



TAX DEVELOPMENTS IN THE SECOND QUARTER OF 2006

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 that 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 Dec. 31, 2005.
- Income limit on Roth IRA conversions eliminated for tax years beginning after Dec. 31, 2009.
- extension of increased Code Sec. 179 expensing for small business through the end of 2009.
- Modification of the 50% W-2 wage limit on the Code Sec. 199 domestic production deduction, effective for tax years beginning after May 17, 2006.
- Information reporting required for tax-exempt interest after Dec. 31, 2005.
- Changes for corporate estimated tax payments due on Sept. 15, 2010 and Sept. 15, 2011.
- Capital gain treatment allowed for self-created musical works at the taxpayer’s election for a pre-Jan. 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 Dec. 31, 2005 and before Jan. 1, 2011.

- The active business test for a tax-free corporate spin-off is simplified for distributions made after May 17, 2006 and before Jan. 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 Dec. 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 SEC. 199 FINAL REGS AND OTHER GUIDANCE

The IRS has issued a barrage of new guidance on the Code Sec. 199 domestic production activities deduction, including final regs, temporary regs, 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 regs, 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 customers’ 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 that 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 Feb. 28, 2003 and before Aug. 1, 2006. Remarkably, the IRS has also conceded that the excise tax doesn't apply with regard to Voice over Internet Protocol service, prepaid telephone cards, and plans that provide both local and long distance service for either a flat monthly fee or a charge that varies with the elapsed transmission time—all issues that the IRS hasn't 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. The Code 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 Code 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 Code 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 that he's paid tax on property (e.g., stock) that's worth less than when he made the election, or worse, is worthless, with the result that he's not only paid tax sooner but that 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 that 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 that the interest on an S corporation's refund wasn't limited to the rate for large corporate overpayments. That lower rate applied only to C corporations, and not S corporations. However, the Court also said that 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 that 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 that their customers may continue to claim the full Code Sec. 30B alternative motor vehicle credit at least through Sept. 30, 2006.

For more information, please contact an attorney in the Armstrong Teasdale Tax Department:

Armstrong Teasdale Tax Department

Robert Lewis Jackson, (314) 342-8076
rjackson@armstrongteasdale.com

Larry M. Sewell, (314) 342-8020
lsewell@armstrongteasdale.com

Christopher J. Anderson, (816) 472-3117
canderson@armstrongteasdale.com

Jonathan W. Igoe, (314) 342-8019
jigoe@armstrongteasdale.com

Scott Hunt, (314) 342-4145
shunt@armstrongteasdale.com

Guy A. Schmitz, (314) 259-4738
gschmitz@armstrongteasdale.com

John E. Dooling, Jr., (314) 259-4743
jdooling@armstrongteasdale.com

This alert is offered as a service to clients and friends of Armstrong Teasdale LLP and is intended as an informal summary of certain recent legislation, cases, rulings and other developments. This alert does not constitute legal advice or a legal opinion and is not adequate substitute for the advice of counsel.

“ADVERTISING MATERIAL: COMMERCIAL SOLICITATIONS ARE PERMITTED BY THE MISSOURI RULES OF PROFESSIONAL CONDUCT BUT ARE NEITHER SUBMITTED TO NOR APPROVED BY THE MISSOURI BAR OR THE SUPREME COURT OF MISSOURI.”

St. Louis, MO
One Metropolitan Square
St. Louis, Missouri 63102
(314) 621-5070

Jefferson City, MO
3405 West Truman Boulevard
Jefferson City, Missouri 65109
(573) 636-8394

Kansas City, MO
2345 Grand Boulevard
Kansas City, Missouri 64108
(816) 221-3420

Overland Park, KS
7400 West 132nd Street
Overland Park, Kansas 66213
(913) 814-0969

Belleville, IL
23 South First Street
Belleville, Illinois 62220
(618) 397-4411

Edwardsville, IL
241 North Main Street
Edwardsville, Illinois 62025
(618) 655-4004

Las Vegas, NV
701 North Green Valley Parkway
Henderson, Nevada 89074
(702) 678-5070

Washington, DC
1747 Pennsylvania Avenue, N.W.
Washington, D.C. 20006
(202) 454-2800

Shanghai, China
1376 Nan Jing Xi Lu
Shanghai Centre - Suite 718
Shanghai 200040
P.R. China
011-8621-6279-8808