April 1, 2003

RECAP OF SIGNIFICANT TAX DEVELOPMENTS THAT OCCURRED IN THE FOURTH QUARTER OF 2002

The following is a summary of the most important tax developments that have occurred in the past three or four months that may affect you, your family, your investments and your livelihood. Please call me for more information about any of these developments and what moves you should make to take advantage of favorable developments and to minimize the impact of those that are unfavorable.

IRS EXPLAINS WHEN IT WILL WAIVE 60-DAY ROLLOVER REQUIREMENT

You don't pay current tax on eligible rollover distributions from qualified plans and certain distributions from traditional IRAs if they are rolled over to an eligible retirement plan (which includes qualified plans and traditional IRAs) within 60 days of receipt of the distribution. A distribution rolled over past the 60-day mark generally will be taxed (and also may be subject to a 10% premature withdrawal penalty tax). However, effective for post-2001 distributions, the IRS may waive the 60-day rule if an individual suffers a casualty, disaster, or other event beyond his reasonable control and not waiving the 60-day rule would be against equity or good conscience. The IRS has explained that it will automatically waive the 60-day rule if a financial institution's error caused the rollover to be untimely. For example, a financial institution may erroneously deposit a rollover into a non-IRA account. For the automatic waiver to apply, the funds must (among other conditions) be actually deposited into an eligible retirement plan within one year from the beginning of the 60-day rollover period. Individuals who don't qualify for automatic waiver of the 60-day rule may ask the IRS for a waiver of the rule. The IRS may waive the 60-day rule where failing to do so would be against equity or good conscience, including casualty, disaster or other events beyond the taxpayer's reasonable control (e.g., hospitalization, postal error).

HOMESALE RULES LIBERALIZED

The IRS has issued new regulations liberalizing key aspects of the home sale exclusion. This exclusion allows an individual to treat as tax-free up to $250,000 of gain from the sale of a home owned and used by him as a principal residence (his main home) for at least two of the five years before the sale. The full exclusion doesn't apply if, within the two-year period ending on the sale date, there was another home sale by the taxpayer to which the exclusion applied. Married individuals filing jointly for the year of sale may exclude up to $500,000 of home-sale gain if they meet a number of conditions.

The new regulations liberalize two important rules:

- The IRS originally took the position that if a principal residence consistently was used in part for residential purposes and in part for business purposes, only the gain allocable to the residential portion could be excluded. The new IRS regulations adopt a more liberal rule. They provide that all of the gain from the home sale (except for gain resulting from certain depreciation deductions) is eligible for the exclusion if both the residential and non-residential portions of the home are within the same dwelling unit (e.g., one room in the home is used as the office of a sideline business). However, gain is allocated if the non-residence portion of the home is separate from the dwelling unit (e.g., an office in a converted garage).

- An individual may claim a partial home sale exclusion if he: (1) doesn't qualify for the two-out-of-five-year ownership and use rule, or (2) previously sold another home within two years. The failure to meet either rule must result from the home being sold because of a change of place of employment, health, or to the extent provided by IRS regulations, other unforeseen circumstances. The new IRS regulations interpret these conditions liberally. For example, the health condition would be met if a person sells his home and moves cross-country to care for an ailing parent. The term “unforeseen circumstances” is defined as the occurrence of an event that the individual didn't anticipate before buying and moving into the home, such as divorce or legal separation, the birth of twins and change in employment or self-employment status that results in inability to pay housing costs and reasonable basic living expenses.

The new IRS home sale exclusion regulations generally apply to sales after December 23, 2002, but taxpayers may elect to apply them to sales after May 6, 1997, and before December 24, 2002. This election may create a refund opportunity for some home sellers.

DEDUCTIONS OK'D FOR AUTOS DONATED TO CHARITY'S AGENT

Many charities that solicit individuals to contribute autos in return for a tax deduction use a for-profit business to operate the donation program. The IRS has ruled that individuals may claim a charitable contribution deduction for autos donated to the charity's agent that runs the donation program. It also says that the agent's written acknowledgment substantiates the gift. The fair market value of the donated car for purposes of determining the amount of the deduction may be established by using an established used-car pricing guide (e.g., “Blue Book”). However, the pricing guide may be used only if it lists the sales price for a car that is the same make, model, and year, sold in the same area, and in the same condition, as the donated car.

PROPOSED IRS REGS WOULD ALLOW PENSION TO CASH BALANCE PLAN CONVERSIONS

IRS has issued proposed regs that would, if finalized, allow traditional defined benefit (pension-type) qualified plans to be converted into cash balance plans without running a foul of the age discrimination rules even though they can effectively limit some future accruals for older workers. A cash balance plan is a type of defined benefit plan that 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.

IRS RULINGS OK DEDUCTIONS IN CAPTIVE INSURANCE ARRANGEMENTS

In some industries where liability insurance is hard to find or prohibitively expensive, a business or businesses may set up a “captive” insurance entity to provide needed protection. In the past, the IRS made it tough for businesses to treat payments to such captive insurance entities as deductible insurance premiums. Recently, the IRS issued three rulings that take a more pro-business stance. For example, in one ruling, the IRS OK'd deductions for a small group of unrelated businesses that set up a group captive insurance entity to take care of their insurance needs. All the businesses are in one highly concentrated industry, face significant liability hazards, and are required by state regulators to maintain adequate liability insurance coverage in order to do business. Because of unusually severe loss events, the businesses can't get affordable coverage from commercial insurance companies.

 # IRS CHANGES ITS MIND ABOUT WHEN STATE TAX REFUNDS ACCRUE

In a change of position, the IRS has held that a state or local income or franchise tax refund isn't included in the income of an accrual-basis business until the state or local taxing authority approves the claim. The new ruling is good news for an accrual-basis business that submits a state tax refund claim in one year that's not approved until the following tax year. Thanks to the new rule, the business now gets to defer reporting the income until the next year.

 # NEW REPORTING RULES FOR NON-STATUTORY STOCK OPTIONS

Employers must report compensation from the exercise of non-statutory stock options in box 12 of Form W-2, using Code V, on Forms W-2 issued for 2003 and later years. The compensation element is equal to the fair market value of the stock purchased less the exercise price under the option. Before 2003, the employer had to report compensation from the exercise of non-statutory options on Form W-2 as part of the employee's wages in boxes 1, 3 (up to the social security wage base), and 5, but did not have to show the spread separately. The new reporting requirement does not apply to exercises of statutory options (incentive stock options or employee stock purchase plan options).

 # NON-REFUNDABLE DEPOSIT PAID TO ACCRUAL-BASIS BUSINESS NOT TAXABLE UNTIL GOODS AND SERVICES ARE PROVIDED

A business that designs, sells and installs equipment for customers may require its customers to make a non-refundable deposit when a contract is signed. The IRS has held that if such a business is on the accrual basis, it can defer including the non-refundable deposit in income until the equipment is delivered and installed. Some enterprises that order and install equipment for customers may normally have the equipment delivered to the customer's site to avoid the delay and additional cost for delivery from the enterprise's location to the customer. If the enterprise wants to avoid a controversy over the proper time for reporting a customer deposit for the job, and the amount at issue is significant, it should consider having the equipment delivered by the supplier to the enterprise's location and then arrange for the equipment to be moved to the job site.

 # NEW REPORTING RULES FOR CORPORATE INVERSIONS

Some large corporations have taken the controversial move of relocating their headquarters offshore to lower their U.S. tax bill. Some legislators have called these maneuvers unpatriotic and have introduced legislation to ban or penalize such corporate inversions, as they are called. The IRS took a small step to address the problem-it issued regulations that require corporate inversions to be reported to the IRS and the company's shareholders, who may owe tax as a result of the inversion. However, the new regulations do not prohibit companies from moving offshore to lower taxes or penalize them for doing so. Penalties can be incurred, though, if the reporting requirements are not met.