

## **RECAP OF SIGNIFICANT TAX DEVELOPMENTS THAT OCCURRED IN THE THIRD QUARTER OF 2004**

Although the Working Families Tax Relief Act of 2004 dominated the tax news in the third quarter of 2004, there were many other important tax developments which may affect you, your family, your investments and your livelihood. We have summarized the most important new developments below.

### ■ **IRS offers guidance and transitional relief for health savings accounts (HSAs)**

As of January 1, 2004, eligible individuals may set up a tax-favored HSA if they are covered under a high deductible health plan (HDHP) (individual or family coverage) and not covered under any other non-HDHP (except for certain permitted insurance or coverage). Contributions made to HSAs are subject to annual maximum limits. The IRS has clarified the HSA rules by indicating, among other things: (1) family HDHP coverage is a health plan covering one eligible individual and at least one other individual; and (2) coverage received under an Employee Assistance Program, disease management program or wellness program generally doesn't make an individual ineligible to contribute to an HSA as long as the program doesn't provide a significant benefit in the nature of medical care or treatment.

The IRS has also provided special transitional relief which affects an individual's eligibility to make contributions to an HSA. The relief is provided for:

- health plans otherwise qualifying as high deductible health plans (HDHPs) but for the absence of an express limit on out-of-pocket expenses (individuals covered under these health plans are eligible to contribution to HSAs for months before January 1, 2005); and
- health plans allowing "annual" deductibles to be satisfied over a period greater than 12 months (individuals covered under these health plans are eligible to contribute to HSAs for months before January 1, 2006).

### ■ **IRS explains election to treat qualified dividends as investment income**

The amount of investment interest which may be deducted in any tax year by a non-corporate taxpayer is limited to "net investment income" for the year and generally doesn't include "qualified dividends" (i.e., dividends taxed at a top rate of 5% or 15%). However, a taxpayer can elect to treat qualified dividends as investment income for purposes of the investment income deduction and, as a result, the qualified dividends will be taxed as ordinary income. The IRS has explained the election to treat qualified dividends as investment income for purposes of the investment interest deduction is made on Form 4952, "Investment Interest Expense Deduction."

■ **Tax relief for victims of recent hurricanes and tropical storms**

The IRS has granted some forms of tax relief to victims of hurricanes and tropical storms which recently devastated large portions of Southern and Eastern U.S., including Alabama, Florida, Louisiana and Mississippi. In the hardest hit states, the deadlines for filing certain kinds of returns have been extended and penalties for failure to make some types of business deposits have been waived. In some cases, the IRS has provided several extensions to taxpayers hit by multiple storms in Florida. Also, storm victims in places designated as disaster areas can choose to deduct their uninsured casualty losses on their 2003 returns instead of their 2004 returns. This choice (which requires filing an amended return for 2003) may generate a quick tax refund.

■ **New law may affect employers' state unemployment taxes**

Generally, unemployment compensation is administered by the states through state insurance programs where they collect state unemployment taxes from employers. The unemployment insurance tax rate is tied to the number of unemployment claims filed by an employer's work force (i.e., the unemployment workforce experience). Thus, new employers may start off with a low state unemployment tax rate, which may later be increased (up to a capped rate) based on the rate of employee turnover in its workforce. The state unemployment tax (SUTA) is a companion to the Federal unemployment tax (FUTA). The employer gets a credit against FUTA tax for contributions paid into state unemployment funds.

A newly enacted law forces states to take steps to curb employer practices aimed at avoiding unemployment insurance taxes. The new law requires, among other things, that states change their unemployment compensation laws to provide that employers who transfer employees to another business must also transfer the "unemployment experience" of the first company if the two employers are under substantially common ownership, etc.

■ **Home sale rules finalized**

The IRS has finalized regulations which continue to liberalize key aspects of the home sale exclusion. This exclusion allows an individual to treat as tax-free up to \$250,000 of gain from the sale of a home owned and used by him or her as a principal residence (the main home) for at least two of the five years before the sale. The full exclusion doesn't apply if, within the two-year period ending on the sale date, there was another home sale by the person to which the exclusion applied. Married individuals filing jointly for the year of sale may exclude up to \$500,000 of home sale gain if they meet a number of conditions.

Under the final rules, a partial home sale exclusion may apply to a person who fails to qualify for the two-out-of-five-year ownership and use rule, or who previously sold another home within the 2 year period ending on the sale date of the current home in a transaction to which the exclusion applied. The failure to

meet either rule must result from the home being sold (or exchanged) due to (1) a change of place of employment, (2) health, or (3) other unforeseen circumstances.

The new home sale regulations also reflect changes made by a recent law that provides tax relief to military and foreign service personnel by permitting them to make an election to suspend for a maximum of ten years the running of the five-year period for purposes of the homesale exclusion rules while away on active duty assignments.

■ **IRS clarifies election under new liberalized business expensing rules**

A tax law passed in 2003 increased the expensing and phaseout limits and added off-the-shelf software to the list of expensing-eligible property for business property placed in service in 2003-2005. The IRS has clarified that:

- A taxpayer may make or revoke an expensing election without the IRS's consent on an amended return filed within the time prescribed for filing an amended return for the tax year for which the election is made.
- An expensing election made on an amended return must specify the item of eligible business property to which the election applies and the portion of the cost of each such item to be expensed. A taxpayer that elected to expense only part of the cost basis of property for a particular tax year (or didn't make any expensing election) may file an amended return and expense any part of the cost basis of property that was not expensed under a prior election. Any such increase in the expensed amount is not treated as a revocation of the prior election for that particular tax year.

■ **Assets transferred to a FLP included in individual's gross estate**

In general, an individual's taxable gross estate includes property they transferred during their life if they retained the possession or enjoyment of the property or the right to the income from the property for life. Individuals typically transfer assets to family limited partnerships (FLPs) in the hopes of achieving large estate tax discounts for the assets. However, in a major victory for the IRS, the Third Circuit Court of Appeals held assets transferred to a FLP were allowed to be included in an individual's gross estate because at the time of the transfer, an implied agreement existed under which he would retain lifetime enjoyment and economic benefit of the assets. In reaching this result, the Court noted the individual did not retain sufficient assets to support him for the remainder of his life, as calculated at the time of the transfer. It also indicated the individual's lack of control over the transferred property didn't defeat the inference of an implied agreement under the circumstances of the case.

■ **Federal per-diem rates revised effective October 1<sup>st</sup>**

Reimbursements of an employee's business travel costs (lodging, meal and

incidental expenses) at a per-diem rate are payroll-and income-tax free if properly substantiated and the daily rate doesn't exceed the federal per-diem rate (the maximum amount that the federal government reimburses its employees) for the locality of travel for that day. These per-diem rates, which vary by travel destination, are changed annually, generally effective for the last quarter of each year and the first three quarters of the next year. The per-diem rates for the October 1, 2004, through September 30, 2005, period have been issued. The simplified per-diem rates, which assign one per-diem to high-cost areas within the continental U.S., and another to non-high-cost areas, also have been issued, along with a modified list of high-cost areas. Effective October 1, 2004, the high-cost-area rate is \$199 and the rate for non-high-cost areas is \$127.

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