RECAP OF SIGNIFICANT TAX DEVELOPMENTS THAT OCCURRED IN THE SECOND QUARTER OF 2004

The following is a summary of the most important tax developments that have occurred in the past three months which may affect you, your family, your investments and your livelihood.

- **New guidance offered on Health Savings Accounts (HSAs)**

  As of January 1, 2004, an eligible individual may set up a tax-favored HSA if he or she is covered under a high deductible health plan (HDHP) and not covered under any other non-HDHP (except for certain permitted insurance or coverage). Generally, if substantially all the coverage in a health plan is provided through a health flexible spending account (FSA) or a health reimbursement arrangement (HRA), the health plan isn't an HDHP. However, the IRS issued guidance outlining situations where individuals can use FSAs and HRAs and still remain eligible to contribute to an HSA. These arrangements include:

  (1) a limited purpose FSA or HRA that restricts reimbursements to certain permitted benefits such as vision, dental or preventive care benefits; and,

  (2) a suspended HRA, where the employee has elected to forgo health reimbursements for the coverage period.

  The IRS has also provided transitional relief for HSA eligibility in states where an HDHP isn't available because of certain state-mandated disqualifying benefits. These disqualifying benefits include first-dollar coverage or coverage with a low deductible, for certain non-preventive care benefits (e.g., first few substance abuse/mental health treatment visits). The transitional relief covers months before January 1, 2006, for state requirements in effect on January 1, 2004.

- **Finalized rules on education loan interest deduction**

  The IRS has issued final regulations explaining the above-the-line deduction for interest paid on qualified education loans. The maximum annual deduction is $2,500, but is phased-out ratably for taxpayers with modified AGI of $50,000 to $65,000 ($100,000 to $130,000 for joint returns). The deduction is not allowed in a year to an individual who is claimed as a dependent on another's return for that year, and may only be claimed by a person legally obligated to make the payments. For example, a student who pays interest and is not claimed as a dependent by her parents for that year may claim the deduction. However, where a student who pays education loan interest during a tax year is claimed as a dependent by his parents for that year, neither the student nor his parents may claim a deduction for the interest paid by the dependent student. However, if a student obtains a qualified education loan to attend college and his parents cannot claim him as a dependent, but make a required monthly interest payment as a gift to him, the student can deduct that payment of interest (assuming all other requirements are met).

- **Nonpersonal use vans and trucks retroactively exempt from luxury auto**

depreciation limits

Annual depreciation and expensing deductions for so-called luxury autos used for business are limited to specific dollar amounts known as the luxury auto depreciation limits. Leased luxury autos are subject to income inclusion rules. The luxury auto rules apply to almost all cars as well as to trucks or vans rated at 6,000 pounds gross (loaded) vehicle weight or less.

The IRS has issued final regulations which exempt qualified nonpersonal use vehicles placed in service after July 6, 2003, from the luxury auto depreciation limits (and the special lease rules). These vehicles, which because of their nature (i.e., design) are not likely to be used more than a minimal amount for personal purposes, include trucks and vans which have been specially modified (e.g., painting the vehicle to display company's name or advertising, only a front bench for seating). The final regulations also allow businesses to apply the exemption retroactively. This can create a refund opportunity for businesses that placed these vehicles in service before July 7, 2003, and treated them as subject to the luxury auto dollar caps.

■ Guidance on charitable donations of autos

The IRS reminds would-be donors they should:

- Determine if the charity is qualified as a tax-exempt organization. If not, the donation is not tax-deductible.

- Determine the value of the vehicle being donated. The IRS says the deduction is limited to the fair market value of the car and this value may be less than “bluebook” (used car guide) value if, for example, the vehicle needs extensive repairs.

- Follow the proper documentation rules. A deduction of $250 or more requires a written acknowledgment from the charity, the completion of a separate form on the donor's return and/or a qualified appraisal of the auto (depending on the total amount of the deduction claimed).

■ Disability benefits excluded from income if premiums are paid on an after-tax basis

Amounts received through accident or health insurance for personal injuries or sickness generally are excluded from income, except to the extent they are attributable to medical expenses which were deducted in a previous year. The exclusion doesn't apply to amounts received by an employee to the extent they are attributable to employer contributions which weren't includible in his or her gross income or are paid by the employer. The IRS has indicated an employee who irrevocably elected prior to the beginning of the plan year to have the coverage paid by the employer on an after-tax basis, can exclude from his or her income long-term or short-term disability benefits received. This is true even though the employee received tax-free coverage in earlier years.

- **Waiver of employer's tax deposit penalty for voluntary use of EFTPS**

In general, taxpayers whose aggregate annual deposits exceed $200,000 must use electronic funds transfer (EFT). The IRS has recently created an incentive to induce qualified employers who are not required to use the Electronic Federal Tax Payment System (EFTPS) to enroll in and use the system — an automatic one-time refund of previously paid federal tax deposit (FTD) penalty with interest.

To qualify for the offer, the employer must use EFTPS for one year, make all Form 941 (Quarterly Federal Tax Return) payments on time and have previously fully paid the penalty. Beginning in 2005, IRS will automatically determine which employers have achieved four quarter EFTPS compliance and reverse the most recent full-paid EFT penalty (minus any outstanding taxes).

- **More advance payments can be deferred by accrual basis taxpayers**

According to a new IRS revenue procedure, accrual basis taxpayers can defer the inclusion of more advance payments in income until the year following their receipt. Advance payments eligible for this deferral method may include (subject to limitations):

< payments for services
< sale of certain goods
< the use of intellectual property, or
< the sale, lease or license of computer software.

Payments ineligible for this deferral method include rent, insurance premiums or payments for financial instruments. The IRS also indicated an advance payment may be partially attributable to an eligible item. These new rules are generally effective for tax years ending after May 5, 2004.

- **Trader versus investor status**

Stock market investors, regardless of how frequently they trade, have sales which generate capital gain or loss. However, persons engaged in the trade or business of trading securities may elect under the mark-to-market rules to have gain or loss on the securities for the tax year treated as ordinary gain or loss. A recent Tax Court case illustrated how difficult it is for a stock market investor to show his activities rise to the level of a trade or business. Over 300 trades by an investor weren't enough to justify trader treatment because they took place within a limited time (three months) and were not “frequent, regular and continuous” but rather were “sporadic.” In addition, the IRS emphasized the investor had another full-time job and trading was not his primary source of income.

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