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Key Tax Cuts Extended: Good News for Investors and Businesses

An extension of the temporary lower tax rates on dividends and capital gains is the centerpiece of a new tax package that was signed into law on May 17. The tax package also includes alternative minimum tax relief for middle-income taxpayers — also temporary — and removes future income limits for people who want to convert a traditional IRA to a Roth IRA.

The Tax Increase Prevention and Reconciliation Act of 2005 includes a host of tax-law changes affecting a diverse group that includes small-business owners, minors, and even musicians.

There is a fairly strong possibility that one or more of the provisions in this new tax package will affect you and your progress toward financial goals. Understanding some of the key provisions may help you make better decisions about your money.

• **Lower rates for capital gains and dividend income extended:** Under the previous law, capital gains and dividends were taxed at a maximum 15% rate for people in the upper marginal income tax brackets. For people in the 10% and 15% tax brackets, the tax rate on capital gains and dividends was 5% through 2007 and zero in 2008 only. The new tax law extends the effective 2008 tax rates through 2010. Without the extension, dividend income would have been taxed as ordinary income, which is subject to rates up to 35%, and capital gains would have been taxed at a maximum 20% rate beginning in 2009.

• **AMT relief:** An exemption that helped many middle-income taxpayers avoid the alternative minimum tax in 2005 has been increased and extended through 2006. The new exemption levels are $62,550 for joint filers and $42,500 for single filers. Also extended was a provision that allows some taxpayers to claim many nonrefundable personal credits to offset AMT liability. These include the dependent-care credit, the credit for the disabled and elderly, the credit for interest on certain home mortgages, and the Hope and Lifetime Learning credits for certain education expenses.

The AMT was originally designed to ensure that the wealthy don't avoid paying income tax by using certain exemptions that may not be available to people with lower incomes. Because the AMT is not indexed to inflation, it has begun to ensnare more middle-income taxpayers.

• **Roth IRA conversions:** Beginning in 2010, individuals will be able to convert a traditional IRA to a Roth IRA regardless of income or filing status. Under the previous law, only joint and single filers with an adjusted gross income of $100,000 or less were eligible to make the conversion. The new law also allows taxpayers who make the conversion in 2010 to spread the tax liability over two years.

Distributions from traditional IRAs are taxed as ordinary income and, if taken prior to reaching age 59-1/2, may be subject to an additional 10% federal income tax penalty. To qualify for the tax-free and penalty-free withdrawal of earnings, a Roth IRA must be in place for at least five tax years and the distribution must take place after age 59-1/2 or due to death, disability, or a first-time home purchase (up to a $10,000 lifetime maximum)

• **Business expensing:** For at least two more years, businesses will be allowed to deduct up to $100,000 during the first year for any investment (up to $400,000) made in depreciable assets. Had this provision not been extended, the expensing limit would have fallen after 2007 to $25,000, and the phaseout threshold would have been reduced to $200,000.

• **Other provisions:** Minors who have unearned income (such as interest or investment income) will be taxed at their parents' marginal income tax rate until age 18, up from age 14. Income from self-created musical works will now be taxed as a capital gain instead of ordinary income.

Taxes and tax-law changes can be confusing. If you have questions about how the new tax law may affect your financial situation, we can help you find answers.[1]

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