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

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

■ **IRS TAKES A LIBERAL STANCE ON BONUS DEPRECIATION RULES**

You can claim a 50% bonus first-year depreciation deduction for most capital assets (other than buildings) your business acquires new after May 5, 2003, and before 2005 (there can't be a written binding contract for the acquisition in effect before May 6, 2003). There is a 30% bonus first-year depreciation deduction for qualifying capital assets (other than buildings) acquired new after September 10, 2001, and before May 6, 2003. In either case, qualifying new capital assets generally must be placed in service before 2005 (before 2006 for certain longer-lived property). The IRS has issued comprehensive temporary regulations, which take a pro-taxpayer approach on a number of issues, including the following:

- < Property generally must be new to qualify for bonus depreciation. The regulations provide that new property initially used by a taxpayer for personal use and then subsequently used by him in a trade or business qualifies for bonus depreciation (if it meets the other conditions).
- < Used property isn't eligible. However, a taxpayer's additional cost to recondition or rebuild property bought used is eligible for bonus depreciation (if the other conditions are met), but the cost of the reconditioned or rebuilt property is not.
- < A safe-harbor rule provides that property containing used parts isn't treated as reconditioned or rebuilt if the cost of the used parts doesn't exceed 20% of its total cost. In other words, for example, a taxpayer who buys a machine consisting of 80% new parts and 20% reconditioned parts is treated as having bought a new machine, not a reconditioned one.
- < When otherwise eligible property is acquired by way of a like-kind swap (or as a result of an involuntary conversion), both the carryover basis and the excess basis, if any, of the acquired property are eligible for bonus depreciation. For example, suppose your business buys a new truck this month by paying \$30,000 cash and trading-in a used truck worth \$25,000 and having a remaining basis (un-depreciated cost) of \$20,000. Under the regulations, you can claim a \$25,000 first-year bonus depreciation allowance ($\$30,000 \text{ cash} + \$20,000 \text{ remaining basis} \times .50$). Before the regulations were issued, some businesses in this situation might have claimed bonus depreciation on only the \$30,000 cash paid to acquire the new truck. The regulations give these taxpayers a number of ways to claim the full deduction they're entitled to, even if they already filed a return for the swap year.

■ **IRS ISSUES FINAL REGULATIONS ON SPLIT-DOLLAR LIFE INSURANCE**

The IRS has issued final regulations on “split-dollar” life insurance plans where the employer typically pays part of the premiums, to the extent of the annual increase in the policy's cash surrender value, and the employee pays the rest. Under recently issued final regulations, which generally track earlier guidance, the tax treatment of split-dollar life insurance arrangements depends on who owns the policy:

- < If the employer owns the policy, then its premium payments are treated as providing taxable economic benefits to the employee. These benefits include the employee's interest in the current life insurance protection and policy cash value.

- < If the employee owns the policy, the employer's premium payments are treated as loans to the employee. Unless the employee is required to pay the employer market-rate interest on the loan, he will be taxed on the difference between market-rate interest and the actual interest.

The final regulations apply to any split-dollar life insurance arrangement entered into (or materially modified) after September 17, 2003. Complex transitional rules apply to earlier arrangements.

■ **IRS SAYS EMPLOYER HEALTH PLAN AND FSA REIMBURSEMENTS FOR OVER-THE-COUNTER DRUGS ARE TAX-FREE TO EMPLOYEES**

The IRS has ruled that employer reimbursements of employee payments for over-the-counter (non-prescription) medicines and drugs aren't taxed to the employee. As a result, employees can pay for over-the-counter drugs with pre-tax dollars through health care flexible spending accounts (FSAs). The IRS stressed, although individuals aren't taxed on an FSA reimbursement for over-the-counter drugs and medicines, these expenses, if un-reimbursed, cannot be deducted as medical expenses (deductible medical expenses include only doctor-prescribed medicines and drugs, plus insulin). Thus, under the IRS ruling, you can get reimbursed tax-free through an FSA for the cost of items such as antacid, allergy medicine, pain reliever or cold medicine, even though you're not able to deduct such costs if you are not reimbursed for them.

■ **IRS EXPLAINS HOW TO REPORT 2003 PAYMENTS IN LIEU OF DIVIDENDS**

For 2003, “qualified dividends” are taxed at the same favorable rate as capital gains, that is, at 15% (or 5%, to the extent that the dividends would be taxed in the 10% or 15% tax bracket if they were treated as ordinary income). However, qualified dividend income does not include payments in lieu of dividends (sometimes referred to as “substitute payments”). These payments are typically made to owners of stock which has been lent in connection with a short sale. The IRS has made it clear, if a payment in lieu of dividends is reported as dividend income on a 2003 Form 1099-DIV, the taxpayer receiving the form may treat the payment for tax purposes as a dividend, and not as a payment in lieu of dividends, unless he knows, or has reason to know, of the actual character of the payment.

■ **COURTS DEAL A BLOW TO CASH-BALANCE RETIREMENT PLANS**

A cash balance plan is a hybrid type of defined benefit plan which determines benefits by reference to an employee's hypothetical account. The hypothetical account balance is credited with hypothetical allocations, referred to as service or pay credits, and hypothetical earnings, referred to as interest credits. Two courts recently have held against employers sponsoring cash balance plans. In one case, a district court in the Seventh Circuit held IBM's pension equity plan impermissibly reduced a participant's accrued benefit solely because of increases in the participant's age or service. The district court also held IBM's pension equity and cash balance plans impermissibly reduced a participant's rate of benefit accrual based on age. The Federal Court of Appeals for the Seventh Circuit ruled the Xerox Corporation's cash balance plan failed to properly credit interest when making lump sum payouts to participants who separated from service before age 65. The holding in the IBM case may cause the IRS to rethink proposed cash balance regulations issued last year. Also, the House of Representatives has passed a bill which would, among other provisions, block the issuance of IRS regulations dealing with cash balance plans.

■ **NON-PERSONAL USE VANS AND TRUCKS EXEMPT FROM LUXURY AUTO DEPRECIATION LIMITS**

Annual depreciation and expensing deductions for so-called luxury autos used for business are limited to specific dollar amounts known as the luxury auto depreciation limits. Leased luxury autos are subject to income inclusion rules. The luxury auto rules apply to virtually all cars as well as to trucks or vans rated at 6,000 pounds gross (loaded) vehicle weight or less. The IRS has issued temporary regulations which exempt qualified nonpersonal use vehicles from the luxury auto depreciation limits (and the special lease rules). These are vehicles which, by reason of their nature (i.e., design) are not likely to be used more than a minimal amount for personal purposes. Qualified, nonpersonal use vehicles include trucks and vans which have been specially modified (e.g., installation of permanent shelving and painting the vehicle to display company's name or advertising), so they are not likely to be used more than a minimal amount for personal purposes.

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