

RECAP OF SIGNIFICANT DEVELOPMENTS THAT OCCURRED IN THE FOURTH QUARTER OF 2005

Although hurricane-related legislation (the Gulf Opportunity Zone Act of 2005 and the Katrina Emergency tax Relief Act of 2005) dominated the tax news in the last quarter of 2005, there were many other important tax developments that may affect you, your family, your investments and your livelihood. We've summarized the most important new developments below. Please call me 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 six-month automatic extension for most 2005 returns**

The IRS has issued new regulations allowing most individuals and businesses to request a six-month automatic filing extension on a single form for 2005 returns. For example, an individual can get an automatic six-month extension to file an income tax return by submitting a timely, completed application for extension on Form 4868. No signature or explanation is required. Taxpayers must still estimate their tax due and pay that amount. Thus, by filing Form 4868, an individual whose 2005 return is due on April 17, 2006, (April 15th falls on a weekend) will automatically have until October 16, 2006, to file his 2005 return. Under prior rules, to get a six-month extension, you had to file one application for an initial four-month automatic extension, and then use a second one to ask for a two-month discretionary extension.

■ **2006 mileage rates announced**

For 2006, the optional standard mileage rate drops to 44.5 cents per business mile, down from 48.5 cents for the last four months of 2005. The 2006 rate for computing deductible medical or moving expenses drops to 18 cents a mile, down from 22 cents for the last four months of 2005. A person who uses a vehicle in providing donated services to a charity for relief related to Hurricane Katrina during 2006 computes the charitable mileage deduction by using a standard mileage rate of 32 cents (rather than the usual charitable standard mileage rate of 14). Additionally, volunteers may be reimbursed by a charity for the cost of driving their cars for the charity's benefit in connection with providing donated services for Hurricane Katrina relief during 2006. These volunteers may exclude a reimbursement of up to 44.5 cents per mile.

■ **New rules issued for domestic production activities deduction**

For tax years beginning after 2004, taxpayers can deduct a percentage of income earned from production activities undertaken in the U.S. (including manufacturing, certain food production, software development, film and music production, construction and engineering and architectural services). The

deduction is a percentage (e.g., 3% for tax years beginning in 2005 or 2006) of the smaller of (1) the qualified production activities income of the taxpayer for the tax year, or (2) taxable income (modified adjusted gross income, for individual taxpayers) without regard to the manufacturing deduction, for the tax year. An employer's deduction for domestic production activities can't exceed 50% of all employees' W-2 wages reported for the tax year.

New guidance from the IRS (in the form of proposed reliance regulations on which taxpayers may rely) includes the following clarifications:

- If an enterprise's otherwise qualifying receipts and related expenses are recognized for general tax purposes in different tax years, it must take receipts (including advance payments) into account for purposes of the domestic production activities deduction in the tax years in which they are otherwise recognized under its regular method of tax accounting.
 - In general, amounts earned for providing services don't qualify for the domestic production activities deduction. The latest guidance carves out exceptions for (among other items), qualifying delivery or distribution services, or installation services, connected with an item of property which does qualify for the domestic production activities deduction.
 - Proceeds from the sale of land aren't eligible for the domestic production activities deduction, but the latest guidance carries an extremely generous method of allocating gross receipts between the sale of (1) real property built by the taxpayer (and potentially eligible for the new deduction), and (2) land (which isn't eligible for the deduction). Also, if less than 5% of the total gross receipts derived by a taxpayer from a construction project are derived from nonqualifying activities (for example, from non-construction activities, the sale of tangible personal property, or land) then the total gross receipts derived by the taxpayer from the project are counted when determining the domestic production activities deduction.
- **IRS eases up on some nonqualified deferred compensation rules**

Effective generally for amounts deferred in tax years beginning after 2004 new tax rules apply to nonqualified deferred compensation (NQDC). Under the new rules, if certain conditions aren't met, all amounts deferred under a NQDC plan for all tax years may be currently includible in gross income by the plan participant. Recently, the IRS eased up on a number of the new NQDC rules, including the following:

- Under prior guidance, a NQDC plan adopted before December 31, 2005, wasn't treated as violating the distribution, acceleration of benefit and election requirements under the new rules if it was operated in good-faith compliance with the new rules during calendar year 2005 and was amended on or before December 31, 2005, to conform to the new rules. Now, the IRS has extended the amendment and good faith compliance period for one year (until December 31, 2006) for plans adopted before December 31, 2006.

- The IRS suspended for calendar year 2005 employer and payor reporting and wage withholding requirements for deferred compensation under the new NQDC rules. Earlier guidance had required NQDC W-2 or Form 1099 reporting for 2005.

■ **Employer's annual Federal return OK'd for many small businesses**

The IRS announced many small businesses will be able to file a Form 944, Employer's Annual Federal Tax Return, rather than Form 941, Employer's Quarterly Federal Tax Return. The simplified filing is limited to employers meeting certain eligibility requirements (e.g., estimated annual employment tax liability of \$1,000 or less). Eligible employers will receive written notification from the IRS of their qualification for the new Form 944 Program. The IRS says the new Form 944 program will significantly reduce tax filing burdens for nearly 950,000 small business owners because they will only have to file the new Form 944 once a year rather than filing Form 941 four times a year.

■ **Final regulations explain Roth-IRA option for 401(k) plans**

The IRS has issued final regulations explaining the post-2005 rule which permits 401(k) plans to allow participants to choose to have all or part of their elective deferrals treated as Roth-IRA contributions ("designated Roth contributions"). The final regulations carry a few surprises which will complicate designated Roth contributions and may make them less attractive to plan participants. For example, they say the established ordering rules which apply to regular Roth IRA payouts do not apply when determining the tax character of distributions of designated Roth contributions. More significantly, the regulations say designated Roth contributions are subject to the lifetime required minimum distribution (RMD) rules which apply to non-pension qualified plan payouts. By contrast, regular Roth IRAs are not subject to the lifetime RMD rules.

■ **Sharp increase in IRS users fees**

On February 1, 2006, the IRS will dramatically increase select user fees. Many of these increases are considerable. For example, a new \$50,000 flat fee, instead of the previous \$1,000 to \$10,000 fee, will apply for pre-filing agreements for corporate taxpayers. Advance Pricing Agreements, which currently cost from \$5,000 to \$25,000, will cost from \$22,500 to \$50,000. For employee plans, fees for opinion letters on prototype IRAs, SEPs, SIMPLE IRAs and Roth IRAs, which are currently \$125 to \$2,570, will now range from \$200 to \$4,500. Requests for changes in accounting methods for businesses will increase from \$1,500 to \$2,500. The fee for some private letter rulings will increase from \$7,500 to \$10,000, but lower fees will apply to taxpayers with gross income of less than \$250,000 (\$625) or with gross income of \$250,000 to \$1 million (\$2,500).

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