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Tax Increase Prevention and Reconciliation Act of 2005

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On May 17, 2006, President Bush signed yet another tax act into law. The new legislation (P.L. 109-222), titled "The Tax Increase Prevention and Reconciliation Act of 2005" (TIPRA), provides extensions and modifications of current tax provisions that allow for tax cuts and increased revenue. Although TIPRA has provisions for both individuals and businesses, this article will concentrate on five key provisions that are applicable to individuals. Specifically, we will look at capital gain and dividend tax rates, alternative minimum tax (AMT), nonrefundable personal credits, Roth IRA conversions, and the kiddie tax.

Capital Gains and Dividends Rates

In general, a capital gain or loss is recognized on the sale or exchange of a capital asset. Sections 301 and 302 of the Jobs Growth and Tax Relief Reconciliation Act of 2003 (JGTRRA) reduced the maximum rate of tax on the net capital gain for individuals to 15% for tax years 2003-2008. Furthermore, any adjusted net capital gain that otherwise would be taxed at a 10% or 15% rate is taxed at a 5% rate (zero for taxable years 2007 and 2008). These rates apply for purposes of both the regular tax and the alternative minimum tax. Still further, the net capital gain of an individual is reduced (but not below zero) by the sum of the 28% rate gain, the unrecaptured Section 1250 gain, and the amount of gain that the individual treats as investment income for purposes of determining the investment interest limitation under §163(d).

Dividends also received favorable tax treatment under JGTRRA. That is, dividends distributed by a corporation to its shareholders out of its after-tax earnings and profits and received by an individual from domestic corporations (and qualified foreign corporations) are taxed at the same rates that apply to capital gains. As with capital gains, this treatment applies to both regular and alternative minimum tax.

Beginning in 2009, the tax rate on the adjusted net capital gain and dividends for individuals was scheduled to return to the previous 20% rate, and any adjusted net capital gain that otherwise would be taxed at a 10% or 15% rate is taxed at a 10% rate. Section 102 of TIPRA, however, provides a two-year extension of the reduced rates. That is, the lower rates apply to capital asset transactions and dividends distributed in both 2009 and 2010. In fact, capital gain treatment is extended by §204 of TIPRA to sales and exchanges of musical compositions or copyrights in musical works created by the taxpayer.

Extension of and Decrease in AMT

The AMT is the amount by which the tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is the sum of (1) 26% of the taxable excess, not exceeding $175,000 ($87,500 in the case of a married individual filing a separate return), and (2) 28% of the remaining taxable excess. The taxable excess is the amount of alternative minimum taxable income (AMTI) that exceeds the exemption amount. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments.

Currently, the exemption amount is (1) $45,000 ($58,000 for taxable years beginning before 2006) in the case of married individuals filing a joint return and surviving spouses, (2) $33,750 ($40,250 for taxable years beginning before 2006) in the case of unmarried individuals other than surviving spouses, (3) $22,500 ($29,000 for taxable years beginning before 2006) in the case of married individuals filing a separate return, and (4) $22,500 in the case of estates and trusts. The exemption amount is phased out by an amount equal to 25% of the amount by which the individual's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of unmarried individuals other than surviving spouses, and (3) $75,000 in the case of married individuals filing separate returns, estates, and trusts. These amounts aren't indexed for inflation.

For taxable year 2006—and only 2006—§301 of TIPRA increases the AMT exemption amounts 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.

Allowance of Nonrefundable Personal Credits

Current law provides for certain nonrefundable personal tax credits, such as the dependent care credit, the adoption credit, the child tax credit, and the HOPE Scholarship and Lifetime Learning credits.

Prior to taxable year 2006, the nonrefundable personal credits are allowed to the extent of the full amount of the individual's regular tax and AMT. Beginning in 2006, the nonrefundable personal credits (other than the adoption, child, and saver's credits) are allowed only to the extent that the individual's regular income tax liability exceeds his or her tentative minimum tax, without regard to the minimum foreign tax credit. The adoption, child, and saver's credits are allowed to the full extent of the individual's regular tax and AMT.

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The exemption amount is (1) $45,000 ($58,000 for taxable years beginning before 2006) in the case of married individuals filing a joint return and surviving spouses, (2) $33,750 ($40,250 for taxable years beginning before 2006) in the case of other unmarried individuals, (3) $22,500 ($29,000 for taxable years beginning before 2006) in the case of married individuals filing a separate return, and (4) $22,500 in the case of an estate or trust. The exemption amount is phased out by an amount equal to 25% of the amount by which the individual's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married

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TIPRA extends for one year the present-law provision allowing nonrefundable personal credits to the full extent of the individual's regular tax and alternative minimum tax (through taxable years beginning on or before December 31, 2006).

Conversions to Roth IRAs

There are two general types of individual retirement arrangements (IRAs): traditional and Roth IRAs. The total amount that an individual may contribute annually to one or more IRA is generally limited to the lesser of (1) a specific dollar amount ($4,000 for 2006) or (2) the amount of the individual's compensation that's includible in gross income for the year. Contributions to a traditional IRA may or may not be deductible. Contributions to a Roth IRA aren't deductible. Qualified distributions from a traditional IRA are included in gross income to the extent not attributable to a return of nondeductible contributions. Qualified distributions from a Roth IRA are excluded from gross income.

A taxpayer with AGI of $100,000 or less may convert all or a portion of a traditional IRA to a Roth IRA. The amount converted is treated as a distribution from the traditional IRA for income tax purposes, except the 10% additional tax on early withdrawals doesn't apply. Beginning in 2010, TIPRA eliminates the income limits on conversions of traditional IRAs to Roth IRAs. Thus, taxpayers may make such conversions without regard to their AGI.

Kiddie Tax

New tax legislation wouldn't be complete without a stinger provision, and TIPRA is no exception! For those taxpayers rejoicing in the fact that your child has finally turned 14 and the kiddie tax on unearned income is no longer applicable, you can stop rejoicing. The kiddie tax has been expanded to include children under the age of 18 (not 14) beginning in tax year 2006 (retroactive). This does not apply to married children filing a joint tax return. Not all tax laws are perfect, now are they? ■

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