The Tax Increase Prevention and Reconciliation Act of 2006

(Contributed by Evan H. Ice and Matthew H. Hoy – 05/2006)

On May 17, 2006, President Bush signed the Tax Increase Prevention and Reconciliation Act the (the "Act") into law. Although not as sweeping as other tax acts, the Act includes important tax changes for individuals. Some apply in 2006 year while others apply several years down the road, and while most changes (such as those affecting the AMT and capital gains) are tax-savers, others (such as the new "Kiddie Tax" rules) enhance revenue collection and will have a negative affect on some individuals. The following is an overview some of the more broadly applicable provisions of the Act:

Individuals and Families:

1. AMT relief. Although, the Alternative Minimum Tax ("AMT") was originally enacted to make sure that wealthy Americans did not escape paying income taxes, the AMT has wound up ensnaring many middle-income taxpayers. This is because many of the tax figures (such as the tax brackets, standard deductions, and personal exemptions) used to arrive at an individual's regular tax bill are adjusted for inflation, but the tax figures used to arrive at the AMT are not. In general terms, AMT is calculated starting from the individual's regular taxable income, which is modified with various adjustments (such as add-backs for certain deductions and dependency exemptions), and then subtracting from that amount an exemption amount (which phases out at higher levels of income). The result is subject to an AMT tax rate of 26% or 28%. Individuals pay the AMT only if it exceeds the tax bill. For 2006 only, the Act provides some relief. It increases the maximum AMT exemption amount over its 2005 level by $4,550 for married taxpayers filing a joint return, and by $2,250 for unmarried individuals. Thus, for 2006, the exemption amounts are as follows: (1) $62,550 for married individuals filing jointly and for surviving spouses; (2) $42,500 for unmarried individuals other than surviving spouses; and (3) $31,275 for married individuals filing a separate return. After 2006, the maximum AMT exemption amount will drop precipitously to where it was in the year 2000 unless Congress provides another fix.

Another provision in the new law provides AMT relief for those individuals claiming certain "nonrefundable" personal tax credits (such as the credit for dependent care and the Scholarship and Lifetime Learning credits). For 2006, these credits may offset both an individual's regular tax and AMT. After 2006, unless Congress acts, these credits will be allowed only to the extent that an individual has regular income tax liability in excess of the tentative minimum tax, which has the effect of disallowing these credits against AMT.

2. Kiddie Tax age limit raised from under 14 to under 18. At one time, wealthy parents could significantly lower their family's overall tax bill by transferring investment assets to minor children. This tax technique, called income shifting, worked by taking income out of the parents' higher tax bracket and placing it in the lower tax brackets of their children. To curtail the use of this tax technique, Congress enacted the "Kiddie Tax" rules, which provided that children under 14 who had more than a small amount of unearned (investment) income had to pay tax at their parents' marginal tax rate (the rate of tax on the last dollar earned). The threshold amount at which the Kiddie Tax kicks in is two times the amount allowed as a standard deduction for a dependent who has only investment income. For 2006, that amount is $850, so the Kiddie Tax begins to apply when the child has more than $1,700 in unearned income.

Under the new law, the age limit below which a child's income from investments is taxed at the parents' rates is raised from 14 to 18. The new law specifies, however, that the Kiddie Tax does not apply to a child who is married and files a joint return for the tax year. It also adds an exception to the Kiddie Tax for distributions from certain qualified disability trusts. The new provisions apply to tax years beginning after Dec. 31, 2005.

Business / Investment Changes:

1. Section 179 deduction. The new law extends for two years the increased amount that a taxpayer may deduct, and the other Section 179 rules. Currently, taxpayers are allowed an increased deduction limit of up to $100,000 of certain capital expenditures in the year the asset is acquired, without depreciating over a number of years. The increased deduction limit was set to expire at the end of 2008, but the new law extends the increased deductible amounts for two years.

2. Investor tax breaks extended. An individual's long-term capital gain generally isn't taxed at a rate higher than 15%. It may be taxed at just 5% (0% for 2008) if the gain would have been taxed at 10% or 15% if it were ordinary income instead of the regular long-term capital gain. Most dividends from domestic corporations (and certain qualifying foreign corporations) also qualify for the same favorable tax treatment as long-term capital gain. These favorable tax rates were set to expire at the end of 2008, but the new law extends the favorable rates through 2010.

3. Capital gain treatment for self-created musical works. Before the new law came along, literary, musical, or artistic compositions, letters or memoranda, or similar property held by a taxpayer whose personal efforts created the property weren't treated as capital assets. As a result, when an individual sold copyrights she owned in songs she created, gain from the sale was treated as high-taxed ordinary income rather than low-taxed capital gain.

Under the new law, at the election of the individual, the sale or exchange of musical compositions or copyrights in musical works created by the individual's personal efforts is treated as the sale or exchange of a capital asset. This applies to sales in exchanges after May 17, 2006, the date President Bush signed the Act into law by the President, and before 2011.

Retirement Changes:

Income limit on Roth IRA conversions eliminated, beginning in 2010. An individual who makes deductible contributions to a regular individual retirement account (IRA) gets a tax break now for the dollars he puts in and his earnings grow tax free. However, he pays ordinary income tax on every dollar he takes out, and withdrawals are subject to significant restrictions, such as the "required minimum distribution" rules. An individual who makes contributions to a Roth IRA doesn't get a tax deduction for contributions, but his money grows tax free and there's no tax (with a few restrictions) on qualifying withdrawals.

Under current law, only individuals with $100,000 or less in modified adjusted gross income can convert a regular IRA into a Roth IRA. An individual making the conversion generally must pay tax on money he takes out of his regular IRA, but once it's in his Roth IRA, he won't pay income tax on the withdrawal of that money or the money it earns (assuming a few relatively simple requirements are met). Generally speaking, Roth conversions appeal to taxpayers who either think their tax rate will go up in retirement, or believe that the value of their account will rise significantly, and thus are willing to make an upfront tax payment when they convert in order to reap large tax savings in later years. In addition, individuals with an estate subject to estate tax may determine it advantageous to convert regular IRAs so that the income tax is paid prior to the individual's death or is a debt of the individual's estate, thus reducing the individual's taxable estate and providing income-tax free assets to the individual's beneficiaries.

Under the new law, beginning in 2010, taxpayers will be able to convert a regular IRA into a Roth IRA regardless of how high their modified adjusted gross income is. What's more, the new law permits taxpayers who convert in 2010 to spread the income and resulting tax payments on the converted funds over two years – 2011 and 2012. The problem, of course, is that this provision is not effective until 2010 and Congress may repeal or revise this provision before it ever becomes effective.

Miscellaneous:

Changes to the foreign earned income exclusion and housing allowance for U.S. citizens working abroad. The new law makes three changes to the foreign earned income exclusion and housing allowance. First, the income exclusion is indexed for inflation starting in 2006 (rather than 2008 under current law). Second, the base housing amount used in calculating the foreign housing cost exclusion in a taxable year is modified (the new base amount is 16% of the amount of the foreign earned income exclusion limitation). Reasonable foreign housing expenses in excess of the base housing amount remain excluded from gross income, but the amount of the housing exclusion in excess of the base housing amount is limited to 30% of the taxpayer's foreign earned income exclusion. Third, income excluded as either foreign earned income or as a housing allowance is included for purposes of determining the marginal tax rates applicable to non-excluded income.