

2006 TAX LAW CHANGES TIPRA

May 11, 2006

Dear Clients and Other Friends-

I have been waiting to send out my post-tax season newsletter until Congress finished the current tax bill. At the rate they were going, I thought I may never do a newsletter again.

They did finally finish a bill officially called the Tax Increase Prevention and Reconciliation Act or TIPRA. It is expected to go to the President for his signature by the end of the week. As usual, you have to look closely at the provisions since they have a variety of effective dates (some do not become effective until 2010), and a variety of termination dates. There were also a couple of surprises of what the bill did not cover.

As a quick reminder, there are numerous other tax related changes going into effect in 2006 under previously passed legislation. Please refer to my January 19th newsletter for a recap.

First, what isn't in TIPRA that I thought would be-

- Sales tax deduction: for the last couple of years we have been able to deduct as an itemized deduction the greater of the state sales tax paid or state income tax paid. In Washington this was a material deduction since we do not have a state income tax. This expired at the end of 2005. TIPRA did not extend it.
- Research & development credit: at the personal level this does affect many of us. However it does affect numerous businesses in the area. This is a credit that historically has been extended by Congress for only a year or two at a time, often times retroactively. It expired at the end of 2005. TIPRA did not extend it.

I would expect at least the R&D credit to be extended in a later bill this year, retroactive to the beginning of the year. I am unsure about the sales tax deduction.

There are many provisions in TIPRA that only a tax-geek could love so I will not cover them here. An example is "TIPRA creates a temporary exception from subpart F for dividends, interest, rents and royalties received by one CFC (controlled foreign corporation) from a related CFC to the extent attributable to non-subpart F income of the payor." Do you think I could be the life of the party or what?

TIPRA is supposed to be revenue-neutral. So, what they give in one area they must take away in another. I will first cover what they give us.

Increased 2006 AMT Exemption:

In my November 16, 2005 newsletter I explained how the AMT was originally implemented to hit the higher income taxpayer. To prevent the middle income taxpayer from becoming subject to AMT there was an exemption amount (\$45,000 for married taxpayers) which was deducted from regular income before computing AMT. However, the exemption amount was not indexed for inflation so as incomes rose due to inflation, and the exemption did not, more and more people became subject to AMT. Congress had previously increased the exemption to \$58,000 just for 2004 and 2005. It reverted back to \$45,000 as of 2006.

TIPRA increases the exemption to \$62,550 for married taxpayers and \$42,500 for single taxpayers just for 2006. So, we get to revisit this again in 2007.

Lower Capital Gains Rates Extended:

Under current law long term capital gains and qualified dividends are taxed at a rate of 0% (after 2007), 5% or 15% (depending on your income level.) This law was due to expire at the end of 2008. Capital gains would then be taxed at rates of 8% to 20%.

TIPRA extends these favorable rates to the end of 2010.

Capital Gain Treatment for Self-Created Musical Works:

Under current law, the proceeds from the sale of musical compositions or copyrights in musical works created by a taxpayer's personal efforts are treated as ordinary income.

TIPRA allows (at the taxpayer's election) these proceeds to be treated as capital gains and taxed at the more favorable rates.

Section 179 Expensing:

Currently businesses can expense up to \$108,000 of tangible personal property purchased for use in their trade or business. This was to drop to \$25,000 in 2008. Also, currently off-the-shelf computer software qualified for this deduction. After 2007 the software would no longer qualify.

TIPRA extends both provisions for 2008 and 2009.

Now, how are they going to pay for what they gave us-

IRA-to-Roth-IRA Conversions:

Under current law, an amount in a traditional IRA can be converted to a Roth IRA if the taxpayer's adjusted gross income is less than \$100,000 in the year of conversion. The amount converted is subject to tax, but not the 10% early withdrawal penalty.

TIPRA eliminates the \$100,000 AGI limitation for 2010. One half of the amount converted in 2010 will be taxed in each 2011 and 2012 unless the taxpayer elects to include the full amount in 2010. Don't ask me why they didn't have some taxed in 2010.

So, this is kind of a split give and take. It is a positive step to allow more people to convert their traditional IRAs to Roths. However, it will cost immediate tax dollars to do it. This is again a reminder much of our tax law revolves around timing. This provision will generate considerable tax revenue in 2010. However, since any income generated within a Roth can be withdrawn tax free in the future, it will cost the treasury even more tax dollars in the future.

Anybody want to make a bet that this will not be changed before it becomes effective in 2010?

Kiddie Tax:

Under current law, the unearned (i.e. dividends, interest, capital gains) income in excess of \$1,700 of a child who has not reached the age of 14 by the end of the year is taxed at the parent's marginal tax rate.

TIPRA changes the age to 18 years of age. It does allow one exception – if the child is married and files a joint return. Um, an under-18 year old married child – I don't think taxes would be my top concern....

Information Reporting – Tax-Exempt Bond Interest:

Currently banks and other financial institutions are not required to report to the IRS the amount of tax-exempt interest paid to a taxpayer.

TIPRA make this reporting a requirement starting in 2006. Your first reaction is probably “who cares – the interest is not taxable.” However, there are common situations where the interest does, in effect, become taxable.

For example, social security benefits are only taxable to the extent the taxpayer's total income exceeds a certain threshold. Tax exempt interest is added back to the taxpayer's taxable income to determine how much of the benefit exceeds the non-taxable threshold. Another situation is tax exempt interest from private activity bonds. Although this interest is not taxable for regular tax purposes, it is added to your income for AMT purposes. If you are subject to AMT you need to be careful in what type of tax exempt investment your broker invests.

This gives you an overview of the provisions which will affect many of you. As I mentioned, there are numerous additional provisions which may affect a few of you. I will be in touch with my clients who need to be aware of these more specialized provisions.

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.

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