**Chapter Five**

**Deductions For and From AGI**

**2020**

**Learning Objective 5.1 Health Savings Accounts**

Health Savings Accounts (HSAs) are used for the purpose of paying unreimbursed medical expenses by taxpayers who carry qualifying high-deductible medical insurance.

* In 2019, taxpayers can contribute $7,000 for a family or $3,500 for self only.
  + There is an additional “catch-up” of $1,000 per person for ages 55+.
* Distributions from HSAs are free of tax when used to pay for qualified medical expenses.
  + Distributions that are not used to pay for medical expenses are subject to both income tax and a 20% penalty.
  + At 65 years old, a taxpayer may take distributions for nonmedical expenses and will be subject to income tax, but not the 20% penalty.
  + Distributions from HSAs are reported on Form 1099-SA.
  + Publication 969 is a good source of information on HAS-related issues.

Three other types of tax-favored medical spending plans include the following:

1. Health care flexible spending arrangements (FSAs)
2. Health Reimbursements Arrangements (HRAs)
3. Medical Savings Accounts (MSAs or Archer MSAs)

**Learning Objective 5.2 Self-Employed Health Insurance Deduction**

Self-employed taxpayers are allowed an above-the-line deduction for health insurance premiums paid for themselves and their families.

* Taxpayers with income reportable on Schedule C are generally self-employed (also certain partnerships, S corporations, LLCs, and farms).
* Deductible insurance includes medical/dental insurance paid to cover taxpayer, spouse, and dependents.
* It includes medical/dental insurance paid for children under 27 who aren’t dependents.
  + Must net advance premium credit received under ACA
* Long-term care insurance is paid for the taxpayer and the family of the taxpayer (within limits).

*Note:* Health insurance premiums are not allowed for any months in which the taxpayer can participate in a subsidized health care plan.

**Learning Objective 5.3 Individual Retirement Accounts**

The two major types of IRAs are traditional and Roth.

A traditional IRA is an account to which individuals contribute funds for their retirement.

* Deductions from AGIand the fund’s earnings (interest and dividends) are tax deferred.
* The maximum annual contribution to an IRA is equal to the lesser of either 100% of the taxpayer’s compensation or $6,000 ($12,000 if the taxpayer has a spouse with no earned income).
  + The maximum contribution to either spouse’s IRA may not exceed $6,000.
  + An additional $1,000 is allowed for a contribution if a taxpayer and their spouse are over 50 years old.
  + Phase-outs depend on whether one, both, or neither spouse is an active participant in a retirement plan. (See table on page 5-9 for phase-outs on traditional IRAs.)
* Even if a taxpayer phases out their ability to deduct a traditional IRA contribution, they can still make a nondeductible IRA contribution.
* Distributions cannot begin before age 59½ (10% penalty); they must begin by age 70½.

Early withdrawals may be made without a penalty if one of the following conditions applies to the taxpayer:

1. Disabled
2. Using a special level payment option
3. Using withdrawal for unreimbursed medical expenses in excess of 10% of AGI
4. Paying medical insurance premiums for the dependent(s) of a taxpayer who has received at least 12 weeks of unemployment compensation
5. Paying higher education costs for the taxpayer, the spouse, a child, or a grandchild
6. Withdrawing funds due to an IRS levy
7. Withdrawing first-time home-buying expenses up to $10,000
8. Beneficiary due to the death of the IRA owner
9. A qualified reservist

*Note:* While these withdrawals are not penalized, the amounts are still subject to income taxes.

Another type of IRA is a Roth IRA.

* Contributions to Roth IRAs are nondeductible, but qualified distributions are tax free.
  + Annual contributions = $6,000 or $7,000 if age 50+.
  + Phase-outs apply (see table on page 5-9).
  + Tax-free withdrawals from a Roth IRA may be made after a 5-year holding period and if any of the following conditions are met:
* Distribution is made on or after the date the participant reaches age 59½.
* Distribution is made to a beneficiary (or participant’s estate) on or after participant’s death.
* The participant becomes disabled.
* Distribution is used to pay for qualified first-time home-buyer’s expenses.
* A distribution will be taxable if the distribution does not satisfy the above requirements.
* Again, the contributions are subject to AGI phase-outs.

**Learning Objective 5.4 Small Business and Self-Employed Retirement Plans**

Internal Revenue Code provides favorable tax treatment for contributions, by or for employees, to qualified retirement plans.

* Employers get current year deduction.
* Employees do not include contributions in income.
* Tax on earnings is deferred until distribution.

Qualified retirement plans may qualify including pension plans, profit-sharing plans, stock bonus plans, and employee stock ownership plans (ESOP).

* To be “qualified,” a plan must:
* Be created for exclusive benefit of employees/beneficiaries
* Not discriminate in favor of highly compensated employees
* Meet participation and coverage requirements
* Meet minimum vesting requirements
* Meet uniform minimum distribution rules.
* Self-employed taxpayers and their employees are eligible to be members of a Simplified Employee Pension (SEP).
  + In 2019, contributions were limited to the lesser of 25% of compensation or $56,000.

Many types of plans are available, including SEP IRAs, SIMPLE IRAs (for 100 or fewer employees), and Payroll Deduction IRAs. There are different limits for each type of plan.

* To avoid penalties, distributions must begin at age 70½, but not before age 59½.
* A 401(k) plan allows an employee to make contributions and defer tax on the compensation.
* 2019 annual maximum—$19,000 or $25,000 if age 50.
* An employer may match contributions to encourage participation; this match is excludable from income.
* Contributions in excess of the maximum are subject to an excise tax.
  + A self-employed (SE) or solo 401(k) is designed for SE individuals with no employees.
  + Traditional can be used by any type of company: it is best for 20+ employees because of setup costs.
  + A safe harbor 401(k) has one very different feature: it requires full vesting in ER contributions immediately.

*Note:* Max contribution is reduced dollar for dollar for amounts contributed to other salary reduction plans.

* Roth 401(k) plans are popular for high-income taxpayers because there is no AGI limitation.
* This is a complex area with many tax preparers turning to retirement tax specialists for help.

**Learning Objective 5.5 Other For AGI Deductions**

* Eligible educators may deduct up to $250 for unreimbursed cost of classroom materials as a deduction for AGI.
  + Eligible educators are K-12 teachers, counselors, principals, or 900+ hour aids.
* The TCJA suspended employee business expenses, but three different professions are eligible for this deduction:

1. Performing artists who meet four stipulations (see page 5-17)
2. National Guard or Reserve members who travel more than 100 miles in connection with service in reserves
3. State or local fee-based officials

* Only members of the Armed Forces are able to deduct moving expenses.

**Learning Objective 5.6 Medical Expenses**

Medical expenses are the first itemized deduction on Schedule A.

* Deduction includes amounts paid for the taxpayer, their spouse, and dependents.
* Medical expenses include prescription medications; visits to doctors, dentists, and hospitals; medical insurance premiums; lodging and transportation expenses for medical care; hearing aids; dentures; eyeglasses; and contact lenses.
  + Insurance reimbursements are subtracted.
  + Deductible amount is reduced by 10% threshold.
* Capital expenditures such as installing medical/special equipment in home may be deducted.
* Transportation is deductible at $0.20/mile in 2019.
* Lodging is $50 per night, per person, to travel to essential medical care.

**Learning Objective 5.7 Taxes**

Certain state, local, and foreign taxes paid during the year are deductible. The TCJA changed a number of provisions:

1. Foreign property taxes are only deductible if incurred in carrying on a business or for the production of income.
2. Aggregate amount of deduction for state/local real property taxes, state/local personal property taxes, income tax, and general sales tax cannot exceed $10,000 ($5,000 if MFS).

* Taxpayer may deduct state and local income taxes paid during the year.
  + Taxpayer may elect to deduct either state/local sales tax or state income tax.
* Real estate taxes are deductible.
  + Service fees, such as homeowners’ dues, are not deductible.
* Personal property taxes based on the value of the property (ad valorem) are deductible.
* Federal income taxes, Social Security taxes, estate taxes, and excise taxes are not deductible.

**Learning Objective 5.8 Interest**

Taxpayers are allowed a deduction for certain types of interest. To deduct interest on a debt, the taxpayer must be legally liable for the debt.

* Nondeductible interest includes service charges, credit investigation fees, and loan fees other than “points.”
* Interest paid on a qualified residence is deductible on up to a $750,000 primary mortgage; home equity debt is no longer deductible.
  + The TCJA allows grandfathering of higher qualified mortgage debt: if debt was incurred on or before December 15, 2017, then interest can still be deducted on up to a $1 million home loan.
* Consumer interest (such as the interest on credit cards) is not deductible.
* Education loan interest is limited to $2,500 and phased out if taxpayer’s modified AGI is $70,000 to $85,000 (S) and $140,000 to $170,000 (MFJ).
  + Qualified expenses include tuition, room and board, and related expenses.
* Investment interest and certain interest associated with passive activities are deductible.
  + Investment interest is limited to the net investment income.

**Learning Objective 5.9 Charitable Contributions**

Taxpayers may deduct charitable contributions of cash or property.

* The IRS maintains a list of organizations that are considered to be charitable (called “Tax Exempt Organization Search”).
* If property is donated, the deduction is equal to its fair market value.
* Generally, taxpayer can only deduct up to 50% of AGI.
  + The TCJA increased that to 60% for contributions of cash to public charities and other 50% organizations. Noncash contributions are still limited to 50%.
  + Special rules apply to donations to private nonoperating foundations, fraternal societies, and veterans’ organizations (gifts are limited to 30%).
* Other contribution limits are established for long-term capital gain property.
  + The amount over the contribution limit may be carried forward for five years.
* Taxpayers should keep all records, receipts, cancelled checks, and other proof of contributions.
  + Complete Form 8283 if the individual made a contribution of property over $500.
  + Gifts of clothing/household items must be in “good” condition or better.
  + Taxpayers donating vehicles must attach Form 1098-C provided by the charity. This gives resale information. If charity doesn’t sell vehicle, but rather gives it or uses it, then taxpayer can claim estimated value.

**Learning Objective 5.10 Other Itemized Deductions**

* Deductions are allowed for casualty and theft losses.
  + Itemized: Deduction fromAGI or
  + Business related: Deduction for AGI
* To be classified as a casualty loss, an event needs to be sudden, unexpected, or unusual.
  + Theft must be proved (i.e., with police report).
  + Different calculations for deduction are based on type of property.
* Casualty losses are generally deductible in the year of occurrence; there is an exception for federally declared disaster area losses.
* There are two ways to establish the amount of losses.
  + Rule A allows a loss based on the decrease in fair market value of the property.
  + Rule B limits the deduction to the adjusted basis of the property.
    - A $100 floor per occurrence limits the overall amount of the deduction.
    - The total loss must exceed 10% of AGI.
    - There are different rules based on whether the property is used for business or personal purposes.

There are two types of miscellaneous deductions:

* Deductions limited by 2% of AGI:
  + - Unreimbursed employee business expenses and employee business expenses reimbursed under a nonaccountable plan
    - Investment expenses
    - Other expenses such as tax preparation fee, union dues, job hunting expenses, and professional subscriptions
    - Legal fees related to a job
* Deductions not limited by 2% (and still available):
  + - Certain estate taxes
    - Amortizable bond premiums
    - Unrecovered annuity costs at death
    - Handicapped “impairment related work expenses”
    - Gambling losses to the extent of gambling winnings
    - Casualty and theft losses on business property