduct an additional \$1,000 annually.
  - (4) Distributions from a HSA are tax free if they pay for qualified medical expenses of the taxpayer, spouse, and dependents that occurred after the HSA was established (even if the distribution occurs in a year after the expense was incurred or in a year in which the taxpayer is no longer covered under a high deductible health plan). Taxpayers just need to maintain medical receipts to substantiate the previously unreimbursed qualified medical expenses.
  - (5) Otherwise, distributions are taxed as ordinary income (and subject to an additional 20% tax unless the taxpayer is disabled, age 65 or older, or deceased).
  - (6) Work through Example 6-7.
- vii) Penalty for early withdrawal of savings
  - (1) Allows a deduction *for* AGI for any interest income an individual forfeits to a bank as a penalty for prematurely withdrawing a certificate of deposit or similar deposit.
  - (2) Work through Example 6-8.
- d) Deductions subsidizing specific activities
  - i) Deduction for interest on qualified education loans
    - (1) Up to \$2,500 of interest on education loans is deductible *for* AGI.

- (2) A loan qualifies as an education loan if the proceeds are used to fund qualified education expenses.
- (3) The interest deduction is phased out for taxpayers with AGI exceeding \$85,000 (\$170,000 married filing jointly).
- (4) Refer to Exhibit 6-4 for Summary of Limitations on Deduction of Interest on Education Loans.
- (5) Work through Example 6-9.
- e) Summary: Deductions *for* AGI
  - i) Refer to Exhibits 6-5, 6-6, 6-7, and 6-8.
- 2) Deductions *from* AGI: Itemized deductions
  - i) Medical expenses
    - (1) Designed to provide relief for taxpayers whose ability to pay taxes is seriously hindered by health-related circumstances.
    - (2) Qualified medical expenses include any payments for the care, prevention, diagnosis, or cure of injury, disease, or bodily function that are not reimbursed by health insurance or are not paid for through a “flexible spending account” or “health savings account.”
    - (3) Common medical expenses include:
      - (a) Prescription medication, insulin, and medical aids such as eyeglasses, contact lenses, and wheelchairs. Over-the-counter medicines are generally not deductible.
      - (b) Payments to medical care providers such as doctors, dentists, and nurses and medical care facilities such as hospitals.
      - (c) Transportation for medical purposes.
      - (d) Long-term care facilities.
      - (e) Health insurance premiums (if not deducted *for* AGI by self-employed taxpayers) and insurance for long-term care services.
    - (4) Work through Example 6-10.
    - (5) Transportation and travel for medical purposes
      - (a) Taxpayers traveling for the primary purpose of receiving essential and deductible medical care may deduct the cost of lodging while away from home overnight (with certain restrictions) and transportation.
      - (b) Taxpayers using personal automobiles for medical transportation purposes may deduct a standard mileage allowance in lieu of actual costs.
      - (c) Work through Example 6-11.
    - (6) Hospitals and long-term care facilities
      - (a) Taxpayers may deduct the cost of meals and lodging at hospitals.
      - (b) Work through Example 6-12.
    - (7) Medical expense deduction limitation
      - (a) The deduction for medical expenses is limited to the amount of unreimbursed qualified medical expenses paid during the year (no matter when the services were provided) reduced by 7.5 percent of the taxpayer’s AGI.
      - (b) Work through Example 6-13.
  - ii) Taxes
    - (1) Individuals may deduct as itemized deductions the payments they made during the year for the following taxes:
      - (a) State, local, and foreign income taxes, including state and local taxes paid during the year through employer withholding, estimated tax payments, and overpayments on the prior-year return that the taxpayer applies to the current year (the taxpayer asks the state to keep the overpayment rather than refund it).
      - (b) State and local real estate taxes on property held for personal or investment purposes.
      - (c) State and local personal property taxes that are assessed on the value of the specific property.

- (2) Taxpayers may elect to deduct state and local sales taxes instead of deducting state and local income taxes. The total itemized deduction for state and local taxes is limited to \$40,000 (\$20,000 for a taxpayer filing married separate) in 2025. The itemized deduction for foreign income taxes is not subject to this limitation.
  - (3) The \$40,000 state and local tax deduction cap (\$20,000 for a taxpayer filing married separate) is reduced by 30 percent of the excess of the taxpayer's modified AGI (defined as AGI plus certain types of foreign excluded income) over the phase-out threshold (\$500,000 in 2025; \$250,000 for a taxpayer filing married separate in 2025). However, the cap is not reduced below \$10,000 (\$5,000 for a taxpayer filing married separate).
  - (4) Work through Example 6-14.
- iii) Interest
- (1) Individuals can deduct interest paid on loans secured by a personal residence (on acquisition indebtedness up to \$1,000,000 (\$500,000 if filing married separate) if indebtedness originated before December 16, 2017; \$750,000 (\$375,000 if married filing separately) if indebtedness originated after December 15, 2017).
  - (2) Individuals can also deduct interest paid on loans used to purchase investment assets such as stocks, bonds, or land (investment interest expense).
  - (3) Work through Example 6-15.
- iv) Charitable contributions
- (1) Congress encourages donations to charities by allowing taxpayers to deduct contributions of money and other property to qualified domestic charitable organizations.
  - (2) Qualified charitable organizations include organizations that engage in educational, religious, scientific, governmental, and other public activities.
  - (3) Work through Example 6-16.
  - (4) Contributions of money
    - (a) Cash contributions are deductible in the year paid, including donations of cash or by check, electronic funds transfers, credit card charges, and payroll deductions.
    - (b) Work through Example 6-17.
  - (5) Contributions of property other than money
    - (a) When a taxpayer donates property to charity, the amount the taxpayer is allowed to deduct depends on whether the property is capital gain property or ordinary income property.
    - (b) Work through Examples 6-18, 6-19, and 6-20.
  - (6) Charitable contribution deduction limitations
    - (a) The amount of a taxpayer's charitable contribution deduction for the year is limited to a ceiling or maximum deduction.
    - (b) Refer to Exhibit 6-9 for Summary of Charitable Contribution Limitation Rules.
    - (c) Work through Example 6-21.
- v) Casualty and theft losses on personal-use assets
- (1) Only casualty losses on personal-use assets attributable to a federally declared disaster are deductible (subject to \$100 floor for each casualty and 10 percent of AGI floor for all casualties in a year).
- vi) Other Itemized Deductions
- (1) Unreimbursed employee business expenses, tax preparation fees, investment expenses (other than investment interest expense), and hobby expenses are no longer deductible as other itemized deductions subject to 2 percent AGI floor.
  - (2) Gambling expenses and losses are deductible to extent of gambling winnings for the year.
  - (3) Casualty and theft losses on property held for investment (not personal-use property) and the unrecovered cost of a life annuity (if the taxpayer died before recovering the full cost of the annuity) also are deductible as other itemized deductions.
- vii) Summary of itemized deductions

- (1) Work through Example 6-22.
  - (2) Refer to Exhibit 6-10 for Courtney's Form 1040, Schedule A.
- 3) The standard deduction
  - a) Standard deduction
    - i) A flat amount that most individuals can elect to deduct instead of deducting their itemized deductions (if any).
    - ii) Taxpayers generally deduct the greater of their standard deduction or their itemized deductions.
    - iii) The amount of the standard deduction varies according to the taxpayer's filing status, age, and eyesight.
    - iv) Basic standard deduction is greater for married taxpayers filing jointly and those supporting a family (head of household) than it is for married taxpayers filing separately and unmarried taxpayers not supporting a family.
    - v) Taxpayers who are at least 65 years of age on the last day of the year or blind are entitled to additional standard deduction amounts above and beyond their basic standard deduction.
    - vi) Refer to Exhibit 6-11 for Standard Deduction Amounts.
    - vii) Work through Examples 6-23 and 6-24.
    - viii) Bunching itemized deductions
      - (1) Some taxpayers may deduct the standard deduction every year because their itemized deductions always fall just short of the standard deduction amount and thus never produce any tax benefit.
      - (2) The basic strategy consists of shifting itemized deductions into one year such that the amount of itemized deductions exceeds the standard deduction for the year, and then deducting the standard deduction in the next year (or vice versa).
  - (3) Work through Example 6-25.
- 4) Other from AGI deductions
  - a) Deduction for qualified business income
    - i) Deduction is limited to qualified trade or business.
      - (1) Excludes specified service trade or business (except for taxpayers with taxable income below \$197,300; \$394,600 if married filing jointly; \$197,300 if married filing separate).
    - ii) Work through Example 6-26.
    - iii) Limitations
      - (1) The deduction for qualified business income cannot exceed the greater of:
        - (a) 50 percent of the wages paid with respect to the qualified trade or business, or
        - (b) The sum of 25 percent of the wages with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property in the qualified trade or business.
    - iv) Work through Example 6-27.
  - b) Deduction for qualified tip income
    - i) For tax years from 2025 through 2028, taxpayers can deduct up to \$25,000 of qualified tips received during the year that are properly reported on IRS-approved forms.
    - ii) Qualified tips are defined as cash tips received by an individual in an occupation where tipping was customary before January 1, 2025.
    - iii) The maximum qualified tip income deduction is phased-out by \$100 for every \$1,000 of modified AGI (AGI increased by certain foreign income excluded) above \$150,000 (\$300,000 for married filing joint taxpayers). Married taxpayers must file jointly to claim the deduction.
    - iv) Work through Example 6-28
  - c) Deduction for qualified overtime compensation
    - i) For tax years from 2025 through 2028, taxpayers can deduct up to \$12,500 (\$25,000 for married filing jointly) for qualified overtime compensation received during the year and properly reported of on Form W-2 (for employees) and Form 1099 (for non-employees).

- ii) Qualified overtime compensation is overtime compensation paid to an individual required under the Fair Labor Standards Act for hours worked beyond 40 hours in a work week. Qualified overtime compensation does not include any qualified tip income. Married taxpayers must file jointly to claim the deduction.
  - iii) The maximum deduction for qualified overtime compensation is subject to phase-out. Specifically, the \$12,500 maximum deduction (\$25,000 maximum deduction for married filing joint) is reduced by \$100 for each \$1,000 the modified AGI for the taxpayer (AGI increased by certain foreign income excluded) exceeds \$150,000 (\$300,000 for married filing joint return).
  - iv) Work through Example 6-29
  - d) Deduction for qualified car loan interest
    - i) For tax years from 2025 through 2028, taxpayers can deduct up to \$10,000 of qualified car loan interest per year. To qualify, the car debt must have been incurred after December 31, 2024 for the purchase of a new personal use vehicle (car, minivan, SUV, pickup truck, or motorcycle with a gross vehicle weight rating under 14,000 pounds) of the taxpayer.
    - ii) The final assembly of the vehicle must have occurred in the United States, the taxpayer must report the vehicle identification number on their tax return, lenders must file information returns reporting the interest received on qualified personal auto loans with the IRS, and the vehicle's original use must begin with the taxpayer.
    - iii) The \$10,000 maximum deduction for qualified car loan interest is subject to phase-out. Specifically, the \$10,000 maximum is reduced by \$200 for each \$1,000 (or portion thereof) the modified AGI for the taxpayer (AGI increased by certain foreign income excluded) exceeds \$100,000 (\$200,000 for married filing joint return).
    - iv) Work through Example 6-30
  - e) Deduction for seniors
    - i) For tax years from 2025 through 2028, taxpayers age 65 or older can claim a \$6,000 deduction (and a \$6,000 deduction for their spouse age 65 or older). Married taxpayers must file jointly to claim the deduction.
    - ii) The senior deduction is phased-out by 6% (but not below zero) of the amount the taxpayer's modified AGI (AGI increased for certain foreign income excluded) exceeds \$75,000 (\$150,000 for married filing joint).
    - iii) Work through Example 6-31
- 5) Taxable income summary
- a) Refer to Exhibits 6-12, 6-13, and 6-14.
- 6) Conclusion
- 7) Summary
- 8) Key Terms