

# CPA CLIENT

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# TAXLETTER

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America Counts on CPAs

## Special Issue: Highlights of the Tax Increase Prevention and Reconciliation Act

The Tax Increase Prevention and Reconciliation Act (TIPRA, as it's known), is a major tax law. Among many provisions, some are crucial to business owners and individual taxpayers.

### Relief from the Alternative Minimum Tax (AMT)

The alternative minimum tax (AMT) is a parallel tax system, originally enacted to ensure that wealthy taxpayers could not completely avoid income tax. Despite its original purpose, the AMT now affects millions of taxpayers, many with moderate incomes, who are now forced to pay higher income tax.

A key feature of the AMT is the *AMT exemption*, which acts as a deduction and helps taxpayers avoid this tax. For 2005, the AMT exemption was \$58,000 for married couples filing jointly and \$40,250 for single filers. TIPRA raises these amounts, respectively, to \$62,550 and \$42,500 for 2006. This increase, which replaces a decrease that was scheduled to go into effect, will keep an estimated 19 million taxpayers from paying the AMT for this year.

### Phasing out

The AMT exemption phases out as income calculated for AMT purposes exceeds certain amounts. The phase-out range begins

at \$150,000 on joint returns and \$112,500 for singles. Couples with over \$400,200 in AMT income and singles with over \$282,500 will have no AMT exemption in 2006.

It's important to note that the increase in the AMT exemption is limited to 2006. For multiyear tax planning, you should consult with your CPA to devise a strategy for minimizing the impact of this extremely complex form of taxation.

### Where credit is due

The new law also extends the provision in the law that allows certain tax credits to be applied to both the regular and AMT tax liability. The allowable credits include nonrefundable personal credits such as education and dependent care credits. If the 2006 tax law had not been passed, the tax savings from such other personal credits could not exceed the excess of regular tax liability over "tentative minimum tax," as it's now calculated. Now, for 2006, the maximum amount that can be saved by these personal credits is the sum of (1) regular income tax liability minus foreign tax credits and (2) the AMT.

Suppose a hypothetical: The Jones family owes \$8,000 in regular income tax and their CPA calculates their tentative minimum tax at \$7,000. Suppose they have \$1,500 in higher education credits.

The new tax law permits them to take the \$1,500 worth of tax credits in 2006. If it had not been passed, the Jones family would have been limited to a \$1,000 tax credit (\$8,000 minus \$7,000), even if the family doesn't owe the AMT.

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## Kiddie Tax Affects Older Teens

For many years, a so-called "kiddie tax" applied to the unearned income (dividends, interest, and capital gains, for example) of children who were age 13 or younger. The new law raises the age limit to age 17.

What's more, the expansion of the kiddie tax rules is retroactive, so it covers the full year of 2006.

In essence, the kiddie tax has the following effects on the investment income of youngsters:

- A certain amount is tax-free. For 2006, that ceiling is \$850.
- An equivalent amount is taxed at the lowest federal income tax rate. For 2006, a child's next \$850 of investment income will be taxed at a rate from 5% to 10%, depending on the type of investment income.
- The \$850 limits will increase periodically, to keep up with inflation.
- Above the limits, investment income is taxed at the parents' income tax rate, which generally will be higher.

### A shift on income-shifting

The new kiddie tax rules affect income-shifting strategies. Previously, children age 14 and older were taxed as adults. They could have taxable income up to \$30,650 (in 2006)

that would be taxed at a rate no higher than 15%.

Therefore, it often made sense to transfer investment assets to children age 14 or older, to use their lower tax rates. Appreciated assets could be transferred to these children, who probably would owe less tax on a sale.

Now, the income-shifting won't work until children reach age 18.

### Strategies to consider

If you have children who will be younger than age 18 at year-end 2006, try to keep their investment income below \$1,700 for the year. Up to that amount, the children will benefit from low tax rates, but higher income will be taxed at your rate.

A number of problems might be avoided by changing investment strategies to emphasize capital gains or deferred income, rather than current income (realizing the income and paying the tax at age 18 when lower rates will likely apply). Assuming that you're comfortable with the risks involved, you might move some money from youngsters' bank accounts to U.S. Savings Bonds, no-dividend growth stocks, or tax-managed mutual funds. Such vehicles can generate little or no taxable current income.

If your children age 14 to 17 will be over the \$1,700 limit for the year (or if

they're already over the limit), you may pay higher-than-expected income tax in 2006. In such situations, check with your CPA about increasing your estimated tax payments on September 15 and next January 15 to avoid penalties for underpayment of estimated tax.

On the other hand, you don't have to wait until your kids reach age 18 to transfer appreciated assets to them, in anticipation of future sales. The sooner you begin, the more assets you'll be able to transfer to your children under the annual gift tax exclusion, now set at \$12,000 per recipient per year.

### Early birds

As an example, suppose George and Grace Smith have two children, ages 12 and 15. The Smiths expect to eventually sell appreciated stocks and mutual funds to help pay for college.

This year, the Smiths can transfer up to \$48,000 worth of securities to their children, tax-free: each spouse can give each child \$12,000. Similar transfers can occur in subsequent years.

Once the children reach the year in which they'll turn 18, they can begin to sell the (hopefully still) appreciated securities. As long as the children stay in the lowest two federal tax brackets, they'll owe relatively little tax on such sales.

## Low Tax Rates Extended for Dividends and Long-Term Gains

The 2003 tax act reduced the top tax rate on most stock dividends and long-term capital gains to 15%. For taxpayers in the lowest federal income tax brackets (10% and 15%), the tax rate on dividends and long-term gains was put at 5%.

Moreover, low-bracket taxpayers were scheduled to pay 0% on dividends and long-term gains in 2008. After 2008, though, the bargain rates were to expire so dividends would be taxed as high as 35%, long-term gains up to 20%.

The tax law, enacted May 17, 2006, extends the low rates for another two years. As a result, qualified dividends and

long-term gains will be taxed no higher than 15%, through 2010. This creates the opportunity for longer-range investment planning.

### Three-year tax holiday

The two-year extension applies to the tax rates scheduled to go into effect in 2008. Therefore, the 0% rate for low-bracket taxpayers will be available in 2008, 2009, and 2010.

In 2006, the two lowest federal income tax rates cover taxable income (not gross income) up to \$30,650. By 2008,

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inflation adjustments will send that ceiling higher, probably to over \$32,000. On joint returns, the upper limit is now \$61,300 worth of taxable income and may be around \$65,000 by 2008.

Therefore, many college students and young workers will be able to pay no tax on dividends and long-term capital gains during those three years. (Children under age 18 also will be able to use the 0% tax rate, but such use will be

limited by the new kiddie tax rules, described on page 2.)

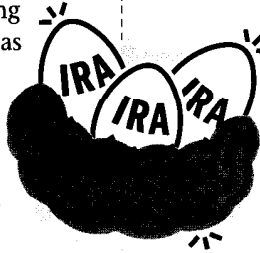
In addition, many retirees likely will meet the income requirements for tax-free dividends and long-term capital gains in 2008, 2009, and 2010. This year and next, you should begin investment planning to enable family members to take full advantage of this opportunity for tax-free investment income.

**Roth IRA Conversions Will Become Widely Available**

A traditional individual retirement account (IRA) may be converted to a Roth IRA, fully or partially. Such a conversion involves a tradeoff, as follows:

- On the negative side, a conversion now requires earlier payment of deferred income tax. Without a conversion, tax may be deferred for many more years.
- The positive aspect of a conversion is the prospect of future tax-free income. Five years after opening up a Roth IRA, all withdrawals will be tax-free, as long as you're at least 59½ years old.

In addition, no minimum distributions from a Roth IRA are required. If you don't need the money, you can leave it in the account indefinitely, benefiting from tax-free buildup. Moreover, your beneficiaries can stretch out tax-free withdrawals over their lifetimes.



**The \$100,000 question**

For many taxpayers, Roth IRA conversions are appealing. Generally, the longer you have until you plan to take withdrawals, the more a conversion makes sense.

There is a catch, though. You can't convert a traditional IRA to a Roth IRA in a year when your income is over \$100,000. This upper limit applies to single and joint tax returns. The \$100,000 income ceiling has prevented some people from implementing a desired conversion.

The new tax law eases those rules. Beginning in 2010, anyone with a traditional IRA can convert it to a Roth IRA, and it won't make any difference how much income you report.

A special rule applies to conversions in 2010. Unless you elect to recognize the taxable income resulting from the conversion in 2010, that income will be averaged between your tax returns for 2011 and 2012.

**Planning possibilities**

Even though the \$100,000 limit on income applies through 2009, you can begin to do some planning now. As long as you have earned income this year, you can make a non-

deductible contribution of up to \$4,000 to a traditional IRA in 2006. If you'll be at least 50 years old by December 31, you can contribute up to \$5,000.

For married couples, each spouse can make a \$4,000 or \$5,000 nondeductible contribution in 2006, as long as one or both spouses work.

(The same \$4,000 and \$5,000 opportunities apply to deductible contributions to traditional IRAs and nondeductible contributions to Roth IRAs, but income and other limits apply. Nondeductible contributions to traditional IRAs can be made regardless of income.)

Similar nondeductible contributions to traditional IRAs can be made for each subsequent year. The \$4,000 and \$5,000 limits will be increased each year to keep up with inflation.

Through 2010, therefore, a married couple in their 50s with at least one working spouse could contribute more than \$50,000 to their traditional IRAs, no matter what their income. Then, in 2010, high-income taxpayers could convert their traditional IRAs to Roth IRAs, including amounts derived from nondeductible contributions.

Roth IRA Income Limits		
	Single Filers	Joint Filers
Full Annual Contribution	Up to \$95,000	Up to \$150,000
Partial Annual Contribution	\$95,000-\$110,000	\$150,000-\$160,000
Conversion of Traditional IRA (2006-2009)	\$100,000	\$100,000

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## Fine points

If this strategy sounds attractive, some issues should be considered.

**Mixing deductible and nondeductible contributions.** If you already have a traditional IRA that was generated by deductible contributions, adding nondeductible contributions increases the paperwork and the complexity of figuring out the tax on distributions.

To minimize such complexity, plan on converting all of your traditional IRA to a Roth IRA in the same year. (You'll still need to work with your CPA to determine the right amount of income to recognize and avoid paying tax on already-taxed nondeductible contributions.)

**Cash concerns.** For the best results, you should pay tax on any Roth IRA conversion from other funds rather than from the money in your traditional IRA. The larger the amount you can keep in the Roth IRA for long-term accumulation, the greater the ultimate tax-free payoff, so start putting some money aside.

**Congressional second thoughts.** Depending on politics and federal budgeting, Congress could once again change the law before higher-income Roth conversions become available in 2010.

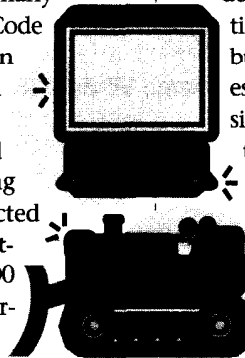
## Business Equipment Writeoffs Remain in Six Figures

Although most business equipment must be depreciated over many years, Internal Revenue Code (IRC or the Code) Section 179 permits many small companies to "expense" their purchases of new and used equipment, meaning that costs can be deducted immediately. In 2006, first-year writeoffs up to \$108,000 worth of equipment purchases are permitted.

The IRC Section 179 allowance was scheduled to go down to \$25,000 after 2007. However, the new tax law keeps the 2006 limit in effect,

through 2009. Each year, the maximum deduction will increase with inflation. This extension allows small businesses to plan capital purchases on a longer-term basis, using a simple system with an immediate tax benefit. The new law also extends to 2009 the time in which a business can make or revoke an expensing election without Internal Revenue Service (IRS) consent.

A special provision of the new law allows off-the-shelf computer software to remain eligible for the IRC Section 179 deduction, through 2009.



## IRS Offers-in-Compromise

The new tax law also increases the amount you will have to pay if you are proposing a compromise with the Internal Revenue Service (IRS) on a tax dispute. From now on, you are required to make partial payments to the IRS while your "offer-in-compromise" is being considered, thus reducing the appeal to many cash-strapped taxpayers.

If you are offering to settle with the

IRS in five or fewer installments, you'll have to write a check for 20% of the total amount you're promising to pay. If you're proposing to make installment payments for longer than five years, you should go ahead and make payments on the suggested schedule.

If your offer has not been rejected by the IRS within two years, it will be considered as accepted, under the terms proposed by the taxpayer.

## Closely-Held Corporations: Focus on the 15% Dividend Rate

Under current federal law, most corporate dividends are taxed no higher than 15%, through 2010. Press coverage of this tax law usually features publicly-traded stock and the impact on investors. For example, if you receive \$1,000 in dividend income this year from the stocks and stock funds you own, you generally will owe \$150 (15% of \$1,000) to the IRS. That's true if you're in the 25%, 28%, 33%, or 35% federal tax brackets.

### Private corporations, too

The law regarding taxes on dividends is not limited to publicly-traded shares. If you own shares in a closely-held corporation and receive dividends, the bargain tax rates also apply. As a result, this tax break may be valuable to owners of private companies, too.

### Opportunity for C corporations

Among those who stand to gain are the owner-employees of C corporations. Under previous law, such owner-employees

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**Closely-Held Corporations:  
Focus on the 15% Dividend Rate**

often were reluctant to pay out dividends.

That's because dividends are not deductible from corporate income. In effect, such dividends are double-taxed: they're subject to the corporate income, and also to personal income, tax on the return of the shareholder receiving the dividend.

Double taxation of corporate dividends is still effective. However, this double taxation is not as painful now, with the top personal tax rates on dividends capped at 15%. Under prior law, dividends were taxed as ordinary income, at rates that now go up to 35%.

What's more, tax rates on dividends might be lower than 15%. In 2006 and 2007, taxpayers in the lowest two federal tax brackets pay only 5% on corporate dividends. This year, that 5% rate will be effective for single taxpayers with taxable income up to \$30,650. For married couples filing jointly, the 5% rate on dividends applies to \$61,300 of taxable income.

Thus, if shares of your corporation are owned by retirees or by children, it may be possible to pay them dividends that will be taxed at only 5%. In 2008 to 2010, moreover, those low-bracket taxpayers will owe no tax at all on qualified dividends.

**Savvy planning**

One tactic C corporation owners might consider is to pay themselves just enough compensation (salary and bonus) to leave \$50,000 as corporate earnings this year. That \$50,000 will be taxed at only 15%, under the corporate income tax rates. (Keep in mind that any compensation paid must be justified as reasonable, considering corporate performance, the employee's experience, and so on.)

After paying 15% (\$7,500) tax on the \$50,000 in corporate income, the remaining \$42,500 can be passed through to shareholders as a dividend, taxed at only 15%, or even 5%. The total tax on that \$50,000 may be less than if the entire amount had been paid out as compensation, subject to ordinary income tax and Medicare tax.

This differs from past tax strategies for closely-held corporations. Previously, many small businesses tried to minimize distributions to avoid double taxation. The corporation would defer taxes and retain capital for growth which would ultimately be taxed at capital gains rates. The maximum capital gains tax rate also stays at 15% through 2010.

**Exit strategies**

At least through 2010, the low tax rate on dividends will provide C corporation owners with an opportunity to pull cash from their companies. Suppose, for example, Bob Brown is the sole owner of Bob Brown Corp. (BBC). Over the years, BBC has accumulated a substantial amount of cash rather than pay him double-taxed dividends.

Now, Bob can distribute BBC's cash to himself as a dividend. In all likelihood, some of these earnings and profits (E&P) will be taxed at 15%, as a dividend, while some of that payout may be a tax-free return of capital. There might be some long-term capital gains, too, which also will be taxed at only 15%, under current law.

Thus, if you have been building up cash inside your C corporation, you should ask your CPA to determine the tax you'd owe on a withdrawal. The time between now and the end of 2010 might be a window for low-taxed distributions.

Other advantages may apply as well. Taking cash from your company might reduce your exposure to a tax on

excess accumulated earnings and may reduce the value of the shares you hold for gift and estate tax purposes.

**Smart moves for S corporations**

Owners of S corporations also may benefit from low tax rates on dividends. There's no double taxation of corporate earnings, but by paying themselves dividends rather than compensation, owner-employees may realize payroll tax savings.

Suppose, for example, Ann Jones is the sole owner of Ann Jones Corp. (AJC), which has elected S corporation status. In 2006, AJC's income exceeds expenses by \$200,000.

S corporations are not subject to the corporate income tax. Therefore, AJC's \$200,000 in net income will be taxed on Ann's personal tax return, as ordinary income, no matter how it is handled.

However, Ann may be able to cut her tax bill by treating that \$200,000 as a dividend to herself, rather than as compensation. Such a dividend will avoid payroll tax and save Ann at least \$5,800: the 2.9% Medicare tax on \$200,000 in compensation.

Again, Ann must be able to justify her compensation. Here, she should have evidence to support the fact that her compensation is not *unreasonably low*, in order to avoid payroll tax on the dividend her company has paid to her.

Corporate Tax Rates		
Taxable income over	Not over	Tax rate
\$ 0	\$ 50,000	15%
\$ 50,000	\$ 75,000	25%
\$ 75,000		34%-39%

# CPACIENT TAXLETTER

## Trade Your Turkeys by Thanksgiving

We know you may be thinking about year-end; and your tax planning should begin well before December 31. In fact, you may want to act before the end of November. Some shrewd moves then might pay off next April, when your 2006 tax returns are due.

When you file that tax return, you'll net all your capital gains and losses for 2006. You'll be able to deduct up to \$3,000 worth of net capital losses while excess losses can be carried forward to future years until they are completely used up.

### Tally your trades

Your first step in year-end securities trading, then, is to calculate your capital gains and losses so far this year. Don't forget to include capital gains distributions from mutual funds. Even if you reinvested those distributions, they'll count as taxable gains on your tax return.

Suppose you discover that you have \$10,000 worth of net gains so far this year. For tax purposes, your best tactic is to take \$13,000 worth of losses by December 31, to give you \$3,000 net loss for the year, which you can deduct against ordinary income. Instead of owing \$1,500 in tax on your \$10,000 gain (assuming a 15% capital gain rate), you'll save up to \$1,050 on a \$3,000 loss (at ordinary income rates as high as 35%).

The situation is a bit different if you discover you have a net loss greater than \$3,000 for the year-to-date. If so,

you can take capital gains to bring your loss down to \$3,000. Otherwise, you'll wind up with an excess loss that can't be used immediately.

For example, if you have a \$20,000 capital loss for the year so far, you can take \$17,000 worth of capital gains and receive tax-free cash.

### Be wary of wash sales

Whether you take losses or gains at year-end, you will disrupt your portfolio. Instead of holding stocks or bonds or mutual funds, you'll hold cash. What's more, if you take a loss and reinvest in the same securities within 30 days, you will not be allowed to deduct the capital losses, under the "wash-sale" rules.

How can you keep your investment plan intact yet avoid a wash sale? There are three options:

1. You can wait for 31 days, then repurchase the same security. Here, your risk is that the stock or fund will shoot up in price during those 31 days. If you can bear that risk and you still want to own this security, this can be a good choice.
2. If you want to reinvest sooner than 31 days, you can buy similar but not identical securities. If you sell one large-company growth stock fund, for example, you immediately can buy another large-company growth stock fund. If you have sold one auto company, you can buy the stock of another car maker. The net effect may be to realize sizable tax savings while making only minor changes in your portfolio, as long as you are confident that your replacement security

will perform in much the same manner as the one you sold.

3. You can "double up" by buying an equivalent amount of the securities now trading at a loss. Then you can sell your original holding 31 days later.

### Double play

Say you invested \$25,000 in a growth fund that has failed to perform so your holding is now worth only \$20,000. However, you still like that fund and you think it's even a better buy now, at the lower price.

You can buy another \$20,000 worth of shares in that fund. After 31 days, you can sell your original holding. You won't run into the wash-sale rules and you won't run the risk that the fund's price will go up while you're on the sidelines.

The catch? Doubling up is not truly a year-end maneuver. You should buy the second lot by November 29 if you want to sell the original lot at the end of December and take a tax loss for 2006.

### Immediate gratification

In addition, you should be aware that the wash-sale rules do not apply to the sale and repurchase of appreciated securities. Therefore, if you take year-end gains to soak up some excess capital losses, as described above, you can reinvest in the same securities right away, without having to wait 31 days. This will result in a higher basis in the repurchased securities and reduce the tax when you eventually close out your position.

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