



# Client advisor

CURRENT INFORMATION, NEWS AND TRENDS

SPRING/SUMMER 2004 Volume VIII, Number 1

**Brenda J. McGivern, CPA**

## This Issue Includes:

Volume VIII, Number 1/ SPRING/SUMMER 2004

**Here is your issue of Client Advisor. Enjoy!**

[High Deductibles? Check Out a Health Savings Plan.](#)

### High Deductibles? Check Out a Health Savings Plan.

**A**t the end of 2003, the president signed into law the Medicare Act of 2003. One of the key provisions of that legislation was the creation of the Health Savings Account. Simply described, a Health Savings Account is a trust account into which tax-deductible contributions can be made by qualified taxpayers who have high deductible medical insurance plans. Income earned on the HSA balance is tax-free. [click here for full article](#)



[Are You Napping On Home Sale Gain?](#)

### Are You Napping On Home Sale Gain?

**W**ith each passing year, inflation pushes up the value of homes, and the recent decline in mortgage rates has further fueled the rapid appreciation of homes. These increased values can create unexpected tax events when the home is sold. Some taxpayers still believe as long as they replace their home for one of equal or higher value, their gain is deferred to the new home. That is no longer true! Starting in 1997, the tax law allows each taxpayer to exclude \$250,000 (\$500,000 for a married couple) of gain from the sale of his or her primary residence, and any excess gain is taxable. This exclusion does not apply to gain from the sale of a second home, which would be fully taxable. [click here for full article](#)

[Is the AMT Your Tax Nemesis?](#)

### Is the AMT Your Tax Nemesis?

**W**hat is AMT? AMT is the acronym for Alternative Minimum Tax, which is simply another way of computing your tax liability without certain tax benefits included in the regular tax method. The final tax is the higher of the two computations. AMT was created by Congress to combat excessive use of tax preferences and tax shelters by wealthier taxpayers to insure they paid at least a minimum tax. However, years of inflation have brought the income of many middle-income taxpayers to levels that equal those of wealthier taxpayers at the time the AMT was created. As a result, more taxpayers each year are getting caught up in the AMT. [click here for full article](#)

[Questions & Answers](#)

### Questions & Answers

[Tax Calendar](#)



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**Q** Is it true that I can exchange my series EE/E savings bonds for series HH bonds and defer reporting the accrued interest on those bonds?

A - Yes, as long as the exchange is made before September 1, 2004. August 2004 will be the last month in which Series HH savings bonds are issued. Whether or not an individual holding EE/E bonds should exchange them before September 1, 2004, to continue the deferral for up to 20 years depends on a number of factors, including the amount of interest that

is actually deferred from reporting and the interest rate on the bonds. [click here for full article](#)

The purpose of this newsletter is to provide current information on tax, financial, and business developments and to suggest general tax planning ideas that may be appropriate in certain situations. The opinions are generalizations and may not apply to all taxpayers, so it is important that you seek appropriate professional advice before implementing any of the tax ideas suggested.

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## High Deductibles? Check Out a Health Savings Plan.

At the end of 2003, the president signed into law the Medicare Act of 2003. One of the key provisions of that legislation was the creation of the Health Savings Account. Simply described, a Health Savings Account is a trust account into which tax-deductible contributions can be made by qualified taxpayers who have high deductible medical insurance plans.

Income earned on the HSA balance is tax-free. The funds from these accounts are then used to pay qualified medical expenses not covered by the medical insurance for an eligible individual. If these funds are not used, they roll over year to year. Once the taxpayer turns 65, the funds can be used like a retirement plan (taxable when withdrawn, but not subject to a withdrawal penalty) or saved for future medical expenses. Since the contribution is an above-the-line deduction, a taxpayer need not itemize to take advantage of this new tax break. The rules discussed here are applicable to federal tax returns and may not apply to your particular state.

**Eligible Individual** The new law defines an eligible individual as one who is covered by a high deductible plan and, while covered by that plan, is not also covered by another plan that does not have a high deductible. For purposes of determining if a plan does or does not have a high deductible, the new law allows certain types of coverage, such as workers' compensation, insurance for a specific condition, dental care, vision, long-term care and certain others, to be disregarded.

**High Deductible Plans** High deductible plans are defined as those with the following deductible amounts:

" Self-only coverage with an annual deductible of \$1,000 or more and limits on annual expenses, other than premiums, required to be paid by the plan during the year, up to \$5,000; or

" Family coverage with an annual deductible of \$2,000 or more and limits on annual expenses, other than premiums, required to be paid by the plan during the year, up to \$10,000.



**Qualified Medical Expenses** Qualified medical expenses that can be paid from these accounts are generally defined as those that would be allowable as a medical deduction on your tax return.

**Contribution Limits** The eligibility and contribution amounts for these accounts are determined monthly. Therefore, during any month in which you qualify, you would be entitled to contribute one-twelfth of the annual limits. For 2004, the annual limits are either the lesser of the policy annual deductible or:

" \$2,600 for single coverage plans;  
" \$5,150 for family coverage plans;  
and  
" \$500 additional for individuals age 55 or older.

Individuals entitled to benefits under Medicare and those claimed as a dependent on another person's tax return cannot make contributions. Contributions can be made as late as the due date of the tax return without extensions; contributions in excess of the allowable amounts are subject to an annual 6% excise penalty. If your employer makes the contributions for you through a payroll deduction plan, the contributed amounts are not subject to normal payroll withholdings such as FICA and taxes.

**Example:** John, a single taxpayer, age 58, begins a high deductible health plan with an annual deductible of \$5,000 starting in March 2004. We need to determine his maximum annual contribution limit (\$3,100), which is the smaller of the deductible amount or \$3,100 (\$2,600 plus \$500 for being over 55). Next, we

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divide the annual limit by 12 to determine the monthly limit; in John's case, it is \$258.33 (\$3,100/12). Since John was in a high deductible health plan for 10 months during 2004, his contribution limit for 2004 would be \$2,583.30 (\$258.33 x 10). If John were in the 25% tax bracket, he would realize a tax savings of \$646.

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## Are You Napping On Home Sale Gain?



A combination of inflation and low mortgage interest rates has fueled the rapid appreciation of homes. These increased values can create unexpected tax events when the home is sold. Some taxpayers still believe as long as they replace their home for one of equal or higher value, their gain is deferred. Not true! Starting in 1997, each taxpayer may exclude \$250,000 (\$500,000 for a married couple) of gain from the sale of his or her primary residence; any excess gain is taxable. This exclusion does not apply to gain from the sale of a second home, which is fully taxable.

### Exclusion of Gain

To qualify for the exclusion, the taxpayer must meet two tests: during the five-year period ending on the sale date, the taxpayer must have owned the home for at least two years (the ownership test) and lived in it as his or her main home for at least two years (the use test).

If the two tests are met, and the exclusion has not been used for another home's sale within two years of the current sale, up to \$250,000 of gain on the sale of the taxpayer's principal home is excluded. The maximum exclusion is \$500,000 if ALL of the following are true:

- 1) Taxpayer is married and files a joint return for the year.
- 2) Either taxpayer or spouse meets the ownership test.
- 3) Both taxpayer and spouse meet the use test.

2) Health reasons - If the primary reason for the sale is to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of a qualified individual's disease, illness, or injury, or to obtain or provide medical or personal care for a qualified individual suffering from a disease, illness, or injury;

3) Involuntary conversion of the residence;

4) A disaster, act of war or terrorism resulting in a casualty to the residence;

5) Death of a qualified individual;

6) A qualified individual's cessation of employment making him eligible for unemployment compensation;

7) A qualified individual's change in employment or self-employment status causing inability to pay housing and reasonable basic living expenses for the taxpayer's household;

8) A qualified individual's divorce or legal separation; and

9) Multiple births resulting from the same pregnancy of a qualified individual.

A qualified person is the taxpayer, the taxpayer's spouse, the co-owner of the residence or a person whose principal place of abode is in the taxpayer's household. For the second item above (health reasons) a qualified individual also includes the taxpayer's family members, even if they aren't the taxpayer's dependents or descendants of the taxpayer's grandparents.

The amount of the partial exclusion is:

<u>The shorter of (a) or (b)*</u>	Regular
730	X Exclusion
	Amount

\* (a) = # of days from home's purchase date through current sale date.

(b) = if gain was previously excluded, # of days from prior sale date to current sale date.

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[Tax Calendar](#)

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4) During the two-year period ending on the sale date, neither taxpayer nor spouse excluded gain from another home's sale.

#### **Unforeseen Circumstances**

Even when a taxpayer fails to meet the ownership and use tests, a partial exclusion applies when the sale is due to unforeseen circumstances. Unforeseen circumstances is defined as the sale or exchange of a home due to the occurrence of an event that the taxpayer does not anticipate before purchasing and occupying the residence. The IRS provides a series of factors as a guide to determining if a specific circumstance qualifies for exclusion under the unforeseen circumstances rule. Because these factors are so generalized, the regulations also provide safe-harbor circumstances that, if all the conditions are met, cannot be challenged by the IRS:

1) Change of a qualified individual's employment where the new place of employment is at least 50 miles farther from the residence than was the former place of employment;

**Example:** The taxpayers purchased their home 18 months (547 days) earlier but had sold their prior home on which they excluded gain 12 months (365 days) prior to this sale. The exclusion would be based on the shorter period, and, if otherwise qualified, the taxpayer would be eligible for 50% (365/730) of the normal exclusion amount.

**TAX TIP** Keeping good records of the cost and subsequent improvements of your home can help you avoid future taxable gain when you sell your home. With home prices soaring, this exclusion may not seem as generous, and your records might make a big difference.

Please call this office for information regarding special allowances made for disabled taxpayers, divorced taxpayers and surviving spouses. We can also provide planning assistance with the sale of your home.

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Nemesis?](#)[Questions & Answers](#)[Tax Calendar](#)

## Is the AMT Your Tax Nemesis?

What is AMT? AMT is the acronym for Alternative Minimum Tax, which is simply another way of computing your tax liability without certain tax benefits included in the regular tax method. The final tax is the higher of the two computations. AMT was created by Congress to combat excessive use of tax preferences and tax shelters by wealthier taxpayers to insure they paid at least a minimum tax. However, years of inflation have brought the income of many middle-income taxpayers to levels that equal those of wealthier taxpayers at the time the AMT was created. As a result, more taxpayers each year are getting caught up in the AMT.

The AMT includes a myriad of adjustments and preference items and full or partial disallowances of certain deductions that are otherwise perfectly legal and allowed in figuring the regular income tax. There are far too many to discuss, especially when most are rarely encountered by the average taxpayer. There are, however, certain AMT issues that frequently affect taxpayers:

" **Medical Deductions** The regular tax requires the medical expenses included in itemized deductions to be reduced by 7 1/2% of the taxpayer's Adjusted Gross Income (AGI). For AMT purposes, this adjustment is increased to 10%.

" **Taxes** For regular tax purposes and as part of the itemized deductions, taxpayers are allowed to deduct certain taxes they pay, including real estate taxes, state income tax, personal property tax and foreign taxes. For AMT purposes, none of these taxes are deductible.

" **Home Mortgage Interest** Generally, for regular tax purposes, a deduction is allowed for interest paid on home acquisition debt and home equity debt within certain debt limits. For AMT purposes, however, only home acquisition debt interest is deductible. With mortgage rates at all-time lows, many taxpayers are incurring equity debt on their homes to pay off credit cards, purchase cars etc., in the belief that the equity debt interest is deductible. If the taxpayer is subject to the AMT, the equity debt interest is not deductible.

" **Miscellaneous Itemized Deductions** Certain miscellaneous expenses, such as investment expenses, union dues, employment-related expenses, certain legal fees etc., are allowed for regular tax purposes after being reduced by 2% of the taxpayer's AGI. For AMT purposes, the deduction is not allowed.

" **Interest from Private Activity Bonds** Interest from certain Private Activity Bonds (such as bonds used to finance mass transit, water treatment facilities and similar projects) is tax-free for regular tax purposes but is taxable for AMT purposes.

" **Incentive Stock Options** Some employers offer their employees the opportunity to acquire stock through Incentive Stock Option Plans. This allows the employees to purchase the company stock at a substantial discount and then qualify for long-term capital gain rates when they ultimately sell the stock, provided certain holding periods are met. However, for AMT purposes, the discount must be added to an employee's income in the year the stock is purchased.

" **Standard Deduction** Taxpayers who do not itemize their deductions are allowed a standard deduction for regular tax purposes. The standard deduction is not allowed for AMT purposes.

In computing the AMT, a substantial exemption amount is allowed against the AMT taxable amount based upon filing status. For 2004, the exemption amounts are:

Filing Status	Married Joint or Surviving Spouse	Single or Head of Household	Married Separate
Exemption Amount	\$ 58,000	\$ 40,250	\$ 29,000

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Whereas the rates for regular tax are in six tiers (10%, 15%, 25%, 28%, 33% and 35%), the AMT rates only have two tiers (26% and 28%).

The following example illustrates the impact from typically encountered regular tax and AMT tax computations. In this example, Joe and Susan have three children and are filing a joint return. For 2004, they have wages, some interest income and deductions consisting of taxes, home acquisition debt interest, home equity debt interest and charitable contributions.

	<i>Regular</i>	<i>AMT</i>
Wages	\$132,000	\$132,000
Interest Income	500	500
Taxes	<14,475>	0
Acquisition Debt Interest	<9,105>	<9,105>
Equity Debt Interest	<6,145>	0
Contributions	<800>	<800>
Exemptions	<15,500>	<58,000>
Taxable	86,475	64,595
Tax	15,094	16,795
		<15,094>
<b><i>Increase due to AMT</i></b>		<b><i>\$1,701</i></b>

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## Questions & Answers

**Question** A co-worker told me there was a provision in the tax law that allows me to give up to \$11,000 to relatives and to deduct the \$11,000 from my taxable income. Is that accurate?

**Answer** It just goes to show that you can't believe everything you hear. To prevent taxpayers from giving away their assets before they pass on and thereby circumvent the inheritance taxes, the Revenue Code restricts the amount that can be given away during an individual's lifetime. That amount has varied over the past few years and is currently at \$1 million. In addition to the lifetime limitation, an individual can annually make gifts of \$11,000 (was \$10,000 before 2002) to as many separate individuals as they wish; the individual's relationship to the taxpayer is of no significance. Neither the \$1 million nor the annual \$11,000 gifts are deductible by the giver or taxable to the recipient. If the gifts exceed the limitation, they may be subject to gift tax. If you make gifts during the year to any single individual in excess of \$11,000, you will generally be required to file a gift tax return.



**Question** Is it true that I can exchange my series EE/E savings bonds for series HH bonds and defer reporting the accrued interest on those bonds?

**Answer** Yes, as long as the exchange is made before September 1, 2004. August 2004 will be the last month in which Series HH savings bonds are issued. Whether or not an individual holding EE/E bonds should exchange them before September 1, 2004, to continue the deferral for up to 20 years depends on a number of factors, including the amount of interest that is actually deferred from reporting and the interest rate on the bonds.

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## **Tax Calendar (June - August 2004)**

### **June 15, 2004:**

- U.S. Citizens living abroad on April 15, 2004 must file a 2003 Income Tax Return (if not already filed) or file for an extension.

- Second installment of 2004 Individual Estimated Taxes due. If your income or deductions have significantly changed, you should call this office to determine if any adjustment in estimates is appropriate.

### **June - July 2004:**

- Time to review 2004 year-to-date income and expenses to ensure estimated tax payments and withholding are adequate to avoid underpayment penalties.

### **July 31, 2004:**

- Due date for self-employed individuals and employers to file 5500 Series Returns for 2003 calendar year benefit plans (including Keogh/HR-10 plans).

### **August 16, 2004:**

- Extended 2003 Individual Returns due (if 4-month automatic extension was filed).

- Last day to file for an additional extension of time to file the extended 2003 Return. The additional extension, if granted by the IRS, can extend the filing date to October 15, 2004.

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