



THE PLAYING FIELD: Extension Explication

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By Melanie Waddell

Good and bad news—and uncertainty—from the tax bill

While a number of the provisions in the recently passed \$70 billion tax package, the “Tax Increase Prevention and Reconciliation Act of 2005,” will have a direct effect on how advisors plan for their clients—namely repeal of the Roth IRA limits, extending the Kiddie Tax to age 18, raising the AMT exemption for 2006, and extension of the 15% long-term capital gains rate—questions remain whether the most beneficial provisions with future effective dates will occur at all.

Some of the tax provisions that didn’t make it into the new tax bill recently signed by President Bush are expected to get tacked on to the compromise bill on pension reform that’s stuck in a House-Senate conference and is due out this year. Those provisions may include extensions on deductibility of state and local sales taxes, charitable giving incentives, and certain college expenses, says Mary Bell, government relations manager for the Financial Planning Association. Senator Chuck Grassley (R-Iowa), chairman of the Senate Finance Committee, originally wanted to move those provisions into a separate bill, but all signs point to the provisions being added to the pension bill “because it’s the only bill moving,” Bell says. Congress failed to unveil a pension bill by its Memorial Day deadline, and House Majority Leader John Boehner (R-Ohio) recently voiced his frustration at the prolonged process, saying he wants Congress to hammer out a compromise bill before the July 4 recess. The college expenses provision may address permanency of 529 college savings plans, which is an issue that’s still looming.

Meanwhile, another vote on repealing the estate tax is likely this year. Last month the Senate fell three votes short of the 60 votes needed to approve a permanent repeal of the estate tax. Senate Majority Leader Bill Frist (R-Tennessee) vowed that the Senate would indeed vote again this year on “wiping this vicious tax from the books.”

The Kiddie Tax

The new law’s Kiddie Tax provision is the one with the most “immediate impact,” says Jim Holtzman, a planner with Legend Financial Advisors in Pittsburgh. In 2006, \$1,700 is exempt from parents’ taxation on kids’ assets, he explains. The first \$850 of unearned income is tax-free under law—which is the

standard deduction parents have, he says. The next \$850 is taxed at the child's tax bracket, which is generally lower than the parents'. "Anything above \$1,700," notes Holtzman, "is taxed at the parents' tax rate, even if it's in the child's name." Previously, any child under the age of 14 was subject to the standard deduction rule; under the new law, it's been raised to age 18. From an asset accumulation standpoint, the new law is good news because it gives money set aside for the child more time to grow. "From age 14 to 18 may be one of the higher periods of their asset balance growth," he says.

Ken Weingarten, a planner with Weingarten & Associates in Trenton, New Jersey, says he recommends clients with children shift highly appreciated assets to their children in advance of needing funds for educational expenses. "Raising the age to 18 will require changes in how some of my clients plan for these expenses," he says. It seems unfair to Weingarten that the age change is retroactive to the beginning of 2006, since "some folks have already done an asset transfer and realized gains in a child's name for 2006," he argues. "These folks are stuck now paying more in taxes than they anticipated."

Steven Podnos, a planner with Wealthcare LLC in Rockledge, Florida, told clients in a recent newsletter that now that the Kiddie Tax applies to older teens, "the first \$1,700 of unearned income for children remains lightly taxed." He said that "educational investing for children that might produce income over this amount should be tilted toward 529 plans to avoid taxation in the parents' tax bracket."

Traditional and Roth IRAs

The way it stands now, anyone whose AGI is more than \$100,000 is barred from converting her traditional IRA to a Roth IRA. The new law, however, repeals any income limitations on conversions come 2010. Weingarten wonders if this new rule will ever see the light of day, considering "we are two Congressional elections and one Presidential election away from that change taking effect." If the Democrats take control, he says, "many of the future changes" included in the bill may never take hold. Planner Holtzman adds that the huge budget deficit may also prevent the repeal from occurring.

Why wait until 2010 to allow such conversions? That's the year the government needs revenue. "The government has revenue generators until [2010], and then there's a big blackout period between 2010 and 2013 where there's no revenue coming in," says the FPA's Bell. When traditional IRA holders convert to a Roth IRA, they have to pay taxes up front, so the government gets the money immediately. If the money was rolled into a deductible IRA, Bells says, the government doesn't get the money until the accountholder retires.

Michael Steiner, a planner with RegentAtlantic Capital in Chatham, New Jersey, says his firm is "licking its chops" in anticipation of 2010. "When we have clients that are appropriate for [the conversion to a Roth IRA] now, we're aggressively seeking out those opportunities," he says. "For clients that don't hit the \$100,000 AGI threshold, it's a tremendous opportunity." Steiner says conversion to a Roth IRA makes the most sense for "a client who has more money than he needs to live on and a big chunk of that is in a tax-deferred IRA or 401(k) that he doesn't need to roll over."

By pulling the money out now and paying the tax, he says, "we'll typically try to play the tax brackets and engineer the income so that we can keep the tax bracket, generally today, under 28%. If it were to go above 28%, we'd have to look at what their expected tax bracket is over the next few years or look

at where they are in retirement to determine whether it makes sense to pay [taxes] now even at 28% versus where they think they'd be at 70 1/2 when they'd have to start taking minimum distributions." From a tax standpoint, he continues, "it's a no-brainer to pay the tax now for the ultimate long-term deferral. If it's money you'll need in 10 years, I don't think [a Roth conversion is] appropriate."

The Alternative Minimum Tax

Both Steiner and Holtzman say raising the AMT exemption for 2006 only is a Band-Aid on a larger problem, and it makes planning very tricky. The new law raises the exemption used in the AMT only in 2006 for married and single individuals to \$62,550 and \$42,500, respectively. "If you think about making the decision to pay state income taxes in December, for example, the conventional wisdom was always to make the payment in December to get the deduction," Steiner says. "Now, a lot of people are saying, and rightly so, let's not make that payment because AMT might be an issue. Many people would defer making that payment and putting it in next year, so you're shifting that burden from this year to next, but what you don't know at the time is what next year is going to look like." When you're planning for AMT, he adds, "you want to do a break-even analysis and look at it over two years to see where you're better off. The problem here [with the AMT exemption for 2006] is that you can't plan for next year."

Adds Holtzman: "If you have any flexibility in taking income or deductions this year or next—you don't really know what to do."

Berdon LLP, a group of CPAs and advisors in Jericho, New York, recently issued a Tax Alert that explains that the new tax law also allows taxpayers to use certain nonrefundable personal tax credits to offset 2006 AMT liability, an allowance that had been scheduled to expire in 2005. The credits include the dependent care credit, education credits, and certain energy credits.

The new act also extends the current 15% tax rate on long-term capital gains and qualified dividends from 2008 to 2010. "Individuals with taxable income in the lowest two brackets—10% and 15%—will continue to be taxed at 5% through the end of 2007, and at zero beginning in 2008," Berdon's tax alert explains. The publication also notes that beginning this year, all interest paid on tax-exempt bonds must be reported by the payor on Form 1099; previously, this information was not required to be reported to the IRS.

A less talked about provision that affects business owners is that the act extends Section 179 deduction rules for two more years, says Holtzman of Legend Financial. This allows "business owners to immediately write off up to \$108,000 of their income as opposed to depreciating it," he says. The deduction limit was set to fall back to \$25,000 in 2007, but the new law extends it until 2008.

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