

Tax Tips

Summer 2004

Keeping you informed...

How Can You Save Money for Health Care?

Open a Health Savings Account

A Health Savings Account (HSA) works very much like an IRA, except that the money you contribute is used to pay health care costs. Participants enroll in a relatively inexpensive high-deductible insurance plan, then open a tax-deductible savings account to cover current and future medical expenses. The money deposited, as well as the earnings, is tax-deferred. Participants can later withdraw the money to cover qualified medical expenses tax-free.

For 2004, a high-deductible insurance plan is a health plan with a minimum deductible of \$1,000 for self-coverage and \$2,000 for family coverage. The maximum out-of-pocket expenses for allowed costs must be no more than \$5,000 for self-coverage and no more than \$10,000 for family coverage. Annual contribution limits for 2004 are capped at the deductible portion of the high-deductible insurance plan or \$2,600 for an individual (\$5,150 for a family), whichever amount is less.

Here's how it works. Obtain coverage under a qualified high-deductible health insurance plan. Each year, deposit the money you saved on lower premiums into the tax-favored HSA. Use the savings account to pay for your deductible portion with tax-free dollars. Once you meet the deductible, the insurance starts paying for your medical expenses.

Everyone (not just self-employed taxpayers or small business owners) with a qualified high-deductible insurance plan is eligible for a tax-deductible HSA.

Payments You Receive From a Settlement Are Taxable

**Unless they're a result of personal
physical injury or physical sickness**

Settlements resulting from a lawsuit can arise for a number of reasons. Since August 21, 1996, all damage awards, including punitive damages, are included in

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taxable income unless the award was due to personal physical injury or physical sickness. Damage awards can also be paid as a result of injury to a capital asset. For example, a car careens into your home and causes damage to the structure. You sue the driver and are awarded a settlement. The amount you receive is only taxable if it exceeds the basis in your home. If that's the case, the excess is reported as a capital gain. In any event, the amount you receive will reduce the basis of your home.

Sell It on eBay!

And report the gain on your tax return

What most people don't realize is that when they sell property at a profit, the gain is taxable. Sales on eBay have skyrocketed to over \$24 billion in 2003 and millions of taxpayers are earning good money selling items they either make or just don't want any longer. If you're one of them, you need to decide if your activity is a business or just a hobby. In any event, any profits are taxable, and you must report them on your tax return.

For most taxpayers who sell on eBay, this is not an issue. Often items are sold for less than what was originally paid for them. If this is the case, losses on the sale of personal use property are not deductible and are not required to be reported. Unfortunately, personal losses cannot be used to offset any profits you may have.



Charitable Contributions

Take care when valuing donated property

Not all charitable contributions are made in cash. The rules state that when noncash property is donated to a charity, you are generally allowed to deduct the fair market value of that property. Determining the fair market value of assets can sometimes be tricky.



The fair market value of stocks and bonds with an active market is the average price between highest and lowest selling price on the valuation date. If you donate your car, you may also claim the fair market value. The fair market value takes into account many factors, including the vehicle's condition. The fair market value may differ substantially from the vehicle's "Blue Book" value.

If your contributions entitle you to merchandise, goods, or services that include admission to a charity ball, banquet, theatrical performance, or sporting event, you can only deduct the amount that exceeds the fair market value of the benefit received.

For any contribution of \$250 or more, you can claim a deduction only if you obtain a written acknowledgment from the qualified organization. You must obtain this written acknowledgement by the date you file your tax return or the due date of the return, whichever is earlier. If you donate property valued at more than \$5,000 you must obtain a qualified written appraisal. You cannot deduct the value of your time or services, personal expenses, appraisal fees, or contributions to specific individuals.

Did You Repay Income You Originally Thought Was Yours?

You may be allowed a deduction

Often taxpayers properly include wages, disability benefits, or other income on their tax return only to find out later that they did not have an unrestricted right to the income. If this happens to you, you'll have to repay the income, usually in a later year. The IRS will allow a deduction or tax credit, depending on how much you paid back within the tax year.

If the repayment was \$3,000 or less, the amount is generally deducted as a miscellaneous itemized deduction on Schedule A, Itemized Deductions. The total of all miscellaneous itemized deductions must exceed 2% of your total adjusted gross income before any tax benefit is derived.

If the repayment was more than \$3,000, you have two choices. You can either deduct the total amount you repaid as a miscellaneous itemized deduction not subject to 2%, or you may choose a tax credit for the year of repayment equal to the difference in the tax you paid on the income and the amount you would have paid if the income was not included on your tax return in the prior year.

Did You Lose Money in an IRA?

Your loss may be deductible

Investors have been losing money in the stock market and other investments for the past several years. What recourse do you have if the money you've invested for your retirement evaporates? The IRS may allow a loss on your tax return.

To qualify for the deduction, you must have basis in your IRA. Your basis is equal to the nondeductible contributions to your Traditional IRA, or the contributions you have made to your Roth IRA. The loss is only deductible if you withdraw all your IRA accounts and the amount you receive is less than your basis. Traditional IRAs and Roth IRAs are treated separately. This means that you must withdraw the funds from all of your Traditional IRAs before any loss on your Traditional IRAs is allowed. The same is true for your Roth IRAs.

The loss is deducted on Schedule A, Itemized Deductions, as a miscellaneous deduction. Before you derive any tax benefit, the total of all your miscellaneous itemized deductions must exceed 2% of your total adjusted gross income.

QUICK TIPS

1 Convert nondeductible interest expense on credit cards and automobile loans into deductible home mortgage interest. A deduction for the interest on a home equity loan or line of credit is allowed if you itemized your deductions. The interest on a home equity loan is deductible no matter how the loan money is used provided the loan is not over \$100,000. Interest on a home equity loan in excess of \$100,000 is not deductible.

2 If you receive a notice from the IRS, don't assume that it is correct and automatically pay the amount shown on the notice. Many IRS notices just require you to give the IRS additional information to show why you do not owe the additional taxes or penalties. Always consult your tax preparer when you receive notices from the IRS.

3 If you receive a lump-sum payment of social security benefits for the current year and prior years in one payment, you may be able to reduce the taxable amount of social security. This is done by making a special election that allows you to determine the amount of the social security that would have been taxable in that prior year instead of all in the current year.

4 Deduct the loan interest on your RV, camper, or even your boat. You are allowed to deduct mortgage interest on your primary residence and one other residence. The definition of what constitutes a residence is very broad and includes RV's, campers, and boats as long as they have cooking, toilet, and sleeping facilities.



Making Gifts to Children

Consider the tax consequences first

Parents give their children gifts all the time. Did you ever consider the tax consequences of a gift prior to giving it? In most cases, there are none. However, if income-producing property is given as a gift, the tax burden shifts to the donee. If the donee is a child under the age of 14 and has unearned or investment income of more than \$1,500, special rules apply.

What is commonly referred to as the "kiddie tax rules" make an under-14 child's unearned or investment income taxable at the parent's highest marginal rate, not at the child's tax rate. The unearned income of a child includes income produced by property given as a gift to the child, including gifts given by grandparents or any other person and gifts made under the Uniform Gifts to Minors Act (UGMA) or under the Uniform Transfer to Minors Act (UTMA), whether or not that income is distributed to the child. In most cases, the income from these gifts is in the form of interest and is taxable to the child at the parent's higher rate.

Types of gifts that a child might receive that generate investment income potentially subject to the kiddie tax are U.S. savings bonds, cash (if placed in, for instance, a savings account bearing taxable interest), and shares of stock.



Did Your Employer Grant You a Stock Option?

Tax treatment varies depending on the type of option

A common method of compensating employees is to grant them an option to purchase stock in the company at a price lower than fair market value. While this seems like a great bargain, it may bring unexpected tax consequences.

Generally, no income results upon grant or exercise of an incentive stock option (ISO) or an option granted under an employee stock purchase plan (ESPP). However, once the stock is purchased under an ISO, the taxpayer may be subject to alternative minimum tax (AMT). This is because the IRS requires taxpayers to include the difference between the exercise price and the fair market value of the stock in the computation of AMT. This is what often produces unexpected results. If the stock is purchased through the exercise and sold in the same tax year, AMT is not an issue; however, the fair market value of the stock, less the option price, is included in the employee's W-2.