Deductions Eliminated Under Trump's Tax Reform Proposal

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One of President Trump's key tax reforms is to eliminate all individual tax deductions except for those that incentivize home ownership, charitable contributions and retirement contributions. Although the administration's one-page outline of the proposed tax reforms provides little detail, if all of the deductions except those noted are eliminated, the reform will impact both itemized deductions and income adjustments. This article will explore the deductions that the president's proposal retains and those that it would eliminate, so you will be able see how these changes could play out for your particular circumstances.

Deductions the Proposal Retains

Incentives for Home Ownership – Although Trump's proposal provides no details about what "incentives for home ownership" means, this category would presumably include deductions for home-mortgage interest and property taxes. However, it is unknown if the plan will include the existing restrictions that limit the home-mortgage interest deduction to $1 million of home-acquisition debt and $100,000 of equity debt. It is also unclear if the incentives for home ownership would include second homes.

Charitable Contributions – Presumably, the plan would continue to be subject the 50%, 30% and 20% adjusted gross income (AGI) limits. The proposal does not address one of the most complicated areas (and one that is significantly abused) – contributions of overly valued property.

Retirement Contributions – Retirement contributions are deducted as an adjustment to income; this is frequently referred to as an above-the-line-deduction. Presumably, in the new plan, this still would include traditional IRAs and self-employed retirement plan contributions.

Itemized Deductions the Proposal Eliminates

Medical Itemized Deductions – Currently, medical deductions are already limited to those that exceed 10% of a taxpayer's AGI. The Trump plan eliminates the medical deduction altogether, which would significantly impact senior citizens, especially those requiring significant elder care, and taxpayers who have incurred extraordinary medical expenses. What is curious about the elimination of the medical deduction is that, just a couple of months ago, as part of the failed ACA repeal, the administration wanted to reduce the medical AGI limitation and allow larger medical deductions. Now, it wants to eliminate them altogether.

Deduction for State and Local Taxes – Currently, deductions are allowed for state income tax, city and other income taxes, real and personal property taxes and (under certain circumstances) sales taxes.

Eliminating this deduction would have the most significant impact on taxpayers living in states that have income taxes. Taxpayers residing in those states would no longer be able to deduct their state and local income taxes and thus would be doubletaxed on the same income. All but seven states have income tax, with California, New York and New Jersey imposing the highest rates. Support for this change is questionable, even among Republican senators, as representatives from states with income taxes will certainly want to retain the state income-tax deduction for their constituents.

Investment Interest Deduction – Currently, a deduction is allowed for investment interest in the amount of net investment income (investment income minus investment expenses). This means that the interest taxpayers pay on money that they borrow to purchase investments would no longer be deductible.

Casualty & Theft Losses – Every year, Americans deal with casualty losses from accidents, fires, floods, tornados, hurricanes, earthquakes and other natural disasters. Currently, those taxpayers can deduct casualty losses – generally to the extent that they exceed $100 per event and 10% of their AGI. Under Trump's plan, this deduction would be eliminated, which penalizes taxpayers who are in the greatest need – those who are recovering from a disaster.

Employee Business Expenses – Currently, employee business expenses, including the home-office deduction for employees who work out of their own homes, are deductible as miscellaneous itemized deductions, but these deductions are limited to those expenses that exceed 2% of AGI. Under the Trump plan, this deduction would be eliminated. This could pose a serious handicap for telecommuting employees, who would then have the bear the cost of their own offices, office equipment and supplies. Another example are mechanics who must pay for their own (expensive) tools.

Legal Fees – Currently, legal fees are deductible when they are incurred for the protection or production of taxable income. This includes taxable awards as a result of winning or settling a lawsuit. Typically, legal fees are contingent upon the taxpayer winning the suit; they often represent a large percentage of the award. Without this deduction, the taxpayer would have to pay taxes on the entire award even though a significant portion went toward attorneys' fees.

Gambling Losses – Currently, gambling losses are only deductible in an amount equal to gambling winnings. Under Trump's plan, these losses would no longer be deductible, meaning that taxpayers would have to pay taxes on all their winnings – even if they have net losses. Senior citizens and others who gamble recreationally could be hit with significant taxes even when they actually lose money.

Other Deductions the Proposal Eliminates

The following deductions are not itemized deductions but are considered adjustments to income. This includes retirement-plan deductions (such as those for IRAs and self-employed retirement plans, including SEPs, SIMPLE and other qualified plans); all of these deductions would be retained. However, if all other deductions are eliminated, the eliminated deductions would include:

Teacher's Expenses – This is the educator's deduction for classroom supplies (up to $250 per year). The 2015 PATH Act recently made this deduction permanent.

Health Savings Account (HSA) Deduction – Individuals with high-deductible health insurance can currently deduct contributions to HSA plans when the funds are used to pay qualified medical expenses. It is doubtful that this deduction will actually be eliminated, as HSAs are a key element of the administration's plan to replace Obamacare.

Moving Expenses – Individuals who move over 50 miles as a result of a change in work location and who work at the new location for a minimum period of time can deduct the cost of the move.

Self-Employed Health-Insurance Deduction – Self-employed individuals, including partners and those who hold more than 2% of an S corporation's shares, can deduct the cost of their own medical insurance as well as that of their spouse and dependents, subject to certain conditions.

Penalty for Early Withdrawal of Savings – When taxpayers withdraw from term savings accounts, they may incur interest penalties, which are deductible. This deduction was implemented to avoid having taxpayers pay taxes on interest income that they did not receive.

Alimony Paid – When a taxpayer pays alimony to a former spouse, that alimony is taxable for the recipient. To avoid taxing both parties on the same income, the one who makes the payments is allowed to deduct the alimony paid. Eliminating this deduction would have a significant impact on taxpayers who pay alimony.

Student-Loan Interest Deduction – These rules allows for a deduction of up to $2,500 for interest paid on student loans.

Domestic-Production Activities Deduction – Tax law includes a special tax deduction that encourages domestic production (as opposed to foreign production). C-corporations take this deduction on their corporate tax returns; self-employed individuals, partners and S-corporation shareholders must take this deduction on their 1040. It is doubtful that Congress would continue to allow this deduction for corporations while also discriminating against self-employed taxpayers by not allowing them to take the deduction.

We can only wonder if the president expects all of these deductions to be eliminated; perhaps he only proposed the eliminations as a tool to start negotiations with Congress. Details are not promised to arrive until June, so we will have to wait and see how this plays out.