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RAUPC News

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A New Kid on the Block

The Health Savings Account

By Jay Hanson

Health Savings Account ("HSA") plans are the latest choice of health insurance plans available to both individual and employer consumers. HSAs first became effective in 2004, but were not initially well received for a variety of reasons. However, HSAs are fast becoming one of the most popular insurance benefit products on the market in 2005, and most large-scale employers are now offering HSAs as a health insurance option for their employees. HSAs now offer an additional health insurance alternative for employees, self-employed individuals and other qualified individuals. In addition to providing an alternative in the arena of available health insurance benefits, HSAs also provide additional tax planning opportunities for many of our clients.

What Is an HSA?

An HSA is a type of investment account created exclusively for the benefit of the account holder, the assets of which are made available for the payment of qualified medical expenses. The HSA is structured in a manner very similar to an Individual Retirement Account. The HSA is coordinated with a health insurance policy known as a "High Deductible Health Plan," or HDHP (discussed below), with the goal of offering lower monthly health insurance premium costs and providing assets to pay out-of-pocket medical expenses. An account holder is permitted to contribute funds to his or her HSA on an annual basis, subject to predetermined maximum contribution thresholds. The contributions are then taken as a deduction against taxable income (operating in a manner similar to a deductible Individual Retirement Account contribution). The funds contributed to an HSA grow tax-free and can be withdrawn tax-free for the payment of qualified medical expenses and long-term care insurance premiums.

Who Is Eligible for an HSA?

HSAs are available to any individual under age 65 who is not enrolled in Medicare, is not claimed as a dependent on another individual's income tax return and has no other plan of health insurance (other than certain plans with very limited types of insurance coverage). For married couples, each spouse must have their own HSA as spouses cannot maintain a joint HSA. There are no income limitations imposed on opening an HSA.

What is an HDHP?

An HDHP is a new type of health insurance plan structured with an annual deductible of at least

$1,000 for individual coverage or an annual deductible of $2,000 for family coverage. The maximum out-of-pocket expenses with respect to an HDHP for medical expenses, including the annual deductible, cannot exceed $5,100 for individual coverage and $10,200 for family coverage. These limitations are increased annually for cost of living adjustments.

How Are HSA Contributions Taxed?

Contributions to an HSA are taken as an "above-the-line" deduction in determining a taxpayer's adjusted gross income. There is no phase-out based on the account holder's income; therefore, each dollar contributed to an HSA reduces a dollar of taxable income. Employer contributions are excludible from an employee's gross income. Earnings on HSA assets are not currently taxable, nor are the distributions made from an HSA which are used to pay qualified medical expenses. However, a tax of 6% is imposed on any contributions made to the HSA which are above the annual contribution limits. Contributions to an HSA may be made until April 15th following the close of the preceding tax year (*e.g.,* April 15, 2005, for 2004 tax deduction purposes). The maximum annual contribution to an HSA for 2005 is the *lesser* of the annual deductible under the HDHP or $2,650 for individual coverage, or $5,250 for family coverage. Individuals over age 55 are permitted to make an additional $500 contribution.

How Are HSA Distributions Taxed?

Distributions from an HSA which are used to pay for the qualified medical expenses of the account holder, his or her spouse or dependents are not included in the account holder's income. Qualified medical expenses include health insurance deductibles, co-payments, physician and hospital costs and other expenses related to prescription drugs, over-the-counter first aid and medical supplies. Items not generally covered include cosmetics, non-prescription foods, vitamins and non-prescribed weight loss items. Additionally, HSA distributions

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IRS Issues New Rules on Tax Advice

By Jay Hanson

The United States Treasury Department has issued new rules which will affect how we as tax professionals communicate with our clients. The rules, which took effect on June 20, 2005, are generally applicable whenever a tax practitioner provides written advice on tax issues to a client. Written advice can be in the form of e-mails, faxes, text messages and letters. The rules of practice which a tax practitioner must now follow require the dispensing of most tax advice to either be accompanied by an exhaustive analysis of the facts and law attendant to a particular transaction or be accompanied by a disclaimer that the particular tax advice cannot be relied upon to avoid the imposition of IRS penalties. Unfortunately, given the broad sweep of the revised rules, many tax practitioners have decided that the only safe way to avoid professional sanctions under the revised rules is to include a disclaimer regarding penalties on all written tax advice given to clients.

While the revised rules are motivated by the government's well-founded concern with curbing abusive tax shelters, the rules will apply to advice given on many common and accepted transactions. The new rules particularly address the practice of tax shelter promoters obtaining boiler-plate opinions for their marketed tax shelters. Taxpayers engaging in abusive tax shelter transactions use these types of opinions in an attempt to escape tax penalties of 20% or more, on top of what they owe in taxes, by claiming they "reasonably" and "in good faith" relied upon the tax opinion for their belief that the transaction was permissible under the law. Under the revised rules, taxpayers cannot rely on a tax opinion for protection from penalties unless the tax practitioner provides a comprehensive and exhaustive opinion which considers and discusses all the relevant facts and applicable law, the relationship between the facts and the law, a conclusion as to the legal consequences of each tax issue, and the likelihood that the taxpayer will prevail if the IRS challenges the transaction.

The revised rules also apply to tax advice for transactions which have a "significant purpose" or "principal purpose" of tax avoidance. These standards are vague and uncertain, in large part because the Treasury Department did not want to create any loopholes. It is arguable that most tax-advantageous transactions are structured and entered into principally to avoid the imposition of federal taxation. Consequently, the revised rules may sweep in many routine, non-abusive transactions. The penalties to practitioners can be severe, including disbarment from practice before the IRS, for providing written advice that does not meet either the comprehensive analysis requirements described above or include a disclaimer regarding penalties. It is for this reason that many, if not most, tax practitioners are opting to include disclaimer language that the tax advice included in written communications cannot be relied upon to avoid the imposition of IRS-imposed penalties.

Because of the new rules, the cost of securing a comprehensive opinion (*i.e.,* an opinion without a disclaimer which can be relied upon to avoid penalties) will be significantly higher. An alternative to writing an expensive comprehensive opinion is to include a disclaimer on written tax advice furnished to the client. This disclaimer will state that a client cannot rely on the opinion for protection from tax penalties. Accordingly, effective this month, RAUPC will routinely include the following language in its written communications:

> *Please be advised that, based on current IRS rules and standards, the advice contained herein is not intended to be used, nor can it be used, for the avoidance of any penalty that the IRS could assess related to this matter. Please do not hesitate to contact me if you have any questions regarding this matter.*

Just because a disclaimer is placed in a written communication does not mean that a taxpayer is without recourse if the IRS imposes penalties on a particular tax transaction; a taxpayer is still afforded defenses to penalties. Additionally, for certain transactions a comprehensive opinion would be drafted to protect the taxpayer from the imposition of penalties. However, the usual course of business will dictate the usage of a disclaimer in most written tax advice.

Please be assured that we will continue to act diligently to meet your needs and the use of this disclaimer in our written advice does not change the quality of our service and the quality of the advice you have come to expect from us. If you have any questions about this important development, please contact our office.

Given the broad sweep of the revised rules, many tax practitioners have decided that the only safe way to avoid professional sanctions under the revised rules is to include a disclaimer regarding penalties on all written tax advice given to clients.

Proposed Treatment of Partnership Interests

By Derek Hayner

In a reversal of prior treatment, the IRS has issued proposed regulations to treat the receipt of a profits interest in a partnership as a taxable event. In a 1974 Circuit Court case, the court held that under the law, the receipt of a profits interest was taxable. However, the IRS has been reluctant to apply its conclusion and even issued two separate Revenue Procedures, which held that the receipt of a profits interest is not taxable to the service provider. In the past, the receipt of a capital interest in a partnership was a taxable event.

The proposed regulations apply Section 83 of the Internal Revenue Code to all partnership interests, without distinguishing between partner capital or profits interests. Section 83 generally applies to a transfer of property by one person to another in connection with the performance of services. Since all partnership interests constitute personal property under state law and give the holder the right to share in future earnings from partnership capital and labor, the IRS does not believe there is any reason to distinguish between them for purposes of Section 83. Commentators and the IRS believe that the proposed regulations will stop any exploitation of the tax differences between a capital or profits interest.

Under Section 83, the amount of compensation to be included in income by the service provider (increasing their capital account) and deducted generally

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We're Back to a Washington Estate Tax!

By Jay Hanson

If you blinked you may have missed the period in which Washington State did not have a state-level estate tax in place. On February 3, 2005, the Washington State Supreme Court decided in *Estate of Hemphill v. Dep't of Revenue* that the Washington State estate tax as administered was an invalid tax not authorized under state law. The court's ruling in *Estate of Hemphill* required the Washington State Department of Revenue to refund all estate taxes collected since the tax was initially imposed on January 1, 2002. The effective result of the decision in *Estate of Hemphill* was the elimination of the Washington State estate tax.

Fast forward two months. The elimination of the Washington State estate tax only helped to compound the state's already growing revenue shortfalls, and replacing the loss of the estate tax's revenue generation was actively sought. At the urging of Governor Christine Gregoire, a bill creating a stand-alone Washington State estate tax was introduced into the legislature earlier this year. The bill titled "Engrossed Senate Bill 6069" and commonly known as the "Estate and Transfer Tax Act" passed both the House and Senate in late April of this year. This bill was signed into law on May 17th by Governor Gregoire. As a result, anyone passing away on or after May 17th will now be subject to the Washington State estate tax. To the relief of the heirs of the already deceased, there will be no retroactive application of the law; therefore, the estate of a decedent who passed away prior to May 17th will not be subject to the new law.

This tax is here to stay regardless of what changes happen to occur at the federal level.

The Estate and Transfer Tax Act creates a new stand-alone estate tax and replaces the estate tax invalidated by the *Estate of Hemphill* decision. This new estate tax will continue even if the federal estate tax is revised or repealed; therefore, this tax is here to stay regardless of what changes happen to occur at the federal level. Until 2009 the Washington State estate tax exemption (*i.e.,* the amount which can pass without the imposition of estate tax) will be consistent with the federal estate tax exemption. Therefore, in 2005 $1,500,000 can pass free of estate tax and in 2006 and thereafter $2,000,000 will be able to pass free of estate tax. In 2009 $3,500,000 will be able to pass free of estate tax at the federal level while Washington State will permit $2,000,000 to pass free of estate tax. This disconnect of $1,500,000 between the amount which can pass free of the tax at the federal level versus the state level is something we will need to help our clients plan for.

The Estate and Transfer Act creates a higher estate tax rate than what was present prior to passage of this new law. The new, higher rate table starts at 10% for the first $1,000,000 of Washington taxable estate assets and then tops out at 19% for a Washington taxable estate in excess of $9,000,000. There is no cap on the amount of an estate subject to the 19% tax bracket. The new rates of tax, even at the lowest bracket, make the Washington State estate tax a formidable presence in terms of its erosive effect on one's estate. Even if the federal estate tax is repealed as planned in 2010, in its place will exist a carryover basis regime where a limited amount of a decedent's property will receive a step-up in its cost basis. Property not allocated a step-up in cost basis will then have a cost basis in the hands of an heir equal to that of the decedent. Federal law as currently written would allow a step-up in the cost basis of a decedent's property up to $1,300,000 for property passing to any heir (with an additional $3,000,000 for property passing to a surviving spouse). Upon the sale of inherited property, the difference between the fair market value of the property in the hands of the heir and that property's cost basis will be taxed as long-term capital gain in the hands of the heir. Even with a 15% capital gains rate (which is scheduled to rise back to 20% by the time the federal estate tax is repealed in 2010), estate property could be subject to as high as a 34% tax between state and federal estate taxation (or 39% if capital gains rates rise back to 20%). This illustrates the tax bite estate property can face even in an environment free of federal estate tax and means that some families may stand at a great disadvantage if a decedent's estate is comprised of highly appreciated assets not sufficiently covered by the allocation of available basis step-up.

What should you do at this point? We understand that there have been so many changes on both the federal and state estate tax fronts in recent years that it is

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cannot be used to pay the HDHP premiums but distributions can be used to pay long-term care insurance premiums. Distributions not used to pay qualified medical expenses are subject to both income taxation and an additional 10% penalty tax. Distributions can be made for any reason without the imposition of the 10% tax if made on account of the account holder's death, disability, or after the account holder attains age 65 and becomes eligible for Medicare.

Benefits of HSAs

HSAs have the potential for being a beneficial health insurance alternative in the following situations:

- ✓ If the account holder and his or her family are healthy and expect minimal medical expenses, the HSA's assets are permitted to accumulate and grow tax-free over time. Over time an HSA can grow to become a somewhat sizable account to be made available for a variety of purposes.
- ✓ If the account holder and his or her family expect large but non-chronic medical expenses within a one-to-two-year period, the HSA assets can be used to subsidize the HDHP deductible and out-of-pocket medical expenses with tax-deductible contributions and tax-free HSA distributions. The HSA under these circumstances helps to absorb the payment of expenses which would need to be paid under any other health insurance plan (*e.g.,* co-payments, deductibles and out-of-pocket expenses). However, a chronic illness will deplete the HSA over time, taking away the benefit of the tax-free build-up of account assets over time.
- ✓ Provides the account holder and his or her family a measure of tax-subsidized self-insurance while capping catastrophic insurance costs through an HDHP.
- ✓ Creates an additional retirement planning opportunity as the unused HSA assets can be distributed from the HSA for any purpose when the account holder attains age 65 without the imposition of the 10% penalty tax.
- ✓ For employers, HSAs offer the promise of lowering an employer's out-of-pocket costs in regards to outlays for employee health insurance premiums. HDHPs feature lower overall premium structures than traditional low-deductible health insurance plans. Employers also have the ability to determine the level of employer contributions to be made to an employee's HSA, if any (such contributions are deductible by the employer). This funding mechanism effectively allows an employer to scale the level of health insurance benefits an employer offers to their employees. For example, an employer can contribute the maximum contribution amount to an employee's HSA, thereby permitting the employee to subsidize many health care expenditures through the employer contributions. Alternatively, an employer could scale down contributions to an employee's HSA to control the employer's health insurance costs.

In an environment where health care expenses are experiencing double-digit growth, the arrival of an additional heath insurance alternative is welcome. For certain individuals, an HSA has the potential to be the right type of health insurance product, but each individual needs to assess his or her own heath insurance needs. For our clients who currently self-insure their health care expenses, the HSA is a great opportunity to cap catastrophic expenses while receiving a bit of tax relief. For our clients in great health, an HSA can be an opportunity to create a tax-advantaged account to cover the occasional out-of-pocket co-payment with the goal of growing the HSA over time for use in retirement. If you would like to discuss whether an HSA may be an option worth exploring, please contact our office and we'll be happy to explore the options with you.

In an environment where health care expenses are experiencing double-digit growth, the arrival of an additional health insurance alternative is welcome.

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by the partnership is the fair market value of the partnership interest. Because it can be difficult to value a partnership interest, the IRS is proposing to allow partnerships to elect to use a safe harbor amount equal to the "liquidation value of the interest." This is the amount of cash that the holder of that interest would receive with respect to the interest if, immediately after the transfer of interest, the partnership sold all of its assets at fair market value for cash, and then liquidated. The election must be filed with the IRS within 30 days after the date the property was transferred. In addition, one copy must be submitted with the service provider's income tax return.

For example, if equal partners A and B, with assets worth $100 and a basis of $50, allow C to join the partnership for a 10% future profits interest of the partnership, in exchange for his services, C would have to report $0 of income for the receipt of the interest. Since C is only entitled to a future profits interest, the $50 of built-in gain would be allocated to A and B under the deemed liquidation, leaving $0 to be distributed to C upon liquidation.

Using the same example, if C were to have received a 10% interest in all of the income of the partnership, C would have to report $5 of income for the receipt of the interest. Upon a deemed liquidation, the partnership would report $50 of income, of which $5 would be C's portion and thus his "liquidation value of the interest."

These regulations are currently only "proposed" and therefore will only apply to transfers of property on or after the date final regulations are published in the Federal Register. Since the public hearing is scheduled for October 5, 2005, we anticipate they will not be effective until the end of 2005.

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Given the high rates of tax imposed on property subject to the Washington State estate tax, planning for this tax will become a necessity for nearly all of our clients with property located within Washington State.

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difficult to comprehend whether planning seems to make a difference. Yes, planning for these changes does make a difference. However, we empathize with our clients' frustration in having to consistently make changes to their estate planning documents. One thing we can say is that, barring a successful initiative to strike down the Washington State estate tax (one can hear Tim Eyman scribing an initiative at this moment), or the success of the lawsuit already filed challenging the validity of the estate tax, the Washington State estate tax is likely here to stay. Given the high rates of tax imposed on property subject to the Washington State estate tax, planning for this tax will become a necessity for nearly all of our clients with property located within Washington State. There are several active planning tools we can use to help alleviate the impact of the estate tax including gifting strategies and the movement of both property and people outside of Washington State. Additionally, your estate planning documents will need to be assessed to determine whether the current language in those documents takes into account your planning goals and the impacts imposed by the creation of this new tax.

As always, we are here to answer all of your questions regarding the impact the Washington State estate tax may have on your estate plan. Whether we've assisted you in the past with the preparation of your estate plan or not, we can assist you with navigating these seas of change for both federal and Washington State estate tax purposes. Please contact our office for further assistance

RAUPC Stats

Trivia by the Numbers

By Amy Bockelman

Collective number of miles we at RAUPC commute to and from the office each day	152.58
Average two-way commute, in miles	21.80
Number of times FedEx attempted to deliver a six-foot-tall modern art "totem pole" that we absolutely, positively did not order or even consider ordering	3
Approximate time, in minutes, that it took us to figure out what it was when we opened it upon the first delivery	45
Number of catalogs we receive at the office	23
Number of those catalogs that are not office/business supply catalogs	8
Cumulative weight, in pounds, of tax returns mailed to clients in March and April of this year (does not include returns sent by FedEx or other courier)	62.19
Cans of soda we consumed during busy season	304
Estimated ratio of espresso machine usage to regular coffee machine usage in the office	12:1
Number of slate tiles in our lobby (includes partial tiles)	330
Percentage of RAUPC employees who own a dog and/or cat	100
Ratio of dogs owned to cats owned	2:1
Number of different software manuals Amy has at her desk for just one collection of software	11
Approximate percentage of time spent referencing those manuals that has actually yielded a clear answer	20

Tax Events Calendar

Date	Taxpayer	Event
July 15, 2005	Partnerships	Last day for filing prior-year income tax return (Form 1065 series) by calendar-year partnerships that obtained an automatic three-month extension of time to file. Last day for filing Form 8800 to request an additional three-month extension of time to file.
August 15, 2005	Individuals	Last day for filing previous-year income tax return (Form 1040 series) by calendar-year individuals who obtained an automatic four-month filing extension. Last day for filing Form 2688 to request an additional two-month extension of time to file.
August 15, 2005	Nonprofits	Last day for filing prior-year income tax returns (Form 990 series) by nonprofit organizations who obtained an automatic three-month extension of time to file. Last day for filing Form 8886 to request an additional three-month extension of time to file.
September 15, 2005	Individuals	Third installment of current-year estimated tax by individuals is due (Form 1040-ES).
September 15, 2005	Corporations	Last day for filing previous-year income tax return (Form 1120 series) by calendar-year corporations that obtained an automatic six-month filing extension.
September 15, 2005	Corporations	Due date for depositing at least 80% of the third installment of current-year estimated income tax by corporations (use Form 1120-W to determine estimated tax liability).

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