INTRODUCTION

The 16th Amendment to the U.S. Constitution gives Congress the power to tax income. Congress could, presumably, assess an income tax on gross income without taking into consideration any deductions, but for fairness and public policy reasons, deductions from income are made available to taxpayers. Deductions are not entitlements for taxpayers – they are based on legislative grace. Legitimate deductions from income must be specifically permitted by statute (the Internal Revenue Code).

In the U.S. tax system, the taxpayer, not the IRS, has the responsibility for substantiating deductions. To justify deductions taken for income tax purposes, taxpayers must maintain adequate records of their expenses. Receipts or proof of expenditures should be kept by taxpayers at least until the statute of limitations expires for the tax year in question. For some deductions, such as those for meals, more extensive recordkeeping is required. This chapter introduces deductions available to taxpayers.

CLASSIFICATION OF DEDUCTIBLE EXPENSES

Income tax deductions fall into two basic categories: **above-the-line deductions** (or deductions for AGI) which are sometimes referred to as adjustments, and **below-the-line deductions** (deductions from AGI) which are often referred to as Itemized Deductions. (Note that the "line," for income tax purposes, is adjusted gross income (AGI).) AGI is the basis for many of the phaseouts and thresholds that will have to be met to take advantage of certain deductions and tax planning opportunities. Understanding where deductions are taken in the tax formula, therefore, is important when considering tax planning alternatives for clients.

When considering income tax deductions and their planning implications for clients, it is helpful to recall the income tax formula.

Gross Income	**$xx,xxx**
Less: Deductions for Adjusted Gross Income (*above-the-line deductions*)	(x,xxx)
Adjusted Gross Income (AGI)	**$xx,xxx**
Less: Deductions from Adjusted Gross Income Greater of Standard or Itemized Deductions and the Qualified Business Income Deduction (*below-the-line deductions*)	(xx,xxx)
Taxable Income	**$xx,xxx**

As the tax formula illustrates, adjustments (above-the-line deductions) are subtracted from gross income to arrive at AGI, while below-the-line deductions (the greater of itemized deductions or the standard deduction, plus the QBI deduction) are subtracted from AGI and are not taken into account until after AGI is computed.

Exhibit 6.1 | Adjustments to Gross Income
(from Form 1040, Schedule 1)

Adjustments to Income	23	Educator expenses	23		
	24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106	24		
	25	Health savings account deduction. Attach Form 8889	25		
	26	Moving expenses for members of the Armed Forces. Attach Form 3903	26		
	27	Deductible part of self-employment tax. Attach Schedule SE	27		
	28	Self-employed SEP, SIMPLE, and qualified plans	28		
	29	Self-employed health insurance deduction	29		
	30	Penalty on early withdrawal of savings	30		
	31a	Alimony paid **b** Recipient's SSN ▶	31a		
	32	IRA deduction	32		
	33	Student loan interest deduction	33		
	34	Reserved	34		
	35	Reserved	35		
	36	Add lines 23 through 35		36	

Deductions for AGI (Above-the-Line Deductions)

Adjustments, or above-the-line deductions, reduce a taxpayer's adjusted gross income (AGI). Most above-the-line deductions relate to expenses for business and production of income activities (from investment activities) by taxpayers, but there are some deductions permitted for individual taxpayers as well (such as IRA deductions, student loan interest, and educator expenses, to name a few). Above-the-line deductions are listed in IRC Section 62, and they can be claimed by the taxpayer even if the taxpayer does not itemize deductions. See **Exhibit 6.1 | Adjustments to Gross Income**.

Expenses associated with a business activity are above-the-line deductions. Only the net income of the business (gross receipts from the business less expenses incurred in producing that income) is included in the taxpayer's gross income for the year. For example, if a taxpayer operates a sole proprietorship, the financial results will be reported on Schedule C of the taxpayer's individual tax return. If a taxpayer engages in rental real estate activities, the gross receipts from the rental activity less expenses associated with the rental activity will be reported on Schedule E of the income tax return, and only the net income from the activity will be reported in the taxpayer's gross income for the year. Schedules C and E are essentially income statements for the business and production of income activities, detailing the gross receipts and expenditures incurred in the activity. Since business related and production of income related expenses directly reduce gross income, they are effectively treated as above-the-line deductions.

Key Concepts

1. Name the two categories of income tax deductions.
2. Describe an above-the-line deduction.
3. Describe a below-the-line deduction.
4. Explain which type of deduction is generally considered to be most favorable to taxpayers.

All other above-the-line deductions are found in the Adjustments to Income section (**Exhibit 6.1 | Adjustments to Gross Income**) of Form 1040, Schedule 1.

Deductions from AGI (Below-the-Line Deductions)

When most taxpayers think of deductions, they usually think of itemized deductions. Itemized deductions, one of the two types of below-the-line deductions, are deductions that are allowed for personal expenses and losses that are not typically associated with the conduct of a business or with production of income activities. While there are fewer itemized deductions than above the line deductions (there are only six categories of itemized deductions), itemized deductions are sometimes more important when planning for individual clients.

Taxpayers may take the greater of their itemized deductions or the standard deduction in determining taxable income. In order to achieve a tax benefit, the taxpayer's itemized deductions must be greater than the allowable standard deduction.

The types of itemized deductions, and their associated limitations, are discussed in detail in Chapter 7.

TCJA 2017 introduced a new type of below-the-line deduction: the deduction for Qualified Business Income (QBI) (also known as the Section 199A deduction). The QBI deduction is a below-the-line deduction that is not affected by a taxpayer's standard deduction. A taxpayer who qualifies for the QBI deduction may take both the QBI deduction plus the greater of his or her itemized deductions or standard deduction when calculating taxable income.

Quick Quiz 6.1

1. Above-the-line deductions are also known as adjustments to income.
   a. True
   b. False
2. Whenever expenses are associated with a business activity, they are below-the-line deductions.
   a. True
   b. False
3. Taxpayers must deduct the lesser of their itemized deductions or the standard deduction.
   a. True
   b. False
4. Above-the-line deductions are usually considered to be more favorable than below-the-line deductions on a dollar-for-dollar basis.
   a. True
   b. False

True, False, False, True.

Which Type of Deduction is Better – Above or Below-the-Line Deductions?

Due to the limitation imposed on itemized deductions by the standard deduction (since a taxpayer can only take the greater of the two), the various deduction floors and ceilings, as well as phaseouts associated with below-the-line deductions, above-the-line deductions are usually considered to be more favorable to the taxpayer on a dollar-for-dollar basis.

Example 6.1

Erin and Brian are single, and each of them has gross income of $75,000 and deductions of $15,000. Neither Erin nor Brian qualify for the QBI (or Sec. 199A) Deduction. Erin's deductions, however, can be taken above-the-line, while Brian will have to report his deductions as itemized deductions. Erin and Brian's taxable income for 2019 is calculated as follows:

		Erin	Brian	Difference
	Gross Income	$75,000	$75,000	$0
-	Adjustments (for AGI ded)	$15,000	$0	$15,000
=	Adjusted Gross Income (AGI)	$60,000	$75,000	($15,000)
-	Standard/Itemized Deductions	$12,200	$15,000	($2,800)
-	Personal Exemption (Repealed TCJA)	$0	$0	$0
=	**Taxable Income**	**$47,800**	**$60,000**	**($12,200)**

While both Erin and Brian have exactly the same gross income and the same out of pocket deductions, Erin's taxable income is less than Brian's. The difference between their incomes equals the standard deduction. Erin was able to take both the standard deduction and her above-the-line deductions, while Brian was only able to benefit from his below-the-line deductions and then only to the extent that they exceeded the standard deduction. Erin will pay a much lower tax than Brian, even though their income and out-of-pocket expenses were the same.

In the example above, Erin and Brian had modest income, and would not have been subject to phaseouts, floors, and ceilings that apply to some itemized deductions. If their income was higher, or their expenses were subject to the limitations imposed on itemized deductions, the difference in tax liability between the two parties would be even greater.

ABOVE-THE-LINE DEDUCTIONS FOR INDIVIDUALS

Trade or Business Expenses

Trade or business expenses are, by their very nature, above-the-line tax deductions. If a taxpayer owns an interest in a C corporation, S corporation or Partnership (including general and limited partnerships, LLCs, and LLPs), business expenses are deducted from income on the entity tax return, and only the net profit (in the case of S corporations and partnerships), or dividends distributed (in the case of C corporations) are included on an individual taxpayer's income tax return. Likewise, if the taxpayer conducts business as a sole proprietorship, business income and expenses are reported on Schedule C, and only the net income of the business (gross receipts less expenditures) is included in gross income on the front page of the taxpayer's income tax return.

For sole proprietors and partners, there are three additional above-the-line deductions related to business activities that may be available. These include:

1. one-half of self-employment tax paid
2. self-employed pension contributions (to Simplified Employee Pensions (SEPs), SIMPLEs, and other qualified pension plans)
3. the self-employed health insurance deduction

Self-employed individuals must pay Social Security taxes, just like employees. Employees, however, have an advantage in that one-half of their Social Security taxes is paid by their employer. An employee pays 7.65 percent on income up to the Social Security wage base for Social Security and Medicare taxes, and 1.45 percent (the Medicare component) on income above the Social Security wage base ($132,900 for 2019). The employer matches these contributions. High income individuals, as defined in the Affordable Care Act, must also pay an additional 0.9 percent Medicare surtax on income over specified thresholds ($250,000 for married filing jointly status; $200,000 for single individuals). Self-employed individuals have a dual role, they are both the employer and the employee, so they must pay both the employer and employee portion of the tax. Employers who pay Social Security and Medicare taxes on behalf of an employee deduct their payment from business income in arriving at a net profit amount, so a self-employed person should be able to do the same. A deduction is not allowed on Schedule C for employment taxes paid, but an adjustment to income (an above-the-line deduction) is permitted for one-half of the self-employment taxes paid (not including the 0.9 percent Medicare surtax imposed by the Affordable Care Act on "high income individuals"). Allowing this deduction above the line ensures that it will not be subject to the limitations and phaseouts that apply to below-the-line (itemized) deductions.

Self-employed individuals are also permitted to set up qualified and nonqualified tax advantaged retirement plans, and are permitted to deduct contributions to those plans up to a specified amount. The deduction allowed depends on the type of plan established, as well as the coverage rules that apply to the plan. Plan contributions for employees of a business are deducted on the business tax return or on the Schedule C of a self-employed individual. Allowable retirement plan deductions for a self-employed person are treated as adjustments to income and are deducted above-the-line. By making the retirement plan contributions for self-employed individuals an adjustment to income as opposed to a business expense deduction, the Code subjects the self-employed individual's retirement plan contributions to the self-employment tax.

Self-employed individuals are also permitted to deduct 100 percent of health insurance premiums paid on behalf of themselves and their dependents. The deduction for their own insurance is not permitted on Schedule C (for sole proprietors) or in determining business income on Form 1065 or 1120S (partnership/S Corporation tax return, but can be taken as an adjustment to income (above-the-line). Health care premiums paid on behalf of employees by the self-employed individual are deducted on Schedule C. These rules apply to self-employed individuals who file a Schedule C, partners, and more than two percent owners of S corporations.

One type of health insurance often overlooked by business owners is long-term care insurance. Self-employed individuals may deduct the cost of long-term care insurance on their lives up to specified amounts based on their age (**Exhibit 6.2 | Deduction Limitation on Long-Term Care Insurance Premiums**) as an adjustment to income (above-the-line). Long-term care can be provided as an employee benefit on a discriminatory basis, so business owners who wish to purchase long-term care coverage for themselves may do so without creating an obligation to purchase similar coverage for their employees.

In order to obtain the deduction, however, the contract must be a qualified long-term care contract. Most contracts currently being sold are qualified contracts. Qualified contracts cover only qualified long-term care expenses, are guaranteed renewable, do not provide cash surrender value, and do not reimburse expenses recovered under Medicare. Long-term care policies that have life insurance features and cash values will not generally meet the definition of a qualified long-term care contract.

Exhibit 6.2 | Deduction Limitation on Long-Term Care Insurance Premiums

Age	2019 Deduction Limit
40 or less	$420
41-50	$790
51-60	$1,580
61-70	$4,220
71 and over	$5,270

Medical Savings Accounts (MSAs) and Health Savings Accounts (HSAs)

As part of the Health Insurance Portability and Accountability Act (HIPAA) of 1996, Congress created **Medical Savings Accounts**. These accounts were available to self-employed individuals and small corporations, and allowed participants to contribute part of the annual deductible amount on their health insurance policies to the MSA, which could grow on a tax-free basis if funds distributed from the account were used to pay for medical expenses. MSAs were available on a pilot basis, and can no longer be set up due to legislation passed in 2003 authorizing the creation of **Health Savings Accounts** (HSAs). MSAs that were in existence at the time of the HSA legislation may still be used, and are referred to as "Archer MSAs" in honor of their sponsor, Congressman Bill Archer of Texas. Subject to certain limits, contributions to an HSA or MSA allow the taxpayer to take an above-the-line deduction on their income tax returns.

Unlike MSAs, which were primarily for the self-employed, HSAs allow individuals to save on a tax-free basis to fund their medical expenses. To qualify for an HSA, a taxpayer must:

1. be covered by a high deductible health insurance plan (sometimes referred to as an HDHP)
2. have no other health insurance coverage except the HDHP
3. not be enrolled in Medicare
4. not be claimed as a dependent on someone else's tax return

A High Deductible Health Plan (HDHP) is any plan that had a deductible falling between the minimum and maximum annual amounts, shown in **Exhibit 6.3 | Deductible Limits for HDHPs**.

Key Concepts

1. List those who qualify to participate in MSAs and HSAs.
2. Discuss the contribution rules for MSAs and HSAs.
3. Describe the deduction for contributions to an HSA or MSA.
4. Explain the circumstances under which long-term care insurance premiums are deductible.

Exhibit 6.3 | Deductible Limits for HDHPs
(2019)

	Minimum Deductible	Maximum Deductible and Out of Pocket Expenses
Individual	$1,350	$6,750
Family	$2,700	$13,500

HSA contributions can be made at any time during the tax year and up to the due date of the tax return, plus extensions. Contributions may not be made in advance, however. If the HSA is offered through an employer, contributions may be made through the employer's cafeteria plan. For taxable years beginning after December 31, 2006, the maximum allowable contribution to an HSA is an indexed amount provided by the IRS. In addition, individuals over age 55 are entitled to a catch-up contribution.

Exhibit 6.4 | Maximum HSA Contributions
(2019)

	Maximum Contribution	Age 55 or older Catch-Up
Individual	$3,500	$1,000
Family	$7,000	$1,000

The maximum allowable contribution to a HSA is reduced by any contributions made to an MSA. An individual who qualifies for an HSA as of the first day of the last month of the year (December 1st for most taxpayers) is an eligible individual for the entire year.

If contributions exceed the allowable amount, they are not deductible if made by the individual, and are included in the gross income of employees who receive funding through a cafeteria plan at work. In addition, if the excess contribution is not distributed prior to the due date of the income tax return including extensions, a six percent penalty applies to the excess contribution (which is similar to the excess contribution penalty that applies to retirement plans).

If a self-employed individual makes a contribution to his own HSA, that contribution is not taken into account when calculating net earnings from self employment. Consequently, the contribution to the HSA is subject to employment tax, but will not reduce self-employment earnings for purposes of calculating the maximum self-employed pension contribution for the individual.

Once in the HSA, contributions are placed in available investment vehicles to generate a return on investment. Unlike Flexible Spending Accounts offered by employers, which allow employees to make an election to allocate part of their income on a pre-tax basis each year to the account but required the funds to be used or forfeited by the end of the calendar year, contributions to HSAs are not required to be spent or forfeited at the end of each year, allowing taxpayers to accumulate an emergency fund for future health care purposes.

Distributions from HSAs used to cover qualified medical expenses for the taxpayer, the taxpayer's spouse, or the taxpayer's dependents are excluded from income. "Qualified medical expenses" are the same as medical expenses eligible for deduction if a taxpayer itemizes deductions, with the exception of medical insurance premiums. Interestingly, distribution of amounts to cover long-term care insurance premiums, and health insurance premiums under COBRA are also excluded from income. Any distributions from an HSA or Archer MSA that are not used to pay for qualified medical expenses are subject to income tax plus a 20 percent penalty. Note that if a medical expense is reimbursed from an HSA, it is not a deductible qualified medical expense. See IRS Publication 502 for more information on this topic.

Once the taxpayer reaches age 65, he is eligible to receive Medicare health coverage from the government. Amounts in the HSA may continue to be used to cover medical expenses after age 65 (and will therefore be excluded from income), but if distributions are made for other purposes, the 20 percent penalty rule will no longer apply. Other exceptions to the 20 percent penalty rule include distributions caused by the account owner's death or disability. In the event the account owner dies when there are still funds in the HSA, the account is transferred to the person who is named as beneficiary, which is often the surviving spouse. A spousal beneficiary may treat the account as his own HSA, but a nonspouse beneficiary must include the HSA in his or her ordinary income.

Quick Quiz 6.2

1. Individuals who are enrolled in Medicare qualify to establish an HSA.
   a. True
   b. False
2. The maximum allowable contribution to an HSA is reduced by any contributions made to an MSA.
   a. True
   b. False
3. Self-employed individuals may deduct 100% of health insurance premiums paid on behalf of themselves and their dependents.
   a. True
   b. False
4. The long-term care contract must be a qualified contract in order to receive an income tax deduction.
   a. True
   b. False

False, True, True, True.

HSAs are particularly valuable tools for younger individuals. Since young individuals tend to have few health problems, using a HDHP will help lower their annual insurance costs. If contributions are made to HSAs on an annual basis, but are not used each year (during the taxpayer's younger years) to fund health care expenses, the funds inside the HSA are permitted to grow, creating an emergency fund for medical expenses. This emergency fund can be drawn down without income tax consequences when needed, allowing the taxpayer to continue to use high deductible health plans when they are older since the funds needed to cover increased medical expenses incurred as the taxpayer ages can be drawn from the HSA. HSAs are tools that can be used to help minimize an individual's health insurance premiums over their lifetime by creating a tax-advantaged reserve of funds to pay health care expenses when necessary.