

MANY TAX LAW CHANGES EFFECTING INDIVIDUAL TAXPAYERS GO INTO EFFECT IN 2006

Many important tax changes go into effect in 2006 apart from the numerous indexing changes. These non-indexing changes primarily result from the Gulf Opportunity Zone Act of 2005 (GO Zone Act), the Katrina Emergency Tax Relief Act of 2005 (KETRA), and the Energy Tax Incentives Act of 2005 (Energy Act). However, they also result from earlier legislation with phased-in changes, such as the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and IRS guidance. This article carries an overview of the non-indexing changes for individuals for 2006.

BROAD-BASED TAX CHANGES FOR INDIVIDUALS

■ **Itemized deduction phaseout reduced**

A higher-income taxpayer's itemized deductions (other than those for medical expenses, investment interest, nonbusiness casualty and theft losses, gambling losses, and certain hurricane-related charitable contributions) are reduced if his adjusted gross income (AGI) exceeds an inflation-adjusted amount. His itemized deductions generally are reduced by the lesser of:

- 3% of the excess of adjusted gross income over the applicable amount, or
- 80% of the itemized deductions otherwise allowable for the tax year.

For 2006, the phaseout begins at \$150,500 of AGI (\$75,250 for marrieds filing separately). However, under an EGTRRA change which applies for the first time in 2006, a taxpayer will lose only 2/3 of the amount he would otherwise lose under the regular reduction computation.

Illustration

For 2006, Sam, a calendar year unmarried taxpayer has AGI of \$191,550 and \$20,000 of itemized deductions, consisting of \$9,000 taxes, \$6,000 of mortgage interest, \$3,000 of charitable contributions to his church, and \$2,000 of miscellaneous itemized deductions. Sam's total itemized deduction of \$20,000 is reduced by \$821 ($(\$191,550 \text{ AGI} - \$150,500) \times 3\%$) = $\$1,231.50 \times 2/3 = \821). Thus, his total itemized deduction is \$19,179 ($\$20,000 - \$821 = \$19,179$). Without the change, Sam's total itemized deduction for 2006 would have been only \$18,768.50 ($\$20,000 - \$1,231.50$).

■ **Personal exemption phaseout reduced**

The personal exemption amount of a taxpayer whose AGI exceeds an inflation-indexed threshold amount is reduced by an applicable percentage. This applicable

percentage is 2% for each \$2,500 (or fraction thereof) by which the AGI of a taxpayer (other than a married taxpayer filing separately) exceeds the appropriate threshold amount. For marrieds filing separately, the applicable percentage is 2% for each \$1,250 (or fraction of that amount) by which his AGI exceeds the threshold amount. The applicable percentage can't exceed 100%. The inflation-adjusted threshold amounts for 2006 are \$225,750 (joint returns and surviving spouses), \$188,150 (head of household), \$150,500 (unmarried individuals) and \$112,875 (marrieds filing separately).

However, under an EGTRRA change which applies for the first time in 2006, a taxpayer will lose only 2/3 of the amount he would otherwise lose under the regular phase-out computation.

■ **Residential energy credits**

A taxpayer may be able to take two residential energy credits for expenses paid in 2006 to have qualified energy savings items installed on his main home.

A. Code Section 25C Tax credit

In general, under this credit, an individual is allowed a lifetime credit of up to \$500 for making qualifying energy saving improvements to his main home (only \$200 of which may be for qualifying window (which includes skylight) expenses). Subject to these caps, the credit equals the sum of:

1. A 10% credit for energy efficiency improvements to the building envelope (i.e., insulation, exterior windows, skylights, exterior doors and pigmented coated metal roofs); and
2. A credit for residential energy property expenses in the following amounts:
 - \$50 for each advanced main air circulating fan;
 - \$150 for each qualified natural gas, propane or oil furnace or hot water boiler; and
 - \$300 for qualified energy-efficient property (e.g., heat pumps, water heaters, and central air conditioners that meet certain requirements).

Illustration

In 2006, a taxpayer installs \$2,000 of certified energy saving insulation and \$2,000 of certified energy efficient windows in his main home. He can claim a \$400 credit for 2006 ($\$4,000 \times .10$).

B. Code Section 25D Tax credit

In general, under Code Sec. 25D, an individual is allowed an annual credit for the purchase of residential energy efficient property equal to the sum of:

1. 30% of the amount paid for qualified photovoltaic property (i.e., property that uses solar power to generate electricity in a home), up to a maximum credit of \$2,000;
2. 30% of the amount paid for qualified solar water heating property, up to a maximum credit of \$2,000; and
3. 30% of the amount paid for qualified fuel cell property up to a maximum credit of \$500 for each 0.5 kilowatt of capacity.

Illustration

In 2006, a taxpayer buys \$8,000 of solar energy equipment and installs it in his main home. He may claim a \$2,000 tax credit for 2006 ($\$8,000 \times .30 = \$2,400$), but the credit for this class of energy efficient property is limited to \$2,000).

The energy efficient improvements in categories (a) and (b) may be made to any residence (including a vacation home); improvements in the third category may only be made to a taxpayer's main home.

■ **Alternative motor vehicle credit**

A taxpayer may be able to take a credit by buying a hybrid or lean burn vehicle in 2006. The tax credit may be as much as \$3,400 for those who buy the most fuel-efficient vehicles. The full amount of the allowable credit is available only up to the end of the first calendar quarter after the quarter in which the manufacturer records its sale of the 60,000th hybrid and advanced lean-burn technology motor vehicle. There's also a new credit for 30% of the cost of "alternative fuel vehicle refueling property" (with a cap of \$1,000 for personal property). The new-for-2006 credits replace the deduction for certain clean fuel vehicles and clean fuel property that was available for property placed in service before 2006.

■ **Clean renewable energy bond credit**

A taxpayer may be able to take a nonrefundable credit based on the face amount of any clean renewable energy bond he holds during 2006. These are a special class of bonds used to finance renewable energy projects. The amount of any credit before tax liability limits must be included as interest income.

- **Carryover of unused credits**

For tax years beginning after 2005, the rules relating to the carryover of unused personal credits (including the credit for residential energy efficient property) have been redrafted so as to include in the Code rules for both the tax years in which the credits are allowed against the AMT, and the tax years in which the credits are not so allowed.

- **Six-month automatic extension**

Most individuals may request a six-month automatic filing extension for their 2005 return on a single form, without a reason or even a signature. Under prior rules, an individual who wanted a six-month extension had to request an initial four-month extension on one form and then use a second one to request a two-month discretionary extension.

HURRICANE-RELATED TAX CHANGES FOR INDIVIDUALS

- **Housing exclusion for employees**

For lodging provided during the period beginning on January 1, 2006, and ending on July 1, 2006, an employee may exclude from gross income up to \$600 per month for the value of in-kind lodging provided to him (and his spouse or dependents) by or on behalf of a qualified employer located in the GO Zone (that portion of the Hurricane Katrina disaster area determined by the President to warrant individual or individual and public assistance because of Hurricane Katrina). However, the exclusion doesn't apply for purposes of social security and Medicare taxes or unemployment tax.

- **Charitable use of vehicle**

A taxpayer who uses a vehicle in providing donated services to a charity for relief related to Hurricane Katrina during 2006 computes his charitable mileage deduction using a standard mileage rate of 32 cents, rather than the usual charitable standard mileage rate of 14 cents. Subject to meeting certain conditions, reimbursement by a organization including public charities and private foundations to a volunteer for the cost of operating a passenger automobile for the charity's benefit in connection with providing donated services for relief related to Hurricane Katrina during 2006 is excludable from the volunteer's gross income. The excludable reimbursement may not exceed 44.5 cents per mile.

- **Additional exemption for housing individuals displaced by Hurricane Katrina**

An individual can claim an additional exemption amount of \$500 for each

displaced individual. To be a displaced individual, an individual must be housed by the taxpayer for a consecutive period of at least 60 days that ends in the tax year and other requirements must be met. The additional exemption amount is allowable once for a specific individual. The maximum additional exemption amount that a taxpayer can claim for all displaced individuals is \$2,000 (\$1,000 if married filing separately). The additional exemption amount claimed for displaced individuals in 2005 reduces the \$2,000 maximum for 2006.

TAX CHANGES FOR INDIVIDUALS DUE TO EXPIRED PROVISIONS

The following tax changes for 2006 involve tax provisions that expired at the end of 2005 but may be reinstated by Congress.

- **Credits reduced by AMT calculation**

Personal tax credits (other than the adoption credit, the child tax credit and the credit for elective deferrals and IRA contributions) can't exceed the excess of regular tax liability over tentative minimum tax.

- **Decreased AMT exemption amount**

The AMT exemption amount has decreased to \$33,750 for unmarried individuals, \$45,000 for marrieds filing jointly or qualifying surviving spouses, and \$22,500 for marrieds filing separately. For 2005, the AMT exemption amounts were \$40,250, \$58,000, and \$29,000 respectively.

- **Educator expenses**

The above-the-line deduction for educator expenses doesn't apply for post-2005 tax years.

- **Tuition and fees deduction**

The above-the-line deduction for higher-education expenses isn't available for tax years beginning after 2005.

- **D.C. first-time homebuyer credit**

This credit does not apply to homes purchased after 2005.

ESTATE PLANNING CHANGES

- **Rate drop**

For gifts made and decedents dying after 2005, under EGTRRA, the top estate and gift tax rate has dropped from 47% to 46%.

■ **Estate tax exclusion**

The amount exempted from estate tax by the unified credit has increased from \$1.5 million to \$2 million.

CHANGES FOR IRAS, QUALIFIED PLANS AND NONQUALIFIED DEFERRED COMPENSATION

■ **Retirement plan contribution limits**

For tax years beginning after 2005, the following statutory increases in retirement plan contribution limits apply under EGTRRA phase-in rules:

- IRA catchup contribution, from \$500 to \$1,000;
- 401(k), 403(b), salary reduction SEPs, and Sec. 457 contributions, from \$14,000 to \$15,000;
- catchup 401(k), 403(b), salary reduction SEPs, and Sec. 457 contributions, from \$4,000 to \$5,000;
- SIMPLE catchup contribution, from \$2,000 to \$2,500.

■ **IRA deduction**

A taxpayer may be able to take an IRA deduction if he is covered by a qualified plan and his 2006 modified AGI is less than \$85,000 (was less than \$80,000 for 2005) if married filing jointly or qualifying widow(er).

■ **Designated Roth contributions**

For plan years beginning after 2005, an individual may choose to have all or part of his elective deferrals to a 401(k) plan treated as Roth-IRA contributions (designated Roth contributions) if the plan allows this choice.

■ **Cumulative limit on catch-up contributions**

For tax years beginning after 2005, the \$15,000 cumulative limit on catch-up contributions made to a 403(b) annuity plan must be reduced by designated Roth contributions made to the plan in earlier years.

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