



Adjustments to Income



Introduction

This lesson covers the Adjustments to Income section of Form 1040, Schedule 1. Taxpayers can subtract certain expenses, payments, contributions, fees, etc. from their total income. The adjustments, subtracted from total income on Form 1040, establish the adjusted gross income (AGI).

Some items in the Adjustments to Income section are out of scope. This lesson will cover all in-scope topics. Refer to the Volunteer Resource Guide, Tab B, Starting a Return and Filing Status, or go to irs.gov to view Form 1040.

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Identify which adjustments are within the scope of the VITA/TCE programs
- Calculate and accurately report the adjustments to income that are within the scope of the VITA/TCE programs

How do I determine if the taxpayer has adjustments to income?

To identify the adjustments to income that taxpayers can claim, you will need to ask the taxpayers if they had the types of expenses listed on the Adjustments to Income section of Schedule 1. Review the taxpayers' answers on their intake and interview sheet.

During the tax year did the taxpayer or spouse:

- Pay qualified educator expenses?
- Receive income from self-employment?
- Have self-employed health insurance?
- Pay a penalty for early withdrawal of savings?
- Pay alimony?
- Make charitable contributions?
- Make contributions to a traditional IRA?
- Make a contribution to a health savings account?
- Pay student loan interest?
- Receive income from jury duty that was turned over to an employer?
- Have a Form W-2 Box 12 code H contribution to Sec 501(c)(18)(D) pension plan?

What do I need?

- Form 13614-C
- Form 8889
- Form 8889 Instructions
- Publication 4012
- Publication 17
- Publication 969

Optional:

- Publication 504
- Publication 590-A
- Publication 970
- Form 1040 Instructions
- Form 1040 (Sch SE)
- Form 1098-E
- Form 1099-INT
- Form 1099-OID
- Form 8606
- IRA Deduction Worksheet
- Student Loan Interest Deduction Worksheet



Please refer to the Legislative Extenders lesson in this publication for information regarding tuition and fees deduction.

There are other adjustments to income, such as self-employed SEP, SIMPLE, and qualified plans and domestic production activities deductions. These are beyond the scope of the VITA/TCE programs. If you believe a taxpayer could benefit from one of these other adjustments, encourage the taxpayer to consult a professional tax preparer.



Tax Software Hint: To review the tax software entry screen for Adjustments, go to the Volunteer Resource Guide, Tab E, Adjustments.

How do I handle educator expenses?

Who is eligible?

Eligible educators can deduct up to \$250 of qualified expenses paid during the tax year. If the taxpayer and spouse are both eligible educators, they can deduct up to \$500, but neither can deduct more than their own expenses up to \$250. The deduction amount is indexed for inflation, so future maximum deduction amounts may be higher.

If the taxpayer or spouse is an educator, probe a little deeper to see if they qualify for this adjustment. Ask questions such as:

- Are you or your spouse a teacher, instructor, counselor, principal, or aide in a school? (Cannot be a home school)
- What grade or grades do you teach? (Must be K-12)
- Were you employed for at least 900 hours during the school year? (Required minimum)

What expenses qualify?

If the taxpayer or spouse is an eligible educator, ask about their qualified expenses. Advise taxpayers that they must have receipts for verification if they get audited.

Expenses that qualify include books, supplies, equipment (including computer equipment, software, and services), and other materials used in the classroom. The educator's own professional development expenses related to the curriculum in which the educator provides instruction are also included. Qualified expenses don't include expenses for home schooling or for nonathletic supplies for courses in health or physical education.

example

Gloria is a 5th and 6th grade teacher who works full-time in a year-round school. She had 1800 hours of employment during the tax year. She spent \$262 on supplies for her students. Of that amount, \$212 was for educational software. The other \$50 was for supplies for a unit she teaches sixth graders on health. Only the \$212 is a qualified expense. She can deduct \$212.

example

Debbie is a part-time art teacher at an elementary school. She spent \$185 on qualified expenses for her students. Because she has only 440 hours of documented employment as an educator during the tax year, she cannot deduct her educator expenses.

What other rules apply?

Probe to learn if the taxpayer or spouse received reimbursement that would reduce the amount of their educator expenses. For example, ask:

- Did you receive reimbursement that is not listed as income on Form W-2?
- Did you redeem U.S. Series EE or I Savings Bonds where the interest would be tax-free, such as redeeming savings bonds to pay educational expenses?
- Did you receive a nontaxable distribution from a qualified tuition program (QTP) or a distribution of nontaxable earnings from a Coverdell education savings account (ESA)?

Educator expenses are reduced by any of these applicable reimbursements.

How do I report this?

Educator expenses are reported in the adjustments section of Form 1040, Schedule 1. Don't forget to reduce the total educator expenses by any reimbursements, nontaxable savings bond interest, nontaxable distribution from a QTP, or nontaxable distribution of earnings from an ESA.

Taxpayer Example

Bob teaches elementary school. His wife Janet teaches high school chemistry. Here is how a volunteer helped them determine if they can take the deduction for educator expenses.

SAMPLE INTERVIEW

VOLUNTEER SAYS...

You've already mentioned that you both work full-time as teachers, so you may be able to deduct some of the money you spent on qualified educator expenses. Can you tell me how much you spent, or did you bring your receipts?

Can you tell me what you purchased? Janet, maybe you could go first.

Your receipts add up to \$382. Now, we can count only the first \$250 of educator expenses, but because you are married and filing jointly, we can count up to \$250 for Bob. Bob, tell me about your expenses.

Yours total \$263. Now, did either of you receive any reimbursement that is not shown on Form W-2?

That would bring your total down to \$213.

No, I'm sorry, each person's expenses have to stand alone.

JANET & BOB RESPOND...

[Janet] Yes, all teachers keep careful records of their expenses. Here are my receipts and here are Bob's.

[Janet] Sure. Three receipts are for quick reference cards for my chemistry students. And two are for special reagents the department doesn't stock.

[Bob] These four receipts are for art supplies – paint and brushes, as you can see – and these two are for special papers and sculpting clay.

[Janet] No, we paid these expenses out of our own pockets.

[Bob] Wait, now that I think about it, I got reimbursed \$50 for the clay.

[Janet] Can't we apply some of my excess expense to Bob and bring his total up to \$250?

[Janet] Okay.

SAMPLE INTERVIEW

VOLUNTEER SAYS...

Did you redeem U.S. series EE or I Savings Bonds during the tax year?

We would complete a form to see what percentage of the tax-free interest should be applied as a reimbursement. One more thing: did you receive distributions from a qualified tuition program or a Coverdell education savings account?

Okay, we can claim \$213 for Bob and the maximum \$250 for Janet. That gives you a total of \$463 on your joint return as a deduction for educator expenses. Any questions before we go on?

JANET & BOB RESPOND...

[Janet] No, we didn't. What if we had?

[Bob] No, neither of those.

[Janet] No, I think we understand.

[On the intake and interview sheet, indicate that the taxpayers are entitled to the educator expense adjustment.]



How do I handle self-employment tax?

Self-employed taxpayers can deduct a portion of their self-employment tax from their income. Self-Employment Tax is covered in the Other Taxes Lesson.



Tax Software Hint: The deductible portion of the self-employment tax is automatically calculated on Schedule SE by the software and the deductible portion is carried to adjustments section on Form 1040, Schedule 1. To review information related to the software, go to the Volunteer Resource Guide, Tab E, Adjustments.

How do I handle self-employed health insurance deduction?

Self-employed taxpayers who reported a net profit on Schedule C for the year may be able to deduct the cost of their health insurance paid as a deduction from their gross income. The insurance plan must be established under the trade or business and the deduction cannot be more than the earned income from that trade or business. When filing Schedule C, the health insurance policy can be either in the taxpayer's name, the spouse's name (if Married Filing Jointly), or in the name of the business.

Medicare premiums voluntarily paid to obtain insurance in the taxpayer's name that is similar to qualifying private health insurance can be used to figure the deduction. The spouse's Medicare premiums qualify for the deduction when Married Filing Jointly even though paid from the spouse's benefits. Include health, dental, vision, supplemental, limited coverage, and long-term care (LTC) premiums. LTC is limited to the deduction cap for Schedule A, based on age.

Self-employed taxpayers cannot deduct payments for medical insurance for any month in which they were eligible to participate in a health plan subsidized by their employer, a spouse's employer, or an employer of the taxpayer's dependent or child under age 27 at the end of the tax year. Taxpayers cannot deduct payments for a qualified long-term care insurance contract for any month in which they were eligible to participate in an employer-subsidized long-term care insurance plan.

Whose health coverage qualifies?

For this purpose, health coverage can be for the taxpayer, spouse, dependents, or the taxpayer's child under the age of 27 even though the child is not the taxpayer's dependent. A child includes a son, daughter, stepchild, adopted child, or foster child.

What is the limit on the self-employed health insurance deduction?

The self-employed health insurance deduction is limited to the net self-employment profit shown on the return reduced by the deduction for one-half of the self-employment tax.

example

Carson is single and has his own business. During the year, he paid qualified health insurance premiums of \$3,000. His Schedule C shows a profit of \$5,500 and his self-employment tax deduction is \$389 for a net of \$5,111 (\$5,500 – \$389). The full \$3,000 premium paid is deductible as self-employment health insurance because it is less than the net profit.



When the total health insurance costs exceed the self-employed health insurance deduction limit, a taxpayer can generally include any remaining premiums as an itemized medical expense deduction.

What if the insurance was purchased through the Marketplace?

Self-employed taxpayers who purchased their coverage from the Marketplace and are eligible for the Premium Tax Credit are out of scope for the VITA/TCE programs.



How do I handle penalties on early withdrawal of savings?

Taxpayers can adjust their gross income to deduct penalties they paid for withdrawing funds from a deferred interest account before maturity. Ask if the taxpayer and/or spouse made any early withdrawals during the tax year. If so, ask to see Form 1099-INT, Interest Income, or Form 1099-OID, Original Issue Discount, documenting the penalty. The early withdrawal penalty deduction is reported on Form 1040, Schedule 1.



Tax Software Hint: The early withdrawal penalty amount should be entered in the interest income section if it is listed on Form 1099-INT. Otherwise, go to the Deductions section, then Adjustments, and click begin on the Penalty on Early Withdrawal of Savings or CD line.

example

Gloria withdrew \$5,000 early from a one-year, deferred-interest certificate of deposit. She had to pay a penalty of three months' interest. She can claim this penalty amount as an adjustment to income.

How do I handle alimony paid?

Pre-2019 Divorces

Alimony is a payment to a spouse or former spouse under a divorce or legal separation instrument. The payments do not have to be made directly to the ex-spouse. For example, payments made on behalf of the ex-spouse for expenses specified in the instrument, such as medical bills, housing costs, and other expenses can qualify as alimony. Alimony does not include child support or voluntary payments outside the instrument. The person paying alimony can subtract alimony payments as an adjustment to income; the person receiving alimony must treat it as income. A summary of the alimony requirements can be found in Tab E, Adjustments, in the Volunteer Resource Guide.

When you conduct the interview, ask if the taxpayer paid alimony under a divorce or separation instrument. If so, explain that you need the exact amount, as well as the Social Security number of the recipient,

because the recipient must report the payment to the IRS as income and the two amounts must agree. The date of the divorce, or a reasonable estimate, is also needed to complete Schedule 1.

For additional information on alimony, refer to the Alimony chapter in Publication 17 and Publication 504, Divorced or Separated Individuals.

Post-2018 Divorces

Alimony or separate maintenance payments made under a divorce or separation agreement (1) executed after 2018, or (2) executed before 2019, but later modified if the modification expressly states the repeal of the deduction for alimony payments applies to the modification, are no longer deductible. Alimony and separate maintenance payments received under such an agreement are not included in the gross income of the recipient.

example

Anthony was divorced in 2017. Under his divorce instrument, he paid his ex-wife \$8,000 during the tax year. As a favor, he also made \$4,000 in payments to cover part of her vehicle lease so she could keep steady employment. He can take the \$8,000 as an adjustment to income. He cannot count the lease payments because those were payments not required by the divorce instrument.



EXERCISES

Answers are at the end of the lesson summary.

Question 1: Victoria divorced in 2007. Her divorce settlement states that she must pay her ex-husband \$12,000 a year. She is also required to pay his ongoing medical expenses for a condition he acquired during their marriage. During the tax year, the medical expenses were \$11,400. How much can she deduct as an adjustment to income?

- A. \$12,000
- B. \$11,400
- C. \$23,400
- D. \$600



How do I handle IRA contributions?

Individual Retirement Arrangements (IRAs) are personal savings plans that offer tax advantages to set aside money for retirement. This section discusses “traditional” IRAs. A traditional IRA is any IRA that is not a Roth or SIMPLE IRA. See the Individual Retirement Arrangements (IRAs) chapter in Publication 17, and Publication 590-A, Individual Retirement Arrangements, for more information on all types of IRAs.

Some of the features of a traditional IRA are:

- Taxpayers may be able to deduct some or all of their contributions to the IRA (depending on circumstances).
- Generally, amounts in an IRA, including earnings and gains, are not taxed until distributed.
- Contributions may be eligible for the retirement savings contributions credit.

Although contributions to a Roth IRA cannot be deducted, the taxpayer may be eligible for the retirement savings contributions credit, discussed in the lesson on Miscellaneous Credits.

example

Fred has a traditional IRA account and a Roth IRA account. During the tax year, Fred contributed \$2,200 to his traditional IRA and \$1,000 to his Roth IRA. The most Fred will be able to deduct is the \$2,200 contribution to his traditional IRA.



Based on the intake and interview form, ask the taxpayer about any IRA contributions during the year or that they intend to make by the due date of the return.

What are the eligibility requirements for an IRA contribution?

The taxpayer, and the taxpayer's spouse if applicable, must meet these eligibility requirements in order to make an IRA contribution:

- **Types of IRAs:** Verify the types of IRAs to which the taxpayer and spouse contributed. Only contributions to traditional IRAs are deductible.
- **Age limit:** Under the SECURE Act of 2019, there is no age limit for either traditional or Roth IRA contributions effective for tax years beginning after December 31, 2019.
- **Compensation:** Individuals must have taxable compensation (i.e., wages, self-employment income, commissions, taxable alimony, or taxable scholarships or fellowships, as shown in Box 1 of Form W-2).
- **Time limits:** Contributions must be made by the due date for filing the return, not including extensions. Verify with the taxpayer and spouse that they made the contribution(s) (or will make them) by the due date of the return.



Be sure the taxpayer knows that if a contribution is reported on the tax return but is not made by the deadline, the taxpayer must file an amended return.

How much can a taxpayer deduct for an IRA contribution?

Generally, you can deduct the lesser of:

- The contributions to your traditional IRA for the year, or
- The general limit reduced for Roth IRA contributions made for the same tax year

What is the compensation requirement?

Compensation is generally the income a taxpayer has earned from working; it also includes taxable alimony, and other forms of earned income. (See Publication 17 for more information on compensation.) Taxpayers cannot make IRA contributions that are greater than their compensation for the year.



An IRS certified volunteer preparer must exercise due diligence when preparing or assisting in the preparation of, approving, and filing tax returns. Based on this, volunteers may rely in good faith without requiring certain documents from the taxpayer. However, the volunteer preparer may not ignore the implications of information furnished to, or actually known by, the preparer. The preparer must ask questions if the information furnished appears to be incorrect, inconsistent, or incomplete.

If taxpayers file a joint return, and one spouse's compensation is less than the other spouse's compensation, the most that can be contributed for that spouse is the lesser of:

- The general limits, or
- The total compensation includible in the gross income of both spouses for the year, reduced by:
 - Traditional IRA contributions for the spouse with the greater compensation
 - Any contribution for the year to a Roth IRA for the spouse with the greater compensation

In other words, as long as they file a joint return, married taxpayers' combined IRA contributions cannot exceed their combined compensation, and neither spouse can contribute more than the general IRA limit to their own IRA.

Beginning in 2019, taxpayers can elect to increase their compensation for difficulty of care payments that are excluded from gross income for the purpose of nondeductible IRA contributions.

example

Gene and Sue are married and are both over 50 years old. Gene earned \$70,000 and Sue earned \$1,500. During the tax year, Gene contributed \$3,500 to his traditional IRA and \$2,000 to a Roth IRA, making his total contributions \$5,500. To figure the maximum contribution to Sue's IRA, use a total compensation of \$66,000 (i.e., \$71,500 – \$5,500). If Gene and Sue file jointly, they can contribute up to the IRA limit to Sue's IRA even though her own compensation was just \$1,500.

Although a person may have IRA accounts with several different financial institutions, the tax law treats all of their traditional IRA accounts as one single IRA. Inherited IRAs, however, are treated separately. If a taxpayer inherits a traditional IRA from a deceased spouse, they can treat the account as their own and make contributions and rollovers into the inherited account. A taxpayer cannot make a contribution to an IRA they inherited from someone other than a spouse. A surviving spouse who elects to transfer an IRA inherited from their spouse to their own IRA can make contributions to the transferred IRA.

example

Bill is 29. He has a traditional IRA account at City Home Savings Bank and another traditional IRA account through his stockbroker. He also opened a Roth IRA through his stockbroker. Bill can contribute to any or all of his accounts this year, but the combined contributions for the tax year cannot exceed the lesser of the general IRA limit or his compensation for the tax year.



EXERCISES (continued)

Question 2: Stan, an unmarried college student working part time, earned \$4,500 during the tax year. What is the maximum he can contribute to an IRA?

- A. \$1,000
- B. \$3,500
- C. \$4,500
- D. \$5,500

Question 3: Bob and Carol are married and both are 55 years old. They both work and each has a traditional IRA. During the tax year, Bob earned \$2,000, and Carol earned \$50,000. If they file separate returns, what is the maximum that Bob can contribute to his IRA? \$_____.

Are there special rules for certain military personnel?

Current or former members of the Armed Forces may qualify for additional retirement benefits. Under the Heroes Earned Retirement Opportunities (HERO) Act, taxpayers can count tax-free combat pay as compensation when determining whether they qualify to contribute to either a Roth or traditional IRA. Before this change, members of the Armed Forces whose earnings came entirely from tax-free combat pay were generally barred from using IRAs to save for retirement.

When can IRA contributions be deducted?

Deductions can be taken for contributions to traditional IRAs for returns that are in scope. The taxpayer's deduction for IRA contributions may be "phased out" (i.e., reduced or eliminated) depending on their income, filing status, and whether the taxpayer is covered by a retirement plan at work. The difference between the permitted contributions and the IRA deduction, if any, is the taxpayer's nondeductible contribution. Form 8606, Nondeductible IRAs, must be completed for any nondeductible traditional IRA contributions.

If taxpayers do not report nondeductible contributions, all of the contributions to a traditional IRA will be treated as having been deducted. This means all distributions will be taxed when withdrawn unless the taxpayer can show, with satisfactory evidence, that nondeductible contributions were made.

Form 8606 requires basis information in IRAs from prior years and can be complex. If Form 8606 is required, refer the taxpayer to a professional tax preparer.

How do I determine the deduction amount?

The factors that affect whether traditional IRA contributions are deductible include:

- Whether the taxpayer (or spouse, if filing a joint return) is covered by a retirement plan at work.
- The taxpayer's Modified Adjusted Gross Income (MAGI) before taking the deduction. If the taxpayer or spouse is covered by a retirement plan, the deduction amount will be reduced or eliminated if the MAGI on the tax return is above a certain limit.

Retirement coverage at work

Ask if the taxpayer and/or spouse were covered by a retirement plan at work at any time during the tax year. If so, their deduction may be limited. Employees covered by a retirement plan will have Box 13 on Form W-2 checked.

Filing status and income

If the taxpayer or spouse was covered by an employer retirement plan, they may not be able to deduct the full amount. Notice that the income limitation amount may be different for each spouse on a joint return, but that the MAGI computation is the same. This is because if one spouse is covered by a retirement plan but the other is not, the noncovered spouse will have a higher income limit before their IRA deduction is phased out.

If the MAGI is greater than the income limits, the deduction cannot be taken. If this is the case, explain to the taxpayers and answer any questions they may have about why the deduction cannot be taken. The contribution may still be made, it is just not deductible.

Enter the total contributions to traditional IRAs that were made (or will be made) for each spouse (on a joint return) by the due date of the return.

How do I report the IRA deduction?

Report the deduction in the adjustments section of Form 1040, Schedule 1.



Tax Software Hint: To review information related to the software, go to the Volunteer Resource Guide, Tab E, Adjustments.

What if the taxpayer has an excess IRA contribution?

An excess IRA contribution is an amount contributed to a traditional or Roth IRA that is more than the lesser of:

- The taxable compensation for the year, or
- General limit amount

The taxpayer may not know that a contribution qualifies as “excess” until the tax return is completed. When this situation is identified, the excess amount, with any earnings on that amount, must be withdrawn by the due date of the return (including extensions). If the excess amount is not withdrawn by the due date of the return, including extensions, the taxpayer will be subject to an additional 6% tax on this amount. This additional tax is covered in the Other Taxes lesson, but is out of scope for the VITA/TCE programs. Taxpayers subject to the additional 6% tax should be referred to a professional tax preparer.



CAUTION When the taxpayer has modest wages or other compensation and traditional or Roth IRA contributions, confirm that the limit has not been exceeded.

The withdrawn excess contribution is not included in the taxpayer’s gross income before the tax return is due if both of the following conditions are met:

- No deduction was allowed for the excess contribution
- All interest or other income earned on the excess contribution is withdrawn

If taxpayers timely filed the tax return without withdrawing a contribution that they made during the tax year, they can still have the contribution returned to them within 6 months of the due date of the tax return, excluding extensions.

Taxpayers must include in gross income the interest or other income that was earned on the excess contribution. Taxpayers must report it on their return for the year in which the excess contribution was made. The withdrawal of interest or other income may be subject to an additional 10% tax on early distributions.

Form 1099-R

Taxpayers will receive Form 1099-R indicating the amount of the withdrawal. If the excess contribution was made in a previous tax year, the form will indicate the year in which the earnings are taxable.

example

Maria, age 35, made an excess contribution of \$1,000, which she withdrew by the due date of her return. At the same time, she also withdrew the \$50 income that was earned on the \$1,000. She must include the \$50 in her gross income (for the year in which the excess contribution was made). She must also pay an additional tax of \$5 (the 10% additional tax on early distributions because she is not yet 59½ years old), but she does not have to report the excess contribution as income or pay the 6% excise tax. Maria receives a Form 1099-R showing that the earnings are taxable for the current year.

How do I handle Health Savings Accounts?



What is an HSA?

An HSA is a tax-exempt trust or custodial account that a taxpayer sets up with a qualified HSA trustee. Distributions from an HSA are nontaxable if the funds are used for qualified medical expenses. A taxpayer must be an eligible individual to qualify to contribute to an HSA.

Individuals Who Qualify for an HSA

To be an eligible individual and qualify for an HSA, the taxpayer must meet the following requirements:

- Be covered by a high-deductible health plan (HDHP) on the first day of the month
- Not be covered by other health insurance (see Publication 969 for exceptions)
- Not be enrolled in Medicare (the individual can be HSA-eligible for the months before being covered by Medicare)
- Not be eligible to be claimed as a dependent on someone else's tax return (see Caution)



If another taxpayer is entitled to claim the individual as a dependent, the individual cannot claim a deduction for an HSA contribution. This is true even if the other person does not actually claim the dependent.

Rules for Married Individuals

In the case of married individuals, each spouse who is an eligible individual who wants to have an HSA must open a separate HSA. Married couples cannot have a joint HSA, even if they are covered by the same HDHP; however, distributions can be used to cover the qualified expenses of the other spouse.

In the event of the death of one of the married individuals, the HSA will be treated as the surviving spouse's HSA if the spouse is the designated beneficiary of the HSA.



An employee covered by an HDHP and a health FSA or an HRA that pays or reimburses qualified medical expenses generally cannot make contributions to an HSA.

Contributions to HSA

Any eligible individual can contribute to an HSA. For an employee's HSA, the employee, employer, or both may contribute to the employee's HSA in the same year. For an HSA established by a self-employed (or unemployed) individual, the individual can contribute. Family members or any other person may also contribute on behalf of an eligible individual. Contributions to an HSA must be made in cash. Contributions of stock or property are not allowed.

Amounts contributed to an HSA, except for employer contributions and qualified HSA funding distributions from IRAs, can be used as an adjustment to income for the account owner.

Employer Contributions

Employer contributions (including an employee's contribution through a cafeteria plan) are allowed to be made to an employee's HSA. Generally, employer contributions are excluded from an employee's income. Employer contributions are reported on Form W-2, Box 12 using code W. Taxpayers must reduce the amount they, or any other person, can contribute to their HSA by the amount of any contributions made

by the taxpayer's employer that are excludable from income. This includes amounts contributed to the taxpayer's account by the employer through a cafeteria plan. For example, if the employer contributed \$1,000 to a taxpayer's HSA who had a self-only HDHP, the remaining contribution limit would be reduced by that \$1,000. Refer to the Volunteer Resource Guide, Tab E, Adjustments, for current year contribution limits.

example

Arnold has a high-deductible health plan with an HSA with his company. His mother contributed to his HSA as a gift on his 40th birthday, which is an allowable contribution.

HSA Limits on Contributions

The amount the taxpayer or another other person can contribute to the taxpayer's HSA depends on the type of HDHP coverage (individual or family) the taxpayer has, the taxpayer's age, the date the taxpayer became an eligible individual, and the date the taxpayer ceases to be an eligible individual.

Eligible individuals who are 55 or older by the end of the tax year can increase their contribution limit up to \$1,000 a year. This extra amount is the catch-up contribution allowed for an HSA.

Refer to HSA contribution limits in the Volunteer Resource Guide, Tab E, Adjustments.



Taxpayers with excess contributions (contributions over the limits) must withdraw the excess to avoid an additional 6% tax. If the excess is not timely withdrawn, refer the taxpayer to a professional tax preparer. Review Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts, Form 8889, Health Savings Accounts (HSAs) Instructions, and Publication 969, Health Savings Accounts and Other Tax-Favored Health Plans, for details.

Rules for Married People

The rules for married people apply only if both spouses are eligible individuals. If either spouse has family HDHP coverage, the family contribution limit applies; both spouses are treated as having family HDHP coverage.

If both spouses are 55 or older and not enrolled in Medicare:

- Each spouse is entitled to increase his or her contribution limit with an additional contribution.
- Their maximum total contributions under family HDHP coverage would include a catch-up contribution for each spouse.
- The contribution limit is divided between the spouses by agreement. If there is no agreement, the contribution limit is split equally between the spouses.
- Any additional contribution for age 55 or over must be made by each spouse to his or her own HSA.

example

This year, Mr. Auburn and his wife are both eligible individuals. They each have family coverage under separate HDHPs. Mr. Auburn is 58 years old and Mrs. Auburn is 53. Mr. and Mrs. Auburn can split the family contribution limit equally, or they can agree on a different division. If they split it equally, each can contribute one-half the maximum contribution for family coverage. Mr. Auburn can contribute an additional \$1,000 because he is age 55 or over. Refer to HSA contribution limits in the Volunteer Resource Guide, and Publication 969.

Distributions from an HSA

Distributions for Qualified Medical Expenses

Generally, taxpayers will pay medical expenses during the year without being reimbursed by the HDHP until the plan's annual deductible is reached. When the taxpayer pays these medical expenses that are not reimbursed by the HDHP, the taxpayer can request a distribution from the HSA trustee. The taxpayer can receive tax-free distributions from an HSA to pay or be reimbursed for qualified medical expenses incurred in the current or prior year, but after the taxpayer establishes the HSA.

Qualified medical expenses are expenses that generally would qualify for the medical and dental expenses deduction. Examples include unreimbursed expenses for doctors, dentists, and hospitals. The Coronavirus Aid, Relief, and Economic Security (CARES) Act modifies the rules that apply to various tax-advantaged accounts (HSAs, Archer MSAs, Health FSAs, and HRAs) so that additional items are "qualified medical expenses" that may be reimbursed from those accounts. Specifically, the cost of menstrual care products is now reimbursable. These products are defined as tampons, pads, liners, cups, sponges or other similar products. In addition, over-the-counter products and medications are now reimbursable without a prescription. The new rules apply to amounts paid after Dec. 31, 2019. Health insurance premiums are not included as qualified medical expenses except for Medicare premiums.



See Publication 502, Medical and Dental Expenses, for more information.

For recordkeeping requirements on HSA distributions see Publication 969, Distributions from an HSA. Taxpayers are not required to take annual distributions from their HSA. However, taxpayers who have taken HSA distributions will receive Form 1099-SA, Distributions from an HSA, Archer MSA, or Medicare Advantage MSA, from their HSA trustee and must provide it before the return can be completed.

example

Vikki's doctor suggested she take some exercise classes. Vikki signed up for yoga, swimming classes, and a health club. Since these are for general health improvement, they cannot be considered as qualified medical expenses.

Form 8889, Health Savings Accounts (HSA)

A taxpayer must complete Form 8889 with Form 1040 if the taxpayer (or spouse if filing a joint return) had any activity in an HSA. This is true even if only the taxpayer's employer or the spouse's employer made contributions to the HSA.

Taxpayers who are filing jointly and who each have separate HSAs will each complete a separate Form 8889. Married taxpayers cannot have a joint HSA.

Ask taxpayers during the interview process if their HDHP coverage is "self-only" or "family," and check the corresponding box on Form 8889, click to view [Form 8889](#).

Form 8889, Part I

Form 8889, Part 1, is used to report all HSA contributions and to compute the allowable HSA deduction. This includes contributions made by the filing deadline that are designated for the tax year. Contributions made by an employer are also shown in Part I, but are not included in the deductible amount.

An HSA may receive contributions from an eligible individual or any other person, including an employer or a family member, on behalf of an eligible individual.

Form 8889, Part II

Form 8889, Part II, is used by taxpayers to report distributions from an HSA. Taxpayers receive tax-free distributions from an HSA to pay or be reimbursed for qualified medical expenses. The taxpayer will have to tell you what types of expenses were paid or reimbursed with the distribution.

Form 1099-SA reports distributions to a taxpayer. Box 5 will indicate whether the distribution is from an HSA, Archer MSA, or a Medicare Advantage MSA. The code in Form 1099-SA, Box 3, identifies the distribution the taxpayer received. Code 1 is a normal distribution. Refer to Form 1099-SA for an explanation of the other codes.

If distributions are not offset with qualified medical expenses, the amount withdrawn will be included in income and reported on Form 1040. HSA distributions included in income are subject to an additional 20% tax unless the account beneficiary:

- Dies
- Becomes disabled (see Form 8889 instructions)
- Turns age 65

Form 8889, Part III

Form 8889, Part III, is out of scope for the VITA and TCE programs.



Tax Software Hint: Refer to Tab E, Adjustments, in the Volunteer Resource Guide for software entries.



How do I handle student loan interest?

The student loan interest deduction is generally the smaller of \$2,500 or the interest payments paid that year on a qualified student loan. This amount is gradually reduced (phased out) or eliminated based on the taxpayer's filing status and MAGI.

example

Robert has taken his first job after completing law school. His filing status is Single. He paid \$3,000 in interest on his student loans during the tax year. With all adjustments to income (except student loan interest adjustment), his MAGI is below the limits. He can deduct \$2,500 of his student loan interest as an adjustment to income.

example

Veronica and her husband are filing jointly. Their MAGI is above the fully deductible income limits. She completed her doctoral degree last year and paid \$2,400 in student loan interest during the tax year. Due to their high MAGI, the software will calculate their deduction; it will be less than the full amount of interest that she paid.

What type of interest qualifies?

Generally, student loan interest is paid during the year on a loan for qualified higher education expenses. The loan must meet all three of these conditions:

- It was for the taxpayer, the taxpayer's spouse, or a person who was the taxpayer's dependent when the loan was obtained
- The qualified higher education expenses were paid within a reasonable period of time before or after obtaining the loan
- It was for an eligible student

Interest does not qualify if the loan was from a related person, a qualified employer plan, or if the taxpayer is not legally liable for the loan.

What are the exceptions?

For purposes of the student loan interest deduction, the following are exceptions to the general rules for dependents:

- An individual can be your dependent even if you are the dependent of another taxpayer
- An individual can be your dependent even if the individual files a joint return with a spouse
- An individual can be your dependent even if the individual had gross income for the year that was equal to or more than the threshold amount for the year (see the Volunteer Resource Guide, Tab E, Adjustments, for the current year amount)



EXERCISES (continued)

Question 4: Todd and Janet have a MAGI below the limits. They are filing jointly. Two years ago, they took out a loan so Todd's mother could earn her RN degree at night school. Todd could not claim her as a dependent on his return because he did not pay for more than one half of her support. This year, they paid \$1,000 in interest on the loan. Does his mother meet the student qualifications? Yes
 No

Who is eligible for the deduction?

Generally, a taxpayer can claim the deduction if all the following are true:

- The taxpayer is not using the Married Filing Separately filing status
- The taxpayer will not be claimed as a dependent on someone else's return
- The taxpayer is legally obligated to pay interest on a qualified student loan
- The taxpayer paid interest on a qualified student loan

Conduct a probing interview to verify that the taxpayer meets all these tests for the deduction.

What are qualified higher education expenses?

Qualified expenses include: tuition and fees; room and board; books, supplies and equipment; and other necessary expenses (such as transportation).

Qualified expenses must be reduced by certain other educational benefits. Ask the taxpayer if the expenses were offset by any of the following:

- Employer provided educational assistance benefits
- Tax-free distributions from a Coverdell ESA or from a qualified tuition program
- U.S. savings bond interest excluded from income because it is used to pay qualified higher education expenses
- Certain scholarships and fellowships
- Veteran's educational assistance benefits
- Any other nontaxable payments (other than gifts, bequests, or inheritances) received for educational expenses

No double benefit allowed

Taxpayers cannot deduct as interest on a student loan any amount that is an allowable deduction under any other provision of the tax law (e.g., as business interest).

A taxpayer cannot deduct as interest on a student loan any amount paid from a distribution of earnings made from a qualified tuition program (QTP) after 2018 to the extent the earnings are treated as tax free because they were used to pay student loan interest.



As a result of the CARES ACT, the taxpayer cannot claim a deduction for student loan interest paid by the employer and excluded from the employee's income. This CARES Act provision applies for tax year 2020 only.

What is an eligible educational institution?

An eligible educational institution is generally any accredited public, nonprofit, or private post-secondary institution eligible to participate in the student aid programs administered by the Department of Education. It includes virtually all accredited, public, nonprofit, and privately owned profit-making post-secondary institutions. If the taxpayers do not know if an educational institution is an eligible institution, they should contact the school. A searchable database of all accredited schools is available on the U.S. Department of Education website.

Who is an eligible student?

An eligible student is someone enrolled at least half-time in a program leading to a degree, certificate, or other recognized educational credential. The standard for what is half the normal full-time work load is determined by each eligible educational institution.

example

This year, Jeremy paid interest on a loan that allowed his 21-year-old daughter, Kate, to complete a program in holistic medicine as a full-time student at the Southwestern College of Synergistic Therapy. Although she qualifies as his dependent, and the loan paid for books, supplies, and equipment, the college is not accredited. Therefore, Jeremy cannot deduct the interest on the student loan.

Where can I get the information?

If the taxpayer paid \$600 or more in interest to a single lender, the taxpayer should receive Form 1098-E, Student Loan Interest Statement, or another statement from the lender showing the amount of interest paid. This information will assist you in completing the student loan interest deduction.

The taxpayer should keep documentation of all qualified student loan interest paid during the tax year.

See Publication 970, Tax Benefits for Education, for more information on the Student Loan Interest Deduction.



Tax Software Hint: To review information related to the software, go to the Volunteer Resource Guide, Tab E, Adjustments.

Taxpayer Interview and Tax Law Application

Here is how a volunteer helped Brenda determine if she can take the deduction for her student loan interest.

SAMPLE INTERVIEW

VOLUNTEER SAYS...

BRENDA RESPONDS...

In reviewing your intake and interview sheet, I see you did not indicate if you had any educational expenses. Did you pay any student loan interest this year?

Yes, I just graduated a year ago and I'll be paying those loans for a while.

Well, you might be able to take a deduction for that. You are filing as Single, and your income before adjustments is not more than the limit for your filing status. Do you know how much interest you paid?

I have two loans; here are the statements.

The interest amounts add up to \$2,600. Now, if your interest payments qualify for the deduction, the most we can claim is \$2,500. Do you have any questions about that?

No, I understand.

I just need to ask a few questions to see if you qualify, okay? Earlier we decided that you can't be claimed as a dependent on someone else's return, so that's no problem. Can you tell me what you used the loan to pay for?

My tuition and fees, and my books.

Did you receive any educational assistance, like from your employer or the Veteran's Administration?

No.

How about tax-free withdrawals from a Coverdell educational savings account, another qualified tuition program, or from U.S. savings bonds?

No, none of those.

Did you get any other nontaxable payments, not counting gifts, bequests, or inheritances, which were specifically for educational expenses?

Heavens, no, I wish I had!

SAMPLE INTERVIEW

VOLUNTEER SAYS...

BRENDA RESPONDS...

It looks like you can claim the maximum deduction of \$2,500.
[Indicate on the intake and interview sheet whether Brenda is eligible for this adjustment.]

Is pay for jury duty an adjustment to income?

As you learned earlier, jury duty pay received by taxpayers is included in Other income on Form 1040, Schedule 1. Some employees receive their regular wages from their employers while they are serving on a jury instead of working at their jobs.

Often, employees must turn their jury duty pay over to their employers. This may be claimed as an adjustment to income.

Is a charitable contribution adjustment allowed?

Taxpayers may deduct up to \$300 of cash contributions to charitable organizations per return when they do not itemize their deductions. This provision applies to the 2020 tax year only. Refer to the Itemized Deductions lesson for the definition of a qualified charitable organization.

How do I determine Adjusted Gross Income?

The taxpayer's total Adjusted Gross Income (AGI) is the amount that is used to compute some limitations, such as the medical and dental deduction on Schedule A and the credit for child and dependent care expenses. To find the taxpayer's AGI:

1. Add the Income section. This is the taxpayer's total income.
2. Add the Adjustments to Income section. These are the total Adjustments.
3. Subtract the Schedule 1 adjustments from the total income. This is the AGI.

Taxpayer Interview and Tax Law Application

The volunteer assists Daniela with the adjustments to income covered in this lesson.

SAMPLE INTERVIEW

VOLUNTEER SAYS...

DANIELA RESPONDS...

Daniela, we've discussed your income, so we can go on to Adjustments to Income. We might find ways to reduce the income that you're taxed on. Do you have any questions before we go on?

No, it all makes sense.

Now, let's review the expenses listed on your intake and interview sheet and the deductions listed in the Adjustments to Income section. Do you have a Health Savings Account?

No, I don't.

SAMPLE INTERVIEW

VOLUNTEER SAYS...

DANIELA RESPONDS...

Okay. That brings us to self-employment tax. The tax software will calculate the deductible portion of your self-employment tax. The same thing happens with the penalty for an early withdrawal. I will put that in when I enter your interest income, and it will show up as an adjustment.

Cool!

Did you pay any alimony?

No, I've never even been married.

Did you pay any health insurance premiums during the year?

No.

Now, did you contribute to an IRA?

I put in \$2,000 right after Christmas.

Good for you. Will you be contributing any more? You can put money in your IRA before the deadline for filing the return.

I don't think so, but that's good to know.

Was it a traditional, Roth IRA, or a SIMPLE IRA?

It was just a plain old IRA. Here's the statement.

There we go; it is what we call a traditional IRA. Were you covered by any kind of employer retirement plan at any time during the tax year?

No, none.

Because you weren't covered by a retirement plan, you will be able to deduct the full \$2,000 you contributed.

[The volunteer reviews all expenses listed on the intake and interview sheet and reviews all the adjustments on Schedule 1, asks more questions and determines that Daniela does not qualify for the remaining adjustments.]

We'll enter all the adjustments that apply to you. The software will calculate your total income, total adjustments, and will determine your Adjusted Gross Income that will be used to determine your deductions.

That's great! This program makes it really easy!

[On the intake and interview sheet, note that you have addressed this adjustment.]

Summary

In this lesson, you learned how to identify and work with these adjustments to income:

- Educator expenses
- Deductible portion of self-employment tax
- Deduction for self-employed health insurance
- Penalty on early withdrawal of savings
- Alimony paid
- IRA deduction
- Health Savings Account deduction
- Student loan interest deduction
- Jury duty pay turned over to the taxpayer's employer

If you believe a taxpayer could benefit from an adjustment that is out of scope and was not covered in this lesson, encourage the taxpayer to consult a professional tax preparer.

What situations are out of scope for the VITA/TCE programs?

The following are out of scope for this lesson:

- Other adjustments to income, such as:
 - Self-employed health insurance deduction with premium tax credits
 - Self-employed SEP, SIMPLE, and qualified plans
 - Certain business expenses of performing artists
 - Domestic production activities deduction
- Form 8606, Nondeductible IRAs

While this list may not be all inclusive, it is provided for your awareness only. Refer to the Volunteer Resource Guide, Scope of Service, for additional items not covered in the lessons.



TAX LAW APPLICATION

To gain a better understanding of the tax law, complete the practice returns(s) for your course of study using the Practice Lab on L<.



EXERCISE ANSWERS

Answer 1: C. She can deduct the full \$23,400 because it is all required by the divorce instrument.

Answer 2: C. His IRA contributions are limited to \$4,500, the amount of his compensation.

Answer 3: If Married Filing Separately, Bob can contribute no more than \$2,000, the amount of his compensation.

Answer 4: No. Todd's mother was not their dependent at the time they took out the loan and none of the exceptions applies.

Notes
