Client Alert

ARMSTRONG TEASDALE LLP

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TAX DEVELOPMENTS IN THE FIRST QUARTER OF 2007

A number of important tax developments occurred in the past three months that may affect you, your family, and your livelihood.

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 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 that key rules are met (such as when distributions from the inherited IRA must begin). The one downside is that 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 701/2 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 made out 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 SEC. 199 FINAL REGS ON COMPUTER SOFTWARE

The IRS has issued final regs that clarify that the online software exceptions (which allow the Code Sec. 199 deduction to be taken) are intended to apply only to gross receipts derived from providing customers access to computer software for the customers' direct use while connected to the Internet and only when the taxpayer or another person also derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of the computer software (or substantially identical software) affixed to a tangible medium or by download. The Code Sec. 199 domestic production activities deduction 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.

NEW REGS ON DEPRECIATION OF PROPERTY ACQUIRED IN LIKE-KIND SWAP OR INVOLUNTARY CONVERSION

The IRS has issued final regs on how to depreciate MACRS property acquired in a Code Sec. 1031 like-kind exchange or as a result of a Code Sec. 1033 involuntary conversion. The regs apply when both the acquired and relinquished property are subject to the MACRS accelerated depreciation rules in the hands of the acquiring taxpayer. These regs are extremely complex and could be burdensome for taxpayers that 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 regs—an option that should be given careful consideration—unless the final regs' 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 5/17/2006), 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 that not only increased higher maximums that 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 that 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 that 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 that 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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