TaxTips

Keeping You Informed • Summer 2010

From your friends at

Maco & Associates

740 W. Main St. Suite 3 • Collegeville, PA 19426
610.489.7215 • info@macoassociates.com
www.macoassociates.com

Want to Save for Future Medical Expenses?

Consider opening a Health Savings Account

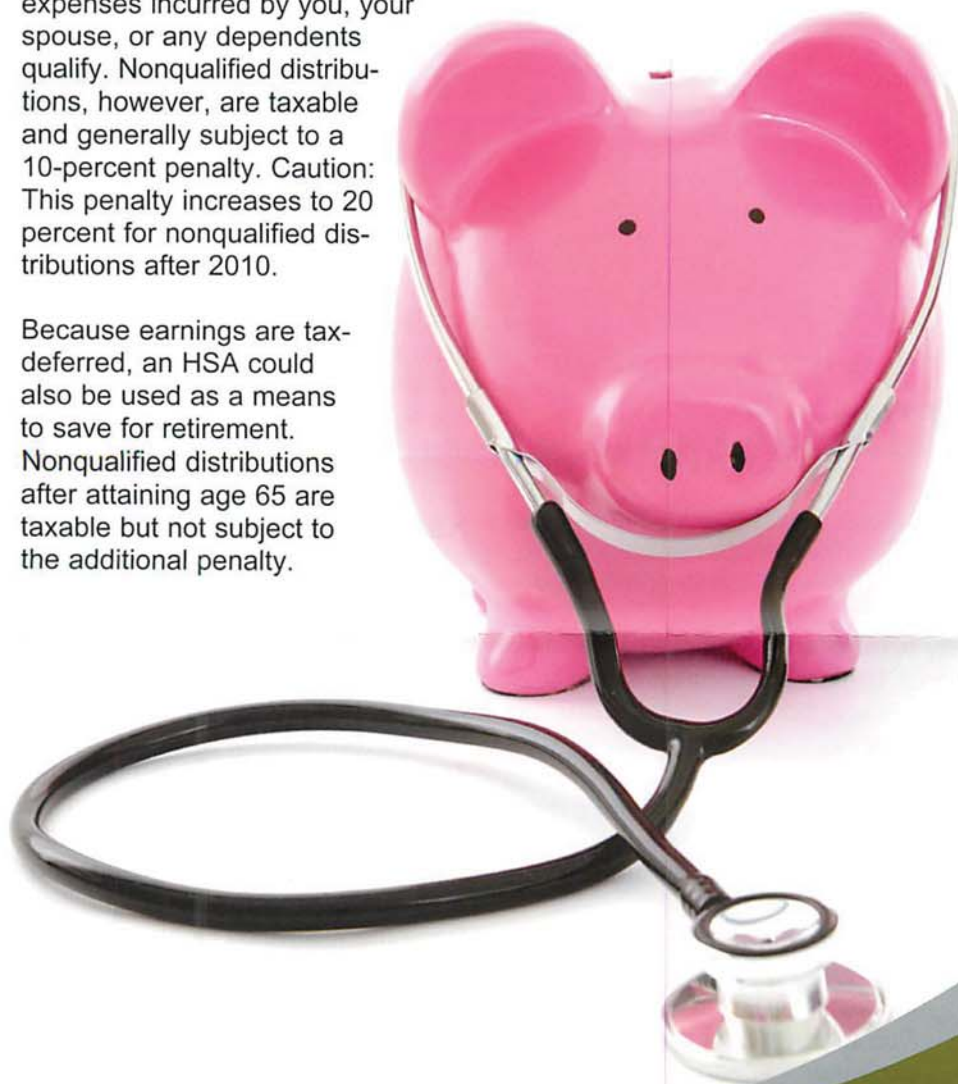
If you are covered under a high deductible health plan, you may be eligible to make tax deductible contributions to a Health Savings Account (HSA). Contributions may remain in the account from year-to-year until you use them and can generate tax-deferred or tax-free earnings. An HSA is "portable" so it stays with you if you change employers or leave the work force. Also, the interest or other earnings on the assets in the account accumulate tax free.

For 2010, you can contribute up to:

- $3,050 if you have self-only coverage with an annual deductible of not less than $1,200 and your annual out-of-pocket expenses do not exceed $5,950.
- *$6,150 if you have family cover-*age with an annual deductible of not less than $2,400 and your annual out-of-pocket expenses don't exceed $11,900.
- $1,000 in catch-up contributions for individuals age 55 or older.

You can receive tax-free distributions from your HSA to pay for any qualified medical expenses for the current or prior year as long as the expenses were incurred after the HSA was established. Most medical expenses incurred by you, your spouse, or any dependents qualify. Nonqualified distributions, however, are taxable and generally subject to a 10-percent penalty. Caution: This penalty increases to 20 percent for nonqualified distributions after 2010.

Because earnings are tax-deferred, an HSA could also be used as a means to save for retirement. Nonqualified distributions after attaining age 65 are taxable but not subject to the additional penalty.



Over-the-Counter Drugs

Get reimbursed before it's too late!

In 2010, you may receive a nontaxable reimbursement from a health flexible spending account (FSA) or a health reimbursement arrangement (HRA) for qualified medical expenses, including expenses incurred for over-the-counter drugs. In addition, you may take nontaxable distributions from a health savings account (HSA) or an Archer medical savings account (MSA) for over-the-counter drugs.

However, due to changes made by the *Affordable Care Act*, after 2010 over-the-counter drugs no longer qualify as a medical expense unless they are prescribed. In other words, if you want to use such plans to pay for over-the-counter drugs, 2010 is the last year to do so without a prescription. Note: Insulin is an exception to the rule.

Early Distributions From Qualified Plans

Are you subject to a penalty?

If you take a distribution from a qualified retirement plan before reaching age 59½, it is considered an early distribution and is generally taxable and subject to an additional 10-percent penalty. There are some exceptions for distributions that are:

- Due to death.
- Due to the account owner's disability.
- Substantially equal periodic payments.
- Due to separation from service after age 55 (employer-provided plan only).
- Due to the extent medical expenses exceed 7.5 percent of adjusted gross income.
- On account of an IRS levy.
- Under a qualified domestic relations order (employer-provided plan only).

Note: Hardship is not one of the exceptions. It's simply a means to take an early distribution from a 401(k) or other type of employer plan.

Some exceptions only apply to early distributions from an IRA, including:

- Health insurance related distributions to the unemployed.
- Distributions taken for qualified higher education expenses.
- Distributions taken for first-time home purchases.

If you take an early distribution from an IRA to pay qualified higher education expenses, the 10-percent penalty does not apply. However, if you take an early distribution from a 401(k) for the same purpose, the penalty does apply. You can avoid the penalty if you roll over the distribution from the 401(k) into an IRA first and then take a distribution from the IRA. It's best to seek the advice of a tax professional before taking a distribution from any retirement plan.

Saver's Credit

Another reason to save for retirement

If you make contributions to a traditional or Roth IRA, elective deferrals to a 401(k), 403(b), governmental 457, SEP, or SIMPLE plan, voluntary employee contributions to a federal Thrift Savings Plan, or contributions to a 501(c)(18)(D) plan, you may qualify for a Credit for Qualified Retirement Savings Contributions (saver's credit).

The credit equals a percentage of your eligible contributions (up to $2,000). The percentage varies from 10, 20, or 50 percent depending on your adjusted gross income and filing status. Thus, the maximum credit is $1,000 ($2,000 x 50%). For 2010, the saver's credit is available if your adjusted gross income does not exceed:

- $55,500 on a joint return.
- $41,625 on a head of household return.
- $27,750 on all other returns.

In addition, your eligible contributions must be reduced by any taxable distributions received after 2007 and before the due date of the 2010 return (including extensions) from any plan to which eligible contributions may be made. Keep this in mind if you qualify for the saver's credit and are thinking of taking a distribution from one of these plans.

Adopting a Child?

You may be eligible for a tax credit

If you already adopted a child or have simply started the adoption process, you may be able to claim a credit on your 2010 tax return. For a domestic child with special needs, you may be entitled to a credit of $13,170 regardless of your actual adoption expenses. For all other adoptions, the credit is limited to the qualified adoption expenses you paid, up to $13,170. In addition, the credit is reduced when your modified adjusted gross income is between $182,520 and $222,520.

The adoption credit is not always claimed in the same year the expenses were paid. In general, if it's a foreign adoption or a special-needs adoption, the credit is claimed in the year the adoption becomes final. If it's a domestic adoption, the credit is claimed in the year after the year of payment. However, expenses paid in the final year, or any year after the adoption becomes final, are claimed in the year of payment.

This credit is refundable in 2010, so it's not limited by your tax liability. Even if you don't owe tax, you'll receive a refund for the full amount of the credit.

First-Time Homebuyer Credit

Are you required to repay it?

If you purchased a home in 2008 and claimed the first-time homebuyer credit, you must repay the credit in equal installments over a 15-year period beginning on your 2010 tax return.

If you purchased a home after 2008 and claimed the first-time homebuyer credit, you do not have to repay the credit if you own and use the home as your principal residence for at least 36 months beginning on the date of purchase. On the other hand, you generally must repay the credit if you dispose of your home or stop using it as your principal residence within this 36-month period. This includes situations where you sell the home, convert the home to business or rental property, abandon the home, or the lender forecloses on the mortgage.

In general, you repay the credit by including it as additional tax on the return for the year you dispose of the home or it ceases to be your main

Quik *Tips*

1. In 2009, the first $2,400 of your unemployment benefits was excluded from gross income. This exclusion is no longer available in 2010, so you may need to request additional withholding by filing Form W-4V, Voluntary Withholding Request.
2. The $400 ($800 if married filing jointly) Making Work Pay Credit is still available for 2010, so your withholding will remain a little lower for one more year. You may need to request additional withholding if you get a second job or your spouse starts working, because each employer is withholding less and the total reduced withholding may exceed the allowable credit.
3. There is no federal tax credit for individuals who buy energy efficient appliances. There may be a state rebate. You can check to see if your state offers such a rebate by going to www.energystar.gov and clicking on the Appliance Rebate Program map.
4. If you moved recently, you should notify the IRS of the change of address by filing Form 8822.
5. In 2010, you can convert a traditional IRA or a qualified plan to a Roth IRA regardless of your adjusted gross income. In addition, half of the taxable income from a 2010 conversion will be included in your gross income in 2011 and the other half in 2012. However, you can elect out of this two-year period and include all of it in 2010.

home. Following are some exceptions to the repayment rules:

- If you sell the home to an unrelated person, the repayment in the year of sale is limited to the amount of gain on the sale. The amount of the credit in excess of the gain does not have to be repaid.
- If you are a member of the uniformed services, you do not have to repay the credit if, after 2008, you sell the home or cease to use it as your principal residence because you received government orders to serve on qualified official extended duty.
- If the home is destroyed, condemned, or disposed of under threat of condemnation, you do not have to repay the credit as long as you purchase a new main home within two years of the event and you own and use it as your new main home during the remainder of the 36-month period.
- If the home is transferred to a spouse or former spouse incident to divorce.
- If you die, repayment is not required. However, if the credit was claimed on a joint return, your surviving spouse is still subject to the repayment rule for his or her half of the credit.

American Opportunity Tax Credit (AOTC)

Should your child claim the credit?

The AOTC is a partially-refundable tax credit to help make college more affordable. A refundable tax credit allows a taxpayer to receive a refund if the amount of the taxpayer's tax credit exceeds the taxpayer's income tax liability. The AOTC is refundable up to a maximum of 40 percent ($1,000) of the maximum tax credit of $2,500.

If you claim your child as a dependent, you can claim an education credit for his or her qualified education expenses. You can even include expenses paid by your child or someone else. You can choose not to claim your child as a dependent so he or she can claim the education credit. However, if an individual is eligible to be claimed as a dependent, that individual's personal exemption deduction is zero. Please note: If you don't claim your child as a dependent so he or she can claim the AOTC, your child does not qualify for the refundable portion of the credit if all of the following apply.

- Your child was:
  - Under age 18 at the end of 2010; or
  - Age 18 at the end of 2010 and his or her earned income (i.e., wages, salaries, tips, etc.) was less than one-half of his or her support; or
  - A full-time student over age 18 and under age 24 at the end of 2010 and his or her earned income was less than one-half of his or her support.
- At least one of the child's parents was alive at the end of 2010.
- Your child is not filing a joint return for 2010.

The AOTC can also be claimed in the same year a beneficiary takes a tax-free distribution from a 529 plan, as long as the same expenses are not used for both benefits.

Foreclosures and Cancellation of Debt

Are there any tax consequences?

If you lose your house in foreclosure, there may be some tax consequences. If you were personally liable for the debt, you must report a sale for the lesser of the debt outstanding or the fair market value (FMV) on the date of foreclosure. If you were not personally liable, the sales price equals the debt outstanding. Up to $250,000 ($500,000 on a joint return) of any gain on the sale may be excluded if you owned and used the home as your principal residence for at least two out of five years ending on the date of the foreclosure. Any loss on the sale is a nondeductible personal loss.

You may also have cancellation of debt income if you were personally liable for the debt, the debt outstanding exceeded the FMV, and the excess debt was canceled. In general, cancellation of debt income is taxable. However, you can exclude it from gross income if it was qualified principal residence indebtedness, to the extent you were insolvent, or due to bankruptcy.

Qualified principal residence indebtedness is debt incurred to acquire, construct, or substantially improve your principal residence. If you took out a home equity loan to pay off credit card debt, that part of the loan does not qualify for the exclusion. In this case, the amount that may be excluded from income is limited to the amount canceled over the amount that is not qualified principal residence indebtedness. The balance of the debt, however, may still qualify for the insolvency or bankruptcy exception.