

TAX NEWS

DARNALL
Accounting & Tax Service, Inc.
425-771-9120

Summer 2006

TAX CLIENT NEWSLETTER

The Summer 2006 Tax Client Newsletter brings you up-to-date on a number of important tax law changes for 2006. The United States Congress has been busy, enacting four separate tax acts in the last nine months, including the Tax Increase Prevention and Reconciliation Act of 2005, TIPRA, signed into law on May 17, 2006.

Many important tax law provisions went away (the process called sunset) on December 31, 2005. The expiring provisions include the \$250 adjustment to income known as the Educator's Deduction, the Tuition and Fees Deduction, the deductibility of State Sales Tax, the Research and Development Credit and the Saver's Credit. The Pension Bill, thought by many to be a "trailer bill" to TIPRA, will generally include most if not all of these expiring provisions. It is anticipated that agreement on this bill will be reached and passage of the Act complete by Labor Day.

Washington is focused on the budget. Funding for the war, homeland security, Social Security and Medicare, with the September 30 year-end looming for the government, it is doubtful that the budget for next year will be forthcoming by September 30, leaving the government to run on what is called a "continuing resolution".

With 2006 an election year, many in Washington are concentrating on their election or the election of their colleagues. With interest focused on campaigning, it is almost certain that additional tax acts will be initiated after the November election:

If you have any questions concerning any of the information being reported on in this issue of the Tax Client Newsletter, please contact my office to schedule an appointment.

2006 Tax Legislation

The Increase Prevention and Reconciliation Act of 2005 - TIPRA (75 pages) includes \$90 billion in targeted benefits and \$20 billion in revenue "offsets". The official name of the legislation carries a 2005 date because it represents a carry-over from last year's budget. In this issue of the Tax Client Newsletter we will review some of the most important changes for 2006.

Highlights of the Legislation

Stock investors are the broadest group of beneficiaries of the Act. The 15% favorable tax rate on long-term capital gains and qualifying dividends is extended through 2010. The Joint Committee on Taxation estimates that the extension of the 15% tax rate on long-term capital gains will cost \$40.8 billion over ten years.

TIPRA raises the amount of income exempted from the Alternative Minimum Tax (AMT). Taxpayers who would appear to benefit from this provision are those with incomes in the \$100,000 to \$500,000 range. A hypothetical family of four with \$185,000 in income and \$33,000 in itemized deductions would have faced an AMT of \$3,700 in 2006, however, with TIPRA the family will not be exposed to the AMT. This is a oneyear fix. Congress must address the AMT each and every year. With this fix, it is anticipated that no more taxpayers will be subject to the AMT in 2006 then were subject to the AMT in 2005. Without this fix, an additional 4.1 million taxpayers would be added to the roles of those taxpayers subject to the AMT.

Interesting, controversial and challenging the revenue "offset" in the bill concerns the provision for ROTH IRAs. Beginning in 2010, taxpayers with incomes in excess of \$100,000 will also have the opportunity to convert their regular IRAs to a ROTH IRA.

Supporters of this measure noted that it will raise revenue since taxpayers converting to a ROTH IRA must pay taxes based on the value at the time of the conversion. It is estimated that ROTH IRA conversions will yield \$6.4 billion in revenue between 2010 and 2015.

Americans living and working abroad will pay an estimated \$2.1 billion in taxes over the next decade. Expatriates will face tighter rules on how employer-provided housing will be treated and they could face higher taxes on investment income as a result of an adjustment in tax rates; calculating the excluded foreign earned income as if taxable for the effective tax rate on taxable income.

The Details AMT Relief: A One-Year Fix

The amount of income exempted from the AMT is increased to \$62,500 for married couples filing jointly up from \$58,000 in 2005. Without the tax measure, the exempted amount was scheduled to decrease to \$45,000 in 2006. The exemption for single filers will be raised to \$42,500 for 2006 up from \$40,250 in 2005.

TIPRA extends through 2006 the provision allowing taxpayers to use non-refundable personal credits to offset AMT liability. The credits include:

- Dependent Care Credit
- Credit for Elderly and Disabled Hope Credit
- Lifetime Learning Credit

Capital Gains and Dividends: Two-Year Extension

The Act extends the current 15% tax rate on capital gains and qualifying dividends from the end of 2008 through 2010. By extending the capital gains/dividends break through 2010, the provisions are now aligned with the tax cuts enacted

in the Economic Growth and Tax Relief Reconciliation Act of 2001.

Musicians/Musical Compositions/Musical Composition Copyrights

Musicians benefit from a special provision in the Act. TIPRA allows taxpayers to elect to treat the sale or exchange of self-created musical compositions or copyrights as the sale or exchange of a capital asset. This change is effective for tax years beginning after the President signed the bill on May 17, 2006 and through 2010. The Act allows a taxpayer who puts any musical composition or musical copyright into service to elect to use the 5-year amortization period for certain expenses paid or incurred with respect to all musical compositions and musical composition copyrights placed in service in that tax year.

Small Business Expensing

TIPRA continues the special small business expensing under Code Section 179. The enhanced small business thresholds contained in the American Jobs Creation Act of 2004 are extended through 2009. The maximum amount that may be expensed is \$100,000 of qualifying property, reduced by the amount by which the cost of qualifying property exceeds \$400,000. The \$100,000 and \$400,000 amounts are indexed for inflation after 2003 and before 2010. For 2006, the amounts are \$108,000 and \$430,000, respectively. Without the extension in the TIPRA, the amounts would have dropped to \$25,000 on a \$200,000 cap after 2007.

Revenue "Offsets" Kiddie Tax: Age Increase

The TIPRA provides for increasing the age limit of the "kiddie-tax" to children under 18 years of age which is up from the previous under age 14. If a child under 18 has investment income, the first \$850 is tax-free and the next \$850 is typically taxed at the child's tax rate. "Unearned" income above \$1,700 is taxable at the parents' top tax rate. This change in the law is effective for 2006. Estimated tax payments for 2006 may need to be adjusted for this provision.

ROTH IRAs: Increase in Eligibility

TIPRA eliminates the \$100,000 adjusted gross income test for converting a traditional IRA to a ROTH IRA. The change is effective for tax years

after 2009. Taxpayers who convert in 2010 can elect to recognize the conversion income in 2010 or average it over the next two years of 2011 and 2012. While contributions to a ROTH IRA are not deductible - the earnings are tax-free. ROTH IRAs do not require minimum distributions at age 70 ?

Offers-in-Compromise: Required Payment with Offer

The TIPRA increases the amounts that must be paid by taxpayers submitting an offer-in-compromise. Under the new law, taxpayers are required to make partial payments of their liability in addition to any user fees now imposed by the Internal Revenue Service. The required payment amount will be applied to the outstanding tax liability and not refunded if the offer is not accepted. For a lump sum offer, taxpayers will be required to pay 20% of the amount being offered. For an installment payment offer, taxpayers will be required to make their proposed scheduled payments while the offer is being considered. It should be noted, if the IRS fails to process the OIC within two years, the offer will be deemed to be accepted by the IRS.

Average Tax Savings per Taxpayer

Income (2005 dollars)	Average Tax Savings
Less than \$10,000	\$ 0
10,000 - 20,000	3
20,000 - 30,000	10
30,000 - 40,000	17
40,000 - 50,000	47
50,000 - 75,000	112
75,000 - 100,000	406
100,000 - 200,000	\$ 1,395
200,000 - 500,000	\$ 4,527
500,000 - 1 million	\$ 5,656
Over 1 million	\$ 42,766

Other Tax Items of Note:

The maximum IRA contribution for 2006 remains at \$4,000 however the "catch up" amount for taxpayers age 50 and older has increased from \$500 to \$1,000, making the maximum contribution for a taxpayer age 50 and older to be \$5,000.

President Bush signed into law the "Hero Act" on May 28, 2006 allowing non-taxable combat pay to be deemed earned income to qualify for an IRA contribution. This Act is deemed effective for years 2004, 2005 and future years allowing those taxpayers

who qualify to make IRA contributions for the years of 2004, 2005 and 2006 beyond the normal contribution due date. The contribution due date has been extended for qualifying taxpayers until May 28, 2009.

For 2006, taxpayers who are participants in 401(k) plans may now have an opportunity to participate in a ROTH 401(k), if the employers plan so allows. 401(k) limits are \$15,000 with an additional \$5,000 "catch up" contribution for taxpayers age 50 and older. Unlike the ROTH IRA there is no income limitation on the ROTH 401(k).

Energy credits are available for homeowners for 2006 and 2007. A \$500 lifetime credit is available for certain energy-saving expenditures for your personal residence.

Although not in a tax act, you have undoubtedly heard of the decision by the Department of the Treasury to rebate Federal Excise Taxes charged on longdistance telephone service. Not only will taxpayers receive a credit for the Federal Excise Tax paid for three years they will also receive interest on their money. IRS is working with the Treasury Department to offer taxpayers a "standard credit" rather than put taxpayers through the rigorous exercise of compiling the taxes paid.

And finally, for taxpayers making too much in income and losing the deductibility of their itemized deductions and personal exemptions, known as the phase out, 2006 will see the beginning of the phase out of the phase out. Taxpayers in 2006 will lose only 2/3 of the deductions and exemptions they lost in 2005. In 2007 they will only lose 1/3 and in 2008 they will lose nothing. The phase out will no longer exist after 2007.

In the Summer 2006 Tax Client Newsletter we have reviewed many of the most significant tax law changes affecting your taxes.

Our combined focus should be on how the tax law changes affect you, how the tax law changes can benefit you and what tax planning techniques should be implemented in order to maximize their tax benefit to you.

Thank you for reviewing the Summer 2006 Tax Client Newsletter and for the opportunity and privilege of allowing me to serve as your tax professional.