

RECAP OF SIGNIFICANT DEVELOPMENTS THAT OCCURRED IN THE SECOND QUARTER OF 2006

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

■ **New tax reconciliation act**

The "Tax Increase Prevention and Reconciliation Act" (TIPRA) was signed into law by the President on May 17, 2006. The most talked about provisions in this law were the short-term alternative minimum tax relief for 2006 and the extension of the current low-taxed capital gains and dividends rate which was due to expire after 2008.

However, it also carried a number of other changes affecting individuals and businesses, and included corporate and foreign provisions, technical corrections and extensions of several provisions. Some of these are:

- Kiddie tax age limit raised from under 14 to under 18 for tax years beginning after December 31, 2005.
- Income limit on Roth IRA conversions eliminated for tax years beginning after December 31, 2009.
- Extension of increased asset expensing for small business through the end of 2009.
- Modification of the 50% W-2 wage limit on the domestic production deduction, effective for tax years beginning after May 17, 2006.
- Information reporting required for tax-exempt interest after December 31, 2005.
- Changes for corporate estimated tax payments due on September 15, 2010, and September 15, 2011.
- Capital gain treatment allowed for self-created musical works at the taxpayer's election for a pre-January 1, 2011, sale or exchange in tax years beginning after May 17, 2006.
- Amortization of expenses paid for musical works and copyrights for tax years beginning after December 31, 2005, and before January 1, 2011.
- The active business test for a tax-free corporate spin-off is simplified for

distributions made after May 17, 2006, and before January 1, 2010.

- Changes (some not favorable to taxpayers) to the foreign earned income exclusion and housing allowance for U.S. citizens working abroad for tax years beginning after December 31, 2005.

■ **Military tax relief law**

On May 29, 2006, the President signed the "Heroes Earned Retirement Opportunities Act" (HERO Act) into law. The HERO Act allows excluded combat pay to be treated as compensation for purposes of the individual retirement account (IRA) contribution rules. Most individuals who received excluded combat pay in 2004 or 2005 have until May 28, 2009, to make an IRA contribution for either or both of those years.

■ **Code Section 199 final regulations and other guidance**

The IRS has issued a barrage of new guidance on the domestic production activities deduction, including final regulations, temporary regulations and a new revenue procedure. This deduction, which has attracted much criticism, commentary and several waves of interim guidance since it was added to the Code by the 2004 Jobs Act is 3% (for 2006; 6% through 2009; and 9% thereafter) of the lesser of a taxpayer's qualified production activities income or taxable income, subject to a 50% of W-2-wages limitation. The long-awaited final regulations, though complex, carry a number of liberalizations, simplifying conventions and examples. The guidance provides major breaks for the software and construction industries. Where either of two fairly broad exceptions to the general rules is satisfied, the IRS, reversing its previous position, allows gross receipts from providing software for a customer's direct use while connected to the Internet to be treated as derived from a qualifying disposition. The IRS also broadens the definition of qualifying construction activities, allowing gross receipts derived from materials and supplies consumed in a construction project to be included in domestic production gross receipts from the construction of real property.

■ **The IRS concedes on long-distance telephone excise tax**

The IRS, after repeatedly losing in one court after another, has finally conceded the Federal excise tax doesn't apply to long-distance calls for which the charges are computed on an elapsed time basis regardless of distance. Taxpayers no longer have to pay the tax and can request a credit or refund under the terms of an IRS notice for amounts paid for service billed to them after February 28, 2003, and before August 1, 2006. Remarkably, the IRS has also conceded the excise tax doesn't apply with regard to Voice over Internet Protocol (VOIP) service, prepaid telephone cards and plans which provide both local and long distance service for either a flat monthly fee or a charge which varies with the elapsed transmission time - all issues the IRS has not repeatedly litigated and lost. Individuals (including Schedule C filers), but not other taxpayers, can request a refund or credit using either the actual amount of tax

paid for services or use a safe harbor amount (which the IRS has yet to specify).

■ **How to revoke an election not to defer income**

Generally, an employee or independent contractor is taxed on property received in connection with the performance of services only when the property is either not subject to a substantial risk of forfeiture or is transferable to a third party free of this risk. However, a person may instead elect under Code Sec. 83(b), to include the income from the transfer for the year in which the property is received. This Sec. 83(b) election subjects an employee to immediate tax liability, but any increase in the value of the property after its receipt and up to the time it's disposal is taxed as capital gain. The IRS has explained how to request its consent to revoke a Sec. 83(b) election not to defer income from restricted stock or property. While the formalized procedures basically leave the existing rules unchanged, they underscore how care must be taken by a taxpayer making the Sec. 83(b) election because circumstances in which the IRS will allow it to be revoked are relatively narrow. In a market that suddenly declines, an electing employee can find he's paid tax on property (e.g., stock) which is worth less than when he made the election, or worse, is worthless, with the result he has not only paid tax sooner but he's paid more tax than he would have at a later point in time. Once elected, undoing the election isn't easy.

■ **Interest on S corporation's overpayment**

In general, the interest rate on a tax overpayment by a corporation is the Federal short-term rate, plus two percentage points. However, to the extent a tax overpayment by a corporation for any tax period exceeds \$10,000, the interest rate for such a "large corporate overpayment" is the Federal short-term rate plus 0.5 percentage points. The Tax Court has held the interest on an S corporation's refund wasn't limited to the rate for large corporate overpayments. This lower rate applied only to C corporations, and not S corporations. However, the Court also said the S corporation wasn't entitled to the higher overpayment rate for noncorporate taxpayers - the Federal short-term rate, plus three percentage points.

■ **Ford, Honda, and Toyota vehicles qualify for the alternative motor vehicle income tax credit**

The IRS has said various model years of the Ford Escape Hybrid, Mercury Mariner Hybrid, Honda Civic Hybrid, Honda Insight, Honda Accord Hybrid, Toyota Prius, Toyota Highlander, Toyota Camry, Lexus GS 450h, and Lexus RX400h qualify for the alternative motor vehicle income tax credit. The credit amount may be as much as \$3,400 for a hybrid vehicle. Taxpayers may claim the full amount of the allowable credit up to the end of the first calendar quarter after the quarter in which the manufacturer records its sale of the 60,000th vehicle. Additional phaseouts apply to later periods. The IRS's sales report for the first quarter indicate that Ford and Toyota haven't hit this limit yet and their customers may continue to claim the full alternative motor vehicle credit at least through September 30, 2006.

This Hot Topic 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.