



TAX DEVELOPMENTS IN FIRST QUARTER OF 2006

Chances of being audited. The IRS has issued its annual data book, which provides statistical data for fiscal year 2005 activities, including how many tax returns examined (audits), and what categories of returns resources are focused on. In general, audit rates were raised in all categories of non-business individual returns except for those 1040A filers under \$25,000. The audit rate for most corporations has declined, but increased for corporations with assets of \$250 million or more.

Energy-efficient home improvements tax credit. The IRS has issued guidance on the up-to-\$500 Code Sec. 25C tax credit available to homeowners for energy-efficient home improvements implemented after 2005 and before 2008. A 10% credit is allowed for the cost of certain improvements, e.g., insulation, exterior windows, skylights, exterior doors, and pigmented coated metal roofs; and a specified amount is allowed for other items such as: advanced main air circulating fans (\$50), natural gas, propane, or oil furnaces or hot water boilers (\$150), and heat pumps, water heaters, and central air conditioners (\$300). Manufacturers of these energy-efficient items must provide consumers with a certification that they can rely on in claiming the credit.

Donations of cars, boats, and planes valued at more than \$500. The IRS has revised the form which a charity must use in 2006 to report qualified donated vehicles, Form 1098-C, Contributions of Motor Vehicles, Boats, and Airplanes. Under stringent new rules, a taxpayer's charitable deduction for these vehicles with a claimed value in excess of \$500 can

not, with a few narrow exceptions, exceed the charity's gross proceeds from its sale of the vehicle. The revised form clarifies that for a donor to get a deduction, the charity's acknowledgement must include (along with other required information):

- whether the charity provided any goods or services in exchange for the vehicle
- a description
- a good faith estimate of the value of any such goods or services
- if the goods or services consist solely of intangible religious benefits, a statement to that effect

Phaseouts of 2006 itemized deductions and personal exemptions. Under liberalized tax law changes that apply for the first time in 2006, there are smaller phaseouts of a higher-income taxpayer's itemized deductions and personal exemptions. All things being equal, a smaller phaseout means a larger deduction and, as a result, less taxes due for 2006. This may be of particular importance to individuals who must pay a quarterly estimated tax or face a penalty (i.e., most taxpayers who have income that is not subject to withholding). The smaller reductions in a taxpayer's itemized deductions and personal exemptions may result in smaller required estimated tax payments during the year. The IRS has just provided official worksheets for calculating these reduced phaseout amounts.

Domestic production deduction. The IRS's instructions for the new Form 8903, Domestic Production Activities Deduction, and revised instructions to S corporation Form 1120S, and partnership Form 1065 carry additional guidance on some aspects of the new-for-2005 U.S. production activities deduction. Under this provision, taxpayers are allowed a deduction equal to a percentage (3% for 2006; 6% through 2009; and 9% thereafter) of the lesser of their qualified production activities income for the tax year (i.e., net income from U.S. manufacturing, production, or extraction activities) or their taxable income, subject to a 50% of W-2-wages limitation. The new instructions shed some light on the often tortuous computations necessary to determine this credit. For example, they explain how disallowance rules under other deductions apply, and provide liberalized rules for computing qualified production activities income. They also explain special rules that apply to S corporations and partnerships.

Contractor's energy-efficient home credit. The IRS has explained how an eligible contractor can obtain the required certification for a dwelling (including a vacation home) that has been constructed in order to qualify for the \$1,000 or \$2,000 energy-efficient credit. This new credit applies to homes purchased after Dec. 31, 2005 and before Jan. 1, 2008. To get the credit, the home's construction (which can include substantial reconstruction and rehabilitation) must be substantially completed after Aug. 8, 2005 and meet specific energy saving requirements. The IRS guidance carries a list of software programs that may be used in calculating energy consumption to obtain the certification.

Cost of removing building's mold is currently deductible. Generally, expenses must be capitalized if they are needed to place property in an ordinarily efficient operating condition (as in the case of expenses to remedy a condition that existed when the property was acquired), or if they add to a property's value, substantially prolong its useful life, or adapt it to a new use. The IRS and some courts have treated the costs of removing asbestos from a building as a capital expenditure because it results in an improvement in the property by reducing or eliminating human health risks. In welcome news for taxpayers affected by the sometimes devastating cost of a mold condition in a structure, the IRS has privately ruled that-unlike the

costs of removing asbestos-the cost a business incurs to remove mold from a building it owned and leased out is deductible as an ordinary and necessary expense.

Luxury auto depreciation limits for 2006. The IRS has released the inflation-adjusted depreciation limits for business autos, light trucks and vans, including minivans and sport-utility vehicles (SUVs), placed in service during 2006. Also released in the annual income inclusion were the amounts for such vehicles first leased in 2006. The "luxury passenger auto limits" cap the otherwise allowable depreciation that can be claimed in a year. In general, the limits are the same as for vehicles placed in service last year, except for a slight increase (\$100) for business autos in some later years. The IRS guidance also carries the depreciation limits and lease inclusion amounts for electric autos.

Distributions from Roth 401(k)s. The IRS has issued proposed reliance regulations that provide comprehensive guidance on the taxation of distributions from Roth 401(k) accounts. For the tax years beginning after 2005, an employer's Code Sec. 401(k) plan or Code Sec. 403(b) annuity can include a qualified Roth contribution program (i.e., a "Roth 401(k)") that allows participants to elect to have all or part of their elective deferrals treated as Roth contributions. These amounts are currently includible in income, but their distribution may be excluded from income. The complex rules that apply to Roth 401(k)s are different from those applicable to Roth IRAs. For example, the special ordering rule that treats the first distributions from a Roth IRA as a return of contributions (and thus not includible in income) until all contributions have been returned as basis does not apply to distributions from a Roth 401(k); instead the tax rules for annuities apply.

Toyota Prius Hybrid certified for the clean burning fuel deduction. The IRS has certified the 2006-model-year Toyota Prius Hybrid as being eligible for the clean-burning fuel deduction. The original owner of one of these vehicles may claim a deduction of \$2,000 for vehicles placed in service in 2005, the last year this credit is available. (However, hybrid vehicles may qualify for the new Code Sec. 30B alternative motor vehicle credit). Other 2006 model-year vehicles previously certified by the IRS are the Ford Escape Hybrid, the Mercury Mariner Hybrid, the Lexus RX 400h, and the Toyota Highlander Hybrid.

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