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2006 Tax Update

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Dear Client,

We have so many tax changes this year that I have decided to send this letter. In the letter I comment on the tax law changes that are most likely to impact my clients. In addition, I provide an explanation of alternative minimum tax, as most of my clients are now subject to it.

The Tax Increase Prevention and Reconciliation Act (TIPRA) was signed into law by President Bush on May 17, 2006. The law makes several individual tax law changes including:

- Extends the 15% rate for dividends and capital gains until 2010, instead of 2008
- Increases for one year the AMT exemption amounts
- Increases the age to which the kiddie tax provisions apply from under age 14 to under age 18

The Pension Protection Act of 2006 (PPA) was signed into law by the President on August 17, 2006. The law is the first major reform of pension tax law in 30 years. The changes include:

- Allows tax-free distributions from IRAs for charitable purposes
- Requires increased substantiation for cash charitable contributions
- Requires increased substantiation for non-cash charitable contributions of household goods and clothing
- Makes permanent the tax-free treatment of Section 529 plans to the extent used for college expenses

Here are some details:

Non-Cash Charitable Contributions: Effective for contributions made on or after August 17, 2006, you cannot claim a deduction for donations of clothing or household items unless the item is in “good used condition or better”. The law does not define “good condition” so you will need to be more discriminating with the items you are donating and *you may want to take photos of large items to help verify their condition.*

Cash Contributions: Starting in 2007, you will no longer be able to deduct the small amounts of cash given to Salvation Army bell ringers or cash in the church collection basket (unless the Church acknowledges the contribution in writing). In short, you will not be able to take deductions for any contributions not paid by check or acknowledged in writing by the charity.

IRA Charitable Contributions: In 2006 and 2007, if you are at least 70-1/2, you can make a charitable contribution directly from your IRA. Although you will not be able to claim a deduction for the contribution (to the extent it was made with “pre-tax” dollars), you will not be taxed on the withdrawal of the money from your IRA.

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Vehicle Donations (effective 2005): The IRS realized that taxpayers were abusing the deduction for vehicle donations. Taxpayers claimed $654 million in write-offs from car donations in the 2000 tax year, but charities reported getting just $32.7 million from the sales of those donated cars after expenses, a study by the Government Accountability Office found late last year. Effective with the 2005 year, Congress changed the law so that the deduction for a donated vehicle is generally limited to the actual sales price that the charity obtains for the vehicle. To substantiate the deduction, Form 1098-C, which is supplied by the charity, needs to be attached to the taxpayer's tax return.

Alternative Minimum Tax (AMT): The alternative minimum tax is a second income tax system that runs parallel to the regular individual income tax. First enacted in 1969, the AMT was intended to target a small group of high-income individuals who had managed to avoid all taxes, to ensure that they paid a minimum amount of tax. Changes since AMTs original enactment mean that today it reaches into the ranks of the middle class. Generally, the tax base for the AMT calculation is the taxpayer's normal taxable income, increased or decreased by certain adjustments. The resulting amount, called the alternative minimum taxable income, is reduced by an exemption amount and taxed at a progressive tax rate. The result is called "tentative minimum tax". AMT is the extent to which "tentative minimum tax" exceeds regular tax.

What is causing more Americans to become subject to AMT is that unlike regular tax, the AMT tax brackets and exemption amounts are not indexed for inflation. In addition, taxpayers in high income tax states like CA are more likely to be subject to AMT because state and property taxes are not deductible for AMT. The 2006 TIPRA tax bill will provide temporary AMT relief for some as it increases for one year (2006) the AMT exemption amounts.

The ramifications of AMT can be painful. For instance if you are subject to AMT and purchased a hybrid vehicle in 2006 (both are "yes" for me), then the hybrid tax credit is lost, because it is not available to reduce AMT.

Maximum Long-term Capital Gains of 15% extended through year 2010: There was an oddity in the tax act that created the maximum 15% capital gains rate a couple of years ago. For year 2008, taxpayers in the 10% and 15% bracket have a 0% capital gains rate (down from 5%). This means that low-income taxpayers could have capital gains of up to $30,000 and pay no tax. TIPRA extends this 0% tax rate for two more years, through 2010. Since kiddie tax now extends through age 17, the planning opportunity is to use a custodial account to gift highly appreciated stock to children that are attending college. *A gain of up to $30,000 could be generated with no Federal tax!* The custodian (the parent) can then use the proceeds to pay for college expenses.

IRA (Regular & Roths) Contribution: The annual amount that can be contributed has increased as follows:

	2002-2004	2005	2006	2007	2008
Taxpayers Under Age 50	$3000	$4000	$4000	$4000	$5000
Taxpayers Over Age 50	$3500	$4500	$5000	$5000	$6000

Roth IRA Conversions for 2010: Roth IRAs are very appealing because no tax is paid when qualified distributions are received. Contributions to Roths, though, are only allowed for taxpayers below a certain income limit. In addition, for taxpayers with modified adjusted gross income below $100,000, a regular IRA can be converted into a Roth IRA. Income is taxed to the extent that the amount converted is with pre-tax dollars. For instance if a $25,000 IRA with no tax-basis is converted to a Roth, the $25,000 must be recognized as ordinary income in the year of conversion.

Starting in 2010, the existing $100,000 income test for converting a traditional IRA to a Roth IRA will no longer apply. In addition, under the 2006 Tax Act, taxpayers who convert an IRA to a Roth-IRA in 2010 can elect to defer the related income inclusion and recognize the income ratably over the two years, 2011 and 2012.

The tax planning this new law provides is for high-income taxpayers to make non-deductible IRA contributions in years 2006 through 2010, and then convert the IRA to a Roth IRA in 2010. The income realized by the conversion will be the value of the IRA, less the basis in the IRA (which is based on the amount of the non-deductible contributions). *There is a very significant catch, though. If a taxpayer has other IRAs, the taxable basis must be allocated over all IRA assets.* For instance, if someone who has only one $25,000 IRA with a basis of $20,000 (due to non-deductible contributions), converts it to a Roth, only $5000 will be taxed as a result of the conversion. If instead she also has another IRA worth $100,000 with no basis (from a 401(k) rollover), the $20,000 basis is allocated between the two IRAs. In this case, only $4000 of the basis is attributed to the converted IRA, and $21,000 will be taxed as a result of the conversion.

Medicare Premium Surcharge Starting in 2007: Included in the 2003 Medicare prescription drug bill was a little noticed provision that added a premium surcharge to be paid in addition to the normal Part B premium. Staring in 2007, the premium for Medicare Part B can increase substantially for high income individuals. It is projected that about 1.5 million people will see the increase.

The surcharge will be charged to Social Security recipients who are married and for year 2005 had "modified adjusted gross income" greater than $160,000, or are single and 2005 their income was greater than $80,000. The base Medicare B premium for 2007 will be $93.50 per month before the imposition of any premium surcharge. Depending on the level of income, the surcharge for high income taxpayers will range from $12.50 to $68.60 per month. *This premium surcharge will dramatically increase in the future*, as in 2008, the surcharge will double from 2007 and will be based on 2006 income, and in 2009, the surcharge will triple from 2007, and be based on 2007 income.

Credit for Energy-Efficient Improvements to a Personal Residence by a Homeowner: During 2006 and 2007 individuals can make energy-conscious purchases that may provide a Federal tax credit. Manufacturers offering energy efficient products can assure their customers, and homeowners may rely on these claims, that their energy efficient items will qualify for the tax credit if certain energy efficiency requirements are met. Only expenditures for a taxpayer's primary residence qualifies. The maximum credit for all taxable years is $500 and no more than $200 of the credit can be attributable to expenses for windows. Eligible expenditures include insulation systems that reduce heat loss, exterior windows and skylights (limited to $200), exterior doors, metal roofs, advanced main air circulating fan (limited to $50), hot water heater (maximum $150), central air conditioners (maximum $300).

Telephone Tax Refunds: The IRS stopped requiring the collection of a federal excise tax on long-distance telephone service as of July, 2006, a tax first imposed in 1898 to finance the Spanish-American War. The current rate is 3% of the charges billed for these services. Taxpayers may request a credit or refund of the excise tax that was actually paid after February 28, 2003, and before August 1, 2006, but only on their 2006 Federal income tax returns. *Individual taxpayers may request a safe harbor amount for the refund (which I plan to use for clients). The amount is $30 for returns with 1 exemption (single), $40 for 2 exemptions, $50 for 3 exemptions, and $60 for 4 or more exemptions.* No documentation will be required to be submitted or kept to support the safe harbor request.

Please let me know if you have any questions regarding these tax law changes.

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