## TJAGLCS Practice Notes

### *Tax Law Note*

### Update for 2006 Federal Income Tax Returns

This note is to inform legal assistance attorneys of changes that may be relevant to military taxpayers for purposes of completing and filing taxes for the upcoming tax season and providing information to assist clients in tax planning for future tax years. Most changes are in the area of Individual Retirement Arrangements (IRAs)[1], taxation of unearned income of minors[2], and the deduction of charitable donations.[3] This note highlights the changes in the order they would appear on Internal Revenue Service (IRS) Form 1040, income tax return.

### Key Changes for 2006

#### *Expansion of IRA Options for Military Members*

Under the Heroes Earned Retirement Opportunities (HERO) Act, taxpayers who received tax-free combat pay can now use that pay to determine whether they qualify to contribute to either a Roth or traditional IRA.[4] Prior to this change, military taxpayers who received tax-free combat zone pay could not use the amount earned to determine qualification for IRA contributions.[5] Consequently, a military taxpayer who spent the entire year deployed in a combat zone was barred from contributing to an IRA.[6] Servicemembers who earned tax-free combat pay and wish to make contributions for tax year 2004 or 2005 may make contributions for those years until 28 May 2009.[7] Taxpayers wishing to make contributions for 2004 can contribute up to $3,000 (for taxpayers under the age of 50) or up to $3,500 (for taxpayers over the age of 50).[8] Taxpayers wishing to contribute for 2005 can contribute $4,000 if the taxpayer is under the age of 50 and $4,500 if the taxpayer is over the age of 50.[9] For tax year 2006, taxpayers under the age of 50 may contribute $4,000 to an IRA, while those taxpayers over the age of 50 may contribute up to $5,000.[10]

Taxpayers who make up contributions to a Roth IRA for 2004 and 2005 need not report those contributions to the IRS, because Roth IRA contributions are not deductible.[11] However, taxpayers who make up contributions to a traditional IRA must file an amended tax return, using IRS Form 1040X, whether or not the contributions are deductible.[12] Military taxpayers who make up contributions to a traditional IRA for tax years 2004 and 2005 may discover that they are entitled to additional tax refunds.[13]

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[1] I.R.C. § 408 (LEXIS 2006).

[2] *Id.* § 1(g).

[3] *Id.* § 170.

[4] Heroes Earned Retirement Opportunities Act, Pub. L. No. 109-227, 120 Stat. 385 (2006) (codified at I.R.C. § 219(f)(7) (LEXIS 2006)).

[5] I.R.C. § 219(f) (LEXIS 2005).

[6] *Id*.

[7] News Release, I.R.S., New Law Expands IRA Options for Military; Many Can Still Contribute for 2004 and 2005 (IR-2006-129, Aug. 18, 2006) [hereinafter I.R.S. News Release]

[8] Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16m, 115 Stat. 94 (2001) (codified at I.R.C. § 219(b) (LEXIS 2006)).

[9] *Id*.

[10] *Id*.

[11] I.R.C. § 408A(c) (LEXIS 2006).

[12] I.R.S. News Release, *supra* note 7.

[13] *Id*.

### *Changes in Rollover Options*

Individuals who wanted to convert a 401(k), SIMPLE, or other qualified retirement plan[14] to a Roth IRA would have to roll the amount in the qualified plan over into a traditional IRA and then convert the traditional IRA into a Roth IRA.[15] Under the Pension Protection Act of 2006, taxpayers who wish to roll funds from a qualified plan into a Roth IRA will now be able to roll those funds over directly into a Roth IRA after 31 December 2007.[16] The taxpayer need only meet the conversion qualifications.[17]

Taxpayers who rollover amounts from a qualified plan to a Roth IRA can only do so if the taxpayer's adjusted gross income is $100,000 or less.[18] The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) eliminates the adjusted gross income ceiling on rollovers to Roth IRAs in 2010.[19] Generally, amounts taxpayers rollover into a Roth IRA are taxable in the year they are transferred.[20] Under the TIPRA, however, taxpayers who rollover from a traditional or other than Roth IRA to a Roth IRA can elect to pay tax on the amounts rolled over in equal installments in 2011 and 2012.[21]

Finally, the Pension Protection Act of 2006 has changed tax treatment of rollovers to an individual retirement plan by a nonspousal beneficiary.[22] As of 1 January 2007, a nonspousal heir who inherits a qualified plan can roll the qualified plan over into his own IRA.[23] Previously, only a spouse could roll over an inherited qualified plan into his own IRA.[24]

### *IRA Distributions*

Normally, if a taxpayer takes a distribution from an IRA before the taxpayer reaches age 59½, the taxpayer will have to pay a 10% penalty for early withdrawal on the distribution, with a few exceptions.[25] The Pension Protection Act of 2006 added another exception to the 10% penalty for reservists called to active duty.[26] The change allows a member of the reserves called to active duty for more than 179 days from 11 September 2001 through to 31 December 2007, to take distributions from their IRAs without penalty.[27] The distribution must be made from IRA during the time the reservist is called to active duty.[28] The servicemember then has two years from the date of leaving active duty to re-contribute the amount withdrawn to avoid paying income tax on the distribution.[29] Those reservists who have already paid penalties resulting from a distribution received when called to active duty may receive credit or refund for overpayment of taxes, but they must file an IRS Form 1040X within a year of the Pension Protection Act's enactment, if the reservist would be otherwise precluded from filing an amended return for the refund or credit.[30]

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14 A qualified retirement plan is a plan that meets the requirements for qualification under I.R.C. § 401(a). I.R.C. § 401(a) (LEXIS 2006).

15 *Id.* § 408A(c).

16 Pub. L. No. 109-280, 120 Stat. 779 (2006).

17 120 Stat. at 824 (codified at I.R.C. § 408A(d)(3)(A)).

18 I.R.C. § 408 (c)(3)(B).

19 Pub. L. No. 109-222, 120 Stat. 345 (2006).

20 I.R.C. § 408A(c).

21 120 Stat. at 345 (codified at I.R.C. § 408A(d)(3)(A)(iii).

22 Pub. L. No. 109-280, 120 Stat. 779 (2006) (codified at I.R.C. § 402(c)(11)).

23 *Id*.

24 I.R.C. § 402(c)(9) (LEXIS 2005).

25 I.R.C. § 72(t) (LEXIS 2006). These exceptions include, for example, distributions for first-time home purchases and payments for qualified higher education expenses. *Id*.

26 Pub. L. No. 109-280, 120 Stat. 779 (2006).

27 *Id*. (codified at I.R.C. § 72(t)(2)(G) (LEXIS 2006)).

28 *Id*.

29 *Id*.

30 120 Stat. at 827.

*IRA Contributions*

The increase in the amount of contributions to an IRA under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) is now permanent.[31] The EGTRRA was set to end in 2010, taking with it the increased dollar amounts allowed for IRA contributions.[32] Starting in 2006, IRA contributions were increased from $3,000 in 2005, $4,000 in 2006, and $5,000 in 2008.[33] Under the Pension Protection Act of 2006, the increase in IRA contributions started by the EGTRRA is permanent and will be adjusted for inflation.[34]

*Unearned Income for Minors*

All children who receive unearned income are taxed on that income at the "kiddie tax" rate of 15%.[35] The Tax Increase Prevention and Reconciliation Act of 2005 has changed the age at which the "kiddie tax" rates apply.[36] Previous to this act, the "kiddie tax" only applied to the unearned income of children who were under the age of 14.[37] Under the new law, which went into effect 1 January 2006, children who are under the age of 18 receive the first $850 of unearned income tax free.[38] The second $850 of unearned income is taxed at 15%--the "kiddie tax" rate.[39] Anything over $1,700 is taxed at the parent's marginal rate.[40]

*Charitable Deductions*

For those taxpayers who deduct charitable contributions, there are now stricter requirements for the deduction of charitable donations of clothing and household items. The Pension Protection Act of 2006 amends section 170 of the Internal Revenue Code, only allowing deductions for donations of clothing and household goods if the items are in good used condition or better.[41] Items of minimal value, such as worn socks and underwear, may be denied deduction.[42] Further, the act modifies recordkeeping requirements for charitable donations of clothing and household goods.[43] A deduction will not be allowed unless the taxpayer maintains a record of the contribution, such as a bank record or a written communication from the donee organization stating the organization's name, the date of the contribution, and the amount of the contribution.[44] These changes affect contributions after 17 August 2006, the date the act was signed.[45]

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[31] 120 Stat. at 811 (codified at I.R.C. §§ 72(t), 219, 401-408).

[32] Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16m, 115 Stat. 94 (2001) (codified at I.R.C. § 219(b)).

[33] I.R.C. § 219(b).

[34] 120 Stat. at 811.

[35] I.R.C. § 1(g).

[36] Pub. L. No. 109-222, 120 Stat. 345 (2006) (codified at I.R.C. § 1(g)).

[37] I.R.C. § 1(g)(2)(A) (LEXIS 2005).

[38] 120 Stat. at 345 (codified at I.R.C. § 1(g)(2)(A) (LEXIS 2006)).

[39] I.R.C. § 1(g); Rev. Proc. 2005-70, 2005 I.R.B. 47.

[40] Rev. Proc. 2005-70, 2005 I.R.B. 47.

[41] Pub. L. No. 109-280, 120 Stat. 779 (2006) (codified at I.R.C. § 170(f)(16) (LEXIS 2006)).

[42] *Id.*

[43] *Id*.

[44] *Id.*; I.R.C. § 1217 (codified at I.R.C. § 170(f)(17)).

[45] *Id.*; I.R.C. § 1216-1217 (codified at I.R.C. §§ 170(f)(16), 170 (f)(17)).

## *Phone Credit*

Taxpayers will be able to get a refund on their 2006 federal income tax return for federal excise tax paid on long distance phone calls.[46] The refund is in response to a number of federal court decisions holding that the federal excise tax does not apply to current long-distance services.[47] The IRS is offering the refund of long-distance service taxes from 28 February 2003 through 1 August 2006.[48] Anyone who paid the long-distance service taxes during the time period will get a standard refund between $30 and $60.[49] The taxpayer will only need to fill out the line on the federal tax form pertaining to the refund (Line 71, Form 1040; Line 42, Form 1040A; Line 9, Form 1040EZ).[50] There is no need to gather up old telephone bills or fill out additional forms.[51]

## *Tax Relief and Health Care Act of 2006*[52]

On 20 December 2006, the Tax Relief and Health Care Act of 2006 was signed. This Act extends deductions that expired 31 December 2005 until 31 December 2007.[53] One of those deductions is for the state and local sales taxes enacted under the American Jobs Creation Act of 2004.[54] Consequently, for tax year 2006, taxpayers can choose between a deduction of state and local income taxes or state and local sales taxes on Form 1040, Schedule A.[55] Taxpayers should determine which deduction is more beneficial, keeping in mind that any amount of a state income tax refund must be included as income for the next tax year. As in previous years, taxpayers can either deduct the exact amount of sales tax paid based upon sales receipts or using the Optional State Sales Tax Tables, which take into consideration the taxpayer's income, state where the taxpayer resides, and the number of exemptions the taxpayer claims.[56]

Another deduction extended through 31 December 2006, was the above-the-line deduction for Qualified Tuition and Related Expenses.[57] Single taxpayers with adjusted gross incomes (AGI) that are $65,000 or less and married filing jointly taxpayers with an AGI of less than $130,000 will be able to deduct $4,000 for higher education tuition and fees.[58] An above-the-line deduction of $2,000 is available to single taxpayers with an AGI of less than $80,000 and to married filing jointly taxpayers with an AGI of less than $160,000.[59]

Finally, the Educator Expenses deduction was also extended to 31 December 2007.[60] For tax years 2006 and 2007, teachers, instructors, counselors, principals, and classroom aides who work at least 900 hours during the school year will be able to deduct up to $250 for certain out-of-pocket classroom expenses.[61] To take the deduction, the qualifying taxpayer

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[46] I.R.S., Internal Revenue Bulletin 2006-25, Notice 2006-50 Communications Excise Tax; Toll Telephone Service (June 19, 2006) [hereinafter Notice 2006-50].

[47] *Id*. (citing Am. Bankers Ins. Group v. United States, 408 F.3d 1328 (11th Cir. 2005) (ABIG); OfficeMax, Inc. v. United States, 428 F 3d 583 (6th Cir. 2005); Nat'l R.R. Passenger Corp. v. United States, 431 F. 3d 374 (D.C. Cir. 2005) (Amtrak); Fortis v. United States, 2006 U.S. App. LEXIS 10749 (2d Cir. Apr. 27, 2006); Reese Bros. v. United States, 2006 U.S. App. LEXIS 11468 (3d Cir. May 9, 2006).

[48] Notice 2006-50, *supra* note 46.

[49] News Release, I.R.S., I.R.S. Announces Standard Amounts for Telephone Tax Refunds (IR-2006-37, Aug. 31, 2006).

[50] *Id*.

[51] *Id*.

[52] Pub. L. No. 109-432, 120 Stat. 2922 (2006).

[53] *Id*.

[54] Pub. L. No. 108-359, 118 Stat. 1418 (2004).

[55] I.R.C. § 164 (LEXIS 2006).

[56] Internal Revenue Service, Form 1040, Schedule A, Instructions (2006), *available* at www.irs.gov.

[57] *See* Internal Revenue Service, Form 1040, Line 34 (2006).

[58] *See* INTERNAL REVENUE SERVICE, PUBLICATION 970, TAX BENEFITS FOR EDUCATION (2006).

[59] *Id*.

[60] Internal Revenue Service, Form 1040, Line 23 (2006).

[61] I.R.C. § 62(a)(2)(D) (LEXIS 2006); *see also* INTERNAL REVENUE SERVICE, PUBLICATION 17, YOUR FEDERAL INCOME TAX (2005).

must work in a kindergarten, elementary school, or high school and purchase classroom supplies such as pens, paper, books, and computer software.[62] Any expense exceeding the $250 threshold may be deducted as a business expense on Form 1040, Schedule A.[63]

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[62] INTERNAL REVENUE SERVICE, PUBLICATION 17, YOUR FEDERAL INCOME TAX (2005).

[63] I.R.C. § 164.

## Appendix

There are six different marginal tax brackets for tax year 2006: 10%, 15%, 25%, 28%, 33%, and 35%.[64]

1. Married Individuals Filing Joint Returns and Surviving Spouses:

| Taxable Income *Over* | *But Not Over* | Marginal Tax Rate |
|---|---|---|
| $1 | 15,100 | 10% |
| 15,100 | 61,300 | $1,510 + 15% of amount over $15,100 |
| 61,300 | 123,700 | $8,440 + 25% of amount over $61,300 |
| 123,700 | 188,450 | $24,040 + 28% of amount over $123,700 |
| 188,450 | 336,550 | $42,170 + 33% of amount over $188,450 |
| 336,550 | | $91,043 + 35% of amount over $336,550 |

2. Unmarried Individuals (other than Surviving Spouses and Heads of Households):

| Taxable Income *Over* | *But Not Over* | Marginal Tax Rate |
|---|---|---|
| $1 | 7,550 | 0% |
| 7,500 | 30,650 | $755 + 15% of amount over $7,550 |
| 30,650 | 74,200 | $4,220 + 25% of amount over $30,650 |
| 74,200 | 154,800 | $15,107.50 + 28% of amount over $74,200 |
| 154,800 | 336,550 | $37,675.50 + 33% of amount over $154,800 |
| 336,550 | | $97,653 + 35% of amount over $336,550 |

3. Heads of Households:

| Taxable Income *Over* | *But Not Over* | Marginal Tax Rate |
|---|---|---|
| $1 | 10,750 | 10% |
| 10,750 | 41,050 | $1,075 + 15% of amount over $10,750 |
| 41,050 | 106,000 | $5,620 + 25% of amount over $41,050 |
| 106,000 | 171,650 | $21,857.50 + 28% of amount over $106,000 |
| 171,650 | 336,550 | $40,239.50 + 33% of amount over $171,650 |
| 336,550 | | $94,656.50 + 35% of amount over $336,550 |

4. Married Individuals Filing Separate Returns:

| Taxable Income *Over* | *But Not Over* | Marginal Tax Rate |
|---|---|---|
| $1 | 7,550 | 10% |
| 7,550 | 30,650 | $755 + 15% of amount over $7,550 |
| 30,650 | 61,850 | $4,220 + 25% of amount over $30,650 |
| 61,855 | 94,225 | $12,020 + 28% of amount over $61,850 |
| 94,225 | 168,275 | $21,085 + 33% of amount over $94,225 |
| 168,275 | | $45,521.50 + 35% of amount over $168,275 |

5. Estates and Trusts:

| Taxable Income *Over* | *But Not Over* | Marginal Tax Rate |
|---|---|---|
| $1 | $2,050 | 15% |
| 2,050 | 4,850 | $307.50 + 25% of amount over $2,050 |
| 4,850 | 7,400 | $1,007.50 + 28% of amount over $4,850 |
| 7,400 | 10,050 | $1,721.50 + 33% of amount over $7,400 |

[64] I.R.C. § 1(a)-(d), (i)(2); Rev. Proc. 2005-70, 2005 I.R.B. 47.

| | |
|---|---|
| 10,050 | $2,596 + 35% of amount over $10,050 |

The 2006 Standard Deduction amounts are:

Married filing jointly or qualifying widow(er) – $10,300.
Single – $5,150.
Head of household – $7,500.
Married filing separately – $5,150.[65]

Reduction of Itemized Deductions. (I.R.C. § 68) Otherwise allowable itemized deductions are reduced if AGI in 2006 exceeds:

Married filing separately - $75,250.

All other returns - $150,500.[66]

The 2006 Personal Exemptions are:

Personal exemption deduction – $3,300.

2006 Phase Out Amounts for personal exemptions

| Taxpayer | Begins After | Fully Phased Out* |
|---|---|---|
| Married filing jointly | $225,750 | $348,250 |
| Single | $150,500 | $273,000 |
| Head of household | $188,150 | $310,650 |
| Married filing separately | $112,875 | $174,125[67] |

*Phase-out occurs at rate of 2% for each $2,500 or part of $2,500 ($1,250 in both cases for married filing separately) by which the taxpayer's adjusted gross income exceeds the "Begins After" amount.

[65] *Id.*

[66] *Id.*

[67] *Id.*