

PKF PERSPECTIVES

HIGHLIGHTS OF THE TAX INCREASE PREVENTION AND RECONCILIATION ACT

THE TAX INCREASE PREVENTION AND RECONCILIATION ACT WAS SIGNED INTO LAW BY THE PRESIDENT ON MAY 17, 2006. THIS NEW LAW BEGAN LIFE AS A TAX RECONCILIATION BILL DESIGNED PRIMARILY TO RETROACTIVELY EXTEND A NUMBER OF POPULAR TAX BREAKS THAT EXPIRED AT THE END OF 2005, AND EXTEND A NUMBER OF TAX BREAKS DUE TO EXPIRE IN FUTURE YEARS. AFTER MONTHS OF CONGRESSIONAL NEGOTIATION THAT EXTENDED BEYOND 2005, THE NEW LAW PROVIDES FOR A SHORT LIST OF EXTENDED PROVISIONS, SEVERAL NEW TAX BREAKS AND A NUMBER OF REVENUE RAISERS.

The Tax Increase Prevention and Reconciliation Act ("the Act") includes the following extenders and new tax breaks.

Provisions Affecting Individuals

Reduced Rates on Capital Gains and Dividends

Under current law, capital gains and dividend income are taxed at a 15-percent rate. The rate will be reduced to zero in 2008 for taxpayers in the 10- and 15-percent tax brackets. Without any action, these rates were scheduled to increase after 2008. The Act extends these reduced rates through 2010.

Capital Gains Treatment for Certain Self-Created Musical Works

The Act provides that at the election of the taxpayer, the sale or exchange of musical compositions or copyrights in musical works

created by the taxpayer's personal efforts is treated as the sale or exchange of a capital asset.

The provision is effective for sales or exchanges before January 1, 2011, in taxable years beginning after the date of enactment.

Kiddie Tax Reform



The kiddie tax rules require a child's unearned income, such as dividends and interest, to be taxed at the parents' tax rate, which is usually a higher rate. Under current law, the kiddie tax applies if the child is under age 14, the child has net unearned

income over \$1,700, and the parent can claim the child as a dependent. The Act raised the age limit to under 18. The provision is effective immediately, for the entire 2006 tax year. Thus, parents who had planned to sell a child's stock portfolio after age 13 have no opportunity now to accelerate that planning technique if the child is over 13.

Increase Individual AMT Exemption Amount

The 2003 Tax Act increased the AMT exemption amount to \$40,250 (\$58,000 married couples filing jointly) for 2003 and 2004 to prevent new taxpayers from becoming subject to the alternative minimum tax (AMT). The Working Families Tax Relief Act of 2004 extended those exemption amounts through the end of 2005. The 2005 Tax Act would again extend the exemption levels through the end of 2006 but at a higher level – \$62,550 (married) and \$42,500 (other). Without this relief, millions of additional taxpayers would be subject to the AMT.

AMT Relief for Personal Tax Credits

Under current law, certain non-refundable personal credits (including dependent care, elderly and disabled, Hope Scholarship and Lifetime Learning Credits) are allowed only to the extent that a taxpayer has regular income tax liability in excess of the tentative minimum tax. (This has the effect of disallowing these credits against AMT.) Temporary provisions in the Act have been enacted which permit these credits to offset the entire regular and AMT liability through the end of 2005. The Act would allow the non-refundable personal tax credits to the full extent of the individual's regular tax and alternative minimum tax for taxable years beginning in 2006.

Roth IRA Conversions Relief

The Act eliminates the adjusted gross income limits on conversions of traditional IRAs to Roth IRAs for tax years after 2009. Thus, taxpayers may make such conversions without regard to their AGI.

For conversions occurring in 2010, unless a taxpayer elects otherwise, the amount includible in gross income as a result of the conversion is included ratably in 2011 and 2012. Income inclusion is accelerated if converted amounts are distributed before 2012.

Amended Section 911 Foreign Earned Income and Housing Exclusion Provisions

The Act makes three changes to the foreign earned income exclusion and housing allowance:

- 1 The income exclusion of \$80,000 is indexed for inflation starting in 2006 (rather than 2008 under current law).



- 2 The base housing amount used in calculating the foreign housing cost exclusion in a taxable year is 16% of the amount of the foreign earned income exclusion limitation (instead of the present law 16% of the grade GS-14, step 1 amount). Reasonable foreign housing expenses in excess of the base housing amount remain excluded from gross income, but the amount of the exclusion is limited to 30 percent of the taxpayer's foreign earned income exclusion.

The Treasury Secretary is given authority to issue regulations or other guidance providing for the adjustment of this 30% housing cost limitation based on geographic differences in housing costs relative to housing costs in the United States.

- 3 Income excluded as either foreign earned income or as a housing allowance is included for purposes of determining the marginal tax rates applicable to non-excluded income. Thus, the Act subjects individuals to the same tax rates applicable to individuals living and working in the United States who have the same amount of economic income.

Provisions Affecting Business

Increased Expensing for Small Business

The 2003 Tax Act increased the amount that small businesses may expense from \$25,000 to \$100,000 for three years (through the end of 2005). The American Jobs Creation Act of 2004 extended a slightly expanded version of small business expensing (with higher phase-out levels for small business) through 2007.

The Act extends that enhanced provision through the end of 2009.

Thus, the maximum amount a taxpayer may expense is \$100,000 of the cost of qualifying property reduced by the amount by which the total costs for the year for eligible property exceeds \$400,000. For 2006, the amounts are \$108,000 and \$430,000 respectively.

Inclusion of Off-the-Shelf Computer Software as Section 179 Property Eligible for the Expensing Election

The Act extends the inclusion of off-the-shelf computer software in the definition of "Section 179 property" for two additional years.



Amortization of Song Rights



The Act permits music publishers to elect to amortize over five years the advances they pay to songwriters. This five-year amortization method would be an alternative to the income forecast method of accounting for these advances.

Subpart F Active Financing and Insurance Income

Subpart F of the tax code imposes immediate taxation on certain income earned by foreign subsidiaries of U.S. companies, even if their income has not been brought back to the United States.

There is a temporary exception from Subpart F for active financing and insurance income. The active financing exception generally applies to the U.S.-based financial services and insurance industries and to domestic manufacturers who finance sales of large equipment to foreign customers.

The Tax Act extends the active financing exception for two years, until the end of 2008.

Subpart F – New Exception

The Act adds a new temporary exception from subpart F for dividends, interest, rents and royalties received by one controlled foreign corporation (CFC) from a related CFC to the extent attributable to non-subpart F income of the payor.

This provision is effective for tax years beginning after December 31, 2005 and before January 1, 2009.

Application of Earnings Stripping Rules to Partners Which Are C Corporations

The Act codifies proposed regulations by providing that, in the case of a corporation that owns, directly or indirectly, an interest in a partnership, the corporation's share of partnership liabilities, interest income, and interest expense are treated as liabilities, interest income, and interest expense of the corporation for purposes of applying the earnings stripping rules to the corporation.

The result of this change is that many more corporations could be subject to the earnings stripping rules which potentially limit interest expense due to foreign related parties.

The provision is effective for taxable years beginning on or after May 17, 2006.

Oil and Gas Industry

5-Year Amortization of Geological and Geophysical (G&G) Costs for Major Integrated Oil Companies

The Act extends the two-year amortization period for G&G costs to five years for certain major integrated oil companies. Under the Act, the five-year amortization rule for G&G costs applies only to integrated oil companies that have an average daily worldwide production of crude oil of at least

500,000 barrels for the taxable year, gross receipts in excess of \$1 billion in the last taxable year ending during calendar year 2005, and an ownership interest in a crude oil refinery of 15 percent or more.

The provision applies to amounts paid or incurred after May 17, 2006.

Tax-Exempt Entities

Involvement in Tax Shelter Transactions

The Act subjects certain tax-exempt entities to penalties for participating in a prohibited tax-shelter transaction as accommodation parties. A prohibited tax-shelter transaction is generally any transaction that the Treasury Secretary determines is a listed transaction or a reportable transaction as defined under current law.

The Act also clarifies that an exempt organization that participates in a reportable transaction (including a listed transaction) in order to shelter from tax the organization's own tax liability (e.g., the unrelated business income tax) is subject to the current-law rules pertaining to disclosure of such transactions.

These new rules are in response to Congress' concern about the role of tax exempts in tax shelters.

In the Words of ...

Government is the people's business and every man, woman and child becomes a shareholder with the first penny of tax paid.

Ronald Reagan
(40th U.S. President)

The Declaration of Independence, the words that launched our nation – 1,300 words. The Bible, the word of God – 773,000 words. The Tax Code, the words of politicians – 7,000,000 words – and growing!

Steve Forbes
(President and CEO of Forbes, Inc.)

Professional

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