

Tax Update

Pepper Hamilton LLP
Attorneys at Law

MAY 2006

Highlights of the Tax Increase Prevention and Reconciliation Act of 2005

On May 17, President Bush signed into law the Tax Increase Prevention and Reconciliation Act of 2005 (Act), a \$70 billion tax package. The short title refers primarily to provisions that extend reduced tax rates on capital gains and dividends, enacted part of the American Jobs Creation Act of 2004, and to provisions designed to reduce the reach of the alternative minimum tax (AMT) by indexing the AMT exemption amounts. Of course, the Act contains numerous other tax provisions, including multiple “revenue offset provisions,” i.e. provisions that attempt to offset revenue losses from the extension of reduced capital gain and dividend rates and AMT relief.

Individual Provisions

Extension of Reduced Capital Gain and Dividend Rates

The preferential tax rates enjoyed by individuals on adjusted net capital

gains and qualified dividends is extended through tax years ending on or before December 31, 2010. The preferential rates were set to expire after tax years ending on or before December 31, 2008.

AMT

To prevent more middle income taxpayers from falling into the alternative minimum tax, the Act contained modest adjustments to the thresholds for the application of the individual AMT exemption amounts.

AGI Ceiling on IRA to Roth IRA Conversions Removed after 2009

For tax years beginning after December 31, 2009, a taxpayer can convert an IRA to a Roth IRA regardless of the taxpayer's modified adjusted gross income. Current law allows a taxpayer to effect the conversion only if modified adjusted gross income does not exceed \$100,000. The advantage of a Roth IRA over a traditional IRA is that qualified distributions are not taxed. Additionally, Roth IRAs are not subject to the minimum distribution requirements of Section 409(a)(9)(A). However, taxpayers who elect to convert a traditional IRA to a Roth IRA will be taxed on the full balance

Speakers Corner

Joan Arnold and Lance Jacobs spoke at the Third Annual Corporate Tax Workshop on June 7, 2006 in Reston, VA, co-sponsored by Pepper Hamilton.

Todd Reinstein will speak at a Federal Bar Association Section of Taxation breakfast on “A Review of the Final Section 199 Treasury Regulations” on June 16, 2006 in Washington, DC.

Joan Arnold and Howard Goldberg will speak at The Private Equity Tax Practices Conference on June 19-20, 2006 in Boston, MA.

Quotable

Todd Reinstein was quoted in BNA's *Daily Tax Report*, *Tax Notes Today* and CCH's *Tax Day* publications on different occasions in May 2006 regarding the recently issued regulation under Section 199.

of the IRA being converted in the year of the conversion, except for a conversion in 2010, in which case half of the income is includable in gross income in 2011 and the other half in 2012.

Also In This Issue

- 4 IRS Hangs Up the Phone on Certain Excise Taxes
- 5 The Eyes of Texas: Texas Replaces Franchise Tax System

Required Payment with Offer-in-Compromise

Effective for offers-in-compromise submitted on or after July 16, 2006, taxpayers must submit partial payment (up to 20%) to the IRS while their submission is under consideration. The wording in the legislation seems to suggest that the mandatory deposit would not be returned if the offer is refused.

Because taxpayers might lose this deposit if the offer is allowed, the new law may discourage many taxpayers from entering into the program and getting a fresh start.

Business Provisions - Domestic

New Estimated Tax Payment Schedule for Certain Corporations

Corporations with assets of at least \$1 billion will face a modified schedule of estimated tax payments starting with estimates due in July, 2006. Payments due in July, August and September of 2006 are increased to 105% of the payment otherwise due, and the next required payment is reduced accordingly. Payments due in July, August and September of 2012 are increased to 106.25% of the payment otherwise due, and the next required payment is reduced accordingly. Finally, payments due in July, August and September of 2013, are increased to 100.75% of the payment otherwise due, and the next required payment is reduced accordingly.

Modification of Section 199

An important limitation to the new production activities deduction is the amount of W-2 wages incurred by the

The modification of Section 199 may have an effect on taxpayers in industries heavily dependent on independent contractors.

taxpayer. That is, the amount of the deduction is capped at 50% of a taxpayer's W-2 wages. The Act modified the definition of W-2 wages to not include any amount that is not properly allocable to domestic production gross receipts. The Act also repeals the two times 3 percent QPAI limitation for pass-through entities. The new definition is effective for taxable years after May 17, 2006.

This new modification may have an effect on taxpayers engaged in industries that are heavily dependant on independent contractors (whose wages do not qualify for the limitation) and were depending on the W-2 wages of individuals (i.e. management) whose activities are not properly allocable to domestic production gross receipts.

Withholding on Certain Government Payments

The Act has imposed a 3 percent withholding on certain payments made by the federal government and every state government to persons providing property or services, regardless of whether the government entity making the payment is the recipient of the property or services. The provision applies to payments made after December 31, 2010.

This will have a major cash flow impact on government contractors. The question that arises is whether governmental entities will be ready to impose the new withholding tax by 2010.

Active Trade or Business Test for Corporate Spin-Offs

The Active Trade or Business test has been amended to provide that "all members of such corporation's separate affiliated group shall be treated as one corporation." The second sentence of Section 355(b)(3)(B) explains that "a corporation's separate affiliated group is the affiliated group which would be determined under section 1504(a) if such corporation were the common parent and section 1504(b) did not apply." Taxpayers have long requested this rule in order to avoid the somewhat artificial movement of assets around a group prior to a distribution.

The transition rules provide that the new test can be used for distributions pursuant to a transaction that is entered into or announced in an SEC filing after the date of enactment, and before December 31, 2010. By its terms it does not apply if a request is pending with the IRS to rule on a proposed transaction. However, the IRS may consider applying the new rule, if the taxpayer requests.

Cash Rich Split Off

A new provision has been added to Section 355 that states that Section 355 does not apply to distributions of "disqualified investment companies." In order for the provision to apply, the split-off must be to a person that holds a "non-historic" 50

percent or great interest in the “disqualified investment company.”

For purposes of this new provision, a corporation is a “disqualified investment company” if 2/3 or more of the fair market value of all the assets of the corporation are investment assets (cash, marketable securities, partnership interests held for investment, debt instruments and other investment assets). There are transition rules for distributions prior to December 31, 2006 (generally changing 2/3 to 3/4). In addition, exceptions are available for companies whose business involves buying and selling investment assets. Also, if the company owns 20 percent or more of a subsidiary, then a look through to the underlying assets is undertaken to determine whether or not the entity is a “disqualified investment company.”

There is broad regulatory authority to carry out this new provision.

Business Provisions - International

Look Through Rules for FPHCI for Section 951 Inclusions - A Three-Year Window

In a stunning development, for tax years that begin after December 31, 2005 and end before January 1, 2009, dividends, interest, rents and royalties received by one controlled foreign corporation (CFC) from another commonly controlled CFC will NOT be foreign personal holding company income (FPHCI), even if the CFCs are not in the same country, to the extent the income is allocable to non-subpart F income of the paying CFC. For this purpose, interest includes income from factoring of receivables.

The amount of base compensation that can be excluded from U.S. taxable income under Section 911 of the Code is now indexed for inflation starting in 2006, a year ahead of schedule.

Active Finance Exception to FPHCI is Extended

The active finance exception to FPHCI income is extended through 2008. This extension is important to the financial-services industry.

Earning Stripping Rules

The earnings stripping rules limit the ability of a U.S. corporation to deduct interest paid to a related foreign person. The limitation is based in part on the debt to equity ratio of the U.S. Corporation. The Act confirms that the liabilities of a U.S. corporation include liabilities of a partnership in which a U.S. corporation is a partner, effectively codifying existing proposed regulations. The effective date is for tax years that begin after May 17, 2006

Repeal of FSC/ETI Binding Contract Relief

The general transition rules remain in effect for the repeal of extra terrestrial income regime (ETI). The Act repeals, however, the transition rules that allowed the use of a foreign sales corporation (FSC) and/or the ETI benefits on a going forward basis if: (i) the transactions were in the

ordinary course of business; (ii) were pursuant to a binding contract between the taxpayer and an unrelated person; and (iii) the contract was in effect on September 17, 2003 at all times thereafter. A similar rule allowed for the long-term continuation of FSC benefits when the FSC rules were repealed in 2000. The FSC binding contract rules was also repealed by the Act.

Modifications for Individuals Living Abroad - Impacts the 2006 Tax Year

The amount of base compensation that can be excluded from U.S. taxable income under Section 911 of the Code is now indexed for inflation starting in 2006, a year ahead of schedule, which increases the exclusion for 2006 to \$82,400 from \$80,000. However, income in excess of that amount is now taxed at the rates that would apply if the \$82,400 were not excluded, for both income and AMT purposes. In addition, excludable foreign housing expenses are now limited to 30% of the maximum amount of a taxpayer's foreign earned income exclusion. Assuming an employee is present outside the US for the entire year, the maximum amount of the foreign housing cost exclusion for 2006 is \$11,536. These changes will not only have an effect on a US citizen working abroad; it will have a major impact on the costs corporations typically incur in sending executives abroad.

Pepper Perspective

Although the focus of the Act was to extend popular tax breaks afforded individuals, Congress enacted several revenue raising provisions that affect corporations including the current acceleration of corporate estimated tax

payments. Congress has also chosen some provisions to ease taxpayer burden and what was thought to be unnecessary restructuring in simplifying the active trade or business test of Section 355. With careful review, there may be some tax planning and restructuring opportunities from the new international look through rules that are effective for taxable years 2006-2008.

Authors:

Joan C. Arnold
215.981.4362
arnoldj@pepperlaw.com

Annette M. Ahlers
202.220.1218
ahlersa@pepperlaw.com

Todd B. Reinstein
202.220.1520
reinstein@pepperlaw.com

Michiel Muizelaar
215.981.4894
muizelaarm@pepperlaw.com

IRS Hangs Up the Phone On Certain Excise Taxes

On May 25, 2006, the Internal Revenue Service announced that it was giving up in its fight to maintain the federal excise tax on long-distance telephone service by issuing IRS Notice 2006-50 (Notice). The Notice provides procedures for taxpayers to claim refunds of all long-distance excise tax they have paid, including interest, on long-distance service billed to them after February 28, 2003 and before August 1, 2006.¹

The tax at issue is a 3 percent excise tax applied to “toll telephone service,” described at IRC § 4252(b) as “a toll charge which varies in amount with the distance *and* elapsed transmission time of each individual communication [emphasis supplied].” This description no longer accurately describes modern long-distance since long-distance telephone services rarely charge by distance anymore, opting increasingly to charge a per-minute fee since the 1990s, or more recently a flat per-month fee.

Suffering five defeats in five cases before five different circuit courts in less than two years from taxpayers looking for refunds,² the IRS announced it would no longer seek to enforce the excise tax.

Wireless and Bundled Services Included

Arguably succumbing to the weight of their defeats, the IRS firmly closed the door on all potential conflicts regarding the long-distance tax. The

IRS included wireless services in its definition of “nontaxable services,” despite the fact that none of the lawsuits decided addressed the taxation of wireless services. Further, the IRS exempted bundled services from the tax. Included in the description of bundled services were Voice over Internet Protocol (VoIP), prepaid telephone cards and plans that include both local and long-distance services, whether they are charged at a flat fee or per minute rate.

Local Service is Still Subject to Tax

The federal excise tax on local telephone services as described at IRC § 4252(a) was not at issue in the relevant litigation, and has been pronounced specifically by the Service as remaining in effect despite a recently introduced bill in Congress that would eliminate this excise tax as well.

Obtaining Refunds Could Still Be Difficult

To obtain a refund or credit, taxpayers must make a request on their 2006 federal income tax returns (Forms 1040, 1041, 1065, 1120 and 990-T). This requirement applies even if a taxpayer is not otherwise required to file a return. Recognizing that many taxpayers do not retain telephone bills, Notice 2006-50 states that the IRS will provide a safe harbor amount that individual taxpayers may request.

However, non-individuals, such as corporations, trusts, and other taxable

and exempt entities, will be required to adequately substantiate their refund claims. The Notice provides that this may be accomplished through records indicating the amounts charged by service providers and evidence that the amount was actually paid.

Pepper Perspective

At first glance, these procedures do not seem an unreasonable burden for the relatively sophisticated taxpayer. However, on closer inspection, the refund procedure may create some thorny disputes. The Notice specifically states that refund requests for taxes paid during the relevant period, whether filed before or after its publication, that do not follow the notice provisions will not be processed. This seems to indicate that taxpayers with currently pending refund claims are now in the unenviable position of having to refile their refund requests with their 2006 returns.

In addition to the refiling snag, the Notice seems to shorten the normal limit on filing a refund claim from three years to when the taxpayer files

its 2006 return. This provision may have the effect of encouraging the filing of more lawsuits by taxpayers, challenging the Service's authority to contract the filing period through a notice.

Businesses wishing to take advantage of the refund should be prepared to invest significant employee resources in the recovery of the necessary records to substantiate the claim; therefore a cost-benefit analysis is warranted. Because all telecommunication excise taxes are not subject to the refund claim, taxpayers may need to investigate the nature of its carriers invoices since corporations must document the exact amount of excise taxes paid.

Those taxpayers currently pursuing a refund claim should consult with an attorney to determine what affect Notice 2006-50 will have on their efforts.

Authors:

Todd B. Reinstein
202.220.1520
reinsteint@pepperlaw.com

Marc D. Nickel
202.220.1200
nickeld@pepperlaw.com

(Mr. Nickel is a law clerk in the Washington D.C. office of Pepper Hamilton LLP.)

ENDNOTES

- ¹ IRS Notice 2006-50, sec. 4(a). Of note, Taxpayers should also be aware that any interest received on a refund will be included in their income, and must be reported on their 2007 tax return.
- ² *Am. Bankers Ins. Group v. United States*, 408 F.3d 1328 (11th Cir. 2005); *OfficeMax, Inc. v. United States*, 428 F.3d 583 (6th Cir. 2005); *Nat'l R.R. Passenger Corp. v. United States*, 431 F.3d 374 (D.C. Cir. 2005); *Fortis v. United States*, 2006 U.S. App. LEXIS 10749 (2d Cir. Apr. 27, 2006); and *Reese Bros. v. United States*, 2006 U.S. App. LEXIS 11468 (3d Cir. May 9, 2006).

The Eyes of Texas: Texas Replaces Franchise Tax System

On May 18, 2006, Texas Governor Rick Perry signed a package of legislation implementing property tax reform mandated by the Texas Supreme Court. Included in the package of legislation was Texas H.B. 3, which replaced the old Texas Franchise Tax with the "taxable margin" tax system.

A Brief History of the Franchise Tax

The Texas franchise tax was imposed on the greater of two bases: earned surplus (based upon the net income of the entity subject to the tax), which was taxed at a rate of 4.25 percent; and taxable capital, which was taxed at a rate of .25 percent. The tax was imposed upon corporations and limited liability companies (LLCs), regardless of the LLCs' tax

treatment for federal income tax purposes. Limited partnerships, however, were not subject to the franchise tax. By operating a business in a limited partnership structure in Texas, businesses were often able to minimize or eliminate Texas tax.

Taxable Margin

The principal change in the new legislation is a move away from the

franchise tax base toward "taxable margin." The computation of taxable margin starts with "total revenue" from the entire business. For a corporation, total revenue is the total income from line 1c of its Form 1120, plus lines 4-10. Bad debt, foreign royalties and dividends and certain other specific deductions are subtracted to arrive at total revenue. "Margin" is defined as total revenue less the greater of cost of goods sold or compensation. Margin cannot exceed 70 percent of total revenue under the revised statute.

Taxpayers can elect annually whether to subtract cost of goods sold or compensation in calculating margin. This election is not binding from year to year, and taxpayers can change methodology within any given year by filing an amended return within the period provided for in the statute of limitations.

Cost of goods sold includes identified direct costs of acquiring or producing real or tangible personal property and certain other related costs. Certain expenses are excluded in calculating cost of goods sold, such that only those costs incurred to produce a good (real or tangible personal property only) are included in cost of goods sold. In addition, costs of services are not considered costs of goods.

There are some general rules regarding the calculation of the "compensation" deduction in calculating margin. Compensation includes wages, stock options, salaries and other income paid to an entity's officers, directors, owners, partners and employees. The compensation deduction for any individual person may not exceed \$300,000. Compensation also includes non-cash benefits paid

to officers, directors, owners, partners and employees, including worker's compensation, health care and retirement to the extent deductible in calculating federal income taxes.

Margin is then apportioned, using a single factor, gross receipts methodology that is similar to the apportionment methodology in place under the current franchise tax system. The major modification in the new apportionment scheme is that throwback is eliminated. For example, under the old system, if a Texas manufacturer shipped product to California via a common carrier, and the Texas manufacturer was not taxable in California, the sale would be "thrown back" to Texas for apportionment purposes. Since throwback is eliminated under the apportionment formula in calculating taxable margin, the sale would not be included in the Texas numerator in calculating taxable margin.

A critical apportionment issue is how Texas will address the issues raised by the courts in *Finnigan*¹ and *Joyce*.² In the context of unitary taxation, the issues often arise (both within and without throwback) as to whether certain entities that are members of a unitary group but do not individually have nexus with Texas are required to include sales that would be sourced to Texas for these non-nexus members. For example, consider a two-member unitary group. One member has nexus in Texas, and one does not. The one without nexus makes a sale of tangible personal property to someone in Dallas. The courts in *Finnigan* and *Joyce* addressed the question of whether this sale is included in the numerator of the sales factor for apportionment purposes. The court in *Finnigan* concluded that inclusion for all members of the

group was appropriate under the facts presented. The court's holding in *Joyce*, however, dictates the opposite approach. Thus, the tax burden for unitary groups with substantial activity performed by other entities without Texas could be substantially increased.

There are certain other industry-specific deductions from the apportioned margin that are subtracted in calculating taxable margin. Taxable margin is multiplied by the tax rate to arrive at the total tax due. The tax rate is 1 percent for most taxpayers, though it is .5 percent for wholesalers and retailers.

Businesses Subject to Tax

The revised statute defines a taxable entity as a partnership, corporation, banking corporation, savings and loan association, limited liability company, business trust, professional association, business association, joint venture, holding company or other legal entity. It also includes a combined group. Excluded from the definition of taxable entity are sole proprietorships, general partnerships directly owned by natural persons, passive entities (itself a statutorily defined term, with at least 90 percent of its gross income from certain passive sources), and other entities otherwise exempt from taxation. Also excluded are grantor trusts, estates, escrows, certain family limited partnerships, trusts that meet the definition of a passive entity and certain real estate investment trusts. Interestingly, the statute excludes from the definition of "sole proprietorship" (and therefore, subjecting such an entity to tax) an entity if the entity is formed under laws that provide for limited liability of the entity. It appears that disregarded

LLCs owned by natural persons would fall within the purview of the tax.

Unitary Businesses

Taxable entities that are members of an affiliated group that constitute a unitary business are required to file on a combined basis. The threshold ownership requirement to be considered a unitary group is 80 percent or more, owned by a common owner, and will include entities that do not have nexus in Texas. The unitary business concept, as applied in Texas, is virtually identical to traditional unitary business concepts: entities that are under common ownership and are integrated, interdependent and in the same or similar lines of business will be considered unitary for Texas tax purposes. So-called 80/20 companies (those that have 80 percent of their property and payroll outside of the United States) would not be included in the unitary group.

Unitary businesses are considered one entity for purposes of the margins tax. Thus, a unitary business will sum, for example, its total revenue across all entities within the combined group, and eliminate intercompany transactions reflected in the individual revenue of each entity. The compensation and cost of goods sold deductions are calculated in a similar manner. Since the unitary business is considered one entity for purposes of the margins tax, it follows that the election to deduct compensation (or cost of goods sold) is made on a unitary basis.

Credits

Credits that are available currently under the franchise tax system are

generally repealed. Taxable entities with unused credits that accrued prior to the effective date of the new tax, however, may use the credits against the margin tax liability.

A temporary credit is available that can be used by taxpayers for up to 20 privilege periods, provided the taxpayers notify the Comptroller in writing by March 1, 2007. The credit is equal to deferred tax assets and net operating loss carryforwards (net of any valuation allowance on said carryforwards) less deferred tax liabilities, as reflected on the taxable entity's books and records on the last day of its 2006 taxable year. This difference will then be apportioned using the taxpayer's 2007 apportionment factor, multiplied by 10 percent, then by the applicable tax rate.

Pepper Perspective

It appears that wholesalers and retailers of tangible personal property received favorable treatment under the legislation, because, in addition to the preferential rate, these businesses also get to use the cost of goods sold deduction as a means of reducing their margins tax, while a similar opportunity is unavailable to service

providers. This was presumably done to mollify high volume, low margin retailers who argued that equivalent tax rates would be unfair to them.

The legislature desired a fix to the limited partnership loophole, but in doing so, may have been overzealous and ran afoul of the Texas Constitution. The Texas Constitution bans a personal income tax, and some have complained that some of the entities drawn into the tax (such as sole proprietor LLCs) result in a de facto tax on individuals which appears inconsistent with the constitutional prohibition.

Author:

Lance S. Jacobs
202.220.1202

jacobs@pepperlaw.com

ENDNOTES

- 1 *Appeal of Finnigan Corp.*, No. 88-SBE-022 (Cal. St. Bd. of Equal. Aug. 28, 1988), reh'g den. No. 88-SBE-022A (Cal. St. Bd. of Equal. Jan. 25, 1990).
- 2 *Appeal of Joyce, Inc.*, No. 66-SBE-069, (Cal. St. Bd. of Equal. November 23, 1966).

Pepper Hamilton LLP

Attorneys at Law

www.pepperlaw.com

Philadelphia | Washington, D.C. | Detroit | New York | Pittsburgh
Berwyn | Harrisburg | Orange County | Princeton | Wilmington

PROMOTIONAL MATERIAL

The material in this publication is based on laws, court decisions, administrative rulings and congressional materials, and should not be construed as legal advice or legal opinions on specific facts.

© 2006 Pepper Hamilton LLP ALL RIGHTS RESERVED.

Pepper Hamilton LLP Tax Practice Group

Federal and International Tax Issues

Annette M. Ahlers	202.220.1218	ahlersa@pepperlaw.com
Joan C. Arnold	215.981.4362	arnoldj@pepperlaw.com
James W. Barson	412.454.5077	barsonj@pepperlaw.com
Gordon R. Downing	215.981.4434	downingg@pepperlaw.com
W. Roderick Gagné	215.981.4695	gagner@pepperlaw.com
Howard Goldberg	215.981.4955	goldbergh@pepperlaw.com
Michiel Muizelaar	215.981.4894	muizelaar@pepperlaw.com
Lisa B. Petkun	215.981.4385	petkunl@pepperlaw.com
Todd B. Reinstein	202.220.1520	reinstein@pepperlaw.com
Joan M. Roll	215.981.4515	rollj@pepperlaw.com
Laura D. Warren	215.981.4593	warrenl@pepperlaw.com
David Young*	202.220.1229	youngrd@pepperlaw.com

State and Local Tax Issues

David H. Adams	412.454.5809	adamsd@pepperlaw.com
Philip E. Cook, Jr.	412.454.5075	cookp@pepperlaw.com
Lance S. Jacobs	202.220.1202	jacobsls@pepperlaw.com
Charles L. Potter, Jr.	412.454.5073	potterc@pepperlaw.com

Employee Benefits Issues

Jonathan A. Clark	215.981.4436	clarkja@pepperlaw.com
David M. Kaplan	215.981.4620	kapland@pepperlaw.com
Andrew J. Rudolph	215.981.4749	rudolpha@pepperlaw.com

*Admitted only in Pennsylvania and New Jersey; supervision by principals of Pepper Hamilton LLP who are members of the DC Bar

*For more information about any of our tax professionals listed,
please visit our Web site, www.pepperlaw.com.*

Subscribe to Future Issues

Please return this form by e-mail, facsimile or by mail to be added to our mailing list or to update your information. Send to Pepper Hamilton LLP, Hamilton Square, 600 Fourteenth Street, N.W., Washington, D.C. 20005-2004, Attn: Homeira Ghorbani. (Fax - 202.220.1665 or e-mail ghorbanih@pepperlaw.com)

Name	_____
Title	_____
Company	_____
Address	_____
Phone	_____
Fax	_____
E-mail	_____