Client Alert Bulletin

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This letter gives you a broad overview of a new tax law, the "Tax Increase Prevention and Reconciliation Act of 2005," which the President signed into law on May 17, 2006. The Act provides $70 billion in tax incentives. The Act affects a broad spectrum of taxpayers, including individuals, small business owners, corporations, and expatriates. The following information outlines the major provisions affecting individual taxpayers and small business owners.

Investments and Capital Gains

Capital Gain and Dividend Rate Extension. The two provisions receiving the most national press are the reduction of capital gains rates and taxing qualified dividends at the capital gains rate. Thus, for taxpayers above the 15% tax bracket, capital gains will be taxed at a maximum rate of 15% through 2010. For taxpayers in the 10% or 15% tax bracket, capital gains will be taxed at 5% through 2007, but then be dropped to 0% for 2008 through 2010.

Miscellaneous Investor Extensions. The Act extends the sunset date to December 31, 2010, on several items that were set to expire on December 31, 2008:

(1) the minimum tax preference item for sales of small business stock under §1202 of 7%;

(2) the provision treating a dividend as investment income for purposes of determining deductible investment interest only if the taxpayer elects to treat the dividend as not eligible for the capital gains rates;

(3) the special rules allowing dividends paid by REITs and RICs to qualify for the capital gains rates; and

(4) the reduced tax rate of 15% for the accumulated earnings tax and the personal holding company tax.

Capital Gains Treatment for Self-created Musical Works. The Act allows taxpayers to elect capital gains treatment for the sale or exchange of musical compositions or copyrights in musical works created by their personal efforts. This new law is effective for sales and exchanges before January 1, 2011, in taxable years beginning after May 17, 2006. In a related provision, the Act allows taxpayers incurring otherwise deductible expenses paid or incurred in creating or acquiring any musical composition, or any copyright with respect to a musical composition, to elect to amortize those expenses over a five-year period beginning with the month in which the property is placed in service. Taxpayers not making the election would continue to use the income forecast method. This provision is effective for expenses paid or incurred with respect to property placed in service in taxable years beginning after December 31, 2005, and before January 1, 2011.

Kiddie Tax Age Limit Raised. In an unexpected move, the Act increases the age to which a child's unearned income (i.e., income from investments) is taxed at the parent's tax rate, from under 14 to under 18 years of age (the "kiddie tax"). The Act provides an exception to the kiddie tax for distributions from certain qualified disability trusts. The Act also provides that the kiddie tax does not apply to a child who is married and files a joint return for the taxable year. This provision is effective for taxable years beginning after December 31, 2005.

Elimination of Income Limits on Roth Conversions. Beginning in 2010, the Act eliminates the income limits on conversions of traditional IRAs to Roth IRAs. Thus, taxpayers could make such conversions without regard to their adjusted gross income. Furthermore, in contrast to current law, the Act allows married taxpayers filing separate returns to convert amounts in a traditional IRA into a Roth IRA. Under the Act, for conversions occurring in 2010, unless the taxpayer elects otherwise, none of the amount includible in gross income as a result of the conversion in 2010 is includible in gross income in 2010; half of the income resulting from the conversion is includible in gross income in 2011, and half is includible in 2012. However, the Act provides that income inclusion is accelerated if converted amounts are distributed before 2012.

According to the Act, in that case, the amount included in income in the year of the distribution is increased by the amount distributed, and the amount included in income in 2012 (or 2011 and 2012 in the case of a distribution in 2010) is the lesser of: (1) half of the amount includible in income as a result of the conversion; and (2) the remaining portion of such amount not already included in income.

Alternative Minimum Tax

The Act has two provisions that help taxpayers avoid the alternative minimum tax. These two provisions are effective for the tax year 2006. The new law increases the alternative minimum tax exemption amounts to: (1) $62,550 for married individuals filing jointly and for surviving spouses; (2) $42,500 for unmarried individuals other than surviving spouses; and (3) $31,275 for married individuals filing a separate return. The Act also extends for one year (i.e., to taxable years beginning in 2006) the allowance of the nonrefundable personal credits to offset an individual's alternative minimum tax as well as the taxpayer's regular tax.

Business Expenses

Small Business Expensing Extension. The Act extends for two years the temporary $100,000 (adjusted for inflation) amount for small business to expense, rather than capitalize and depreciate, equipment purchased for use in business. This dollar amount was set to expire in 2008, but the new law extends the provision to tax years beginning before 2010.

Domestic Manufacturing Deduction Changes. The Act modifies the recently enacted provision regarding the domestic manufacturing deduction. The Act modifies the definition of W-2 wages, limiting qualified wages to only amounts that are properly allocable to domestic production gross receipts. Thus, the amount of the deduction is limited to 50% of only those wages that are deducted in arriving at qualified production activities income. The Act also repeals the special limit on wages treated as allocated to partners or shareholders of pass-through entities. Thus, for purposes of the wage limitation, a shareholder in an S corporation or a partner in a partnership who is allocated components of qualified production activities income (QPAI) from a pass-through entity is treated as having W-2 wages from the pass-through entity in an amount equal to that person's allocable share of the pass-through entity's wages, even if that amount is more than twice the QPAI that actually is allocated to that person for the taxable year. That person (partner or shareholder) will then include in its wage limitation only the wages that are deducted in calculating QPAI. These provisions are effective for taxable years beginning after May 17, 2006.

Tax Collection

For taxpayers trying to settle controversies with the IRS, the Act provides that a taxpayer making an offer-in-compromise must: (1) in the case of a lump sum offer, pay 20% of the offer when the offer is submitted; and (2) in the case of an offer of periodic payments, pay the amount of the first proposed installment when the offer is submitted. Under the Act, a lump sum offer is any offer of payments made in five or fewer installments. The Act provides that, during the time an offer of periodic payments is being evaluated by the IRS, if the taxpayer fails to make a payment under the submitted offer, it must be treated as a withdrawal of the offer. The Act also provides that if the IRS fails to reject the offer-in-compromise within 24 months of its submission (not taking into account any period during which the subject tax liability is in dispute in a judicial proceeding), it is deemed accepted. This provision is effective for offers-in-compromise submitted on or after July 16, 2006 (60 days after the May 17, 2006, date of enactment).

We hope the preceding summary has been informative and useful. Please contact our firm for further details of interest to you.

This Client Alert Bulletin is not intended to cover the entire Act and provides general information only. It does not constitute legal advice applicable to any particular situation. If you have any questions concerning the Act, please contact one of the following YoungWilliams attorneys:

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