

2006 TAX LAW CHANGES

January 19, 2006

Dear Clients and Other Friends-

Ya, I know - you haven't even started to put your 2005 tax stuff together and I am going to confuse you with the new laws for 2006. Unfortunately, the new year started a couple of weeks ago and as a result these new laws are already in effect. So, let's see if they affect you.....

Some of what we will discuss are not really new tax laws. As I discussed in my newsletter about the Alternative Minimum Tax, if Congress does not index certain deductions, limits, brackets etc. for inflation, it has the effect of building in an automatic tax increase each year. Although that may be tempting to some members of Congress, they are building in more indexing in the tax laws.

There were numerous tax law changes specifically directed to the hurricane zone. These GO Zone (Gulf Opportunity) tax incentives are narrowly focused and will not affect many of you. Therefore I will not cover them in this newsletter. If you were affected by the hurricanes and want to know more about these incentives, please contact me.

Residential Energy Credits:

I summarized this in my August 2nd newsletter so I will not repeat it all here. However, I have attached a more detailed analysis of the residential energy credit requirements. Also, if you did not get, or can not find, my August 2nd newsletter please contact me and I can send it to you.

Alternative Motor Vehicle Credit:

This is a credit for purchasing a hybrid, fuel cell, advanced lean burn and other alternative power vehicles. (I always thought of an "alternative power vehicle" as one where my sons had to purchase their own gas.) The tax credit can be as much as \$3,400 depending upon the weight class and rated fuel economy of the vehicle. Heads up: the full amount of the credit is available only until the manufacturer records its 60,000th hybrid and advanced lean-burn technology vehicle. He who hesitates..... This credit replaces the deduction (normally \$2000) we received for hybrid cars prior to 2006.

Tax lesson: which is better- a tax deduction or a tax credit? And of course, the answer is: it depends. Since a tax credit is a dollar for dollar reduction of your taxes, the "usual" answer is a tax credit is better than a tax deduction. However, if the deduction is a greater dollar amount than the credit, it will depend upon your tax bracket. For example, if you are in the 35% tax bracket and could choose between a \$10,000 deduction or a \$3,000 credit, the deduction would give you a \$500 greater benefit. Here again the good old Alternative Minimum Tax raises its ugly head. There are many credits allowed against regular tax which are not allowed against AMT. As a result, if you are subject to AMT, the deduction may be better. And you thought tax planning was difficult.....

Itemized Deduction Phase-out Reduced:

For a number of years itemized deductions have been reduced by 3% of the amount a taxpayer's adjusted gross income (AGI) exceeded a certain threshold. This threshold is indexed for inflation and will be \$150,500 in 2006. In 2006, this reduction will effectively be 2% of the excess amount instead of 3%. Question: if Congress reduces a take-away, is that considered a give-back?

Personal Exemption Phase-out Reduced:

Similar to the above, the deduction for personal exemptions has been reduced by 2% for each \$2,500 (or fraction thereof) by which a taxpayer's AGI exceeds an inflation-indexed threshold amount. The threshold for 2006 is \$225,750 for joint returns and \$150,500 for single returns. For 2006, the exemption phase-out will equal 2/3 of the normal full reduction. Or in other words, the reduction will be 1.33% for each \$2,500 of excess income.

Six-Month Automatic Extension:

Prior to 2006 we were able to file for a 4 month automatic extension from the April 15th filing date. Then, to receive an additional 2 month extension to October 15th, we had to come up with some lame excuse that the IRS didn't even read so they would "approve" the additional extension. I quote the reason I used for 30 years- "Taxpayer was unable to compile the necessary records to file a complete and accurate return." I have never had one refused. Anyhow, in order to quit playing this game, and in the interest of filing efficiency, we can now file for a single, automatic 6 month extension effective for the 2005 returns due in 2006.

Caution: this does not extend the time to pay your tax. You will pay interest on any tax not paid as of April 15th. Presently the interest rate is 7%. Also, if you have not paid in at least 90% of the tax due by April 15th you will pay another 1/2% per month, or partial month, penalty. So, effectively, if you have not paid in at least 90%, your "interest" rate will be 13%. An even bigger caution: if you don't file for an extension you can tack on another 5% per month (or part thereof) penalty up to a maximum of 25%. I have seen numbers that get large really fast without an extension.

Good Stuff That Went Away:

Tax lesson: How do you hide the true cost of a tax break? Answer: enact it for only a year or two at a time, and then extend it when it expires. It is much easier to sell a tax break that "costs" \$2 billion for 2 years than it is one that cost \$10 billion for 10 years, even if you extend the first one 5 times. Congress has made this an art form. However, due to the strong partisan politics at the end of the year they did not get around to extending some popular tax breaks. Some or all may still be extended retroactively. However, as of now the following tax breaks have expired.

Deceased AMT exemption: I covered this in my AMT newsletter. In 2005 the exemption was \$58,000 for joint returns and \$40,250 for single returns (another example where it is better to be two individuals living together than married - tax law considerations only, of course.) For 2006 the exemption will revert to "old" law - \$45,000 and \$33,750 respectively. This means more people will be subject to the AMT.

Educator expense: In 2005 an educator could deduct up to \$250 for materials used in the classroom. This was an "above the line" deduction which means you do not need to itemize to take advantage of it. Kind of a token deduction, but still nice. It is gone!

Tuition and fees deduction: In 2005 you could deduct higher education expenses "above the line". The amount was limited based on your AGI. This is gone for 2006, but you may be able to deduct it as a miscellaneous itemized deduction.

Estate & Gift Tax Changes:

The top estate and gift tax rate has dropped from 47% to 46%.

The amount exempted from federal estate tax has increased from \$1.5 million to \$2 million.

The annual gift tax exclusion has increased from \$11,000 to \$12,000. That rich uncle can cough up a little more this year!

The lifetime gift tax exclusion (which is included in the \$2 million estate tax exclusion) remains at \$1 million.

Retirement Plan Changes:

Here is an area where we have both statutory adjustments (i.e. pre-set changes mandated by law) and adjustments due to inflation.

Statutory increases:

- Elective deferrals: 401(k) deferrals are increased from \$14,000 to \$15,000.
- Catch-up contributions for those of us 50 years or older: increased from \$4,000 to \$5,000 except for SIMPLE plans where the increase is from \$2,000 to \$2,500; and IRAs where the increase is from \$500 to \$1000.

Indexed increases: (I have not listed all increases since most of them relate to the very technical areas of plan administration - and you think you are bored now...)

- Maximum contribution to a defined contribution plan: increased from \$42,000 to \$44,000. The catch-up contribution noted above is in addition to this amount.
- Annual compensation limit: increased from \$210,000 to \$220,000. This is the maximum amount of salary which can be considered for purposes of computing a retirement contribution.

Unchanged limits: (Just as a reminder)

- Simple salary deferral: remains at \$10,000
- SEP compensation qualification: you must still cover anyone who has made \$450 during 3 of the immediately preceding 5 years.
- IRA contributions: remain at \$4,000.

Roth 401(k):

A taxpayer can not contribute to a Roth IRA if their AGI is over \$160,000 for a joint filer or \$110,000 for a single filer (another "live together" friendly limit). Also, if you can contribute, the maximum contribution is \$4,000; \$4,500 if 50 years old or older. Starting in 2006, a 401(k) plan can (doesn't have to) allow an individual to redirect part or all their regular deferral to a Roth 401(k) within the 401(k) plan. This accomplishes 2 things. First, even someone whose income level precludes them from contributing to a regular Roth IRA can contribute to the Roth 401(k). Second, the limit for a Roth 401(k) is the same as for a regular 401(k) deferral - \$15,000 plus \$5,000 if you are 50 or over. This is much higher than the regular Roth IRA limits.

Since you are redirecting a regular 401(k) deferral which is made with pre-tax dollars to a Roth 401(k) which is made with post-tax dollars it may seem like this would be a dumb move. However, since the Roth 401(k), including the earnings, can be withdrawn tax free it makes sense to utilize this in just about every case.

Miscellaneous Changes:

Health Savings Accounts (HSAs): An HSA can only be established by individuals who are covered by a high deductible health plan (HDHP). For 2006 an HDHP is a health plan with an annual deductible of at least \$1,050 for individual coverage (\$2,100 for family coverage and maximum out-of-pocket expenses of \$5,250 for individual coverage (\$10,500 for family coverage). For 2005, the amounts were \$1,000, \$2,000, \$5,100 and \$10,200 respectively.

Social Security Wage Base: increases from \$90,000 to \$94,200. This means the employee and employer will each pay \$260.40 more in social security if over the wage base. If you are self-employed and make over the wage base you will pay \$520.80 more. An unlimited amount of wages remains subject to the 1.45% Medicare tax.

Nanny Tax Threshold: Yes, this is still with us. If you any single individual \$1,500 or more in wages for domestic help, you must withhold and match FICA tax on those wages. This is up from \$1,400. You may run for office yet.

Section 179 Expense: For those of you with businesses, you can now write-off \$108,000 of equipment purchased in 2006. This is up from \$105,000. This is reduced if you buy more than \$430,000 of equipment - up from \$420,000 in 2005. The SUV Section 179 write-off remains at \$25,000 (this is the provision created to counteract the Hummer write-offs).

If this newsletter accomplishes nothing else, I hope you at least have a better understanding of why I do not have every limit and threshold at the tip of my tongue when you call.

Well, the season is upon us. For those of you who are my clients, I look forward to meeting with you. For those who are not clients, if I can answer any questions, or help you in any way with your tax or business consulting needs, please feel free to call.

And of course, no newsletter would be complete without my-

Disclaimer: By nature of a newsletter, this information is in summary form and does not necessarily detail every requirement, restriction or tax planning opportunity. Prior to executing any tax strategy, you should consider non-tax implications - you may cost yourself more than you save in taxes. Please use this information with these limitations in mind. If you are considering executing a particular tax strategy, please contact me so we can discuss the specifics.

Any tax advice in this communication is not intended to be a "covered opinion." Therefore this communication cannot be used by any party to avoid penalties which may be imposed by the Taxing Authorities.
