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THE BACK BAY ADVISOR

New Act Provides Some AMT Relief

The alternative minimum tax (AMT) was originally designed to ensure wealthy taxpayers paid at least a minimum amount of tax. An important component in the AMT calculation is the AMT exemption amount, which does not increase automatically with inflation. Thus, more people become subject to the AMT as time passes. For instance, 3.6 million taxpayers paid the AMT with their 2005 tax returns. In 2006, the AMT exemption amount was scheduled to decrease, which would have subjected an additional 15.3 million taxpayers to the AMT (Source: *The Wall Street Journal*, May 10, 2006).

The Tax Reconciliation Act increased, for the year 2006 only, the AMT exemption amount to \$62,550 for married taxpayers filing jointly, \$42,500 for single taxpayers, and \$31,275 for married taxpayers filing separately. In 2005, the amounts were \$58,000 for married taxpayers filing jointly, \$40,250 for single taxpayers, and \$29,000 for married taxpayers filing separately, but these amounts were scheduled to decrease to \$45,000, \$33,750, and \$22,500, respectively, without this 2006 tax change.

Additionally, the Tax Reconciliation Act allows taxpayers to use nonrefundable personal credits against their AMT liability in 2006. These credits include the dependent care credit, the credit for the elderly and disabled, the adoption credit,

the child tax credit, the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, the credit for savers, the credit for certain non-

business energy property, the credit for residential energy efficient property, and the DC first-time homebuyer credit.

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Roth IRA Conversions for All Taxpayers

To convert from a traditional individual retirement account (IRA) to a Roth IRA, adjusted gross income (AGI) for single taxpayers and married taxpayers filing jointly cannot exceed \$100,000 in the year of conversion, which does not include any income resulting from the conversion. Amounts converted must be included in income if taxable when withdrawn (i.e., contributions and earnings in deductible IRAs and earnings in nondeductible IRAs), but are exempt from the 10% early withdrawal penalty.

Starting in 2010, the Tax Reconciliation Act removes the income limitation for conversions from traditional IRAs to Roth IRAs, so that all taxpayers can convert to a Roth IRA. Furthermore, if the conversion is made in 2010, the taxpayer can pay the tax in two installments in 2011 and 2012, with no tax due in 2010. However, if the taxpayer prefers, he/she can elect to pay the tax in 2010, which may make sense if the current lower tax rates are not extended beyond 2010. Taxes on conversions made after 2010 must be paid in the year of conversion.

Taxpayers with income over

\$100,000 may want to consider a conversion for the following reasons:

- Converting and paying taxes due with funds outside the IRA will increase your IRA's value by the amount of tax paid. For instance, if you have a \$200,000 traditional deductible IRA and are in the 33% tax bracket, you would pay \$66,000 in income taxes when the funds are withdrawn, netting you \$134,000. In 2010, you can convert the entire \$200,000 and pay the \$66,000 in income taxes with funds outside the IRA, thus increasing your tax-free balance by the amount of the income taxes. A conversion is less attractive if you must pay income taxes due from the conversion with IRA funds. The amount withheld for this purpose will be subject to income taxes and the 10% penalty if you are under age 59 1/2.
- Roth IRAs have no withdrawal requirements. Since you aren't required to withdraw funds from a Roth IRA, even after age 70 1/2, your IRA balance can continue to

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Some AMT Relief

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Despite the increased exemption amounts, the exemption still phases out at the same income levels — 25% of AMT taxable income over \$150,000 for married taxpayers filing jointly, \$112,500 for single taxpayers, and \$75,000 for married taxpayers filing separately. Thus, the AMT exemption completely phases out at AMT income of \$400,200 for married taxpayers filing jointly, \$282,500 for single taxpayers, and \$200,100 for married taxpayers filing separately.

AMT income is determined by adding several amounts to your taxable income, including:

- Personal exemption deduction
- Standard deduction if you don't itemize
- State and local tax deductions
- Miscellaneous deductions
- Mortgage interest deductions when the proceeds were not used to improve, buy, or build the taxpayer's home
- Medical expenses, unless they exceed 10%, rather than 7.5%, of AGI
- Municipal interest income from certain private-activity bonds
- Certain business-related items if you own a business, rental property, or interest in a partnership or S corporation
- The difference between the market price and exercise price of incentive stock options

From this calculation, you subtract the AMT exemption amount detailed above, and multiply the result by the AMT rates — 26% of the first \$175,000 of income (\$87,500 for married couples filing separately) and 28% on amounts over that. If the AMT exceeds your regular income tax, the difference must be paid as the AMT. If you pay the AMT, some portion may be refunded in future years through an AMT credit that offsets your regular tax liability. However, the credit can only be used in years when you don't pay the AMT.

While the AMT rates (26% and

Extension of Capital Gains and Dividend Tax Rates

In 2003, the tax rate on qualified long-term capital gains and dividend income was reduced to 15% through 2008. The rate for taxpayers in the 10% or 15% tax bracket was reduced to 5% through 2007 and 0% for 2008. In 2009, the rates were set to increase to the rates prior to the tax change.

The Tax Reconciliation Act extends these lower rates for an additional two years, through the end of 2010. Thus, taxpayers in the 10% or 15% tax bracket will pay 0% for 2009 and 2010, while other taxpayers will be taxed at a maximum rate of 15%.

After 2010, the long-term capital gains tax rate will increase to 20% (10% for taxpayers in the 10% or 15% tax bracket), while dividend income will be taxed at the taxpayer's marginal tax rate, which could be as high as 39.6%. In addition, any gain from the sale or exchange of property held more than five years that would have been taxed at 10% will be taxed at 8%, while gains that would have been taxed at 20% and the holding period began after December 31, 2000 will be taxed at 18%. This extension means that the expiration of the lower rates for long-term capital gains and dividend income will expire at the same time as other tax cuts, including lower marginal tax rates, marriage penalty relief, and the reduction in estate taxes.

To take advantage of these

lower rates, consider these strategies:

- Don't assume that the lower rates will be permanent. While the lower rates will be in effect from 2003 to 2010, there is no assurance that Congress will extend the rates past this date, especially as concerns grow about large federal budget deficits. Your current focus should be to ensure you take advantage of the lower long-term capital gains tax rates. If selling an asset would result in a short-term gain, waiting until the gain would be classified as long term could save a significant amount of taxes. As 2010 approaches, you will want to evaluate your investments to determine whether you should accelerate the sale of investments to lock in a lower capital gains tax rate if these rates are not extended.
- Take advantage of the 0% capital gains tax rate for taxpayers in the 10% or 15% tax bracket for 2008, 2009, and 2010. One strategy would be to gift an asset to a child in a low tax bracket, who could then sell the asset with no taxes. However, a change in the "kiddie tax" means the child must be at least 18 years old, rather than 14 years old, in the year the asset is sold. (See the article "Age for 'Kiddie Tax' Increased to 18" for more details.) ■■■

28%) are lower than some marginal tax rates (33% and 35%), the AMT includes more items in income than the regular income tax calculation, which increases the liability for many taxpayers. Since so many items affect the AMT calculation, it's difficult to determine who will be subject to the tax. Taxpayers have found themselves subject to the tax because they have many children or live in states with high income taxes.

If you are not consistently subject to the AMT, you might want to

accelerate income or postpone deductions in years when you are subject to the AMT. You will typically pay less tax by postponing deductions (many of which are added back in the AMT calculation) and accelerating income (so income is taxed at lower rates). Income that could be accelerated includes short-term gains, prepayments of bonuses, and withdrawals from individual retirement accounts and other retirement plans. ■■■

Roth IRA Conversions

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- grow on a tax-free basis.
- Uncertainty about future tax rates is eliminated. With traditional IRAs, the income tax paid on distributions is determined by the income tax rates in effect at that time. With a Roth IRA, you pay the income taxes when the funds are converted and then make no further tax payments when funds are distributed, provided it is a qualified distribution.
- Roth IRAs provide a tax-advantaged way to leave assets to heirs. With a Roth IRA, your heirs receive the proceeds free of federal income taxes. Also, if you don't withdraw funds from the Roth IRA after age 70 1/2, you could potentially leave your heirs with a much larger balance than from the traditional IRA. Keep in mind, however, that the balance may still be subject to estate taxes, depending on the size of your taxable estate and the year of your death.

This conversion provision will effectively remove the income limitations for contributing to a Roth IRA. Currently, Roth IRA contributions can be made by single taxpayers with AGI less than \$95,000 (contributions are phased out with AGI between \$95,000 and \$110,000) and by married couples filing jointly with AGI less than \$150,000 (contributions are phased out with AGI between \$150,000 and \$160,000). It doesn't matter whether you participate in a company-sponsored pension plan. Starting in 2010, taxpayers with income over these limits can make contributions to a nondeductible traditional IRA and then immediately convert the balance to a Roth IRA.

While these rules don't go into effect until 2010, taxpayers can make the maximum IRA contributions to

Age for "Kiddie Tax" Increased to 18

The "kiddie tax" refers to the manner in which investment income is taxed when received by children. In the past, it applied to children under age 14, but now applies to children under age 18. In 2006, the first \$850 of investment income is tax free, the second \$850 is taxed at the child's marginal tax rate (typically 10% or 15%), and any remaining investment income is taxed at the parents' marginal tax rate. Once the child is age 18 or older (previously age 14 or older), all investment income is taxed at his/her marginal tax rate. This tax rule does not apply to individuals who are under age 18, are married, and file a joint return with their spouse. Also, distributions from certain qualified disability trusts are exempt from the "kiddie tax" rules.

This tax provision became effective May 17, 2006 and applies to the entire 2006 tax year. Thus, parents with children between the ages of 14 and 18 have no opportunity to accelerate planning techniques. Long-term capital gains and dividend income will be taxed at 15% instead of 5%, and short-term capital gains and interest income will be taxed at the parents' marginal tax rate (which could be as high as 35%) instead of the child's tax rate (usually 10% or 15%).

A common college funding

technique is to gift investments to the child as he/she approaches college age and then have the child sell the assets to take advantage of lower capital gains tax rates (5% instead of 15%). Some families were planning to postpone the sales until 2008, when the long-term capital gains tax rate would be 0% for taxpayers in the 10% or 15% tax bracket. If the child will be under age 18 in 2008 to 2010, the family will have to pay a 15% long-term capital gains tax rate instead of 0%.

Taxpayers with children under age 18 should reevaluate their investments, looking into investments that generate little or no taxable income. Another alternative, if you are saving for a child's college education, is to invest the child's assets in section 529 plans or Coverdell education savings accounts, which provide tax-free distributions as long as the funds are used for qualified education expenses. If the child also has earned income, he/she can also set up a traditional or Roth individual retirement account. Taxpayers who own a business may want to employ their children, especially those in the 14- to 17-year age group, since earned income is not subject to the "kiddie tax" rules and is taxed at the child's marginal tax rate. ■■■

a nondeductible IRA in 2006, 2007, 2008, and 2009, and then convert the nondeductible IRA to a Roth IRA in 2010. Since contributions are nondeductible, you would only have to pay income taxes on earnings within the IRA. In 2006 and 2007, the maximum IRA contribution is \$4,000, increasing to \$5,000 in 2008. After 2008, the contribution amount will be adjusted for inflation in \$500 increments. Additionally, individuals age 50 or older can make additional

catch-up contributions of \$1,000 annually.

There are a variety of factors that should be considered before deciding whether to convert a traditional IRA to a Roth IRA. Once the balance is converted, a qualified distribution cannot be made until after the five-tax-year holding period. Distributions before then are subject to the 10% early withdrawal penalty, unless one of the exceptions applies. ■■■

Miscellaneous Provisions

Capital gains for sale of self-created musical works — Taxpayers may now elect to treat the sale or exchange of self-created musical compositions or copyrights as the sale or exchange of a capital asset, effective from May 17, 2006 to December 31, 2010.

Amortization of song rights — Taxpayers who put any musical composition or musical copyright into service can elect to use a five-

year amortization period for certain expenses paid or incurred for all musical compositions and copyrights placed in service in that tax year. Thus, music publishers can amortize advances made to songwriters over five years.

Section 179 expensing of property — The Tax Reconciliation Act extended the maximum amount that a taxpayer may expense for qualifying business property through 2009.

The maximum amount is \$100,000 of the cost of qualifying property, reduced by the amount by which the cost exceeds \$400,000. Both amounts are indexed for inflation for tax years after 2003 and before 2010. For 2006, the amounts are \$108,000 and \$430,000, respectively. This provision allows businesses to immediately deduct the cost of up to \$108,000 of property under Code Section 179, rather than capitalizing and then depreciating the property.

Settlement funds — Special tax treatment has been provided to certain settlements resolving claims under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), commonly referred to as the Superfund. The settlement funds will be treated as beneficially owned by the U.S. government and will not be subject to federal income taxes. This treatment is not available to settlement funds established after December 31, 2010.

Offers-in-compromise — The Tax Reconciliation Act increases the amounts that must be paid when submitting an offer-in-compromise. Now, taxpayers must make partial payments of their liability in addition to user fees imposed by the Internal Revenue Service (IRS). With lump-sum offers, the taxpayer must pay 20% of the offered amount. With installment offers, the taxpayer must make the scheduled payments while the IRS considers the offer. If the offer is not processed within two years, it is deemed accepted.

Withholding on government payments — Starting in 2011, federal, state, and local government agencies must withhold 3% on payments for services or property provided by a taxpayer.

Foreign earned income exclusion and housing allowance — Changes were made to the foreign earned income exclusion and housing allowance for U.S. citizens working abroad.

This is not a complete list of tax changes enacted. Please call if you'd like to discuss your situation. ■■■

What Is the Cost?

The official cost of the Tax Reconciliation Act for the years 2006 through 2010 is \$70 billion and for the years 2006 through 2015 is \$69 billion, and is comprised of the following items (in billions of dollars):

	2006-10	2006-15
Extension of reduced tax rates for dividends	\$13.3	\$30.8
Extension of reduced tax rates for capital gains	7.3	20.0
Individual AMT provisions	33.9	33.9
Elimination of income limitations on Roth IRA conversions	4	-6.4
Withholding on certain government payments for property and services	—	-7.0
Other provisions	15.1	-2.2
Total	\$70.0	\$69.1

Source: Joint Committee on Taxation, May 2006

The Tax Reconciliation Act is a result of a Congressional budget resolution to reduce revenues by not

more than \$70 billion over the 2006-2010 period.

Who will benefit from the Tax Reconciliation Act? The Tax Policy Center analyzed the Tax Reconciliation Act and determined the average federal tax change and percentage of total tax change by income level:

Income	Average Federal Tax Change	Share of Total Federal Tax Change
Less than \$10,000	\$0	0.0%
\$10–20,000	-3	0.1
\$20–30,000	-10	0.3
\$30–40,000	-17	0.4
\$40–50,000	-47	0.9
\$50–75,000	-112	3.6
\$75–100,000	-406	7.6
\$100–200,000	-1,395	32.0
\$200–500,000	-4,527	27.2
\$500–1,000,000	-5,656	5.7
Over \$1,000,000	-42,766	22.2
Overall	-453	100.0

Source: Tax Policy Center, May 2006

Please Call

The Tax Increase Prevention and Reconciliation Act of 2005 (Tax Reconciliation Act) was signed into law on May 17, 2006. Many of the provisions extend the effective dates of current tax laws, but some significant new provisions were also enacted. The articles in this newsletter cover major provisions in the Tax Reconciliation Act in the areas of the alternative minimum tax (AMT), the Roth individual retirement account (IRA), the “kiddie tax,” and capital gains and dividend income tax rates. There are many more provisions in the Tax Reconciliation Act that may apply to individual situations. If you'd like to review your situation to determine how specific provisions may affect you, please call. ■■■