

May 1, 2003

## RECAP OF SIGNIFICANT TAX DEVELOPMENTS THAT OCCURRED IN THE FIRST QUARTER OF 2003

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. 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.

### # **EXPANDED APPEAL RIGHTS FOR SPOUSES NOT REQUESTING INNOCENT SPOUSE RELIEF**

Married joint return filers are jointly and severally liable for the tax arising from their returns. Innocent spouses may request relief from this liability in certain circumstances. Previously, the IRS gave only the spouse requesting relief the right to file a written protest about an innocent spouse determination and to receive an administrative conference with the IRS's Appeals Office. Now, however, in addition to having the right to be notified of the requesting spouse's claim for relief and to submit information to be considered by the IRS in deciding the claim, the spouse not seeking innocent spouse relief may file a protest and receive an Appeals conference regarding an IRS decision granting innocent spouse relief to the requesting spouse. A non-requesting spouse would be likely to protest an IRS decision granting innocent spouse relief to a requesting spouse, because the non-requesting spouse then would be solely liable for unpaid taxes on their joint return.

### # **ANOTHER COURT HOLDS THAT RECLASSIFICATION OF DEPRECIABLE PROPERTY DOESN'T REQUIRE THE IRS'S CONSENT**

The Fifth Circuit Court of Appeals has affirmed the Tax Court's holding that a taxpayer who reclassified property for depreciation purposes under the current MACRS rules by placing it in a shorter recovery class did not make an accounting method change requiring prior IRS consent. The reclassification was analogous to a change in useful life under prior-law depreciation rules, which the regulations say is not an accounting method change requiring prior IRS consent. The holding is beneficial for taxpayers who believe they are entitled to faster depreciation of assets than they have claimed in the past but don't want to run the gauntlet of requesting IRS's prior consent for the change.

### # **THE TAX COURT SAYS THAT CHANGING TO CORRECT DEPRECIATION METHOD DOESN'T REQUIRE AN ADJUSTMENT FOR AN ACCOUNTING-METHOD CHANGE**

A taxpayer that uses a different tax accounting method from the method used in the preceding year must make an adjustment to prevent items of income or expense from being duplicated or entirely omitted (a "Sec. 481(a)" adjustment). The adjustments may be positive (increasing taxable income) or negative (decreasing taxable income). The Tax Court has ruled that a change from an impermissible to a permissible MACRS depreciation method is not a change in accounting method. As a result, no "Sec.

481(a)" adjustment is required for such a change.

# **COURT OF FEDERAL CLAIMS OKS DEDUCTION FOR REMOVAL AND ENCAPSULATION OF ASBESTOS**

The Court of Federal Claims has held a taxpayer may deduct the cost of removing and encapsulating deteriorating asbestos in an office building because the work wasn't done to refurbish the building or prepare it for a new use and the cost represented only a small fraction of the building's value. Encapsulation (i.e., re-wrapping) of asbestos to prevent a health hazard has been held to be deductible. However, this appears to be the first time that a court has OK'd a deduction for the cost of removing asbestos. Note, however, the cost of asbestos removal and encapsulation must be capitalized if the work is done as part of an overall plan to rehabilitate or renovate a building.

# **IRS SAYS ROTATABLE SPARE PARTS MAY BE TREATED AS DEPRECIABLE CAPITAL ASSETS RATHER THAN INVENTORY**

Some businesses that sell and service expensive machinery and equipment use pools of rotatable spare parts in connection with their maintenance and repair services. Rotatable spare parts are parts for machinery that can be re-serviced or repaired when they malfunction and can be used repeatedly. The IRS previously maintained rotatable spare parts are property held for sale in the ordinary course of business and should be included in inventory, but it now says it will follow two court decisions that held rotatable spare parts are depreciable assets. The IRS says a taxpayer may treat rotatable spare parts as depreciable assets if its facts are substantially similar to those in the two decisions (which involved computer manufacturers who maintained equipment they sold to customers). A revenue procedure will be issued explaining how taxpayers may obtain automatic consent to change their treatment of rotatable parts.

# **INTERIM GUIDANCE ISSUED ON NON-ACCRUAL EXPERIENCE METHOD**

The IRS released interim guidance carrying safe harbor methods for taxpayers eligible to use the non-accrual expense (NAE) method, and change in method of accounting procedures for those no longer eligible to use the NAE method. Under this method, a business doesn't accrue service-related income that, on the basis of its experience, won't be collected. Because of a recent tax law change, effective for tax years ending after March 9, 2002, an accrual-method business may use the NAE method only if it (1) provides services in the health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting fields, or (2) meets a maximum \$5 million annual gross receipts test. The NAE method is available only to taxpayers not charging interest or penalties for failure to timely pay the amount charged. Pending the issuance of regulations, the IRS says businesses eligible to use the NAE method may use a new actual-experience method to account for uncollectible amounts, or use any alternative method which clearly reflects its actual NAE and meets certain self-test requirements. The IRS also said a change from the NAE method by a taxpayer no longer qualified to use it is treated as an accounting method change initiated by the taxpayer and made with the IRS's consent. The net amount of the required adjustment for the change is taken into account over four tax years (or, if less, the number of tax years that the taxpayer has used the NAE

method).

## # **RELAXED REPORTING RULES FOR CORPORATE INVERSIONS**

Some large corporations have relocated their headquarters offshore to lower their U.S. tax bill. Legislation has been introduced to ban or penalize such corporate inversions, as they are called. In 2002, the IRS addressed this problem by issuing 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. The new regulations did not prohibit companies from moving offshore to lower taxes or penalize them for doing so, but it did impose penalties if the reporting requirements are not met. In January of 2003, the IRS eased these reporting requirements for transactions covered by the regulations occurring in 2002. Affected corporations could satisfy the information reporting requirement by giving non-exempt shareholders of record a letter that, in essence, informed them that gain on their exchange of shares may be subject to tax. The corporation also had to (1) file an interim statement with the IRS, and (2) upon inquiry by a shareholder of record on the date of the transaction (including any clearing organization or broker), identify itself as a corporation affected by the reporting requirements.

Comments is an informative publication for our clients and friends of the Firm. It is designed to provide accurate information on the subject matter covered. We recommend you consult with your legal and other advisors to determine if the information is applicable in your specific circumstances. If these advisors are not available to you, please feel free to contact Barry N. Finkelstein, CPA at 972/934-1577 or e-mail at [info@facpa.com](mailto:info@facpa.com).