6 1996 Tax Legislation

Included in this chapter are the significant tax provisions of the Small Business Jobs Protection Act of 1996 [August 20, 1996], the Health Insurance Portability and Accountability Act of 1996 [August 21, 1996], the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 [August 22, 1996], and the Taxpayer Bill of Rights 2 [July 30, 1996].

The TRA of 1997 impacts many of the provisions.

Provisions Applicable for the First Time in 1996 and Before

Individuals

1. Personal Injury and Sickness Damage Awards

[I.R.C. §104, Small Business Act §1605]

[Effective for amounts received after August 20, 1996, in tax years ending after August 20, 1996]

Explanation of Provisions. **The Act provides that the exclusion from gross income "does not apply" to any punitive damages received on account of personal injury or sickness whether or not related to a physical injury or physical sickness.**

- Under the Act, prior law continues to apply to punitive damages received in a **wrongful death action** if the applicable state law (as in effect on September 13, 1995) provides, or has been construed to provide, that only punitive damages may be awarded in a wrongful death action.
- **The Act provides that the exclusion from gross income only applies to damages received on account of a personal physical injury or physical sickness.**
- If an action has its **origin** in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness, whether or not the recipient of the damages is the injured party.

- **For example,** damages (other than punitive damages) received by an individual on account of a claim for loss of consortium due to the physical injury or physical sickness of such individual's spouse **are excludable** from gross income.
- In addition, damages (other than punitive damages) received on account of a claim of **wrongful death** continue to be **excludable** from taxable income as under prior law.
- **The Act also specifically provides that emotional distress is not considered a physical injury or physical sickness.** Thus, the exclusion from gross income **does not apply** to any damages received (other than for medical expenses as discussed below) based on a claim of employment discrimination or injury to reputation accompanied by a claim of emotional distress.
- **Because all damages received on account of physical injury or physical sickness are excludable from gross income, the exclusion from gross income applies to any damages received based on a claim of emotional distress that is attributable to a physical injury or physical sickness.**
- In addition, the exclusion from gross income **specifically applies to** the amount of damages received that is not in excess of the amount paid for medical care attributable to emotional distress.

Summary of Prior and New Law

Type of Damage Award	Treatment under Prior Law	Treatment under New Law
Compensatory damages for physical injury or sickness	Excluded from income	Excluded from income
Punitive damages for physical sickness or injury	Courts disagree	Not excluded from income
Compensatory damages for nonphysical injury or sickness	Sometimes excluded from income	Not excluded from income
Punitive damages for nonphysical injury or sickness	Not excluded from income	Not excluded from income
Punitive damages under certain wrongful death statutes	No cases	Excluded from income
Costs of medical care for emotional distress	No cases	Excluded from income

2. Earned Income Credit: Exclusion of Individuals Not Authorized to Work in U.S.

[I.R.C. §32, Welfare Reform Act §451]

[**Effective for returns that are due (without regard to extensions) after September 21, 1996.**]

Individuals are not eligible for the credit if they do not include their social security numbers on their tax returns. This makes individuals who are not authorized to be employed in the United States ineligible for the earned income credit.

3. Earned Income Credit: Investment Income Disqualification

[I.R.C. §32, Welfare Reform Act §909]

[**Effective for tax years beginning after December 31, 1995. For individuals who, as of June 26, 1996, had made an election to receive current year credit on an advance basis, the provision is effective for taxable years beginning after December 31, 1996.**]

Prior Law. Taxpayers were denied the earned income tax credit if they had disqualified income of $2,350 or more. **Disqualified income included interest, dividends, and net income from rents and royalties.**

Explanation of Provisions. The new law makes **two changes** to the disqualification rules:

1. The investment income threshold that disqualifies a taxpayer for the earned income credit **is reduced** from $2,350 to $2,200. [The threshold is indexed based on the consumer price index for tax years beginning after 1996.]
2. **Capital gain net income and net passive activity income are added** to the definition of disqualified income.

The IRS has interpreted the term "capital gain net income" to include some gains from the sale of assets used in a trade or business, such as land, buildings, equipment, and livestock. The gains that are included by the IRS interpretation are those from the sale of assets that satisfy the holding period requirement of I.R.C. §1231 (more than a year for most assets, 12 months or more for livestock other than cattle and horses, and 24 months for cattle and horses) **and are not subject to the recapture rules of Sections 1245** (depreciation recapture on personal property), 1250 (depreciation recapture on real property), **1252** (recapture of soil and water conservation expenses), 1254 (recapture of depletion), or 1255 (recapture of excluded cost sharing expenses.).

Practitioner Note.

The maximum amount of the earned income credit for 1997 is more than it was in 1996. The most a taxpayer can receive in 1997 is:

- $2,210 with one qualifying child,
- $3,656 with more than one qualifying child, or
- $332 without a qualifying child.

Earned Income Is More. The amount a taxpayer can earn in 1997 and still get the earned income credit is more than it was in 1996. The amount that can be earned in 1997 must be less than:

- $25,760 with one qualifying child,

- $29,290 with more than one qualifying child, or
- $9,790 without a qualifying child.

4. Earned Income Credit: Phase-Out Based on Modified AGI (Rather than AGI)

[I.R.C. §32, Welfare Reform Act §909]

[**Effective for tax years beginning after December 31, 1995. For individuals who, as of June 26, 1996, had made an election to receive current year credit on an advance basis, the provision is effective for taxable years *beginning after December 31, 1996.***]

Explanation of Provision. The new law uses **modified adjusted gross income in place of adjusted gross income.** Modified adjusted gross income is defined as adjusted gross income determined without regard to

1. Losses from the sale or exchange of capital assets in excess of gains from such sales or exchanges [up to the $3,000 limit ($1,500 on a married filing separate return)]
2. Net losses from estates and trusts
3. Net losses from rents or royalty activities
4. 50% of the net loss from carrying on a trade or business, computed separately with respect to
   a. Trades or businesses (other than farming) conducted as a sole proprietorship
   b. Trades or businesses of farming conducted as a sole proprietorship
   c. Other trades or businesses

Practitioner Note.

For purposes of the above rules, amounts attributable to a business that consist of compensation for the performance of services by the taxpayer as an employee are not taken into account.

Example. Jake earned $40,000 as an employee of a parcel delivery service in 1996. His farming business operated as a sole proprietorship showed a net loss of $30,000. His share of partnership profits from a partnership that sells T-shirts was $5,000.

To calculate modified adjusted gross income, Jake does not treat his employment income as being from a trade or business. His losses from his farming business and his income from the T-shirt partnership are treated separately. Therefore, Jake must add $15,000 ($30,000 ÷ 2) to his adjusted gross income to determine his modified adjusted gross income for purposes of the earned income credit phase-out.

Note: For tax years beginning after 1997 the **TRA of 1997** modifies these rules. See that chapter in this book.

S and C Corporations

5. Reelecting S Status

[I.R.C. §1362, Small Business Act §1317]

[Effective Date. The provision is effective for terminations occurring in taxable years beginning *before* January 1, 1997.]

Prior Law. A small business corporation that terminated its subchapter S election (whether by revocation or otherwise) could not make another election to be an S corporation for five taxable years unless the Secretary of the Treasury consented to such election.

New Law. For purposes of the five-year rule, any termination of subchapter S status **in effect immediately before the date of enactment** [August 20, 1996] is not to be taken into account. Thus, any small business corporation that had terminated its S corporation election **within** the five-year period before the date of enactment may reelect subchapter S status **without** the consent of the Secretary of the Treasury.

6. Adjustments to Basis of Inherited S Stock to Reflect Certain Items of Income

[I.R.C. §§1367, 691, 1014; Small Business Act §1313]

[Effective Date. The provision applies with respect to decedents dying after August 20, 1996.]

- The act provides that a person acquiring stock in an S corporation from a decedent **would treat** as IRD his or her pro rata share of any item of income of the corporation that would have been IRD if that item had been acquired directly from the decedent.
- Where an item is treated as IRD, a deduction for the estate tax attributable to the item generally will be allowed under the provisions of §691(c).
- The stepped-up basis in the stock in an S corporation acquired from a decedent **is reduced** by the extent to which the value of the stock is attributable to items consisting of IRD.
- This basis rule is comparable to the present-law partnership rule.

7. Rules Relating to Inadvertent Terminations and Invalid Elections—S Corporations

[I.R.C. §1362, Small Business Act §1305]

[Effective Date. **Taxable years beginning after December 31, 1982.]**

New Law

- Under the act, the authority of the IRS to waive the effect of an inadvertent termination is **extended** to allow the Service to **waive the effect of an invalid election** caused by an inadvertent failure to qualify as a small business corporation or to obtain the required shareholder consents (including elections regarding qualified subchapter S trusts), or both.
- The provision also allows the IRS to treat a late subchapter S election as timely where the Service determines that there was reasonable cause for the failure to make the election timely.
- The IRS may exercise this authority in cases where the taxpayer never filed an election.
- It is intended that the IRS be reasonable in exercising this authority and apply standards that are similar to those applied under present law to inadvertent subchapter S terminations and other late or invalid elections.

Announcement 97-4: Inadvertent Invalid S Elections and Late S Elections

I. Late Subchapter S Elections

A small business corporation must elect to be an S corporation no later than the 15th day of the third month of the taxable year for which the election is effective. Under prior law, the IRS did not have the authority to validate a late election.

New §1362(b)(5) of the Code allows the Secretary to treat an election to be an S corporation as timely filed if either the election is made after the date prescribed or no such election was made, provided the Secretary determines there was reasonable cause for the failure to timely file the S election.

Generally, in order to obtain relief under §1362(b)(5) of the Code, a taxpayer must receive a private letter ruling from the IRS. The procedural requirements for requesting a ruling are described in Revenue Procedure 97-1, 1997–1 I.R.B. But see Rev. Proc. 97-40 for special relief.

II. Inadvertent Invalid S Corporation Elections

Under prior law, if the IRS determined that a corporation's subchapter S election was inadvertently terminated, the IRS could waive the effect of the terminating event for any period if the corporation timely corrected the event and if the shareholders agreed to be treated as if the election had been in effect for that period. Such waivers generally are obtained through the issuance of a private letter ruling. Prior law did not grant the IRS the ability to waive the effect of an inadvertent invalid subchapter S election.

New §1362(f) of the Code applies the inadvertent termination relief rules in situations where an election by a corporation to be treated as a small business corporation was invalid due to a failure to meet the requirements of an S corporation found in §1361(b) or to obtain all of the shareholder consents.

Generally, in order to obtain relief for inadvertent invalid elections, the corporation must request a private letter ruling from the IRS. Sections 1.1362-4(c) through (f) of the Income Tax Regulations provide rules for corporations requesting inadvertent termination relief under §1362(f). These rules will also apply to corporations requesting inadvertent invalid election relief.

In situations where taxpayers fail to obtain all of the necessary shareholder consents on Form 2553, §1.1362-6(b)(3)(iii) provides rules for obtaining §1362(f) relief from the district director or director of the service center with which the corporation files its income tax return.

Rev. Proc. 97-40

This revenue procedure provides guidance under §1362(b)(5) of the Internal Revenue Code for requesting relief for late S corporation elections that are filed within 6 months of the due date of the election.

Section 3. Scope

This revenue procedure provides a special procedure to request relief for a late S corporation election.

This revenue procedure applies only to a corporation (1) that has not filed a timely S corporation election under §1362(a)(1), and (2) for which an S corporation election is filed within 6 months of the original due date for the election. This revenue procedure does not provide relief for late shareholder elections including a qualified subchapter S trust (QSST) election or electing small business trust (ESBT) election. **This special procedure is in lieu of the letter ruling procedure that is used to obtain relief for a late S corporation election under §1362(b)(5). Accordingly, user fees do not apply to corrective action under this revenue procedure.** A corporation that is not eligible for relief under this revenue procedure, or is denied relief, may request relief by applying for a private letter ruling. The procedural requirements for requesting a private letter ruling are described in Rev. Proc. 97–1, 1997-1 I.R.B. 11 (or its successor).

Section 4. Relief for Late S Corporation Elections under This Revenue Procedure

.01 *Eligibility for Relief.* A corporation is eligible for relief if it meets the following requirements:

(1) The corporation fails to qualify as an S corporation solely because the Form 2553 (Election by a Small Business Corporation) **was not filed timely** pursuant to §1362(b)(1); and

(2) **the due date for the tax return (excluding extensions) for the first year the corporation intended to be an S corporation has not passed.**

.02 *Procedural Requirements for Relief.* Within 6 months of the original due date for the S corporation election, the corporation must file with the applicable service center a completed Form 2553, signed by an officer of the corporation authorized to sign and all persons who were shareholders (or deemed to have been shareholders) at any time during the period that began on the first day of the taxable year for which the election is to be effective and ends on the day the election is made. The Form 2553 must state at the top of the document "FILED PURSUANT TO REV. PROC. 97-40." Attached to the Form 2553 must be a statement explaining the reason for the failure to file a timely S corporation election.

.03 *Relief for Late S Corporation Elections.* Upon receipt of a completed application requesting relief under this revenue procedure, the Internal Revenue Service will determine if there was a reasonable cause for the failure to file a timely S corporation election and will notify the corporation of the result of the reasonable cause determination.

Section 5. Effective Date

This revenue procedure is effective for all applications for relief satisfying the requirements of section 4 of this revenue procedure, including those applications now being considered by the Service.

Other Qualified Plans

8. Retirement Benefits of Ministers Not Subject to Tax on Net Earnings from Self-Employment

[I.R.C. §1402, Small Business Act §1456]

[Effective Date. **The provision is effective for years beginning before, on, or after December 31, 1994.]**

Explanation. The act provides that retirement benefits received from a church plan after a minister retires, and the rental value of a parsonage (including utilities) furnished to a minister after retirement, **are not** subject to self-employment taxes.

9. Pension Plans: Prohibited Transactions Excise Tax Increased

[I.R.C. §4975, Small Business Act §1453]

[**Effective for prohibited transactions after August 20, 1996 through August 5, 1997.**]

Prior Law. Prior law prohibits certain transactions (prohibited transactions) between a qualified plan and a disqualified person in order to prevent persons with a close relationship to the qualified plan from using that relationship to the detriment of plan participants and beneficiaries. A two-tier excise tax is imposed on prohibited transactions. The initial level tax is equal to 5% of the amount involved with respect to the transaction. If the transaction is not corrected within a certain period, a tax equal to 100% of the amount involved may be imposed.

Explanation of Provision. The Act increases the initial-level prohibited transaction tax from 5% to 10%.

The tax is increased to 15% after August 5, 1997, by TRA 1997.

10. Pension Plans: Exemptions from Prohibited Transaction Rules

[I.R.C. §4975, Small Business Act §1702]

[**Effective 1-1-1975**]

Explanation of Provision. The Act conforms the statutory language to legislative intent by providing that transactions that are exempt from the prohibited transaction rules of ERISA by reason of ERISA §408(b)(12) **are also exempt** from the prohibited transaction rules of the Code.

IRA and Pension Plan Distributions

11. Taxation of Annuity Distributions Simplified

[I.R.C. §72(d), Small Business Act §1403(a)]

[Effective Date. Annuity starting dates beginning 90 days after August 20, 1996.]

Present Law. Under a simplified alternative method provided by the IRS, the taxable portion of qualifying annuity payments is determined under a **simplified exclusion ratio method** [see IRS Notice 88-118].

New Law. The act provides that basis recovery on payments from qualified plans generally is determined under a method similar to the present-law simplified alternative method provided by the IRS. The portion of each annuity payment that represents a return of basis is equal to the employee's total basis as of the annuity starting date, divided by the number of anticipated monthly payments under the following table:

Age	Number of Payments (Monthly)
Not more than 55	360
56--60	310
61--65	260
66--70	260

More than 70	160

See TRA 1997 chapter for the table that applies to benefits based on the life of more than one annuitant.

Note: Amended I.R.C. §72(d)(1)(E) creates an exception to this method for annuitants who are 75 or older on the annuity's starting date.

For additional information and examples, also see **IRS Pub. 575.**

12. Repeal of $5,000 Death Benefit

[I.R.C. §101(b), Small Business Act §1402(a)]

[Effective Date. **For decedents dying after August 20, 1996, the benefit exclusion is repealed.]**

Explanation. Under prior law, the beneficiary or estate of a deceased employee generally could exclude up to $5,000 in benefits paid by or on behalf of an employer by reason of the employee's death or to a distribution from a self-employed person's Keogh plan.

New Law. The $5000 death benefit exclusion is repealed.

Note: Death benefits paid under qualified plans will now be eligible for a tax-free rollover to another qualified plan or an IRA.

Business and Employment Related Deductions and Credits

13. Home Office Deduction—Product Sample Storage

[I.R.C. §280A, Small Business Act, §1113]

[Effective Date. **Taxable years beginning after December 31, 1995.]**

Explanation of Provision. The act clarifies that the special rule contained in prior-law §280A(c)(2) permits deductions for expenses related to a storage unit in a taxpayer's home regularly used for **inventory or product samples** (or both) of the taxpayer's trade or business of **selling products at retail or wholesale,** provided that the home is the **sole fixed location** of such trade or business.

14. Disposal of Leasehold Improvements at Termination of Lease

[I.R.C. §168(i)(8), Small Business Act §1121(a)]

[Effective Date. **The provision is effective for leasehold improvements disposed of after June 12, 1996.]**

Explanation of New Law. The act provides that a lessor of leased property that **disposes of** a leasehold improvement **that was made by the lessor for the lessee of the property** may take the adjusted basis of the improvement into account for purposes of determining gain or loss if the improvement is **irrevocably** disposed of or **abandoned by** the lessor at the termination of the lease. [The provision thus conforms the treatment of lessors and lessees with respect to leasehold improvements disposed of at the end of a term of lease.]

The provision does not apply to the extent §280B applies to the demolition of a structure, a portion of which may include leasehold improvements. **[This portion must be capitalized.]**

15. Gasoline Convenience Store Depreciation

[I.R.C. §168, Small Business Act §1120]

[**Effective for MACRS property placed in service on or after August 20, 1996. The taxpayer may elect the application of the provision for property placed in service prior to the date of enactment. If a taxpayer has already treated qualified property that was placed in service before the date of enactment as 15-year property, the taxpayer will be deemed to have made the election with respect to such property.**]

Rev. Rul. 97-29

Section 168.—Accelerated Cost Recovery System **Retail motor fuels outlet.** A retail motor fuels outlet is 15-year property for depreciation purposes whether or not the taxpayer-owner is the operator of the motor fuels business.

Issue

If a taxpayer is the owner, but not the operator, of a retail motor fuels outlet, is the outlet 15-year property for depreciation purposes under §168(e)(3)(E) of the Internal Revenue Code?

Facts

A retail motor fuels outlet may be owned by one entity and operated by another entity. Often, the owner of the property leases the property to an operator. In addition, businesses other than the motor fuels business may operate in the same building. For example, an outlet building may contain a restaurant or video arcade. These businesses may be owned and operated by different taxpayers that make payments to the owner of the outlet building or to a sublessor.

Law and Analysis

Section 1120 of the Small Business Job Protection Act of 1996 (the Act), amended §168(e)(3)(E) to provide that 15-year property includes any §1250 property that is a retail motor fuels outlet whether or not food or other convenience items are sold at the outlet. The legislative history of the Act provides that property will qualify as a retail motor fuels outlet if 50% or more of the gross revenues generated from the property are derived from petroleum sales, or 50% or more of the floor space in the property is devoted to petroleum marketing sales. A motor fuels outlet of 1,400 square feet or less qualifies as a retail motor fuels outlet under the Act without application of either 50% test. **S. Rep. No. 281 (1996).**

Section 168(e)(3)(E) provides that any §1250 property that qualifies as a retail motor fuels outlet is 15-year property. There is no distinction between an owner of a retail motor fuels outlet that also operates the motor fuels business and an owner that does not operate the motor fuels business. Accordingly, §1250 property the use of which meets the definition of a retail motor fuels outlet is treated as 15-year property for depreciation purposes whether or not the owner is the operator. In applying the 50% gross revenues test to determine if the property qualifies as a retail motor fuels outlet, the owner of an outlet building **must aggregate the gross revenues of all businesses operated** in the outlet building **whether or not** such businesses are operated by the owner.

Holding

A retail motor fuels outlet is 15-year property for depreciation purposes under §168(e)(3)(E) whether or not the taxpayer-owner is the operator of the motor fuels business.

16. Research Tax Credit

[I.R.C. §§41, 174, 280C, 501, 52, 6654, 6655; Small Business Act §1204]

[Effective Date. Extension of the research tax credit is effective for expenditures paid or incurred during the period July 1, 1996, through May 31, 1997 (with a special rule for taxpayers who elect the alternative incremental research credit regime).]

The research tax credit has been further extended. See the TRA 1997 chapter.

17. Work Opportunity Tax Credit

[I.R.C. §51, Small Business Act §1201]

[Effective date. **Wages paid or incurred to a qualified individual who begins work for an employer after September 30, 1996, and before October 1, 1997.]**

See the TRA 1997 chapter. The credit has been extended and modified.

18. Employer-Provided Educational Assistance

[I.R.C. §127, Small Business Act §1202]

See the TRA 1997 chapter for provisions that further extend the provision.

[**Effective for taxable years beginning after December 31, 1994, and before May 31, 1997. In the case of taxable years beginning in 1997, only the expenses paid with respect to courses beginning before July 1, 1997, are excluded from income.**]

Sales and Exchanges

19. Application of Involuntary Conversion Rules to Property Damaged as a Result of Presidentially Declared Disasters

[I.R.C. §1033, Small Business Act §1119]

[Effective Date. **The provision is effective for disasters for which a Presidential declaration is made after December 31, 1994, in taxable years ending after that date.]**

If **business or investment** property is involuntarily converted as a result of a presidentially declared disaster, the more restrictive **related or similar in use test** for replacement property may be ignored. Instead, the **replacement property** may be **any tangible business property.**

Example. A movie theater is destroyed by a Florida hurricane in 1995 or a later year. Under the **old law,** it could **not** be replaced by a restaurant without recognition of the realized gain. But under the **new law,** it can for presidentially declared disasters that occur in 1995 or later years. **Why?** Because the restaurant structure (replacement property) is **tangible business property.** The replacement property does **not** have to be **related or similar in use** to the movie theater as under the **old law.**

20. Clarification of Passive Loss Disposition Rule

[I.R.C. §469(g)(1)(A), Small Business Act §1805(b)]

[Effective Date. **Taxable years beginning after December 31, 1986.]**

Prior Law

- The Tax Reform Act of 1986 ("1986 Act") provided that if a passive activity is disposed of in a transaction in which all gain or loss is recognized, any overall loss from the activity in the year of disposition is recognized and allowed against income (whether active or passive income).
- The language of the 1986 Act provided that any loss was allowable, **first,** against income or gain from the passive activity, **second,** against income or gain from all passive activities, and **finally,** against any other income or gain.
- This rule was rewritten by the technical corrections portion of the Technical and Miscellaneous Revenue Act of 1988 ("1988 Act").
- The statutory language (as amended by the 1988 Act) providing for the computation of the overall loss for the taxable year of disposition **is not entirely clear where the activity is disposed of at a gain.**

Explanation. The act provides that, in a transaction in which all gain or loss is recognized on the disposition of a passive activity, any loss from the activity for the taxable year (taking into account all income, gain, and loss, including gain or loss recognized on the disposition) **in excess of** any net income or gain from other passive activities for the taxable year is treated as a loss **that is not from a passive activity.**

This provision clarifies the situation when passive activity property is sold. It can best be explained by the following example:

Example. Bonnie owns an apartment building. She sells it in late 1997 and receives all of the sales price from the buyer (not an installment sale). She has a $10,000 **recognized gain** from the sale on her 1997 Form 4797. During the time she owned it in 1997, the **rental loss** (shown on her 1997 Schedule E) was $20,000. Therefore, her net **loss** on the apartment building (passive activity property) for 1997 is **$10,000** ($10,000 gain on Form 4797 and $20,000 loss on Schedule E).

She has **other passive income in 1997 of $5,000** from a cash rental profit of farmland (reported on her 1997 Schedule E).

This provision clarifies that her **$10,000 net loss** on the apartment building is applied **first** against her $5,000 of other passive income. The **remaining** $5,000 loss is treated as a **non-passive** loss and **can be used to offset any other 1997 income.**

Employment Classification and Taxes

21. Clarify Treatment of Newspaper Distributors and Carriers as Direct Sellers

[I.R.C. §3508, Small Business Act §3508]

[Effective Date. **With respect to services performed after December 31, 1995.]**

Explanation of Provision. The Act clarifies the treatment of qualifying newspaper distributors and carriers as direct sellers.

Under the act, a person engaged in the trade or business of the delivery or distribution of newspapers or shopping news (including any services that are directly related to such trade or business such as solicitation of customers or collection of receipts) qualifies as a direct seller, provided substantially all the remuneration for the performance of the services is directly related to sales or other output rather than to the number of hours worked, and the services performed by the person are performed pursuant to a written contract between such person and the service recipient and such contract provides that the person will not be treated as an employee for Federal tax purposes.

The act is intended to apply to newspaper distributors and carriers **whether or not** they hire others to assist in the delivery of newspapers. The act also applies to newspaper distributors and carriers operating under either a buy-sell distribution system (i.e., where the newspaper distributors or carriers purchase the newspapers from the publisher) or an agency distribution system. **For example, newspaper distributors and carriers operating under an agency distribution system who are paid based on the number of papers delivered and have an appropriate written agreement qualify as direct sellers.** The status of newspaper distributors and carriers who do not qualify as direct sellers under the act continues to be determined under present-law rules.

No inference is intended with respect to the employment status of newspaper distributors and carriers prior to the effective date of the Act. Further, the provision is intended to clarify the worker classification issue for income and employment taxes only.

Procedure and Reporting

22. Information Reporting: Real Estate Reporting Compliance Costs

[I.R.C. §6045, Small Business Act §1704]

[**Effective November 11, 1988, as if it were included in the Technical and Miscellaneous Revenue Act of 1988.**]

Explanation of Provision. The Act clarifies that real estate reporting persons may take into account the cost of complying with the reporting requirements of Code §6045 in establishing charges for their services, **so long as a separately listed charge for such costs is not made.**

23. Six-Month Delay in Implementation of Electronic Fund Transfer System for Collection of Taxes

See the TRA 1997 chapter for an update on this subject.

Miscellaneous

24. Contributions of Stock to Private Foundations

[I.R.C. §170, Small Business Act §1206]

Note: The TRA of 1997 extends the special rule contained in §170(e)(5) for contributions of qualified appreciated stock made to private foundations during the period June 1, 1997, through May 31, 1998.

Present and Prior Law

- In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the fair market value of property contributed to a charitable organization.
- **However, in the case of a charitable contribution of short-term gain, inventory, or other ordinary income property, the amount of the deduction generally is limited to the taxpayer's basis in the property.**
- In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose.
- **In cases involving contributions to a private foundation** (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property.
- However, under a special rule contained in §170(e)(5), taxpayers were allowed a deduction equal to the fair market value of "qualified appreciated stock" contributed to a private foundation prior to January 1, 1995.
- **Qualified appreciated stock was defined as publicly traded stock that is capital gain property.**

- The fair market value deduction for qualified appreciated stock donations applied only to the extent that total donations made by the donor to private foundations of stock in a particular corporation did not exceed 10% of the outstanding stock of that corporation.
- For this purpose, an individual was treated as making all contributions that were made by any member of the individual's family.
- This special rule contained in §170(e)(5) expired after December 31, 1994.

Explanation of Provision. **The act extends the special rule** contained in §170(e)(5) for contributions of qualified appreciated stock made to private foundations for contributions made during the period July 1, 1996, through May 31, 1997.

Taxpayer Bill of Rights 2 (TBR2)

The Taxpayer Bill of Rights 2 was passed by Congress on July 11, 1996, and was signed by the President **on July 30, 1996.** The original taxpayer rights law was enacted in 1988. Following is a synopsis of the most important provisions that might affect taxpayers and tax practitioners.

Most of these are summarized in the IRS Update chapter of this book.

1. Expansion of Authority to Abate Interest

A) The IRS now has authority to abate interest caused by **any unreasonable** error or delay resulting from managerial actions, such as

i) Loss of records by the IRS

ii) IRS personnel transfers

iii) Extended illnesses

iv) Extended personnel training

v) Extended leave

[Effective Date. Effective for interest accruing regarding deficiencies or payments for taxable years beginning after date of enactment (July 30, 1996).]

B) The Tax Court has been given jurisdiction to determine whether the IRS's **failure to abate interest** for an eligible taxpayer **was an abuse of discretion.** The Tax Court may order an abatement of interest if the action is brought within 180 days after the date of mailing of the IRS's final determination not to abate interest.

[Effective Date. Applies to requests for abatement after the date of enactment (July 30, 1996).]

2. Abatement of Penalty to Make Required Deposits of Payroll Taxes

A) The Act provides that the IRS may waive this penalty with respect to an **inadvertent failure** to deposit any employment tax **if:** (a) the depositing entity meets the **net worth requirements** (generally, net worth may not exceed $2 million for individuals and $7 million for corporations) applicable for an award of attorney's fees; (b) the failure to deposit occurs during the **first quarter** that the depositing entity was required to deposit any employment tax; **and** (c) the return for the employment tax was filed **on or before the due date.**

B) The Act also provides that the IRS may abate any penalty for failure to make deposits **for the first time** if the depositing entity **sends a deposit to the IRS instead of to the required government depository.**

[Effective Date. Date of enactment (July 30, 1996).]

3. Information Returns

A) The Act provides that, if any person **willfully** files a **fraudulent information return** with respect to payments purported to have been made to another person, the other person may bring a civil action for damages against the person filing the return. A copy of the complaint initiating the action must be provided to the IRS. Recoverable damages are the greater of (1) $5,000 or (2) the amount of actual damages and, in the court's discretion, reasonable attorney's fees. Any action must be brought within 6 years after the filing of the fraudulent information return, or one year after the fraudulent information return would have been discovered through the exercise of reasonable care, **whichever is later.**

[Effective Date. Applies to fraudulent information returns filed after date of enactment (July 30, 1996).]

B) The Act provides that, in any court proceeding, if a taxpayer asserts a reasonable dispute with respect to any item of income reported on an information return filed by a third party, and the taxpayer has fully cooperated with the IRS, the government has the **burden of producing** reasonable and probative **information concerning the deficiency (in addition to the information return itself).**

[Effective Date. Date of enactment (July 30, 1996).]

4. Enrolled Agents

Enrolled agents now have the status of "third party" record keepers.

[Effective Date. Date of enactment (July 30, 1996).]

5. Required Notice to Taxpayers of Certain Payments.

The act requires the IRS to make reasonable efforts to notify, within 60 days, those taxpayers who have made payments which the IRS cannot associate with the taxpayer.

[Effective on the date of enactment (July 30, 1996).]

6. Responsible Person Notice

Preliminary notice requirement.—The act requires the IRS to issue a notice to an individual the IRS has determined to be a responsible person with respect to unpaid trust fund taxes at least 60 days prior to issuing a notice and demand for the penalty. The statute of limitations shall not expire before the date 90 days after the date on which the notice was mailed. The provision does not apply if the Secretary finds that the collection of the penalty is in jeopardy.

[Effective Date. Applies to assessments made after June 30, 1996.]

Provisions Applicable for the First Time in 1997 and Later Taxable Years

Individuals

25. Adoption Credit

[I.R.C. §§23, 25, 1016; Small Business Act §1807]

[**Effective for tax years beginning after December 31, 1996.**]

Explanation of New Law. The new law provides taxpayers with a maximum nonrefundable credit against income tax liability of $5,000 per child for qualified adoption expenses paid or incurred by the taxpayer. The maximum credit is increased from $5,000 to $6,000 in the case of special needs adoptions (other than foreign adoptions). Any unused adoption credit may be carried forward by the taxpayer for up to five years. [The credit is phased out ratably for taxpayers with modified adjusted gross income (AGI) above $75,000, and is fully phased out at $115,000 of modified AGI.] **The credit is repealed for expenses paid or incurred after 12-31-2001.**

See Question 1 in the Non–Agriculture-Related section of Chapter 5 for an example and the 1997 form.

26. Exclusion for Adoption Expenses Paid by an Employer

[I.R.C. §§86, 135, 137, and 1016; Small Business Act §1807]

[**Effective for tax years beginning after December 31, 1996.**]

Explanation of Provision. The proposal provides a maximum $5,000 exclusion from the gross income of an employee for specified certain adoption expenses paid by the employer. The exclusion is $6,000 in the case of a special needs adoption (other than a foreign adoption). The $5,000 ($6,000) limit is a per child limit, not an annual limitation. [The exclusion is phased out ratably for taxpayers with modified AGI above $75,000 and is fully phased out at $115,000 of modified AGI.] **The exclusion is repealed after December 31, 2001.**

27. Tax Treatment of Accelerated Death Benefits under Life Insurance Contracts

[I.R.C. §§101(g) and 818(g), Health Reform Act §§331 and 332]

[Effective Date. **Applies to amounts received after December 31, 1996.]**

Explanation of Provision. The act provides an exclusion from gross income as an amount paid by reason of the death of an insured for (1) amounts received under a life insurance contract and (2) amount received for the sale or assignment of a life insurance contract to a qualified viatical settlement provider, **provided that the insured under the life insurance contract is either terminally ill or chronically ill.**

The provision does not apply in the case of an amount paid to any taxpayer other than the insured, if such taxpayer has an insurable interest by reason of the insured being a director, officer, or employee of the taxpayer, or by reason of the insured being financially interested in any trade or business carried on by the taxpayer.

"A terminally ill individual" is defined as one who has been certified by a physician as having an illness or physical condition that reasonably can be expected to result in death within 24 months of the date of certification.

Special Requirements for Chronically Ill. The tax treatment of payments with respect to chronically ill individuals is similar to the long-term care rules of the act. In the case of a chronically ill individual, the exclusion under this provision with respect to amounts paid under a life insurance contract and amounts paid in a sale or assignment to a viatical settlement provider applies if the payment received **is for costs incurred by the payee** (not compensated by insurance or otherwise) **for qualified long-term care services** (as defined under the long-term care rules of the act) **for the insured person for the period,** and two other requirements (similar to requirements applicable to long-term care insurance contracts under the act) are met.

See Notice 97-31 in the What's New chapter of this book concerning an expanded discussion of this issue. Also see the TRA of 1997 chapter.

28. Tax Treatment of Long-Term Care Insurance and Services

[I.R.C. §§162, 213, 4980C, 6050Q, 7702B; Health Reform Act §§321–327]

[Effective Date. The provisions relating to treatment of eligible long-term care premiums and long-term care services as a medical expense are effective for taxable years beginning after December 31, 1996.]

Practitioner Note.

This is a complex provision. Only the basic rules are explained below.

Exclusion of Long-Term Care Proceeds

- A long-term care insurance contract generally is treated as an accident and health insurance contract.
- Amounts (other than policy-holder dividends or premium refunds) received under a long-term care insurance contract **generally** are **excludable** as amounts received for personal injuries and sickness, subject to a cap of $175 per day, or $63,875 annually, on per diem contracts only.

The amount of the dollar cap with respect to any one chronically ill individual (who is not terminally ill) is $175 per day ($63,875 annually, as indexed), reduced by the amount of reimbursements and payments received by anyone for the cost of qualified long-term care services for the chronically ill individual.

Long-Term Care Insurance Premiums Treated as Medical Expenses.

Long-term care insurance premiums that do not exceed specified dollar limits **are treated as medical expenses** for purposes of the itemized deduction for medical expenses. The limits per individual are as follows:

In the Case of an Individual with an Attained Age Before the Close of the Taxable Year of:	The Limitation on Premiums Paid for Such Taxable Years Is:
Not more than 40	$ 200
More than 40 but not more than 50	375
More than 50 but not more than 60	750
More than 60 but not more than 70	2,000
More than 70	2,500

Expenses for Long-Term Care Services Treated as Medical Expenses

- Unreimbursed expenses for qualified long-term care services provided to the taxpayer or the taxpayer's spouse or dependent are treated as medical expenses for purposes of the itemized deduction for medical expenses (subject to the present-law floor of 7.5% of adjusted gross income).
- For this purpose, amounts received under a long-term care insurance contract (regardless of whether the contract reimburses expenses or pays benefits on a per-diem or other periodic basis) are treated as reimbursement for expenses actually incurred for medical care.

Definition of Qualified Long-Term Care Services. Qualified long-term care services means necessary diagnostic, preventive, therapeutic, curing, treating, mitigating and rehabilitative services, and maintenance or personal care services that are required by a chronically ill individual and that are provided pursuant to a plan of care prescribed by a licensed health care practitioner.

Exclusion for Employer-Provided Long-Term Care Coverage. A plan of an employer providing coverage under a long-term care insurance contract generally is treated as an accident and health plan. [Employer-provided coverage under a long-term care insurance contract is not, however, excludable by an employee if provided through a cafeteria plan; similarly, expenses for long-term care services cannot be reimbursed under an FSA.]

Deduction for Long-Term Care Insurance of Self-Employed Individuals. The present-law 30% deduction for health insurance expenses of self-employed individuals is phased up to 80% under the act. **Because the act treats payments of eligible long-term care insurance premiums in the same manner as medical insurance premiums, the self-employed health insurance deduction applies to eligible long-term care insurance premiums under the act.**

See Notice 97-31 in the What's New chapter for further explanation, and see the TRA of 1997 chapter for an amendment to I.R.C. §162(l).

S and C Corporations

29. S Corporations Permitted to Have 75 Shareholders

[I.R.C. §1361, Small Business Act §1301]

[Effective Date. **Taxable years beginning after December 31, 1996.]**

New Law. The act increases the maximum number of shareholders from 35 to 75.

30. Expansion of Post-Death Qualification for Certain Trusts—S Corporations

[I.R.C. §1361, Small Business Act §1361]

[Effective Date. **Taxable years after December 31, 1996.]**

Prior Law. A grantor trust could remain an S corporation shareholder for 60 days after the death of the grantor. The 60-day period was extended to 2 years if the entire corpus of the trust was includable in the gross estate of the deemed owner. In addition, a testamentary trust could be an S corporation shareholder for 60 days after the transfer of S corporation stock to the trust pursuant to a will.

New Law. **The act expands the post-death holding period to 2 years for all trusts, even if the corpus of the trust is not included in the grantor's estate.**

31. Electing Small Business Trusts—S Corporations

[I.R.C. §§1361, 641, 642, 1366; Small Business Act §1302]

[Effective Date. **Taxable years beginning after December 31, 1996.]**

Prior Law. Under prior law, trusts **other than** grantor trusts, voting trusts, certain testamentary trusts, and "qualified subchapter S trusts" ***could*** *not be* shareholders in an S corporation.

New Law

(1) The act allows stock in an S corporation to be held by certain trusts ("electing small business trusts").

(2) In order to qualify for this treatment, all beneficiaries of the trust must be individuals or estates eligible to be S corporation shareholders, except that charitable organizations may hold contingent remainder interests.

(3) No interest in the trust may be acquired by purchase.

(4) Thus, interests in the trust must be acquired by reason of gift, bequest, etc.

(5) **A trust must elect to be treated as an electing small business trust.** An election applies to the taxable year for which it is made and can be revoked only with the consent of the Secretary of Treasury or his delegate.

(6) **Each potential current beneficiary** of the trust is counted as a shareholder for purposes of the 75-shareholder limitation (or if there were no potential current beneficiaries, the trust would be treated as the shareholder).

(7) A qualified subchapter S trust with respect to which an election is in effect or an exempt trust **is not eligible** to qualify as an electing small business trust.

(8) **The portion of the trust that consists of stock in one or more S corporations is treated as a separate trust for purposes of computing the income tax attributable to the S corporation stock held by the trust.**

(9) The trust is taxed at the highest individual rate (currently, 39.6% on ordinary income) and 28% on net capital gain) on this portion of the trust's income. [But see the TRA of 1997 chapter for the appropriate capital gain rate for 1997.]

(10) In computing the trust's income tax on this portion of the trust, **no deduction is allowed for amounts distributed to beneficiaries, and no deduction or credit is allowed for any item other than the items described above.** This income is **not included** in the distributable net income of the trust, and thus is **not included** in the beneficiaries' income. No item relating to the S corporation stock could be apportioned to any beneficiary.

Notice 97-12: Electing Small Business Trusts

ESBT Election

The trustee of the ESBT must make the ESBT election pursuant to §1361(e)(3) by signing and filing with the service center with which the corporation files its income tax return a statement that—

(1) Contains the name, address, and taxpayer identification number of all potential current beneficiaries, the trust, and the corporation;

(2) Identifies the election as an election made under §1361(e)(3);

(3) Specifies the date on which the election is to become effective (not earlier than 15 days and two months before the date on which the election is filed);

(4) Specifies the date (or dates) on which the stock of the corporation was transferred to the trust; and

(5) Provides all information and representations necessary to show that:

(A) All potential current beneficiaries meet the shareholder requirements of §1361(b)(1); and

(B) The trust meets the definitional requirements of an ESBT under §1361(e).

The trustee of the ESBT must file the ESBT election within the time requirements prescribed in regulation §1.1361-1(j)(6)(iii) for filing Qualified Subchapter S Trust (QSST) elections (generally within the 16-day-and-2-month period beginning on the day that the stock is transferred to the trust). The trustee may attach the ESBT election to the Form 2553 in the case of newly electing S corporations.

ESBT Consent to S Corporation Election

Section 1362(a) provides that all shareholders must consent to the S corporation election. Section 1361(c)(2)(B) generally provides that all potential current beneficiaries of the ESBT are treated as shareholders for purposes of determining whether the corporation has eligible shareholders and whether the number of shareholders does not exceed 75, as provided by §1361(b)(1). For purposes of the ESBT's consent to the S corporation election under §1362(a), however, because the ESBT is taxed on the S corporation's income and the trustee makes the ESBT election, only the trustee need consent to the S corporation election.

32. Treatment of Distributions During Loss Years—S Corporations

[I.R.C. §§1366, 1368; Small Business Act §1309]

[Effective Date. **Tax years beginning after December 31, 1996.]**

New Law. **The act provides that the adjustments to the adjusted basis of a shareholder's stock for distributions made by an S corporation during a taxable year are taken into account before applying the loss limitation for one year.** Thus, distributions during a year reduce the adjusted basis for purposes of determining the allowable loss for the year, **but the loss for a year does not reduce the adjusted basis for purposes of determining the tax status of the distributions made during that year.**

The provision also provides that in determining the amount in the accumulated adjustment account for purposes of determining the tax treatment of distributions made during a taxable year by an S corporation having accumulated earnings and profits, net negative adjustments (i.e., the excess of losses and deductions over income) for that taxable year are disregarded.

The following examples illustrate the application of these provisions:

Example 1. **X is a sole shareholder of corporation A, a calendar year S corporation with no accumulated earnings and profits.** X's adjusted basis in the stock of A on January 1, 1998, is $1,000, and X holds no debt of A. During 1998, A makes a distribution to X of $600, recognizes a capital gain of $200, and sustains an operating loss of $900. Under the bill, X's adjusted basis in the A stock is increased to $1,200 ($1,000 plus $200 capital gain recognized) pursuant to §1368(d) to determine the effect of the distribution. X's adjusted basis is then reduced by the amount of the distribution to $600 ($1,200 less $600) to determine the application of the loss limitation of §1366(d)(1). X is allowed to take into account $600 of A's operating loss, which reduces X's adjusted basis to zero. The remaining $300 loss is carried forward pursuant to §1366(d)(2).

Example 2. The facts are the same as in Example 1, except that on January 1, 1998, **A has accumulated earnings and profits of $500 and an accumulated adjustments account of $200.** Under the Act, because there is a net negative adjustment for the year, no adjustment is made to the accumulated adjustments account before determining the effect of the distribution under §1368(c).

As to A, $200 of the $600 distribution is a distribution of A's accumulated adjustments account, reducing the accumulated adjustments account to zero. The remaining $400 of the distribution is a distribution of accumulated earnings and profits (E&P) and reduces A's E&P to $100. A's accumulated adjustments account is then increased by $200 to reflect the recognized capital gain and reduced by $900 to reflect the operating loss, leaving a negative balance in the accumulated adjustment account on January 1, 1999, of $700 (zero plus $200 less $900).

As to X, $200 of the distribution is applied against X's adjusted basis of $1,200 ($1,000 plus $200 capital gain recognized), reducing X's adjusted basis to $1,000. The remaining $400 of the distribution is taxable as a dividend and does not reduce X's adjusted basis. Because X's adjusted basis is $1,000, the loss limitation does not apply to X, who may deduct the entire $900 operating loss. X's adjusted basis is then decreased to reflect the $900 operating loss. Accordingly, X's adjusted basis on January 1, 1999, is $100 ($1,000 plus $200 less $200 less $900).

33. Agreement to Terminate Year—S Corporations

[I.R.C. §1377, Small Business Act §1306]

[Effective Date. **Taxable years beginning after December 31, 1996.]**

New Law. The election to close the books of an S corporation does not need the consent of a shareholder whose tax liability is **unaffected** by the election.

34. Other S Corporation Items

(1.) Expansion of post-termination transition period (§1307 of Small Business Act): **taxable years after December 31, 1996.** [See T. D 8696 in the What's New chapter.]

(2.) **S corporations will eliminate accumulated earnings and profits from pre-1983 years in which they were S corporations.** Such balances should be closed to other retained earnings, and will never be treated as dividends, if they are distributed after 1996 (§1311 of Small Business Act): **taxable years after December 31, 1996.**

(3.) **S corporations will be able to own 80% or more of the stock of subsidiary corporations.** If an S corporation owns 100% (but not less) of a subsidiary corporation, the subsidiary itself may be an S corporation, known as a qualified subchapter S subsidiary. Practitioners will need to study the procedures regarding the treatment of these qualified subsidiaries. (§1308 of Small Business Act): **taxable years after December 31, 1996.**

[See **Notice 97-4** in the What's New chapter for important information, as well as the TRA of 1997 chapter.]

35. Treatment of S Corporations as Shareholders in C Corporations

[I.R.C. §1371, Small Business Act §1310]

[**Effective for tax years beginning after December 31, 1996.**]

Explanation of Provision

- The Act repeals the rule that treats an S corporation in its capacity as a shareholder of another corporation as an individual. Thus, the provision clarifies that the liquidation of a C corporation into an S corporation will be governed by the generally applicable subchapter C rules, including the provisions of §§332 and 337 allowing the tax-free liquidation.

- Following a tax-free liquidation, the built-in gains of the liquidating corporation may later be subject to tax under §1374 upon a subsequent disposition. An S corporation also will be eligible to make a §338 election (assuming all the requirements are otherwise met), resulting in immediate recognition of all the acquired C corporation's gains and losses (and the resulting imposition of a tax).

36. S Corporations—Real Property Subdivided for Sale

[I.R.C. §1237, Small Business Act §1314]

[**Effective for sales in tax years beginning after December 31, 1996.**]

Explanation of Provision. The Act allows the prior-law capital gains presumption in I.R.C. §1237 in the case of land held by an S corporation. It is expected that rules similar to the attribution rules for partnerships will apply to S corporations [**Treas. Reg.** §1.1237-1(b)(3)].

IRAs, Medical Savings Plans, SIMPLE Retirement Plans

37. Spousal IRA Deduction

[I.R.C. §219, Small Business Act §1427]

[**Effective for tax years beginning after December 31, 1996.**]

Prior Law. Under prior law, the maximum deductible contribution that could be made to an IRA generally was the lesser of $2,000 or 100% of an individual's compensation (earned income in the case of a self-employed individual). In the case of a married individual whose spouse has no compensation (or elects to be treated as having no compensation), the $2,000 maximum limit on IRA contributions was increased to $2,250.

New Law. **The new law permits deductible IRA contributions of up to $2,000 to be made for each spouse (including, for example, a homemaker who does not work outside the home) if the combined compensation of both spouses is at least equal to the contributed amount.**

Note. This also applies to the new Roth IRA—see the TRA of 1997 chapter.

38. Pension Plans: SIMPLE Retirement Plans

[I.R.C. §§72, 219, 280, 401, 402, 404, 408, 414, 416, 457, 3121, 3306, 3401, 4972, and 6693; Small Business Act §1421]

[**Effective for years beginning after December 31, 1996.**]

New Law

- The new law creates a simplified retirement plan for small businesses called the savings incentive match plan for employees ("SIMPLE") retirement plan.
- SIMPLE plans can be adopted by employers who employed 100 or fewer employees with at least $5,000 in compensation for the preceding year and who do not maintain another employer-sponsored retirement plan.
- A SIMPLE plan can also be adopted as part of a 401(k) plan.
- In that case, the plan does not have to satisfy the special nondiscrimination tests applicable to 401(k) plans and is not subject to the top-heavy rules.
- The other qualified plan rules continue to apply.

SIMPLE Retirement Plans in IRA Form

In General. A SIMPLE retirement plan allows **employees** to make elective contributions to an IRA. Employee contributions have to be expressed as a percentage of the employee's compensation and **cannot exceed** $6,000 per year. The $6,000 limit is indexed for inflation in $500 increments.

- Each employee of the employer who received at least $5,000 in compensation from the employer during any two prior years and who is reasonably expected to receive at least $5,000 in compensation during the year generally must be eligible to participate in the SIMPLE plan.
- Self-employed individuals can participate in a SIMPLE plan.
- All contributions to an employee's SIMPLE account have to be fully vested.

Tax Treatment of SIMPLE Accounts, Contributions, and Distributions

- **Contributions to a SIMPLE account generally are deductible by the employer.**
- In the case of matching contributions, the employer is allowed a deduction for a year only if the contributions are made by the due date (including extensions) for the employer's tax return.
- Contributions to a SIMPLE account **are excludable** from the employee's income.
- SIMPLE accounts, like IRAs, are not subject to tax.
- Distributions from a SIMPLE retirement account generally are taxed under the rules applicable to IRAs.
- Thus, they are includable in income when withdrawn.
- Tax-free rollovers can be made from one SIMPLE account to another.
- A SIMPLE account can be rolled over to an IRA on a tax-free basis after a two-year period has expired

since the individual first participated in the SIMPLE plan.

- To the extent an employee is no longer participating in a SIMPLE plan (e.g., the employee has terminated employment), and two years have expired since the employee first participated in the SIMPLE plan, the employee's SIMPLE account **is treated as an IRA.**
- Early withdrawals from a SIMPLE account generally are subject to the 10% early withdrawal tax applicable to IRAs.
- However, withdrawals of contributions during the two-year period beginning on the date the employee first participated in the SIMPLE plan are subject to a 25% early withdrawal tax (rather than 10%).
- Employer matching or nonelective contributions to a SIMPLE account **are not treated as wages** for employment tax purposes.

Example of "Simple Retirement Account" for Self-Employed Individual

Assumptions:		
Self-employed		
No employees		
No related businesses		
Plan is established timely		
Net earnings from self-employment = $60,000.00		
Individual wishes to set aside/contribute the maximum amount		
Calculation:		
Net earnings from self-employment		$60,000.00
Amount of "elective employee contributions"	$6,000.00	
Amount of employer matching contribution	$1,800.00	
Total amount contributed	$7,800.00	

Repeal of SARSEPs. The new law repeals salary reduction simplified employee pensions (SARSEPS) effective December 31, 1996. **However, SARSEPs that were established before January 1, 1997,can continue to receive contributions—including contributions for employees that were hired after December 31, 1996.**

A comprehensive question and answer section on "Simples" is found in Notice 97-6 in the What's New chapter. It is quite helpful! The new form is also included.

39. Pension Plans: SIMPLE Retirement Plan as Part of 401(k) Plan

[I.R.C. §401, Small Business Act §1422]

[**Effective for plan years beginning after December 31, 1996.**]

In general, **under the new law,** a cash or deferred arrangement (i.e., 401(k) plan), is deemed to satisfy the special nondiscrimination tests applicable to employee-elective deferrals and employer matching contributions if the plan satisfies the contribution requirements applicable to SIMPLE plans. In addition, the plan is not subject to the top-heavy rules for any year for which this safe harbor is satisfied. The plan is subject to the other qualified plan rules.

40. Withdrawals from IRAs for medical expenses

[I.R.C. §72, Health Reform Act §361(a) and (b)]

[Effective Date. **Tax years beginning after December 31, 1996.]**

Explanation of Provision

1. The act extends the exception for medical expenses in excess of 7.5% of AGI to withdrawals from IRAs.
2. A new exception from the 10% penalty tax is created for withdrawals (distributions) to a class of unemployed individuals if the distribution doesn't exceed the premiums paid during the tax year of the distribution for medical care insurance for the taxpayer, his or her spouse, and dependents. To be eligible, the unemployed person:

(a) Must have been receiving unemployment compensation for 12 consecutive weeks (a self-employed individual is eligible if he or she would have been eligible for unemployment compensation but for the fact that he or she was self-employed)

(b) The distribution is in the taxable year (or succeeding year) of the payment of unemployment compensation

(c) The exception does not apply to the distributions made after the person is reemployed for at least 60 days

41. Medical Savings Accounts

[I.R.C. §§62, 106, 125, 220, 848, 3231, 3306, 3401, 4973, 4975, 4980, 6051, and 6693; Health Insurance Act §301]

[**Effective on a pilot basis in tax years beginning after December 31, 1996.**]

New Law **In general.** Within limits, contributions to a medical savings account ("MSA") **are deductible** if made by an eligible individual and **are excludable** from income if made by the employer of an eligible individual. Earnings on amounts in an MSA are **not currently taxable.** Distributions from an MSA for medical expenses **are not taxable.**

Eligible individuals

- Beginning in 1997, MSAs are available to employees covered under an employer-sponsored high-deductible plan (if the employer is a "small employer") and self-employed individuals. An employer is a small employer if it employed, on average, no more than 50 employees during either the preceding or the second preceding year.
- In order for an employee of an eligible employer to be eligible to make MSA contributions (or to have employer contributions made on his or her behalf), the employee must be covered under an employer-sponsored high-deductible health plan and must not be covered under any other health plan (other than a plan that provides certain permitted coverage). In the case of an employee, contributions can be made to an MSA either by the individual or by the individual's employer. However, an individual is not eligible to make contributions to an MSA for a year if any employer contributions are made to an MSA on behalf of the individual for the year.
- Similarly, in order to be eligible to make contributions to an MSA, a self-employed individual must be covered under a high-deductible health plan and no other health plan (other than a plan that provides certain permitted coverage).

Tax treatment of and limits on contributions

- Individual contributions to an MSA **are deductible** (within limits) **in determining AGI** (i.e., "above the line").
- In addition, employer contributions are **excludable** (within the same limits), **except** that this exclusion does not apply to contributions made through a cafeteria plan.
- In the case of a self-employed individual, the deduction **cannot exceed** the individual's earned income from the trade or business with respect to which the high-deductible plan is established.
- In the case of an employee, the deduction **cannot exceed** the individual's compensation attributable to the employer sponsoring the high-deductible plan in which the individual is enrolled.
- The **maximum annual contribution** that can be made to an MSA for a year is 65% of the deductible under the high-deductible plan in the case of individual coverage and 75% of the deductible in the case of family coverage.
- No other dollar limits on the maximum contribution apply.

Definition of high-deductible plan

- A high-deductible plan is a health plan with an annual deductible of a least $1,500 and no more than $2,250 in the case of individual coverage, and at least $3,000 and no more than $4,500 in the case of family coverage.
- In addition, the maximum out-of-pocket expenses with respect to allowed costs (including the deductible) must be no more than $3,000 in the case of individual coverage and no more than $5,500 in the case of family coverage.

Definition of MSA. In general, an MSA is a trust or custodial account created exclusively for the benefit of the account holder and is subject to rules similar to those applicable to individual retirement arrangements.

Tax treatment of MSAs. Earnings on amounts in an MSA are not currently includable in income.

Taxation of distributions

- Distributions from an MSA for the medical expenses of the individual and his or her spouse or dependents generally **are excludable** from income.
- However, in any year for which a contribution is made to an MSA, withdrawals from an MSA maintained by that individual are excludable from income only if the individual for whom the expenses were incurred was eligible to make an MSA contribution at the time the expenses were incurred.
- This rule is designed to ensure that MSAs are in fact used in conjunction with a high-deductible plan, and that they are not primarily used by other individuals who have health plans that are not high-deductible plans.
- **For example,** suppose that, in 1997, individual A is covered by a high-deductible plan, and A's spouse ("B") is covered by a health plan that is not a high-deductible plan. A makes contributions to an MSA for 1997. Withdrawals from the MSA to pay B's medical expenses incurred in 1997 would be includable in income (and subject to the additional tax on nonmedical withdrawals) because B is not covered by a high-deductible plan.
- Distributions that are not for medical expenses are includable in income. Such distributions are also subject to an additional 15% tax unless made after age 65, death, or disability.

Estate tax treatment

- Upon death, any balance remaining in the decedent's MSA is includable in his or her gross estate.
- If the account holder's surviving spouse is the named beneficiary of the MSA, then, after the death of the account holder, the MSA becomes the MSA of the surviving spouse, and the amount of the MSA balance may be deducted in computing the decedent's taxable estate, pursuant to the estate tax marital deduction provided in Code §2056. The surviving spouse can exclude from income amounts withdrawn from the MSA for expenses incurred by the decedent prior to death, to the extent they otherwise are qualified medical expenses.
- If, upon death, the MSA passes to a named beneficiary other than the decedent's surviving spouse, the MSA ceases to be an MSA as of the date of the decedent's death, and the beneficiary is required to include the fair market value of MSA assets as of the date of death in gross income for the taxable year that includes the date of death—reduced by amounts used to pay qualified medical expenses incurred prior to death.

Cap on taxpayers utilizing MSAs

- In general—The number of taxpayers benefiting annually from an MSA contribution is limited to a threshold level (generally 750,000 taxpayers).

MSAs are available in 1998.

End of pilot project

- After December 31, 2000, no new contributions may be made to MSAs except by or on behalf of individuals who previously had MSA contributions and employees who are employed by a participating employer. An employer is a participating employer if (1) the employer made any MSA contributions for any year to an MSA on behalf of employees, or (2) at least 20% of the employees covered under a high-deductible plan made MSA contributions of at least $100 in the year 2000.
- Self-employed individuals who made contributions to an MSA during 1997–2000 also may continue to make contributions after 2000.

Practitioner Note:

See **Rev. Rul.** 97-20 in the What's New chapter for a definition of "high-deductible health plan." See **Notice** 96-53 in the same chapter for helpful questions and answers and **Announcement** 97-10 for reporting and forms. Also see the TRA of 1997 chapter for minor modifications.

Other Qualified Plans

42. Retirement Plans Covering Self-Employed Individuals

[I.R.C. §401, Small Business Act §1441]

[Effective Date. **Years beginning after December 31, 1996.]**

Prior Law. Prior to the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), different rules applied to retirement plans maintained by incorporated employers and unincorporated employers (such as partnerships and sole proprietors). In general, plans maintained by unincorporated employers were subject to special rules in addition to the other qualification requirements of the Code. Most, but not all, of this disparity was eliminated by TEFRA. Under prior law, certain special aggregation rules apply to plans maintained by owner employees of unincorporated businesses that do not apply to other qualified plans [§§401(d)(1) and (2)].

Explanation of Provision. The bill eliminates the special aggregation rules that apply to plans maintained by self-employed individuals that do not apply to other qualified plans.

43. Repeal of Combined Plan Limit

[I.R.C. §§415(e) and 416(b), Small Business Act §§1452(a) and (c)(7)]

[Effective Date.

The provision repealing the combined plan limit is effective with respect to limitation years beginning after December 31, 1999.]

Present Law—Combined plan limit. An overall limit applies if an individual is a participant in both a defined benefit pension plan and a defined contribution plan (called the combined plan limit).

New Law. The combined plan limit is repealed.

44. Treatment of Leased Employees

[I.R.C. §414, Small Business Act §1454]

[Effective Date. The provision is effective for years beginning after December 31, 1996, except that the act does not apply to relationships that have been previously determined by an IRS ruling not to involve leased employees. In applying the leased employee rules to years beginning before the effective date, it is intended that the Secretary use a reasonable interpretation of the statute to apply the leasing rules to prevent abuse.]

Explanation of Provision

- Under the act, the present-law "historically performed" test is replaced with a new test under which an individual is not considered a leased employee unless the individual's services are performed under primary direction or control by the service recipient.
- As under prior law, the determination of whether someone is a leased employee is made after determining whether the individual is a common-law employee of the recipient.
- Thus, an individual who is not a common-law employee of the service recipient could nevertheless be a leased employee of the service recipient.
- Similarly, the fact that a person is or is not found to perform services under primary purposes of the employee leasing rules is not determinative of whether the person is or is not a common-law employee of the recipient.

45. Pension Plans: Nondiscrimination Rules—Definition of Compensation for Purposes of the Limits on Contributions and Benefits

[I.R.C. §§414 and 415, Small Business Act §1434)

[**Effective for years beginning after December 31, 1997.**]

Present Law. Prior law imposes limits on contributions and benefits under qualified plans based on the type of plan. For purposes of these limits, prior law provides that the definition of compensation generally does not include elective employee contributions to certain employee benefit plans.

Explanation of Provision. The Act provides that elective deferrals to 401(k) plans and similar arrangements, elective contributions to nonqualified deferred compensation plans of tax-exempt employers and state and local governments [§457 plans], and salary reduction contributions to a cafeteria plan **are considered compensation for purposes of the limits on contributions and benefits.**

46. Pension Plans: Nondiscrimination Rules—Highly Compensated Employees

[I.R.C. §§129, 401, 408, 414, and 416; Small Business Act §1431]

[**Effective for years beginning after December 31, 1996.**]

Prior Law—Definition of highly compensated employee. An employee, including a self-employed individual, is treated as highly compensated if, at any time during the year or the preceding year, the employee (1) was a 5% owner of the employer, (2) received more than $100,000 (for 1996) in annual compensation from the employer, (3) received more than $66,000 (for 1996) in annual compensation from the employer and was one of the top-paid 20% of employees during the same year, or (4) was an officer of the employer who received compensation in excess of $60,000 (for 1996). If, for any year, no officer has compensation in excess of the threshold, then the highest paid officer of the employer is treated as a highly compensated employee.

Explanation of Provisions—Definition of highly compensated employee. Under the Act, an employee is treated as highly compensated if the employee (1) was a 5% owner of the employer at any time during the year **or** the preceding year **or** (2) had compensation for the preceding year in excess of $80,000 (indexed for inflation) and the employee was in the top 20% of employees by compensation for such year. The Act also **repeals** the rule requiring the highest paid officer to be treated as a highly compensated employee.

47. Pension Plans: Churches

[I.R.C. §414, Small Business Act §1461)

[**Effective for years beginning after December 31, 1996.**]

New Law. The new law allows self-employed ministers to participate in a church plan. For purposes of the definition of a church plan, a self-employed minister is treated as his or her own employer and as if the employer were a tax-exempt organization under §501(c)(3). The earned income of the self-employed minister is treated as his or her compensation. Self-employed ministers are able to deduct their contributions.

In addition, ministers employed by an organization other than a church are treated as if employed by a church. Thus, such ministers can also participate in a tax-sheltered annuity plan [I.R.C. §403(b) plans] of the church.

48. Pension Plans: Tax-Exempt Organizations

[I.R.C. §401, Small Business Act §1426]

[**Effective for plan years beginning after December 31, 1996.**]

New Law. The new law generally allows tax-exempt organizations (including, for this purpose, Indian tribal governments, a subdivision of an Indian tribal government, an agency or instrumentality of an Indian tribal government or subdivision thereof, or a corporation chartered under federal, state, or tribal law that is owned in whole or in part by any of such entities) to maintain qualified cash or deferred arrangements.

IRA and Pension Plan Distributions

49. Lump-Sum Distributions—Five-Year Averaging

[I.R.C. §402(d), Small Business Act §1401(a)]

Effective Date. **Tax years beginning after 12-31-99.**

Present Law

- Lump-sum distributions from qualified plans and qualified annuity plans are eligible for special five-year forward averaging.
- In **general,** a lump-sum distribution is a distribution within one taxable year of the balance to the credit of an employee that becomes payable to the recipient **first,** on account of the death of the employee, **second,** after the employee attains age 59½, **third,** on account of the employee's separation from service, or **fourth,** in the case of self-employed individuals, on account of disability.
- Lump-sum treatment is not available for distributions from a tax-sheltered annuity.
- A taxpayer is permitted to make an election with respect to a lump-sum distribution received when the employee attains age 59½ or after to use five-year forward income averaging under the tax rates in effect for the taxable year in which the distribution is made.
- **In general,** this election allows the taxpayer to pay a separate tax on the lump-sum distribution that approximates the tax that would be due if the lump-sum distribution were received in five equal installments.
- If the election is made, the taxpayer is entitled to deduct the amount of the lump-sum distribution from

gross income.

- Only one such election on or after age 59½ may be made with respect to any employee.

Under the Tax Reform Act of 1986 (the "1986 Act"), individuals who attained age 50 by January 1, 1986, can elect to use 10-year averaging (under the rates in effect prior to the 1986 Act) in lieu of five-year averaging. In addition, such individuals may elect to retain capital gains treatment with respect to the pre-1974 portion of a lump-sum distribution.

New Law. **The act repeals five-year averaging for lump-sum distributions from qualified plans. Thus, the act repeals the separate tax paid on a lump-sum distribution and also repeals the deduction from gross income for taxpayers who elect to pay the separate tax on a lump-sum distribution.**

The Act preserves the transition rules adopted in the Tax Reform Act of 1986 (10-year averaging only).

50. Required Distributions from Qualified Plans

[I.R.C. §401(a)(9)(c), Small Business Act §1404]

[Effective Date. **Years beginning after December 31, 1996.]**

New Law. **The act modifies the rule that requires all participants in qualified plans to commence distributions by age 70½ without regard to whether the participant is still employed by the employer and generally replaces it with the rule in effect prior to the Tax Reform Act of 1986.**

Under the act, distributions generally are required to begin by April 1 of the calendar year following the later of first, the calendar year in which the employee attains age 70½ or second, the calendar year in which the employee retires.

5% or More Owners. However, in the case of a 5% owner of the employer, distributions are required to begin no later than April 1 of the calendar year following the year in which the owner reaches age 70½.

Note. Includes self-employed individuals [5%].

Actuarial Adjustment. In addition, in the case of an employee (other than a 5% owner) who retires in a calendar year after attaining age 70½, the act generally **requires the employee's accrued benefit to be actuarially increased to take into account the period after age 70½ in which the employee was not receiving benefits under the plan.** Thus, under the act, the employee's accrued benefit is required to reflect the value of benefits that the employee would have received if the employee had retired at age 70½ and had begun receiving benefits at that time.

Note: The actuarial adjustment is not intended to apply to a defined contribution plan.

It is intended that a plan (or an annuity contract) could permit, but is not required to permit, participants who have already begun to receive distributions but do not have to under the new provision, to stop receiving distributions until such distributions are required under the provision.

[House Committee Report]

The actuarial adjustment rule and the rule requiring 5% owners to begin distributions after attainment of age 70½ do not apply under the act, in the case of a governmental plan or church plan.

Note: See Announcement 97-70 in the What's New chapter for transition relief.

51. Excess Distribution Excise Tax Is Suspended

[I.R.C. §4980A(g), Small Business Act §1452(b)]

This 1996 provision has been modified and expanded by TRA of 1997; see that chapter—applies to the 1997 tax year.

Business and Employment Related Deductions and Credits

52. Self-Employed Health Insurance Deduction

[I.R.C. §162, Health Insurance Act §311]

[**Effective for tax years beginning after December 31, 1996.**]

The applicable percentages provided in the 1996 act have been increased by the TRA of 1997. See Chapter 9.

53. Increase in I.R.C. §179 expensing amount and qualifying property

53. Increase in I.R.C. §179 expensing amount and qualifying property

[I.R.C. §179, Small Business Act §§1111(a) and 1702(h)(19)]

[Effective Date. **Tax years after December 31, 1996.]**

Explanation of Provision **Part 1:** The act **increases** the $17,500 amount of qualified property allowed to be expensed under Code §179 to **$25,000.** The increase is **phased** in as follows:

Taxable Year Beginning in---	Maximum Expensing
1997	$18,000
1998	18,500
1999	19,000
2000	20,000
2001	24,000
2002	24,000
2003 and thereafter	25,000

Part 2: The act provides that the following is added to the list of property not qualifying for the I.R.C. §179 expensing election [effective for property placed in service after December 31, 1990]:

1. Property used outside the United States
2. Property used in connection with furnishing lodging
3. Property used by certain tax exempt organizations
4. Property used by governmental units or foreign persons or entities
5. Air conditioning or heating units

Note: See I.R.C. §50(b) for a more detailed discussion of these four items.

Also Note: Horses that meet the requirement of I.R.C. §179(d) are eligible for §179 expensing.

The Committee also believes that horses should qualify as §179 property. The Committee believes that horses are similar to other tangible personal property for which expensing is allowed and that any potential tax shelter abuses inherent in allowing the cost of a horse to be expensed are better addressed by the phase-out and taxable income limitations of §179, the hobby loss rules of §183, and the passive loss rules of §469. Thus, the Committee bill **does not** adopt a technical correction that would deny §179 expensing for horses.

[Senate Committee Report]

Employment Classification and Taxes

54. Modifications to §530 of the Revenue Act of 1978

[Small Business Act §1122]

Effective Date. The provisions generally apply to periods after December 31, 1996. The provision regarding the burden of proof applies to disputes with respect to periods after December 31, 1996. The provision requiring the IRS to notify taxpayers of the provisions of §530 applies to audits commencing after December 31, 1996.

Present Law

Section 530. Under §530, a reasonable basis for treating a worker as an independent contractor is considered to exist if the taxpayer reasonably relied on (1) published rulings or judicial precedent, (2) past IRS audit practice with respect to the taxpayer, (3) long-standing recognized practice of a significant segment of the industry of which the taxpayer is a member, or (4) if the taxpayer has any "other reasonable basis" for treating a worker as an independent contractor. The legislative history states that §530 is to be "construed liberally in favor of taxpayers."

Practitioner Note.

The Internal Revenue Service recently issued a draft training guide for field agents that provides current IRS views regarding worker classification issues. The act has a significant effect on some IRS positions in this "guide."

Explanation of Provision. The Act makes several clarifications of and modifications to §530.

- First, a worker does not have to otherwise be an employee of the taxpayer in order for §530 to apply.
- The provision **is intended to reverse the IRS position,** as stated in the IRS Training Guide, that there first must be a determination that the worker is an employee under the common law standards before application of §530.
- The act modifies the prior audit safe harbor so that **taxpayers may not rely on an audit** commencing **after** December 31, 1996, **unless** such audit included an examination for employment tax purposes of whether the worker involved (or any worker holding a position substantially similar to the position held by the worker involved) should be treated as an employee of the taxpayer.
- The provision **does not affect** the ability of taxpayers to rely on prior audits that commenced before January 1, 1997, even though the audit was not related to employment tax matters, as under present law.

The act also makes a number of changes to the industry practice safe harbor.

- **First,** the act provides that a **significant segment** of the taxpayer's industry under the industry practice safe harbor **does not require** a reasonable showing of the practice **of more than** 25% of an industry (determined without taking into account the taxpayer).
- The provision is intended to be a **safe harbor;** a lower percentage may constitute a significant segment of the taxpayer's industry based on the particular facts and circumstances.

The act also provides that an industry practice need not have continued for more than 10 years in order for the industry practice to be considered long standing.

- As with the significant segment safe harbor, this provision is intended to be a safe harbor; an industry practice in existence for a shorter period of time may be considered long standing based on the particular facts and circumstances.
- In addition, the act clarifies that an industry practice will not fail to be treated as long standing merely because such practice began after 1978.
- Consequently, the provision clarifies that new industries can take advantage of §530.

The act **modifies the burden of proof in §530 cases** by providing that if a taxpayer establishes a prima facie case that it was reasonable not to treat a worker as an employee for purposes of §530, the burden of proof shifts to the IRS with respect to such treatment.

For example, the taxpayer must establish a prima facie case that it reasonably satisfies the requirements of §530 for not treating the worker as an employee, including the reporting consistency and consistency among workers with substantially similar positions requirements, and the requirement that the taxpayer have a reasonable basis for not treating the worker as an employee.

- In order for the shift in burden of proof to occur, the taxpayer must fully cooperate with reasonable requests by the IRS for information relevant to the taxpayer's treatment of the worker as an independent contractor under §530.
- It is intended that a request by the IRS will not be treated as reasonable if complying with the request would be impracticable given the particular circumstances and the relative costs involved.
- The shift in the burden of proof does not apply for the purposes of determining whether the taxpayer had any other reasonable basis for treating the worker as an independent contractor, but does apply to all other aspects of §530.
- **So, for example,** provided the taxpayer establishes its prima facie case and fully cooperates with the IRS's reasonable requests, the burden of proof shifts to the IRS with respect to all other aspects of §530, including whether the taxpayer had a reasonable basis for treating the worker as an independent contractor under the judicial or administrative precedent, prior audit, or long-standing industry practice safe harbors, whether the taxpayer filed all federal tax returns on a basis consistent with treating the worker as an independent contractor, and whether the taxpayer treated any worker holding a substantially similar position as an employee.
- No inference is intended with respect to the application of the burden of proof in §530 cases prior to the effective date of this provision.

The act also provides that if a taxpayer prospectively changes its treatment of workers from independent contractors to employees for employment tax purposes, such a change will not affect the applicability of §530 with respect to such workers for prior periods.

Finally, the act provides that, in determining whether a worker holds a substantially similar position to another worker, the relationship of the parties must be one of the factors taken into account.

55. Information Reporting: Purchasers of Fish

[I.R.C. §§6050R and 6724, Small Business Act §1116]

[**Effective for payments made after December 31, 1997.**]

Explanation of Provision. The provision requires persons engaged in the trade or business of purchasing fish for resale who pay more than $600 in cash in a calendar year for fish or other forms of aquatic life from any seller engaged in the trade or business of catching fish to file information reports with the Secretary regarding such purchases. A copy of the report must be provided to the seller including the telephone number—TRA 1997.

56. Information Reporting: Pension Reporting Penalties

[I.R.C. §§408, 6047, 6652, 6693, and 6724; Small Business Act §1455]

[**Effective for returns, reports, and other statements that are due after December 31, 1996.**]

New Law. The new law incorporates into the general penalty structure the penalties for failure to provide information reports relating to pension payments to the IRS and to recipients.

Miscellaneous

57. Family Aggregation Rules Repealed

Prior Law. Contributions may not discriminate in favor of the highly compensated or family employees. Attribution rules in I.R.C. § 414(q)(6) have the effect of limiting the total amount of compensation that may be considered for a **family group.** One $150,000 limit is applied. If total compensation is more that $150,000, a **proportionate** amount may be considered for each employee. (For this purpose, "family" means a **spouse** of the employee and any **lineal descendants** of the employee

who have not attained age 19 before the close of the year [I.R.C. §401(a)(17)].

Example of Prior Law. Dan, a sole proprietor, had a 1996 Schedule C net profit of $150,000. His wife Marsha was paid a 1996 salary of $25,000 from the business. Dan has a SEP profit sharing plan. He must prorate the $150,000 **compensation limit** between himself and his wife. Only **$128,571** ($150,000/$175,000 × $150,000) of his 1996 Schedule C profit can be counted in figuring **his 1996 SEP contribution,** and only **$21,429** ($25,000/$175,000 × $150,000) of Marsha's wages can be considered in figuring **her 1996 SEP-IRA contribution.**

Note: This definition of "family" also applies to Keogh plans and qualified corporate plans of self-employed individuals.

Explanation of Provision. For tax years beginning after 1996, the special aggregation rules that apply to self-employed individuals have been repealed.