

A Primer on the Tax Increase Prevention and Reconciliation Act of 2005

On May 17, 2006, President Bush signed into law the Tax Increase Prevention and Reconciliation Act of 2005, or TIPRA for short. TIPRA affects taxes on capital gains and dividends, the alternative minimum tax or AMT, the so-called kiddie tax, and Roth conversions. Given all the changes, including those affected most by the sunset measures introduced in 2001 and 2003, the new tax law heightens further the need to do financial planning now rather than later. Here's a summary of the changes:

Capital gains and dividends

The Jobs and Growth Tax Relief Reconciliation Act of 2003 established a maximum tax rate of 15 percent for long-term capital gains and "qualified" dividend income. These rates were scheduled to expire after 2008, but TIPRA extends the rates that apply in 2008 for two years, through 2010. For taxpayers in the top four tax brackets, this means the tax rate on long-term capital gains and "qualified" dividends will be 15 percent for all years through December 31, 2010. For taxpayers in the lowest two tax brackets (10 and 15 percent), the capital gains and qualified dividend rates will be five percent through 2007 and zero percent from 2008 through 2010.

Among other things, the extension may make it attractive for wealthy families to give appreciated assets—up to the annual gift tax exclusion limit (\$12,000 in 2006 or \$24,000 for married couples who gift split)—to children who are age 18 or older, but still in the lowest tax brackets. In essence, any appreciation after the date of the gift should not be subject to gift taxes, so experts suggest gifting securities that may have growth potential. The extension also creates the opportunity for Americans with low taxable income, including many retirees, to harvest small amounts of capital gains at zero percent in 2008-2010.

Alternative minimum tax (AMT)

AMT exemption amounts, which were expanded under various tax laws in 2001, 2003 and 2004, expired at the end of 2005. TIPRA increases AMT exemption amounts beyond their 2005 levels for the 2006 year only. New AMT exemption amounts for 2006 are:

- \$62,550 for married individuals filing jointly
- \$42,500 for single filers
- \$31,275 for married individuals filing separately

The Act also resurrects, at least for 2006, the rules that allow non-refundable personal tax credits (the dependent care credit, the credit for the elderly and disabled, the Hope credit for certain college expenses and the Lifetime Learning credit, for instance) to offset the AMT.

In 2005, an estimated four million taxpayers were subject to the AMT, but a recent report from Congressional Research Services estimates AMT will affect 23 million Americans in 2007 without further tax law change. That's because the AMT is not currently indexed for inflation, while the regular tax system is, and consequently every year more average-income households cross over into the AMT. Experts say the current relief is not substantial and it's uncertain whether AMT will either be reformed or repealed because of the substantial tax revenue cost.

Roth IRA conversions

TIPRA eliminates the restriction that heretofore prevented individuals with adjusted gross income exceeding \$100,000 from converting a traditional IRA to a Roth IRA. This change is not effective, however, until 2010.

In addition, TIPRA enables individuals who convert a traditional IRA to a Roth IRA in 2010 will automatically spread the resulting reportable income over the following two years, including the income ratably in 2011 and 2012. Individuals can elect to report 100 percent of the resulting income in 2010 if they wish. Of note, income tax is due on the full amount of the traditional IRA conversion. With this change to Roth IRA conversions, individuals who have traditional IRA balances can weigh the benefits of converting some or all of their balances to a Roth IRA. The true potential benefit of Roth IRA conversions is this: the taxpayer would pay an income tax at current rates because they believe the rate will be higher in the future (either because the person who withdraws the money will have higher income then, or because they believe that Congress will raise tax rates in the future).

Kiddie tax

According to the IRS, the investment income of a young child may, under some circumstances, be taxed at the child's parents' top marginal income tax rate. This is commonly referred to as the "kiddie tax." TIPRA increases the relevant age of children that are affected by the kiddie tax rules from 14 to 18. Retroactively effective to January 1, 2006, children under the age of 18 are subject to the kiddie tax rules. Exceptions apply for minor children who are married and file a joint tax return, and distributions from certain qualified disability trusts. The implication of this change is that it prevents parents from shifting any of their investment income to their children in a lower tax bracket. This change affects families wealthy enough to gift assets with significant appreciation or short-term appreciation potential. It also affects parents who were or are still saving for their children's college using custodial accounts and affects a wide swath of young teenagers who simply saved enough of their own money for future college (or other purposes), who now get taxed at their parents' rates for the income they saved entirely on their own.

TIPRA brought about a number of tax law changes, so it's a good idea to consult with your financial planner to see how it might affect your own situation.