



TAX ALERT

SEPTEMBER 29, 2005

THE ALTERNATIVE MINIMUM TAX - NEW INSIGHTS TO AN OLD PROBLEM

The Alternative Minimum Tax (AMT) was enacted in 1969 as a reaction to a relative handful of super wealthy taxpayers who were able to avoid paying income tax. Unfortunately because the exemption was not indexed for inflation, an increasingly large number of middle class taxpayers have become ensnared in the AMT. Worse yet, the number of middle class taxpayers paying AMT increases each year. Three million taxpayers will pay AMT this year, nineteen million next year and 30 million - one-third of all taxpayers - by 2010.

While everyone - taxpayers, Congress and the President - agrees the AMT is awful and should be abolished, unfortunately it has grown to become an 800 pound gorilla. The cost of abolishing it will cost in excess of 650 billion dollars over the next 10 years. The Treasury has concluded that by 2013 it will be less expensive to terminate the regular tax system than the AMT. Even absent Iraq and Katrina, the cost is too great - termination is out of the question. The AMT has gotten too big to kill.

The only other option is to try to cage it. In other words, increase the exemption to keep it from hitting the middle class.

Since the AMT seems to be here to stay, we have to learn to live with it. In order to live with it, we have to adjust our thinking.

- **Long-Term Capital Gains**

We all know that the maximum tax rate on long-term capital gains is 15% while the maximum tax on short-term capital gains

which are taxed as ordinary income is 35%. This causes taxpayers to try to satisfy the 12 month holding period requirement (often a bad idea for economic reasons) to get long-term capital gain treatment. The problem is that since the AMT, in effect, supersedes the normal tax rules, the actual tax on a long-term capital gain could be in excess of 20%. The only way to determine your effective tax rate on an actual or contemplated long-term capital gain is to project your tax under both alternatives.

- **Dividends**

Qualifying dividends are taxed at a maximum rate of 15%. This is a true statement if one focuses on the normal tax. However, looking at the complete picture, the AMT can cause the effective income tax on qualified dividends to be over 20%. This can distort your conclusion when you are trying to determine whether to invest in dividend paying stock or municipal bonds.

- **Municipal Bonds**

When determining whether to invest in municipal bonds one looks at his highest bracket and concludes that his savings will be in that bracket. If he is paying AMT, his actual tax savings can be considerably less. Also, be aware that interest income on certain private activity bonds is subject to AMT.

- **Charitable Contributions**

Virtue may be its own reward but frequently we are asked to determine the tax savings if a taxpayer makes a particular charitable contribution. Even though the taxpayer may be solidly in the highest bracket - 35% - his

income tax savings may not be at the 35% rate. If he is subject to AMT, his savings could be considerably less.

The examples given above are not meant to be exhaustive. They are intended to illustrate some of the more common traps for the unwary.

The best advice that we can give our readers is to contact us before they do something that will have a substantial effect on their tax return. We can evaluate the effect of contemplated transactions to avoid common pitfalls.

NEW IRS DEVELOPMENTS

- **Longer Filing Extension Under Consideration**

Individual income tax returns are due April 15th. You can request a four month automatic extension to August 15th and then request an additional two months to October 15th. This additional extension is discretionary on the part of the IRS. You must give a reason although the IRS rarely rejects these discretionary extensions.

The IRS recently announced that it is replacing the four month automatic + two month discretionary extension with a six month automatic extension. Same result but less wasted effort.

CAVEAT – Bear in mind that under both the old and new procedures, you must pay your tax timely. An extension only extends the filing date, not the payment date.

- **Business Mileage Rate Increases**

Responding to the surging gasoline prices, in an unusual step, the IRS has increased the standard mileage rate for business driving in the middle of the year. The increase became effective September 1, 2005 and continues to December 31, 2005. The rate increased

from 40.5 cents per mile to 48.5 cents per mile. The rate for driving for medical care increased from 15 cents per mile to 22 cents per mile but the rate for driving for charitable purposes remains at 14 cents per mile (as required by statute).

- **IRS To Audit More S Corporations**

An S corporation unlike a C corporation usually does not pay tax. Generally, it is taxed like a partnership, that is, its income flows through and is taxed to its shareholders. The IRS has announced that it will increase the number of audits that it performs on S corporations. Later this year, the IRS plans to audit 5,000 randomly selected 2003 and 2004 S corporation returns. The audits will be very extensive and painstakingly detailed. Among other things, the IRS will focus on compensation paid to employees who are also shareholders. If the shareholder's salary is too low and the shareholder receives a dividend, the IRS may try to treat the dividend as disguised salary and assess self-employment tax.

THE ENERGY AND TRANSPORTATION ACTS OF 2005

President Bush recently signed into law the Energy and Transportation Acts of 2005. The new tax breaks contained in these acts are intended to encourage and reward domestic energy production and conservation. Following is a brief summary of the changes that we think most of our readers will find important.

New Tax Credits for Vehicles

Beginning January 1, 2006, the Act repeals the tax deduction for new hybrid gas - electric passenger automobiles such as the Toyota Prius and the Ford Escape. However, the new law creates new motor vehicle tax credits. The new credits are available for **NEW** purchased or

leased vehicles placed in service after December 31, 2005. The credits are available for the following types of vehicles:

- Hybrid vehicles — vehicles which combine an internal combustion engine with another propulsion system that uses a portable energy source such as electric batteries. Fuel economy credits ranging between \$400 and \$2,400 will be allowed for new hybrid autos and trucks with gross vehicle ratings of up to 8,500 lbs. The credits depend on how much the vehicle's fuel economy is improved over comparable vehicles from the 2002 model year. Additionally, conservation credits ranging between \$250 and \$1,000 are allowed for hybrid vehicles based on anticipated lifetime fuel savings.
- Additional credits are available for vehicles that run on hydrogen power cells, use alternative fuel sources such as compressed or liquefied natural gas, liquefied petroleum gas, or any other liquid that is at least 85% methanol. You will have to rely on information furnished by the car manufacturers to determine the amount of your credits.

CAVEAT — as in the case of most deductions and credits, these credits cannot be used to reduce your federal income tax below the alternative minimum tax amount. Since the credit amounts begin to be phased-out when the manufacturer has sold a combined total of 60,000 vehicles for use in the U.S. after December 31, 2005, your purchase should be made before June 30, 2006 to avoid being reduced by the phase-out.

Personal Energy Property Credit

The energy credit for residential energy property expenditures is limited to a lifetime amount of \$500. It applies to items put to use after December 31, 2005 but prior to 2008. The credit applies to expenditures on your principal residence - it does not extend to second homes.

Qualified home improvements include the following:

- Metal roofs coated with heat-reduction segment.*
- Exterior windows including skylights.*
- Exterior doors.*
- Insulation material or systems.*
- Energy efficient electric heat pumps, electric heat pump hot water heaters, geothermal heat pumps, and central air conditioners. The credits for expenditures for these items cannot exceed \$300 per item.
- Qualified natural gas, propane, and oil furnaces and qualified hot water boilers. The credits for expenditures for these items cannot exceed \$150 per item.

* Credit limited to 10% of the expenditure.

Credit for Builders of Energy Efficient New Homes

Contractors that build new energy-efficient homes are eligible for a credit of \$2,000 per unit. To qualify, the unit must have annual energy consumption for heating and cooling that is at least 50% less than comparable units. This credit also applies to substantial reconstruction and rehabilitation of an existing residence. These homes must be substantially completed after the 2005 energy act was signed into law and the home must be purchased after December 31, 2005 but before 2008.

Deduction for Energy Efficient Commercial Building Improvements

An immediate deduction is allowed for the cost of qualified energy-saving improvements to commercial buildings in the U.S. The maximum deduction is limited to \$1.80 per square foot. The improvements must be installed as part of interior lighting systems, heating, cooling and ventilation systems, hot water systems or the building envelope. In

order to qualify, these improvements must also meet the 50% reduced energy consumption standard. This deduction is available for qualified energy efficient commercial building improvements put to use after December 31, 2005 but before 2008.

We realize that this legislation is very complex. If you have a particular question, we will be happy to work with you to resolve it.

THE NEW ROTH 401(k)

Beginning next year, the Roth 401(k) becomes available to taxpayers. They can choose to contribute to a conventional 401(k), the Roth 401(k) or split their contributions between the two. Total contributions for 2006 cannot exceed \$15,000 for taxpayers under 50 or \$20,000 for taxpayers 50 and above by year-end.

In order to determine whether to use a conventional 401(k) or a Roth 401(k), taxpayers will have to predict whether they will be in a high bracket when they retire [use a Roth 401(k)] whether tax rates will rise [use a Roth 401(k)] or whether the government will scrap the conventional tax system in favor of a flat tax or a national sales tax [use a conventional 401(k)].

Unlike conventional 401(k)'s, contributions to a Roth 401(k) are not deductible when made. However, earnings are allowed to grow tax-free. Like Roth IRA's, withdrawals from a Roth 401(k) are generally tax-free if:

1. the withdrawal occurs after the employee becomes 59-1/2, dies, or becomes disabled, and
2. the withdrawal occurs after five years have passed since the initial contribution to the Roth 401(k).

The Roth 401(k)'s are scheduled to disappear in 2010. However, it is possible that Congress will extend it.

SENATORS NEARING AGREEMENT ON ESTATE TAX

President Bush's 2001 tax bill reduced the estate tax rate and increased the per person exemption. It also scheduled additional increases in the per person exemption and decreases in the tax rate. The tax was scheduled to be eliminated altogether in 2010 and fully restored in 2011. The gradual reduction followed by the complete restoration in 2011 was a compromise required to win passage.

Congress has been trying to reach a compromise on the estate tax. The problem is that in general the Republicans would like the tax eliminated altogether while the Democrats would like the tax to stay almost as high as it was in 2001. The House of Representatives has repeatedly passed legislation which permanently repeals the tax but the legislation dies in the Senate because the Republican majority does not have the 60 votes needed to avoid a filibuster on the Senate floor. The Senate Republicans led by Senator Jon Kyl (Arizona) and the Democrats led by Senator Max Baucus (Montana) have been working for months to reach a compromise. Senator Kyl would like to increase the current exemption of \$1,500,000 per person to \$10 million and to lower the tax rate to 15% - the same rate at which dividends and capital gains are taxed. Senator Baucus would like to limit the per person exemption to \$3,000,000. Increasing the per person exemption dramatically reduces the number of estates that have to file returns. In 2003, 20,600 estate tax returns were filed for estates worth more than \$1,000,000. Only 3,486 of these returns were for estates of \$5 million or more.

Senate leaders were optimistic that a compromise could be reached soon after the Senate returned from adjournment early this month. Unfortunately, the costs of Katrina have temporarily put this issue on the back burner.

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