

November 1, 2002

## **RECAP OF SIGNIFICANT TAX DEVELOPMENTS THAT OCCURRED IN THE THIRD QUARTER OF 2002**

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

### **# NEW HYBRID CARS ELIGIBLE FOR \$2,000 CLEAN-FUEL DEDUCTION**

Individuals, partnerships and corporations may deduct up to \$2,000 of the incremental cost of buying a motor vehicle which uses a clean-burning fuel. The IRS announced that buyers of a new Toyota Prius for model years 2001, 2002 and 2003, a new Honda Insight for model years 2000, 2001 and 2002 and a Honda Civic Hybrid for model year 2003, may claim a deduction of \$2,000 for the year that the vehicle was first put into use. The deduction is available whether or not the auto is used for business and whether or not you itemize deductions. You can claim the deduction for a past year by filing an amended return.

### **# TAXPAYERS AFFECTED BY SEPTEMBER 11<sup>TH</sup> TERRORIST ATTACKS ELIGIBLE FOR PARTIAL HOME SALE EXCLUSION**

Homesellers may exclude up to \$250,000 of home sale gain (up to \$500,000 for joint filers) if: (1) during the 5 years ending on the sale or exchange date, they owned and used the residence as their main home for periods aggregating at least 2 years, and (2) they didn't previously use the exclusion within the preceding two years. A partial home sale exclusion rule allows homesellers to exclude part or all of their home sale gain even though they don't fully meet these requirements. The partial exclusion applies only if the homeseller's failure to meet either rule occurs because he or she must sell the home due to "a change of place of employment, health or other unforeseen circumstances." The IRS has said that last year's September 11<sup>th</sup> terrorist attacks are an "unforeseen circumstance" for purposes of partial home sale exclusion rule.

### **# NEW REFUNDABLE CREDIT FOR HEALTH INSURANCE COSTS OF TRADE-DISPLACED WORKERS AND PBGC PENSION RECIPIENTS**

The Trade Act of 2002 (H.R. 3009), signed into law on August 6th created a new, refundable tax credit for qualifying health insurance costs of workers who lose their jobs as a result of a trade-related circumstance (broadly, workers eligible for help under the Trade Adjustment Assistance program, which assists workers injured by imports) or are eligible Pension Benefit Guaranty Corporation (PBGC) pension recipients (broadly, age 55 or older individuals receiving PBGC benefits due to retirement plan termination). The credit is equal to 65% of the amount paid by an eligible person for qualified health insurance coverage for coverage months beginning no earlier than December, 2002. The IRS is to establish, no later than August 1, 2003, a program to pay the health insurance costs credit in advance directly to providers of qualified health insurance on behalf of eligible individuals. The Trade Act also includes a temporary extension of the COBRA election period for some individuals.

### **# 2003 STANDARD MILEAGE RATE FOR BUSINESS AUTO USE**

The optional mileage allowance for owned or leased autos will be 36¢ for business travel after 2002, down from 36.5¢ for 2002. The mileage allowance deduction replaces separate deductions for lease payments (or depreciation if the car is purchased), maintenance, repairs, tires, gas, oil, insurance and license and registration fees. You may, however, claim separate deductions for parking fees and tolls connected to business driving. The standard mileage rate can be used for a purchased auto only if a number of conditions are met. For example, you can't use it if you previously depreciated the auto under the regular accelerated depreciation rules.

#### # **RELATED BUSINESS-AUTO MILEAGE CHANGES**

For 2003, employers that require employees to supply their own autos may reimburse them at 36¢ a mile for employment-connected business mileage, whether the autos are owned or leased. The reimbursement will be tax-free to the employee if he or she substantiates the time, place, business purpose and mileage of each trip. Additionally, an employee's personal use of lower-priced company autos during 2003 may be valued at 36¢ per mile if certain conditions are met.

#### # **FEDERAL PER-DIEM RATES REVISED EFFECTIVE OCTOBER 1st**

Reimbursements of an employee's business travel costs (lodging, meal and incidental expenses) at a per-diem rate are payroll- and income-tax free if properly substantiated and the daily rate doesn't exceed the federal per-diem rate (the maximum amount the federal government reimburses its employees) for the locality of travel for that day. These per-diem rates, which vary by travel destination, are changed annually, generally effective for the last quarter of each year and the first three quarters of the next year. The per-diem rates for the October 1, 2002, through September 30, 2003, period have been issued. The simplified per-diem rates, which assign one per-diem to high-cost areas within the continental U.S. and another to non-high-cost areas, also have been issued, along with a modified list of high-cost areas. Effective October 1, 2002, the high-cost-area rate is \$204 and the rate for non-high-cost areas is \$125. These rates are the same as the rates that applied for the previous 12 months, but the portion of the per-diem treated as reimbursing meals and incidental expenses is slightly higher than it was for the previous 12 months. In a related change, after 2002, incidental expenses will include transportation (such as taxicab fares) at the out-of-town destination, but will no longer include laundry expenses.

#### # **IRS OKS INTERNET-BASED RECORDKEEPING OF BUSINESS TRAVEL EXPENSES**

An employee who is away from home overnight on business may be reimbursed for his or her business-related travel expenses tax-free if the employee (1) substantiates to the employer the time, place, business purpose and amount of the expense and (2) keeps and submits to the employer documentary evidence (paid bills, receipts) of all lodging expenses, and other expenses of \$75 or more (except for transportation charges if the documentary evidence is not readily available). In a recent private letter ruling, the IRS permitted a company that gives employees a credit card usable only for business-related travel expenses to satisfy these requirements by way of electronic receipts and internet-based employee substantiation. The company's recordkeeping system, which submitted each reimbursement request to rigorous review and audit procedures, met all the substantiation requirements.

#### # **INTEREST ON BUSINESS TAX DEFICIENCY ISN'T DEDUCTIBLE**

The Tax Court has concluded that interest on an income tax deficiency arising from an

unincorporated business is not deductible as a business expense on Form 1040. The Tax Court had earlier decided that such interest was deductible, but changed its mind after it was reversed on this issue by five Circuit Courts.

## # **PASSIVE LOSS SELF-CHARGED INTEREST RULES FINALIZED**

Losses from a passive activity can't offset non-passive income, such as portfolio interest. On the other hand, passive activity deductions can offset passive activity income. If an S corporation shareholder or partner (a passthrough owner) lends money to the passthrough entity and the entity uses the loan proceeds in a passive activity, the entity's interest expense is a passive activity deduction. The interest income the passthrough owner receives in his capacity as lender, however, is portfolio income. Under the usual passive activity loss rules, the passive activity interest deduction allocated to the passthrough owner couldn't offset his non-passive activity interest income. Fortunately, under the self-charged interest rule in recently issued final IRS regulations, where the passthrough owner lends money to the entity, part of his interest income from the entity is treated as passive activity income so it can be offset by his share of the corresponding passive activity interest deduction. However, the final regulations don't extend the self-charged rule to non-interest situations, such as self-charged management fees.

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).