

Tax Provisions Affecting Individuals

The recently enacted Tax Increase Prevention and Reconciliation Act contains investor tax breaks, alternative minimum tax (AMT) relief, and several other provisions with immediate and long-term impact on individuals. Although the new legislation also contains several provisions affecting primarily businesses and corporations, I am writing this to provide you with a quick overview of the provisions in the new law that directly affect individual taxpayers. AMT relief.

Originally enacted to make sure that wealthy Americans did not escape paying taxes, the AMT, which is a parallel tax system which does not permit several of the deductions permissible under the regular tax system, such as state, local and property taxes, has started to affect more middle-income taxpayers. This is in part due to the fact that the AMT parameters are not indexed for inflation. In recent years, Congress has provided a measure of relief from the AMT by raising the AMT “exemption amounts” - allowances that reduce the amount of alternative minimum taxable income (AMTI), reducing or eliminating AMT liability. (However, these exemption amounts are phased out for taxpayers whose AMTI exceeds specified amounts.) For 2005, the AMT exemption amounts were \$58,000 for married couples filing jointly and surviving spouses; \$40,250 for single taxpayers; and \$29,000 for marrieds filing separately. However, for 2006, those amounts were scheduled to fall back to the amounts that applied in 2000: \$45,000, \$33,750, and \$22,500, respectively. This would have brought millions of additional middle-income Americans under the AMT system, resulting in higher federal tax bills for many of them, along with higher compliance costs associated with filling out and filing the complicated AMT tax form.

To prevent the unintended result of having millions of middle-income taxpayers pay tax under the AMT rules, Congress has once again relied on a temporary fix to the problem, this time a one-year extension of the 2005 AMT exemption amounts, increased slightly. Under the new law, for tax years beginning in 2006, the AMT exemption amounts are increased to: (1) \$62,550 in the case of married individuals filing a joint return and surviving spouses; (2) \$42,500 in the case of unmarried individuals other than surviving spouses; and (3) \$31,275 in the case of married individuals filing a separate return.

Another provision in the new law provides AMT relief for those who have personal tax credits. The tax liability limitation rules generally provide that certain nonrefundable personal credits (including dependent care, elderly and disabled, and Hope Scholarship and Lifetime Learning) are allowed only to the extent that a taxpayer has regular income tax liability in excess of the tentative minimum tax, which has the effect of disallowing these credits against AMT. Temporary provisions had been enacted which permitted these credits to offset the entire regular and AMT liability through the end of 2005. The new law extends this temporary provision to tax years beginning in 2006.

Investor tax breaks extended.

In 2003, Congress passed a measure to lower the tax rate on most dividends to 15 percent from as high as 38.6 percent, and to lower the rate on most capital gains from 20 percent to 15 percent. That measure was due to expire at the end of 2008, but the new law extends the favorable tax rates through 2010.

Income limitations on Roth IRA conversions eliminated, beginning in 2010.

A taxpayer 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, but he pays ordinary income tax on every dollar he takes out, and withdrawals are subject to significant restrictions. In a Roth IRA, the taxpayer gets no tax deduction for contributions, but his money grows tax free and there's no tax, and few restrictions, on qualifying withdrawals.

Under pre-Act law, only taxpayers with \$100,000 or less in modified adjusted gross income can convert a regular IRA into a Roth IRA. A taxpayer 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 tax on that money or the money it earns. 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.

Under the new law, beginning in 2010, taxpayers with more than \$100,000 of modified adjusted gross income also will be able to convert a regular IRA into a Roth IRA. To make such conversions more attractive in 2010, 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.

Kiddie tax age limit raised from under 14 to under 18.

At one time, wealthy parents could significantly lower their family's 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 said 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.

Capital gain treatment for self-created musical works.

Under pre-Act law, capital assets do not include copyrights, literary, musical, or artistic compositions, letters or memoranda, or similar property held by a taxpayer whose personal efforts created the property. As a result, when a taxpayer sells copyrights he owns in, for example, books, songs, or paintings that he created, gain from the sale is treated as ordinary income, not capital gain, which is generally taxed at a lower rate.

Under the new law, at the election of a taxpayer, the sale or exchange before Jan. 1, 2011 of musical compositions or copyrights in musical works created by the taxpayer's personal efforts is treated as the sale or exchange of a capital asset. The change applies for sales or exchanges in tax years beginning after May 17, 2006.

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 pre-Act law). Second, the base housing amount used in calculating the foreign housing cost exclusion in a taxable year is 16 percent of the amount of the foreign earned income exclusion limitation (instead of the pre-Act law 16 percent of the U.S. government employee grade GS-14, step 1 amount). Reasonable foreign housing expenses in excess of the base housing amount remain excluded from gross income, but the amount of the exclusion is limited to 30 percent 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.