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

The following is a summary of the most important tax developments that 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.

- **Pension Protection Act makes many changes for individuals**

  On August 17, 2006, the President signed the Pension Protection Act of 2006 into law. This complex 900-plus-page law makes a host of changes relating to pension plans and their beneficiaries, and also revises key charitable giving rules. Its key changes affecting individuals include:

  - Statutory rules for a relatively new type of company sponsored retirement plan generally called a cash balance plan. This type of plan determines an employee's retirement benefit by reference to his or her "cash balance" in a hypothetical account. Each employee's hypothetical account balance is based on annual pay credits to his or her account, plus interest credits on the account. Cash balance plans tend to favor younger workers over older workers. Traditional pension plans can be converted to cash balance plans, if a number of detailed requirements are met.

  - Generally effective for plan years beginning after 2006, "defined contribution" retirement plans (such as profit sharing plans) invested in employer securities only must offer participants at least three other investment choices.

  - Generally effective for plan years beginning after 2006, an accelerated vesting schedule applies to all employer contributions made to "defined contribution" retirement plans (currently, faster vesting applies only to matching employer contributions).

  - Generally effective for plans years beginning after 2007, retirement plans that provide for a joint and survivor annuity payout option must offer as an option a joint and 75% survivor annuity benefit.

  - Generally effective after 2006, plans will be able to offer investment advice to participants in plans such as profit-sharing arrangements or 401(k) plans, if certain strict new standards are met. Similarly, fiduciaries will be able to provide investment advice to owners and beneficiaries of IRAs (as well as health savings accounts, Archer medical savings accounts and Coverdell education savings accounts).

- Post-2006 cost-of-living increases to the income limits at which the IRA deduction phases out when an individual (or spouse) is an active participant in an employer sponsored retirement plan. This will result in more active participants being able to make deductible IRA contributions.

- Post-2006 cost-of-living adjustments to the income limits at which the ability to make contributions to a Roth IRA phases out. As a result, more taxpayers will be able to make Roth IRA contributions.

- For distributions after 2006, nonspouse beneficiaries of retirement plan accounts will be able to make rollovers to inherited-IRA accounts. Currently, only spouse-beneficiaries of retirement plan accounts can make rollovers to IRAs. The change gives much-needed flexibility to those who inherit retirement plan accounts from a non-spouse (such as a parent or uncle).

- More rollover options for after-tax contributions to retirement plans. After 2006, such contributions may be rolled over to another retirement plan or to a tax-sheltered annuity, if the transfer is made via direct rollover and the receiving plan or annuity separately accounts for the after-tax contributions.

- After 2007, distributions from retirement plans, tax-sheltered annuities, and governmental Code Section 457 plans can be rolled over directly into a Roth IRA, subject to the usual rules that apply to rollovers from a traditional IRA into a Roth IRA. For example, under these rules, a rollover to a Roth IRA generally is taxable, and, until 2010, can't be made if adjusted gross income is $100,000 or more (but the $100,000 rule won't apply after 2009).

- For distributions in plan years beginning after 2006, pension plans may make distributions once a plan participant reaches age 62, even if he or she continues working. This change will make it easier for employees to phase into retirement (assuming their employers decide to adopt the change).

- Makes permanent many pro-taxpayer retirement plan and IRA changes made by the Economic Growth and Tax Relief Reconciliation Act of 2001 which were supposed to sunset at the end of 2010. These include the ability to make "catchup" contributions to IRAs and 401(k)s after reaching age 50, increases in maximum IRA and Roth IRA contributions and widened rollover choices.

- A new opportunity in 2006 and 2007 for an individual age 70 ½ or older to exclude up to $100,000 a year of distributions from IRAs (including Roth IRAs) which are paid directly by the IRA or Roth IRA trustee to a qualifying charity. If the exclusion is chosen, the donated amount can't be deducted as a charitable contribution.

- Toughened rules for certain contributions. For example, post-August 17, 2006, contributions of clothing and household items which are not in good used condition or better can't be deducted. In addition, the IRS may deny a deduction for any contribution of clothing or a household item with minimal monetary value, such as used socks or undergarments.

  A deduction may be approved for clothing or a household item not in good used condition or better which has a more than $500 claimed value and is backed up by a qualified appraisal.

- New substantiation requirements. A taxpayer won't be able to deduct a post-2006 contribution of cash, check or other monetary gift unless he maintains as a record of the contribution a bank record or a written communication from the charity showing its name, the date of the contribution and the amount of the contribution.

- **Spouse's rollover of decedent's IRA leads to 10% penalty**

The Tax Court held a surviving spouse who rolled over her deceased husband's IRA into her own IRA had to pay the 10% premature withdrawal penalty when she later withdrew funds from the IRA before reaching age 59 ½. Once she transferred the funds to her own IRA (instead of keeping them in her spouse's IRA), the withdrawal no longer qualified for the exception to the penalty for a distribution to a beneficiary on account of the IRA owner's death. The decision points up the need to get expert advice on how to handle the complex rules on IRA distributions and rollovers.

- **The IRS unveils telephone excise tax refund amounts**

Following up on its acknowledgment that certain long-distance telephone excise taxes were unlawfully collected, the IRS announced the "safe harbor" amounts ranging from $30 to $60 individual long-distance customers can use to compute their telephone excise tax refund. Individuals (including Schedule C filers), may request a refund or credit on their 2006 income tax return using either the actual amount of telephone excise tax paid for nontaxable services or the safe harbor amount. If the latter is used, no documentation to support the refund request is required. Most taxpayers will only have to fill out one line on their regular 2006 return, and a special Form 1040EZ-T can be used by taxpayers who don't need to file a return.

- **One court says tax law's exclusion for damage awards is unconstitutional**

In a controversial opinion, the Court of Appeals for the D.C. Circuit held the Internal Revenue Code rule taxing awards for a non-physical personal injury that is unrelated to lost wages or earnings is unconstitutional. In a lawsuit, a taxpayer who was blacklisted by her former employer received compensatory damages for emotional distress and injury to her professional reputation. None of the award was for lost wages or diminished earning capacity. The IRS said the award was taxable because the Internal Revenue Code only excludes awards for personal physical injury or personal physical sickness. The court's endorsement of the taxpayer's argument (which might previously have been thought untenable or even frivolous) that the Internal Revenue Code section cited by the IRS is unconstitutional is almost unprecedented, and commentators speculate it may very well open the floodgate to other constitutional challenges to the Internal Revenue Code and its definition of what is taxable income.

- **Simplified per diem rates rise effective October 1st**

Reimbursements of an employee's business travel costs (lodging, meal and incidental expenses (M&IE)) at a per diem rate are payroll-and income-tax free if simplified substantiation is provided and the daily rate doesn't exceed the Federal per diem rate (the maximum amount that the Federal government reimburses its employees) for the locality of travel for that day. While the per diem rates vary by travel destination, employers can make reimbursements at the simplified "high-low" per diem rates, which assign one per diem rate to high-cost areas within the continental U.S., and another to non-high-cost areas. The IRS has issued the "high-low" simplified per diem rates for post-September 30, 2006, travel. An employer may reimburse up to $246 for high-cost localities ($188 for lodging and $58 for M&IE) and $148 for other localities ($103 for lodging and $45 for M&IE). The list of high-cost areas is also updated.

- **Foreign housing allowances 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 to 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, allowing taxpayers living and working abroad in high-cost areas, such as Tokyo, to claim higher housing cost exclusions than those located in non-high-cost foreign areas.

- **Reduced hybrid credit allowed for Toyota cars after September, 2006**

  The IRS announced that only 50% of the otherwise available alternative motor vehicle credit amount is allowed for Toyota hybrid vehicles bought after September 30, 2006, and before April 1, 2007 (and only 25% for Toyota hybrids bought after March 31, 2007, and before October 1, 2007). The phaseout of the credit is tied to the number of hybrids sold per-manufacturer. No credit will be allowed for Toyota hybrids bought after September 30, 2007. While Toyota hybrid sales are now subject to a reduced credit, hybrids purchased from other manufacturers, such as Honda, Ford and GM, are not. In the past several months, the IRS has announced the following vehicles are eligible for the credit, in the following amounts:

  - Toyota: 2007 Prius ($3,150), Highlander Hybrid 2WD and 4WD ($2,600), Lexus RX 400h 2WD and Lexus 4WD ($2,200);

  - Honda: 2006 Insight ($1,450), Civic Hybrid ($2,100), Accord Hybrid ($1,300; $650 without updated calibration), and Accord Hybrid Navi ($1,300; $650 without updated calibration);

  - GMC: 2006 and 2007 model years Silverado Hybrid 2WD,($250), Silverado Hybrid 4WD ($650), Sierra Hybrid 2WD, ($250), Sierra Hybrid 4WD ($650) and 2007 Saturn Vue GreenLine ($650); and

  - Ford: 2007, 2006, 2005 Escape 2 WD Hybrid ($2,600), Escape 4 WD Hybrid ($1,950), and 2007 and 2006 Mercury Mariner 4WD ($1,950).