Chapter 14: New Legislation

Corrections were made to this workbook through January of 2005. No subsequent modifications were made.

THE MEDICARE PRESCRIPTION DRUG, IMPROVEMENT, AND MODERNIZATION ACT OF 2003

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003,[1] which was signed into law on December 8, 2003, is a massive piece of legislation. The 415-page bill overhauls and extends national involvement in health care. One notable feature of the legislation is authorization of health savings accounts (HSAs).

OVERVIEW OF HEALTH SAVINGS ACCOUNTS

Clearly, one of the greatest sources of financial uncertainty and insecurity is unforeseen medical expenses. The Act creates IRC §223, establishing HSAs, which are a significant improvement over the previously used Archer Medical Savings Accounts (MSAs). HSAs are tax-preferred accounts similar to Archer MSAs, which expired at the end of 2003 (although existing MSAs are grandfathered). HSAs allow individuals to save for medical expenses in portable, tax-free, interest-bearing accounts.

HSAs differ from MSA plans which were reserved for companies of 50 or fewer employees and the self-employed. Contributions to HSAs, as with MSAs, are fully deductible for income tax purposes for the tax year in which the contributions are made and are not subject to withholding or other taxes. However, a deduction is not allowed for any individual who may be claimed by another taxpayer as a dependent for the calendar year.

Similarly, no HSA deduction is permitted for anyone who is eligible for and enrolled in Medicare. Thus, HSA contributions **generally** must cease after age 65. See **Eligibility to Make Contributions** later in this chapter for more details.

In addition, a person covered under a High Deductible Health Plan (HDHP) is not eligible if he is also covered under a non-HDHP. Consequently, an individual is **not** eligible to establish an HSA if he is covered under a spouse's typical employer-provided health plan (a non-HDHP).

Note. The new HSA deduction, which is computed on Form 8889, *Health Savings Accounts (HSAs),* is allowable regardless of whether the taxpayer itemizes medical deductions.

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1. Pub. L. 108-173, 108th Cong. 1st Session (2003)

HSAs may be offered under company cafeteria plans, and may also be established as a stand-alone benefit. HSAs are available for tax years after December 31, 2003. The interest and investment earnings of the account are not taxable while in the HSA, and distributions are tax-free to the extent they are used to pay "qualified medical expenses," including long-term care premiums. See **HSA Distributions** later in this chapter for more details.

> **Observation.** HSAs provide a new mechanism to contribute funds, obtain a tax deduction for the contribution, and receive tax-free distributions to pay for medical expenses. Congress is also considering various proposals that would allow $500 to be carried over to HSAs from unused medical and childcare flexible spending accounts. That would be a significant exception to the "use it or lose it" nature of these cafeteria plan accounts.

ESTABLISHING AN HSA

Beginning January 1, 2004, any eligible individual can establish an HSA with a qualified HSA **trustee or custodian.** HSAs are established similarly to the way individuals establish IRAs or in the manner that Archer MSAs were established. No permission or authorization from the IRS is necessary, and an HSA may be established with or without the involvement of the individual's employer.

> **Note.** Married couples cannot establish a "joint HSA." Spouses (and others) must establish separate HSAs. Only one person may be the account owner of an HSA. But, an otherwise eligible individual may establish more than one HSA, and may contribute to more than one HSA. If a person has multiple HSAs, the maximum contribution limit applies to the **total** amount contributed to **all** HSAs for that person.

An HSA must be established as either a trust or a custodial account with a bank, insurance company or another qualified person.[2] **It is not necessary that the HSA be established at the same institution that provides the HDHP.** HDHPs are discussed in the next section of this chapter.

> **Observation.** When a trustee or custodian does **not** sponsor the HDHP, the trustee or custodian may require certification that the account beneficiary is an eligible individual, including proof that the individual is covered by a health plan that meets all of the requirements of an HDHP.

The account owner, not the trustee or custodian, is responsible to ensure the HSA complies with the rules for establishing and maintaining the HSA. Specifically, the account owner must certify he is:

- Covered by an HDHP and no other non-HDHP (with exceptions),
- Not entitled to Medicare benefits, and
- Not eligible to be claimed as a dependent.

The account owner is also responsible for determining whether contributions to the HSA have exceeded the maximum annual contribution limit.

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2. IRC §223(d)(1)(B). Any insurance company or any bank (including a similar financial institution as defined in IRC §408(n)) can be an HSA trustee or custodian. In addition, any other person already approved by the IRS to be a trustee or custodian of IRAs or Archer MSAs is automatically approved to be an HSA trustee or custodian. Other persons may request approval to be a trustee or custodian in accordance with the procedures set forth in Treas. Reg. §1.408-2(e). See also IRS Announcement 2003-54, IRB 2003-40, 761.

If contributions to the HSA exceed the maximum annual limit, the account owner must notify the trustee or custodian and request withdrawal of the excess contributions and any attributable income. **An excise tax of 6% for each taxable year is imposed on the account owner for excess individual and employer contributions.** The account owner is also responsible for maintaining records to prove that HSA distributions are used to pay qualified medical expenses.

> **Note.** IRS Form 5305-B, *Health Savings Trust Account,* and Form 5305-C, *Health Savings Custodial Account,* were released as drafts in June 2004. Once finalized, the forms will serve as safe harbors for banks, financial institutions and others custodians or trustees that manage HSA accounts. The forms specifically state that the custodian or trustee is **not** required to determine whether the distributions are used to pay qualified medical expenses.

Form **5305-B**
(August 2004)
Department of the Treasury
Internal Revenue Service

Health Savings Trust Account

(Under section 223(a) of the Internal Revenue Code)

Do not file with the Internal Revenue Service

Name of account owner (grantor)	Date of birth of account owner	**Identifying number** (see instructions)
Address of account owner (Street address, city, state, zip code)		
Name of trustee	Address or principal place of business of trustee	

The account owner named above is establishing this health savings account (HSA) exclusively for the purpose of paying or reimbursing qualified medical expenses of the account owner, his or her spouse, and dependents. The account owner represents that, unless this account is used solely to make rollover contributions, he or she is eligible to contribute to this HSA; specifically, that he or she: (1) is covered under a high deductible health plan (HDHP), (2) is not also covered by any other health plan that is not an HDHP (with certain exceptions for plans providing preventive care and limited types of permitted insurance and permitted coverage), (3) is not entitled to benefits under Medicare (generally, has not reached age 65), and (4) cannot be claimed as a dependent on another person's tax return.

$ .... dollars in cash is assigned to this trust account.

The account owner and the trustee make the following agreement:

Article I

1. The trustee will accept additional cash contributions for the tax year made by the account owner or on behalf of the account owner (by an employer, family member or any other person). No contributions will be accepted by the trustee in excess of the maximum amount for an account owner with family coverage plus the catch-up contribution.

2. Contributions for any tax year may be made at any time before the deadline for filing the account owner's federal income tax return for that year (without extensions).

3. Rollover contributions from an HSA or an Archer Medical Savings Account (Archer MSA) (if permitted under this agreement) need not be in cash and are not subject to the maximum annual contribution limit set forth in Article II.

Article II

1. For calendar year 2004, the maximum annual contribution limit for an account owner with single coverage is the lesser of the amount of the deductible under the HDHP but not more than $2,600. For calendar year 2004, the maximum annual contribution limit for an account owner with family coverage is the lesser of the amount of the deductible under the HDHP but not more than $5,150. These limits are subject to cost-of-living increases after 2004.

2. Contributions to Archer MSAs or other HSAs count toward the maximum annual contribution limit to this HSA.

3. For calendar year 2004, an additional $500 catch-up contribution may be made for an account owner who is at least age 55 and less than age 65. The catch-up contribution increases to $600 in 2005, $700 in 2006, $800 in 2007, $900 in 2008, and $1,000 in 2009 and later years.

4. Contributions in excess of the maximum annual contribution limit are subject to an excise tax. However, the catch-up contributions are not subject to an excise tax.

Article III

It is the responsibility of the account owner to determine whether contributions to this HSA have exceeded the maximum annual contribution limit described in Article II. If contributions to this HSA exceed the maximum annual contribution limit, the account owner shall notify the trustee that there exist excess contributions to the HSA. It is the responsibility of the account owner to request the withdrawal of the excess contribution and any net income attributable to such excess contribution.

Article IV

The account owner's interest in the balance in this trust account is nonforfeitable.

Article V

1. No part of the trust funds in this account may be invested in life insurance contracts or in collectibles as defined in section 408(m).

2. The assets of this account may not be commingled with other property except in a common trust fund or common investment fund.

3. Neither the account owner nor the trustee will engage in any prohibited transaction with respect to this account (such as borrowing or pledging the account or engaging in any other prohibited transaction as defined in section 4975).

Article VI

1. Distributions of funds from this HSA may be made at any time upon the direction of the account owner.

2. Distributions from this HSA that are used exclusively to pay or reimburse qualified medical expenses of the account owner, his or her spouse, or dependents are tax-free. However, distributions that are not used for qualified medical expenses are included in the account owner's gross income and are subject to an additional 10 percent tax on that amount. The additional 10 percent tax does not apply if the distribution is made after the account owner's death, disability, or reaching age 65.

3. The trustee is not required to determine whether the distribution is for the payment or reimbursement of qualified medical expenses. Only the account owner is responsible for substantiating that the distribution is for qualified medical expenses and must maintain records sufficient to show that the distribution is tax-free.

Cat. No. 38260U Form **5305-B** (8-2004)

Article VII

If the account owner dies before the entire interest in the account is distributed, the entire account will be disposed of as follows:

1. If the beneficiary is the account owner's spouse, the HSA will become the spouse's HSA as of the date of death.

2. If the beneficiary is not the account owner's spouse, the HSA will cease to be an HSA as of the date of death and the fair market value of the account will be taxable to that person (or the estate of the account owner) in the tax year that includes such date.

Article VIII

1. The account owner agrees to provide the trustee with information necessary for the trustee to prepare any report or return required by the IRS.

2. The trustee agrees to prepare and submit any report or return as prescribed by the IRS.

Article IX

Notwithstanding any other article that may be added or incorporated in this agreement, the provisions of Articles I through VIII and this sentence are controlling. Any additional article in this agreement that is inconsistent with section 223 or IRS published guidance will be void.

Article X

This agreement will be amended from time to time to comply with the provisions of the Code or IRS published guidance. Other amendments may be made with the consent of the persons whose signatures appear below.

Article XI

Article XI may be used for any additional provisions. If no other provisions will be added, draw a line through this space. If provisions are added, they must comply with the requirements of Article IX.

Account owner's signature .... Date ....

Trustee's signature .... Date ....

Witness' signature ....

(Use only if signature of account owner or trustee is required to be witnessed.)

General Instructions

Section references are to the Internal Revenue Code.

Purpose of Form

Form 5305-B is a model (nonmandatory) trust account agreement that has been approved by the IRS. An HSA is established after the form is fully executed by both the account owner and the trustee. The form can be completed at any time during the tax year. This account must be created in the United States for the exclusive benefit of the account owner.

Do not file Form 5305-B with the IRS. Instead, keep it with your records. For more information on HSAs, see Notice 2004-2, 2004-2 I.R.B. 269.

Definitions

Identifying Number. The account owner's social security number will serve as the identification number of this HSA. For married persons, each spouse who is eligible to open an HSA and wants to contribute to an HSA must establish his or her own account. An employer identification number (EIN) is required for an HSA for which a return is filed to report unrelated business taxable income. An EIN is also required for a common fund created for HSAs.

High Deductible Health Plan (HDHP). For calendar year 2004, an HDHP for self-only coverage has a minimum annual deductible of $1,000 and an annual out-of-pocket maximum (deductibles, co-payments and other amounts, but not premiums) of $5,000. For calendar year 2004, an HDHP for family coverage has a minimum annual deductible of $2,000 and an annual out-of-pocket maximum of $10,000. These limits are subject to cost-of-living increases after 2004.

Self-only coverage and family coverage under an HDHP. Family coverage means coverage that is not self-only coverage.

Qualified medical expenses. Qualified medical expenses are amounts paid for medical care as defined in section 213(d) for the account owner, his or her spouse, or dependents (as defined in section 152) but only to the extent that such amounts are not compensated for by insurance or otherwise. With certain exceptions, health insurance premiums are not qualified medical expenses. See Notice 2004-25, 2004-15 I.R.B. 727 for transition relief for distributions for qualified medical expenses incurred in calendar year 2004.

Trustee. A trustee of an HSA must be a bank, a life insurance company, a person previously approved by the IRS to be a trustee of an individual retirement account (IRA) or Archer MSA, or any other person approved by the IRS.

Specific Instructions

Article XI. Article XI and any that follow it may incorporate additional provisions that are agreed to by the account owner and trustee. The additional provisions may include, for example, definitions, restrictions on rollover contributions from HSAs or Archer MSAs (requiring a rollover not later than 60 days after receipt of a distribution and limited to one rollover during a one-year period), investment powers, voting rights, exculpatory provisions, amendment and termination, removal of trustee, trustee's fees, state law requirements, treatment of excess contributions, distribution procedures (including frequency or minimum dollar amount), use of debit, credit, or stored-value cards, return of erroneous distributions, and descriptions of prohibited transactions. Attach additional pages if necessary.

Form **5305-C**
(August 2004)
Department of the Treasury
Internal Revenue Service

Health Savings Custodial Account

(Under section 223(a) of the Internal Revenue Code)

Do not file with the Internal Revenue Service

Name of account owner	Date of birth of account owner	**Identifying number** (see instructions)
Address of account owner (Street address, city, state, zip code)		
Name of custodian	Address or principal place of business of custodian	

The account owner named above is establishing this health savings account (HSA) exclusively for the purpose of paying or reimbursing qualified medical expenses of the account owner, his or her spouse, and dependents. The account owner represents that, unless this account is used solely to make rollover contributions, he or she is eligible to contribute to this HSA; specifically, that he or she: (1) is covered under a high deductible health plan (HDHP); (2) is not also covered by any other health plan that is not an HDHP (with certain exceptions for plans providing preventive care and limited types of permitted insurance and permitted coverage); (3) is not entitled to benefits under Medicare (generally, has not reached age 65); and (4) cannot be claimed as a dependent on another person's tax return.

$ .... dollars in cash is assigned to this custodial account.

The account owner and the custodian make the following agreement:

Article I

1. The custodian will accept additional cash contributions for the tax year made by the account owner or on behalf of the account owner (by an employer, family member or any other person). No contributions will be accepted by the custodian in excess of the maximum amount for an account owner with family coverage plus the catch-up contribution.

2. Contributions for any tax year may be made at any time before the deadline for filing the account owner's federal income tax return for that year (without extensions).

3. Rollover contributions from an HSA or an Archer Medical Savings Account (Archer MSA) (if permitted under this agreement) need not be in cash and are not subject to the maximum annual contribution limit set forth in Article II.

Article II

1. For calendar year 2004, the maximum annual contribution limit for an account owner with single coverage is the lesser of the amount of the deductible under the HDHP but not more than $2,600. For calendar year 2004, the maximum annual contribution limit for an account owner with family coverage is the lesser of the amount of the deductible under the HDHP but not more than $5,150. These limits are subject to cost-of-living increases after 2004.

2. Contributions to Archer MSAs or other HSAs count toward the maximum annual contribution limit to this HSA.

3. For calendar year 2004, an additional $500 catch-up contribution may be made for an account owner who is at least age 55 and less than age 65. The catch-up contribution increases to $600 in 2005, $700 in 2006, $800 in 2007, $900 in 2008, and $1,000 in 2009 and later years.

4. Contributions in excess of the maximum annual contribution limit are subject to an excise tax. However, the catch-up contributions are not subject to an excise tax.

Article III

It is the responsibility of the account owner to determine whether contributions to this HSA have exceeded the maximum annual contribution limit described in Article II. If contributions to this HSA exceed the maximum annual contribution limit, the account owner shall notify the custodian that there exist excess contributions to the HSA. It is the responsibility of the account owner to request the withdrawal of the excess contribution and any net income attributable to such excess contribution.

Article IV

The account owner's interest in the balance in this custodial account is nonforfeitable.

Article V

1. No part of the custodial funds in this account may be invested in life insurance contracts or in collectibles as defined in section 408(m).

2. The assets of this account may not be commingled with other property except in a common trust fund or common investment fund.

3. Neither the account owner nor the custodian will engage in any prohibited transaction with respect to this account (such as borrowing or pledging the account or engaging in any other prohibited transaction as defined in section 4975).

Article VI

1. Distributions of funds from this HSA may be made at any time upon the direction of the account owner.

2. Distributions from this HSA that are used exclusively to pay or reimburse qualified medical expenses of the account owner, his or her spouse, or dependents are tax-free. However, distributions that are not used for qualified medical expenses are included in the account owner's gross income and are subject to an additional 10 percent tax on that amount. The additional 10 percent tax does not apply if the distribution is made after the account owner's death, disability, or reaching age 65.

3. The custodian is not required to determine whether the distribution is for the payment or reimbursement of qualified medical expenses. Only the account owner is responsible for substantiating that the distribution is for qualified medical expenses and must maintain records sufficient to show that the distribution is tax-free.

Cat. No. 38257X   Form **5305-C** (8-2004)

Article VII

If the account owner dies before the entire interest in the account is distributed, the entire account will be disposed of as follows:

1. If the beneficiary is the account owner's spouse, the HSA will become the spouse's HSA as of the date of death.
2. If the beneficiary is not the account owner's spouse, the HSA will cease to be an HSA as of the date of death and the fair market value of the account will be taxable to that person (or the estate of the account owner) in the tax year that includes such date.

Article VIII

1. The account owner agrees to provide the custodian with information necessary for the custodian to prepare any report or return required by the IRS.
2. The custodian agrees to prepare and submit any report or return as prescribed by the IRS.

Article IX

Notwithstanding any other article that may be added or incorporated in this agreement, the provisions of Articles I through VIII and this sentence are controlling. Any additional article in this agreement that is inconsistent with section 223 or IRS published guidance will be void.

Article X

This agreement will be amended from time to time to comply with the provisions of the Code or IRS published guidance. Other amendments may be made with the consent of the persons whose signatures appear below.

Article XI

Article XI may be used for any additional provisions. If no other provisions will be added, draw a line through this space. If provisions are added, they must comply with the requirements of Article IX.

Account owner's signature .... Date ....

Custodian's signature .... Date ....

Witness' signature ....

(Use only if signature of account owner or custodian is required to be witnessed.)

General Instructions

Section references are to the Internal Revenue Code.

Purpose of Form

Form 5305-C is a model (nonmandatory) custodial account agreement that has been approved by the IRS. An HSA is established after the form is fully executed by both the account owner and the custodian. The form can be completed at any time during the tax year. This account must be created in the United States for the exclusive benefit of the account owner.

Do not file Form 5305-C with the IRS. Instead, keep it with your records. For more information on HSAs, see Notice 2004-2, 2004-2 I.R.B. 269.

Definitions

Identifying Number. The account owner's social security number will serve as the identification number of this HSA. For married persons, each spouse who is eligible to open an HSA and wants to contribute to an HSA must establish his or her own account. An employer identification number (EIN) is required for an HSA for which a return is filed to report unrelated business taxable income. An EIN is also required for a common fund created for HSAs.

High Deductible Health Plan (HDHP). For calendar year 2004, an HDHP for self-only coverage has a minimum annual deductible of $1,000 and an annual out-of-pocket maximum (deductibles, co-payments and other amounts, but not premiums) of $5,000. For calendar year 2004, an HDHP for family coverage has a minimum annual deductible of $2,000 and an annual out-of-pocket maximum of $10,000. These limits are subject to cost-of-living increases after 2004.

Self-only coverage and family coverage under an HDHP. Family coverage means coverage that is not self-only coverage.

Qualified medical expenses. Qualified medical expenses are amounts paid for medical care as defined in section 213(d) for the account owner, his or her spouse, or dependents (as defined in section 152) but only to the extent that such amounts are not compensated for by insurance or otherwise. With certain exceptions, health insurance premiums are not qualified medical expenses. See Notice 2004-25, 2004-15 I.R.B. 727 for transition relief for distributions for qualified medical expenses incurred in calendar year 2004.

Custodian. A custodian of an HSA must be a bank, a life insurance company, a person previously approved by the IRS to be a custodian of an individual retirement account (IRA) or Archer MSA, or any other person approved by the IRS.

Specific Instructions

Article XI. Article XI and any that follow it may incorporate additional provisions that are agreed to by the account owner and custodian. The additional provisions may include, for example, definitions, restrictions on rollover contributions from HSAs or Archer MSAs (requiring a rollover not later than 60 days after receipt of a distribution and limited to one rollover during a one-year period), investment powers, voting rights, exculpatory provisions, amendment and termination, removal of custodian, custodian's fees, state law requirements, treatment of excess contributions, distribution procedures (including frequency or minimum dollar amount), use of debit, credit, or stored-value cards, return of erroneous distributions, and descriptions of prohibited transactions. Attach additional pages if necessary.

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No part of the HSA custodial/trust assets may be invested in life insurance contracts, or commingled with other property (except for a common trust fund or common investment fund). In addition, the interests of the HSA account must be nonforfeitable.

The HSA plan must be funded and held with a qualified trustee or custodian. The establishment of an HSA requires no IRS permission or involvement of an employer. **HSA contributions must be in cash.**[3]

> **Observation.** The trustee or custodian of an HSA is not required to provide the high-deductible health insurance, but it is likely that marketers will sell the two products (insurance and investment account) together.

Account owners may not enter into "prohibited transactions" with an HSA. The owner cannot sell, exchange, or lease property, borrow or lend money, furnish goods, services, or facilities, transfer to or use by or for the benefit of the beneficiary or pledge the HSA. Any amount distributed as the result of a prohibited transaction is not treated as used to pay for qualified medical expenses. Therefore, such distributions must be included in gross income and are subject to an additional 10% tax.

The balance in an HSA that is not spent for "qualified medical expenses" in one year can be carried over to the next year.

CONTRIBUTIONS TO AN HSA

Contribution Limits

HSA contributions can be made directly by an individual, through salary reductions under an employer cafeteria (§125) plan, or directly by employers. Contributions must be made in cash.

For calendar year 2004, the **maximum monthly contribution** for eligible individuals with **self-only coverage** under an HDHP is 1/12 of the lesser of:

- 100% of the annual deductible under the HDHP **(minimum of $1,000),** or
- $2,600.

For eligible individuals with **family coverage** under an HDHP, the **maximum monthly contribution** is 1/12 of the lesser of:

- 100% of the annual deductible under the HDHP **(minimum of $2,000),** or
- $5,150.

High Deductible Health Plan (HDHP)

An HDHP is a plan with a **minimum deductible of at least $1,000 for self-only coverage or $2,000** (indexed for inflation) **for family coverage.** The **maximum out-of-pocket deductible amount** (other than premiums) is:

- **$5,000 for self-only coverage,** or
- **$10,000 for family coverage.**

A health plan does not meet the HDHP definition if substantially all of its coverage is for accidents, disability, dental care, vision care, or long-term care.

3. IRC §408(m)(3)

Note. The HDHP family deductible **cannot** be split among family members. The **typical** family medical plan contains a separate lower deductible amount for **each** family member and a **combined** higher deductible figure for the family as a whole. Coverage begins when the deductibles are met. This is not the case for HSAs. There are no lower individual deductibles. **No HDHP claims are paid until family medical expenses exceed the family deductible.**

Example 1. Stan has a health plan for himself and his family. The plan pays covered medical expenses of **any member** of his family if the member incurs annual expenses of $1,000 or more, even if the **family has not** incurred covered expenses of $2,000 or more. If Stan incurred covered medical expenses of $1,500 in a year, the plan would pay $500.

Question. Does Stan's family health plan qualify as an HDHP?

Answer. No. Benefits are available under the plan even if the family's covered medical expenses do **not** exceed $2,000. Because the plan provides family coverage with an annual deductible of **less than $2,000,** the plan is **not** an HDHP.

Note. An HDHP may provide preventive care benefits without a deductible or with a deductible below the generally required minimum annual deductible for HDHPs. In Notice 2004-23 (IRB 2004-15, 725), the IRS provides a **safe harbor list of preventive care benefits** and requests public comments on expanding the list of preventive benefits.

A plan can qualify as an HDHP even if it fails to have a deductible for preventive care. Also, plans that use a network of providers can qualify even if they have an out-of-pocket limitation for services provided **outside** the network that is higher than the maximum out-of-pocket expense limits allowed for an HDHP.

A health plan **without an express limit on out-of-pocket expenses** is generally **not** an HDHP **unless** the limit is not necessary to prevent exceeding the out-of-pocket maximum.

Example 2. Sam's health plan provides **self-only coverage** with a $2,000 deductible and pays 100% of covered benefits above the deductible.

Question. Does Sam's plan qualify as an HDHP?

Answer. Yes. The plan pays 100% of covered benefits after the deductible is satisfied. As a result, the maximum out-of-pocket expenses paid by Sam **never exceed the deductible.** Since Sam's plan does not require a limit on out-of-pocket expenses, he is not subject to out-of-pocket expenses that exceed the prescribed maximum.

Example 3. Mary's health plan provides **self-only** coverage with a $2,000 deductible. The plan imposes a lifetime limit on reimbursements for covered benefits of $1 million. For covered expenses incurred above the deductible, the plan reimburses 80% of the usual, customary and reasonable costs. **The plan includes no express limit on out-of-pocket expenses.**

Question. Does Mary's plan qualify as an HDHP?

Answer. No. The plan does **not** have a limit on out-of-pocket expenses. However, **if** the plan provided that when the 20% coinsurance amount paid by Mary reached $3,000, the plan would pay 100% of the usual, customary and reasonable costs until the $1 million limit is reached, it **would qualify** as an HDHP. In that scenario, for purposes of determining Mary's out-of-pocket expenses, the plan would take into account the 20% of the usual, customary and reasonable costs paid by Mary.

> **Note.** Notice 2004-50 provides transitional relief for HDHPs that do not qualify because they lack an express maximum of out-of-pocket payments above the deductible. Individuals covered under under these health plans are eligible to contribute to HSAs until January 1, 2005.

Eligibility to Make Contributions

To be eligible to make contributions to an HSA, an individual must be covered by an HDHP. A person with no earned income is still eligible to make HSA contributions. Thus, unlike Archer MSAs, HSAs can be used to shelter pension, interest, and dividend income. However, anyone enrolled in Medicare cannot establish or contribute to an HSA.

> **Warning.** An individual must be covered by an HDHP to be eligible to contribute to an HSA. However, an individual covered by an HDHP who **also** receives health benefits under TRICARE (the health care program for active duty and retired members of the uniformed services, their families and survivors) cannot contribute to an HSA. Coverage options under TRICARE do **not** satisfy the minimum annual deductible requirements for an HDHP.

Eligibility is **determined monthly** and contributions may be made for any month a person is:

- Covered by an HDHP on the **first** day of the month,
- Has no other health plan coverage (with limited exceptions),
- Is not yet enrolled in Medicare, and
- Cannot be claimed as another taxpayer's dependent.

> **Note.** An otherwise eligible individual who is eligible for Medicare, but **not enrolled** in Medicare Part A or Part B can contribute to an HSA and can make the additional catch-up contribution for persons age 55 and older.
>
> An individual ceases to be an eligible individual beginning with the month the person is **entitled to benefits under Medicare.** "Entitled to benefits under Medicare" means both eligibility **and enrollment** in Medicare.[4] Also, an otherwise eligible individual who is eligible to receive VA medical benefits, but who has not actually received such benefits during the preceding three months, may contribute to an HSA.

An individual who has **both of the following** does **not qualify** as an eligible individual and **cannot** make HSA contributions:[5]

1. An HDHP which does **not** cover prescription drugs, and
2. A separate prescription drug policy which provides benefits before the minimum annual HDHP deductible has been satisfied

The result is the same if the prescription drug coverage is provided by a health plan of the individual's spouse.

However, if no benefits are provided under the separate drug plan **until the minimum annual HDHP deductible has been satisfied,** or the prescription drug plan is part of an HDHP and is subject to the minimum annual deductible, the individual **is eligible.**[6]

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4. Notice 2004-50, IRB 2004-33, which revised Notice 2004-2, A-2, A-12 & A-14
5. Rev. Rul. 2004-38, IRB 2004-15, 717
6. Id.

An otherwise eligible individual who is covered by **both** an HDHP and an insurance contract for one or more specific diseases (such as cancer, diabetes, asthma, or congestive heart failure) can contribute to an HSA even if the insurance provides benefits **before** the deductible of the HDHP is satisfied.[7]

Likewise, an individual with an HDHP and a health services/products discount card (including a prescription drug discount card) **is eligible** to contribute to an HSA **if** he must pay his discounted health care costs until the HDHP deductible is satisfied.

Transitional Relief for 2004-2005

This rule is detrimental to employees whose employers offer separate prescription drug plans that provide first-dollar drug coverage with either a flat dollar or percentage co-payment. In response, the IRS has provided **transitional relief** for 2004-2005 for individuals covered by both HDHPs and by a separate policy providing prescription drug benefits before the minimum annual HDHP deduction is satisfied. Therefore, these individuals will be eligible and may make contributions to an HSA based on their annual HDHP deductible for months before January 1, 2006.[8]

Likewise, the IRS has provided **transitional relief** to health plans that are unable to qualify as HDHPs due to **state mandates.** Under this relief, a health plan that fails to qualify as an HDHP because it provides benefits required **under state law in effect on January 1, 2004,** will nevertheless be treated as an HDHP until January 1, 2006. Consequently, individuals in states that require health plans to provide HSA disqualifying benefits (for example, first-dollar coverage with a low deductible or coverage for certain nonpreventive care) can participate in HSAs.[9]

Contribution Deadlines

HSA contributions can be made in one or more payments **at any time before** the filing deadline (without extensions) for the HSA owner's income tax return for the tax year of the HSA contribution. However, the HSA contribution cannot be made **before** the beginning of that tax year.

> **Observation.** For calendar year taxpayers, the deadline for contributions to an HSA is generally April 15 following the year for which the contributions are made. (See line 2 on Form 8889 shown in **Example 5.**) **Although the annual contribution is determined monthly, the maximum contribution may be made on the first day of the year.**

Tax Consequences of Contributions

Individual Contributions. Contributions made by an individual are deductible regardless of whether the individual itemizes deductions. However, an itemized medical expense deduction cannot also be taken for contributions.

Another feature is that a family member (e.g. a wealthy parent) can fund an HSA for another family member (e.g. daughter with low income). In this situation, the daughter is entitled to the HSA deduction on Form 8889, even though she did not pay the HDHP premium.

Example 4. Marsha is a divorced mother of two children. She lost her high-paying factory job in addition to her employer-provided health plan in May 2004. She established her own house cleaning business in June 2004.

Although she cannot afford to fund an HSA, her parents want to fund it for her. If Marsha establishes an HSA funded by her parents on July 1, 2004, she will be entitled to an HSA deduction on her 2004 Form 8889.

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7. IRC §223(c)(1)(B)(i) allows an eligible individual covered by an HDHP to be covered by "permitted insurance." IRC §223(c)(3)(B) defines the term "permitted insurance" as insurance for a specified disease or illness. See also Notice 2004-50, IRB 2004-33, revised August 9, 2004.

8. Rev. Proc. 2004-22, IRB 2004-15, 727

9. Notice 2004-43, IRB 2004-27, 10

Employer Contributions. HSA employer contributions are treated as employer-provided coverage for medical expenses and are **excludible** from the employee's gross income. These contributions are deductible by the employer and are not subject to federal income tax withholding, FICA and Medicare taxes, and FUTA taxes.[10] Employer contributions through a cafeteria plan are treated as employer contributions. The employee **cannot** deduct employer contributions on the employee's tax return, either as HSA contributions on Form 8889, or as medical expenses on Schedule A.

DEDUCTIBILITY

An individual with an HDHP is allowed a deduction for an amount **paid in cash** to an HSA based upon the annual deductible amount. The 2004 HSA deduction is limited to the **lesser** of:

1. The annual deductible, or
2. **$2,600** for **single** coverage, or **$5,150** for **family** coverage.

Higher limits for older taxpayers. For those **between ages 55 and 65,** the annual limit is increased **by $500 for each spouse** for the 2004 tax year. That amount increases in $100 increments until it reaches $1,000 in 2009.

Example 5. Catherine is age 60, single and retired. She began **self-only** coverage under an HDHP with an **annual maximum deductible of $5,000** on June 1, 2004. Her monthly HDHP premium is $75. She continued to be covered for the remainder of 2004. She made seven $250 monthly contributions to her newly established HSA during 2004.

Question. What is her HSA deduction on her 2004 Form 8889?

Answer. **$1,750,** as shown on her completed Form 8889. The contribution limit is computed each month. Since Catherine is between age 55 and 65 during the year, she is entitled to the extra $500 limit **($2,600 + $500 = $3,100).**

The lesser of Catherine's deductible ($5,000) and her HSA contribution limitation ($3,100) is $3,100. The monthly contribution limit is $258.33 ($3,100 ÷ 12). Catherine's contribution limit for 2004 is $1,808.31 (7 months × $258.33). Since her $1,750 actual contribution is less than the limit, her deduction is equal to her contribution. Her $75 monthly HDHP premium is not included in her deduction.

10. Notice 2004-2, IRB 2004-2, 269, Q&A-19

For Example 5

Form **8889** | **Health Savings Accounts (HSAs)** | OMB No. 1545-XXXX | **2004**

Department of the Treasury Internal Revenue Service | ▶ Attach to Form 1040. ▶ See separate instructions. | Attachment Sequence No. **138**

Name(s) shown on Form 1040: **Catherine** | Social security number of HSA beneficiary. If both spouses have HSAs, see page 1 of the instructions ▶ **111 11 1111**

Before you begin: Complete Form 8853, Archer MSAs and Long-Term Care Insurance Contracts, if required.

Part I **HSA Contributions and Deduction.** See page X of the instructions before completing this part. If you are filing jointly and both you and your spouse each have separate HSAs, complete a separate Part I for each spouse (see page X of the instructions).

1	Check the box to indicate your coverage under a high-deductible health plan during 2004 (see instructions) . . . . ▶ ☑ Self-only ☐ Family		
2	HSA contributions you made for 2004 (or those made on your behalf), including those made from January 1, 2005, through April 15, 2005, that were for 2004. **Do not** include employer contributions or rollovers (see page X of the instructions)	2	1,750
3	If you were under age 55 at the end of 2004, and on the first day of **every** month during 2004, you were an eligible individual with the **same** annual deductible and coverage, enter the **smaller** of: • Your annual deductible or • $2,600 ($5,150 for family coverage). All others, enter the limit from the worksheet on page XX of the instructions **($258.33 x 7)** .	3	1,808
4	Enter the amount you and your employer contributed to your Archer MSAs for 2004 from Form 8853, lines 1 and 2. If you or your spouse had family coverage under a high-deductible health plan at any time during 2004, also include any amount contributed to your spouse's Archer MSAs	4	0
5	Subtract line 4 from line 3. If zero or less, enter -0-	5	1,808
6	If you and your spouse each have separate HSAs and had family coverage under a high-deductible health plan at any time during 2004, see the instructions for the amount to enter. All others, enter the amount from line 5	6	1,808
7	If you were age 55 or older at the end of 2004, married, and you or your spouse had family coverage under a high-deductible health plan at any time during 2004, enter the additional contribution amount from the worksheet on page XX of the instructions	7	
8	Add lines 6 and 7	8	1,808
9	Employer contributions made to your HSAs for 2004	9	0
10	Subtract line 9 from line 8. If zero or less, enter -0-	10	1,808
11	**HSA deduction.** Enter the **smaller** of line 2 or line 10 here and on Form 1040, line 28 . . . . **Caution:** *If line 2 is more than line 11, you may have to pay an additional tax (see page X of the instructions).*	11	1,750

Part II **HSA Distributions.** If you are filing jointly and both you and your spouse each have separate HSAs, complete a separate Part II for each spouse.

12a	Total distributions you received in 2004 from all HSAs (see page X of the instructions)	12a	
b	Distributions included on line 12a that you rolled over to another HSA. Also include any excess contributions (and the earnings on those excess contributions) included on line 12a that were withdrawn by the due date of your return (see page X of the instructions)	12b	
c	Subtract line 12b from line 12a	12c	
13	Unreimbursed qualified medical expenses (see page X of the instructions)	13	
14	**Taxable HSA distributions.** Subtract line 13 from line 12c. If zero or less, enter -0-. Also, include this amount in the total on Form 1040, line 21. On the dotted line next to line 21, enter "HSA" and the amount	14	
15a	If any of the distributions included on line 14 meet any of the **Exceptions to the Additional 10% Tax** (see page 4 of the instructions), check here . . . . ▶ ☐		
b	**Additional 10% tax** (see page 4 of the instructions). Enter 10% (.10) of the distributions included on line 14 that are subject to the additional 10% tax. Also include this amount in the total on Form 1040, line 62. On the dotted line next to line 62, enter "HSA" and the amount	15b	

For Paperwork Reduction Act Notice, see page X of the instructions. Cat. No. 37621P Form **8889** (2004)

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If a spouse participates in an individual's plan, the basic limit is equal to the family unit's plan. Therefore, **each spouse** between ages 55 and 65 is eligible for a separate "catch-up" 2004 contribution. As a result, **it is possible for a married couple to deduct $6,150 of 2004 HSA contributions [$5,150 + ($500 × 2)].**

No HSA contributions can be made for any month during which an individual is **eligible for and enrolled in** Medicare Part A or Part B.

Example 6. William attained age 65 and enrolled in Medicare in July 2004. Prior to July, he participated in self-only coverage under an HDHP with a $1,000 annual deductible.

Question. What is William's monthly contribution limit for 2004?

Answer. William is not eligible to make HSA contributions, including catch-up contributions, after June. William's monthly contribution limit through June 2004 is $125 [($1,000 ÷ 12) + ($500 ÷ 12)].

> **Observation.** Amounts remaining in an HSA when the account owner reaches age 65 can be used to make future tax-free distributions to pay "qualified medical expenses."

In the case of married individuals, if **either** spouse has **family coverage, both** are treated as having family coverage. If **each** spouse has **family coverage** under a separate HDHP, **both** spouses are treated as covered under the plan with the **lowest deductible.**

The contribution limit for the spouses is the lowest deductible amount, divided equally between the spouses unless they agree on a different division. The **family coverage** limit is reduced further by any contribution to an Archer MSA. However, both spouses may make the catch-up contributions for individuals age 55 or over without exceeding the **family coverage** limit.

Example 7. Harry and Wilma are married. Harry is 58 and Wilma is 53. Both have **family coverage** under **separate** HDHPs. Harry has a $3,000 deductible under his HDHP and Wilma has a $2,000 deductible under her HDHP.

Harry and Wilma are treated as covered under the plan with the $2,000 deductible. Harry can contribute $1,500 to an HSA (1/2 the deductible of $2,000 + $500 catch up contribution) and Wilma can contribute $1,000 to an HSA (unless they agree to a different division).

Example 8. Dennis and Kathy are married. Dennis is 35 and Kathy is 33, and both have a **self-only** HDHP. Dennis has a $1,000 deductible under his HDHP and Kathy has a $1,500 deductible under her HDHP. Dennis can contribute $1,000 to his HSA and Kathy can contribute $1,500 to her HSA.

HSA DISTRIBUTIONS

Distributions from an HSA may be received at any time. **Amounts distributed from an HSA that are used exclusively to pay qualified medical expenses of an account owner (as well as the owner's spouse and dependents) are not included in gross income.** That is true even if the medical expenses are paid at a time when the individual is not eligible to contribute to an HSA (after reaching age 65, for example).

HSA distributions that are **not** used to pay medical expenses **must be included in gross income and are subject to an additional 10% tax on the taxable amount** (similar to early distributions from IRAs). The 10% penalty does not apply if the HSA distribution is made **after the account owner:**

- Dies,
- Becomes disabled, or
- Reaches age 65.

Any HSA distribution used to pay qualified medical expenses is not treated as a medical expense on the account owner's Schedule A. Thus, if medical expenses are paid by HSA distributions, they **may not be deducted a second time** on Schedule A.

Note. "Qualified medical expenses" are defined as expenses for the diagnosis, care, mitigation, treatment or prevention of disease, qualified long-term care services and prescription drugs."[11] This broad definition covers many items that are not generally covered under traditional health insurance plans (e.g., eyeglasses, contact lenses, chiropractic services, dental services, and nursing home care).

Individuals (not HSA trustees, custodians, or employers) are responsible for proving and documenting that amounts distributed from an HSA are paid for qualified medical expenses.

Health insurance may not be purchased from HSA funds.[12] However, certain exceptions apply. The following health insurance premiums are "qualified medical expenses" for HSA distribution purposes:

- COBRA health care continuation coverage required under federal law

Note. While premiums paid for COBRA health care continuation coverage are "qualified medical expenses" for HSA distribution purposes, HSAs are not subject to COBRA continuation coverage under IRC §4980B. The same is true for Archer MSAs.

- A qualified long-term care insurance contract
- A health plan during a period in which the individual is receiving unemployment compensation under federal or state law
- In addition, when a person reaches age 65, the premiums for Medicare Parts A and B can be paid by an HSA distribution. The same is true for Medicare HMO premiums and a retired employee's share of employer-provided health plans. **However, premiums for a supplemental Medicare policy are not "qualified medical expenses" and may not be paid by HSA distributions.**[13]

Note. Medicare supplemental policies are often referred to as "Medigap" policies.

Transitional Relief for 2004. Qualified distributions must pay for qualified medical expenses that are incurred **after the HSA has been established.**[14] However, the IRS has provided **transitional relief for calendar year 2004 for individuals who establish an HSA on or before April 15, 2005.**[15] For calendar year 2004, an HSA established **on or before April 15, 2005,** can pay or reimburse a qualified medical expense that arose on or after the **later** of:

- January 1, 2004, or
- The first day of the first month that the HSA account owner became eligible.[16]

This relief encourages taxpayers to establish HSAs for the 2004 tax year.

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11. IRC §223(d)(2)(A)
12. IRC §223(d)(2)(B)
13. IRC §213(d)(2)(C)(iv)
14. Notice 2004-2, IRB 2004-2, 269, Q & A-26
15. Notice 2004-25, IRB 2004-15, 727
16. Id.

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Distributions of Excess Contributions. Any excess HSA contribution for a tax year will not trigger tax or penalties on distributions if the distribution is received by the account owner and is accompanied by the amount of the net income attributable to the excess contribution. The amount of any excess HSA contribution refunded to the HSA account owner must be increased by any earnings on it.

> **Note.** An "excess contribution" means any contribution which is **neither** excludable from gross income under IRC §106(d) nor deductible as an HSA deduction on Form 8889.

Other Distributions. If an account owner's spouse or dependents are covered under a non-HDHP, distributions from an HSA to pay their qualified medical expenses are excluded from the account owner's gross income. However, HSA distributions used to pay expenses reimbursed by another health plan are **not** excludable from gross income, whether or not the health plan is an HDHP.

If a husband and wife have separate HSAs and one spouse uses distributions from his HSA to pay qualified medical expenses of the other spouse, the distributions are excluded from the account owner's gross income. However, both HSAs may **not** pay for the **same medical expense**.

Timing of HSA Distributions. In general, an HSA account owner may defer to later tax years distributions used to pay qualified medical expense incurred in the current year, assuming the expense was incurred after the HSA was established. Similarly, a distribution from an HSA in the **current year** can be used to pay or reimburse expenses incurred in any **prior year,** provided they were incurred **after** the HSA was established. Thus, there is no time limit on when the distribution must occur.

In order for HSA distributions to be excluded from the account owner's gross income, **the owner must maintain records to prove that the:**

- Distributions were used exclusively to pay or reimburse qualified medical expenses,
- Qualified medical expenses have not been previously paid or reimbursed from another source, and
- Medical expenses have not been claimed as an itemized deduction in any prior taxable year.

Eligible individuals may use debit, credit or stored-value cards to receive distributions from an HSA for qualified medical expenses.

COORDINATION WITH SIMILAR PROGRAMS

Archer MSAs

The HSA provisions provide for **coordination with other contributions to similar programs.** Otherwise allowable contributions to an HSA for any taxable year **are reduced (but not below zero) by the sum of:**

- The aggregate amount paid for that tax year to Archer MSAs, and
- The aggregate amount of employer contributions to an account owner's HSA which have been excluded from gross income for the tax year.

> **Note.** Employer contributions must be reported in box 12 on the employee's 2004 Form W-2 using Code W.[17]

However, this limitation may differ for spouses. If **either** spouse has **family coverage,** then **both spouses** are treated as having **only** family coverage. And, if both spouses have **family coverage** under **different** plans, they are treated as having the family coverage with the **lowest** annual deductible.

17. Announcement 2004-2, IRB 2004-3, 322

In addition, the limitation, disregarding any additional "catch-up" contributions, is reduced by the aggregate amount paid to the spouses' Archer MSAs for the tax year. Any reduction under this limitation rule is divided equally between the spouses unless they agree to a different division.

Observation. The above limitation does not apply to medical benefit plans provided to employees under IRC §105, including medical reimbursement plans. Thus, if an employer wanted to make contributions to employees' HSAs, the employer could still offer them a §105 plan for current medical expenses. Contributions to an HSA may also be made by employees from their employer's cafeteria plans.

Employer Contributions and Plans

The legislation allows employer contributions to employee-owned HSAs. Employer contributions are treated as a tax-free fringe benefit to the extent the amounts do not exceed the HSA limits.[18] Employer contributions are income tax deductible and are not subject to FICA taxes.[19]

Note. A penalty is imposed **if** the employer fails to make **comparable** HSA contributions for **comparable** employees. This rule does not appear to require the plan to cover a nondiscriminatory group of employees. Thus, coverage could be restricted only to a group of highly-compensated employees, provided HSA contributions within the group meet the comparability standard. A question remains, however, as to whether the nondiscrimination rules apply if an HSA is offered as part of a cafeteria plan.

If an employee begins HDHP coverage mid-month, the employee becomes an eligible individual (for purposes of contributions to an HSA) at the **beginning of the next month.**

HSAs allow mid-year changes so employees can adjust the amount of salary reduction contributions. Also, employers cannot recoup payments made to employee HSAs. Thus, if an employer pre-funds an HSA early in a year and the employee later quits, the employee retains the previous employer contributions.

If an employer changes health plans mid-year, the new health plan does not fail to be an HDHP if the period during which expenses are incurred (for purposes of satisfying the deductible) is 12 months or less.

Example 9. Wiley Widget Co. has a calendar year health plan. The company switches from a non-HDHP plan to a new health plan effective July 1. The annual deductible under the new plan satisfies the minimum annual deductible for an HDHP. The new plan counts expenses incurred under the old plan during the first six months of the year in determining the new plan's annual deductible. The new plan satisfies the HDHP deductible limit.

If an HSA owner changes coverage during the plan year from self-only HDHP coverage to family HDHP coverage, the owner remains eligible even though the family HDHP coverage takes into account expenses incurred while the individual had only self-coverage.

Observation. This situation is likely to arise where an individual marries during the year. The individual's contribution to an HSA is based on the time period (in terms of months) of self-only coverage and the time period of family coverage.

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18. IRC §106(d)(1)

19. Notice 2004-2, IRB 2004-2, 269, Q & A-19

Coverage under an Employee Assistance Program (EAP), disease management program or wellness program does not disqualify an individual from contributing to an HSA if the program does not provide significant medical benefits. The EAP is not considered a "health plan."

If an employer offers an employee a choice between a low deductible health plan and a high deductible health plan (HDHP), and the employee selects coverage only under the HDHP, the employee remains eligible to contribute to an HSA. **The actual health coverage selected by the individual is the key. It is irrelevant what type of health coverage the individual could have chosen.**

Portability

HSAs are portable, so an individual is not dependent on a particular employer for an HSA. Like an IRA, an HSA is owned by the individual, not the employer.

Rollovers

Rollover contributions from Archer MSAs and other HSAs into an HSA are permitted. Rollover contributions need not be in cash, and are not subject to the annual contribution limits. **However, rollovers from an IRA, from a health reimbursement arrangement (HRA), or from a health flexible spending arrangement (FSA) to an HSA are not permitted.**

> **Note.** An employer may structure an FSA or HRA to work with an HSA. Four examples of how an employer can do this are described in Rev. Rul. 2004-45, IRB 2004-22, 971. **The key is compliance with the high deductible insurance plan rules.**

An account owner may make only one rollover contribution to an HSA during a one-year period. In addition, to qualify as a rollover, any amount paid or distributed from an HSA to an account owner must be repaid to the HSA within 60 days after HSA distribution date. However, direct transfers of HSA amounts from one HSA trustee directly to another HSA trustee are not subject to the rollover restrictions.[20]

DIVORCE

The transfer of an account owner's interest in an HSA to a spouse or former spouse under a divorce or separation instrument is not considered a taxable transfer. The spouse or former spouse transferee is treated as the new HSA account owner.[21]

DEATH

Surviving Spouse as Beneficiary

If a surviving spouse is the named beneficiary of the account owner, the HSA passes to the surviving spouse who is subject to income tax only on HSA distributions which are not used to pay qualified medical expenses.[22] The surviving spouse is treated as the new account owner.

20. IRC §223(f)(5)

21. IRC §223(f)(7)

22. IRC §223(f)(8)(A)

Beneficiaries Other than Spouses

For HSAs passing to a beneficiary other than the surviving spouse, the account ceases to be an HSA as of the decedent's death. The beneficiary is required to include the FMV (determined as of the date of the decedent's death) of the inherited HSA as gross income on the beneficiary's income tax return for the year of death.[23] However, proceeds from the HSA used by the beneficiary to pay the deceased's medical expenses are not taxable to the beneficiary.

A deduction is allowed to the beneficiary under IRC §691(c) for the **estate tax** paid by the decedent's estate on the FMV of the HSA. This deduction is allowed on line 27, Schedule A as an "Other miscellaneous deduction." It is **not** subject to the 2% AGI limitation.

CASES FROM TAXPRO QUARTERLY JOURNAL[24]

The following four hypothetical "cases" show the tax savings potential of establishing HSAs. The four cases assume the following"

1. All family members are healthy, have no pre-existing medical conditions, and do not have maternity coverage.
2. The taxpayers' top tax bracket is 15%.
3. Future annual premiums will increase by:
   - 12% for traditional health insurance plans, and
   - 10% for HSA HDHPs.
4. Undistributed HSA funds will earn 2% annually.
5. Insurance coverage begins on January 1 of the tax year.

Scenario A

Facts. Terry, age 35, is married and has two children. He works for an employer who does not provide health insurance. Terry has a traditional family health insurance plan with a $1,500 deductible and 20% co-pay. Terry's monthly premiums are $800 ($9,600 per year). Terry has $1,500 in medical expenses for the year and expects his medical expenses to increase $200 annually. Terry's total out-of-pocket cost for 2004 for traditional health insurance coverage is $11,100 ($9,600 + $1,500).

If Terry switches to a HDHP plan with a $4,100 deductible, the monthly HDHP premium would be $250 ($3,000 per year, or 60% less). If Terry establishes an HSA which has a $3 per month administration fee and contributes the maximum of $4,100, the tax savings are $615, assuming he is in the 15% marginal tax bracket. Terry's total out-of-pocket costs are $6,485 ($3,000 + $4,100 – $615). Terry has saved $4,615 in the first year and will have saved over $31,000 over five years. Plus he has a balance in his HSA of $3,211, which is carried over to pay future medical bills. Since the HSA is a tax-favored trust account, any interest earned is tax-free. At the end of five years, Terry will have a balance in his HSA of over $14,500 (See Table 1).

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23. IRC §223(f)(8)(B)

24. Cherie O'Neil, Ph.D., CPA and Robert E. Thompson, "Health Savings Accounts," TAXPRO Quarterly Journal 15-23 (Summer 2004). Reprinted with permission from Cherie O'Neil, Ph.D., CPA and the National Association of Tax Professionals.

Table 1 — Family Plan

Marginal tax rate	**15%**					
Traditional health insurance	**2004**	**2005**	**2006**	**2007**	**2008**	
Monthly premium	$ 800	$ 900	$ 1,000	$ 1,100	$ 1,200	
Annual premium cost	9,600	10,800	12,000	13,200	14,400	
Deductible	1,500	1,500	1,500	1,500	1,500	
Co-pay	20%	20%	20%	20%	20%	
Medical expenses incurred	1,500	1,700	1,900	2,100	2,400	
Annual percentage increase in premium	12%					
HDHP with HSA						
Monthly premium	250	280	310	340	370	
Annual premium cost	3,000	3,360	3,720	4,080	4,440	
Deductible	4,100	4,100	4,100	4,100	4,100	
HSA contribution	4,100	4,100	4,100	4,100	4,100	
Interest income rate	2%					
Annual percentage increase in premium	10%					
Cost of traditional insurance						
Premiums	9,600	10,800	12,000	13,200	14,400	
Medical expenses, net of insurance	1,500	1,540	1,580	1,620	1,680	
Total	$11,100	$12,340	$13,580	$14,820	$16,080	
Cost of HDHP insurance with HSA						
Premiums	3,000	3,360	3,720	4,080	4,440	
HSA contribution	4,100	4,100	4,100	4,100	4,100	
Tax savings	(615)	(615)	(615)	(615)	(615)	
Total	$ 6,485	$ 6,845	$ 7,205	$ 7,565	$ 7,925	
Annual reduction in health care costs	$ 4,615	$ 5,495	$ 6,375	$ 7,255	$ 8,155	$31,895
Health savings account						
HSA contribution	4,100	4,100	4,100	4,100	4,100	
Medical expenses, net of tax savings paid from HSA	(885)	(1,085)	(1,285)	(1,485)	(1,785)	
Administration expense	(36)	(36)	(36)	(36)	(36)	
Balance in HSA	$ 3,179	$ 6,190	$ 9,093	$11,853	$14,370	
Interest earned	32	124	182	237	287	
Ending balance in HSA	$ 3,211	$ 6,314	$ 9,274	$12,091	$14,657	

Scenario A: Terry, age 35, is married and has two children. He works for an employer who does not provide health insurance. Terry has a traditional family health insurance plan.

Scenario B

Facts. Larry, age 38, is self-employed, is married and has one child. He currently has no health insurance. Larry's medical expenses are $1,500 in 2004. A traditional health insurance premium would be $700 per month, $8,400 per year. The after-tax cost of health insurance would be $7,140, which is more than Terry can afford. If Terry adopts a HDHP with a maximum $5,100 deductible, his monthly after-tax premium will be only $183, which makes health insurance affordable. If he contributes only $1,500 to his HSA he will save an additional $225 in taxes. If he uses the tax savings to pay for a portion of his medical expenses, he will have an ending balance in his HSA of $191. If he pursues the strategy of contributing an amount to his HSA equal to his medical expenses and using his tax savings to fund a portion of his out-of-pocket medical expenses, by the fourth year he can reduce his deductible from $5,100 to $2,000. He will not only have sufficient funds to pay for medical expenses equal to his deductible, but he will have a positive ending balance in his HSA of approximately $1,400 in five years (See Table 2).

Table 2 — Family Plan

Marginal tax rate **Traditional health insurance**	**15%** **2004**	**2005**	**2006**	**2007**	**2008**	
Monthly premium	$ 700	$ 800	$ 1,000	$ 1,000	$ 1,100	
Annual premium cost	8,400	9,600	10,800	12,000	13,200	
Deductible	3,000	3,000	3,000	3,000	3,000	
Co-pay	20%	20%	20%	20%	20%	
Medical expenses incurred	1,500	1,700	1,900	2,100	2,400	
Annual percentage increase in premium	12%					
HDHP with HSA						
Monthly premium	215	280	380	420	460	
Annual premium cost	2,580	3,360	4,560	5,040	5,520	
Deductible	5,100	5,100	5,100	5,100	5,100	
HSA contribution	1,500	1,700	1,900	2,100	2,400	
Interest income rate	2%					
Annual percentage increase in premium	10%					
Cost of traditional insurance						
Premiums, net of tax savings	7,140	8,160	9,180	10,200	11,220	
Medical expenses, net of insurance	1,500	1,700	1,900	2,100	2,400	
Total	$8,640	$9,860	$11,080	$12,300	$13,620	
Cost of HDHP insurance with HSA						
Premiums, net of tax savings	2,193	2,856	3,876	4,284	4,692	
HSA contribution	1,500	1,700	1,900	2,100	2,400	
Tax savings	(225)	(255)	(285)	(315)	(360)	
Total	$8,640	$9,860	$11,080	$12,300	$13,620	
Annual reduction in health care costs	$5,172	$5,559	$ 5,589	$ 6,231	$ 6,888	$29,439
Health savings account						
HSA contribution	1,500	1,700	1,900	2,100	2,400	
Medical expenses, net of tax savings paid from HSA	(1,275)	(1,445)	(1,615)	(1,785)	(2,040)	
Administration expense	(36)	(36)	(36)	(36)	(36)	
Balance in HSA	$ 189	$ 410	$ 667	$ 959	$ 1,303	
Interest earned	2	84	13	19	26	
Ending balance in HSA	$ 191	$ 418	$ 680	$ 979	$ 1,329	

Scenario B: Larry, age 38, is married and has one child. He is self-employed and currently has no health insurance.

Scenario C

Facts. Suzy, age 32, is single and self-employed. She does not have medical insurance coverage and would like to insure against a catastrophic illness. She would have to pay $190 per month for traditional health insurance coverage with a $2,000 deductible. An HDHP policy with a $2,550 deductible would have a monthly premium of only $75. Since she is self-employed her health insurance premiums are deductible as an adjustment to income. If she makes contributions to an HSA equal to her annual medical expenses and uses the tax savings to pay for a portion of her medical expenses, she can have health care coverage at an annual after-tax cost of under $1,200 ($100 per month) in 2004. (See Table 3).

Table 3 — Single Plan

Marginal tax rate **Traditional health insurance**	**15%** **2004**	**2005**	**2006**	**2007**	**2008**	
Monthly premium	$ 190	$ 210	$ 240	$ 270	$ 300	
Annual premium cost	2,280	2,520	2,880	3,240	3,600	
Deductible	2,000	2,000	2,000	2,000	2,000	
Co-pay	20%	20%	20%	20%	20%	
Medical expenses incurred	500	600	700	800	900	
Annual percentage increase in premium	12%					
HDHP with HSA						
Monthly premium	75	80	90	100	110	
Annual premium cost	900	960	1,080	1,200	1,320	
Deductible	2,550	2,550	2,550	2,550	2,550	
HSA contribution	500	600	700	800	900	
Interest income rate	2%					
Annual percentage increase in premium	10%					
Cost of traditional insurance						
Premiums, net of tax savings	1,938	2,142	2,448	2,754	3,060	
Medical expenses, net of insurance	500	600	700	800	900	
Total	$2,438	$2,742	$3,148	$3,554	$3,960	
Cost of HDHP insurance with HSA						
Premiums	765	816	918	1,020	1,122	
HSA contribution	500	600	700	800	900	
Tax savings	(75)	(90)	(105)	(120)	(135)	
Total	$1,190	$1,326	$1,513	$1,700	$1,887	
Annual reduction in health care costs	$1,248	$1,416	$1,635	$1,854	$2,073	$8,226
Health savings account						
HSA contribution	500	600	700	800	900	
Medical expenses, net of tax savings paid from HSA	(425)	(510)	(595)	(680)	(765)	
Administration expense	(36)	(36)	(36)	(36)	(36)	
Balance in HSA	$ 39	$ 93	$ 164	$ 252	$ 356	
Interest earned	0	2	3	5	7	
Ending balance in HSA	$ 39	$ 95	$ 168	$ 257	$ 363	

Scenario C: Suzy, age 32, is single and self-employed. She is currently uninsured.

Scenario D

Facts. John, age 60, is married and self-employed. John currently has an Archer MSA and HDHP with a monthly premium of $675 and an annual deductible of $4,000. He estimates that his medical expenses will increase $500 annually. His Archer MSA deduction is limited to $3,000 (75% of his annual MSA contribution). John's 2004 medical expenses in excess of $3,000 must be paid from after-tax dollars. By switching to an HSA, his tax deduction will increase to $4,000 and all of his medical expenses will be paid from before-tax dollars. When John renews his insurance for each subsequent year he can reduce his monthly premiums by increasing his deductible $500 each year. John can increase his annual HSA contributions to cover his anticipated annual medical expenses. John has saved over $11,000 in medical costs in just five years and will have approximately $3,800 in his HSA to pay for post-retirement medical expenses once he reaches age 65 (See Table 4).

Table 4 — MSA Rollover

Marginal tax rate	**15%**					
Traditional health insurance	**2004**	**2005**	**2006**	**2007**	**2008**	
Monthly premium	$ 675	$ 700	$ 800	$ 900	$ 1,000	
Annual premium cost	8,100	8,400	9,600	10,800	12,000	
Deductible	4,000	4,000	4,000	4,000	4,000	
Co-pay	0%	0%	0%	0%	0%	
Medical expenses incurred	4,000	4,500	5,000	5,500	6,000	
Annual percentage increase in premium	10%					
HDHP with HSA						
Monthly premium	675	666	657	648	639	
Annual premium cost	8,100	7,992	7,884	7,776	7,668	
Deductible	4,000	4,500	5,000	5,500	6,000	
HSA contribution	4,000	4,500	5,000	5,500	6,000	
Interest income rate	2%					
Annual percentage increase in premium	10%					
Cost of HDHP insurance with MSA						
Premiums, net of tax savings	6,885	7,140	8,160	9,180	10,200	
MSA contribution	3,000	3,000	3,000	3,000	3,000	
Medical expenses paid out-of-pocket	1,000	1,500	2,000	2,500	3,000	
Tax savings	(450)	(450)	(450)	(450)	(450)	
Total	$10,435	$11,640	$13,160	$14,680	$16,200	
Cost of HDHP insurance with HSA						
Premiums, net of tax savings	6,885	6,793	6,701	6,610	6,518	
HSA contribution	4,000	4,500	5,000	5,500	6,000	
Tax savings	(600)	(675)	(750)	(825)	(900)	
Total	$10,285	$10,618	$10,951	$11,285	$11,618	
Annual reduction in health care costs	$ 150	$ 1,022	$ 2,209	$ 3,395	$ 4,582	$11,358
Health savings account						
HSA contribution	4,000	4,500	5,000	5,500	6,000	
Medical expenses, net of tax savings paid from HSA	(3,400)	(3,825)	(4,250)	(4,675)	(5,100)	
Administration expense	(36)	(36)	(36)	(36)	(36)	
Balance in HSA	$ 564	$ 1,209	$ 1,947	$ 2,775	$ 3,694	
Interest earned	6	24	39	55	74	
Ending balance in HSA	$ 570	$ 1,233	$ 1,986	$12,830	$13,768	

Scenario D: John, age 60, is married. He is self-employed and currently has an Archer MSA.

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NOTICE 2004-50

Notice 2004-50 provides a series of 88 questions and answers related to HSAs. It is an excellent reference for answering HSA inquiries. It supplements Notice 2004-2, which contains 38 previous questions and answers. Tax professionals should consider downloading and printing these two notices from the IRS website. **Below are excerpts from Notice 2004-50 related to HSA contributions and distributions. Some of the questions and answers have been rewritten for the sake of clarity and brevity.**

IV. Contributions

Q-28-29. Who may make HSA contributions on behalf of an HSA account owner?

A-28-29. An employer, a state government, a family member, or any other person may make contributions to an HSA on behalf of an eligible account owner.

> **Note.** Any person or entity can fund an HSA of an eligible account owner. That includes government employers, who will be able to offer an HSA option to their employees. This new legislation attempts to encourage individuals and employers to establish HSAs.

Q-30. How is the maximum annual HSA contribution limit determined for an eligible individual with family coverage under an HDHP that includes embedded individual deductibles and an umbrella deductible?

A-30. Generally, the maximum annual HSA contribution limit for an eligible individual with family coverage under an HDHP is the lesser of:

(1) The annual deductible under the HDHP, or

(2) The statutory limit on family coverage contributions.

An HDHP often has a stated expense maximum for the family (the umbrella deductible). It also usually pays medical expenses in excess of the minimum annual deductible for each individual's covered medical expenses (the embedded individual deductible). The maximum annual HSA contribution limit for an eligible individual, who has family coverage under an HDHP, is the **least** of the following amounts:

(1) The maximum annual contribution limit for family coverage ($5,150 for calendar year 2004);

(2) The umbrella deductible; or

(3) The embedded individual deductible multiplied by the number of family members covered by the plan.

See Notice 2004-2, Q&A 3, which requires that the embedded individual deductible satisfy the minimum annual deductible for an HDHP.

Example 10. In 2004, Horace and Winona, a married couple, have HDHP coverage for themselves and their two dependent children. The HDHP pays benefits for any family member whose covered expenses exceed $2,000 (the embedded individual deductible), and pays benefits for all family members after their covered expenses exceed $5,000 (the umbrella deductible). The maximum annual contribution limit is $5,150. The embedded deductible multiplied by the number of covered family members is $8,000 (4 × $2,000). The maximum annual contribution which Horace and Winona can make to their HSAs is $5,000 (the least of $5,000, $5,150 or $8,000). The $5,000 limit is divided equally between Horace and Winona, unless they agree to a different division.

Example 11. Use the same facts as **Example 10** except, the HDHP provides coverage only for Horace and Winona. The maximum annual contribution limit under section 223(b)(2)(B)(ii) is $5,150. The umbrella deductible is $5,000. The embedded individual deductible multiplied by the number of family members covered is $4,000 (2 × $2,000). The maximum annual contribution which Horace and Winona can make to their HSAs for 2004 is $4,000 (the least of $5,000, $5,150 or $4,000).

Q-32. How may spouses agree to divide the annual HSA contribution limit between themselves?

A-32. Spouses can divide the annual HSA contribution in any way they want, including allocating nothing to one spouse.

Example 12. In 2004, Don, an eligible HSA owner, has **self-only** HDHP coverage with a $1,200 deductible from January 1 through March 31. In March, Don and Ellen marry. Don and Ellen do not qualify for the catch-up contributions. From April 1 through December 31, 2004 Don and Ellen have HDHP **family coverage** with a $2,400 deductible. Ellen is an eligible individual from April 1 through December 31, 2004. Don and Ellen's contribution limit for the nine months of family coverage is $1,800 (nine months of the deductible for **family coverage** = 9/12 × $2,400). Don and Ellen divide the $1,800 between them. Don's contribution limit to his HSA for the three months of single coverage is $300 (three months of the deductible for **self-only coverage** = 3/12 × $1,200). The $300 limit is **not** divided between Don and Ellen.

Q-33. What is the contribution limit for an HSA account owner covered by an HDHP and also by a **post-deductible** health reimbursement arrangement (HRA)?

A-33. The deductible for the HRA need not be the same as the deductible for the HDHP, but in no event may the HDHP or other coverage provide benefits **before** the minimum annual deductible is satisfied. When the HDHP and the other coverage do not have identical deductibles, contributions to the HSA are limited to the **lower** of the deductibles. In addition, although the deductibles of the HDHP and the other coverage may be satisfied independently by separate expenses, no benefits may be paid by the HDHP or the other coverage before the minimum annual deductible has been satisfied.

Example 13. In 2004, an HSA account owner has **self-only** coverage under an HDHP with a deductible of **$2,500.** The individual is also covered under a post-deductible HRA which pays or reimburses qualified medical expenses **only after $2,000** of the HDHP's deductible has been satisfied (i.e., if the individual incurs covered medical expenses of $2,250, the HRA will pay $250). Because the HRA's deductible of $2,000 is less than the HDHP's deductible of **$2,500,** the individual's HSA contribution limit is **$2,000.**

Q-34. An HSA account owner wants to withdraw an **excess contribution** from an HSA before the due date of his federal income tax return (including extensions), to avoid the 6% excise tax. How is the net income attributable to the excess contribution computed?

A-34. Any distribution of excess contribution to an HSA must be "accompanied by the amount of net income attributable to such excess contribution." Any net income is included in the individual's gross income. **The rules for computing attributable net income for excess IRA contributions apply to HSAs.**

Q-35. May an individual who has not made excess HSA contributions treat a distribution from an HSA other than for qualified medical expenses as the withdrawal of excess HSA contributions?

A-35. No. This withdrawal is deemed a withdrawal for non-qualified medical expenses and includable in the individual's gross income.

V. Distributions

Q-36. If an account owner's spouse or dependents are covered under a non-HDHP, are distributions from an HSA to pay their qualified medical expenses excluded from the account owner's gross income?

A-36. Yes. Distributions from an HSA are excluded from income if made for any qualified medical expense of the account owner, and the account owner's spouse and dependents, without regard to their status as eligible individuals. However, distributions made for expenses reimbursed by another health plan are not excludable from gross income, whether or not the other health plan is an HDHP.

Q-37. An account owner receives an HSA distribution, resulting from a **mistake due to reasonable cause** (e.g., the account owner reasonably, but mistakenly, believed that an expense was a qualified medical expense and was reimbursed for that expense from the HSA). The account owner repays the improper HSA distribution. Is the distribution included in gross income and subject to the 10% additional tax, or is the repayment subject to the excise tax on excess contributions?

A-37. If there is clear and convincing evidence that amounts were distributed from an HSA resulting from a **mistake due to reasonable cause,** the account owner may repay the mistaken distribution no later than April 15 following the first year he knew or should have known the distribution was a mistake. Under these circumstances, the distribution is **not** included in gross income, or subject to the 10% additional tax, and the repayment is not subject to the excise tax on excess contributions

Q-38. If both spouses have HSAs and one spouse uses distributions from his HSA to pay or reimburse qualified medical expenses of the other spouse, are the distributions excluded from the account owner's gross income?

A-38. Yes. However, both HSAs may not reimburse the same expense amounts.

Q-39. When must a distribution from an HSA be made to pay or reimburse, on a tax-free basis, qualified medical expenses incurred in the current year?

A-39. An account owner may defer to **later tax years** distributions from HSAs to pay or reimburse qualified medical expenses incurred in the **current year,** provided the expenses were incurred **after** the HSA was established. Similarly, a distribution from an HSA in the **current year** can be used to pay or reimburse expenses incurred in any prior year as long as the expenses were incurred **after** the HSA was established. Thus, **there is no time limit on when the distribution must occur.**

However, to be excludable from the account owner's gross income, he must keep records sufficient to later show that:

- The distributions were used exclusively to pay or reimburse qualified medical expenses,
- The qualified medical expenses have not been previously paid or reimbursed from another source, and
- The medical expenses have not been taken as an itemized deduction in any prior taxable year.

Example 14. An eligible HSA account owner contributes $1,000 to an HSA in 2004. On December 1, 2004, the individual incurs a $1,500 qualified medical expense and has a balance in his HSA of $1,025. On January 3, 2005, the individual contributes another $1,000 to the HSA, bringing the balance in the HSA to $2,025. In June, 2005, the individual receives a distribution of $1,500 to reimburse him for the $1,500 medical expense incurred in 2004. The individual can show that the $1,500 HSA distribution in 2005 is a reimbursement for a qualified medical expense that has not been previously paid or otherwise reimbursed and has not been taken as an itemized deduction. The distribution is **excluded** from the account beneficiary's gross income.

Q-40. May an account owner pay qualified **long-term care insurance premiums** with distributions from an HSA if contributions to the HSA are made by salary-reduction though a cafeteria plan?

A-40. Yes. The term "qualified benefit" (under a §125 cafeteria plan) does not include any product which is advertised, marketed, or offered as long-term care insurance. However, **for HSA purposes,** the payment of any expense for coverage under a qualified long-term care insurance contract is a qualified medical expense. Where an HSA that is offered under a cafeteria plan pays or reimburses individuals for qualified long-term care insurance premiums, section 125(f) is not applicable because it is the HSA and not the long-term care insurance that is offered under the cafeteria plan.

Q-41. Do the annual limits on the deduction for "eligible long-term care premiums" restrict the amount of distributions for qualified medical expenses that may be excluded from income under an HSA?

A-41. Yes. "Eligible long-term care premiums" are deductible medical expenses, but the deduction is limited to the annually adjusted amounts based on age. Thus, although HSA distributions to pay or reimburse qualified long-term care insurance premiums are qualified medical expenses, the exclusion amount is limited to the annually adjusted amounts. Any excess premium reimbursements are includable in gross income and may also be subject to the 10% penalty.

Example 15. In 2004, June, age 41, pays premiums of $1,290 for a qualified long-term care insurance contract. The limit in 2004 for deductions for persons age 40, but not more than 50, is $490. June's HSA can reimburse her up to $490 on a tax-free basis for the long-term care premiums. The remaining $800 ($1,290 – $490), if reimbursed from her HSA, is not for qualified medical expenses and is includable in gross income.

Q-42. Are distributions from an HSA for long-term care services qualified medical expenses excludable from income?

A-42. Yes. Amounts paid for qualified long-term care services are medical care and amounts paid or distributed out of an HSA used to pay for qualified medical expenses are not includible in gross income. Although employer-provided coverage for long-term care services provided through a **flexible spending arrangement (FSA)** are included in an employee's gross income, this **does not apply to distributions from an HSA.** This is true whether or not the HSA is funded by salary-reduction contributions through a cafeteria plan.

Q-43. May a retiree who is **age 65 or older** receive tax-free distributions from an HSA to pay the retiree's contribution to an employer's self-insured retiree health coverage?

A-43. Yes. The purchase of health insurance is **generally** not a qualified medical expense that can be paid or reimbursed by an HSA. However, there is an **exception** for coverage for health insurance once an account owner has attained age 65. The exception applies to both insured and self-insured plans.

Q-44. May an individual who is **under age 65** and has end-stage renal disease or is disabled receive tax-free distributions from an HSA to pay for health insurance premiums?

A-44. No. Payment of health insurance premiums are qualified medical expenses, only in specific instances. (See Health Insurance under HSA Distributions.)

Q-45. If a retiree who is **enrolled in Medicare** receives a distribution from an HSA to reimburse the retiree's Medicare premiums, is the reimbursement a qualified medical expense?

A-45. Yes. Premiums for Medicare Parts A and B which are deducted from social security benefit payments may be reimbursed by an HSA.

SUMMARY

The U.S. government has recognized the high cost of health care creates financial problems for many taxpayers. Since the 1990s there have been numerous attempts to create programs which could ease the burden. The Medicare Prescription Drug Improvement and Modernization Act was enacted to address this problem. The legislation is designed to:

- Reward **employers** by eliminating payroll tax expenses on contributions,
- Reward **employees** and other taxpayers by allowing them to lower their taxable income by funding a dedicated account to make tax-free distributions to pay qualified medical expenses, and
- Allow the federal government to begin controlling outlays for Medicare and Medicaid.

Unfortunately, many individuals may not have enough discretionary income to make significant HSA contributions. Another concern is that healthier and wealthier individuals may utilize HSAs, leaving older and less healthy individuals remaining in HMOs and other traditional health plans.

Note. When "health savings accounts" is used with a popular search engine, approximately 41,000 hits occur. A site that contains a number of links to HSA providers is **www.HSAfinder.com.** Companies pay HSAfinder.com to list their product on this website. The University of Illinois does not endorse this site or the vendors listed on the site. It is just one of a number of sites that have been created to help taxpayers find providers of HSAs.

THE MILITARY FAMILY TAX RELIEF ACT OF 2003

On Veterans' Day, November 11, 2003, the President signed into law the Military Family Tax Relief Act of 2003.[25] The measure includes several tax breaks for members of the Armed Forces and their families, as well as for Foreign Service officers and military academy attendees. The Act contains retroactive provisions and possibilities for refunds. Also included are provisions designed to assist veterans' organizations keep their exempt status and changes that suspend tax-exempt status for terrorist organizations and prevent charitable deductions for contributions to terrorist organizations.

MAJOR PROVISIONS

Home Sale Exclusion

Old Law. IRC §121 allows a taxpayer to exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least **two of the last five years.** A taxpayer failing to meet these requirements by reason of change of employment, health or unforeseen circumstances is able to exclude a fraction of the gain based upon the fraction of the two-year time period that it was owned. This provision does not contain any special rules relating to members of the armed services or U.S. Foreign Service.

New Law. For certain active duty service members, the five-year period may be suspended for up to 10 years. This allows the taxpayer more time to meet the two-year requirement for use of the home as a principal residence.

At the election of the taxpayer, the five-year period is suspended while the taxpayer or the taxpayer's spouse is serving on qualified official extended duty as a member of the uniformed services or the U.S. Foreign Service.

25. H.R. 3365, Pub. L. No. 108-121

Example 16. Joseph, an Army corporal, purchased a residence in Texas on June 1, 2000. Joseph used the residence as his principal residence until July 27, 2001. On July 28, 2001, Joseph was assigned to official extended duty in Korea until August 1, 2006. At the end of the period, Joseph returned to the Texas residence and used it as his principal residence until September 1, 2007.

If Joseph makes the election to suspend the five-year period and sells the residence on September 2, 2007, the five-year period will **not include** the period of his qualified official extended duty. **Thus, Joseph will be eligible to exclude up to $250,000 of his gain.** He is deemed to have used the residence as his principal residence for at least two years (June 1, 2000–July 27, 2001 and August 2, 2006–September 1, 2007) in the relevant five-year period (determined after the suspension).

Note. This provision applies retroactively to sales after May 6, 1997. For homes sold before 2001, taxpayers have until November 10, 2004 to file a refund claim for an exclusion allowed by the law change that would otherwise be prohibited by the statute of limitations.

Qualified official extended duty is defined as any extended duty while serving at a duty station which is at least 50 miles from the property or while residing under Government orders in Government quarters.[26] **Extended duty** is any period of active duty under a call or order to active duty for a period of more than 90 days or for an indefinite period. **Uniformed services** includes the Army, Navy, Air Force, Marine Corps, Coast Guard, commissioned corps of the National Oceanic and Atmospheric Administration and commissioned corps of the Public Health Service.

Note. The provision does not specify how and when to make or revoke the election. IRS guidance is anticipated on these points. What is known is that the election can be made on only one property at a time, and may be revoked at any time. The provision restricts the ability of an individual to make an election if an election is in effect. That implies that the individual must make the election before the sale of the residence.

In addition, if the election is made, the five-year period does not include any period up to 10 years that the taxpayer was on active duty.

This legislation also applies to the reduced exclusion rule of prior law and the special rule applicable in situations where a taxpayer becomes physically or mentally incapable of self-care. If the taxpayer did not live in the home for two years, even after suspending the time on qualified active duty, the taxpayer may still qualify for relief under the reduced exclusion rule or the nursing home rule. The five-year period may also be suspended for application of these rules.

The reduced exclusion rule allows taxpayers to prorate the maximum exclusion by the number of days the home was used as a principal residence divided by the two-year requirement.

Example 17. Sarah is single and is a member of the Marines. She purchased a residence in Virginia on January 1, 2001, and used it as her personal residence for the entire year. On January 1, 2002, Sarah was assigned to extended duty in Afghanistan until December 31, 2007. While in Afghanistan, Sarah sold her Virginia home for a gain of $150,000 on July 1, 2007. The sale qualifies for a reduced exclusion (by reason of a change in Sarah's place of employment). If Sarah elects to suspend the five-year period, she will be eligible to exclude up to $125,000 [$250,000 × (365 days ÷ 730 days)] because she used the residence as a principal residence for one year.

The nursing home rule allows taxpayers who used the home as a principal residence for one year during the five-year period and who become incapable of self-care to treat time in a licensed care facility as if the taxpayer were living in the principal residence.

26. H.R. 3365, Sec. 101(a), amending IRC §121(d)(9)(C)(i)

Dependent Care Assistance Programs

While prior law excluded "qualified military benefits" from gross income, it did not specifically exclude dependent care assistance benefits for military personnel. The Act specifies that, for tax years beginning after 2002, dependent care assistance provided under a dependent care assistance program for a member of the Armed Forces is excludable from gross income as a qualified military benefit.[27] Likewise, amounts received by uniformed services personnel under a dependent care assistance program are not considered wages for FICA and FUTA purposes or for wage withholding.

Death Gratuity Benefits

Under pre-Act law, up to $3,000 of the $6,000 death gratuity benefits (as part of "qualified military benefits") were excludible from gross income. The Act increases the amount of the death gratuity benefit to $12,000 for deaths occurring after September 10, 2001. Likewise, the Act increases the death gratuity benefit exclusion to $12,000.[28] Also, any future increases in the maximum amount of the death benefit payable to survivors would automatically be excluded from gross income.

Note. Taxpayers receiving death gratuities exceeding $3,000 for an eligible death occurring after Sept. 10, 2001, and who have already filed a return for either 2001 or 2002, should file amended returns for those years to claim this additional tax benefit.

Overnight Travel Expenses for Reservists

Background. Transportation costs for reservists to attend meetings are **generally not** deductible. Two exceptions to the general rule apply. Transporation costs to attend Reserve or National Guard meetings are allowed when a reservist:

1. Travels to the meeting as a second job on a day he works at his regular job (two places of work on one day rule), or
2. Travels to a meeting which is held outside the metropolitan areas where the reservist lives and normally works.[29]

If a reservist travels overnight, expenses for transportation, lodging and meals (subject to 50% reduction) are allowable but subject to the 2% adjusted gross income (AGI) floor for miscellaneous itemized deductions.

Note. Perhaps Congress thought it was necessary to change the law because:

- Like 75% of all taxpayers, National Guard and Reservists typically don't itemize.
- Those who do itemize may only deduct unreimbursed travel and transportation expenses to attend monthly meetings or two-week camps only if their expenses exceed 2% of AGI.

New Law. The new rules only apply to the **unreimbursed** expenses of National Guard and Reserve members who:

1. **Travel more than 100 miles** to attend Guard or Reserve meetings or camps, and
2. **Stay overnight** instead of returning to their homes.

The new provision allows reservists to claim an **above-the-line deduction** for the transportation, meals and lodging expenses provided the two tests are met. The deduction is limited to the federal per diem rate for the meeting site. **The new provision is effective for 2003 and later years.**

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27. H.R. 3365, Sec. 106, amending IRC §134(b)
28. H.R. 3365, Sec. 102(b), amending IRC §134(b)(3)(C)
29. Rev. Ruls. 55-109 and 90-23

Observation. The U.S. government per diem rates can be accessed at www.policyworks.gov/perdiem.

Unreimbursed expenses include:

- Meals,
- Transportation, including auto, and
- Lodging.

Note. A reservist incurring lodging, meal and incidental expenses in excess of the applicable federal government per diem rate may still be able to deduct the excess, but only if the deductions are itemized. In that event, the excess would be subject to the 2% of AGI floor.

For 2003 returns and later, unreimbursed expenses for reservists' travel is first included as an employee business expense on Form 2106 or 2106-EZ, *Employee Business Expense.* Expenses for overnight travel over 100 miles are subtracted from total expenses and are deducted as an above-the-line deduction on Form 1040. The balance of Form 2106 expenses is allowable on Schedule A as a miscellaneous itemized deduction subject to the 2% AGI floor.

How and Where the Deduction Is Claimed

The unreimbursed expenses are deducted on the 2004 Form 1040, line 24. The deduction is limited to the amount the federal government pays its employees for travel expenses. This limitation is referred to as the **federal per diem rate** for the locality where the expenses were incurred.

Example 18. Otto is a full-time auto mechanic in Decatur, IL. He and his family reside in Decatur. He is also a member of the Air National Guard unit in Springfield, IL, which is 45 miles from Decatur. In **2004,** he made 24 round trips to Springfield to attend reserve meetings. He received no mileage reimbursement and incurred no overnight lodging expenses in Springfield.

Question. Is Otto allowed to deduct auto expenses on his 2004 return?

Answer. Yes. However, since he did not incur any overnight travel expenses, he can deduct them only on Schedule A subject to the 2% AGI limitation. Otto must prepare Form 2106 (or 2106-EZ) to report the unreimbursed auto expense amount.

Example 19. Ginger is single. She is employed full-time in Chicago and resides in a Chicago suburb. She is a member of an Army National Guard unit in Rock Island, IL. In **2004**, she made 12 round trips to Rock Island to attend monthly 2-day meetings. She incurred the following unreimbursed expenses to attend the meetings.

Auto mileage		
12 round trips @360 miles	4,320 miles	
Standard mileage rate	× 37.5¢	
Total automobile expense		$1,620
Lodging		
12 Saturday nights at the YWCA @$15 per night		180
Meals		
24 days while in overnight status @$31 (standard meal allowance rate)	$744	
	× 50% limit	
		372
Ginger's total 2004 unreimbursed overnight travel expenses		**$2,172**

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Question A. Is Ginger allowed to deduct her travel expenses on her 2004 return?

Answer A. Yes. She met both tests.

- The Rock Island National Guard complex is more than 100 miles from her Chicago tax home.
- She incurred overnight expenses while away from home.

Question B. Where does Ginger deduct the $2,172?

Answer B. She deducts the $2,172 on line 24 of her 2004 Form 1040 as shown. She must complete either Form 2106 or 2106-EZ to report the $2,172 of allowable expense. Ginger's 2004 Form 2106 and Form 1040 are shown on the following pages.

Form **2106** — **Employee Business Expenses**
▶ See separate instructions.
▶ Attach to Form 1040.
Department of the Treasury Internal Revenue Service (99)
OMB No. 1545-0139 — **2004** — Attachment Sequence No. **54**

Your name	Occupation in which you incurred expenses	Social security number
Ginger	Army Nat'l Guard Sgt.	999 99 9999

Part I **Employee Business Expenses and Reimbursements**

Step 1 Enter Your Expenses		**Column A** Other Than Meals and Entertainment	**Column B** Meals and Entertainment
1 Vehicle expense from line 22 or line 29. (Rural mail carriers: See instructions.)	1	1,620	
2 Parking fees, tolls, and transportation, including train, bus, etc., that **did not** involve overnight travel or commuting to and from work	2		
3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. **Do not** include meals and entertainment.	3	180	
4 Business expenses not included on lines 1 through 3. **Do not** include meals and entertainment.	4		
5 Meals and entertainment expenses (see instructions)	5		744
6 **Total expenses.** In Column A, add lines 1 through 4 and enter the result. In Column B, enter the amount from line 5	6	1,800	744

Note: *If you were not reimbursed for any expenses in Step 1, skip line 7 and enter the amount from line 6 on line 8.*

Step 2 Enter Reimbursements Received From Your Employer for Expenses Listed in Step 1			
7 Enter reimbursements received from your employer that were **not** reported to you in box 1 of Form W-2. Include any reimbursements reported under code "L" in box 12 of your Form W-2 (see instructions)	7		

Step 3 Figure Expenses To Deduct on Schedule A (Form 1040)			
8 Subtract line 7 from line 6. If zero or less, enter -0-. However, if line 7 is greater than line 6 in Column A, report the excess as income on Form 1040, line 7	8	1,800	744
Note: *If* ***both columns*** *of line 8 are zero, you cannot deduct employee business expenses. Stop here and attach Form 2106 to your return.*			
9 In Column A, enter the amount from line 8. In Column B, multiply line 8 by 50% (.50). (Employees subject to Department of Transportation (DOT) hours of service limits: Multiply meal expenses incurred while away from home on business by 70% (.70) instead of 50%. For details, see instructions.)	9	1,800	372
10 Add the amounts on line 9 of both columns and enter the total here. **Also, enter the total on Schedule A (Form 1040), line 20.** (Armed Forces reservists, fee-basis state or local government officials, qualified performing artists, and individuals with disabilities: See the instructions for special rules on where to enter the total.) ▶	10		2,172

For Paperwork Reduction Act Notice, see instructions. Cat. No. 11700N Form **2106** (2004)

For Example 19

Form 1040 Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 2004
IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2004, or other tax year beginning , 2004, ending , 20 | OMB No. 1545-0074

Label (See instructions on page 19.) **Use the IRS label.** Otherwise, please print or type. LABEL HERE

Your first name and initial: **Ginger**	Last name	**Your social security number** 999 99 9999
If a joint return, spouse's first name and initial	Last name	**Spouse's social security number**
Home address (number and street). If you have a P.O. box, see page 19. **103 Ohio Street**	Apt. no.	**Important!** You **must** enter your SSN(s) above.
City, town or post office, state, and ZIP code. If you have a foreign address, see page 19. **Waukegan, IL 60085**		

Presidential Election Campaign (See page 19.)
Note. Checking "Yes" will not change your tax or reduce your refund.
Do you, or your spouse if filing a joint return, want $3 to go to this fund? ▶ You: ☐ Yes ☑ No Spouse: ☐ Yes ☐ No

Filing Status Check only one box.
1 ☑ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 20.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (see page 20)

Exemptions
6a ☑ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a — Boxes checked on 6a and 6b: 1
b ☐ **Spouse** — No. of children on 6c who: • lived with you ___ • did not live with you due to divorce or separation (see page 21) ___
c **Dependents:** — Dependents on 6c not entered above ___

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 21)
			☐
			☐
			☐
			☐

If more than four dependents, see page 21.
d Total number of exemptions claimed — Add numbers on lines above ▶ 1

Income
Attach Forms W-2 and W-2G here. Also attach Form(s) 1099-R if tax was withheld.
If you did not get a W-2, see page 22.
Enclose, but do not attach, any payment. Also, please use Form 1040-V.

7	Wages, salaries, tips, etc. Attach Form(s) W-2		31,000 00
8a	**Taxable** interest. Attach Schedule B if required		300 00
b	**Tax-exempt** interest. **Do not** include on line 8a	8b	
9a	Ordinary dividends. Attach Schedule B if required		
b	Qualified dividends (see page 23)	9b	
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 23)		
11	Alimony received		
12	Business income or (loss). Attach Schedule C or C-EZ		
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		
14	Other gains or (losses). Attach Form 4797		
15a	IRA distributions 15a — b Taxable amount (see page 25)	15b	
16a	Pensions and annuities 16a — b Taxable amount (see page 25)	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		
18	Farm income or (loss). Attach Schedule F		
19	Unemployment compensation		
20a	Social security benefits 20a — b Taxable amount (see page 27)	20b	
21	Other income. List type and amount (see page 27)		
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		31,300 00

Adjusted Gross Income

23	Deduction for clean-fuel vehicles (see page 29)		
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	2,172 00	
25	IRA deduction (see page 29)		
26	Student loan interest deduction (see page 31)		
27	Tuition and fees deduction (see page 32)		
28	Health savings account deduction. Attach Form 8889		
29	Moving expenses. Attach Form 3903		
30	One-half of self-employment tax. Attach Schedule SE		
31	Self-employed health insurance deduction (see page 33)		
32	Self-employed SEP, SIMPLE, and qualified plans		
33	Penalty on early withdrawal of savings		
34a	Alimony paid b Recipient's SSN ▶		
35	Add lines 23 through 34a		2,172 00
36	Subtract line 35 from line 22. This is your **adjusted gross income** ▶		29,128 00

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 77. Cat. No. 11320B Form **1040** (2004)

Note. When reporting 2004 unreimbursed overnight travel expenses for reservists who meet the 100-mile test, consult the revised Instructions for 2004 Form 2106. These instructions were not available at the time of publication. There is a possibility that a letter code, perhaps "RC," should be entered on line 24 for Ginger.

The new provision has several advantages. The expenses for 2003 and later years:

- Are no longer subject to the 2% AGI floor;
- Are allowed for AMT purposes and will not cause AMT problems;
- Reduce AGI and the floor that otherwise may apply to deductions (such as the 7.5% AGI floor for medical expenses) and increase the taxpayer's deductions for those expenses;
- Are not subject to the 3% reduction that applies to certain itemized deductions of high-income taxpayers.

Note. Consideration should be given to filing amended returns for 2003.

Waiver of 10% Penalty on Coverdell ESAs and §529 Plans Distributions

Old Law. IRC §§529 and 530 provide tax-exempt status to qualified tuition programs established and maintained by a state or agency according to specific rules. Contributions to a Coverdell education savings account (ESA) may not exceed $2,000 annually per beneficiary, and may not be made after the beneficiary reaches age 18. Earnings are generally taxable when withdrawn. Distributions are excludable from gross income if they are used for qualified education expenses during the year the distribution is made.

Earnings from an ESA or qualified tuition (§529) plan that are includable in income are generally subject to a 10% penalty tax. The penalty does not apply if the distribution is made because the beneficiary received a scholarship.

Appointees to armed services academies have service obligations. Because of these obligations, appointments to the academies are not considered scholarships for purposes of the 10% penalty waiver on withdrawals from ESAs and §529 plans that are not used to pay qualified education expenses.

Under prior law, if aggregate distributions from a Coverdell education savings account (Coverdell ESA) exceeded the designated beneficiary's qualified education expenses, a portion of the distributions were included in gross income. The taxable portion was the amount of the excess distribution that represented earnings that accumulated tax-free in the account. The recipient paid an additional 10% on the amount included in income (with some exceptions).

New Law. The Act provides that, for tax years beginning after December 31, 2002, the 10% penalty does not apply if the payment or distribution is made to pay for the designated beneficiary's attendance at a service academy: U.S. Military Academy, U.S. Naval Academy, U.S. Air Force Academy, U.S. Coast Guard Academy or the U.S. Merchant Marine Academy.[30]

Note. Regular tax remains due on the taxable portion of the distribution even though the 10% penalty is waived. Also, the exception from the penalty applies to the extent the amount of the payment or distribution does not exceed the costs of advanced education attributable to attendance at the academy. The term "costs of advanced education" is defined at 10 USC §2005(e)(3).

30. H.R. 3365, Sec. 107(a), amending IRC §530(d)(4)(B)(iv)

Contingency Operations in Combat Zones — Filing Extensions

For members of the Armed Forces deployed outside the United States away from the individual's permanent duty station while participating in a contingency operation,[31] the Act provides for the suspension of the period of time for:[32]

- Filing of income, estate or gift tax returns,
- Payment of any income, estate or gift tax or installment (except withholding and employment taxes), and
- Filing of a petition in the U.S. Tax Court.

Other Provisions

The Act broadens the membership base of tax-exempt veterans organizations to include more ancestors and descendants of veterans, servicemen and cadets, allows the IRS to suspend the tax-exempt status of organizations designated as terrorist organizations, and bars charitable deductions for contributions to terrorist organizations whose tax-exempt status has been suspended. The Act also specifies that payments made as a result of a reduction in value of a house due to a military base closing will be a nontaxable fringe benefit (effective for payments made after the date of enactment).

WORKING FAMILY TAX RELIEF ACT OF 2004

On September 23, 2004, both the House and Senate passed the Working Families Tax Relief Act of 2004. As this workbook went to press, the bill was on the way to the President for his signature. The President issued a press release congratulating Congress for passing the bill, consequently, there is little reason to suggest he will not sign the bill.

The intent of the original bill was to extend various tax provisions due to expire. However, the final version not only extends many provisions, it also provides some simplifications and includes technical corrections.

MARRIAGE PENALTY RELIEF

Standard Deduction

The standard deduction for married taxpayers filing a joint return will continue to be twice the standard deduction for a single taxpayer through 2010. Under the old law, it was scheduled to revert back to the amounts proscribed under EGTRRA. After 2010, the standard deduction for taxpayers using the married filing jointly status will revert back to the EGTRRA amounts.

15% Tax Rate

The new law allows taxpayers using the married filing joint status to retain the 15% tax rate on a bracket amount that is equal to twice that of a single taxpayer. This provision reverts back to the EGTRRA amounts after 2010.

CHILD TAX CREDIT

The $1,000 child tax credit scheduled to be reduced in 2005 was extended through 2010. After that time, it will revert back to $500 under the sunset provisions of EGTRRA. Under prior law, the credit is refundable to the extent of 10% of the taxpayer's taxable earned income in excess of $10,750. Under the new law the refundability is increased to 15% of the taxpayer's earned income in excess of $10,750. The income level of $10,750 will also be indexed for inflation.

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31. As defined in 10 USC §101(a)(13)

32. H.R. 3365, Sec. 104(a), amending IRC §7508(a)

For purposes of calculating the refundable portion of the credit, combat pay is treated as earned income. The bill also provides that a taxpayer may elect to treat combat pay that is excluded from income under IRC §112 as earned income for the purpose of computing the earned income credit. The election is available for any tax year ending after the date of enactment and before January 1, 2006. The election [to treat combat pay as earned income for the purposes of computing EIC] is available for any tax year **ending** after the date of enactment and before January 1, 2006. In other words, this election applies to 2004 and 2005 returns.

UNIFORM DEFINITION OF A QUALIFYING CHILD

Under old law, taxpayers received tax benefits from children in various ways. These benefits include the:

- Dependency exemption
- Child credit
- Earned income credit
- Dependent care credit
- Head of household filing status

Unfortunately, each of the above uses different criteria of what qualifies the child for the applicable benefit.

The new bill establishes a uniform definition of a qualifying child for all of the above benefits. A child is a qualifying child of the taxpayer if the child has:

1. The same principal abode as the taxpayer for more than one half of the taxable year,
2. A specific relationship to the taxpayer, and
3. Not reached a specific age.

A tie-breaking rule applies if more than one taxpayer claims a child as a qualifying child.

Under the new law, the old support and gross income tests used in determining dependency does not apply if the uniform definition of a qualifying child is met.

1. Residency Test

The new law requires the qualifying child to have the same abode as the taxpayer for more than one half of the year. Temporary absences due to special circumstances, such as illness, education, business, vacation, or military service are not intended to be treated as absences.

2. Relationship Test

The qualifying child must be the taxpayer's:

- Son or daughter,
- Stepson or stepdaughter,
- Brother or sister,
- Stepbrother or stepsister, or
- A descendent from any of the above individuals.

A child who is legally adopted by the taxpayer, or a child who is lawfully placed with the taxpayer for legal adoption is treated as a child by blood.

3. Age Test

The age test varies depending on the benefit involved. Normally, a child must be under age 19 (or under age 24 for a full-time student) in order to be a qualifying child. No age limit applies for individuals who are totally and permanently disabled at any time during the year. For the dependent care credit, a child must be under age 13, unless disabled. For the child credit, the child must be under age 17, whether disabled or not.

Children Who Support Themselves

Generally, a child who supports himself is not considered a qualifying child of another taxpayer. This rule was retained, except for the purposes of qualifying the other taxpayer for the earned income credit.

Tie-Breaking Rules

If a child can be the qualifying child for more than one taxpayer, there are three tie-breaker rules. An example of this situation is when the child lives with her mother and grandfather.

1. If one of the taxpayers claiming the child is the child's parent, the child is deemed the "qualifying child" of the parent.
2. If both parents claim the child and the parents do not file a joint tax return, the parent with whom the child resides the longest claims the child. If the time period is equal for both parents, then the parent with the highest AGI claims the child.
3. If neither of the child's parents claim the child, then the child is the "qualifying child" of the person he lives with who has the highest AGI.

For taxpayers who claim an individual not meeting the uniform definition of a qualifying child, there is no change to the old law. For example, a taxpayer may claim a parent as a dependent if he meets the gross income and support tests. Under the new law, a grandparent may claim a dependency exemption for a grandchild who does not reside with the grandparent for over one half of the year if:

- The grandparent can prove he furnished more than one half of the child's support, and
- The child's gross income is less than the exemption amount.

The tie-breaking rules do not apply if a child is a qualifying child for more than one taxpayer, and only one eligible taxpayer claims the child.

Children of Divorced or Legally Separated Parents

There is little change to the current law for children of divorced parents. The custodial parent can still waive the right to claim the dependency exemption. Because the child credit requires the child be claimed as a dependent, the waiver also transfers the child credit.

However, under the new law, signing the waiver does not make the child a qualifying child of the taxpayer claiming the dependency exemption for purposes of the earned income credit, the dependent care credit, or head of household status.

Effect of New Law

Dependency Exemption. The qualifying child test eliminates the support test, except for a child who provides more than one half of his own support. The support test was replaced with a residency test. The gross income test no longer applies to a qualifying child.

Earned Income Credit. The definition of a qualifying child is similar to the old law. The requirement that a foster child or certain other children must be cared for as the taxpayer's own child was eliminated. The present tie-breaker rule applicable for the earned income credit is used for purposes of the uniform definition of a qualifying child.

Child Credit. The same relationships are used under both the old and the new law. The requirement that a taxpayer must care for a foster child as his own has been dropped. There is no change to the under 17 years of age requirement, regardless of whether the child is disabled.

Dependent Care Credit. The new law eliminates the requirement that the taxpayer maintain a household in order to claim the credit. Therefore, if other requirements are met, a taxpayer can claim the dependent care credit if the qualifying child lives with the taxpayer more than one half of the year, even if the taxpayer does not provide more than one half of the cost of maintaining the household.

Head of Household Status. Under the new law, a taxpayer is eligible for the head of household filing status only for a qualifying child or an individual for whom the taxpayer can claim a dependency exemption. A taxpayer may claim head of household status if he is unmarried (and not a surviving spouse) and pays more than one half of the cost of maintaining his household which is the principal residence of the qualifying child or dependent for more than one half of the year.

Effective Date

The uniform definition of a qualifying child rules are effective for years beginning after December 31, 2004.

10% TAX RATE

The bill extends the size of the 10% bracket through 2010. For the years 2005 through 2010, the size of the 10% bracket is set at the 2003 level. This is $7,000 for singles, $10,000 for head of household, and $14,000 for married filing joint. These amounts are indexed for inflation based on the 2003 amount. The change to the 10% tax rate is also subject to the EGTRRA sunset date.

ALTERNATIVE MINIMUM TAX EXEMPTION FOR INDIVIDUALS

The bill extends the increased AMT exemption amounts to taxable years beginning in 2005. These amounts are:

Married filing jointly	$58,000
Surviving spouse	58,000
Single	40,250
Married filing separate	29,000
Estate or trust	22,500

MILITARY PROVISIONS

The House bill included a number of items relating to the military, but these items were not included in the final bill.

OTHER PROVISIONS

Extensions

Various provisions due to expire on December 31, 2004 were extended. These include but are not limited to:

- The **research credit** is extended for qualified amounts paid or incurred before January 1, 2006.
- The **work opportunity credit** expired on December 31, 2003. Under the new law it is available for wages paid or incurred for individuals beginning work after December 31, 2003 and the credit continues through December 31, 2005.
- The **welfare-to-work credit** also expired December 31, 2003. It was reinstated for wages paid or incurred beginning after December 31, 2003 and through December 31, 2005.

- The **charitable contribution deduction for corporations contributing computer technology and equipment used for educational purposes** originally expired for contributions made during any tax year beginning after December 31, 2003. The new law extends the credit for qualified contributions made during any taxable year beginning before January 1, 2006.
- The **above-the-line $250 deduction for qualified expenses paid by an eligible educator** was reinstated for tax years beginning in 2004 and 2005.
- Under old law, beginning in 2004, most credits are only allowed to the extent that regular tax exceeds the alternative minimum tax. Only the adoption credit, child credit, and savers credit are allowed to the full extent of regular tax and alternative minimum tax. Under the new law, **nonrefundable personal credits are allowed to the full extent of the regular tax and the alternative minimum tax** for tax years beginning in 2004 and 2005.
- The new law repeals the phase-down of the 10% credit for the purchase of **electric vehicles** that was to begin in 2004. For 2004 and 2005, the taxpayer may still claim all of the 10% credit. For vehicles purchased in 2006, the credit remains at 25% of the allowable credit.
- The new law also repealed the phase-down of the deduction for **clean-fuel burning vehicles** that was to begin in 2004. Taxpayers who purchase clean-fuel burning vehicles in 2004 and 2005 may continue to claim the entire deduction. For vehicles purchased in 2006, the deduction remains at 25% of the allowable deduction.
- The new law also extends **Archer MSAs** through December 31, 2005.

TECHNICAL CORRECTIONS

Medical Savings Accounts

Under the old law, "regular tax" did not include the tax on distributions from an MSA which was not used for qualified medical expenses. Under the new law, these distributions are included. Also, under old law, distributions taken from an MSA are not taken into account when determining the amount of health coverage tax credit an individual is eligible to receive. Under the new law, amounts distributed from an HSA are also not taken into account.

Ex-dividend Date

JGTRRA provided certain provisions for stock purchases which were based on the ex-dividend date. Essentially, the holding period was met if stock was acquired on the day before the ex-dividend date. Under the new law, these dates are extended by one day.

Capital Gains and AMT

The new law contains a provision that the maximum amount of adjusted net capital gain eligible for the 5% rate under the alternative minimum tax is the excess of the maximum amount of taxable income that may be taxed at a rate of less than 25% under the regular tax over the taxable income reduced by the adjusted net capital gain.

Example 20. John and Mary are married with no dependents. In 2003, they have income consisting of $32,000 of salary, $82,000 of long term capital gain from the sale of stock and $73,000 of itemized deductions consisting entirely of state and local taxes and miscellaneous itemized deductions. For regular tax and AMT their income is computed as follows:

	Regular Tax	AMT
Salary	$32,100	$32,100
Long-term capital gain	82,000	82,000
Itemized deduction	(73,000)	
Personal exemptions	(6,100)	
AMT exemption		(58,000)
Taxable income	$35,000	$56,100

For regular tax, the $35,000 is taxed at 5% which is the lesser of taxable income ($35,000), the adjusted net capital gain ($82,000), or the excess of the amount taxed at the 10% and 15% rates ($56,800 in 2003). Therefore, the regular tax is $1,750 or ($35,000 × 5%).

For AMT, $35,000 is taxed at 5% which is the lesser of the amount of adjusted net capital gain taxed at 5% of regular tax ($35,000) or the taxable excess ($56,100). The remaining $21,100 ($56,100 – $35,000) is taxed at 15%. Therefore, the total tentative minimum tax is $4,915 (($35,000 × 5%) + ($21,100 × 15 %).

For AMT under the new law, $56,100 is taxed at 5%, which is the lesser of the taxable excess ($56,100), the adjusted net capital gain ($82,000), or the excess of the maximum amount taxed at the 10% and 15% rates under regular tax ($56,800) less the ordinary taxable income ($0). Therefore, the tentative minimum tax is $2,805 ($56,100 × 5%).

COMPLEXITY ANALYSIS

Part of the IRS Reform and Restructuring Act of 1998 requires a complexity analysis of tax legislation. This analysis includes an estimate of the number of taxpayers affected and the additional complexity it adds to the tax code.

The complexity analysis for the new law is as follows:

	Number of Taxpayers Affected	Additional Complexity
Modifications to child tax and earned income credits	28 million	None
Standard deduction relief	22 million	None
Expansion of 15% rate bracket	19 million	None
10% tax rate for individuals	73 million	None
Uniform definition of qualifying child	40 million	Will be easier

Caution. This analysis of the Working Family Tax Relief Act of 2004 is not all inclusive since the law was not signed into law at the time this workbook was written.

Chapter 14A: American Jobs Creation Act of 2004

Please note. Corrections for all of the chapters are available at www.ace.uiuc.edu/taxschool.

= Effective date prior to 2004

= Effective date part or all of 2004

= Effective date after 2004

INTRODUCTION TO AJCA

The World Trade Organization found the United States guilty of violating fair trade by subsidizing foreign exports via tax breaks. Consequently the European Union began assessing a trade excise tax which increased monthly until Congress repealed the extraterritorial income exclusion. By the time Congress repealed the exclusion, the sanction amounted to a 12% penalty.

What began as a small tax bill to address this issue, ballooned into a gigantic Act containing over 200 provisions. On October 11, 2004, Congress passed the American Jobs Creation Act of 2004 (AJCA) and sent it to the President to sign. The Act contains provisions that both reduce and increase taxes. In general, AJCA is revenue neutral since $145 billion in tax breaks are offset by revenue enhancing provisions. In addition to other provisions, the Act:

- Repeals the extraterritorial income exclusion.
- Creates a new manufacturers' tax deduction.
- Continues the small business enhanced §179 deduction for two more years.

- Narrows the SUV loophole.
- Limits the write-off for personal use of company planes.
- Accelerates leasehold and restaurant depreciation.
- Significantly changes S corporation rules.
- Simplifies international taxation.
- Provides tax relief to farmers.
- Creates an election to deduct sales tax in lieu of state income tax
- Increases penalties on tax shelters.
- Addresses automobile donation rules.
- Contains numerous other provisions.

There are many different effective dates for the different provisions of AJCA. For example, one provision is effective for S corporation stock distributions made after December 31, 1997. Various provisions are effective on the date of enactment, while other provisions do not begin until January 1, 2007.

Secretary of Treasury John Snow commented that the bill is full of special interest provisions. However, as of the date of this publication, the president is expected to sign the bill into law.

Caution. The following does not contain every provision of the American Jobs Creation Act of 2004. The author selected provisions that were applicable to a majority of tax professionals. Readers are encouraged to obtain a complete copy of the Act through their preferred tax research service.

EXTRATERRITORIAL INCOME

IRC §114 REPEALED

AJCA repeals IRC §114, extraterritorial income (ETI), for transactions occurring after December 31, 2004. ETI allowed companies to exclude foreign income from gross income for income tax purposes. The Act provides transition rules for 2005 and 2006. In those years, the excludable amounts will be 80% and 60% of the benefits that would have applied under ETI.

However, 100% of the ETI exclusion will apply indefinitely to most written binding contracts existing on September 17, 2003 that continue to remain in effect.

MANUFACTURERS' DEDUCTION

AJCA creates a new manufacturers' deduction as a replacement for the ETI. This deduction includes a very broad definition of a manufacturer. **It is not necessary for the manufactured product to be exported in order to be eligible for the deduction.** This provision effectively reduces the top tax rate for domestic manufacturers from 35% to 32%. An additional benefit of the new deduction is that it may be used for alternative minimum tax (AMT) purposes.

In 2010, when the provision is fully phased in, the deduction will equal 9% of the lesser of:

- Qualified production activities income for the year, or
- Taxable income for the year (AGI for individuals).

The new deduction is also limited to 50% of the W-2 wages paid during the year.

Phase-in Percentages

2005	3%
2006	3%
2007	6%
2008	6%
2009	6%
2010	9%

Manufacturers are defined to include:

- Traditional manufacturing,
- Construction,
- Construction-related engineering and architectural services,
- Energy production,
- Computer software,
- Films, videotape, and sound recordings, and
- Processing of agricultural products.

Many of the businesses that will benefit from the new deduction never qualified for the ETI exclusion. Businesses will want to look closely to see if they qualify as a manufacturer. For example, a qualified business is allowed to call its coffee roasting process a manufacturing process.

To qualify as manufacturers, producers of agricultural products must store, handle, or provide processing activities other than transportation of the product. The product must also be consumed in connection with or incorporated into the manufacturing, production, growth or extraction of qualifying property. Manufacturing can be done by the taxpayer or some other party.

> **Example 1.** Hi-Grade Dairy Farm produces milk. It processes the milk into ice cream and cheese. A portion of the production is sold at its farm market and restaurant, and part is wholesaled to various outlets. Hi-Grade's receipts must be separated between the wholesale sales and the retail sales to calculate the deduction. However, since its retail sales include products which it produced, it can allocate the wholesale price of the ice cream or cheese included in the retail sales as a part of its wholesale sales.

The IRS will need to issue regulations to clarify much of the detail of this provision.

Effective Date. The provision is effective for tax years beginning after December 31, 2004.

INDIVIDUAL PROVISIONS

DEDUCTION FOR STATE AND LOCAL GENERAL SALES TAXES

Prior to passage of the Tax Reform Act of 1986, taxpayers were able to deduct sales taxes paid as an itemized deduction. This deduction was repealed by TRA of 86.

AJCA will again allow a sales tax itemized deduction in certain cases. Taxpayers will be able to deduct **either** state and local income taxes **or** state and local general sales taxes on their federal tax return, whichever is greater.

To calculate the deduction, taxpayers have two options:

1. They may use actual receipts to document their deduction, or
2. They may use a standard amount taken from IRS tables **plus** actual taxes paid for purchases of motor vehicles, boats, and/or other specific items to be determined by the IRS.

The deduction is a part of the itemized deductions subject to phase-outs for high income taxpayers.

Note. While taxpayers in most states will need to compare income taxes with sales taxes to determine the best deduction, in states with no state income tax they will only need to determine the deductible amount of sales tax. All taxpayers should keep in mind the impact the deduction might have on AMT.

Effective Date. The effective date for this provision is for tax years **beginning after December 31, 2003. This provision expires after 2006.**

CHARITABLE PROVISIONS FOR NONCASH DONATIONS

Individuals who make noncash charitable contributions are generally allowed a deduction based on the fair market value (FMV) of the property. This provision is not applicable to inventory items.

A taxpayer who claims such a deduction is required to keep certain records depending on the value of the donation. The taxpayer should always keep a record showing what was donated, to whom, and the value of the item. For gifts valued between $250 and $5,000, the taxpayer also needs to receive a written acknowledgement from the organization, which identifies the property and includes the value of any goods or services provided to the donor in exchange for the contribution. The written acknowledgement does not have to include the value of the gift. An appraisal is only required if the FMV of the gift exceeds $5,000.

Note. See Chapter 6, Charitable Giving in the *2004 University of Illinois Federal Tax Workbook,* specifically pages 198–199 relating to Contributions of Automobiles.

Donations of Used Motor Vehicles, Boats, and Airplanes

AJCA expands the reporting requirements for donations of vehicles, including boats and aircrafts. If the FMV is over $500, the taxpayer must receive a contemporaneous written acknowledgement from the donee. The acknowledgment must include the:

- Name and identification number of the donor, and
- Vehicle identification number.

If the donee **retains** the vehicle for its own use, the acknowledgement must be provided within 30 days of the donation and must also include:

- A certification stating the intended use of the vehicle, any material improvement intended for the vehicle, and the intended duration of use, and
- A certification that the vehicle will not be sold prior to completion of the intended use or improvement.

If the donee **sells** the vehicle without any significant use or improvement, the acknowledgement must be provided within 30 days of the sale and it must also include:

- A certification that the sale was an arm's length transaction between unrelated parties,
- The selling price of the vehicle, and
- A statement that the donation deduction may not exceed the selling price.

Copies of the acknowledgement must be attached to the donor's tax return and be provided to the IRS by the donee.

AJCA assesses penalties against the donee organization if it fails to provide a contemporaneous acknowledgement or if the acknowledgement is false or fraudulent. The new penalties are:

1. If the donee sells the vehicle without any significant use or improvement, the penalty is the greater of:
   - **a.** The highest §1 tax rate times the sales price shown on the acknowledgement, or
   - **b.** The gross proceeds from the sale.
2. If the acknowledgement is fraudulent for any other reason, the penalty is the greater of:
   - **a.** The highest §1 tax rate times the sales price shown on the acknowledgement, or
   - **b.** $5,000.

Effective Date. These provisions are applicable to donations made **after December 31, 2004.**

Increased Reporting for Other Noncash Charitable Contributions

Under **old law**, if the property had a value of $500 or more, the taxpayer had to maintain a written record which shows the:

- Acquisition date,
- Manner of acquisition, and
- Cost of the property if it was held less than twelve months before being donated.

AJCA expands these requirements. Now donations of similar items, even to different donees, must be aggregated in determining the threshold value. If the total property value exceeds $500, a written description of the property must be included with the return. There are no changes in the reporting requirements for property values over $5,000, except that qualified appraisals must be included with the return if the value is $500,000 or more.

Effective Date. These provisions are applicable to donations made after **June 3, 2004.**

Treatment of Charitable Contributions of Patents and Similar Property

AJCA changed the rules for deducting the value of patents and similar property. These changes are too detailed to list in this publication. Taxpayers who donate this type of property will need to become familiar with the changes.

Effective Date. These provisions are applicable to donations made after **June 3, 2004.**

SALE OF A PERSONAL RESIDENCE ACQUIRED IN A LIKE-KIND EXCHANGE

Qualified taxpayers can exclude the gain from the sale of their personal residence. The exclusion amounts are $250,000 for a single taxpayer and $500,000 for joint filers. To qualify for this exclusion, the taxpayers must have owned and used the residence for two out of the last five years.

> **Note.** The Military Family Relief Act of 2003 allows members of the Armed Forces additional time to qualify for the exclusion. See Chapter 14, New Legislation, pages 588–589 in the *2004 University of Illinois Federal Tax Workbook* for more information.

AJCA modifies these rules. If the principal residence is acquired in a like-kind exchange, the property must be owned for at least five years prior to its sale or exchange in order to exclude the gain. The use requirement is still two years.

Example 2. Old Law. On January 1, 2004, Chris exchanged a rental property in Urbana, IL for a condo in Ft. Meyers, FL. Both properties had a FMV of $500,000. The gain Chris reported on the Urbana property is deferred under like-kind exchange provisions of IRC §1031. He uses the Florida condo as rental property. A few months later, Chris and his wife decide to sell their Urbana residence. They realize a $450,000 gain on the sale, but the gain is not recognized since they meet the two out of five year rule.

Coincidentally, they decide to move into the Florida condo. After living there two years and three months, they sell that property and realize a $300,000 gain. This gain is not recognized because they again meet the two out of five year rule. (However, they would have to report the gain attributable to depreciation claimed on the property while it was being rented.)

New Law. If the Florida property is sold after the date of enactment, they must own the property for five years in order to exclude the gain.

Effective Date. This provision is effective for sales and exchanges **after the date of enactment.**

CIVIL RIGHTS TAX RELIEF

AJCA provides some relief for taxpayers who are awarded damages from a lawsuit where contingent attorney fees are involved. However, the relief only applies to cases involving:

1. A claim of unlawful discrimination;
2. Claims against the federal government under subchapter III of chapter 37 of Title 31, United States Code; or
3. A private cause of action under the Medicare Secondary Payer statute.

Awards from these types of lawsuits are still taxable to the recipient.

Under prior law, any costs related to these awards were only deductible as itemized deductions subject to the 2% AGI limitation. Compounding the problem, the costs were **not** allowed as a deduction for AMT. Consequently, the tax liabilities related to these judgments eroded a large portion of the settlements.

AJCA allows an above-the-line deduction for attorneys' fees and court costs paid by the recipient of the damage award — up to the amount of the taxable award. As an above-the-line deduction, the costs will not be added back into income for AMT purposes.

Effective Date. The deduction applies to all fees and costs **paid after the date of enactment** for any judgments or settlements **occurring after the date of enactment**.

Note. AJCA settles the issue of deductibility of contingent fees **only** for the above types of civil rights suits settled after the date of enactment. Meanwhile, the courts are currently split on the contingent fee issue. The Supreme Court recently announced it will review two cases involving contingent attorney fees.

More information on this topic can be found in Chapter 1, pp. 19–21 and Chapter 13, pages 513–515 of the *2004 University of Illinois Federal Tax Workbook.*

CERTAIN EXPENSES OF RURAL LETTER CARRIERS

Congress changed the deductions available to rural letter carriers twice in the past. Prior to 1997, letter carriers were allowed a mileage deduction for business use of their vehicle equal to 150% of the standard mileage rate less reimbursements. Excess reimbursements were includible in gross income. In 1997, the law changed the method of calculating the allowable automobile expense deduction. Reimbursements for the use of their vehicles were treated as a reimbursement from a qualified plan not subject to taxation. Therefore, by definition, there were no excess reimbursements. However, if expenses exceeded the reimbursed amount they were not deductible.

The new provisions for rural letter carriers allow postal employees to deduct actual automobile expenses that exceed reimbursements as itemized deductions subject to the 2% AGI limit. However, reimbursements in excess of actual costs are still excluded from gross income.

Note. This could provide a large deduction for these employees. Currently, their reimbursement is inflation adjusted, but the base amount was set in 1991. High fuel costs have exceeded the inflation adjustment.

Caution. Rural letter carriers must document their **actual expenses**. The Act does not allow the use of a standard mileage rate for this deduction.

Effective Date. This provision is effective for tax years **beginning after December 31, 2003.**

NATIONAL HEALTH SERVICES CORPS (HNSC) LOAN REPAYMENTS

Health care professionals who participate in the NHSC loan program are eligible to receive up to $35,000 per year to help repay student loans if they provide health care services in specific geographic areas. Under **old law**, they also received a tax assistance payment of 39% of the repayment amount. These payments were taxable income to the recipients and were subject to FICA and FUTA taxes.

AJCA excludes these payments from gross income and employment taxes. Payments received under similar state programs are also excluded. Since the payments are excluded from income, they are not taken into account in determining social security benefits.

Effective Date. This rule applies for payments received in tax years **beginning after December 31, 2003.**

BUSINESS DEDUCTIONS

SMALL BUSINESS EXPENSING (IRC §179)

The IRC §179 limits remain at the levels identified in the 2003 tax act: $100,000 and $400,000, adjusted for inflation **through 2007.** For 2004, businesses can deduct up to $102,000 of purchases provided the total does not exceed $410,000. All other limitations under the prior law continue to apply.

Off-the-shelf computer software continues to qualify for the expensing deduction. A taxpayer may revoke or change a §179 election by filing an amended return for the years 2003 through 2007. This could be especially helpful if the IRS disallows deductions in an audit. Electing §179 at that time could offset the disallowed deductions.

Effective Date. The extension is effective **through December 31, 2007.**

IRC §179 DEDUCTION LIMITED TO $25,000 FOR SUVS

Depreciation on business-use vehicles is generally limited by IRC §280F. Passenger vehicles are subject to the limit if they are rated at 6,000 lbs. **unloaded gross vehicle weight** or less. Depreciation limits for trucks and vans apply when they are rated at 6,000 lbs. **gross vehicle weight (GVW)** or less. Sports utility vehicles (SUVs) are treated as trucks for this purpose. However, since most SUVs are rated at more than 6,000 lbs. GVW, they are not usually subject to these limits.

Note. See Chapter 10, Small Business Issues, pages 354 and 361–364 in the *2004 University of Illinois Federal Tax School Workbook* for an in depth coverage of IRC §179 requirements and depreciation limits for vehicles.

In the year of purchase, qualifying taxpayers may elect the §179 deduction to expense some or all of the cost of personal property purchases used for business.[1] The deduction is limited to $100,000 for tax years 2003 through 2007[2], adjusted annually for inflation. Vehicles under 6,000 lbs. are eligible for IRC §179 expensing only to the extent of the applicable limits. However, under **old law**, taxpayers could elect to deduct the entire cost, up to $102,000 in 2004, of vehicles **over** 6,000 lbs., which were 100% business use.

AJCA limits the §179 deduction to $25,000 for SUVs rated **between** 6,000 lbs. and 14,000 lbs. GVW. For this purpose, an SUV is defined to **exclude** any vehicle that:

1. Is designed for more than nine individuals in seating rearward of the driver's seat;
2. Is equipped with an open cargo area or a covered cargo box, not readily accessible from the passenger compartment, of at least six feet in interior length; or
3. Has an integral enclosure, fully enclosing the driver compartment and load carrying device, does not have seating rearward of the driver's seat, and has no body section protruding more than 30 inches ahead of the leading edge of the windshield.

The following example illustrates the operation of the provision.

Example 3. In December of 2004, a calendar-year taxpayer acquires and places in service an SUV that costs $70,000, with a GVW of 9,000 lbs. All other §179 requirements are met. The taxpayer's current year deduction for the SUV is calculated as follows:

	Deduction	New Adjusted Basis
§179 deduction	$25,000	$45,000 ($70,000 − $25,000)
50% bonus depreciation (50% × $45,000)	22,500	22,500 (45,000 − 22,500)
Regular depreciation [((200% × $22,500) ÷ 5) ÷ 2]	4,500	$18,000 (22,500 − 4,500)
Total 2004 depreciation	$52,000	

The remaining basis to depreciate in future years is $18,000.

Effective Date. The new law is effective for property placed in service **after the date of enactment.**

DEPRECIATION FOR LEASEHOLD IMPROVEMENTS & RESTAURANTS

The depreciable life of qualified **leasehold improvement** property and qualified **restaurant** property is reduced to 15 years **for property placed in service after the effective date of AJCA and before January 1, 2006.** The improvements must be depreciated using the straight-line method.

Qualified leasehold improvement property is defined using the same rules that apply to "bonus" depreciation.[3] These rules include the requirement that the improvements be made to the interior portion of **nonresidential** real property for the exclusive use of the tenant.[4] In addition, **AJCA** prohibits subsequent owners of the real estate from depreciating the improvements over 15 years unless:

1. The property is transferred because of the owner's death,
2. The transfer qualifies under IRC §381(a) (Carryovers of Certain Corporate Acquisitions),

1. IRC §179
2. As extended by AJCA
3. IRC §168(k)(3)
4. See Temp. Reg. §1.168(k)-1T(c) for IRS regulations defining "qualified leasehold improvements."

3. There is a change in the business form. However, the taxpayer must retain a substantial interest in the new business, **or**

4. One of the additional exceptions applies.

Qualified restaurant property means any improvements to IRC §1250 property:

- Made more than three years after the date the building is placed in service, and
- Where more than 50% of the building's square footage is devoted to preparation of, and seating for on-premise consumption of prepared meals.

Note. Qualified restaurant improvements do not have to be **leasehold** improvements and are not limited by the other restrictions that apply to leasehold improvements.

Effective Date. The depreciation provisions are effective for property placed in service **after the date of enactment and before January 1, 2006.**

START-UP COSTS AND ORGANIZATIONAL EXPENSES

Under **old law**, taxpayers could elect to amortize start-up expenditures and organizational expenditures over a period of not less than 60 months, beginning with the month in which the trade or business begins. **Start-up expenditures** are amounts that would have been deductible as trade or business expenses, had they not been paid or incurred before business began. **Organizational expenditures** are those costs incident to the creation of a corporation[5] or the organization of a partnership,[6] that are chargeable to capital.

Most acquired intangible assets (such as goodwill, trademarks, franchises, and patents) are required to be amortized over 15 years beginning with the month in which the intangible was acquired.[7]

AJCA modifies the treatment of start-up and organizational expenditures. A taxpayer will be allowed to elect to deduct up to **$5,000 of start-up** and **$5,000 of organizational expenditures** in the taxable year in which the trade or business begins.

However, each $5,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of start-up or organizational expenditures exceeds $50,000, respectively. Excess start-up and organizational expenditures are amortized over a 15-year period consistent with the amortization period for IRC §197 intangibles.

Effective Date. The provision is effective for start-up and organizational expenditures incurred **after the date of enactment.** Start-up and organizational expenditures that are incurred on or before the date of enactment are still eligible to be amortized over a period not to exceed 60 months.

PERSONAL USE OF COMPANY AIRCRAFT AND OTHER ENTERTAINMENT EXPENSES

Under **old law**, no deduction is allowed for:

- An activity generally considered to be entertainment, amusement or recreation, unless the taxpayer establishes that the item was directly related to the active conduct of the taxpayer's trade or business, or
- A facility (e.g., an airplane) used in connection with such activity.

5. IRC §248
6. IRC §709
7. IRC §197

The Code includes a number of exceptions to the general rule disallowing deductions of entertainment expenses. For example, the deduction disallowance rule does not apply to expenses that are:

- Properly reported by the taxpayer as compensation and wages to an employee, **or**
- Includible in the gross income of a recipient who is not an employee.

The exceptions apply only to the extent that amounts are includible in income of the recipient. In no event can the amount of the deduction exceed the amount of the actual cost, even if a greater amount is includible in income.

In general, the recipient must include the fair value of any fringe benefits less the amount paid by the individual for the benefit. Treasury regulations provide rules regarding the valuation of fringe benefits, including flights on an employer-provided aircraft.

For employers providing an aircraft to employees for personal use, the Courts have ruled that the company can deduct all of the costs of owning and operating the aircraft, even though the expenses are greater than the amounts included in its employees' compensation.[8] This can result in a deduction many times larger than the amount included in the recipients' income. Often, the recipients are owners of the company who directly benefit from the enhanced deduction, resulting in a net deduction for personal use of the company aircraft.

Under **AJCA**, deductions for entertainment expenses are limited to the amount includible in income for certain recipients. Covered recipients include individuals who are related to the company as described in §16(a) of the Securities and Exchange Act of 1934. Such individuals generally include officers, directors, and 10-percent-or-greater owners of the company.

As under **old law**, the amount of the deduction cannot exceed the actual cost and the benefits must be properly reported by the company as compensation.

> **Note.** AJCA is intended to overturn *Sutherland Lumber-Southwest, Inc. v. Commissioner*[9] for covered employees and related parties.

Effective Date. Effective for expenses incurred **after the date of enactment.**

TREATMENT OF NONQUALIFIED DEFERRED COMPENSATION PLANS

Qualified deferred compensation plans allow employers to currently deduct contributions to retirement plan while allowing the employees to defer reporting the income until funds are withdrawn from the plans. **Nonqualified** (NQ) plans are those that do not meet the requirements of IRC §401. For NQ plans, the specifics of each plan control when company contributions are included in gross income of the employees. A variety of tax principles and Code provisions may be relevant in making this determination, including:

- The doctrine of constructive receipt,
- The economic benefit doctrine,
- The provisions of IRC §83 relating to transfers of property in connection with performance of services, and
- Provisions relating specifically to nonexempt employee trusts[10] and nonqualified annuities.[11]

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8. *Sutherland Lumber Southwest, Inc. v. Commr.* 114 TC 179
9. *Sutherland Lumber Southwest, Inc. v. Commr.,* 2001-2 USTC ¶50,503, July 3, 2001
10. IRC §402(b)
11. IRC §403(c)

In general, the timing depends on whether the plan is unfunded or funded. If unfunded, then the compensation is generally includible in income when it is actually or constructively received. If funded, then income is includible for the year in which the individual's rights are transferable or not subject to a substantial risk of forfeiture.

AJCA supplements and consolidates the existing regulations for NQ deferred compensation plans. It also imposes interest assessments and additional taxes on the deferred amounts when the requirements are not met. In addition, wage withholding requirements are clarified by the Act.

Effective Date. The new provisions apply to amounts deferred **after December 31, 2004** and to certain plans modified after October 3, 2004.

7-YEAR RECOVERY PERIOD FOR RACING TRACK FACILITIES

Generally, nonresidential buildings and land improvements are depreciated over 39 and 15 years, respectively. However, for theme/amusement parks these assets are depreciated over only seven years.

AJCA provides a statutory 7-year recovery period for **qualified** permanent motorsports racetrack complexes. For this purpose, motorsports racetrack complexes include land improvements and support facilities, but do not include transportation equipment, warehouses, administrative buildings, hotels, or motels.

Effective Date. This provision is effective for property placed in service **after the date of enactment and before January 1, 2008.** Congress did not intend for this provision to create any inference as to the treatment of property placed in service on or before the date of enactment.

BONUS DEPRECIATION PERIOD FOR NONCOMMERCIAL AIRCRAFT

Due to the extended production period of aircraft, **AJCA** provides criteria under which the entire cost of certain non-commercial aircraft can qualify for bonus depreciation if placed in service before January 1, 2006.

Effective Date. The provision is effective as if included in the amendments made by section 101 of JCWAA, which applies to property placed in service after September 10, 2001. However, because the property described by the provision qualifies for the additional first-year depreciation deduction under present law if placed in service prior to January 1, 2005, the provision only modifies the treatment of property **placed in service during calendar year 2005.**

S CORPORATION REFORM AND SIMPLIFICATION

SHAREHOLDER LIMIT INCREASED

The number of shareholders allowed for an S corporation has been increased from 75 to 100. In addition, all family members can now elect to be treated as one shareholder.

The definition of **"members of the family"** is very broad. It includes the common ancestor, lineal descendants of the common ancestor, and spouses/former spouses of each. An ancestor is not considered a common ancestor if he is **more than six generations** removed from the youngest generation of shareholders who would be members of the family.

Effective Date. These changes are effective for tax years **beginning after December 31, 2004.**

TRANSFER OF SUSPENDED LOSSES INCIDENT TO DIVORCE

Suspended losses caused by insufficient basis are lost when a shareholder transfers the stock to another person. Under the new law, **if the stock is transferred because of divorce to the spouse or former spouse, the suspended losses and deductions are transferred with the stock.**

> **Note.** While the law is not clear, it would seem that if only a portion of the stock were transferred, the suspended losses would be transferred pro rata.

Effective Date. This provision applies to tax years **beginning after December 31, 2004.**

RELIEF FROM INVALID QSUB ELECTIONS AND TERMINATIONS

Under current law, the IRS has authority to grant relief from inadvertently invalid elections and terminations made by S corporations. However, until AJCA, this relief did not apply to qualifying S subsidiaries (QSUBs). Taxpayers usually requested relief in the form of a letter ruling.

Under **AJCA**, the IRS is granted the same authority for QSUBs as for S corporations.

Effective Date. The IRS has this authority for elections and terminations made **after December 31, 2004.**

PASSIVE ACTIVITY LOSS AND AT-RISK AMOUNTS BY QSST INCOME BENEFICIARIES

A qualified subchapter S trust (QSST) may be a shareholder in an S corporation. The QSST's proportionate share of income, losses and deductions from the S corporation pass through to the trust on a Schedule K-1. Typically, the trust then passes the income et al. to the income beneficiary. However, the QSST is the actual owner of the stock and reports the tax consequences on the sale of the stock.

Previously, if the at-risk or passive loss rules limited the amount of losses the beneficiary could deduct, the law was unclear on whether the beneficiary could take the suspended losses in the year of disposition.

Under **AJCA**, a disposition of the stock by the QSST is treated as a disposition made by the beneficiary for purposes of deducting suspended losses. However, any gain or loss from the sale still belongs to the QSST.

Effective Date. This provision applies to any transfers made **after December 31, 2004.**

UNEXERCISED POWERS OF APPOINTMENT REGARDING BENEFICIARIES OF ESBT

Under the **old law**, **any potential** beneficiary of an electing small business trust (ESBT) was considered a shareholder in the S corporation. Beneficiaries were counted as shareholders even when they did not receive distributions.

> **Example 4. Old Law.** If Manny, the ESBT beneficiary, had the power to appoint income or principal to any of his seven grandchildren, all seven were considered shareholders of the S corporation even though they did not exercise the power.

This caused some corporations to be ineligible for S corporation status, either because of the number of persons considered shareholders or because one of the beneficiaries did not qualify to own S corporation stock.

Under **AJCA**, **only** those beneficiaries who actually receive a distribution are counted as shareholders of the S corporation. The Act also grants the trust one year to dispose of stock if the beneficiary would cause the corporation to lose its S status (i.e. if the beneficiary was a nonresident alien.)

Effective Date. This provision applies to tax years **beginning after December 31, 2004.**

EXPANSION OF BANK S CORPORATION ELIGIBLE SHAREHOLDERS TO INCLUDE IRAS

Under **old law**, some banks were not able to elect S corporation status because shareholders in the corporation held bank shares in their IRA accounts. IRAs do not qualify as an exception to the rule that only individuals may be shareholders in an S corporation. In order to get the shares out of the IRAs, the bank had to purchase the stock. This was not a satisfactory solution for some banks.

Under **AJCA**, banks can elect S status even though some of the bank stock is owned by IRAs or Roth IRAs. There are two ways this is accomplished:

- The IRA owner can purchase the stock from the IRA no later than 120 days after the S election, and
- IRAs are allowed to continue owning those shares held on the date of enactment.

There are various requirements which must be met if the IRA sells the stock to the beneficiary.

Effective Date. These provisions take place **on the date of enactment.**

AGRICULTURE PROVISIONS

FARMER INCOME AVERAGING AND AMT

In 1997, Congress created IRC §1301 which allowed farmers to average their farm income in years of high profits. Unfortunately, many farmers have not been able to take advantage of this provision because much of the savings from using income averaging has been offset by the alternative minimum tax.

AJCA excludes income averaging from the definition of regular tax, therefore making it exempt from the AMT calculation. It also expands the definition of farming to include fishing businesses.

Example 5. Don sold more grain than usual this year to pay for his daughter's wedding. His 2004 income tax is $12,000 before calculating the tax using Schedule J, *Farm Income Averaging,* and before AMT. His "tentative minimum tax" is $13,000. After income averaging, his 2004 tax is $9,000 before AMT.

Under the **old law**, even if he used income averaging, his total income tax could not go below the tentative minimum tax of $13,000. Under **AJCA**, his AMT tax will be $1,000 ($13,000 – $12,000). This will be added to his tax after income averaging for a total income tax liability of $10,000 ($9,000 + $1,000)

Effective Date. The provision is effective for tax years **beginning after December 31, 2003.**

SALE OF LIVESTOCK DUE TO WEATHER CONDITIONS

Farmers have **two years** to reinvest the proceeds from sale of livestock due to involuntary conversions, such as disease or weather-related conditions.[12] The livestock must have been held for breeding, dairy, or draft purposes. (Poultry is not eligible under these rules.) Only the income from sales in excess of normal sales qualifies for reinvestment.

Generally, the reinvestment has to be in similar property. However, if it is not feasible to reinvest the proceeds into similar property because of soil contamination or other environmental contamination, the proceeds can be reinvested in dissimilar property, including real estate, as long as the new property is used for farming.[13]

Instead of reinvesting the proceeds, the farmer may elect in some cases to defer reporting the income to the next year.[14] (This deferral is also available for proceeds from livestock **not** held for breeding, dairy or draft purposes, which do not qualify under the reinvestment provisions.) This election is only available to cash basis farmers affected by weather-related conditions in areas designated eligible for assistance by the federal government.

AJCA expands these provisions:

1. The replacement period is increased to **four years** when the area has been designated eligible for assistance by the federal government due to drought, flood, or other weather-related conditions. In addition, if the weather-related conditions continue for more than three years, the IRS can further expand the replacement period.
2. The provision allowing proceeds to be reinvested in dissimilar property is modified to include situations where it is not feasible to purchase similar property because of weather-related conditions. However, real estate only qualifies as replacement property when contamination limits the feasibility of reinvesting in similar property.
3. If the taxpayer decides during the replacement period not to reinvest the proceeds, he may still make a valid election to report the gain in the year following the year of conversion.

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12. IRC §1033(a)(2)(B)(1)
13. IRC §1033(f)
14. IRC §451(e)

Effective Date. These provisions apply to any tax year for which the **due date of the return**, without extensions, is **after December 31, 2002.**

CAPITAL GAIN TREATMENT FOR OUTRIGHT SALES BY LANDOWNERS

Under **old law**, only landowners who retained an economic interest in timber were allowed capital gain treatment on the sale proceeds. This treatment encouraged owners to prefer "cutting contracts" to outright sales of timber.

AJCA allows taxpayers to treat any gain as a capital gain provided all other requirements are met.

Effective Date. The amendments apply to sales made **after December 31, 2004.**

REFORESTATION EXPENSES

Under **old law**, taxpayers could elect to capitalize up to $10,000 ($5,000 for married taxpayers filing separately) of reforestation expenses each year and amortize the expense over 84 months. Any excess expenses were **not** allowed to be carried forward or backward. The taxpayer could also claim a 10% credit on up to $10,000 of qualified amortizable basis in timber property. If the taxpayer claimed both the amortization deduction and the credit, the amount amortized was reduced by half of the credit claimed.

AJCA allows up to $10,000 of qualifying reforestation expenses to be currently deducted. This deduction is limited to $5,000 for married taxpayers filing separately. Any excess expenses are amortized over 84 months, using the mid-year convention. The credit for reforestation expenses is repealed.

Effective Date. These changes are effective for expenses paid or incurred **after the date of enactment.**

FARMER COOPERATIVES

Farmer cooperatives may be exempt from taxation if they are operated for the purpose of marketing their members' products or purchasing supplies and equipment for the members at cost plus expenses. The cooperative is allowed to deduct any patronage dividends it pays its members. The IRS position is that the cooperative is not marketing the members' product if it adds any value to the product. If the cooperative purchases a members' corn and feeds it to livestock, which it then sells, the IRS ruled this is not a marketing function.

Under **AJCA**, the cost of feeding farm animals and the sale of the animals or animal products is considered marketing.

Effective Date. This applies to taxable years **beginning after the date of enactment.**

Note. Section 312 of AJCA restricts which dividends qualify to reduce patronage income effective for distributions after the date of enactment. This provision is not covered in this publication.

USE TAX ON HEAVY HIGHWAY VEHICLES

An annual highway use tax (HUT) is imposed on certain vehicles with gross weight of 55,000 lbs. or more. The tax period is July 1 through June 30. Generally, the tax is paid by the registered owner. State governments are required to receive proof of payment of the use tax as a condition of vehicle registration.

Highway motor vehicles operated on U.S. highways with Canadian/Mexican base plates are subject to the highway use tax at 75% of the usual rate.

For taxpayers permitted to pay the HUT in quarterly installments, the IRS has no procedure for ensuring that installments subsequent to the first one are actually paid. Thus, it is possible for taxpayers to receive state registrations when only the first quarterly installment is paid with the return. Similarly, it is possible for taxpayers to repeatedly pay the first quarterly installment and continue to receive state registrations because the IRS has no system for checking past compliance when it issues certificates of payment for the current year. It is often not cost effective for the IRS to monitor and enforce compliance.

AJCA does the following:

- Eliminates the ability to pay the tax in installments,
- Eliminates the reduced rates for Canadian and Mexican vehicles,
- Requires taxpayers with 25 or more vehicles for any taxable period to file their returns electronically, and
- Permits proration of tax for vehicles sold during the taxable period.

Effective Date. The provision is effective for taxable periods **beginning after the date of enactment** (i.e. July 1, 2005).

IRS PROCEDURES

PARTIAL PAYMENT AGREEMENTS PERMITTED

The old law allowed the IRS to accept installment payments of taxes due. However, certain requirements had to be met to qualify a taxpayer for the installment agreement. In addition, the tax had to be fully paid within 36 or 60 months, depending on the circumstances.

AJCA allows the IRS to accept most installment agreements even when the monthly installment is insufficient to pay the entire liability within 60 months. The IRS is required to review these agreements every two years. Upon review, the IRS can enter into a new agreement which increases or decreases the amount of the payment.

In some situations, the IRS still must collect full payment. The new provisions do not replace offers-in-compromise or closing agreements.

Effective Date. The partial payment provisions apply to payment agreements entered into **on or after the date of enactment.**

COLLECTION AGENCIES

AJCA allows the IRS to use outside collection agencies to collect delinquent taxes. The Act allows collection agencies to arrange payments, negotiate certain types of installment agreements, and collect financial information from the taxpayer. It also establishes required procedures and restrictions for collection agencies to follow.

Effective Date. The provision becomes effective **on the date of enactment.**

DEPOSITS TO SUSPEND INTEREST ON POTENTIAL UNDERPAYMENTS

Many taxpayers want to stop interest charges from accruing while a tax liability is in dispute. The interest charges may be very large depending on the amount of disputed tax liability and the length of time required to settle the dispute.

The only ways taxpayer can avoid underpayment interest is to make a deposit against the tax due **or** pay the tax due and file a claim for refund.

The potential problem with making a payment is that once payment was made, the taxpayer loses the right to take the dispute to Tax Court. In some instances a taxpayer might have a better chance of winning the dispute if it was heard in Tax Court.

If the taxpayer makes a deposit, he is not barred from Tax Court.

Under **old law** no interest was paid on refunded deposits and the IRS could offset other tax liabilities with both deposits and refundable tax payments.

Under AJCA, making the deposit will still allow the taxpayer to take the case to Tax Court. A taxpayer can make a deposit against underpayments of income, gift, estate, excise or generation-skipping taxes which are not assessed at the time of the deposit. If the IRS uses the deposit to pay the disputed tax, the tax is assumed paid at the time the deposit was made. This stops interest charges from accruing on that portion of the disputed liability. The IRS is also required to return the deposit with interest upon written request of the taxpayer, unless it determines that the collection of the tax is in jeopardy. This request can be made at any time.

Taxpayers who have deposits with the IRS as of the date of enactment which were made under Rev. Proc. 84-58 may redesignate the deposit as being made under these provisions.

Effective Date. This provision applies to deposits made **after the date of enactment.**

EXTENSION OF IRS USER FEES

The IRS is authorized to charge user fees for services such as written rulings or determinations. This authorization was scheduled to expire December 31, 2004.

The new law extends the authorization to September 30, 2014.

Effective Date. This provision applies for requests **after the date of enactment.**

CREDITS

FOREIGN TAX CREDIT

Translation of Foreign Taxes

AJCA allows taxpayers to convert to U.S. currency the amount of foreign taxes paid by electing to use either the average exchange rate for the tax year or the exchange rates at the time the taxes are paid. The election applies for all subsequent years unless revoked with the consent of the IRS.

Ten-Year Carryover; One-Year Carryback

U.S. persons may credit foreign taxes against U.S. tax on foreign-source income. The amount of foreign tax credits that may be claimed in a year is subject to limitations that prevent taxpayers from using foreign tax credits to offset U.S. tax on U.S.-source income. The amount of foreign tax credits is limited to the pro rata portion of U.S. tax attributable to foreign income.

In addition, the limitation is calculated separately for various categories of income, generally referred to as “separate limitation categories” or “baskets.” The total amount of the foreign tax credit used to offset the U.S. tax on income in each basket may not exceed that basket’s pro rata share of total income. Credits cannot be applied against other baskets even when the taxpayer does not use all of the limit for each category. The amount of foreign taxes paid in excess of the allowed credit is carried back/forward until used or the credit expires. Excess credits that are carried back or forward are usable only to the extent that the limit in the carry-year has not been exhausted by current year credits within each basket.

Note. Section 404 of AJCA also reduces the number of baskets to two for tax years beginning after December 31, 2006. This change is not covered in this material.

Under **old law**, the excess credit was carried back two years (to the earliest year first) and carried forward five years.

AJCA limits the carryback period to one year and extends the carryforward period to 10 years.

Note. The expected enactment date of the Act is in the fall of 2004. For calendar year taxpayers, the effective date for the new carry**back** period is for excess credits arising in 2005. However, the new carry**forward** period applies to any credits being carried forward to 2004 or later.

Example 6. Dorothy is a calendar-year taxpayer. She has unused foreign tax credits from 1999. These credits are set to expire if not used by 2004 under the **old law**. However, under **AJCA** the carryforward is extended through 2009.

She also has excess credits in 2004. She must first try to carryback the credits to 2002, then 2003. Any remaining unused credits from 2004 are carried forward until they are used or expire after 2014.

Example 7. Ernie is also a calendar-year taxpayer. He has excess foreign tax credits in 2005. These credits are first carried back to 2004, then any remaining unused credits are carried forward up through 2015.

Effective Date. The extension of the **carryforward period** is effective for excess foreign tax credits that may be carried to any taxable years **ending after the date of enactment**; the **limited carryback period** is effective for excess foreign tax credits arising in tax years **beginning after the date of enactment of the provision.**

Foreign Tax Credit Limit for AMT Purposes

Under **old law**, the AMT foreign tax credit is limited to 90% of the AMT. **AJCA** increases the limit to 100%.

Note. The foreign tax credit for AMT purposes is calculated as the pro-rata share of AMT tax using foreign income after AMT adjustments and preferences divided by the total alternative minimum taxable income.

Effective Date. This provision applied to tax years **beginning after December 31, 2004.**

VOLUMETRIC ETHANOL EXCISE TAX CREDIT

Congress included three provisions relating to biodiesel fuels. Two new credits are available to producers of the fuel and consumers who use the fuel in their trade or business. The consumer credit is not allowed if the fuel was purchased in a retail sale.

Effective Date. The credits become available for qualifying fuel purchased **after December 31, 2004.**

SMALL ETHANOL PRODUCER CREDIT TO CO-OP PATRONS

Under **AJCA**, ethanol cooperatives can now pass-through the small producer ethanol credit to its members. The cooperative must make an election each year and the election becomes irrevocable for that year.

Effective Date. The cooperative can make the election for any tax year **ending after the date of enactment.**

OIL AND GAS PRODUCTION FROM MARGINAL WELLS

Under **old law**, there is no credit for the production of oil and gas from marginal wells. The costs of such production may be recovered under the Code's depreciation and depletion rules, and in other cases as a deduction for ordinary and necessary business expenses.

AJCA creates a new, $3-per-barrel credit for the production of crude oil and a $0.50 credit per 1,000 cubic feet of qualified natural gas production. In both cases, the credit is available only for production from a "qualified marginal well." A qualified marginal well is defined as domestic well:

1. Production from which is treated as marginal production for purposes of the Code percentage depletion rules; or
2. That during the taxable year had average daily production of not more than 25 barrel equivalents and produces water at a rate of not less than 95% of total fluid output.

The maximum amount of production on which credit can be claimed is 1,095 barrels or barrel equivalents.

The credit is not available to production occurring if the reference price of oil exceeds $18 ($2 for natural gas). The credit is reduced proportionately as for reference prices between $15 and $18 ($1.67 and $2 for natural gas). Reference prices are determined on a one-year look-back basis.

For production from a qualified marginal well which is also eligible for the "nonconventional sources" credit,[15] no marginal well credit is allowable unless the taxpayer elects not to claim the nonconventional sources credit.

The credit is treated as a general business credit. However, unused credits can be carried back for up to five years rather than the generally applicable carryback period of one year. For tax years **beginning** after 2005, the credit is indexed for inflation.

Effective Date. The provision is effective for production in taxable years **beginning after December 31, 2004.**

CREDITS ALLOWED FOR REGULAR TAX AND AMT

Generally, business tax credits may not reduce the taxpayer's income tax liability below the tentative minimum tax (TMT), in addition to other limitations. Credits in excess of the limitations may be carried back one year and carried over for up to 20 years.

Under the rules for alternative minimum tax (AMT), TMT is the minimum amount of tax the taxpayer will owe after all AMT adjustments, preferences, exemptions, and credits are considered. To the extent the TMT exceeds the regular tax, a taxpayer is subject to the AMT.

AJCA allows the following credits to reduce TMT as well as regular tax liabilities:

1. The Alaska natural gas credit,
2. The alcohol fuels credit,[16] and
3. The credit for electricity/refined coal facilities.[17]

Effective Date. The provision is effective for taxable years **ending after the date of enactment**. However, the IRC §§40 and 45 credits are also added by AJCA and have their own effective dates and other limitations.

CORPORATE PROVISIONS

STOCK OPTIONS AND EMPLOYEE STOCK PURCHASE PLAN OPTIONS

Under the **old law**, if the employee exercised an option and failed to meet the holding period or employment requirements, any gain was included in the individual's income. The employer was also required to withhold applicable taxes.

Under **AJCA**, income from exercising an incentive stock option[18] or employee stock purchase plan[19] option is excluded from social security taxes, railroad retirement taxes, and federal unemployment taxes. Gains from disposing of stock obtained by exercising the options are also excluded from these taxes.

Income tax continues to apply to both. However, the employer is not required to withhold income taxes.

Effective Date. The new law is effective for stock acquired because of options exercised **after the date of enactment.**

15. IRC §29
16. IRC §40
17. IRC §45
18. IRC §422(b)
19. IRC §423(b)

DEFINITION OF CONTROLLED GROUP OF CORPORATIONS

Members of a controlled group of corporations are treated as one entity for purposes of the graduated tax brackets, minimum tax exemption, and accumulated earnings credit. For this purpose, a controlled group of corporations means a parent-subsidiary controlled group and a brother-sister controlled group.

Under **old law,**[20] corporations were considered to be in a brother-sister controlled group if five or fewer persons:[21]

- Owned at least 80% of the total combined voting power of all classes of stock entitled to vote **or** at least 80% of the total value of all stock, **and**
- Owned more than 50% of percent of the total combined voting power of all classes of stock entitled to vote **or** more than 50% of the total value of all stock, taking into account the stock ownership of each person only to the extent the stock ownership is identical with respect to each corporation.

Under **AJCA**, the 80% requirement is eliminated for purposes of IRC §1561, which relates to corporate tax brackets, the accumulated earnings credit, and the minimum tax. The Act does not affect other Code sections or other provisions that refer to the §1563 brother-sister corporation controlled group test.

Effective Date. The provision applies to taxable years **beginning after the date of enactment.**

DEFINITION OF NONQUALIFIED PREFERRED STOCK

In qualified IRC §351 exchanges, no gain or loss is recognized for assets transferred to corporations in exchange for stock of the company. Certain types of preferred stock, called nonqualified preferred stock, do not qualify for nonrecognition. **Preferred stock** is defined as stock that is "limited and preferred as to dividends and does not participate in corporate growth to any significant extent." **Nonqualified preferred stock** is defined as **any preferred stock** if the:

1. Holder **can** require the issuer or a related person to redeem or purchase the stock,
2. Issuer or a related person **is** required to redeem or purchase,
3. Issuer or a related person has the right to redeem or repurchase, and, as of the issue date, it is likely that the right will be exercised, or
4. Dividend rate is tied to interest rates, commodity prices, or similar indices.

AJCA clarifies the definition of nonqualified preferred stock. To avoid having stock classified as preferred, the Act requires that there be a real and meaningful likelihood that the stock will participate in the company's growth. If the stock is not preferred, it can have attributes of nonqualified preferred stock and still qualify for IRC §351 exchanges.

Example 8. The Hoffman Corp. has two classes of stock. Both stocks are entitled to the same dividends. However, Class B of the stock gets preferential treatment on liquidation of the company. If the company does not in fact pay dividends, Class B is considered a preferred stock. If holders of Class B stock also have the right to require the company to redeem the stock, the stock is considered nonqualified deferred stock. Therefore, gains on property exchanged for Class B stock must be recognized at the time of the exchange.

Example 9. The Greenway Corp. has two classes of stock. Class X is entitled to receive the same dividends as declared on Class Y stock. In addition, Class X is entitled to annual dividends based on the commodity price of corn for that year. The Greenway Corp. pays significant dividends on both classes of stock every year. Since Class X stock actually participates in the earnings and profits of the company, it is **not** considered preferred stock. Since it is not preferred, the commodities dividend does not effect the ability of the company to trade Class X stock for property in an IRC §351 exchange.

20. IRC §1563(a)(2)

21. Individuals, estates or trusts

The Conference Committee report states that "no inference is intended as to the characterization of stock under present law that has terms providing for unlimited dividends or participation rights but, based on all the facts and circumstances, is limited and preferred as to dividends and does not participate in corporate growth to any significant extent."

Effective Date. The provision is effective for transactions **after May 14, 2003.**

TREATMENT OF TRANSFERS TO CREDITORS IN DIVISIVE REORGANIZATIONS

IRC §355 permits a corporation (distributing) to separate its businesses by distributing a controlled subsidiary (controlled) tax-free, if certain conditions are met. In cases where the distributing corporation contributes property to the controlled corporation, no gain or loss is recognized if the property is contributed solely in exchange for stock of the controlled corporation (which is subsequently distributed to distributing corporation's shareholders). The contribution of property to a controlled corporation that is followed by a distribution of its stock may qualify as an IRC §368 divisive reorganization.[22] This also applies to certain transactions that do not involve a distribution under IRC §355 and that are considered acquisitive rather than divisive reorganizations.

The contribution in a divisive reorganization is also subject to the rules of IRC §357(c). That section provides that the transferor corporation will recognize gain if the amount of liabilities assumed by controlled exceeds the basis of the property transferred to it.

Because the contribution transaction in connection with this distribution is also a reorganization, it is subject to certain rules applicable to both divisive and acquisitive reorganizations. One such rule[23] is that a transferor corporation will not recognize gain if it receives money or other property and distributes that money or other property to its shareholders or creditors. Under the **old law,** the amount of property that could be distributed to creditors without gain recognition was unlimited.

For these divisive reorganizations, **AJCA** limits the value distributed to creditors without gain recognition to the basis of the assets contributed to a controlled corporation. In addition, AJCA provides that acquisitive reorganizations are no longer subject to the liabilities assumption rules of §357(c).

Effective Date. The bill is effective for transfers and reorganizations occurring **on or after the date of enactment.**

PARTNERSHIP PROVISIONS

PARTNERSHIP LOSS TRANSFERS AND BASIS ADJUSTMENTS

Contributions of Property

Under **old law,** if a partner contributed property to a partnership, generally no gain or loss was recognized to the contributing partner at the time of contribution. The partnership took the property at an adjusted basis equal to the contributing partner's adjusted basis in the property. The contributing partner increased its basis in its partnership interest by the adjusted basis of the contributed property. Any items of partnership income, gain, loss and deduction for the contributed property were allocated among the partners to take into account any built-in gain or loss at the time of the contribution. This rule was intended to prevent the transfer of built-in gain or loss from the contributing partner to the other partners.

If the contributing partner transferred its partnership interest, the built-in gain or loss was allocated to the recipient partner as it would have been allocated to the contributing partner. When the contributing partner's interest was liquidated, there was no specific guidance preventing the allocation of the built-in loss to the remaining partners. Thus, it appeared that losses could be transferred to other partners when the contributing partner was no longer a partner.

22. IRC §368(a)(1)(D)

23. IRC §361(b)

Under **AJCA**, any built-in loss from contributed property may only be taken into account by the contributing partner. In determining allocations to the other partners, the basis of the contributed property is treated as its FMV at the time of contribution. Therefore, if the asset is transferred or liquidated, the partnership's adjusted basis is the FMV at the time of contribution and any built-in loss is eliminated.

Transfers of Partnership Interests

Under **old law**, a partnership did not adjust the basis of partnership property following the transfer of a partnership interest unless the partnership made a one-time **election** under IRC §754 to make basis adjustments. Under the election, adjustments were made for the recipient partner to credit its capital account for the full amount of consideration paid for the partnership interest. These adjustments were intended to adjust the basis of partnership property to approximate the result of a direct purchase of the property by the transferee partner. Under these rules, if a partner purchased an interest in a partnership with an existing built-in loss and no IRC §754 election was in effect, the transferee partner was allocated a share of the loss related to the property.

Under **AJCA**, basis adjustments are **mandatory** if there is a substantial built-in loss. A substantial built-in loss is defined as one where the adjusted basis of the property exceeds its FMV by more than $250,000. However, there are exceptions for specific types of partnerships, such as investment and "securitization" partnerships.

Distributions of partnership property

Under **old law,** partners generally received distributions of partnership property without recognition of gain or loss by either the partner or the partnership. For a distribution in liquidation of a partner's interest, the basis of the property distributed in the liquidation was equal to the partner's adjusted basis in its partnership interest (reduced by any money distributed in the transaction). In a distribution other than in liquidation of a partner's interest, the recipient partner's basis in the distributed property was equal to the partnership's adjusted basis in the property immediately before the distribution, but could not exceed the partner's adjusted basis in the partnership interest (reduced by any money distributed in the same transaction)

Special rules determined the basis of individual properties distributed by a partnership. Adjustments to the basis of the partnership's undistributed properties were not required unless the partnership made the election under IRC §754 to make basis adjustments. Under these rules, a partnership with no §754 election in effect could distribute property with an adjusted basis lower than the recipient partner's proportionate share of the adjusted basis of all partnership property. This would leave the remaining partners with a smaller net built-in gain or a larger net built-in loss than before the distribution.

Under **AJCA,** a basis adjustment under IRC §743(b) is required for a distribution when the adjusted basis of the property is over $250,000 more than the property's fair market value.

Effective Date. These provisions apply to contributions, distributions, and transfers **after the date of enactment** with the exception of transition rules for electing investment partnerships.

BASIS REDUCTION IN STOCK HELD BY PARTNERSHIP IN CORPORATE PARTNER

Under **AJCA**, when applying the basis allocation rules to a distribution in liquidation of a partner's interest, a partnership is prohibited from decreasing the basis of corporate stock of a related entity. Any decrease in basis that would have been allocated to the stock is allocated to other partnership assets. If the decrease in basis exceeds the basis of the other partnership assets, then gain is recognized by the partnership in the amount of the excess.

Effective Date. The provision applies to distributions **after the date of enactment.**

TAX SHELTERS

PENALTY FOR FAILURE TO DISCLOSE REPORTABLE TRANSACTIONS

Reportable Transactions Defined

Regulations under IRC §6011 require a taxpayer to disclose with her tax return certain information about each reportable transaction in which she participates.

There are **six categories of reportable transactions**.

1. Any transaction that is the same as, or substantially similar to, a transaction that is specified by the Treasury Department as a tax avoidance transaction whose tax benefits are subject to disallowance under present law. These are referred to as **listed transactions**.
2. Any transaction that is offered by a paid advisor under conditions of confidentiality. In general, the advisor places a limitation on disclosure by the taxpayer of the tax treatment, tax structure, or tax strategies related to the transaction. This is irrespective if such terms are legally binding.
3. Any transaction for which (a) the taxpayer has the right to a full or partial refund of fees if the intended tax consequences from the transaction are not sustained or, (b) the fees are contingent on the intended tax consequences from the transaction being sustained.
4. Any transaction resulting in a taxpayer claiming a loss (under IRC §165) of at least:
   a. $10 million in any single year or $20 million in any combination of years by a corporate taxpayer or a partnership with only corporate partners;
   b. $2 million in any single year or $4 million in any combination of years by all other partnerships, S corporations, trusts, and individuals; or
   c. $50,000 in any single year for individuals or trusts if the loss arises with respect to foreign currency translation losses.
5. Any transaction resulting in a difference of more than $10 million between its tax treatment and its treatment for book purposes (using generally accepted accounting principles) in any year. This category only applies to certain taxpayers.
6. Any transaction that results in a tax credit exceeding $250,000 (including a foreign tax credit) if the taxpayer holds the underlying asset for less than 45 days.

Penalties for Non-Disclosure of Reportable Transactions

Under **old law**, there was no specific penalty for failing to disclose a reportable transaction. However, such a failure could jeopardize a taxpayer's ability to claim that any income tax understatement attributable to such undisclosed transaction was due to reasonable cause, and that the taxpayer acted in good faith.

AJCA creates a new **penalty** for **failure to disclose** any required information about a reportable transaction. The new penalty applies regardless of whether the transaction ultimately results in an understatement of tax, and applies in addition to any accuracy-related penalty that may be imposed.

Penalty for:	Natural Persons	All Other Taxpayers
Failure to disclose reportable transactions	$ 10,000	$ 50,000
Failure to disclose listed transactions	100,000	200,000

The provision does not define the terms **listed transaction** or **reportable transaction,** nor does it explain the type of information that must be disclosed in order to avoid the imposition of a penalty. Rather, it authorizes the Treasury Department to define a listed transaction and a reportable transaction.

Waivers of Non-Disclosure Penalties

The penalty **cannot** be waived for a listed transaction. As to reportable transactions, the IRS can abate the penalty only if rescinding the penalty would promote compliance with the tax laws and effective tax administration. In deciding whether to rescind the penalty, the IRS will take into account whether:

1. The taxpayer has a history of complying with the tax laws;
2. The violation is due to an unintentional mistake of fact; and
3. Imposing the penalty would be against equity and good conscience.

The decision is not subject to judicial review. However, the taxpayer may ask the court to determine that the transaction did not qualify as reportable. If the case is found in the taxpayers favor, then the penalty could be nullified by the court as not applicable to that transaction.

Other Requirements

The IRS also is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this provision and the reasons for the rescission.

The Act provides that a public entity must disclose certain penalties related to undisclosed transactions in reports to the Securities and Exchange Commission (SEC). This requirement applies regardless of the dollar amount of the penalty. Failure to disclose these penalties to the SEC is also a failure to disclose a listed transaction.

Effective Date. The provision is effective for returns and statements due **after the date of enactment.**

INTEREST DEDUCTION DENIED ON UNDERPAYMENTS FOR NONDISCLOSED REPORTABLE TRANSACTIONS

In general, **corporations** may deduct interest paid or accrued on delinquent taxes.

Congress believes that it is inappropriate for corporations to deduct interest paid to the government for taxes related to certain tax shelter transactions.

AJCA disallows any deduction for interest paid or accrued on any portion of a tax underpayment that arises from an undisclosed listed transaction or from an undisclosed reportable avoidance transaction.

Effective Date. The provision is effective for interest paid or accrued in taxable years **beginning after the date of enactment.**

ACCURACY-RELATED PENALTIES

New Penalty

An accuracy-related penalty applies to the portion of any underpayment that is attributable to:

- Negligence,
- Any substantial understatement of income tax,
- Any substantial valuation misstatement,
- Any substantial overstatement of pension liabilities, or
- Any substantial estate or gift tax valuation understatement.

The penalty is 20% of the understated tax.

Generally, however, the penalty is reduced if:

1. The treatment of the item resulting in the underpayment was supported by substantial authority, or
2. Facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.

Under the **old law**, special rules applied for **tax shelters**. Disclosures of tax shelters did not mitigate the accuracy-related penalty. The penalty could be avoided **only** if the taxpayer established that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This exception was unavailable to corporate taxpayers.

The understatement penalty could be abated (even for tax shelters) in cases where the taxpayer demonstrated that there was **reasonable cause** for the underpayment and that the taxpayer acted in good faith. Reasonable cause existed where the taxpayer reasonably relied in good faith on a professional tax advisor's unambiguous opinion that there was a greater than 50% likelihood of the tax treatment being upheld if challenged by the IRS.

AJCA replaces the rules applicable to tax shelters with a new accuracy-related penalty that applies to listed transactions and reportable transactions with a significant tax avoidance purpose. These tax shelters are referred to as a **reportable avoidance transaction.** The penalty rate and defenses available to avoid the penalty vary depending on whether the transaction was adequately disclosed.

- **Disclosed transactions.** In general, a 20% accuracy-related penalty is imposed on any understatement attributable to an adequately disclosed listed transaction or reportable avoidance transaction. The only exception to the penalty is if the taxpayer satisfies the **strengthened reasonable cause exception (discussed later)**.
- **Undisclosed transactions**. The penalty is 30% of the understatement attributable to undisclosed transactions. In addition, no reasonable cause exception is available (i.e., a strict-liability penalty applies.)

DETERMINATION OF THE UNDERSTATEMENT AMOUNT

The penalty is applied to any understatement attributable to the listed or reportable avoidance transaction without regard to other items on the tax return. The understatement is the sum of:

- The highest applicable tax rate times the increase in taxable income using the proper treatment of the item, and
- The decrease in the total credits which results from proper tax treatment of the item.

Except as provided in regulations, the taxpayer cannot avoid this penalty by amending or supplementing the filed return after the IRS contacts the taxpayer regarding an examination of the return. The IRS may also impose other dates after which amendments/supplements will not decrease the penalty.

STRENGTHENED REASONABLE CAUSE EXCEPTION

The penalty is not imposed under the provision for any portion of an understatement if it is shown that there was reasonable cause for such portion and the taxpayer acted in good faith. Such a showing requires:

- Adequate disclosure of the facts affecting the transaction in accordance with the regulations under IRC §6011,
- That there is or was substantial authority for such treatment, and
- That the taxpayer reasonably believed that such treatment was more likely than not the proper treatment.

For this purpose, a taxpayer is treated as having a reasonable belief concerning the tax treatment of an item only if such belief:

1. Is based on the facts and law that exist at the time the tax return is filed, and
2. Relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that:
   - The return will not be audited,
   - The treatment will not be raised on audit, or
   - The treatment will be resolved through settlement if raised.

A taxpayer may, but is not required to rely on an opinion of a tax advisor in establishing its reasonable belief for the tax treatment of the item. However, a taxpayer may not rely on an opinion of a tax advisor for this purpose if the opinion is:

- Provided by a "disqualified tax advisor," or
- A disqualified opinion.

Disqualified Tax Advisor

A disqualified tax advisor is any advisor who:

1. Is a material advisor, which is defined as one who participates in the organization, management, promotion or sale of the transaction or who is related to[24] any person who so participates,
2. Is compensated directly or indirectly by a material advisor of the transaction,
3. Has a fee arrangement for the transaction that is contingent on all or part of the intended tax benefits from the transaction being sustained, or
4. Has a disqualifying financial interest in the transaction, as determined under IRS regulations.

Organization, Management, Promotion or Sale of a Transaction.

A material advisor participates in the **organization** of a transaction by performing acts related to the development of the transaction. For example, this may include preparing documents which:

1. Establish a structure used in connection with the transaction, such as a partnership agreement,
2. Describe the transaction, such as an offering memorandum or other statement describing the transaction, or
3. Relate to the registration of the transaction with any federal, state or local government body.

Participation in the **management** of a transaction means involvement in the decision-making process of any business activity related to the transaction.

Participation in the **promotion or sale** of a transaction means involvement in the marketing or solicitation of the transaction to others. Consequently, an advisor who provides information about the transaction to a potential participant is involved in the promotion or sale of a transaction, as is any advisor who recommends the transaction to a potential participant.

24. Within the meaning of IRC §§267(b) or 707(b)(1)

Disqualified Opinion

An opinion may not be relied upon if the opinion:

- Is based on unreasonable factual or legal assumptions, including assumptions as to future events,
- Unreasonably relies upon representations, statements, findings or agreements of the taxpayer or any other person,
- Does not identify and consider all relevant facts, or
- Fails to meet any other requirement prescribed by the IRS.

Coordination With Other Penalties

Any understatement upon which the tax shelter penalty is imposed is not subject to the accuracy-related penalty.[25] However, the understatement is included for purposes of determining whether any understatement[26] is a substantial understatement.[27]

Any understatement upon which the tax shelter penalty is imposed is not subject to the valuation misstatement penalties.[28]

The tax shelter penalty does not apply to any portion of an understatement to which a fraud penalty is applied.[29]

Effective Date. The provision is effective for taxable years **ending after the date of enactment.**

TAX SHELTER EXCEPTION TO CONFIDENTIALITY PRIVILEGES

In general, a common law privilege of confidentiality exists for communications between an attorney and client for the legal advice the attorney gives the client. The Code provides that, for tax advice, the same common law protections of confidentiality also apply to a communication between a taxpayer and a federally authorized tax practitioner — to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney. Under **old law**, this privilege did not apply to communications regarding **corporate** tax shelters.

AJCA extends this rule to **all** tax shelters, whether entered into by corporations, individuals, partnerships, tax-exempt entities, or any other entity. Accordingly, communications about tax shelters are not subject to the confidentiality provision of the Code that otherwise applies to communications between a taxpayer and a federally authorized tax practitioner.

Effective Date. The provision is effective for communications made **on or after the date of enactment.**

STATUTE OF LIMITATIONS FOR UNREPORTED LISTED TRANSACTIONS

In general, the Code requires that taxes be assessed within three years after the date a return is filed. If there has been a substantial omission of items of gross income that totals more than 25% of the amount of gross income shown on the return, the period during which an assessment must be made is extended to six years. If an assessment is not made within the required time periods, the tax generally cannot be assessed or collected at any future time. Tax may be assessed at any time if the taxpayer files a false or fraudulent return with the intent to evade tax or if the taxpayer does not file a tax return at all.

25. IRC §6662
26. IRC §6662(d)(2)
27. IRC §6662(d)(1)
28. IRC §§6662(e) or 6662(h)
29. IRC §6663

AJCA extends the statute of limitations for a listed transaction if a taxpayer fails to include on any return or statement for any taxable year any information for a listed transaction which is required to be included[30] with such return or statement. The statute of limitations for such a transaction does not expire before the date which is one year after the earlier of the date:

- On which the IRS is furnished the information so required, or
- That a material advisor[31] satisfies the list maintenance requirements[32] for a request by the IRS. For example, if a taxpayer engaged in a transaction in 2005 that becomes a listed transaction in 2007, and the taxpayer fails to disclose this transaction, then the transaction is subject to the extended statute of limitations.

Effective Date. The provision is effective for taxable years for which the statute of limitations is still **open on the date of enactment.**

TOBACCO REFORM

TERMINATION OF QUOTA AND PRICE SUPPORT PROGRAMS

Under old law, the tobacco program had two main components: a supply management component and a price support component:

1. **Supply Management.** The supply management component limits and stabilizes the quantity of tobacco marketed by farmers. **This is achieved through marketing quotas**. The Secretary of Agriculture raises or lowers the national marketing quota on an annual basis. The Secretary establishes the national marketing quota for each type of tobacco based upon domestic and export demand, but at a price above the government support price. The purpose of matching supply with demand is to keep the price of tobacco high. There is a secondary market in tobacco quota. Tobacco growers who do not have sufficient quota may purchase or rent one.

2. **Price Support.** Given the numerous variables that affect tobacco supply and demand, marketing quotas alone have not always been able to guarantee tobacco prices. Therefore, in addition to marketing quotas, federal price supports are established and guaranteed through the mechanism of nonrecourse loans available on each farmer's marketed crop. The loan price for each type of tobacco is announced each year by the Department of Agriculture using the formula specified in the law to calculate loan levels. This system guarantees minimum prices for the different types of tobacco.

   The national loan price on 2004 crop flue-cured tobacco is $1.69 per pound; the burley loan price is $1.873 per pound.

No-Net-Cost Assessment. In 1982, Congress passed the "No-Net-Cost Tobacco Program Act." The purpose of this program is to ensure that the price support program is run at no-net-cost to the federal government.

When tobacco is not contracted, it is sold at an auction sale barn. At the auction sale barn, each lot of tobacco goes to the highest bidder, unless that bid does not exceed the government's loan price. When the bid does not exceed this price, the farmer may choose to be paid the loan price by a cooperative, with money borrowed from the Commodity Credit Corporation (CCC). In such cases, the tobacco is consigned to the cooperative (known as a price stabilization cooperative), which redries, packs, and stores the tobacco as collateral for the CCC. The cooperative, acting as an agent for the CCC, later sells the tobacco, with the proceeds going to repay the loan plus interest. If the cooperative does not recover the costs of the loans plus interest, the Secretary of Agriculture **assesses** fees on the tobacco industry.

30. IRC §6011
31. IRC §6111
32. IRC §6112

All growers, purchasers and importers of tobacco participate in paying these assessments, regardless of whether they participate in the loan program.

The no-net-cost assessment on 2004 crop flue-cured is $0.10 per pound; the burley assessment is $0.02 per pound. The no-net-cost assessment funds are deposited in an escrow account that is held to reimburse the government for any financial losses resulting from tobacco loan operations.

Over 80% of growers market their tobacco through contracts with tobacco companies. Therefore, these growers do not participate in the loan program. However, they must still pay the no-net-cost assessment when the Secretary levies it. The remaining 20% of growers market their tobacco through the auction system, and are eligible for participation in the loan program. Of this group, over 60% have consistently participated in the loan program during the past several years.

AJCA repeals all aspects of the federal tobacco support program, including marketing quotas and nonrecourse marketing loans. However, to compensate tobacco quota owners and tobacco growers for the loss of the programs, the Act includes buyout provisions. The tobacco buyout provides:

- eligible **quota holders** $7 per pound on their basic quota allotment and
- eligible **growers** $3 per pound based on their effective quota

These transition payments will be paid in equal installments over 10 years. The Act does allow recipients to assign their payments to financial institutions in exchange for up-front lump-sum payments.

The buyout will be funded by assessments on manufacturers and importers of tobacco products. The quarterly assessments will be deposited into the newly formed Tobacco Trust Fund. The following classes of tobacco are covered: Cigarettes, Snuff, Chewing Tobacco, Pipe Tobacco, Roll-your-own tobacco, and Cigars. Individual manufacturers and importers will be assessed according to their market share. Funds from the Tobacco Trust Fund will also be used to pay for program losses incurred by the U.S. Department of Agriculture.

> **Note.** Local FSA and county extension offices will have more information about the processes. In addition, information about the Tobacco Quota Buyout can be found on the University of Kentucky website: www.uky.edu/Ag/TobaccoEcon/policy.html .

Effective Date. The new law first applies to 2005 crops of tobacco.

APPENDIX

Following is the entire list of the provisions included in the American Jobs Creation Act of 2004.

TITLE I. PROVISIONS RELATING TO REPEAL OF EXCLUSION FOR EXTRATERRITORIAL INCOME

Sec. 101. Repeal of exclusion for extraterritorial income.

Sec. 102. Deduction relating to income attributable to domestic production activities.

TITLE II. BUSINESS TAX INCENTIVES

Subtitle A. Small Business Expensing

Sec. 201. 2-year extension of increased expensing for small business.

Subtitle B. Depreciation

Sec. 211. Recovery period for depreciation of certain leasehold improvements and restaurant property.

Subtitle C. Community Revitalization

Sec. 221. Modification of targeted areas and low-income communities for new markets tax credit.

Sec. 222. Expansion of designated renewal community area based on 2000 census data.

Sec. 223. Modification of income requirement for census tracts within high migration rural counties.

Subtitle D. S Corporation Reform and Simplification

Sec. 231. Members of family treated as 1 shareholder.

Sec. 232. Increase in number of eligible shareholders to 100.

Sec. 233. Expansion of bank S corporation eligible shareholders to include IRAs.

Sec. 234. Disregard of unexercised powers of appointment in determining potential current beneficiaries of ESBT.

Sec. 235. Transfer of suspended losses incident to divorce, etc.

Sec. 236. Use of passive activity loss and at risk amounts by qualified subchapter S trust income beneficiaries.

Sec. 237. Exclusion of investment securities income from passive income test for bank S corporations.

Sec. 238. Relief from inadvertently invalid qualified subchapter S subsidiary elections and terminations.

Sec. 239. Information returns for qualified subchapter S subsidiaries.

Sec. 240. Repayment of loans for qualifying employer securities.

Subtitle E. Other Business Incentives

Sec. 241. Phaseout of 4.3¢ motor fuel excise taxes on railroads and inland waterway transportation which remain in general fund.

Sec. 242. Modification of application of income forecast method of depreciation.

Sec. 243. Improvements related to real estate investment trusts.

Sec. 244. Special rules for certain film and television productions.

Sec. 245. Credit for maintenance of railroad track.

Sec. 246. Suspension of occupational taxes relating to distilled spirits, wine, and beer.

Sec. 247. Modification of unrelated business income limitation on investment in certain small business investment companies.

Sec. 248. Election to determine corporate tax on certain international shipping activities using per ton rate.

Subtitle F. Stock Options and Employee Stock Purchase Plan Stock Options

Sec. 251. Exclusion of incentive stock options and employee stock purchase plan stock options from wages.

TITLE III. TAX RELIEF FOR AGRICULTURE AND SMALL MANUFACTURERS

Subtitle A. Volumetric Ethanol Excise Tax Credit

Sec. 301. Alcohol and biodiesel excise tax credit and extension of alcohol fuels income tax credit.

Sec. 302. Biodiesel income tax credit.

Sec. 303. Information reporting for persons claiming certain tax benefits.

Subtitle B. Agricultural Incentives

Sec. 311. Special rules for livestock sold on account of weather-related conditions.

Sec. 312. Payment of dividends on stock of cooperatives without reducing patronage dividends.

Sec. 313. Apportionment of small ethanol producer credit.

Sec. 314. Coordinate farmers and fishermen income averaging and the alternative minimum tax.

Sec. 315. Capital gain treatment under section 631(b) to apply to outright sales by landowners.

Sec. 316. Modification to cooperative marketing rules to include value added processing involving animals.

Sec. 317. Extension of declaratory judgment procedures to farmers' cooperative organizations.

Sec. 318. Certain expenses of rural letter carriers.

Sec. 319. Treatment of certain income of cooperatives.

Sec. 320. Exclusion for payments to individuals under National Health Service Corps loan repayment program and certain State loan repayment programs.

Sec. 321. Modification of safe harbor rules for timber REITs.

Sec. 322. Expensing of certain reforestation expenditures.

Subtitle C. Incentives for Small Manufacturers

Sec. 331. Net income from publicly traded partnerships treated as qualifying income of regulated investment companies.

Sec. 332. Simplification of excise tax imposed on bows and arrows.

Sec. 333. Reduction of excise tax on fishing tackle boxes.

Sec. 334. Sonar devices suitable for finding fish.

Sec. 335. Charitable contribution deduction for certain expenses incurred in support of Native Alaskan subsistence whaling.

Sec. 336. Modification of depreciation allowance for aircraft.

Sec. 337. Modification of placed in service rule for bonus depreciation property.

Sec. 338. Expensing of capital costs incurred in complying with Environmental Protection Agency sulfur regulations.

Sec. 339. Credit for production of low sulfur diesel fuel.

Sec. 340. Expansion of qualified small-issue bond program.

Sec. 341. Oil and gas from marginal wells.

TITLE IV. TAX REFORM AND SIMPLIFICATION FOR UNITED STATES BUSINESSES

Sec. 401. Interest expense allocation rules.

Sec. 402. Recharacterization of overall domestic loss.

Sec. 403. Look-thru rules to apply to dividends from noncontrolled §902 corporations.

Sec. 404. Reduction to two foreign tax credit baskets.

Sec. 405. Attribution of stock ownership through partnerships to apply in determining §§ 902 and 960 credits.

Sec. 406. Clarification of treatment of certain transfers of intangible property.

Sec. 407. United States property not to include certain assets of controlled foreign corporation.

Sec. 408. Translation of foreign taxes.

Sec. 409. Repeal of withholding tax on dividends from certain foreign corporations.

Sec. 410. Equal treatment of interest paid by foreign partnerships and foreign corporations.

Sec. 411. Treatment of certain dividends of regulated investment companies.

Sec. 412. Look-thru treatment for sales of partnership interests.

Sec. 413. Repeal of foreign personal holding company rules and foreign investment company rules.

Sec. 414. Determination of foreign personal holding company income with respect to transactions in commodities.

Sec. 415. Modifications to treatment of aircraft leasing and shipping income.

Sec. 416. Modification of exceptions under subpart F for active financing.

Sec. 417. 10-year foreign tax credit carryover; 1 year foreign tax credit carryback.

Sec. 418. Modification of the treatment of certain REIT distributions attributable to gain from sales or exchanges of United States real property interests.

Sec. 419. Exclusion of income derived from certain wagers on horse races and dog races from gross income of nonresident alien individuals.

Sec. 420. Limitation of withholding tax for Puerto Rico corporations.

Sec. 421. Foreign tax credit under alternative minimum tax.

Sec. 422. Incentives to reinvest foreign earnings in United States.

Sec. 423. Delay in effective date of final regulations governing exclusion of income from international operation of ships or aircraft.

Sec. 424. Study of earnings stripping provisions.

TITLE V. DEDUCTION OF STATE AND LOCAL GENERAL SALES TAXES

Sec. 501. Deduction of State and local general sales taxes in lieu of State and local income taxes.

TITLE VI. FAIR AND EQUITABLE TOBACCO REFORM

Sec. 601. Short title.

Subtitle A. Termination of Federal Tobacco Quota and Price Support Programs

Sec. 611. Termination of tobacco quota program and related provisions.

Sec. 612. Termination of tobacco price support program and related provisions.

Sec. 613. Conforming amendments.

Sec. 614. Continuation of liability for 2004 and earlier crop years.

Subtitle B. Transitional Payments to Tobacco Quota Holders and Producers of Tobacco

Sec. 621. Definitions.

Sec. 622. Contract payments to tobacco quota holders.

Sec. 623. Contract payments for producers of quota tobacco.

Sec. 624. Administration.

Sec. 625. Use of assessments as source of funds for payments.

Sec. 626. Tobacco Trust Fund.

Sec. 627. Limitation on total expenditures.

Subtitle C. Implementation and Transition

Sec. 641. Treatment of tobacco loan pool stocks and outstanding loan costs

Sec. 642. Regulations.

Sec. 643. Effective date.

TITLE VII. MISCELLANEOUS PROVISIONS

Sec. 701. Brownfields demonstration program for qualified green building and sustainable design projects.

Sec. 702. Exclusion of gain or loss on sale or exchange of certain brownfield sites from unrelated business taxable income.

Sec. 703. Civil rights tax relief.

Sec. 704. Modification of class life for certain track facilities.

Sec. 705. Suspension of policyholders surplus account provisions.

Sec. 706. Certain Alaska natural gas pipeline property treated as 7-year property.

Sec. 707. Extension of enhanced oil recovery credit to certain Alaska facilities.

Sec. 708. Method of accounting for naval shipbuilders.

Sec. 709. Modification of minimum cost requirement for transfer of excess pension assets.

Sec. 710. Expansion of credit for electricity produced from certain renewable resources.

Sec. 711. Certain business credits allowed against regular and minimum tax.

Sec. 712. Inclusion of primary and secondary medical strategies for children and adults with sickle cell disease as medical assistance under the Medicaid program.

Sec. 713. Ceiling fans.

Sec. 714. Certain steam generators, and certain reactor vessel heads and pressurizers, used in nuclear facilities.

TITLE VIII. REVENUE PROVISIONS

Subtitle A. Provisions to Reduce Tax Avoidance Through Individual and Corporate Expatriation

Sec. 801. Tax treatment of expatriated entities and their foreign parents.

Sec. 802. Excise tax on stock compensation of insiders in expatriated corporations.

Sec. 803. Reinsurance of United States risks in foreign jurisdictions.

Sec. 804. Revision of tax rules on expatriation of individuals.

Sec. 805. Reporting of taxable mergers and acquisitions.

Sec. 806. Studies.

Subtitle B. Provisions Relating to Tax Shelters

Part I. Taxpayer-Related Provisions

Sec. 811. Penalty for failing to disclose reportable transactions.

Sec. 812. Accuracy-related penalty for listed transactions, other reportable transactions having a significant tax avoidance purpose, etc.

Sec. 813. Tax shelter exception to confidentiality privileges relating to taxpayer communications.

Sec. 814. Statute of limitations for taxable years for which required listed transactions not reported.

Sec. 815. Disclosure of reportable transactions.

Sec. 816. Failure to furnish information regarding reportable transactions.

Sec. 817. Modification of penalty for failure to maintain lists of investors.

Sec. 818. Penalty on promoters of tax shelters.

Sec. 819. Modifications of substantial understatement penalty for nonreportable transactions.

Sec. 820. Modification of actions to enjoin certain conduct related to tax shelters and reportable transactions.

Sec. 821. Penalty on failure to report interests in foreign financial accounts.

Sec. 822. Regulation of individuals practicing before the Department of Treasury.

Part II. Other Provisions

Sec. 831. Treatment of stripped interests in bond and preferred stock funds, etc.

Sec. 832. Minimum holding period for foreign tax credit on withholding taxes on income other than dividends.

Sec. 833. Disallowance of certain partnership loss transfers.

Sec. 834. No reduction of basis under §734 in stock held by partnership in corporate partner.

Sec. 835. Repeal of special rules for FASITS.

Sec. 836. Limitation on transfer or importation of built-in losses.

Sec. 837. Clarification of banking business for purposes of determining investment of earnings in United States property.

Sec. 838. Denial of deduction for interest on underpayments attributable to nondisclosed reportable transactions.

Sec. 839. Clarification of rules for payment of estimated tax for certain deemed asset sales.

Sec. 840. Recognition of gain from the sale of a principal residence acquired in a like-kind exchange within five years of sale.

Sec. 841. Prevention of mismatching of interest and original issue discount deductions and income inclusions in transactions with related foreign persons.

Sec. 842. Deposits made to suspend running of interest on potential underpayments.

Sec. 843. Partial payment of tax liability in installment agreements.

Sec. 844. Affirmation of consolidated return regulation authority.

Sec. 845. Expanded disallowance of deduction for interest on convertible debt.

Part III. Leasing

Sec. 847. Reform of tax treatment of certain leasing arrangements.

Sec. 848. Limitation on deductions allocable to property used by governments or other tax-exempt entities.

Sec. 849. Effective date.

Subtitle C. Reduction of Fuel Tax Evasion

Sec. 851. Exemption from certain excise taxes for mobile machinery.

Sec. 852. Modification of definition of off-highway vehicle.

Sec. 853. Taxation of aviation-grade kerosene.

Sec. 854. Dye injection equipment.

Sec. 855. Elimination of administrative review for taxable use of dyed fuel.

Sec. 856. Penalty on untaxed chemically altered dyed fuel mixtures.

Sec. 857. Termination of dyed diesel use by intercity buses.

Sec. 858. Authority to inspect on-site records.

Sec. 859. Assessable penalty for refusal of entry.

Sec. 860. Registration of pipeline or vessel operators required for exemption of bulk transfers to registered terminals or refineries.

Sec. 861. Display of registration.

Sec. 862. Registration of persons within foreign trade zones, etc.

Sec. 863. Penalties for failure to register and failure to report.

Sec. 864. Electronic filing of required information reports.

Sec. 865. Taxable fuel refunds for certain ultimate vendors.

Sec. 866. Two-party exchanges.

Sec. 867. Modifications of tax on use of certain vehicles.

Sec. 868. Dedication of revenues from certain penalties to the Highway Trust Fund.

Sec. 869. Simplification of tax on tires.

Sec. 870. Transmix and diesel fuel blend stocks treated as taxable fuel.

Sec. 871. Study regarding fuel tax compliance.

Subtitle D. Other Revenue Provisions

Sec. 881. Qualified tax collection contracts.

Sec. 882. Treatment of charitable contributions of patents and similar property.

Sec. 883. Increased reporting for noncash charitable contributions.

Sec. 884. Donations of motor vehicles, boats, and airplanes.

Sec. 885. Treatment of nonqualified deferred compensation plans.

Sec. 886. Extension of amortization of intangibles to sports franchises.

Sec. 887. Modification of continuing levy on payments to Federal venders.

Sec. 888. Modification of straddle rules.

Sec. 889. Addition of vaccines against hepatitis A to list of taxable vaccines.

Sec. 890. Addition of vaccines against influenza to list of taxable vaccines.

Sec. 891. Extension of IRS user fees.

Sec. 892. COBRA fees.

Sec. 893. Prohibition on nonrecognition of gain through complete liquidation of holding company.

Sec. 894. Effectively connected income to include certain foreign source income.

Sec. 895. Recapture of overall foreign losses on sale of controlled foreign corporation.

Sec. 896. Recognition of cancellation of indebtedness income realized on satisfaction of debt with partnership interest.

Sec. 897. Denial of installment sale treatment for all readily tradable debt.

Sec. 898. Modification of treatment of transfers to creditors in divisive reorganizations.

Sec. 899. Clarification of definition of nonqualified preferred stock.

Sec. 900. Modification of definition of controlled group of corporations.

Sec. 901. Class lives for utility grading costs.

Sec. 902. Consistent amortization of periods for intangibles.

Sec. 903. Freeze of provisions regarding suspension of interest where Secretary fails to contact taxpayer.

Sec. 904. Increase in withholding from supplemental wage payments in excess of $1,000,000.

Sec. 905. Treatment of sale of stock acquired pursuant to exercise of stock options to comply with conflict-of-interest requirements.

Sec. 906. Application of basis rules to nonresident aliens.

Sec. 907. Limitation of employer deduction for certain entertainment expenses.

Sec. 908. Residence and source rules relating to United States possessions.

Sec. 909. Sales or dispositions to implement Federal Energy Regulatory Commission or State electric restructuring policy.

Sec. 910. Expansion of limitation on depreciation of certain passenger automobiles.