

### *Tax Planning 101: Step Three*

Step Three in the Tax Planning Process begins with examining the **ADJUSTMENTS TO INCOME** side of last year's tax return (Form 1040 Lines 23-36). Adjustments to income are referred to as "above the line" deductions. Above the Line deductions mean these deductions are available to all qualified taxpayers, regardless of whether they can "itemize" their deductions or not. They serve to directly reduce your taxable income dollar for dollar. Unfortunately, "above the line" deductions are subject to change from year to year, depending on how Congress votes. Some of these deductions are allowed one year and eliminated in another year. Because of this it is important to keep up with which deductions are allowable in your current tax year. For the purpose of our discussion, we will focus on the line by line deductions that were allowed in tax year 2010 and whether they are currently slated to be available for the 2011 tax year.

Line 23 is the **EDUCATOR EXPENSE** deduction. This deduction is for personal out of pocket expenses that educators spend to help in their classroom settings. The deduction is limited to \$250 (per spouse). This deduction was set to expire at the end of 2009, however, late passage of the 2010 tax bill extended this deduction for 2010 & 2011.

Line 24 is the **CERTAIN BUSINESS EXPENSES OF RESERVISTS, PERFORMING ARTISTS, AND FEE-BASIS GOVERNMENT OFFICIALS FROM FORM 2106 OR 2106-EZ**. This deduction is available to the above noted employees for employee business expenses. These employees can deduct their business expenses on line 24 rather than as miscellaneous itemized deductions on Schedule A, subject to the 2% of Adjusted Gross Income (AGI) limitation. Eligible employees must complete and attach Form 2106 or 2106-EZ to the tax return to qualify for the deduction. Because this deduction is limited to such a small group of individuals, we will not get into details of the deduction in our discussion here.

Line 25 is the **HEALTH SAVINGS ACCOUNT (HSA) DEDUCTION** (from Form 8889). A health savings account (HAS) is a tax-exempt or custodial account set up with a qualified HSA trustee to pay or reimburse certain medical expenses incurred by an individual, his or her spouse, and qualified dependents. The medical expenses must not be reimbursable by insurance or other sources, and distributions from HSA funds will not give rise to a medical expense deduction (Schedule A) on the individual's tax return. From a tax planning standpoint this is a great deduction for some taxpayers because contributions are not subject to the 7.5% of Adjusted Gross Income (AGI) limitation required for non-HSA account medical expenses that are reported on Schedule A as itemized deductions, which prevents many taxpayers from deducting any medical expenses at all. HSA's allow eligible individuals to save for, and pay health care expenses on a tax-free basis. A taxpayer purchases low cost high deductible health insurance. For medical expenses not covered by insurance due to the high deductible, the taxpayer can either make tax deductible contributions to the HSA, or an employer can make contributions to the HSA of an employee and exclude the benefit from taxable wages. Once the pre-tax dollars are in the account, they can be withdrawn tax free to pay for the qualified medical expenses not covered by insurance. The funds in the account can be withdrawn to pay for medical expenses, or they can be allowed to

accumulate from year to year. Interest or other earnings on the account accumulate tax free.

Annual contributions for 2010 and 2011 are limited to:

- |  |         |
|--|---------|
| 1. Self-Only Coverage, under age 55    | \$3,050 |
| 2. Self-Only Coverage, age 55 or older | \$4,050 |
| 3. Family Coverage, under age 55       | \$6,150 |
| 4. Family Coverage, age 55 or older    | \$7,150 |

Amounts in a Health Flexible Spending Arrangement (FSA) or a Health Reimbursement Arrangement (HRA) can be rolled over tax-free into a Health Savings Account (HSA).

In addition, a one-time tax free rollover from an IRA into an HSA is allowed. The IRA-HSA rollover is limited to the otherwise maximum deductible contribution amount to the HSA computed on the basis of the type of coverage under the high deductible health plan at the time of the rollover.

Line 26 is the **MOVING EXPENSE DEDUCTION** (from Form 3903). Moving expenses are deductible if the taxpayer moves to a new home (at least 50 miles away from his previous workplace) because of a new principal workplace.

An important note is that the move does not have to be with the same company, moving expenses are deductible even if a taxpayer begins a new job.

The deductible moving expenses include:

1. The cost of transportation and storage (up to 30 days after the move) of household goods and personal effects.
2. Travel, including lodging, from the old home to the new home. Travel is limited to one person. However, each member of the household can move separately and at separate times. If the taxpayer drives his or her own vehicle, expenses can be figured either using actual out-of-pocket expenses for gas and oil (but not depreciation) or the standard mileage rate for moving (16.5¢ per mile for 2010), plus parking fees and tolls.

Not Deductible. Cost of meals while traveling, temporary living expenses, or house hunting expenses before or after the move.

Line 27 is **ONE-HALF OF SELF EMPLOYMENT TAX** (from Schedule SE). This deduction is for sole proprietorships and partnerships that must pay self employment tax on their business profits.

Business are allowed a deduction of  $\frac{1}{2}$  of the amount of the self employment tax they have to pay. While businesses can reduce their taxable income by  $\frac{1}{2}$  of their self employment tax, the full amount of the self employment tax is taxed to the taxpayer in the form of an additional tax on line 56 of page 2 of the 1040.

Line 28 is **SELF-EMPLOYED SEP, SIMPLE, AND QUALIFIED PLANS**. Self-Employed taxpayers can set up and deduct contributions made to the above list qualified retirement plans. Self-Employed taxpayers deduct their contributions to their personal retirement plans on this line of his tax return. Contributions made for employees are deducted on Schedule C or F. The details of each of the above listed retirement plans are outside the parameters of our discussion here. I recommend that you discuss the specifics of each plan with your tax advisor to determine which plan would be right for you.

Line 29 is the **SELF EMPLOYED HEALTH INSURANCE DEDUCTION**. Health insurance paid on

behalf of the sole proprietor, their spouses, dependents, and any children who have not attained age 27 as the end of the taxable year is deductible for both regular income tax purposes, and as a deduction in computing self-employment tax, even if the taxpayer does not itemize deductions on Schedule A of Form 1040. This is a new law passed for 2010. The deduction is limited to the smaller of eligible health insurance premiums, or net profit from the business, minus the deduction for one-half of SE tax and any deduction for self-employed SEP, SIMPLE, or qualified plan contributions. This deduction also applies to a more than 2% corporation shareholder. Net profit for the S Corporation shareholder means W-2 wages from that corporation.

To qualify for the self-employed health insurance deduction, the insurance must be established by a business. A sole proprietor can meet this requirement by purchasing the health insurance coverage under his or her personal name.

Health insurance premiums paid for an employee of a small business taxpayer, as a employee benefit, is deducted on line 14 of Schedule C.

Line 30 is the **PENALTY ON EARLY WITHDRAWAL OF SAVINGS DEDUCTION**. If you take an early withdrawal on a timed savings plan, you typically encounter a penalty by the savings institution for that early withdrawal. This deduction allows you to deduct the full amount of the penalty paid, even it is more than the interest that you earned.

Line 31 is the **ALIMONY PAID DEDUCTION**. Alimony or separate maintenance paid to a spouse or former spouse is fully deductible. Alimony or separate maintenance received by a spouse or former spouse is fully taxable to the spouse receiving the payment.

Line 32 is the **IRA DEDUCTION**. A deduction for qualified traditional IRA contributions made up to April 15 of the year following your tax year are available for “some” taxpayers. Qualified taxpayers may deduct up to \$5,000.00 (\$6,000.00 for those over 50) per year.

However, taxpayers who participate in an employer sponsored pension plan may be limited on the amount they can deduct of their IRA contribution. The phase-out amounts for deductibility for tax year 2011 are:

\$90,000.00 – \$110,000.00 for Married Filing Jointly  
\$56,000.00 – \$66,000.00 for Single & Head of Household  
\$ 0 - \$10,000.00 for Married Filing Separately

Line 33 is the **STUDENT LOAN INTEREST DEDUCTION**. Taxpayers may be able to deduct up to \$2500.00 for qualified student loan interest paid for the year. The deduction may be limited because in order to qualify the gross income of the taxpayer cannot exceed:

\$60,000.00 for Singles, Head of Household, or Qualifying Widows  
\$120,000.00 for Married Filing Jointly

Please consult your tax advisor to determine if you qualify for this deduction.

Line 34 is the **TUITION AND FEES DEDUCTION**. A deduction is available for qualified tuition and fees paid on behalf of the taxpayer, spouse, or dependent. Taxpayers may deduct “qualified education expenses” they paid for eligible students up to:

\$4,000.00 if modified AGI is \$65,000.00 or less (\$130,000.00 or less MFJ)  
\$2,000.00 if modified AGI is \$80,000.00 or less (\$160,000.00 or less MFJ)  
\$0 if modified AGI is over \$80,000.00 (\$160,000.00 MFJ)

Please consult your tax advisor to determine if your education expenses qualify for the deduction.

The taxpayer may qualify to take a tax credit on line 49 instead of taking the deduction on this line.

In most cases, if you qualify, taking one of the tax credits available on line 49 will result in greater tax savings for you.

Line 35 is the **DOMESTIC PRODUCTION ACTIVITIES DEDUCTION** (from Form 8903). A taxpayer may be able to deduct up to 9% of “qualified” production activities income. Qualified Production Activities Income is limited to certain enterprises. Please consult your tax advisor to determine if your business activities qualify as “domestic production activities”.

Line 36 is where you total lines 23 – 35. In addition to these totals include the total of any of the following write-in adjustments:

1. Archer MSA deduction
2. Jury duty pay that was paid to employer
3. Deductible expenses related to income reported on line 21 from the rental of personal property engaged in for profit.
4. Reforestation amortization and expenses
5. Repayment of supplemental unemployment benefits under the Trade Act of 1974
6. Contribution to Section 501(c) pension plans
7. Contributions by certain chaplains to Section 403(b) plans
8. Attorney fees and court costs for actions settled or decided after October 22, 2004, involving certain unlawful discrimination claims.
9. Attorney fees and court costs paid in connection with an award from IRS for information provided after December 19, 2006 that substantially contributed to the detection of tax law violations.

By subtracting the balance on Line 36 from Line 22 we arrive at the all important **ADJUSTED GROSS INCOME (AGI)** (Line 37). As stated earlier, AGI is important because it is the amount that determines which itemized deductions and tax credits are deductible to you.

While you may not qualify for all the available deductions on lines 23 – 36, you should closely examine your circumstances to determine if you qualify for some of them. Please consult your tax advisor to assist you in this determination.

Next month we will examine which itemized deductions on Schedule A of your tax return that you may qualify for and how to best maximize those deductions.

Till Next Time,

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