RECAP OF SIGNIFICANT TAX DEVELOPMENTS THAT OCCURRED IN THE FIRST QUARTER OF 2004

The following is a summary of the most important tax developments which have occurred in the past three months that may affect you, your family, your investments and your livelihood.

- **New Guidance Offered on Health Savings Accounts (HSAs)**

  As of January 1, 2004, eligible individuals may set up tax-favored HSAs if they are covered under high deductible health plans (HDHPs) and not covered under any other non-HDHPs (except for certain permitted insurance or coverage). In general, an HDHP cannot pay non-preventive care benefits before the minimum annual deductible is satisfied. The IRS has recently clarified the types of preventive care which can be provided under an HDHP. Preventive care includes periodic health evaluations (in connection with routine exams) and routine prenatal and well-child care. It does not include any service or benefit intended to treat an existing illness, injury or condition. Individuals with non-HDHP prescription drug benefits will not be eligible to establish HSAs after 2005. For 2004, individuals may incur qualified medical expenses before they set up their HSAs, as long as certain requirements are met.

- **Rules Liberalized for Qualified Dividends**

  More dividends reported on 2003 returns should qualify for the favorable 15% or 5% capital gain rates as a result of some changes the IRS has made. In general, the IRS has changed the holding period test for qualified dividends. A taxpayer must hold dividend-paying stock for at least 61 days during the 121-day period (instead of the prior 120-day period) beginning 60 days before the ex-dividend date. As a result, stock bought on the day before the ex-dividend date and stock sold on the ex-dividend date can meet the test.

  Under another IRS change, partnerships, S corporations, estates and certain trusts with tax years which began in 2002, may be able to pass through dividends received in 2003 to their partners, shareholders and beneficiaries as dividends qualifying for the lower tax rates. Entities affected by these changes may have to file amended returns for their 2002 to 2003 fiscal years.

- **Opportunity to Continue Deferral of Tax by Exchanging Savings Bonds Ending**

  August, 2004, will be the last month Series HH savings bonds are issued. Thus, after August 31, 2004, current holders of Series EE/E savings bonds will lose the opportunity to defer reporting accrued interest on their EE/E bonds by exchanging them for HH bonds, which can permit tax deferral on accrued interest to continue for another 20 years after the exchange. Whether or not an individual holding EE/E bonds should exchange them before September 1, 2004, to continue the deferral for up to 20 years depends on a number of factors such as:

  < Amount of interest actually deferred from reporting; and,

- The interest rate on the bonds

IRS Crackdown on Abusive Life Insurance Policies in Certain Retirement Plans

The IRS has issued a broad-based attack aimed at shutting down abusive transactions involving life insurance policies in special retirement plans. These arrangements purportedly enable businesses to generate large tax-deductible contributions to retirement plans and tax-free retirement distributions and death benefits. For example, special policies are made available only to highly compensated employees. The insurance contract is designed so that the cash surrender value is temporarily depressed, and the contract is distributed to the employee for the amount of the current cash surrender value during the period the cash surrender value is depressed. The contract is structured so the cash surrender value increases significantly after it is transferred to the employee. Use of this springing cash value life insurance gives employers tax deductions that far exceed what the employee recognizes in income. The IRS's crackdown on these policies involves complex rules under which:

- Life insurance contracts transferred to an employee must be taxed at their full fair market value (FMV);
- An employer cannot buy excessive life insurance in order to claim large tax deductions; and,
- These arrangements generally are listed transactions.

Simplified Procedures for Correcting Some Depreciation Mistakes

Generally, a taxpayer has adopted a method of accounting if it deducted an incorrect depreciation amount (other than a mathematical or posting error) in two or more consecutive tax years. This type of error is corrected by filing Form 3115 under the automatic change procedures. The IRS has made it easier for taxpayers to fix some depreciation-deduction mistakes by waiving the two-year adoption of method-of-accounting rule in specific instances. A taxpayer who used an incorrect depreciation method on assets placed in service during the preceding year may change to a correct depreciation method by filing Form 3115 under the automatic approval procedures. Alternatively, the taxpayer may make the change by filing an amended return for the placed-in-service year before it files its return for the tax year following the placed-in-service year. The waiver of the two-year rule is generally effective for a Form 3115 filed for tax years ending after December 29, 2003.

Most Depreciation Changes are Accounting Method Changes

Under new IRS guidance, most changes in computing depreciation (or amortization) are accounting method changes if made after December 29, 2003. In general, only an adjustment in the useful life of a depreciable or amortizable asset is not an accounting method change. In addition, in general, only changes from an impermissible to a permissible depreciation (or amortization) method require a Code Sec. 481(a) accounting adjustment (to prevent items of income or expense from being duplicated or omitted) for changes made in tax years ending after December 29, 2003.

However, the IRS is giving a break to taxpayers who make depreciation changes for earlier years. In general, changes in computing depreciation or amortization will not be considered a change in method of accounting if made for property placed in service in tax years ending before December 30, 2003.

- **New Guidance on Depreciation of Like-Kind Exchange or Involuntarily Converted MACRS Property**

New rules explain how to depreciate MACRS property acquired (1) in exchange for like-kind MACRS property or (2) to replace converted MACRS property.

The rules basically divide the new property into the "depreciable exchanged basis" (i.e., remaining undepreciated basis of the old property carried over to the new property), and the depreciable excess basis (i.e., additional consideration to acquire the new property). Where the properties share the same recovery class and depreciation method, the depreciable exchanged basis is written off over what's left of the old property's recovery period; and the depreciable excess basis is in effect treated as a separate property with a recovery period which begins anew. These rules apply to a like-kind exchange and involuntary conversion where the disposition and replacement both occur after February 27, 2004. If the disposition, replacement or both occur on or before that date, a taxpayer may: (1) apply the new rules; or (2) rely on prior guidance, using any reasonable, consistent method. The rules are extremely complex and could be burdensome. Fortunately, taxpayers may elect not to apply them.

- **More Honda Vehicles Certified for Clean-Fuel Deduction**

The IRS says, if you purchased a Honda Insight, model years 2003 and 2004, or Honda Civic Hybrid, model year 2004, you can claim an above-the-line tax deduction of $2,000. This deduction is reduced to $1,500 for vehicles bought and used in 2004. You must be the original owner of the vehicle to qualify for the deduction.

- **Tax-free Corporate Divisions Made Easier**

The IRS has made it easier for individuals to make corporate divisions tax-free. Generally, a corporation may make a tax-free distribution of stock in a controlled corporation to its shareholders. The distribution must be motivated, in whole or in substantial part, by one or more corporate business purposes (i.e., a real non-tax purpose germane to the business).

The IRS has ruled a distribution that is expected to cause the aggregate value of the stock of a distributing and controlled corporation to exceed the pre-distribution value of the distributing corporation's stock meets the business purpose test for a corporate division when the increased value is expected to serve a corporate business purpose of either corporation (or both). This is so even if the distribution benefits the shareholders of the distributing corporation.