

RECAP OF SIGNIFICANT DEVELOPMENTS THAT OCCURRED IN THE FIRST QUARTER 2007

A number of important tax developments occurred in the first three months of 2007 which may affect you, your family and your livelihood. Key developments are summarized below.

- **Chances of being audited.**

The IRS has issued its annual data book, which provides statistical data on its fiscal year 2006 activities, including how many tax returns it examines (audits), and what categories of returns it focuses its resources on. Out of a total of 132 million individual returns filed in calendar year 2005, about 1,284,000 individual income tax returns (.97%) were audited during fiscal year 2006, more than double the number examined in FY 2000.

- **New guidance on new rollover option for nonspouse beneficiaries of retirement plan accounts.**

The IRS has issued guidance on a new-for-2007 choice for nonspouse beneficiaries of an inherited qualified plan account. These beneficiaries may be able to transfer part (or all) of the deceased employee's account balance into an inherited IRA. Under the new guidance, a nonspouse beneficiary can, in most situations, receive payouts from the inherited IRA over his or her lifetime. This can make an inherited IRA a powerful tax-deferral tool, but expert help is a must to assure key rules are met (such as when distributions from the inherited IRA must begin). The one downside is under the IRS's latest guidance, company retirement plans may, but are not required to, offer the rollover option for nonspouse beneficiaries.

- **IRS explains new IRA-to-charity rollover options for older taxpayers.**

For 2006 and 2007, an IRA owner who is age 70 ½ or older can directly transfer tax-free up to \$100,000 per year from an IRA to an eligible charitable organization. Amounts transferred are not taxable and a deduction can't be claimed for the amount given to the charity. Transferred amounts are counted in determining whether the owner has met the IRA required minimum distribution rules. The IRS's explanation of how this rollover rule works takes a decidedly liberal approach. For example, it permits each spouse to make an up-to-\$100,000 tax-free transfer, and allows an IRA owner either to make a direct transfer from the IRA to the charity or hand-deliver a check from the IRA payable to the charity. The IRS also permits otherwise qualifying IRA beneficiaries (not just IRA owners) to make the nontaxable rollover.

- **Liberalized 401(k) rules for hardship withdrawals.**

You can take a distribution from a 401(k)-type plan only on account of certain events, such as disability, retirement or "hardship" - you need to withdraw cash to satisfy an

immediate and heavy financial need. The rules used to say that to take a hardship payout, you (and, in some cases, your spouse or dependent) had to have the immediate and heavy financial need. But under a change mandated by the 2006 Pension Protection Act, the IRS has amended the rules to allow 401(k) payouts for a primary beneficiary's hardship. This primary beneficiary doesn't have to be your dependent. However, the hardship must be for certain specific expenses, such as medical bills or tuition costs.

■ **Code Section 199 final regulations on computer software.**

The IRS has issued final regulations which explain when a taxpayer's gross receipts from the provision of online software (i.e., software provided to customers while they are directly connected to the Internet or to any other public or private communications network) are "domestic production gross receipts" which are eligible to be taken into account in computing the taxpayer's Code Section 199 domestic production activities deduction. Generally, this eligibility occurs when the taxpayer or another person derives gross receipts from qualifying dispositions of the same or similar software affixed to a tangible medium (e.g., DVDs or CD-ROMs) or by download. For 2007 tax years, the Code Section 199 domestic production activities deduction is 6% of "qualified production activities income" - i.e, domestic production gross receipts net of properly allocable expenses - subject to a 50%-of-W-2-wages limitation.

■ **New regulations on depreciation of property acquired in like-kind swap or involuntary conversion.**

The IRS has issued final regulations on how to depreciate MACRS property acquired in a Code Section 1031 like-kind exchange or as a result of a Code Section 1033 involuntary conversion. The regulations apply when both the acquired and relinquished property are subject to the MACRS accelerated depreciation rules in the hands of the acquiring taxpayer. These regulations are extremely complex and could be burdensome for taxpayers who engage in many like-kind exchanges during the year, or must deal with multiple involuntary conversions. However, taxpayers may elect not to apply the new regulations - an option which should be given careful consideration - unless the final regulations' approach significantly accelerates depreciation deductions.

■ **Foreign housing allowances again boosted for high-cost areas.**

In general, taxpayers who live and work abroad may be able to claim a foreign income exclusion and a housing cost exclusion. The Tax Increase Prevention and Reconciliation Act (signed into law on May 17, 2006), toughened these exclusions, effective as of the beginning of 2006. It also gave the IRS the power to issue guidance relaxing the rules based on geographic differences in housing costs relative to housing costs in the U.S. The IRS recently issued such guidance which not only increased higher maximums the IRS had earlier authorized (e.g., for Vienna, Austria and Moscow, Russia) but also added new high cost locations to the pre-existing list of such locations (e.g., Beijing and Shanghai, China, Mumbai and New Delhi, India and Zurich, Switzerland).

■ **Full credit for Ford, GM and Honda qualifying hybrids through June of 2007;**

more vehicles qualify for credit.

Taxpayers who purchase new qualified hybrid motor vehicles may claim a tax credit which varies in amount with the car model, but the credit begins to phase out after the manufacturer sells a fixed number of hybrid vehicles. Based on manufacturer sales figures, the IRS has announced the full hybrid credit remains available through at least June 30, 2007, for qualified hybrid vehicles manufactured by Ford, GM and Honda.

The IRS also put the following vehicles on the list of those which qualify for the hybrid credit (credit amounts are in parentheses): Ford Escape 2WD Hybrid Model Year 2008 (\$3,000); Mercury Mariner 2WD Hybrid Model Year 2008 (\$3,000); Ford Escape 4WD Hybrid Model Year 2008 (\$2,200); Mercury Mariner 4WD Hybrid Model year 2008 (\$2,200); and 2007 Saturn Aura (\$1,300).

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