



Tax Increase Prevention Act of 2005—the Highlights and Lowlights



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## **New Tax Law Highlights**

Congress finally finished up work on the 2005 tax law, even if a bit late and short a few items that were expected to be in the bill. The bill has a few features and a couple of important “gotchas” that you need to be aware of.

## **Missing Extenders**

A number of items did not make this bill, but may make a “trailer” bill to come later—or not. Those provisions include:

- State and local sales tax deduction
- Teachers above the line classroom expense deduction

- Research and development expenditures
- Employment tax credits

## **Items that Did Pass**

There were both “good news” and “bad news” items that are in this bill.

### ***Good News Items***

*Alternative Minimum Tax Extension (Bill Sections 301 and 302).* The bill extends for one year the higher AMT exemption and ability to offset certain nonrefundable credits against the alternative minimum tax. So the problem has been pushed forward one more year, though again it seems likely Congress will revisit this rather than let these items expire for good at December 31, 2006.

*Extension of Increased Section 179 Deductions (Bill Section 101).* The bill extends the increases in the Section 179 expensing through the end of 2009. The increased deduction and allowed acquisition provisions had been scheduled to expire at the end of 2007.

*Extension of Lower Capital Gain and Dividend Rates (Bill Section 102).* The bill extends the lower capital gain and dividend rates for two additional years, with the lower rates now expiring at the end of 2010.

*Roth IRA Income Rollover Limits (Act Section 502).* For years beginning after December 31, 2009, the limits imposed on the ability to do a Roth IRA conversion based on income are repealed. As well, for conversions that take place in 2010, the amount of the conversions can be included in income ratably over the two years beginning in 2011.

*Breaks for Buyers and Sellers of Musical Work Related Assets (Act Sections 204 and 207).* Musical works get special treatment under this bill. For sales of self-created musical compositions and copyrights, the law now provides for capital gain treatment for such items sold in taxable years beginning after the date of enactment and before January 1, 2011. So for most musicians the benefit of this provision will first show up for sales made in 2007 through 2010. For musical works and copyright related expenses and acquisition costs that must be capitalized, taxpayers will be able to amortize the expenses over five years for taxable years beginning after December 31, 2005 and before December 31, 2010.

### ***Not Such Good News Items***

*Reporting of Interest on Tax Exempt Bonds (Act Section 502).* Effective beginning in 2006, there will be 1099 reporting of the interest paid on tax exempt bonds. I suppose Congress was concerned that retirees in the social security phase in range were failing to report these amounts. Probably not a major negative for your clients, but there is more to come.

*Wages Must be Attributable to Domestic Production to be Used in Computing §199*

*Limitation (Act Section 514).* Congress plugged up what frankly was likely an oversight in drafting Section 199. Beginning for a taxpayer's first tax year beginning after the date of enactment, wages to be used in computing the 50% of wages limitation on the Domestic Production deduction must be wages attributable to domestic production. Previously any wages counted for purposes of computing this limitation. Not really good news if your client was tight on the wage limitation and was using nonproduction wages to meet the test, but likely not an issue for most who qualified under this provision.

*Tax rates for taxpayers with income above foreign income limitation now taxed at marginal rate computed as if no exclusion applied on income not excluded (Act Section 515).* A number of modifications were made to the foreign earned income exclusion, but a major one is that taxpayers whose income is above that limitation will have their tax computed at the higher tax rates that would have been applicable without the exclusion, rather than simply subtracting the exclusion from income and applying the tax rates to the lowered income. This could have a significant impact on taxpayers who use the foreign earned income exclusion and is likely going to be difficult to explain. This provision will apply to 2006 returns.

*Required Withholding on Payments from Government Agencies (Act Section 511).* Withholding of 3% will be applied to payments from most government agencies to individuals providing any property or services, including voucher or certificate programs. There are a list of items that are excluded from this rule, one of the major one being amounts paid connection with a public assistance or public welfare program for which eligibility is determined by a needs or income test. This will be effective for payments made after December 31, 2010.

*Kiddie Now Applies to Children Under the Age of 18 (Act Section 510).* If your clients had transferred assets to their children that they expected to sell once the child reach age 14 to be taxed at lower rates, the clients plans just had a monkey wrench thrown into them. Effective for 2006, the age the kiddie tax applies to has been raised so that all children under 18 are subject to the higher tax rates on “excess” unearned income.

*Required Deposits on Offers in Compromise (Act Section 509).* The bill imposes additional conditions on submitting offers. A taxpayer who submits a lump sum offer will be required to pay in a 20% “good faith” down payment, while a taxpayer proposing a payment plan will be required to make the first payment with the offer and will be required to keep making such payments according to schedule while the IRS is considering the offer. However, if the IRS has not ruled reject an offer before the end of 24 months has run from the date was offer was submitted will be deemed to be accepted by the IRS.