

# FEDERAL INCOME TAX UPDATE

Presented by:

Dirk Coleman, CPA

Curtis Blakely & Co., P.C.

P. O. Box 5486

Longview, TX 75608

903-758-0734

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[dcoleman@cbandco.com](mailto:dcoleman@cbandco.com)

[www.cbandco.com](http://www.cbandco.com)



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# Start-Up Costs & Organizational Costs

- Start-up costs are trade or business costs that would have been deductible had they not been paid or incurred before the business began.
- Organizational costs are expenses incurred to create the entity. They generally include legal and accounting fees as well as charter and registration fees paid to the State.



# Start-Up Costs & Organizational Costs

- ❑ Prior law allowed an election to amortize these costs over 60 months (5 years) beginning with the month the trade or business began. If the election was not made the costs were considered nondeductible capital expenditures.
- ❑ The new law allows a business to elect to deduct up to \$5,000 of business start-up costs and \$5,000 of organizational costs paid or incurred after October 22, 2004.



# Start-Up Costs & Organizational Costs

- Each potential \$5,000 deduction is reduced by the amount of total start-up or organizational costs (respectively) that exceed \$50,000.
- Any start-up or organizational costs not deducted must be amortized over 15 years.



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# Start-Up Costs & Organizational Costs

- This provision benefits small businesses that incur minimal start-up and organizational costs, but requires larger business ventures to amortize their start-up and organizational costs over 15 years instead of 5 years.



# Section 179 Expense

- Higher expensing amounts have been extended through 2007
  - \$105,000 for tax years beginning in 2005 (\$102,000 for 2004)
  - Limitation is reduced dollar for dollar for cost of qualifying property placed in service during tax year over \$420,000 (\$410,000 for 2004)
  - Both limitations are adjusted for inflation



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# Section 179 Expense

- Sport Utility Vehicles (SUVs) limitation
  - Maximum section 179 expense deduction for SUVs purchased after October 22, 2004 is \$25,000



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# Section 179 Expense

- Depreciable off-the-shelf computer software placed in service 2003-2007 may be expensed under Code Sec. 179. Must be:
  - Readily available for purchase by the general public
  - Subject to a nonexclusive license
  - Not substantially modified



# Depreciation

## □ Qualified Leasehold Improvements

- Generally, leasehold improvements are considered structural components of a building and assigned either a 27.5 or 39 year life depending upon their use as residential rental property or nonresidential real property respectively.



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# Depreciation

- Qualified leasehold improvement property placed in service after October 22, 2004 and before January 1, 2006, is 15-year property using the straight line method under MACRS.



# Depreciation

- Qualified Leasehold Improvement:
  - The improvement is to the interior of non-residential real property
  - The improvement is made by either the lessor or lessee
  - The lease is not between related parties
  - The building is occupied exclusively by the lessee
  - The improvement is a structural component of the building (Sec. 1250 property)
  - The improvement is placed in service more than 3 years after building is placed in service



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# Depreciation

## □ Bonus Depreciation

- The 50% and 30% additional first-year depreciation allowance expired January 1, 2005. qualifying property must have been placed in service prior to January 1, 2005.



# Depreciation

- The placed in service date is January 1, 2006 for certain long-term production property. Property must be:
  - Produced by taxpayer and subject to Section 263A.
  - Class life greater than 10 years but less than 20 years. Most telephone distribution plant falls within this category.
  - Production period greater than 2 years or greater than 1 year with cost exceeding \$1 million.



# Depreciation

- Fiber Equipment – class life
  - Recent IRS audit of a taxpayer with significant fiber network equipment
  - Taxpayer claimed a 5 year class life on most of the equipment (Class 48.12)
  - IRS challenged the 5 year class life and proposed a 10 year class life (Class 48.11)



# Depreciation

- The taxpayer argued that:
  - The equipment was computer-based central office switching equipment (MACRS Class 48.12)
  - The equipment was essentially a special purpose computer or computer peripheral equipment that met the definition of Qualified Technological Equipment (Sec. 168(i)(2))
  - The equipment performed a switching function



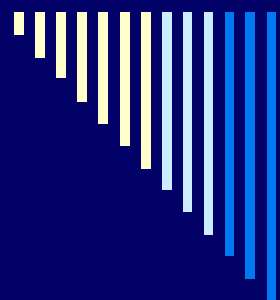
# Depreciation

- The IRS argued that:
  - The equipment did not provide a “switching function” and could not qualify under Class 48.12
  - The equipment did not constitute a computer because it contained more non-computer components than computer components
  - The equipment was more properly classified as Telephone Central Office Equipment (Class 48.11)



# Depreciation

- Taxpayer settled with the IRS using a 6 year life for the equipment placed in service during the two years under audit. This was a negotiated settlement and did not bind the taxpayer regarding classification of fiber optic equipment purchased prior to or subsequent to the years under audit.



# S Corporations

- ❑ Shareholder limit increased from 75 to 100
- ❑ Family members may be treated as one shareholder



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# Controlled Group

- The tax code imposes a graduated tax rate schedule on corporations
- The “controlled group” rules are designed to prevent the benefit derived from dividing a single business into multiple corporations with common ownership and utilizing multiple graduated rates.



# Controlled Group

- The tax on one corporation with \$500,000 taxable income is \$170,000
- The aggregate tax on five corporations with \$100,000 taxable income each is \$111,250 – a savings of \$58,750



# Controlled Group

- A “Brother-Sister” controlled group of corporations was formerly defined as:
  - Two or more corporations;
  - Owned by five or fewer individuals, estates, or trusts; and
  - Those five or fewer individuals own:
    - At least 80% of the total combined voting power or value of each corporation, and
    - More than 50% of the total combined voting power or value of all stock taking into account the stock owned by each person only to the extent the person owns stock in each corporation (the common ownership percentage).



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# Federal Excise Tax

- Telephone Cooperative excise tax refund claims
  - The IRS has recently been auditing 2002 telecommunication excise tax refund claims
  - The IRS is routinely disallowing any claims that do not use the IRS' method of computation
  - The IRS computation has two errors in the formula that result (in our opinion) in an overstatement of the appropriate refund



# Federal Excise Tax

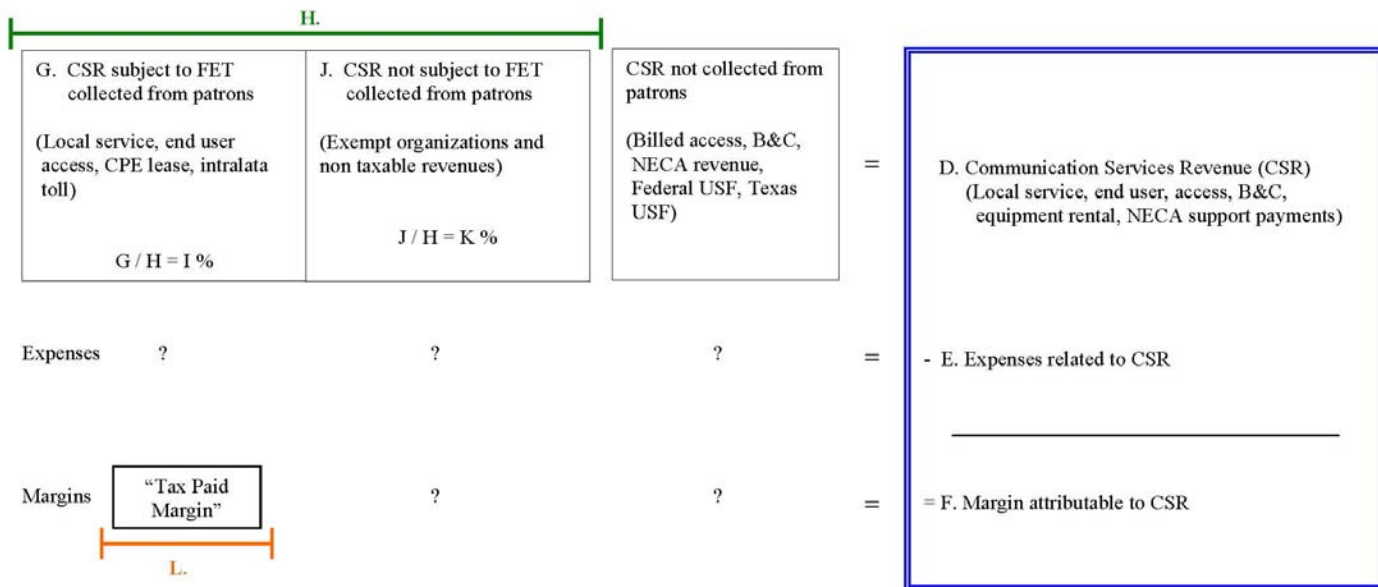
## STEP 2

<p>A. Non-Communication Source Revenue (NCSR) (Interest, rental, directory advertising, dividends, equity in subsidiary earnings)</p> <p>- B. Expenses related to NCSR</p> <hr/> <p>= C. Margin attributable to NCSR</p>	+	<p>D. Communication Services Revenue (CSR) (Local service, end user and billed access, B&amp;C, intralata toll, CPE lease, NECA revenue, Federal USF, Texas USF)</p> <p>- E. Expenses related to CSR</p> <hr/> <p>= F. Margin attributable to CSR</p>	=	<p>A+D. Total Revenue</p> <p>- B+E. Total Expenses</p> <p>= C+F. Total Margin</p>
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To Step 3

# Federal Excise Tax

## STEP 3



### Calculation of "G."

FET paid per Form 720  
 ÷ 3%

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+ Communication services subject to FET  
 - Toll billed to Members

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= CSR collected from members

G (per IRS) – incorrect  
 Subject to FET; not Coop "revenue"

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G (corrected)

### Calculation of "H."

D (all CSR)

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- CSR not collected from patrons

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= H (CSR collected from patrons)



# Federal Excise Tax

## STEP 4

### IRS Calculation

$$I\% \times F = L \text{ (Tax Paid Margin)}$$

Incorrect because I % does not consider all the revenues that are part of F.

I % was derived by ignoring NECA support payments, B&C and access revenues. However, these revenues are included in F.

### Alternative Calculation

$$\frac{G.}{D.} \times F = L. \text{ (Tax Paid Margin)}$$

## STEP 5

$$L \times 3\% = \text{FET refund}$$



# Federal Excise Tax

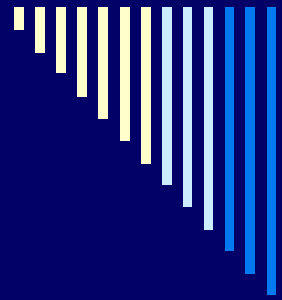
## □ Excise Tax on Long Distance

- Honeywell International, Inc., U.S. Court of Federal Claims (No. 03-1915 T) – February 16, 2005
  - Corporation purchases intrastate, interstate and international long distance telephone service from various carriers that charged the corporation based on the duration of each call
  - IRS argued that the services were taxable toll telephone services
  - Corporation argued that, for toll telephone services to be taxable the service must involve a charge that is based on **time and distance** of call
  - Court of Federal Claims sided with the taxpayer



# Federal Excise Tax

- *American Bankers Insurance Group, Inc. v. United States*, 308 F. Supp. 2d 1360
- *OfficeMax, Inc. v. United States*, 309 F. Supp. 2d 984 (N.D. Ohio 2004)
- *Fortis, Inc. v. United States*, No. 03 Civ. 5137 (JGK), 2004 WL 2085528 (S.D. N.Y. Sept. 16, 2004)
- *National Railroad Passenger Corp. (“Amtrak”) v. United States*, 338 F. Supp. 2d 22 (D.D.C. 2004)
- *Reese Bros. v. United States*, No. 03-CV-745, 2004 WL 2901579 (W.D. Pa. Nov. 30, 2004)



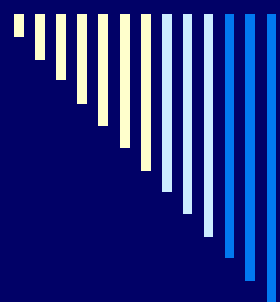
# Production Activities Deduction

- ❑ IRC Section 199 permits taxpayers to claim a deduction from taxable income attributable to domestic production activities
- ❑ Effective for taxable year's beginning after December 31, 2004



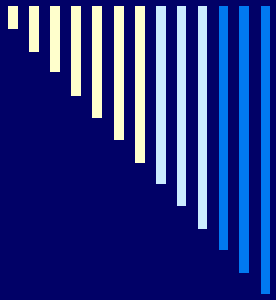
## Amount of Production Activities Deduction

- For 2005 and 2006 deduction is 3% of
  - Qualified Production Activities Income, or
  - Taxable Income
- The deduction increased to 6% for tax years beginning in 2007 – 2009 and grows to 9% beginning 2010
- Limited to 50% of W-2 wages

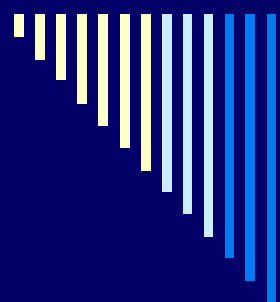


## Notice 2005-14

- Released January 19, 2005
- Provides definitions and rules
- There are instances where the Notice seems to conflict with the intent of the statute.



What activities qualify?



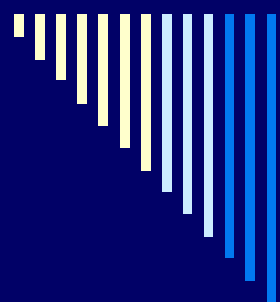
## Telecommunications Specific Issues

- Contract construction of cable facilities
  - Probably would qualify as infrastructure
  - Telecommunications company will likely not be considered in the construction trade or business
  - Lease of the facilities under IRU would not qualify, must be a sale



## Telecommunications Specific Issues (cont)

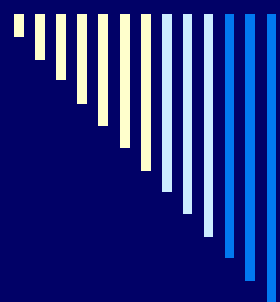
- Yellow page advertising revenues
  - Appears that revenues would not be considered as derived directly from distribution of qualifying production property
  - Domestic production gross receipts from sale of newspapers and magazines includes advertising income
  - Uncertainty as to whether this provision applies to other print and if there must be revenue from the sale of the print to which the advertising is linked



## Telecommunications Specific Issues (cont)

### □ Collocation Agreements

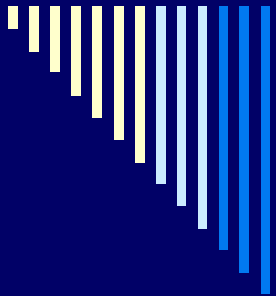
- Sometimes include the purchase of engineering and related construction
- Receipts from the engineering and architectural services could qualify as domestic production gross receipts
- Cost reimbursements probably will not qualify as domestic production gross receipts



## Telecommunications Specific Issues (cont)

### □ Computer Software

- To qualify as domestic production gross receipts, computer software must be transferred
- The Notice specifically excludes receipts derived from internet access and telecommunications, including VOIP, from computer software receipts



The End

