

# An Overview Of The Tax Increase Prevention And Reconciliation Act of 2005

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*Once again, Congress tinkers with the rules*

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ON MAY 17, 2006, President Bush signed the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA") into law. Pub. L. No. 109-222, 120 Stat. 345. As the title of the Act suggests, it has extended many expiring provisions that

benefit taxpayers. It has also omitted extension of many other expiring tax provisions. For those provisions extended and other changes in the revenue laws made by TIPRA, May 17, 2006, will be the "Date of Enactment."

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**PROVISIONS AFFECTING INDIVIDUALS**

- The following provisions apply to individual taxpayers.

**Act Section 301: Increase In Alternative Minimum Tax Relief Exemption Amount For 2006**

For married individuals and surviving spouses filing a joint return, the Tax Increase Prevention and Reconciliation Act of 2005 increases the AMT exemption from \$58,000 in 2005 to \$62,550 in 2006. For unmarried individuals other than surviving spouses, TIPRA increases the AMT exemption from \$40,250 in 2005 to \$42,500 in 2006.

- *Effective Date:* Taxable years beginning after December 31, 2005.
- *Sunset:* Taxable years beginning after December 31, 2006.
- *Code Section Affected:* Section 55(d)(1) amended.

**Tax Planning**

Because the increase and extension of the AMT exemption is only for one year, year-end tax planning will become particularly important. Advisors should run projections of taxpayers' regular and AMT tax liability for 2006 and 2007 to identify items potentially subject to alternative minimum tax which may be accelerated into 2006 before year-end. Without further Congressional action, the AMT exemption amounts will drop in 2007 to \$33,750 for unmarried individuals who are not surviving spouses and \$45,000 for married couples filing jointly (and surviving spouses).

**Act Section 302: Allowance Of Nonrefundable Personal Credits Against Regular And Alternative Minimum Tax**

Generally, certain nonrefundable personal credits (including credits under section 21 for employment-related household and dependent

care expenses; credits under section 22 for elderly and disabled taxpayers; credits for adoption expenses under section 23; nonbusiness energy credits, residential energy credits, and the alternative motor vehicle credit of sections 25C, 25D, and 30B, respectively, as added by the Energy Tax Incentives Act of 2005; credits under section 25 for interest on certain home mortgages; section 25A Hope Scholarship and Lifetime Learning credits; the D.C. first-time home buyer credit; and certain other tax credits) are allowed only to the extent that a taxpayer's regular income tax liability is in excess of the tentative minimum tax liability. This has the effect of disallowing these credits against AMT. Temporary provisions were enacted which permit these credits to offset the entire regular and AMT liability through the end of 2005. TIPRA extends this relief for one year.

- *Effective Date:* Taxable years beginning after December 31, 2005.
- *Sunset:* Taxable years beginning after December 31, 2006.
- *Code Section Affected:* Section 26(a)(2) amended.

**Tax Planning**

Again, because relief from the limitations on use of non-refundable personal credits is limited to one year, year-end tax planning becomes extremely important. Taxpayers should consider accelerating into 2006 expenditures qualifying for the credits to take full advantage of the potential to offset regular and AMT tax liabilities.

**Act Section 102: Capital Gains And Dividend Rates**

The Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA") reduced the capital gains and dividend income tax rates from 10 percent and 20 percent to five percent and 15 percent, respectively, through 2008. TIPRA extends the lower rates for two years.

- *Effective Date:* Taxable years beginning after December 31, 2008.
- *Sunset:* Taxable years beginning after December 31, 2010.
- *Code Section Affected:* Section 1(h)(1) amended.

### **Act Section 510: Increase In Age Of Minor Children Whose Unearned Income Is Taxed As If Parents' Income**

The Code taxes the net unearned income of children under age 14 as if it were included in the child's parents' taxable income. (This is commonly referred to as the "kiddie tax.") In 2006 the kiddie tax will apply to net unearned income in excess of \$1,700.

As a revenue raiser, TIPRA increases the age at which the kiddie tax no longer applies from 14 to 18. Consequently, if a child is 17 years of age or younger, unearned income of the minor in excess of \$1,700 will be taxed at his or her parents' marginal rate.

The definition of "net unearned income" is amended to exclude (i) distributions from qualified disability trusts; and (ii) income earned by a child who is married and files a joint return for the taxable year.

- *Effective Date:* Taxable years beginning after December 31, 2005.
- *Code Section Affected:* Section 1(g) amended.

### **Tax Planning**

Extension of the kiddie tax from children under 14 to children under 18 complicates and clearly disadvantages middle-income taxpayers' ability to plan for funding their children's college education in a tax-efficient manner. In this environment, devices such as section 529 plans and section 2503(c) trusts become more important. Consideration should also be given to electing on Form 8814 to include the child's gross income in excess of \$1,700 (for 2006) on the parents' income tax return, especially if the

effect of inclusion of the income is to increase certain floors which limit available deductions.

### **Act Section 512: Conversions To Roth IRAs**

Taxpayers with adjusted gross income ("AGI") of \$100,000 or less can convert all or a portion of their traditional IRAs to Roth IRAs. As another (short-term) revenue raiser, TIPRA eliminates the income limits on conversions of traditional IRAs to Roth IRAs. Thus, taxpayers may make such conversions without regard to their AGI. For conversions occurring in 2010, unless a taxpayer elects otherwise, the amount includable in gross income as a result of the conversion will be included ratably in the taxpayer's income in 2011 and 2012. However, income inclusion will be accelerated if converted amounts are distributed before 2012.

- *Effective Date:* Taxable years beginning after December 31, 2009.
- *Code Sections Affected:* Sections 408A(c)(3) and (d)(3) amended.

### **Tax Planning**

Removal of the AGI limitation on IRA conversions in 2010 effectively allows taxpayers to circumvent the AGI limitations for contributions to Roth IRAs in the intervening years. Taxpayers can establish traditional IRAs without regard to income limitations in 2006, 2007, 2008, and 2009 and then convert the pre-2010 IRAs to Roth IRAs in 2010. Taxpayers who are prevented from making IRA contributions on a tax-deductible basis because they are active participants in employer-sponsored retirement plans can establish nondeductible IRAs for eventual conversion to Roth IRAs in 2010. Special attention should be given to the computation of the amount of income recognized in 2011 and 2012 on a 2010 conversion in the case of taxpayers who also take distributions from their converted IRAs in 2010.

### **Act Section 209: Modification Of Treatment Of Loans To Qualified Continuing Care Facilities**

Present law requires interest to be imputed on loans that bear interest at below-market rates. The imputed interest is characterized in accordance with the substance of the transaction (for example, as a gift, compensation, a dividend, or interest). An exception to this imputed interest rule is provided for below-market loans made by a lender to a "qualified continuing care facility" pursuant to a "continuing care contract," if the lender, or the lender's spouse, attains age 65 before the close of the calendar year in which the loan is made.

Currently, the exception applies only to the extent the aggregate outstanding loans by the lender and the lender's spouse to any qualified continuing care facility do not exceed \$163,000. TIPRA eliminates this ceiling. All outstanding loans by the lender and the lender's spouse to any qualified continuing care facility will not be subject to the imputed interest rules regardless of the aggregate loan amount.

The Act describes a "continuing care contract" as a written contract between an individual and a qualified continuing care facility under which:

"(A) the individual or the individual's spouse may use a qualified continuing care facility for their life or lives,

"(B) the individual or the individual's spouse will be provided with housing, as appropriate for the health of such individual or individual's spouse—

"(i) in an independent living unit (which has additional available facilities outside such unit for the provision of meals and other personal care), and

"(ii) in an assisted living facility or a nursing facility, as is available in the continuing care facility, and

"(C) the individual or the individual's spouse will be provided assisted living or nursing care as the health of the individual or the individual's spouse requires, and as is available in the continuing care facility."

New §7872(h)(2)

The legislative history clarifies that "the term 'assisted living facility' is intended to mean a facility at which assistance is provided (1) with activities of daily living (such as eating, toileting, transferring, bathing, dressing, and continence) or (2) in cases of cognitive impairment, to protect the health or safety of an individual. The term 'nursing facility' is intended to mean a facility that offers care requiring the utilization of licensed nursing staff." Conference Committee Joint Explanation of H.R. 4297, Tax Increase Prevention and Reconciliation Act of 2005, pages 200-201.

- *Effective Date:* Calendar years beginning after December 31, 2005, without regard to when the loan was made.
- *Code Section Affected:* New Section 7872(h) added.

### **PROVISIONS AFFECTING BUSINESSES •** The following provisions apply to businesses.

#### **Act Section 101: Increased Expensing For Small Business**

In lieu of depreciation, section 179 allows a taxpayer with a sufficiently small amount of annual investment to elect to deduct the entire cost of an asset in the year in which the asset is purchased and placed in use in the active conduct of a trade or business. (This is generally referred to as "expensing.") Current law provides that the maximum amount a taxpayer may expense for taxable years beginning in 2003 through 2007 is \$100,000 of the cost of qualifying property placed in service during the taxable year. In general, qualifying property is depreciable, tangible personal property purchased for use in the