TAX INCREASE PREVENTION AND RECONCILIATION ACT

The Tax Increase Prevention and Reconciliation Act was passed May 11, 2006 and impacts a broad cross-section of taxpayers. The new law extends the dividend and capital gains tax rate cuts for two more years beyond 2008, gives taxpayers some immediate relief from the alternative minimum tax (AMT), extends Sec. 179 expensing thresholds, and allows high-income taxpayers a Roth conversion opportunity. Below are details of the major items.

AMT RELIEF

The Tax Reconciliation Act extends and increases (for 2006 only) the AMT exemption amount for individuals. It also lessens the sting of the AMT for 2006 by allowing the use of certain nonrefundable personal credits.

Higher AMT exemption amounts. Through December 31, 2006, taxpayers will be able to take advantage of higher AMT exemption amounts. The AMT exemption amount for married couples filing jointly is $62,550 and for single taxpayers is $42,500.

Nonrefundable personal credits. The Tax Reconciliation Act extends through 2006 the provision allowing taxpayers to use nonrefundable personal credits to offset AMT liability. Nonrefundable personal credits include the dependent care credit, the credit for the elderly and disabled, the credit for interest on certain home mortgages, the Hope credit for certain college expenses and the Lifetime Learning credit.

DIVIDEND AND CAPITAL GAINS RATE CUTS

In 2003 Congress lowered the maximum dividend and capital gains tax rates (for most, but not all, dividends and capital gains) to 15 percent for qualifying taxpayers. As originally enacted, these tax rate cuts were temporary. They were scheduled to expire at the end of 2008.

The Tax Reconciliation Act extends the cuts for two more years through December 31, 2010.

SMALL BUSINESS EXPENSING

The Act extends the enhanced Code Sec. 179 expensing thresholds through December 31, 2009.

Comment. The maximum amount a taxpayer may expense for 2006 is $108,000 of the cost of qualifying property, reduced by the amount by which the cost of qualifying property exceeds $430,000. Without the extension, the expensing limit would have dropped to $25,000 on a $200,000 cap after 2007.

CORPORATE ESTIMATED TAX PAYMENTS

Increases for large corporations. The Tax Reconciliation Act increases estimated tax payments for corporations with assets of at least $1 billion that are due in 2006, 2012 and 2013. Payments due in July, August and September 2006 are increased to 105 percent; payments due in July, August and September 2012 to 106.25 percent; and payments due in July, August and September 2013 to 100.75 percent.

Delayed due date. 20.5 percent of the corporate estimated tax payment due on September 15, 2010 will not be due until October 1, 2010. 27.5 percent of the corporate estimated tax payment due on September 15, 2011 will not be due until October 1, 2011.

REVENUE RAISERS

IMPORTANT CHANGES TO ROTH IRAS

The Tax Reconciliation Act eliminates the $100,000 adjusted gross income ceiling for converting a traditional individual retirement account (IRA) to a Roth IRA, for tax years after 2009. A conversion is treated as a taxable distribution, but is not subject to the 10-percent early withdrawal penalty. Taxpayers who convert in 2010 can elect to recognize the conversion income in 2010 or average it over the next two years.

Reminder. Contributions to a Roth IRA are not deductible, but the earnings are permanently tax-free. Also, Roth IRAs, have no required minimum distribution at age 70 1/2.

Comment. This provision does not extend to 401(k) plans. However, nothing would prevent Roth IRA conversions of traditional IRAs that have received proceeds of 401(k) balances when an individual leaves employment. Nor does the new law prevent high-income taxpayers from contributing to nondeductible traditional IRAs now in anticipation of converting to Roth IRAs in 2010.

Impact. 2010 is the last year for the low income tax rates before they sunset in 2011. The rush to do Roth conversions in 2010 may be historic, especially if Congress does not extend the lower tax rates.

KIDDIE TAX

The kiddie tax rules require that a child's unearned income, such as dividends and interest, be taxed at the parents' tax rate, which is usually a higher rate. Under current law, the kiddie tax applies if the child is under age 14, the child has net unearned income over $1,700, and the parent can claim the child as a dependent. The Tax Reconciliation Act raises the age limit to under 18.

Impact. This provision is effective immediately, for the entire 2006 tax year.

WAGE LIMITATION IN CODE SEC. 199

Code Sec. 199 allows a deduction from taxable income for the portion of a taxpayer's income that arises from qualified production activities but limits the deduction to 50 percent of the wages paid by the taxpayer in the same calendar year. Partners, shareholders, or other persons who are allocated part of qualified production activities income (QPAI) from passthrough entities were treated as having been allocated their share of the partnership's wages.

The Tax Reconciliation Act modifies the wage limitation by limiting the deductions to 50 percent of the wages that are deducted in arriving at QPAI. Partners and shareholders will be allocated their share of the partnership's W-2 wages but will include in their wage limit only wages paid to determine QPAI.

MORE ON THE WAY

To reach an agreement, and keep within budget constraints, conferees removed some important provisions which will likely appear in stand-alone legislation, a "trailer" bill, or could be tacked onto the pending pension reform bill. These additional provisions include: extending the state and local sales tax deduction, the teachers' classroom expense deduction, R&D provisions, some employment tax credits, and other popular but temporary incentives.

We will continue to update you on tax changes during the year. Please let us know if you have any questions.