

October 1, 2003

RECAP OF SIGNIFICANT TAX DEVELOPMENTS THAT OCCURRED IN THE SECOND QUARTER OF 2003

Although the Jobs and Growth Tax Relief Reconciliation Act of 2003 dominated the tax news in the second quarter of 2003, there were other important tax developments that may affect you, your family, your investments and your livelihood. The most important new developments are below.

■ **NEW WITHHOLDING TABLES ISSUED**

In June, the IRS issued new withholding tables and directed employers to use them as soon as they can work them into their payroll systems, but not later than July 1, 2003. The tables reflect key changes made by the 2003 Jobs and Growth Tax Relief Reconciliation Act (tax rate changes for most taxpayers and a higher standard deduction for married couples).

■ **MANY COMMERCIAL-TYPE LIGHT TRUCKS AND VANS EXEMPTED FROM LUXURY AUTO DEPRECIATION DOLLAR CAPS**

Cars bought and used for business are subject to more restrictive depreciation rules than those that apply to other depreciable assets. Under the so-called "luxury auto" rules, annual depreciation deductions for most purchased business autos are artificially capped. In general, these rules also apply to light duty trucks and vans rated at a gross (loaded) vehicle weight of 6,000 pounds or less. In recently issued temporary regulations, the IRS exempted "qualified nonpersonal use" vehicles placed in service after July 6, 2003 from the luxury auto rules. This term includes trucks and vans which, because of their nature (i.e., design) are not likely to be used more than a minimal amount for personal purposes. Example: a florist's delivery van decorated with the company name and logo and modified with shelving to carry bulk flowers and finished bouquets.

■ **NEW REGULATIONS ISSUED ON INCENTIVE STOCK OPTIONS**

The IRS issued new regulations on incentive stock options (ISOs), which give employees the ability to acquire employer stock without realizing income when the option is exercised. If the employee holds the stock for the required periods, any gains on sale of the stock are capital gains. The 2003 Act's reduction in the top rate of tax on most types of long-term capital gain to 15% makes ISOs even more valuable for employees who meet the special holding periods and for companies to use as a tool to attract and retain talent. ISOs are subject to a number of special conditions. For example, the ISO's exercise price must be no less than the fair market value of the stock when the option is issued, an ISO generally can't be transferable and it must be exercisable only by the employee. An ISO plan must be approved by shareholders, and the amount of ISOs that can be granted to an employee is limited. The employer does not get a deduction, unless the employee sells the acquired stock within two years after option grant or one year after the stock is transferred to him. However,

ISOs may cause alternative minimum tax (AMT) complications for employees.

- **ANOTHER COURT HOLDS THAT RECLASSIFICATION OF DEPRECIABLE PROPERTY ISN'T AN ACCOUNTING METHOD CHANGE**

When a taxpayer uses a different tax accounting method from the method used in the preceding year, accounting method adjustments generally must be made to prevent items of income or expense from being duplicated or omitted. The adjustments may be positive (increasing taxable income) or negative (decreasing taxable income). The Eighth Circuit Court of Appeals has held that the reallocation by the IRS of a taxpayer's depreciable property to another MACRS (modified accelerated cost recovery system) category isn't a change in accounting method. The court said that reallocating an asset into another asset category for MACRS depreciation purposes more closely resembles a correction of a reporting error or inconsistency than a wholesale change in accounting method. This ruling makes it easier for a taxpayer to correct the misclassification of property for depreciation purposes.

- **NEW RULINGS OK DEDUCTIONS FOR CORRECTIVE SURGERY AND NONPRESCRIPTION MEDICAL SUPPLIES**

In two recent rulings, the IRS OK'd a medical expense deduction for the unreimbursed cost of breast reconstruction surgery following cancer surgery, and for the cost of laser eye surgery (e.g., LASIK, radial keratotomy) to correct myopia. However, the unreimbursed cost of paying a dentist to whiten teeth discolored as a result of age isn't a medical expense. The IRS also ruled that the unreimbursed cost of nonprescription supplies, such as crutches and bandages, and diagnostic devices such as blood sugar kits for diabetics, are deductible medical care items. Additionally, in a private letter ruling, the IRS said that a woman who can't conceive children using her own eggs may claim a medical expense deduction for the costs of obtaining an egg donor, including associated legal costs. Note, however, that medical expenses are deductible only to the extent they exceed 7.5% of your adjusted gross income.

- **GUIDANCE ISSUED ON TAX RELIEF AVAILABLE TO ARMED FORCES MEMBERS IN COMBAT ZONE**

The IRS issued detailed guidance on the various forms of tax relief available to armed forces members serving in a combat zone, such as the Persian Gulf area (this includes Iraq, Kuwait, Saudi Arabia, Oman, Bahrain, Qatar and the United Arab Emirate). For example, many types of combat zone pay are tax-free (but there's a dollar limit on excluded pay of officers). Additionally, the IRS will automatically extend the deadline for performing most tax actions (such as filing a tax return or filing a claim for credit or refund) required to be performed on or after the date Armed Forces members (or certain support personnel) began serving in the combat zone.

- **PARTICIPATION OF TRUST'S MANAGERS AND EMPLOYEES COUNTS FOR PASSIVE ACTIVITY LOSS PURPOSES**

Under the passive activity loss (PAL) rules, losses from a passive activity can't offset

non-passive income, such as portfolio interest. In general, this rule applies to a trade or business if a taxpayer affected by the PAL rules (including a trust) does not materially participate in it. A district court has held that in determining whether a trust materially participated in a business for PAL purposes, the participation of those who ran the business on its behalf should be considered, rather than just the participation of its trustee. Their collective activities were enough to treat the trust as a material participant and thus free its losses from the PAL restrictions.

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