Section 2: Income and Assets

2.4 Adjustments to Income

1 Self-Employment

2 Retirement Contribution Limits

3 Health Saving Accounts Deductibility

4 Other Adjustments Income

5. Self- Employment Health Insurance

Deductions—Individual Taxpayers

Individual taxpayers have two categories of deductions:

- **Deductions *for* adjusted gross income (AGI)**
- Deductions *from* adjusted gross income

Deductions for adjusted gross income (AGI

- Sometimes known as above-the-line deductions
- On the tax return, they are taken before the “line” designating AGI

Deductions for adjusted gross income (AGI

Deductions *for* AGI include:

- Ordinary and necessary expenses incurred in a trade or business
- Part of self-employment tax paid
- Alimony paid
- Certain payments to an IRA and Health Savings Accounts
- Unreimbursed moving expenses
- Fees for college tuition and related expenses
- Interest on student loans
- The capital loss deduction, and
- Others

Coverdell Education Savings Account (CESA)

This is a trust for the benefit of anyone under age 18

- $2,000 nondeductible contribution per student per year
  - Phased-out for AGI greater than
    - $190,000 (mfj); $95,000 (others)
    - Max. contribution = $\$2,000 \times \left[1 - \frac{(\text{AGI - phase-out})}{15,000}\right]$
    - Tax-free growth in the IRA
- There is no tax at time of withdrawal if used for qualified expenses
  - Tuition and fees of student

1. Self-employment Income Tax

Who is Self-Employed?

Generally, you are self-employed if any of the following apply to you.

- You carry on a trade or business as a sole proprietor or an independent contractor.
- You are a member of a partnership that carries on a trade or business.
- You are otherwise in business for yourself (including a part-time business)

What are My Self-Employed Tax Obligations?

As a self-employed individual, generally you are required to file an annual return and pay estimated tax quarterly.

Self-employed individuals generally must pay self-employment tax (SE tax) as well as income tax. SE tax is a Social Security and Medicare tax primarily for individuals who work for themselves. It is similar to the Social Security and Medicare taxes withheld from the pay of most wage earners. In general, anytime the wording "self-employment tax" is used, it only refers to Social Security and Medicare taxes and not any other tax (like income tax).

2. Retirement Contribution Limits and Deductibility (Earned Compensation Requirement)

For 2018 and 2019, your total contributions to all of your traditional and Roth IRAs cannot be more than:

- $6,500 (if you're age 50 or older), or
- your taxable compensation for the year, if your compensation was less than this dollar limit.
- The IRA contribution limit does not apply to:
- Rollover contributions
- Qualified reservist repayments

Claiming a tax deduction for your IRA contribution

Your traditional IRA contributions may be tax-deductible. The deduction may be limited if you or your spouse is covered by a retirement plan at work and your income exceeds certain levels.

- IRA deduction limits
- **Roth IRA contribution limit**
- The same general contribution limit applies to both Roth and traditional IRAs. However, your Roth IRA contribution might be limited based on your filing status and income.

IRA contributions after age 70½

You can't make regular contributions to a traditional IRA in the year you reach 70½ and older. However, you can still contribute to a Roth IRA and make rollover contributions to a Roth or traditional IRA regardless of your age.

Spousal IRAs

If you file a joint return, you may be able to contribute to an IRA even if you did not have taxable compensation as long as your spouse did. The amount of your combined contributions can't be more than the taxable compensation reported on your joint return. See the formula in IRS Publication 590-A.

If neither spouse participated in a retirement plan at work, all of your contributions will be deductible.

Tax on excess IRA contributions

An excess IRA contribution occurs if you:

- Contribute more than the contribution limit.
- Make a regular IRA contribution to a traditional IRA at age 70½ or older.
- Make an improper rollover contribution to an IRA.

Excess contributions are taxed at 6% per year as long as the excess amounts remain in the IRA. The tax can't be more than 6% of the combined value of all your IRAs as of the end of the tax year. To avoid the excess contributions tax: withdraw the excess contributions from your IRA by the due date of your individual income tax return (including extensions); and withdraw any income earned on the excess contribution.

3. Health Savings Account

A health savings account is a tax-exempt trust or custodial account you set up with a qualified HSA trustee to pay or reimburse certain medical expenses you incur. You must be an eligible individual to qualify for an HSA.

No permission or authorization from the IRS is necessary to establish an HSA. You set up an HSA with a trustee. A qualified HSA trustee can be a bank, an insurance company, or anyone already approved by the IRS to be a trustee of individual retirement arrangements (IRAs) or Archer MSAs. The HSA can be established through a trustee that is different from your health plan provider.

What are the benefits of an HSA?

You may enjoy several benefits from having an HSA.

You can claim a tax deduction for contributions you, or someone other than your employer, make to your HSA even if you do not itemize your deductions on Form 1040.

Contributions to your HSA made by your employer (including contributions made through a cafeteria plan) may be excluded from your gross income.

The contributions remain in your account until you use them.

The interest or other earnings on the assets in the account are tax free.

Distributions may be tax free if you pay qualified medical expenses.. An HSA is “portable.” It stays with you if you change employers or leave the work force.

Qualifying for an HSA

To be an eligible individual and qualify for an HSA, you must meet the following requirements.

- You must be covered under a high deductible health plan (HDHP), described later, on the first day of the month.
- You have no other health coverage except what is permitted under Other health coverage.
- You are not enrolled in Medicare.
- You cannot be claimed as a dependent on someone else's 2014 tax return.

4. Other adjustments to income (e.g., student loan interest, alimony, moving expenses, write-in adjustments)

- Student Loan Interest
- Alimony
- Moving Expense

Deduction for Higher Education Expenses

For AGI deductions:

- Maximum deduction of $4,000 for tuition and fees paid
- For taxpayers with AGI>$130,000 MFJ, $65,000 all others
- Reduced to $2,000 for taxpayers with AGI between $130,000 and $160,000 MFJ, or $65,000 and $80,000 for all others
- Cannot take this deduction and claim an American Opportunity Tax credit or Lifetime Learning credit
- May receive a distribution from an educational IRA but not for the same expenses.

Education Loan Interest

You may deduct up to $2,500 for interest paid on education loans

- Taken as a "for" deduction
- Only for payments made during first 60 months of the loan
- Deduction phased-out when AGI exceeds
  - Married, $120,000; Others, $60,000
  - Deduction =

  Amt. Allowed x [1 - {(AGI - phase-out) / 15,000}]

Alimony

Amounts paid under divorce or separate maintenance decrees or written separation agreements entered into between you and your spouse or former spouse **are considered alimony** for federal tax purposes if:

- You and your spouse or former spouse do not file a joint return with each other
- You pay in cash (including checks or money orders)
- The payment is received by (or on behalf of) your spouse or former spouse
- The divorce or separate maintenance decree or written separation agreement does not say the payment is not alimony
- If legally separated under a decree of divorce or separate maintenance, you and your former spouse are not members of the same household when you make the payment
- You have no liability to make the payment (in cash or property) after the death of your spouse or former spouse, and
- Your payment is not treated as child support or a property settlement

Alimony

- Not all payments under a divorce or separation instrument are alimony. Alimony **does not** include:
- Child support
- Noncash property settlements
- Payments that are your spouse's part of community property income
- Payments to keep up the payer's property, or
- Use of the payer's property
- Voluntary payments
- You may deduct from income the amount of alimony or separate maintenance you paid, and you must include in income the amount of alimony or separate maintenance you received.

Moving Expenses

Moving expenses are deductible if they meet two tests:

- Distance test
- Time test
  - Employee taxpayers must be employed in the new area for 39 weeks of the 12 months after moving *Self-employed taxpayers must be employed in the* new area for 78 weeks of the 24 months after moving
  - Waived for death, disability, or required transfer

Moving Expenses

If you moved due to a change in your job or business location, or because you started a new job or business, you may be able to deduct your reasonable moving expenses but not any expenses for meals. You can deduct your moving expenses if you meet all three of the following requirements:

- Your move closely relates to the start of work
- You meet the distance test
- You meet the time test

Your move must **closely relate** both in time and in place **to the start of work** at your new location. You can consider moving expenses incurred within one year from the date you first reported to work at the new location as closely related in time to the start of work. A move generally relates closely in place if the distance from your new home to the new job location is not more than the distance from your former home to the new job location. For exceptions to these requirements, see Publication 521, *Moving Expenses*.

Moving Expenses

If you are a member of the Armed Forces and your move was due to a military order and permanent change of station, you do not have to satisfy the distance or time tests.

Return. You cannot deduct any moving expenses covered by reimbursements from your employer that are excluded from your income.

Section 3: Deductions and Credits
3.1 Itemized Deductions

1. Medical and Dental Expenses
2. Various taxes (e.g., state income, personal property, real estate)
3. Interest expense (e.g., mortgage interest, investment interest, tracing rules, points)
4. Charitable Contributions

Part 1 Itemized Deductions

5. Non business Casualty and Theft Losses
6. Miscellaneous Itemized Deductions
7. Employee Travel, Transportation and Entertainment Expenses
8. Other Employee Expenses
9. AGI Limitations
10. Allowed Itemized Deductions for Form 1040-NR

Deductions from AGI

Individual taxpayers may deduct the larger of either:

A standard deduction

or

Total itemized deductions

Deductions From AGI

The standard deduction is the sum of two components:

- *Basic* standard deduction- The mount allowed is based on taxpayer's filing status
- Additional standard deductions- Available for taxpayers who are
    - Age 65 or over, and/or Blind
  - Two additional standard deductions are allowed for a taxpayer who is age 65 or over and blind
  - Amount allowed depends on filing status

Standard Deductions

Is Based on filing status

- Taxpayers who are over 64 years of age receive extra amounts, as do blind taxpayers

Standard deduction amounts:

	2018	**2019**
Single	$12,000	$12,200
Married, filing jointly	$24,000	$24,400
Married, filing separately	$12,000	$12,200
Head of Household	$18,000	$18,350
Surviving spouse	$24,000	$24,400

Itemized Deductions

Through legislative grace, there are 6 categories of personal expenses individual taxpayers may deduct:

- Medical
- Taxes
- Interest
- Charitable Contributions
- Casualty Losses
- Miscellaneous

Adjusted Gross Income (AGI)

AGI is an important subtotal

- Serves as the basis for computing percentage limitations on certain itemized deductions such as
  - Medical expenses
  - Charitable contributions
  - Certain casualty losses
- E.g., For taxpayers under age 65, medical expenses are deductible only to the extent they exceed 10% of AGI
  - This limitation might be described as a 10% "floor" under the medical expense deduction

Deductions From AGI

Deductions *from* AGI include:

The greater of:

- Itemized deductions, or
- The standard deduction

And

- Personal and dependency exemptions

Deductions From AGI

This is a partial list of itemized deductions:

- Medical expenses in excess of 10% of AGI
- Certain taxes and interest
- Charitable contributions
- Casualty Losses in excess of 10% of AGI
- Deductions for expenses related to
  - The production or collection of income, and
  - The management of property held for the production of income
  - Certain miscellaneous itemized deductions in excess of 2% of AGI

1. Medical and Dental Expenses

- Unreimbursed medical expenses of the taxpayer and medical dependents are deductible
  - Medical dependents need not meet the gross income and the joint return tests
  - Costs include premiums for health and accident insurance and transportation at 19 cents per mile
  - Deduction is limited to the excess of total costs over 10% of AGI (7.5% for taxpayers 65 and older through 2016)

2. Taxes

The Following payments are deductible:

- Amounts paid for either sales taxes **<u>or</u>** state and local income taxes are deductible
- Amounts paid for real estate and other personal property taxes are deductible
  - No payments for federal taxes are allowed
  - Property taxes must be based on value

3. Qualified Mortgage Interest

- Qualified home mortgage interest is deductible
  - Debt must be secured by a principal residence
  - *Qualified* interest is interest paid for Home owners. Taxpayers can deduct interest expenses on up to:
  - $750,000 of mortgage debt for couples Married Filing Joint
  - $375,000 for taxpayers Filing Separate from income taxes.
  - However, taxpayers will forego the standard deduction.
  - Home must have been purchased after December 15, 2017

3. Qualified Mortgage Interest – Points

Points on a qualified mortgage are deductible if paid to acquire financing:

- Must be stated as a % of the loan value
- Deductible currently if paid on acquisition debt
  - If for refinancing, amortize over the life of the loan

1.3 Investment Interest

- Deduction for investment interest is limited to the amount of *net investment income*
- Investment Income – Investment Expenses = Net Investment Income
  - Investment income = portfolio income plus gross income and gains from investment assets
  - Investment expenses include all ordinary and necessary expenses directly connected to the production of the investment income other than tax-exempt investment income.

1.4 Charitable Contributions

Deduction amount for property depends on the type of property given:

Ordinary income property or short-term capital gain property

- Deduction is the lesser of the property's
  - FMV, or
  - adjusted basis
- Deduction amount for long-term capital gain property is FMV

1.4 Charitable Contributions

Limitations

- Overall deduction cannot exceed 60% of AGI
- Deduction for long-term capital gain property cannot exceed 30% of AGI
  - If the taxpayer elects to deduct the adjusted basis rather than FMV, the 60% limit is used
- Contributions to non-operating private foundations are subject to additional limits

1.5 Casualty Losses

- Loss is the lesser of
  - Property's adjusted basis, or
  - Decline in the value of the property (repair cost)
- Loss is reduced by
  - Insurance proceeds received,
  - $100 per event (Administrative convenience), and
  - 10% of AGI per year

1.6 Miscellaneous Deductions

Various other expenses are combined as miscellaneous itemized deductions and are either fully deductible or partially deductible

1.6 Miscellaneous Deductions

Partially deductible (to the extent the total of this group of expenses exceeds 2% of AGI):

- Unreimbursed employee expenses
- Investment expenses other than interest
- Hobby-related expenses

1.6 Miscellaneous Deductions Fully Deductible

- Fully Deductible:
  - Gambling losses to the extent of gambling winnings,
  - Impairment-related-work expenses of disabled taxpayers, and
  - Unrecovered capital from a terminated annuity

Phase-out of Itemized Deductions and Exemptions

- High-income taxpayers must reduce their allowable itemized deductions and exemptions if their AGI is above a threshold amount
  - Threshold amounts are based on filing status and are the same for both itemized deductions and exemptions

Phase-out of Itemized Deductions

Taxpayers re subject to a limit on itemized deductions if the AGI is more than:

- $ 313,000 Married Filing Joint or Qualifying Widow (er)
- $ 287,550 Head of Household
- $ 261, 500 Single,
- $156,900 Married Filing Separately