# Chapter Objectives

The following objectives are addressed in this chapter:

5.1 Explain how Health Savings Accounts (HSAs) can be used for tax-advantaged medical care.

5.2 Describe the self-employed health insurance deduction.

5.3 Explain the treatment of Individual Retirement Accounts (IRAs), including Roth IRAs.

5.4 Explain the general contribution rules for small business and self-employed retirement plans.

5.5 Describe other adjustments for adjusted gross income.

5.6 Calculate the itemized deduction for medical expenses.

5.7 Calculate the itemized deduction for taxes.

5.8 Apply the rules for an individual taxpayer’s interest deduction.

5.9 Determine the charitable contributions deduction.

5.10 Describe other itemized deductions.

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# Chapter Outline

*In the outline below, each element includes references (in parentheses) to related content. “CH.##” refers to the chapter objective; “PPT Slide #” refers to the slide number in the PowerPoint deck for this chapter (provided in the PowerPoints section of the Instructor Resource Center); and, as applicable for each discipline, accreditation or certification standards (“BL 1.3.3”). Introduce the chapter and use the Ice Breaker in the PPT if desired, and if one is provided for this chapter. Review learning objectives for Chapter 5. (PPT Slides 2–3).*

I. Learning Objectives (PPT Slides 2*–*3)

1. The Learning Objectives provide students with a brief overview of what they will learn in this chapter.

II. Health Savings Accounts (5.1, PPT Slides 4*–*8)

1. There are four types of tax-favored medical spending plans:
   * 1. Health care flexible spending arrangements (FSAs)
        + Employees set aside money to cover medical expenses.
     2. Health Reimbursements Arrangements (HRAs)
        + Employer funds an account that can be used by employees for medical expenses.
     3. Medical Savings Accounts (MSAs or Archer MSAs)
        + Effective January 1, 2008, no new MSA accounts may be established.
     4. Health Savings Accounts (HSAs)
        + Taxpayers can establish.
2. Health Savings Accounts (HSAs) are used for the purpose of paying unreimbursed medical expenses by taxpayers who carry qualifying high-deductible medical insurance.
   * 1. Contributions are deductions for AGI.
     2. Earnings and unused contributions accumulate tax-free.
     3. In 2021, taxpayers can contribute $7,200 for a family or $3,600 for self only.
        + There is an additional “catch-up” of $1,000 per person for ages 55+.
     4. 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 HSA-related issues.
3. The poll on Slide 8 asks students whether or not a 35-year-old, healthy, single taxpayer should contribute to an HSA. There is no correct answer. If the taxpayer needs the money this year in order to pay nonmedical expenses, it would not make sense to contribute to an HSA. But if he does not need it, he could reduce his AGI and his current-year taxes. Any amount he leaves in the HSA account will accumulate earnings tax free and carry forward to be available for payment of qualifying medical expenses in the future. And after he turns 65, he can withdraw it without penalty and use it for other expenses, he will just have to pay taxes on the amount. Therefore, this may be a good vehicle for him to save for the future.

III. Self-Employed Health Insurance Deduction (5.2, PPT Slides 9*–*10)

1. Self-employed taxpayers are allowed an above-the-line deduction for health insurance premiums paid for themselves and their families.
   * 1. Taxpayers with income reportable on Schedule C are generally self-employed (also certain partnerships, S corporations, LLCs, and farms).
     2. Deductible insurance includes medical/dental insurance paid to cover taxpayer, spouse, and dependents.
     3. It includes medical/dental insurance paid for children under 27 who aren’t dependents.
        + Must net advance premium credit received under ACA.
     4. Long-term care insurance is paid for the taxpayer and the family of the taxpayer (within limits).
2. Note: Health insurance premiums are not allowed for any months in which the taxpayer can participate in a subsidized health care plan.

IV. Individual Retirement Accounts (5.3, PPT Slides 11*–*23)

1. The two major types of IRAs are traditional and Roth.
2. A traditional IRA is an account to which individuals contribute funds for their retirement.
   * 1. Deductions from AGI and the fund’s earnings (interest and dividends) are tax deferred.
     2. 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).
        1. The maximum contribution to either spouse’s IRA may not exceed $6,000.
        2. An additional $1,000 is allowed for a contribution if a taxpayer and their spouse are over 50 years old.
        3. 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.)
        4. A taxpayer who phases out the ability to deduct a traditional IRA contribution can still make a nondeductible IRA contribution.
     3. Distributions cannot begin before age 59½ (10% penalty); they must begin the year after the taxpayer turns 72.
3. 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.

1. The CARES Act extends the 10% penalty tax exemption to distributions of up to $100,000 that meet certain conditions.
2. Another type of IRA is a Roth IRA.
   * 1. 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.
     2. A distribution will be taxable if the distribution does not satisfy the above requirements.
     3. Again, the contributions are subject to AGI phase-outs.
3. Slides 15*–*18 walk students through two examples of taxpayers who want to make contributions to IRAs. The first example is about a single taxpayer who wants to contribute to a Roth IRA, and the second example discusses a couple making a contribution to a traditional IRA.
4. The Knowledge Check on Slide 23 asks students to identify the features of a traditional IRA.

V. Small Business and Self-Employed Retirement Plans (5.4, PPT Slides 24*–*33)

1. Internal Revenue Code provides favorable tax treatment for contributions, by or for employees, to qualified retirement plans.
   * 1. Employers get current year deduction.
     2. Employees do not include contributions in income.
        + Tax on earnings is deferred until distribution.
2. Qualified retirement plans may qualify, including pension plans, profit-sharing plans, stock bonus plans, and employee stock ownership plans (ESOP).
   * 1. 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
3. Self-employed taxpayers and their employees are eligible to be members of a Simplified Employee Pension (SEP).
   * 1. In 2021, contributions were limited to the lesser of 25% of compensation or $58,000.
4. 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.
   * 1. To avoid penalties, distributions must begin at age 72, but not before age 59½.
     2. A 401(k) plan allows an employee to make contributions and defer tax on the compensation.
        + 2021 annual maximum—$19,500 or $26,000 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 for employer contributions immediately.

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

* + 1. Roth 401(k) plans are popular for high-income taxpayers because there is no AGI limitation.
    2. This is a complex area with many tax preparers turning to retirement tax specialists for help.

1. Slides 32*–*33 ask students to discuss the differences between a Roth 401(k) and other types of plans and the advantages of each.

VI. Other For AGI Deductions (5.5, PPT Slides 34*–*37)

1. Eligible educators may deduct up to $250 for unreimbursed cost of classroom materials as a deduction for AGI.
   * 1. Eligible educators are K*–*12 teachers, counselors, principals, or 900+ hour aids.
     2. If a married filing jointly couple are both eligible educators, total deduction is up to $500 (but not more than $250 per spouse).
2. Three different professions are eligible for a deduction for unreimbursed employee costs:
3. Performing artists who meet four stipulations:
   * + - Worked for at least two employers during the year
       - Received at least $200 each for any two of these employers
       - Had business expenses of more than 10% of gross income
       - Had AGI of $16,000 or less after deducting those expenses
4. National Guard or Reserve members who travel more than 100 miles in connection with service in reserves
5. State or local fee-based officials
6. Only members of the Armed Forces are able to deduct moving expenses.
7. The poll on Slide 37 presents the case of a married couple who are both eligible educators and file jointly. They want to shift some of their school supply expenses from one to the other to maximize their deduction. Students are asked if they would sign the form as a paid preparer. While it seems somewhat questionable, if the couple can document that some of the supplies were shared and may have been used by either one of them, the alteration may be justified.

VII. Medical Expenses (5.6, PPT Slides 38*–*43)

1. Medical expenses are the first itemized deduction on Schedule A.
2. Deduction includes amounts paid for the taxpayer, their spouse, and dependents.
3. 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.
4. Insurance reimbursements are subtracted.
5. Deductible amount is reduced by 7.5% threshold.
6. Capital expenditures such as installing medical/special equipment in home may be deducted.
7. Transportation is deductible at $0.16/mile in 2021.
8. Lodging is $50 per night, per person, to travel to essential medical care.
9. The example on Slides 42*–*43 takes students through the process of calculating the medical expense deduction for a couple.

VIII. Taxes (5.7, PPT Slides 44*–*54)

* 1. 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.
  2. The Knowledge Check on Slide 47 asks students to identify which tax is deductible.
  3. The example on Slides 49*–*50 takes student through the calculation of income tax as an itemized deduction. The example on Slides 53*–*54 works through a comprehensive tax deduction.

IX. Interest (5.8, PPT Slides 55*–*61)

1. 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.
   * 1. Nondeductible interest includes service charges, credit investigation fees, and loan fees other than “points.”
     2. Consumer interest (such as the interest on credit cards) is not deductible.

The discussion on Slides 57*–*58 presents a situation in which a father makes a payment on his son’s home mortgage and asks if either the father or son can deduction the interest, and why or why not.

1. 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.
2. Consumer interest (such as the interest on credit cards) is not deductible.
3. 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.
4. Investment interest and certain interest associated with passive activities are deductible.
   * + - Investment interest is limited to the net investment income.

X. Charitable Contributions (5.9, PPT Slides 62*–*75)

* 1. Taxpayers may deduct charitable contributions of cash or property.
     1. The IRS maintains a list of organizations that are considered to be charitable (called “Tax Exempt Organization Search”).
     2. Certain contributions, including gifts to nonqualified recipients; contributions of time, service, use of property, or blood; contributions from which benefit is received; and wagering losses are not deductible.
     3. Out-of-pocket expenses related to charitable activities are deductible; the mileage deduction is 14 cents per mile.
     4. If cash is donated, the deduction is equal to cash amount.
     5. If property is donated, the deduction is equal to its fair market value at the time of donation, with some exceptions.
  2. The example on Slides 66*–*67 determines the amount of deduction for property donated to a nonprofit and considers two scenarios. In one, the property is being used for the organization’s primary purpose, and in the other the purpose is unrelated.
  3. As a temporary COVID-related provision for the 2021 tax year, a deduction up to $300 ($600 MFJ) (from AGI) for cash charitable contributions can be taken.
     1. This deduction is not available if the taxpayer itemizes deductions.
     2. The deduction is reported on Line 12b of the 2021 Form 1040.
  4. Generally, the taxpayer can only deduct up to 50% of AGI.
     1. The TCJA increased that to 60% for contributions of cash to public charities and other 50% organizations. Noncash contributions are still limited to 50%.
     2. In 2021, a temporary provision permits the deduction of 100% of AGI for cash contributions to a 50% organization.
     3. Special rules apply to donations to private nonoperating foundations, fraternal societies, and veterans’ organizations (gifts are limited to 30%).
  5. Other contribution limits are established for long-term capital gain property.
     1. The amount over the contribution limit may be carried forward for five years.
  6. Taxpayers should keep all records, receipts, cancelled checks, and other proof of contributions.
     1. No charitable deduction is allowed for contributions of $250 or more unless written substantiation from the recipient is provided.
     2. Taxpayers donating cash less than $250 must keep a cancelled check or written communication from the charity.
     3. Taxpayers who itemize deductions should use checks instead of cash for church and similar cash donations.
     4. Gifts of clothing/household items must be in “good” condition or better.
     5. Taxpayers donating vehicles must attach Form 1098-C provided by the charity. This gives resale information. If the charity doesn’t sell vehicle, but rather gives it or uses it, then taxpayer can claim estimated value.
     6. For quid pro quo contributions (donations involving receipt of goods or services by the donee) of more than $75, charities must provide donors with written disclosures.
  7. The example on Slides 74*–*75 determines the charitable contribution deduction for a taxpayer who makes multiple donations of different types (cash, property, and use of his property) over the course of the year.

XI. Other Itemized Deductions (5.10, PPT Slides 76*–*80)

1. Deductions are allowed for casualty and theft losses.
   * 1. Itemized: Deduction from AGI or
     2. Business related: Deduction for AGI
2. To be classified as a casualty loss, an event needs to be sudden, unexpected, or unusual.
   * 1. Theft must be proved (i.e., with police report).
     2. Different calculations for deduction are based on type of property.
3. Casualty losses are generally deductible in the year of occurrence; there is an exception for federally declared disaster area losses.
4. There are two ways to establish the amount of losses.
   * 1. Rule A allows a loss based on the decrease in fair market value of the property.
     2. Rule B limits the deduction to the adjusted basis of the property.
5. There are certain deduction limitations.
   * 1. A $100 floor per occurrence limits the overall amount of the deduction.
     2. The total loss must exceed 10% of AGI.
6. There are different rules based on whether the property is used for business or personal purposes.
7. There are two types of miscellaneous deductions:
   * 1. Deductions limited by 2% of AGI:
        1. Unreimbursed employee business expenses and employee business expenses reimbursed under a nonaccountable plan
        2. Investment expenses
        3. Other expenses such as tax preparation fee, union dues, job hunting expenses, and professional subscriptions
        4. Legal fees related to a job
     2. The TCJA suspended the deduction of all miscellaneous itemized deductions subject to the 2% of AGI rule. Miscellaneous itemized deductions not subject to the 2% floor were not affected.
8. Prior to 2018, certain high-income taxpayers were subject to limits on the amount of itemized deductions. The TCJA suspended the phase-out.

XII. Case Studies (PPT Slides 81*–*82)

1. Case Study 1 examines the list of charitable contributions provided by a taxpayer. The student is asked to review the list, determine how much of the deduction is allowed for charitable contributions, and then explain this to the taxpayer.
2. Case Study 2 considers the case of a couple who hosted an exchange student for 9 months and paid for a number of items for his well-being. The student is referred to the IRS Publication 526 to determine if any of the expenses are deductible. The student is then instructed to write a letter to the couple explaining the findings.

XIII. Summary (PPT Slides 83*–*84)

1. The Summary slides review the ten Learning Objectives, covering what the students should have learned in this lesson.

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