

Triple the Taxes for Some Teenagers — New Law Changes Approach to College Savings

by David Beringer, Partner

The new, recently signed tax law can triple the effective tax rate on teenagers and throws a wrench into college saving strategies.

Some background

One of the options available to save for a child's college education is to establish a custodial account sometimes referred to as a minor's (UGMA or UTMA) account. These accounts offer a tax break because the first \$850 of investment income and gains is tax free and the next \$850 is taxed at the child's rate (typically the lowest tax rates available).

Under the old law, if a child was younger than 14 years of age, any investment income and gains above the \$1,700 were subject to "kiddie tax," subject to the parent's tax rate and required a separate tax return to be filed for the child or the attachment of the puzzling Form 8814 to the parent's return.

However, once the child turned 14 years old, the kiddie tax rules disappeared and even income above the threshold was taxed at the minor's low tax bracket, not the parent's.

This caused people to delay shifting assets to their kids until their 14th birthday and motivated parents to "game" the kiddie tax by waiting until then to sell appreciated stocks and securities.

New law

Well, gaming of the kiddie tax is over, because *teenagers ages 14 to 17 with investment income will now be taxed at the same rate as their parents, not at their own rates.*

In addition to extending the age, the law is retroactive to January 1, 2006 so those executing sales and incurring investment income above \$1,700 for children ages 14 to 17 will pay higher taxes than they had expected.

Long-term gains that had been taxed at 5 percent will now be taxed at 15 percent. Interest that had been taxed at 10 percent will now be taxed at as much as 35 percent.

Also, the strategy of incrementally selling appreciated securities and mutual funds over the four years leading up to college is dealt a blow. The new law narrows the window in which you are motivated to incur gains, and you could be executing a sale after the child turns 18 years old (when funds are needed for college), yet selling into a bear market.

Planning and solutions

- Avoid incurring gains until age 18.
- Convert some of the securities to

cash and invest the proceeds in a 529 plan where future income and gains are sheltered from tax. Moving assets out of a minor's account into a 529 plan will help for financial aid purposes also.

- Continue with some balance in the custodial account, but invest in tax efficient stock funds, such as index funds and tax managed funds that work to minimize income

thrown off of the fund. Also, tax exempt bond funds may make sense, depending on the level of income earned.

- Read up on the best way to structure a child's assets in anticipa-

tion of applying for financial aid. Saving in the parents' names will involve higher taxes but may boost your child's chances of getting financial aid. The savingforcollege.com Web site can give you a lot of guidance in this area and lay out the interplay of parent's accounts, custodial accounts and 529 plans.

I know it didn't seem possible: President George W. Bush and Congress raising taxes and on teenagers nonetheless! It is hoped that we've given you some direction to lower the tax hit.

*Some may pay
higher taxes
than expected
for this year*

More on the New Tax Law—

How Parts of Legislation Impact Individuals

by David Beringer, Partner

Congress recently passed the Tax Increase Prevention and Reconciliation Act (Tax Reconciliation Act). Tax legislation is always complicated and the new tax cut package that Congress just passed is no exception.

We know that you've heard a lot about the new tax cuts. We want to take a bit of space here to explore some of the important tax incentives in the new law.

Dividends and capital gains

Three years ago Congress gave investors a valuable tax break when it reduced the maximum dividend tax rate from a high of 35 percent (depending on income tax bracket) to 15 percent and the maximum capital gains tax rate from 20 percent to 15 percent.

Congress also created a lower rate of 5 percent for taxpayers in the 15 percent and 10 percent brackets.

The AMT ensnares many middle-income taxpayers

However, the rate reductions were temporary. As originally enacted in 2003, they were scheduled to expire on December 31, 2008.

The Tax Reconciliation Act extends the reduced rates for two more years. Under the new law, you can take advantage of the lower dividend and capital gains tax rates through December 31, 2010.

The two-year extension opens the door to many tax planning opportunities. Because of the extension, you now are able to take a significantly longer view on long-term investments.

Our office can help you review your portfolio and make some important strategic decisions on how to maximize your tax savings because of the extension.

Kiddie tax

See separate article on page 1 of this newsletter.

AMT relief

The alternative minimum tax (AMT) is quickly becoming the "regular" tax for many two-income couples with children and others supporting large families. The AMT was originally intended to prevent very wealthy individuals from evading taxes. That was more than 30 years ago.

Because the AMT was not indexed for inflation and because of some other factors, it now ensnares many middle-income taxpayers.

Congress could make some fundamental changes to the AMT so it goes back to its original purpose. So far, it has not; it is too used to the tremendous tax revenues that the AMT brings in.

Instead, however, Congress has

given taxpayers some temporary relief designed to cushion the blow of the AMT by raising the AMT exemption levels. However, this relief is not significant, and the AMT will continue to suck in more taxpayers in the absence of meaningful reform.

Roth IRAs

Roth IRAs, like traditional IRAs, are excellent vehicles to save for retirement. They also have many rules that impact how much you can save and when you can withdraw your savings.

Under current rules, individuals with modified adjusted gross incomes of more than \$100,000 could not convert a traditional IRA to a Roth IRA. The Tax Reconciliation Act removes this limitation starting in 2010.

Even though 2010 is four years away, now is the time to start considering a Roth IRA conversion. You should consider possibly rolling over 401(k) balances to IRAs when leaving employment or starting traditional IRAs, which you will convert to Roth IRAs.

Although contributions to a Roth IRA are not tax deductible, unlike contributions to a traditional IRA, your savings in a Roth IRA grow tax-free.

Give our office a call to learn more about converting a traditional IRA to a Roth IRA. In most

cases, conversion makes sense only if there are adequate funds outside of the IRA to pay the income taxes on the conversion. Many experts say this conversion provision will be repealed before 2010 because it will lower tax revenue over the long term.

If you have any questions about these valuable new tax cuts, give our office a call. We can explore in much more detail how some of them could result in future tax savings for you.

Savings in a Roth IRA grow tax-free



Medicare Surcharges— Escalated Monthly Premium Starts in 2007

by Priscilla Bintoro
Senior Accountant

Lost in all the conversation and media coverage for its prescription drug plan is the fact that Medicare will ring in the 2007 new year with, what is in reality, a *new tax on "upper-income" seniors*.

Retirees with incomes that exceed \$160,000 in 2005 (\$80,000 for those who are single) will be hit with an escalated monthly Medicare B premium in 2007. The increases will range from 13 percent to 73 percent, depending on the income level. The monthly surcharge doesn't stop there, as the percentages will double in 2008 and triple in 2009.

Will you be affected? Go to your 2005 tax return and find your 2005 adjusted gross income (Form 1040, line 37). Then add tax exempt interest (Form 1040, line 8b) to the AGI to determine your "modified AGI" and see if you exceed the income threshold. If you exceed the threshold, you'll pay the surcharge. (See the table that follows in this article).

Just as it does for your Social Security benefits, your tax planning and investment mix will have a direct effect on your Medicare premium and will decrease the rate of

return from tax exempt income. Tax exempt income increases the tax exposure of your Social Security benefits and can now push you into paying a higher Medicare premium.

Other information to note:

- The Social Security Administration (SSA) will administer the surcharge based on information gathered from the IRS.
- The SSA will notify Medicare beneficiaries of the increase by the end of 2006.
- The surcharge is above and beyond the premium increases tied to cost of living adjustments.
- The surcharge is owed even if the beneficiary doesn't enroll in the prescription drug program.
- Married couples who are both Medicare beneficiaries will pay



Priscilla Bintoro

double the surcharge because it applies to each person.

Also, with interplay now between the SSA and the IRS in determining the surcharge, a taxpayer who files an amended tax return that reduces the taxpayer's federal AGI may request a redetermination of their surcharge amount.

Finally, a redetermination is allowed for a major life-changing event, such as death of spouse, divorce, retirement, and so on.

Integrating the taxpayers' AGI with their Medicare premiums basically amounts to another "stealth tax" for which revenue is included (Social Security benefits, tax exempt income) and deductions are limited (medical, miscellaneous and so on) based on a taxpayer's unique mix of income and expenses.

2007 Monthly Surcharge Adjustment

Percent	13.3%	33.3%	53.3%	73.3%
If Single & 2005 Modified AGI is	80 to 100K	100K-150K	150K-200K	200K +
If Married Joint & 2005 Modified AGI is	160K-200K	200K-300K	300K-400K	400K +

529 PLANS —

Mutual Fund Ranking Reveals Top Performers

by David Beringer, Partner

Morningstar, which ranks mutual funds, issued its best and worst of 529 plans earlier this year, based on factors including quality and flexibility of investments, costs, asset allocation and shareholder stewardship.

Top choices for investors using a financial adviser:

- Virginia College American, run by American Funds
- Colorado Scholars Choice, run by Legg Mason

Top choices for consumers who invest directly:

- Alaska T. Rowe Price College Savings Plan
- Utah Education Savings Plan

Reminder:

A California resident may invest in another state plan.

California's Scholar Share program fell somewhere in the middle of the list, and its manager, TIAA – CREF, had come under fire for lackluster performance and increasing fees on

its mutual funds.

However, the state is in negotiation with Fidelity Investments to take over the program management and develop both a broker-sold plan and direct-sold plan. Program fees are expected to be lower under Fidelity, and they will provide a wider range of investment options.

Those plans deemed the worst performers were Alabama, Arizona, Nebraska, North Dakota and Wyoming.



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Most frequent names for 2005 births — boy: Jacob; girl: Emily.

— Inside This Issue —

Triple Teen Taxes	1	Medicare Surcharges	3
New Tax Law Impact	2	Top Performing Funds	3

Small Tax Exempts —
Annual Filings a Consideration

by **Jaclyn Chng**
Senior Accountant

Small tax-exempt organizations sometimes find themselves in a quandary with unfiled annual exempt organization tax return Forms 990 or 990-EZ. Organizations with annual receipts of \$25,000 or less should consider filing annual returns even though they are not required to do so.

• An organization that initially is exempt from filing will become liable for filing when its average gross receipts increase beyond \$25,000. However, the persons responsible for the organization's operations (usually hard working, dedicated individual volunteer board members) may not be aware of the need to file a return because, "Gee, we never filed one before." Penalties for not filing a required

return can reach up to 5 percent of gross receipts.

• An organization seeking grants and substantive donations may be required to present a current tax return filed with the IRS.

• Adequate disclosure on an IRS Form 990 or 990-EZ will start the statute of limitations for a variety of exempt organization tax issues, such as unrelated business income.

• The filing of a return is good business practice and forces the development and maintenance of adequate accounting records and procedures.

Sure, there is a preparation cost involved, but if good records are maintained, the cost should not be significant. Also, if a return is filed it becomes a public document and must be furnished to anyone who requests a copy of it.

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David P. Beringer, Editor
Send comments or suggestions
for this newsletter to
dberinger@mwco.com

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