Itemized Deductions Reported on Schedule A (Form 1040)

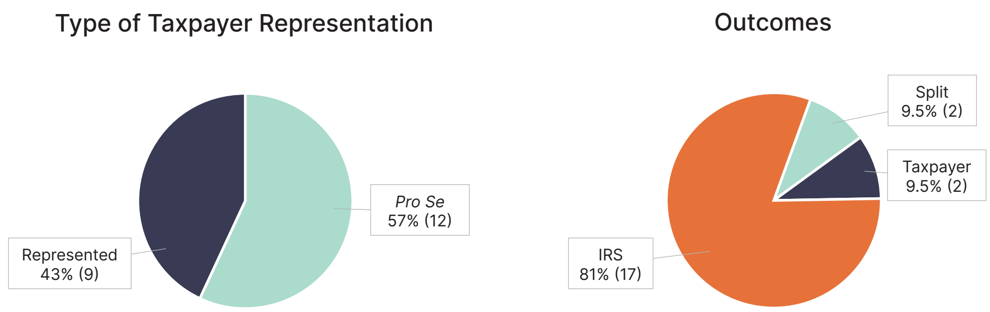
TAXPAYER RIGHTS IMPACTED[1]

- *The Right to Be Informed*
- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Challenge the IRS's Position and Be Heard*
- *The Right to Appeal an IRS Decision in an Independent Forum*
- *The Right to a Fair and Just Tax System*

OVERVIEW

Itemized deductions reported on Schedule A, Itemized Deductions, of IRS Form 1040, U.S. Individual Income Tax Return, were among the ten Most Litigated Issues for the fourth time since the National Taxpayer Advocate's 2000 Annual Report to Congress.[2] During this reporting period between June 1, 2019, and May 31, 2020, we identified 21 decisions, in which itemized deductions were litigated in federal courts.[3] All but four of these cases were litigated in the U.S. Tax Court. Figure 2.8.1 illustrates the outcome of the litigation by type of taxpayer representation. As shown, the courts affirmed the IRS position in 17 of these cases, or about 81 percent, while taxpayers fully prevailed in two cases, or about ten percent of the cases. The remaining two cases, or about ten percent, resulted in split decisions. Taxpayers were represented in 9 of the 21 (or 43%) while 12 of 21 cases (or 57%) had *pro se* (without counsel) taxpayers. During this same period, taxpayers petitioned Tax Court in 1,120 cases where itemized deductions were an issue during the examination.[4]

FIGURE 2.8.1



1 *See* Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are also codified in the IRC. *See* IRC § 7803(a)(3).

2 This year and in previous years, charitable contribution deductions have been considered separately as a Most Litigated Issue.

3 We excluded cases involving unreimbursed employee expenses and charitable deductions as they are discussed elsewhere in the National Taxpayer Advocate's Annual Report to Congress. Unreimbursed employee expenses are discussed in detail in the Most Litigated Issue: *Trade or Business Expenses Under IRC § 162*, *supra*. Cases involving charitable deductions are discussed in the Most Litigated Issue: *Charitable Contribution Deductions Under IRC § 170*, *infra*.

4 IRS Appeals response to TAS information request (Dec. 3, 2020) showing cases petitioned to Tax Court between June 1, 2019, and May 31, 2020. TAS matched this data to the cases identified by examination where an adjustment to itemized deductions was recommended as recorded in the Examination Operational Automation Database on the IRS Compliance Data Warehouse (CDW) (Dec. 2020).

ANALYSIS OF LITIGATED CASES

With the exception of *New York v. Mnuchin,* detailed below,[5] the litigation on itemized deductions focused on the application of well-settled legal principles and applied the relevant statutes, regulations, and case law to the taxpayers' particular facts and circumstances. The largest portion of this year's 21 cases involved taxpayers claiming deductions for casualty and theft losses,[6] mortgage and investment interest expenses,[7] and gambling losses.[8] Figure 2.8.2 categorizes the main issues raised by taxpayers in the 21 cases we identified. As the figure demonstrates, the largest category of deductions was casualty and theft loss deductions.

FIGURE 2.8.2, Itemized Deduction Issues[9]

Itemized Deduction	Number of Cases	Percentage of Cases
Casualty/Theft Loss	7	33%
Mortgage Interest and Investment Interest	6	29%
Gambling	3	14%
State and Local Taxes	2	10%
Medical and Dental Expenses	2	10%
Tax Preparation Fees	1	5%
Other	3	14%

One hurdle faced by taxpayers across the various itemized deduction categories is substantiation. The Code requires taxpayers to substantiate expenses underlying each claimed deduction by maintaining records sufficient to establish the amount of the deduction to enable the Commissioner to determine the correct tax liability.[10] In these cases, taxpayers were unable to or had difficulty substantiating their itemized deduction claims in nine of the 21 cases we identified, or nearly 43 percent of the cases.

The most notable case litigated on the topic of itemized deductions involved the deduction for state and local taxes paid. Specifically, in *New York v. Mnuchin*, the states of New York, Connecticut, Maryland, and New Jersey filed an action against the United States, the IRS, the Acting Commissioner of the Internal Revenue, the United States Department of the Treasury, and the Secretary of the Treasury.[11] The states alleged that the new Tax Cuts and Jobs Act (TCJA) limit on the amount of state and local taxes paid that taxpayers can claim on Schedule A (the "SALT cap") violated constitutional guarantees of federalism and exceeded

5 *New York v. Mnuchin*, 408 F. Supp. 3d 399 (S.D.N.Y. 2019), *appeal docketed*, No. 19-3962 (2d Cir. Nov. 26, 2019).

6 IRC § 165.

7 IRC § 163.

8 IRC § 165(d).

9 Several cases we identified had more than one of the issues listed in Figure 2.8.2. In addition to the top three deductions listed above, IRC § 164(b)(6) provides the deduction for state and local taxes paid; IRC § 213(a) provides the deduction for medical and dental expenses; and IRC § 67 provides the miscellaneous itemized deductions, including tax preparation fees and other professional fees.

10 IRC § 6001; *Welch v. Helvering*, 290 U.S. 111, 115 (1933); *Cohan v. Comm'r*, 39 F.2d 540, 543-44 (2d Cir. 1930) (providing an exception to strict substantiation and allowing the taxpayer to estimate expenses under certain circumstances); Temp. Treas. Reg. § 1.274-5T(b). For detailed recordkeeping guidance for taxpayers, see also IRS, Publication 17, Your Federal Income Tax for Individuals: Tax Guide 2019 for Individuals (July 2020).

11 *New York v. Mnuchin*, 408 F. Supp. 3d 399 (S.D.N.Y. 2019), *appeal docketed*, No. 19-3962 (2d Cir. Nov. 26, 2019).

Congress's taxation powers.[12] The U.S. District Court for the Southern District of New York granted the defendants' motion to dismiss for failure to state a valid legal claim. It concluded that the states failed to cite a constitutional principle that would bar Congress from exercising its otherwise plenary power to impose an income tax with a limited SALT deduction. The court held that there is no basis to conclude that the SALT cap is unconstitutionally coercive. The SALT cap, like any federal tax provision, will affect some states more than others. However, the states still have the ability to make their decisions as to how they will exercise their own sovereign tax powers. Thus, the states failed to plausibly allege that the SALT cap meaningfully constrained their decision-making process.

CONCLUSION

The number of itemizers significantly decreased, by about 66 percent from tax year (TY) 2017 to TY 2019, likely due to the tax changes brought about by the TCJA.[13] A reduction in the number of itemizers may eventually lead to a decrease in litigation in the coming years. In addition, a further decrease in litigation over the issue could occur through increased taxpayer awareness of substantiation requirements. If taxpayers carefully maintain detailed records related to any itemized deductions they claim, they will be in a better position to verify such deductions with the IRS before disputes result in litigation. Accordingly, the IRS must continue to increase awareness of taxpayer recordkeeping requirements, which will protect taxpayers' *rights to be informed* and *to pay no more than the correct amount of tax*. By doing so, the IRS will encourage taxpayers to comply with their tax obligations and minimize the risk of litigation.

Recommendation to Mitigate Disputes

The National Taxpayer Advocate recommends that the IRS:

1. Evaluate the IRS's existing communication strategy, including the IRS website, guidance, and publications, to taxpayers, preparers, and practitioners to determine how to increase awareness about itemized deductions, including recordkeeping requirements. Then based on the findings, conduct outreach within the next two fiscal years to better educate taxpayers.

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12 Section 11042 of the TCJA, Pub. L. No. 115-97, 131 Stat. 2054, 2085 (2017), amended IRC § 164(b)(6) to limit the aggregate amount of the itemized deduction taxpayers can claim for state and local income, general sales, real property, or personal property taxes up to $10,000 per year ($5,000 in the case of a married individual filing a separate return) for Tax Years (TYs) 2018 to 2025.

13 In TY 2017, about 43.4 million taxpayers claimed itemized deductions (30.3 percent). In TY 2019, about 14.6 million taxpayers claimed itemized deductions (9.9 percent). Individual Returns Transaction File on the IRS CDW (comparing tax returns filed between January 1 and October 1 in both TYs 2017 and 2019). The Joint Committee on Taxation staff estimated the number of taxpayers who itemize would decrease as a result of TCJA. Joint Comm. on Taxation, *Tables Related to the Federal Tax System as in Effect 2017 Through 2026* (JCX-32-18), Table 5 (Apr. 23, 2018). TAS has a website, available in both English and Spanish, to educate individual taxpayers about items that were changed and not changed as a result of TCJA. For a detailed list of these changes, see TAS, Tax Changes by Topic, https://www.taxchanges.us/ (last visited Aug. 9, 2020).