THE BASIC'S – TAX FORM 1040 "COST OF LIVING"

By Kathleen Crawford, EA

In the continuing series of income tax basics, the next topic is a more in depth look at the "cost of living" deduction. It is one of the key deductions that reduces the amount of federal income tax and is entered on line 40 of the form 1040. For this deduction, either a standard amount is used or a taxpayer fills out a Schedule A which calculates the "itemized" deductions. Every return gets some deduction in this area, even a dependent child who must file her own return will see some "cost of living" deduction.

Many people are confused about how this deduction works in practice. Everyone, who is not a dependent, starts with the standard deduction. The standard deduction varies with a taxpayer's filing status. Currently, for 2007 returns, the standard deduction for a married couple filing jointly is $10700.00. A single person is one half of that amount or $5350.00. This is the lowest that the deduction should be. There are several exceptions - this is tax law after all.

If you have deductions of certain expenses that are more than the standard amount, then you can itemize your expenses and take the greater number. Itemized deductions are figured on Schedule A and include mortgage interest, taxes, charitable giving, some portion of medical expenses and several other expenses. People who should consider itemizing will have a mortgage payment on their home because mortgage interest is deductible (with some limits) and property taxes are deductible. A taxpayer must be careful to keep in mind that there is always a floor on the deduction. I once had a client burst into unhappy tears because her refund was only $1500. She had purchased a home and was told to expect thousands of dollars in refunds because of the interest she was paying. Her itemized deductions were about $8000, but her standard deduction had been about $7000, so the deduction difference was only $1000. That made only a $150 increase in her refund. Your deduction does not start at zero.

If a family contributes large sums to charity or has large medical expenses, itemizing may increase their deductions. Some people ask if there are limits on how much can be given to charity. The only limits are made by the size of your heart or pocketbook. The IRS does put limits on how much can be used as a deduction for income tax purposes in any year. The limit for most charitable giving is 50% of your income. Any of the money that cannot be deducted this year is carried over to the next year to be used for that return. I know a friend who had a six figure contract to do a project for a company. When the project finished, my friend had a bad feeling about the company and had other resources, so she donated the entire contract amount to the building fund of a local charity. The deduction had to be spread over three years to use it all-but in the end, 100% of it lowered her taxes.

Itemized deductions help many taxpayers lower their income tax liabilities. It is an area where people fudge their numbers and is looked at closely by the IRS. All itemized deductions need to be well documented so that there are no questions during an audit.

The fine print is that this article is for information only. Please call Kathy or a tax professional for questions about your individual tax situation. The Jacksonville Tax Lady can be reached at 541-899-7926 or at 610 North Fifth Street.