

Itemized Deductions—Reductions for High-Income Taxpayers

Many have asked why the total itemized deduction amount shown on your return is less than the sum of the individual deduction amounts. For example, how can you have \$10,000 in mortgage interest deductions, \$10,000 in state and local taxes, and \$7,000 in charitable contributions, and wind up with an itemized deduction less than \$27,000.

This can occur because total itemized deductions are reduced for taxpayers with adjusted gross income (AGI) above specified levels. The general rule is that certain itemized deductions are reduced by 3% of the amount by which your AGI exceeds \$150,500 in 2006 (\$156,400 for 2007). (The threshold AGI amount increases each year to reflect inflation. For married taxpayers filing separately, the threshold amount is half the regular figure: \$75,250 in 2006 (\$78,200 in 2007).

There are several limitations that make the reduction rule less onerous:

- (1) Certain itemized deductions aren't subject to the reduction rules and will always be fully deductible. These "protected" deductions are medical expenses, investment interest, casualty and theft losses, and gambling losses.
- (2) No matter how high your AGI is, you will never lose more than 80% of your other (unprotected) itemized deduction total. That is, you will always be allowed to deduct at least 20% of these itemized deductions.

These rules can be expressed as a formula as follows: Your itemized deductions will be reduced by *the lesser of*:

- 3% of the excess of AGI above the threshold amount, or
- 80% of the itemized deductions subject to the reduction rules.

But, beginning in 2006, the applicable overall limitation on itemized deductions is itself reduced. Specifically, for tax years beginning in calendar years 2006 and 2007 the overall limitation amount equals two-thirds of the otherwise applicable limitation amount. Thus, the overall limit is reduced by one-third in 2006 and 2007.

Example. For 2006, Larry had the following itemized deductions: \$10,000 mortgage interest, \$12,000 state and local property and income taxes, and \$5,000 in charitable deductions, for a total of \$27,000, all "unprotected" from the reduction rules. Larry's AGI is \$190,500, which is \$40,000 above the threshold for 2006. His itemized deductions for the year would be reduced by \$1,200. This is the \$27,000 total reduced by the lesser of:

- (a) \$1,200 (3% of \$40,000), or
- (b) \$21,600 (80% of \$27,000).

However, given the one-third reduction of the overall limitation for 2006, Larry would only have to reduce his itemized deductions by \$800 ($\$1,200 \times \frac{2}{3} = \800). So, his total itemized deductions for 2006 would be \$26,200 ($\$27,000 - \800).