

## **RECAP OF SIGNIFICANT DEVELOPMENTS THAT OCCURRED IN THE FIRST QUARTER OF 2005**

The tax talk over the past few months has focused mainly on filing 2004 tax returns and, to some extent, tax simplification. This happens every year during tax season, but this year it was even more pronounced because there were many new tax breaks to consider, including the new optional sales tax deduction for itemizers, and new tax complications to avoid. While filing 2004 returns, or getting extensions for them has been in the forefront, there have been other important tax developments which may affect you, your family, your investments, and your livelihood.

### **■ Retirement plans and bankruptcy**

The Supreme Court recently held that debtors who go bankrupt may be able to keep some or all of the funds in their traditional IRAs from the reach of their creditors under a federal bankruptcy exemption. Shortly after this decision, which did not specifically address whether Roth IRAs can qualify for the exemption, a massive bankruptcy reform measure containing many changes on the treatment of employee benefit plans in bankruptcy was signed into law. One change allows debtors to exempt from the bankruptcy estate retirement funds in most employer sponsored plans, and, subject to an overall \$1 million cap, in traditional or Roth IRAs. These changes will take effect on October 17, 2005, but they don't apply to cases begun before that date.

### **■ More guidance on the sales tax deduction**

The IRS has issued more guidance for taxpayers who itemize and make the election to deduct state and local general sales taxes instead of state and local income taxes. In addition to explaining the basics of this new deduction, the guidance covers such items as joint filers living in different states, separate filers, revocations and planned changes to the optional sales tax tables for next year. While the tax return due date has come and passed, this information can be quite valuable for individuals who got filing extensions or might want to file an amended return to change their choice.

### **■ New tax breaks for disaster mitigation payments**

A new law was recently enacted which retroactively treats qualified disaster mitigation payments as exempt from income tax. It also provides that qualifying sales under certain hazard mitigation programs are eligible for deferral of gain recognition as involuntary conversions.

### **■ Damages for faulty home construction**

An IRS ruling makes it clear you generally won't be taxed on any damages you receive from a builder, architect or other responsible party, for faulty construction of your residence. Rather, you reduce your basis (your cost for tax purposes) for measuring gain or loss if and when you sell the home. You are, however, taxed currently to the extent the damages you receive exceed your basis. These rules apply whether the damages are awarded in a lawsuit or paid in settlement of a suit.

■ **Like-kind exchanges facilitated**

Like-kind exchanges are popular ways for taxpayers to dispose of appreciated realty without paying a current tax. However, it may be difficult for a taxpayer who finds a willing buyer for his property to find suitable replacement property within the statutory time periods (identification of replacement property no later than 45 days after the transfer of the relinquished property, and receipt of the replacement property within 180 days after the transfer or by the extended due date of the return for the year of transfer, if earlier). One solution is to replace the relinquished property with an undivided fractional interest in like-kind realty (also known as a marketable tenancy-in-common interest). A new IRS ruling supplies a fairly detailed blueprint for real estate entrepreneurs to follow in structuring undivided fractional interest ownership arrangements that will pass muster with the IRS.

■ **No relief for AMT owed from ISO exercise**

Many companies award executives and other key employees options to purchase the company's stock which qualify as incentive stock options (ISOs). For regular tax purposes there's no current tax, and, if holding period requirements are met, the executive's tax bill can be limited to long-term capital gain on ultimate sale of the stock. However, there is one large catch - the bargain element on exercise of an ISO is included in the alternative minimum tax (AMT) tax base. The Tax Court has held the IRS did not abuse its discretion when it rejected a taxpayer's offer in compromise relating to AMT liability which resulted from his exercise of ISOs in 2000. In this case, the taxpayer faced a huge AMT liability from his exercise of ISOs and was left with stock which had dropped precipitously in value after the exercise. While the Tax Court was sympathetic to his plight, it found IRS did not act improperly in denying the offer. This case is not unique. Many taxpayers who received and exercised ISOs before the tech bubble burst in 2000 were left holding stock with little and in some cases no value. Congress has been asked to fix this problem but thus far has not acted. As the Tax Court pointed out, any fix must come from Congress, not from the IRS or the Courts. Commentators have said a fix may not happen unless and until enough affected individuals convince their legislators to take action.

■ **Tax debts discharged even though returns filed late**

A U.S. Circuit Court of Appeals has held a debtor's federal tax returns filed after the IRS had assessed the tax liabilities for the years involved qualified as returns under the bankruptcy law. The debtor's returns were filed late but he waited more than two years after filing them before he petitioned for bankruptcy so he wasn't snared by a bankruptcy rule which excepts from discharge taxes for which a required return was filed late and within two years before the bankruptcy petition.

■ **Huge tax gap foreshadows increased enforcement**

The IRS has released preliminary results from a major research project assessing compliance with the tax laws. The study, which involves tax year 2001, reveals the nation has a net tax gap of over a quarter trillion dollars, which the IRS vows to bring down with its increasing enforcement efforts. The tax gap has three components: under

reporting of income, underpayment of taxes and non-filing of returns. Under reporting accounts for more than 80% of the total tax gap, with non-filing and underpayment at about 10% each.

■ **AMT deduction for refinanced home mortgage interest**

The IRS has clarified that interest paid on a home mortgage which has been refinanced more than once can qualify to be deducted (up to a limit) for alternative minimum tax (AMT) purposes even though the original instructions for Form 6251, Alternative Minimum Tax - Individuals suggested otherwise. The IRS has reissued corrected instructions electronically.

■ **Three more hybrid vehicles certified for clean fuel deduction**

The IRS has certified three more model-year 2005 hybrid gas-electric automobiles as being eligible for the clean-burning fuel deduction: the Honda Insight, Honda Civic Hybrid, and Honda Accord Hybrid. The original owner of one of these vehicles may claim a deduction of \$2,000 for the year that the vehicle is first put into use. The IRS had earlier certified the 2005 Ford Escape SUV and 2005 Toyota Prius.

■ **Home exchange can yield dual tax benefits**

An IRS pronouncement makes it clear the exchange of a home can qualify for both the home sale exclusion and like-kind exchange deferral treatment. This can occur where the property was used as a principal residence and a business consecutively (e.g., use as a principal residence followed by rental of the property) or concurrently (a portion of the home used as a principal residence and a portion used as a home office).

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