9 1997 Taxpayer Relief Act

Introduction

The Taxpayer Relief Act of 1997 is the most complex tax act this author has analyzed in 28 years. There are drafting errors and drafting weaknesses in several important areas. Sometimes congressional intent and the drafted Code section differ. A Corrections Bill is expected later this year that may clear up some of the interpretive questions raised in this chapter.

In addition, we chose only those items that we believed would be of the most interest to the people who use the book. Therefore, many provisions have not been analyzed in this chapter. Please acquire an analysis by a respected tax service for a discussion of the provisions not covered in this chapter. For example, we **excluded** most provisions that relate to **tax-exempt employer pension plans, exempt organizations, electing large partnerships, unified partnership audit procedures, corporations, international provisions, financial intermediaries, excise taxes,** many of the **procedure and administration items, tax-exempt bonds,** and many of the technical **accounting changes.**

Effective for the First Time in 1997 and Earlier Years

Individuals

1. Increased Deduction for Health Insurance Costs of Self-Employed Individuals

[I.R.C. §16(a)(1)(B)]

Present Law. Under present law, self-employed individuals are entitled to deduct the amount paid for health insurance for the self-employed individual and the individual's spouse and dependents as follows: the deduction is **40% in 1997, 45% in 1998 through 2002, 50% in 2003, 60% in 2004, 70% in 2005,** and **80% in 2006 and thereafter.** The deduction for health insurance expenses of self-employed individuals is not available for any month in which the taxpayer is eligible to participate in a subsidized health plan maintained by the employer of the taxpayer or the taxpayer's spouse.

Under present law, employees can exclude from income 100% of employer-provided health insurance.

New Law. Under the Act, the self-employed health deduction is phased up as follows: the deduction is 40% in 1997, **45% in 1998 and 1999, 50% in 2000 and 2001, 60% in 2002, 80% in 2003 through 2005, 90% in 2006,** and **100% in 2007 and thereafter.**

Effective Date. The provision is effective for taxable years beginning after December 31, 1996.

2. Contributions of Stock to Private Foundations

[I.R.C. §170]

Explanation of Act. The Act 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 June 30, 1998.

3. Deduction for Long-Term Care Insurance of Self-Employed Individuals

[I.R.C. §162]

Explanation of New Law. The technical correction applies the rules for the deduction for health insurance expenses of a self-employed individual **separately with respect to** (1) plans that include coverage for qualified long-term care services or that are qualified long-term care insurance contracts, **and** (2) plans that do not include such coverage and are not such contracts.

Thus, the provision clarifies that the fact that an individual is eligible for employer-subsidized health insurance does not affect the ability of such an individual to deduct long-term care insurance premiums, so long as the individual is not eligible for employer-subsidized long-term care insurance.

Effective Date. Tax years beginning after December 31, 1996.

4. Treatment of Cancellation of Certain Student Loans

[I.R.C. §108]

Explanation of Act. The Act expands §108(f) so that an individual's gross income does not include forgiveness of loans **made by tax-exempt charitable organizations** (e.g., educational organizations or private foundations) **if the proceeds of such loans are used to pay costs of attendance at an educational institution or to refinance outstanding student loans and the student is not employed by the lender organization.**

- As under present law, the §108(f) exclusion applies **only if the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers.**
- In addition, in the case of loans made by tax-exempt charitable organizations, the student's work must fulfill a public service requirement.
- The student must work in an occupation or area with unmet needs and such work must be performed for or under the direction of a tax-exempt charitable organization or a governmental entity.

Effective Date. The provision applies to discharges of indebtedness after the date of enactment (after August 5, 1997).

Sales and Exchanges—Including Residence

5. Gain on Sale of a Principal Residence

[I.R.C. §§121 and 1034]

Summary. The TRA of 1997 replaced the previous rules that allowed taxpayers to roll gain into a replacement residence (I.R.C. §1034) and exclude up to $125,000 of gain (former I.R.C. §121) with a new provision that allows taxpayers to exclude up to $250,000 ($500,000 for married filing jointly) of gain on the sale of a personal residence (new I.R.C. §121). The new rules are effective for sales after May 6, 1997.

This new provision changes the tax incentives associated with selling or buying a new residence. The most significant difference under the new rules is that taxpayers who sell a home in a high-cost area and move to a lower-cost area will not be forced to buy a larger home to avoid recognizing gain on the sale of the previous home.

Example 1. On May 10, 1997, Nels and Mary sold their home in New York City for $650,000, net of sales commissions. They had lived in the home for 10 years and had a $200,000 basis in the home. They moved to Des Moines, Iowa, and are looking for a new home.

Prior to the TRA of 1997, Nels and Mary were required to spend at least $650,000 on the new home in Des Moines in order to avoid recognizing at least some of the $450,000 ($650,000 – $200,000) gain on the sale of the New York City home. The TRA of 1997 allows them to avoid recognition of all of the $450,000 gain on the New York City home, regardless of whether they buy a home in Des Moines and of the amount they spend on the Des Moines home.

Basic Requirements

The basic requirements for the exclusion are:

1. The taxpayer **owned** the home and **used** it as a personal residence for periods aggregating **two or more years during the five-year period** ending on the date of sale [I.R.C. §121(a)].

Observation. The $125,000 exclusion rule under the former I.R.C. §121 required the taxpayer to own and use the home as a principal residence for **three** or more years during the five-year period ending on the date of sale.

2. The taxpayer has not used the new exclusion for the gain on the sale of a personal residence **within the two-year period ending on the date of the sale** [I.R.C. §121(b)(3)].

Practitioner Note.

I.R.C. §121(f) allows the taxpayer to elect **not** to have the exclusion apply to a transaction that otherwise qualifies. One reason for making that election is to allow the sale of another home (with more gain to exclude) to meet this one-sale-every-two-years requirement.

Partial Exclusion for Some Taxpayers Who Fail Two-Year Requirements

If a change in place of employment or health or (to the extent provided in regulations) unforeseen circumstances cause a taxpayer to fail either of the above requirements, the taxpayer will be allowed to exclude a portion of the gain realized on an otherwise qualifying sale of principal residence. **The amount that can be excluded is the portion of the gain that would have been excluded but for the two-year requirements equal to the portion of the two-year period the above conditions are satisfied.**

Therefore, the formula for calculating the excluded gain is:

$$X \times Y \div 730 \text{ days} = \text{Excluded gain}$$

where X is the total exclusion under §121 gain that would have been available if the two-year requirements were satisfied and Y is the **lesser of:**

1. The number of days in the five-year period ending on the date of the sale the taxpayer met the ownership and use requirement, or
2. The number of days since the last sale or exchange to which the exclusion applied.

Practitioner Note.

The legislation does not indicate whether the portion of the two-year period is to be calculated using days or months.

Example 2. Georgia bought her first home for $100,000 on January 1, 1996. Because of a change in employment, she sold her home on August 6, 1997, and moved to a new city. She netted $150,000 for her home after selling costs.

The gain that Georgia can exclude is:

Amount realized	$150,000	
Basis	100,000	
Realized gain	$50,000	
Portion excluded:		
584 days ÷ 730 days	.80	
	×$250,000	(Allowable exclusion)
	$200,000	
Excluded gain	$50,000	

Depreciation

Gain realized on the sale of a principal residence does not qualify for the I.R.C. §121 exclusion**to the extent of depreciation claimed by the taxpayer on the principal residence after May 6, 1997.**

Example 3. Zach used a room in his house as an office in the home from the time he bought the house on February 13, 1992, until he moved his office to a new office building on April 15, 1998. He sold his house in 1999 for $180,000, net of sales expenses. Zach paid $120,000 for his house and claimed $3,000 of depreciation before May 7, 1997, and $500 of depreciation after May 7, 1997.

Since Zach did not have an office in the home in the year he sold his house, the entire house is his principal residence. Consequently, but for the depreciation recapture rule, Zach could exclude all of his gain under I.R.C. §121. He reports gain as follows:

Amount realized		$180,000
Basis		
Unadjusted basis	$120,000	
Depreciation	3,500	

Adjusted basis		116,500
Gain realized		$63,500
Depreciation after May 6, 1997		500
Gain excluded under I.R.C. §121		$63,000

Example 4. Assume the same facts as in Example 3 except that Zach sold his house on April 15, 1998, when he moved his office to a new office building. Also assume that the home office is 10% of the house.

Since Zach was using the room as an office in the home at the time of sale, the sale must be treated as the sale of two separate properties—a personal residence and a business office. None of the gain is subject to the depreciation rule since only the gain on the personal residence portion qualifies for the I.R.C. §121 exclusion.

Zach's gain on the principal residence portion is:

Amount realized (90% of $180,000)	$162,000
Basis in personal portion (90% of $120,000)	108,000
Realized and excluded gain	$54,000

Zach's gain on the business portion is:

Amount realized (10% of $180,000)		$18,000
Basis		
Unadjusted basis	**$12,000**	
Depreciation	3,500	
Adjusted basis		8,500
Realized and recognized gain		$9,500

Spousal Rules

If both spouses meet the requirements of I.R.C. §121, they can each claim a $250,000 exclusion, regardless of whether they file separately or jointly and regardless of whether they own the homes separately or jointly.

Example 5. Ike and Tina each owned a home for several years before they married on June 6, 1997. Neither has previously applied the new exclusion to the sale of a home. In September 1997, they sold their homes and they bought a new home jointly. Ike realized a $200,000 gain and Tina realized a $300,000 gain on the sale of their homes.

Ike can exclude his $200,000 of gain and Tina can exclude $250,000 of her gain from the sale of their homes. It does not matter whether they file a joint return or a separate return.

Example 6. Ron and Nancy are married and they owned a home jointly for many years. Neither has previously applied the new exclusion to the sale of a home. On June 20, 1997, they sold the home has previously applied the new exclusion to the sale of a home. On June 20, 1997, they sold the home and realized a $400,000 gain.

Since each of them meets the requirements for the I.R.C. §121 exclusion, they can each exclude $200,000 of gain whether they file separately or jointly.

Example 7. Cher moved into Sonny's house when they were married on March 1, 1997. Neither has previously applied the new exclusion to the sale of a home. On June 30, 1997, Sonny sold the house and realized $300,000 of gain.

Sonny can exclude $250,000 of the $300,000 of gain on his separate return. He must report the other $50,000 of gain. It does not matter whether they file jointly or separately.

Example 8. Burt and Lonny are married and have lived in a house owned by Lonny for several years. Neither has previously applied the new exclusion to the sale of a home. On July 6, 1997, Lonny sold the house and realized a $325,000 gain. They file a separate return for 1997.

Lonny can exclude $250,000 of her gain. She must report the other $75,000 of gain.

$500,000 Exclusion for Joint Returns. Spouses can combine their $250,000 exclusions even though one of them does not meet the two-year ownership requirement if:

1. They file a joint return for the year of the sale,
2. Either spouse meets the two-year ownership requirement,
3. Both spouses meet the two-year use requirement, and
4. Neither spouse has used the new §121 exclusion in the previous two-year period.

Example 9. Assume the same facts as in Example 8 except that Burt and Lonny filed a joint return for 1997. Lonny could exclude the full $325,000 of gain.

Example 10. Clarence and Gwen married on April 1, 1995, and lived together in home A, which Clarence had owned and lived in since 1985. On August 18, 1997, Clarence purchased home B and he and Gwen moved into home B, but Clarence did not sell home A. On September 1, 1999, Clarence sold home B and used the new I.R.C. §121 to exclude the $50,000 gain he realized on that sale. Clarence and Gwen bought home C and moved into it on September 1, 1999. On January 24, 2000, Clarence sold home A and realized $400,000 gain on the sale. Clarence and Gwen file a joint tax return.

How much of the $400,000 of gain on home A can Clarence exclude?

The first question to ask is whether the four requirements for doubling the exclusion are met.

1. Clarence and Gwen satisfy the requirement of filing a joint return.
2. Clarence meets the two-out-of-the-last-five-years ownership requirement since he owned home A continuously from 1985 until the date of sale. Since only one person needs to meet this requirement, it is satisfied.
3. Both Clarence and Gwen lived in home A from April 1, 1995, until August 18, 1997. That is

within the last two years since Clarence used that provision on the sale of home B on September 1, 1999.

Therefore, the $500,000 exclusion does not apply.

Can Clarence still claim the $250,000 exclusion?

As noted above, Clarence meets both the use and ownership requirements, but he does not meet the once-in-two-years requirement. Therefore, he can claim a portion of the $250,000 equal to the portion of two years that has expired since he last used I.R.C. §121.

Days between sale of home B and sale of home A	146
Divided by days in two years	÷730
Portion that can be excluded	.20
Full gain that could be excluded	$250,000
Fraction that can be excluded	×.20
Excluded amount	$50,000

Observation. Since Clarence realized less than $350,000 gain on the sale of home B, he is better off electing not to have I.R.C. §121 apply to the gain on the sale of home B. That allows him to use the full $500,000 exclusion for the gain on the sale of home A, which would allow him to exclude all of the $400,000 gain rather than $50,000 of the gain.

Tacking of Holding Periods. If property is transferred from one spouse to the other, the period the first spouse owned the property is tacked to the holding period of the second spouse. This makes it much more likely that the second spouse will meet the two-year ownership rule.

Example 11. Assume the same facts as in Example 10, except that Clarence gave home A to Gwen in September 1999 and Gwen sold it on January 24, 2000. Since Gwen has a carryover basis from Clarence, she realizes the same $400,000 of gain he would have realized.

Does Gwen qualify for the $500,000 exclusion?

No, Clarence's use of the I.R.C. §121 exclusion on the sale of home B prevents Gwen from using the $500,000 exclusion.

Does Gwen qualify for the $250,000 exclusion?

Yes. She personally met the two-year use requirement. By tacking Clarence's holding period onto hers, she also meets the two-year ownership requirement. Therefore, Gwen can claim the full $250,000 exclusion, even though Clarence used the I.R.C. §121 exclusion within the past two years.

Observation. Clarence and Gwen could have excluded all of the gain on the sales of homes A and B if Clarence had sold home A and had given home B to Gwen (before or after the sale of home A) to sell at a later date. The entire home A gain could be excluded under Clarence's $500,000 exclusion, and the entire home B gain could be excluded under Gwen's $250,000 exclusion.

Practitioner Note.

The $500,000 limit replaces the $250,000 if the four requirements are met [I.R.C. §121(b)(2)]. Since the $250,000 applies to a taxpayer, the $500,000 exclusion apparently applies to the taxpayer rather than the spouses jointly.

Divorce.

The above tacking rule also applies to the transfer of a home incident to a divorce. Therefore, the period the home is held by one former spouse is tacked to the holding period of the other former spouse if the home is transferred incident to the divorce.

A use rule was also added in the case of a divorce. Use by the taxpayer's spouse or former spouse is treated as use by the taxpayer for purposes of meeting the two-year use requirement, if the use is granted under a divorce or separation instrument. This rule makes it easier for the spouse not living in the house to qualify for the exclusion.

Example 12. Jack and Jill jointly owned a house, which they both lived in until their divorce on December 15, 1993. Jack was given the right to live in the house under their divorce decree and has lived in the house since the divorce. They sold the house on September 26, 1997, and each realized $100,000 of gain.

Jack can exclude his gain since he meets both the ownership and use requirements. Jill can also exclude her gain since Jack's use is treated as her use of the home.

Deceased Spouse.

Ownership and use by a deceased spouse is attributed to the surviving spouse [I.R.C. §121(d)(2)].

Example 13. Ozzie and Harriet married on March 1, 1997, and Harriet moved into the house Ozzie owned and lived in for many years. Ozzie continued to own the house until his death in June 1997, when Harriet became the owner. Harriet sold the house on October 29, 1997.

Harriet can add the time Ozzie owned and used the house to the time she owned and used the house for purposes of meeting the two-year requirements of I.R.C. §121.

Observation. This provision will provide a benefit to few taxpayers, since the surviving spouse will get an I.R.C. §1016 basis adjustment to the date of death value for any interest that passed through the decedent's estate, or, in the case of community property, an adjusted basis in the whole property. Therefore, there will be relatively little gain to exclude on sales that occur before the surviving spouse meets the two-year requirements.

Tacking of Holding Periods for §1033 and §1034 Transactions

For purposes of meeting the ownership and use requirements of I.R.C. §121, the holding period of property for which gain is rolled over under the involuntary conversion rules of I.R.C. §1033 **or** the personal residence rules under former I.R.C. §1034 is tacked to the holding period of the replacement property [I.R.C. §121(d)(5)(c) and §121(g)].

Example 14. Bruce and Nancy's home was destroyed by a tornado on June 14, 1996. They used the insurance proceeds to build a new house and rolled the gain they realized from the proceeds into the new house under I.R.C. §1033. On November 21, 1997, they sold the new house.

Bruce and Nancy are allowed to use the $500,000 exclusion under I.R.C. §121, since the time they owned and used the house that was destroyed is added on to the time they owned and used the replacement house.

Example 15. Bob and Kathy sold their home and moved to a new house on November 15, 1996. They rolled the gain from their old house to the new house under I.R.C. §1034. On August 20, 1997, they sold the new house.

Bob and Kathy can exclude all of the gain on the new house, since the time they owned and used the old house is added to the time they owned and used the new house.

Tenant Stockholder in Cooperative Housing Corporation

A taxpayer who owns stock in a cooperative housing corporation can qualify for the I.R.C. §121 exclusion if he or she meets the two-year ownership requirement with respect to the stock and meets the use requirement with respect to the house or apartment which the stock entitles them to occupy [I.R.C. §121(d)(4)].

Involuntary Conversions

If a principal residence is involuntarily converted (destroyed or taken by theft or eminent domain), the involuntary conversion is treated as a sale for purposes of I.R.C. §121 [I.R.C. §121(d)(5)(A)]. The gain for purposes of the involuntary conversion rules of I.R.C. §1033 is the gain that remains after the I.R.C. exclusion is applied [I.R.C. §121(d)(5)(B)].

Example 16. Roxanne owned a house that was purchased by the county government under an eminent domain proceeding. She received $500,000 net of expenses for the house and had a $200,000 basis in the house. Roxanne qualified for the I.R.C. §121 exclusion of $250,000. She plans to replace the house and qualifies for the I.R.C. §1033 rollover of gain to the new house.

If Roxanne does not elect out of the I.R.C. §121 provision, she reports the transaction as follows:

Amount realized	$500,000
Basis	200,000
Gain realized	$300,000
Gain excluded under §121	250,000

Gain rolled over under §1033	$50,000

If Roxanne pays $500,000 for her replacement house, her basis in the house will be $450,000 ($500,000 – $50,000).

Example 17. Assume the same facts as in Example 16, except that Roxanne does not qualify for the I.R.C. §121 exclusion. She still does not have to recognize any gain because she can roll the full $300,000 of gain over to the replacement residence. That will leave her with a $200,000 basis in her replacement residence.

[See I.R.C. §121(d)(7).]

Out of Residence Care

If a taxpayer becomes physically or mentally incapable of self-care and owns property that he or she used as a principal residence **for at least one year during the five-year period before sale,** then the taxpayer is treated as using the property during any period the taxpayer:

1. Owns the property, and
2. Resides in any facility licensed by a state or a political subdivision to care for an individual in the taxpayer's condition.

Remainder Interests

If a taxpayer sells a remainder interest in his or her principal residence and meets the other requirements of I.R.C. §121, he or she qualifies for the exclusion.

Example 18. Gladys wanted to sell her farm but continue to live in the house until her death. Therefore, she sold the farm, including the house, but she retained a life estate in the house. The interest in the house that she sold is a remainder interest. Therefore, her gain on sale of the remainder interest **qualifies** for the I.R.C. §121 exclusion.

Transition Rules

Sales after May 6, 1997, and before August 5, 1997

Taxpayers who sold their homes after May 6, 1997, and before August 5, 1997, can elect to have the old rules apply to the sale. That means they could roll the gain over under the former I.R.C. §1034, if they meet the I.R.C. §1034 requirements. Taxpayers may want to make this election if they want to save the new I.R.C. §121 exclusion for another home sale within two years, or if they realize more gain on the current sale than can be excluded under I.R.C. §121.

Example 19. George and Dorothy sold their home on July 18, 1997, and purchased a replacement home on the same date. They had a $75,000 basis in the old home, had lived in it for 10 years, and sold it for $115,000. They paid $140,000 for the new home.

If George and Dorothy do not elect to have the old law apply to the sale, the $40,000 of gain is excluded under new I.R.C. §121 and they have a $140,000 basis in the new home.

Observation. The new law gives George and Dorothy the advantage of excluding the gain on the old residence and getting a purchase price basis in the new residence. In the event gain on the new residence is taxable in the future, the $40,000 increase in basis will reduce the gain by that amount.

Example 20. Assume the same facts as Example 19 except that George and Dorothy expect to sell the new home on January 18, 1999, and expect to sell it for $160,000.

If they allow the new I.R.C. §121 exclusion to apply to the sale of the old house, they will be allowed to exclude only 75% of $500,000 of gain on the new house (more than the actual gain) since the January 18, 1999, sale is 75% of the way through the two-year period. Therefore, they have no gain to report.

If George and Dorothy elect to have the old rules apply to the sale of the old house, the $40,000 of gain is rolled into the new house. That gives them a $100,000 basis in the new house.

Example 21. Reid and Pauline sold their home on June 15 and bought a replacement home on the same date. They had lived in the old home for 30 years. They had a $200,000 basis in the old home and sold it for $900,000. They paid $950,000 for the new home.

If Reid and Pauline allow the new I.R.C. §121 to apply to the sale of the old home, they can exclude $500,000 of the gain and must report the remaining $200,000.

If Reid and Pauline elect to have the old rules apply to the sale, they can roll all of the $700,000 of gain into the replacement residence.

Observation. If Reid and Pauline own the new residence until their death, it will get a basis adjustment to the date of death value when it passes through their estate. If they do not own it as community property, the basis in one-half will be adjusted on the death of the first spouse and the basis in the whole house will be adjusted on the death of the second spouse. If the house is community property, the basis of the whole property will be adjusted on the death of the first spouse.

Sales after August 4, 1997, and before August 5, 1999

Taxpayers who owned a home on August 5, 1997, and sell it in the two-year period beginning on August 5, 1997, can exclude a portion of the gain on the sale, even if they do not meet the two-year ownership and use requirements. The portion they can exclude is calculated in the same manner as if the sale was a result of a change in health or employment, or other unforeseen circumstance provided in regulations.

Example 22. Jim and Patty bought a home on May 1, 1997, for $130,000. They sold the home on May 1, 1998, for $150,000.

Jim and Patty do not satisfy the two-year ownership and use requirements. They do qualify for the transition rule, so they can exclude a portion of the gain equal to the portion of the two-year period that is satisfied.

Days owned and used	365 days	
Days in two years	÷730 days	
Fraction that can be excluded	.50	
Total gain	$20,000	
Amount that can be excluded	$250,000	(50% of $500,000)
Amount that can be excluded	$20,000	(Lower than $250,000)

6. Modified Exception to the Related-Party Rule of §1033 for Individuals to Only Provide an Exception for De Minimis Amounts

[I.R.C. §1033]

Present Law

- **Under §1033, gain realized by a taxpayer from certain involuntary conversions of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property within a specified replacement period of time.**
- **Subchapter C corporations** (and certain partnerships with corporate partners) **are not entitled to defer gain under §1033 if the replacement property or stock is purchased from a related person.**
- A person is treated as related to another person if the person bears a relationship to the other person described in §267(b) or §707(b)(1).
- An exception to this related-party rule provides that a taxpayer could purchase replacement property or stock from a related person and defer gain under §1033 to the extent the related person acquired the replacement property or stock from an unrelated person within the replacement period.

Explanation of Act. The Act expands the present-law denial of the application of §1033 **to any other taxpayer** (including an individual) that acquires replacement property from a related party [as defined by §267(b) and §707(b)(1)] **unless the taxpayer has aggregate realized gain of *$100,000 or less* for the taxable year with respect to converted property with aggregate realized gains.**

In the case of a partnership (or S corporation), the annual $100,000 limitation applies to both the partnership (or S corporation) **and each** partner (or shareholder).

Effective Date. The provision applies to involuntary conversions occurring **after** June 8, 1997.

Capital Gains and Losses

7. Capital Gains and Losses

[I.R.C. §1(h) (Various effective dates in 1997)]

Present Law. In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of capital assets, the net capital gain is taxed at the same rate as ordinary income, **except that individuals are subject to a maximum marginal rate of 28% of the net capital gain.** Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business; (2) depreciable or real property used in the taxpayer's trade or business; (3) specified literary or artistic property; (4) business accounts or notes receivable; or (5) certain U.S. publications.

In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. **Gain from the disposition of depreciable personal property** is **not treated as capital gain** to the extent of all previous depreciation allowances. **Gain from the disposition of depreciable real property** is generally not treated as capital gain to the extent of the depreciation allowances **in excess of the allowances that would have been available under the straight-line method of depreciation.**

Summary of Law Changes

1. The new changes are quite complicated and difficult to interpret. Hopefully, 1997 worksheets and changes to the Schedule D and Form 4797 (and instructions) will guide the practitioner and taxpayer through the required calculations.
2. In essence, for transactions occurring **after May 6, 1997,** the maximum capital gain rate is reduced from 28% to 20%, and for taxpayers in the 15% bracket the maximum rate is reduced from 15% to 10%.
3. Next, the holding period to qualify a taxpayer for a long-term gain is changed from more than 1 year to more than 18 months for transactions occurring **after July 28, 1997.**
4. After May 6, transactions involving I.R.C. §1250 property (basically, buildings) will be treated differently. **All** depreciation will be recaptured (not just the excess depreciation over the straight-line rate), and this income (but just the straight line depreciation amount) will be subject to a maximum rate of 25%, subject to certain limitations. Excess depreciation is still recaptured as ordinary income. (See item 7 below.) If the sale of I.R.C. §1250 property occurs **after July 28, 1997,** the holding period to qualify for the 25% maximum is increased to **more than** 18 months.
5. **Apparently,** the holding period for §1231 assets, where the net I.R.C. §1231 gain is treated as a capital gain, **has not been changed** by the Act.

6. Note that the total I.R.C. §1250 recaptured amount cannot exceed the **net** I.R.C. §1231(c)(3) income. This is generally determined on Part 1 of the Form 4797.

Example 1. Ace sells a building for $50,000. The date of sale was June 1, 1997. The building cost $60,000, and he has taken $40,000 of straight-line depreciation on the building. He also sold some machinery, but all the gain on the sale was recaptured as ordinary income because it was all attributable to prior depreciation.

§1250 Assets	Gain	Recaptured Amount
Building	$50,000	$30,000
	(20,000) basis	
	$30,000	
Net §1231 Gain		
$0	—Other	
30,000	—Building*	
$30,000	Total	

*Apparently the $30,000 is still §1231 net gain for purposes of calculating the gain subject to the 25% maximum rate.

Answer. $30,000 is subject to the maximum tax rate of 25%.

Example 2. Joe sells long-term stock on June 1, 1997, for $50,000. His tax basis is $10,000. The $40,000 is all in a tax bracket of 28% or above. The $40,000 is taxed at a maximum rate of 20% under the Act (**$8,000** in tax). If he had sold the stock on May 5, 1997, his tax on the gain would be $40,000× 28%, or **$11,200.**

Example 3. Joe and Kathy file jointly. They have $40,000 of taxable income this year (1997). Of this amount, $20,000 is from salary and $20,000 is net capital gain. Since all their taxable income is below $41,200, it is all in the 15% bracket. The net capital gain portion is taxed at 10% if the sale occurred after May 6, 1997.

7. The lower rates apply to installment sale payments received after May 6, 1997, from qualifying property, even if sales were prior to May 7, 1997.

Example 4. Joe and Kathy sell a building on June 7, 1997, for $100,000. They took $60,000 of straight-line depreciation and $15,000 of additional depreciation, as defined by I.R.C. §1250, while they owned the building. Their tax basis on the sale is $25,000. Under the TRA of 1997, $15,000 of the $75,000 of gain would be ordinary income taxed at their regular tax rates. The remaining $60,000 of the gain would be net §1231 gain, but since it is recapturable §1250 gain it would be taxed at a maximum rate of 25%. **I.R.C. §1250 recapturable gain is taxed to the extent of net §1231 gain.**

Different Maximum Percentages May Apply to Sales After the Year 2000

For taxable years beginning after December 31, 2000, the maximum capital gains rates for assets **which are held more than 5 years** are 8% and 18% (rather than 10% and 20%). The 18% rate applies only to assets the holding period for which **begins after** December 31, 2000. A taxpayer holding a capital asset or asset used in the taxpayer's trade or business on January 1, 2001, **may elect to treat the asset as having been sold on such date for an amount equal to its fair market value, and as having been reacquired for an amount equal to such value.** If the election is made, any gain is recognized (and any loss disallowed).

Note: The 8% rate applies to gains after the year 2000 (if held for more than five years), regardless of **when the holding period began.**

Late Note: At this time there is confusion about how capital losses of the various types—current and carryover—will be netted against the various types of capital gains. Watch for developments.

Estates and Trusts Income Tax

8. Executor of Estate and Beneficiaries Treated as Related Persons for Disallowance of Losses, Etc.

[I.R.C. §§267, 1239]

Present Law. **Section 267 disallows a deduction for any loss on the sale of an asset to a person related to the taxpayer.** For the purposes of §267, the following parties are related persons:

1. A trust and the trust's grantor,
2. Two trusts with the same grantor,
3. A trust and a beneficiary of the trust,
4. A trust and a beneficiary of another trust, if both trusts have the same grantor, and
5. A trust and a corporation the stock of which is more than 50% owned by the trust or the trust's grantor.

Section 1239 disallows capital gain treatment on the sale of depreciable property to a related person.

For purposes of §1239, a trust and any beneficiary of the trust are treated as related persons, unless the beneficiary's interest is a remote contingent interest.

Neither §267 nor §1239 presently treats an estate and a beneficiary of the estate as related persons.

Explanation of New Law. Under the Act, **an estate and a beneficiary of that estate are**

treated as related persons for purposes of §§267 and 1239, except in the case of a sale or exchange in satisfaction of a **pecuniary bequest.**

Effective Date. The provision applies to taxable years beginning after the date of enactment (after August 5, 1997).

9. Separate Share Rules Available for Estates

[I.R.C. §663]

Explanation of New Law. The Act **extends the application of the separate share rule to estates.**

There are separate shares in an estate when the governing instrument of the estate (e.g., the will and applicable local law) creates separate economic interests in one beneficiary or class of beneficiaries such that the economic interests of those beneficiaries (e.g., rights to income or gains from specified items of property) are not affected by economic interests accruing to another separate beneficiary or class of beneficiaries.

For example, a separate share in an estate would exist where the decedent's will provides that all of the shares of a closely held corporation are devised to one beneficiary and that any dividends paid to the estate by that corporation should be paid only to that beneficiary and any such dividends would not affect any other amounts which that beneficiary would receive under the will.

As in the case of trusts, the application of the separate share rule is mandatory where separate shares exist.

Effective Date. The provision applies to decedents dying after the date of enactment (after August 5, 1997).

10. Distributions During First 65 Days of Taxable Year of Estate

[I.R.C. §663]

Present Law. In general, trusts and estates are treated as conduits for federal income tax purposes; income received by a trust or estate that is distributed to a beneficiary in the trust or estate's taxable year "ending with or within" the taxable year of the beneficiary is taxable to the beneficiary in that year; income that is retained by the trust or estate is initially taxable to the trust or estate.

In the case of distributions of previously accumulated income by trusts (but not estates), there may be additional tax under the so-called throwback rules if the beneficiary to whom the distributions were made has marginal rates higher than those of the trust.

Under the "65-day rule," a trust may elect to treat distributions paid within 65 days after the close of its taxable year as paid on the last day of its taxable year. The 65-day rule is not applicable to estates.

Explanation of New Law. **The Act extends application of the 65-day rule to distributions by estates.** Thus, an executor can elect to treat distributions paid within 65 days after the close of the estate's taxable year as having been paid on the last day of such taxable year.

Effective Date. The provision applies to taxable years beginning after the date of enactment (after August 5, 1997).

11. Certain Revocable Trusts Treated as Part of Estate

[I.R.C. §262]

Present Law. Both estates and revocable inter vivos trusts can function to settle the affairs of a decedent and distribute assets to heirs. **In the case of revocable inter vivos trusts,** the grantor transfers property into a trust that is revocable during his or her lifetime. Upon the grantor's death, the power to revoke ceases and the trustee then performs the settlement functions typically performed by the executor of an estate. While both estates and revocable trusts perform essentially the same function after the testator or grantor's death, there are a number of ways in which an estate and a revocable trust operate differently. **First,** there can be only one estate per decedent while there can be more that one revocable trust. **Second,** estates are in existence only for a reasonable period of administration; **revocable trusts** can perform the same settlement functions as an estate, but may continue in existence thereafter as testamentary trusts.

Numerous differences presently exist between the income tax treatment of estates and revocable trusts, including:

1. Estates are allowed a charitable deduction for amounts permanently set aside for charitable purposes while post-death revocable trusts are allowed a charitable deduction only for amounts paid to charities.
2. The active participation requirement of the passive loss rules under §469 is waived in the case of estates (but not revocable trusts) for two years after the owner's death.
3. Estates can qualify for §194 amortization of reforestation expenditures, while trusts do not.

Explanation of New Law. The Act provides an **irrevocable election to treat a qualified revocable trust as part of the decedent's estate for federal income tax purposes.**

This elective treatment is effective from the date of the decedent's death **until two years after his or her death** (if no estate tax return is required) or, if later, **six months after the final determination of estate tax liability** (if an estate tax return is required).

The election must be made by **both the executor of the decedent's estate** (if any) and **the trustee of the revocable trust no later than the time required for filing the income tax return of the estate for its first taxable year,** taking into account any extensions. [A conforming change is made to §2652(b) for generation-skipping transfer tax purposes.]

For this purpose, a qualified revocable trust is any trust (or portion thereof) that was treated under §676 as owned by the decedent with respect to whom the election is being made, by reason of a power in the grantor (i.e., trusts that are treated as owned by the decedent solely by reason of a power in a nonadverse party would not qualify).

Effective Date. The provision applies to decedents dying after the date of enactment (after August 5, 1997).

12. Repeal of Throwback Rules Applicable to Domestic Trusts

[I.R.C. §665]

Present Law. A nongrantor trust is treated as a separate taxpayer for federal income tax purposes. Such a trust generally is treated as a conduit with respect to amounts distributed currentlyThe conduit treatment is achieved by allowing the trust a deduction for amounts distributed to beneficiaries during the taxable year to the extent of distributable net income and by including such distributions in the beneficiaries' income. and taxed with respect to any income which is accumulated in the trust rather than distributed. A separate graduated tax rate structure applies to trusts which historically has permitted accumulated trust income to be taxed at lower rates than the rates applicable to trust beneficiaries. This benefit often was compounded through the creation of multiple trusts.

The Internal Revenue Code has several rules intended to limit the benefit that would otherwise occur from using the lower rates applicable to one or more trusts. Under the so-called throwback rules, the distribution of previously accumulated trust income to a beneficiary will be subject to tax (in addition to any tax paid by the trust on that income) where the beneficiary's average top marginal rate in the previous five years is higher than those of the trust.

Under §644, if property is sold within two years of its contribution to a trust, the gain that would have been recognized had the contributor sold the property is taxed at the contributor's marginal tax rates. In effect, §644 treats such gains as if the contributor had realized the gain and then transferred the net after-tax proceeds from the sale to the trust as corpus.

Explanation of New Law. The Act **exempts** from the **throwback rules** amounts distributed by a domestic trust **after the date of enactment** (August 5, 1997). The provision also provides that **precontribution gain on property sold by a domestic trust no longer is subject to §644** (i.e., taxed at the contributor's marginal tax rates).

- However, the throwback rules continue to apply with respect to (a) foreign trusts, (b) domestic trusts that were once treated as foreign trusts (except as provided in Treasury regulations), and (c) domestic trusts created before March 1, 1984, that would be treated as multiple trusts under §643(f) of the Code.

Effective Date. The provision with respect to the throwback rules is effective for distributions made in taxable years beginning after the date of enactment (after August 5, 1997). The modification to §644 also applies to sales or exchanges **after the date of enactment.**

Estate and Gift Tax

13. Gifts to Charities Exempt from Gift Tax Filing Requirements

[I.R.C. §6019]

Present Law. A gift tax generally is imposed on lifetime transfers of property by gift (§2501). In computing the amount of taxable gifts made during a calendar year, a taxpayer generally may deduct the amount of any gifts made to a charity (§2522). Generally, this charitable gift deduction is available for outright gifts to charity, as well as gifts of certain partial interests in property (such as a remainder interest). A gift of a partial interest in property must be in a prescribed form in order to qualify for the deduction.

Individuals who make gifts in excess of $10,000 to any one donee during the calendar year generally are required to file a gift tax return (§6019). This filing requirement applies to all gifts, **whether charitable or noncharitable, and whether or not the gift qualifies for a gift tax charitable deduction.** Thus, under current law, a gift tax return is required to be filed for gifts to charity in excess of $10,000, even though no gift tax is payable on the transfer.

Reasons for Change. Because a charitable gift does not give rise to a gift tax liability, many donors are **unaware of the requirement** to file a gift tax return for charitable gifts in excess of $10,000. Failure to file a gift tax return under these circumstances could expose the donor to penalties. The Act eliminates this potential trap for the unwary.

Explanation of New Law. The Act provides that gifts to charity are not subject to the gift tax filing requirements of §6019, as long as the entire value of the transferred property qualifies for the gift tax charitable deduction under §2522 and is the donor's entire interest in the property. **The filing**

requirements for gifts of partial interests in property remain unchanged.

Effective Date. The provision is effective for gifts made after the date of enactment (after August 5, 1997).

14. Gifts May Not Be Revalued for Estate Tax Purposes After Expiration of Statute of Limitations

[I.R.C. §§7477, 6501, 2001, 2504]

New Law Explanation. The Act provides that a gift for which the limitations period has passed **cannot be revalued** for purposes of determining the applicable estate tax bracket and available unified credit. [For gifts made in calendar years after the date of enactment, the Act also extends the special rule governing gifts valued under Chapter 14 (special valuation rules found in I.R.C. §§2701–2704) to all gifts.] Thus, the statute of limitations will not run on an inadequately disclosed transfer in calendar years after the date of enactment, regardless of whether a gift tax return was filed for other transfers in that same year.

It is intended that, in order to revalue a gift that has been adequately disclosed on a gift tax return, the IRS must issue a final notice of redetermination of value (a "final notice") within the statute of limitations applicable to the gift for gift tax purposes (generally, three years).

This rule is applicable **even where the value of the gift as shown on the return does not result in any gift tax being owed** (e.g., through use of the unified credit). It is also anticipated that the IRS will develop an administrative appeals process whereby a taxpayer can challenge a redetermination of value by the IRS prior to issuance of a final notice.

A taxpayer who is mailed a final notice may challenge the redetermined value of the gift (as contained in the final notice) **by filing a motion for a declaratory judgment with the Tax Court.** The motion must be filed on or before 90 days from the date that the **final notice was mailed.** The statute of limitations is tolled during the pendency of the Tax Court proceeding.

Effective Date. The provision generally applies to gifts made after the date of enactment (after August 5, 1997). The extension of the special rule under Chapter 14 to all gifts applies to gifts made **in calendar years after the date of enactment.**

15. Clarified Eligibility for Extension of Time for Payment of Estate Tax

[I.R.C. §7479]

Prior Law (Through August 5, 1997, for Deaths Before August 6, 1997). Under prior law, there was limited access to judicial review of disputes regarding initial or continuing eligibility for the deferral and installment election under §6166. If the Commissioner determined that an estate was not initially eligible for deferral under §6166, or had lost its eligibility for such deferral, the estate was required to pay the full amount of estate taxes asserted by the Commissioner as being owed in order to obtain judicial review of the Commissioner's determination.

New Law. The Act authorizes the U.S. Tax Court to provide declaratory judgments regarding initial or continuing eligibility for deferral under §6166.

Effective Date. The provision applies to decedents dying after the date of enactment (after August 5, 1997).

16. Estate Tax Recapture from Cash Leases of Specially Valued Property

[I.R.C. §2032A]

Prior Law. Some courts have held that cash rental of specially valued property after the death of the decedent is not a qualified use under §2032A because the heirs no longer bear the financial risk of working the property, and, therefore, results in the imposition of the additional estate tax under §2032A(c). [**The tax saved (or part of it) as a result of the I.R.C. §2032A election has to be repaid—called "recapture."**] See ***Martin v. Commissioner,*** 783 F.2d 81 (7th Cir. 1986) (cash lease to unrelated party not qualified use); ***Williamson v. Commissioner,*** 93 T.C. 242 (1989), aff'd, 974 F.2d 1525 (9th Cir. 1992) (cash lease to family member not a qualified use); ***Fisher v. Commissioner,*** 65 T.C.M. 2284 (1993) (cash lease to family member not a qualified use); cf. ***Minter v. U.S.,*** 19 F.3d 426 (8th Cir. 1994) (cash lease to family's farming corporation is qualified use); ***Estate of Gavin v. U.S.,*** 1997 U.S. App. Lexis 10383 (8th Cir. 1997) (heir's option to pay cash rent or 50% crop share is qualified use).

Explanation of New Law. The Act provides that the cash lease of specially valued real property by a lineal descendant of the decedent to a member of the lineal descendant's family, who continues to operate the farm or closely held business, **does not cause the qualified use of such property to cease** for purposes of imposing the additional estate tax under §2032A(c).

Effective Date. The provision is effective for cash rentals occurring **after December 31, 1976.**

Practitioner Note.

This eliminates a major tax trap for heirs. Note the effective date.

17. Adjustments for Gifts Within Three Years of Decedent's Death

[I.R.C. §2035]

Present Law

- The first $10,000 of gifts of present interests to each donee during any one calendar year are excluded from federal gift tax.
- The value of the gross estate includes the value of any previously transferred property if the decedent retained the power to revoke the transfer (§2038).
- The gross estate also includes the value of any property with respect to which such power is relinquished during the three years before death (§2035).
- **There has been significant litigation as to whether these rules require that certain transfers made from a revocable trust within three years of death be includible in the gross estate.** See, e.g., ***Jalkut Estate v. Commissioner,*** 96 T.C. 675 (1991) (transfers from revocable trust includible in gross estate); ***McNeely v. Commissioner,*** 16 F.3d 303 (8th Cir. 1994) (transfers from revocable trust not includible in gross estate); ***Kisling v. Commissioner,*** 32 F.3d 1222 (8th Cir. 1994) (acq.) (transfers from revocable trust not includible in gross estate).

Explanation of New Law. The Act codifies the rule set forth in the ***McNeely*** and ***Kisling*** cases to provide that a transfer from a revocable trust (i.e., a trust described under §676) is treated **as if made directly by the grantor.**

Thus, an **annual exclusion gift** from such a trust **is not included** in the gross estate.

Effective Date. The provision applies to decedents **dying after the date of enactment** (after August 5, 1997).

18. Opportunity to Correct Certain Failures under §2032A [Estate Tax]

[I.R.C. §2032A]

Present Law. For estate tax purposes, an executor may elect to value certain real property used in farming or other closely held business operations at its current use value rather than its highest and best use (§2032A). A written agreement signed by each person with an interest in the property must be filed with the election.

In 1984, §2032A was amended to provide that if an executor makes a timely election that substantially complies with Treasury regulations but fails to provide all required information or the signatures of all persons required to enter into the agreement, the executor may supply the missing information within a reasonable period of time (not exceeding 90 days) after notification by the Treasure Department.

Treasury regulations require that a notice of election and certain information be filed with the federal estate tax return [Treas. Reg. §20.2032A-8]. **The administrative policy of the Treasury Department is to disallow current use valuation elections unless the required information is supplied.**

Explanation of New Law

- The Act extends the procedures allowing subsequent submission of information to any executor who makes the election and submits the recapture agreements, without regard to compliance with the Treasury regulations.
- Thus, the Act allows the current use valuation election if the executor supplies the required information within a reasonable period of time (not exceeding 90 days) after notification by the IRS.
- During that time period, the Act also allows the addition of signatures to a previously filed agreement.
- Congress believes that the Treasury Department has taken an unnecessarily restrictive view of the 1984 amendment to §2032A and intends no inference that the Treasury Department lacks the power, under law in effect prior to the date of enactment, to correct the situation addressed by this provision.
- **Congress intends that, with respect to technically defective 2032A elections made prior to the date of enactment, prior law should be applied in a manner consistent with the new law.**

Effective Date. The provision applies to decedents dying **after the date of enactment** (after August 5, 1997).

Qualified Pension Plans

19. Repeal of Excess Distribution and Excess Retirement Accumulation Taxes

[I.R.C. §4980A]

Old Law. Under old law, a 15% excise tax was imposed on excess distributions from qualified retirement plans, tax-sheltered annuities, and individual retirement arrangements (IRAs). Excess distributions are generally the aggregate amount of retirement distributions from such plans during any calendar year in excess of $160,000 (for 1997) or five times that amount in the case of a lump-sum distribution ($800,000 for 1997). The 15% excise tax does not apply to distributions received in 1997, 1998, and 1999.

An additional 15% estate tax was imposed on an individual's excess retirement accumulations. Excess retirement accumulations are generally the balance in retirement plans in excess of the present value of a benefit that would not be subject to the 15% tax on excess distributions.

New Law. The Act repeals **both** the 15% excise tax on excess distributions and the 15% estate tax on excess retirement accumulations.

Effective Date. The provision repealing the excess distribution tax is effective with respect to excess distributions received after December 31, 1996. The repeal of the excess accumulation tax is effective with respect to decedents dying after December 31, 1996.

20. Tax on Prohibited Transactions—Qualified Plans

[I.R.C. §4975(a)]

Present Law. Present 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 (through August 5, 1997) is equal to 10% 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.

New Law. The Act **increases** the initial-level prohibited transaction tax from 10 to **15%.**

Effective Date. The provision is effective with respect to prohibited transactions occurring after the date of enactment (August 5, 1997).

21. Matching Contributions of Self-Employed Individuals Not Treated as Elective Employer Contributions

[I.R.C. §§402, 408]

Present Law. A qualified cash or deferred arrangement [a "§401(k) plan"] is a type of tax-qualified pension plan under which employees can elect to make pre-tax contributions. An employee's annual elective contributions are subject to a dollar limit ($9,500 for 1997). Employers may make matching contributions based on employees' elective contributions. In the case of employers, such matching contributions are not subject to the $9,500 limit on elective contributions.

Under present law, matching contributions made for a self-employed individual are generally treated as additional elective contributions by the self-employed individual who receives the matching contribution.

Accordingly, elective contributions and matching contributions for such a self-employed individual **are subject** to the §401(k) limits on elective contributions.

Explanation of New Law. The Act provides that matching contributions for self-employed individuals are treated the same as matching contributions for employees; i.e., **they are not treated as elective contributions and are not subject to the elective contribution limit.**

Effective Date. The provision is effective for years beginning after December 31, 1997.

The provision is effective for years beginning after December 31, 1996, in the case of SIMPLE retirement plans.

22. Salary Reduction Simplified Employee Pensions ("SARSEPs")

[I.R.C. §408]

Explanation of New Law. The Act amends Code §408(k)(6) to clarify that new employees of an employer **hired** after December 31, 1996, may participate in a SARSEP of an employer established **before** January 1, 1997.

Effective after December 31, 1996.

23. Employer Contributions to SIMPLE 401(k) Plans Not Subject to 15% Limit

[I.R.C. §404(a)(3)(A)]

Present Law. Contributions paid by an employer to a profit sharing or stock bonus plan are deductible by the employer for a taxable year to the extent the contributions do not exceed 15% of the compensation otherwise paid or accrued during the taxable year to the participants under the plan. Contributions paid by an employer to a profit sharing or stock bonus plan that are not deductible because they are in excess of the 15% limitation are subject to a 10% excise tax payable by the employer making the contribution.

Explanation of Act. The Act provides that to the extent that contributions paid by an employer to a SIMPLE 401(k) arrangement satisfy the contribution requirements of §401(k)(11)(B), such contribution is deductible by the employer for the taxable year.

Effective for tax years after December 31, 1996.

Agriculture

24. Repeal Installment Method Adjustment for Farmers

[I.R.C. §56]

Present Law. The installment method allows gain on the sale of property to be recognized as payments are received. **Under the regular tax, dealers in personal property are not allowed to defer the recognition of income by use of the installment method on the installment sale of such property.**

For this purpose, dealer dispositions **do not include** sales of any property used or produced in the trade or business of farming.

For alternative minimum tax purposes, the installment method is not available with respect to the disposition of any property that is the stock in trade of the taxpayer or any other property of a kind which would be properly included in the inventory of the taxpayer if held at year end, or property held by the taxpayer primarily for sale to customers.

No explicit exception is provided for installment sales of farm property under the alternative minimum tax.

Reasons for Change

> The Committee understands that the Internal Revenue Service ("IRS") takes the position that the installment method may not be used for sales of property produced on a farm for alternative minimum tax purposes. The Committee further understands that the IRS has announced that it generally will not enforce this position for taxable years beginning before January 1, 1997, so long as the farmer changes its method of accounting for installment sales for taxable years beginning after December 31, 1996.Notice 97-13, January 28, 1997. The Committee believes that this issue should be clarified **in favor of the farmer.**

Explanation of New Law. The Act generally provides that for purposes of the alternative minimum tax, farmers may **use the installment method of accounting.**

Effective Date. The provision generally is effective for dispositions in taxable years beginning after **December 31, 1987** [Retroactive].

25. Treatment of Livestock Sold on Account of Weather-Related Conditions

[I.R.C. §§451, 1033]

Explanation of New Law. The Act amends Code §451(e) to provide that a cash-method taxpayer whose principal trade or business is farming and who is forced to sell livestock **due not only to drought** (as under present law) **but also to floods or other weather-related conditions,** may elect to include income from the sale of livestock in the **taxable year following the taxable year of the sale.**

This elective deferral of income is available only if the taxpayer establishes that, under the taxpayer's usual business practices, the sale would not have occurred but for the drought, flood, or other weather-related conditions that resulted in the area being designated as eligible for federal assistance.

In addition, the Act amends Code §1033(e) to provide that the sale of livestock (other than poultry) that are held for draft, breeding, or dairy purposes in excess of the number of livestock that would have been sold but for drought (as under present law), flood, or other weather-related conditions **is treated as an involuntary conversion.**

Effective Date. The provision applies to sales and exchanges after December 31, 1996.

Practitioner Note.

Also see pages 14–22 of the Agricultural Issues chapter for a thorough explanation of this change.

Education-Related Provisions

26. Extension of Exclusion for Employer-Provided Educational Assistance

[I.R.C. §127(d)]

Prior Law. Under prior law, an employee's gross income and wages did not include amounts paid or incurred by the employer for educational assistance provided to the employee if such amounts are paid or incurred pursuant to an educational assistance program that meets certain requirements. This exclusion was limited to $5,250 of educational assistance with respect to an individual during a calendar year. The exclusion did not apply to graduate-level courses beginning after June 30, 1996. The exclusion **expired** with respect to courses of instruction beginning **after June 30, 1997.** In the absence of the exclusion, educational assistance is excludable from income **only if it is related to the employee's current job.**

New Law. Under the Act, the exclusion for undergraduate education is extended with respect to courses beginning before June 1, 2000. The exclusion does not apply with respect to graduate-level courses beginning after June 30, 1996.

Note: The exclusion is applicable to all of 1997 for undergraduate education.

Effective Date. The provision is effective with respect to taxable years beginning after December 31, 1996.

Credits

27. Work Opportunity Tax Credit

[I.R.C. §51]

Present Law

In General— Rules applying for the period 9-30-96 through 9-30-97

The work opportunity tax credit is available on an elective basis for employers hiring individuals **from one or more of seven targeted groups.** The credit generally is equal to 35% of qualified wages. Generally, qualified wages consist of wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual begins work for the employer.

Generally, no more then $6,000 of wages during the first year of employment are permitted to be taken into account with respect to any individual. Thus, the maximum credit per individual is $2,100. With respect to qualified summer youth employees, the maximum credit is 35% of up to $3,000 of qualified first-year wages, for a maximum credit of $1,050.

The deduction for wages is reduced by the amount of the credit.

Targeted Groups Eligible for the Credit (1) Families Receiving AFDC (IV-A Recipient). An eligible recipient is an individual certified by the designated local employment agency as being a member of a family eligible to receive benefits under AFDC or its successor program for a period of at least nine months part of which is during the nine-month period ending on the hiring date. For these purposes, members of the family are defined to include only those individuals taken into account for purposes of determining eligibility for the AFDC or its successor program.

(2) Qualified Ex-Felon. A qualified ex-felon is an individual certified as (1) having been convicted of a felony under any state or federal law, (2) being a member of a family that had an income during the six months before the earlier of the date of determination or the hiring date which on an annual basis is 70% or less of the Bureau of Labor Statistics lower living standard, and (3) having a hiring date within one year of release from prison or date of conviction.

(3) High-Risk Youth. A high-risk youth is an individual certified as being at least 18 but not yet 25 on the hiring date and as having a principal place of abode within an empowerment zone or enterprise

community (as defined under Subchapter U of the Internal Revenue Code). Qualified wages will not include wages paid or incurred for services performed after the individual moves outside an empowerment zone or enterprise community.

(4) Vocational Rehabilitation Referral. Vocational rehabilitation referrals are those individuals who have a physical or mental disability that constitutes a substantial handicap to employment and who have been referred to the employer while receiving, or after completing, vocational rehabilitation services under an individualized, written rehabilitation plan under a state plan approved under the Rehabilitation Act of 1973 or under a rehabilitation plan for veterans carried out under Chapter 31 of Title 38, U.S. Code. Certification will be provided by the designated local employment agency upon assurances from the vocational rehabilitation agency that the employee has met the above conditions.

(5) Qualified Summer Youth Employee. Qualified summer youth employees are individuals (1) who perform services during any 90-day period between May 1 and September 15, (2) who are certified by the designated local agency as being 16 or 17 years of age on the hiring date, (3) who have not been employees of that employer before, and (4) who are certified by the designated local agency as having a principal place of abode within an empowerment zone or enterprise community (as defined under Subchapter U of the Internal Revenue Code). As with high-risk youths, no credit is available on wages paid or incurred for service performed after the qualified summer youth moves outside of an empowerment zone or enterprise community. If, after the end of the 90-day period, the employer continues to employ a youth who was certified during the 90-day period as a member of another targeted group, the limit on qualified first-year wages will take into account wages paid to the youth while a qualified summer youth employee.

(6) Qualified Veteran. A qualified veteran is a veteran who is a member of a family certified as receiving assistance under (1) AFDC for a period of at least 9 months part of which is during the 12-month period ending on the hiring date, or (2) a food stamp program under the Food Stamp Act of 1977 for a period of at least 3 months part of which is during the 12-month period ending on the hiring date. For these purposes, members of a family are defined to include only those individuals taken into account for purposes of determining eligibility for (i) the AFDC or its successor program, and (ii) a food stamp program under the Food Stamp Act of 1977, respectively.

Further, a qualified veteran is an individual who has served on active duty (other than for training) in the Armed Forces for more than 180 days or who has been discharged or released from active duty in the Armed Forces for a service-connected disability. However, any individual who has served for a period of more than 90 days during which the individual was on active duty (other than for training) is not an eligible employee if any of this active duty occurred during the 60-day period ending on the date the individual was hired by the employer. This latter rule is intended to prevent employers who hire current members of the armed services (or those departed from service within the last 60 days) from receiving the credit.

(7) Families Receiving Food Stamps. An eligible recipient is an individual aged 18 but not yet 25 certified by a designated local employment agency as being a member of a family receiving assistance under a food stamp program under the Food Stamp Act of 1977 for a period of at least six months ending on the hiring date. In the case of families that cease to be eligible for food stamps under §6(o) of the Food Stamp Act of 1977, the six-month requirement is replaced with a requirement that the family has

Food Stamp Act of 1977, the six-month requirement is replaced with a requirement that the family has been receiving food stamps for at least three of the five months ending on the date of hire. For these purposes, members of the family are defined to include only those individuals taken into account for purposes of determining eligibility for a food stamp program under the Food Stamp Act of 1977.

Minimum Employment Period. No credit is allowed for wages paid unless the eligible individual is employed by the employer for at least 180 days (20 days in the case of a qualified summer youth employee) or 400 hours (120 hours in the case of a qualified summer youth employee).

Expiration Date. The credit is effective for wages paid or incurred to a qualified individual who begins work for an employer after September 30, 1996, and before October 1, 1997.

New Law

Effective Date. The Act is generally effective for wages paid to qualified individuals who begin work for an employer after September 30, 1997, and before July 1, 1998.

1. The Act adds SSI beneficiaries as a new category of workers for which the credit is available.
2. The minimum employment period is reduced from 400 to 120 hours.
3. The Act provides a credit percentage of 25% for employment of less than 400 hours and 40% for employment of 400 or more hours.
4. **Definitional changes**

The following defines the new category (SSI recipient) and changes and expands certain time periods.

I.R.C. §51

- (2) **Qualified IV-A recipient.**

  (A) In general. The term "qualified IV-A recipient" means any individual who is certified by the designated local agency as being a member of a family receiving assistance under a IV-A program ***for any 9 months during the 18-month period ending on the hiring date.***

- (3) **Qualified veteran.**

  (A) In general. The term "qualified veteran" means any veteran who is certified by the designated local agency as being a member of a family receiving assistance under a food stamp program under the Food Stamp Act of 1977 ***for at least a 3-month period ending during the 12-month period ending on the hiring date.***

- (9) ***Qualified SSI recipient.*** The term "qualified SSI recipient" means any individual who is certified by the designated local agency as receiving supplemental security income benefits under title XVI of the Social Security Act (including supplemental security income benefits of the type described in §1616 of such Act or §212 of Public Law 930966) ***for any month ending within the 60-day period ending***

on the hiring date.

28. Research Tax Credit Extended

[I.R.C. §41]

Present Law

General Rule. Section 41 provides for a research tax credit equal to 20% of the amount by which a taxpayer's qualified research expenditures for a taxable year exceeded its base amount for that year. The research tax credit expired and generally will not apply to amounts paid or incurred after May 31, 1997.

When originally enacted, the research tax credit applied to qualified expenses incurred after June 30, 1981. The credit was modified several times and was extended through June 30, 1995.

The credit later **was extended for the period of July 1, 1996, through May 31, 1997** (with a special 11-month extension for taxpayers that elect to be subject to the alternative incremental research credit regime).

A 20% research tax credit also applied to the **excess** of (1) 100% of corporate cash expenditures (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) **over** (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation. This separate credit computation is commonly referred to as the "university basic research credit" [see §41(e)].

Computation of Allowable Credit. **Except for certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenditures for the current taxable year exceed its base amount. The base amount** for the current year generally is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenditures and had gross receipts during each of at least three years from 1984 through 1988, then its "fixed-base percentage" is the ratio that its total qualified research expenditures for the 1984–1988 period bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers (so-called start-up firms) are assigned a fixed-base percentage of 3%.The Small Business Job Protection Act of 1996 expanded the definition of "start-up firms" under §41(c)(3)(B)(I) to include any firm if the first taxable year in which such firm had both gross receipts and qualified research expenses began after 1983.

Alternative Incremental Research Credit Regime. **As part of the Small Business Job Protection Act of 1996,** taxpayers are allowed to elect an alternative incremental research credit regime. If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced.

Under a special rule enacted as part of the **Small Business Job Protection Act of 1996,** 75% of amounts paid to a research consortium for qualified research is treated as qualified research expenses eligible for the research credit [rather than 65% under the general rule under §41(b)(3) governing contract research expenses] if (1) such research consortium is a tax-exempt organization that is described in §501(c)(3) (other than a private foundation) or §501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer.

Effective Date. The provision **generally is effective for qualified research expenditures paid or incurred during the period of June 1, 1997, through June 30, 1998.**

A special rule provides that, notwithstanding the general termination date for the research credit of June 30, 1998, if a taxpayer elects to be subject to the alternative incremental research credit regime for its first taxable year beginning after June 30, 1996, and before July 1, 1997, the alternative incremental research credit will be available during the entire 24-month period beginning with the first month of such taxable year—i.e., the equivalent of the 11-month extension provided for by the Small Business Job Protection Act of 1996 **plus** an additional 13-month extension provided for by the Act.

However, to prevent taxpayers from effectively obtaining more than 24 months of research credits from the **Small Business Job Protection Act of 1996** and this Act, the 24-month period for taxpayers electing the alternative incremental research credit regime is reduced by the number of months (if any) after June 1996 with respect to which the taxpayer claimed research credit amounts under the regular 20% research credit rules.

Under the provision, taxpayers are permitted to elect the alternative incremental research credit regime under §41(c)(4) for any taxable year beginning after June 30, 1996, and such election will apply to that taxable year and all subsequent taxable years **unless revoked** with the consent of the Secretary of the Treasury.

Partnerships

29. Basis Allocation of Properties Distributed by a Partnership

[I.R.C. §732]

Present Law

Partner's Basis in Distributed Properties and Partnership Interest.

- Present law provides two different rules for determining a partner's basis in distributed property, depending on whether or not the distribution is in liquidation of the partner's interest in the partnership.
- Generally, substituted basis rule applies to property distributed to a partner in liquidation.
- Thus, the basis of property distributed in liquidation of a partner's interest is equal to the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction) [§732(b)].
- By contrast, generally, a carryover basis rule applies to property distributed to a partner other than in liquidation of its partnership interest, subject to a cap [§732(a)].
- Thus, in a nonliquidating distribution, the distributee partner's basis in the property is equal to the partnership's adjusted basis in the property immediately before the distribution, but not to exceed the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction).
- In a nonliquidating distribution, the partner's basis in its partnership interest is reduced by the amount of the basis to the distributee partner of the property distributed and is reduced by the amount of any money distributed [§733].

Allocating Basis Among Distributed Properties

- In the event that multiple properties are distributed by a partnership, **present law** provides allocation rules for determining their bases in the distributee partner's hands.
- An allocation rule is needed when the substituted basis rule for liquidating distributions applies, in order to assign a portion of the partner's basis in its partnership interest to each distributed asset.
- An allocation rule is also needed in a nonliquidating distribution of multiple assets when the total carryover basis would exceed the partner's basis in its partnership interest, so a portion of the partner's basis in its partnership interest is assigned to each distributed asset.
- **Present law** provides for allocation in proportion to the partnership's adjusted basis.
- The rule allocates basis first to unrealized receivables and inventory items in an amount equal to the partnership's adjusted basis (or if the allocated basis is less than partnership basis, then in proportion to the partnership's basis), and then among other properties in proportion to their adjusted bases to the partnership [§732(c)].
- Under this allocation rule, in the case of a liquidating distribution, the distributee partner can have a basis in the distributed property that exceeds the partnership's basis in the property.

Explanation of New Law. The Act modifies the basis allocation rules for distributee partners.

Please see pages 330 and 331 of the LLCs and Partnerships chapter for a complete explanation of the changes and a comprehensive example.

Effective Date. The provision applies to partnership distributions **after** the date of enactment (after August 5, 1997).

30. Tax Treatment of Partnership Inventory

[I.R.C. §§751, 724, 732, 735]

Present Law. Under present law, upon the sale or exchange of a partnership interest, any amount received that is attributable to unrealized receivables, or to inventory that has **substantially appreciated,** is treated as an amount realized from the sale or exchange of property that is **not** a capital asset [§751(a)].

New Law. The Act repeals the requirements that inventory be substantially appreciated only with respect to sales or exchanges of partnership interest under §751(a) of the Code, but not with respect to distributions under §751(b) of the Code. **Thus, present law is retained with respect to distributions governed by §751(b).**

See pages 332 and 333 of the LLCs and Partnerships chapter for a thorough explanation of this law change.

Effective Date. Applies to sales and exchanges **after** August 5, 1997.

31. Time for Taxing Precontribution Gain with Respect to Appreciated Property—Partnerships

[I.R.C. §§704, 737]

Present Law

- Under present law, if a partner contributes appreciated property to a partnership, no gain is recognized to the contributing partner at the time of the contribution.
- The contributing partner's basis in its partnership interest is increased by the basis of the contributed property at the time of the contributions.
- The precontribution gain is reflected in the difference between the partner's capital account and its basis in its partnership interest ("book/tax differential").
- Income, gain, loss, and deduction with respect to the contributed property must be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution [§704(c)(1)(A)].
- If the property is subsequently distributed to another partner within **five years** of the contribution, the

contributing partner generally recognizes gain as if the property had been sold for its fair market value at the time of the distribution [§704(c)(1)(B)].

- Similarly, the contributing partner generally includes precontribution gain in income to the extent that the value of other property distributed by the partnership to that partner exceeds its adjusted basis in its partnership interest, if the distribution by the partnership is made within **five years** after the contribution of the appreciated property (§737).
- If a partnership distributes property to a partner, the partner does not recognize gain except to the extent any money (including marketable securities) received in the distribution exceeds the partner's basis for its partnership interest [§731(a)].
- In addition, a partnership **does not recognize gain** on a distribution to a partner [§731(b)].

New Law

- The Act **extends to seven years** the period in which a partner recognizes precontribution gain with respect to property contributed to a partnership.
- Thus, under the Act, a partner that contributes appreciated property to a partnership generally recognizes precontribution gain in the event that the partnership distributes the contributed property to another partner, or distributes to the contributing partner other property whose value exceeds that partner's basis in its partnership interest, if the distribution occurs **within seven years** after the contribution to the partnership.

See pages 328 and 329 of the LLCs and Partnerships chapter for a discussion of this law change.

Effective Date. The provision is effective for property contributed to a partnership **after** June 8, 1997.

Employment and Self-Employment taxes

32. Clarification of Standard To Be Used in Determining Tax Status of Retail Securities Brokers

[I.R.C. §3121]

Explanation of Act. Under the Act, in determining the status (employee or independent contractor) of a registered representative of a broker-dealer for federal tax purposes, no weight may be given to instructions from the service recipient which are imposed only in compliance with governmental investor protection standards or investor protection standards imposed by a governing body pursuant to a delegation by a federal or state agency.

Effective Date. The provision is effective with respect to services performed after December 31, 1997. No inference is intended that the treatment under the new Act is not present law.

33. Tax Court Jurisdiction for Determination of Employment Status

[I.R.C. §§7436, 7437]

Explanation of New Law. The Act provides that, in connection with the audit of any person, if there is an actual controversy involving a determination by the IRS as part of an examination that (a) **one or more individuals performing services for that person are employees of that person** or (b) **that person is not entitled to relief under §530 of the Revenue Act of 1978,** the Tax Court would have jurisdiction to determine whether the IRS is correct.

For example, one way the IRS could make the required determination is through a mechanism similar to the employment tax early referral procedures. A failure to agree would also be considered a determination for this purpose.

The bill provides for de novo review (rather than review of the administrative record). **Assessment and collection of the tax would be suspended while the matter is pending in the Tax Court.**

Any determination by the Tax Court would have the force and effect of a decision of the Tax Court and would be reviewable as such; accordingly, it would be binding on the parties.

Effective Date. The provision takes effect **on the date** of enactment (August 5, 1997).

Earned Income Credit

34. Earned Income Credit Compliance Provisions

[I.R.C. §§32, 6213, 6695]

Effective for tax years beginning after December 31, 1996.

Ineligible to Claim Credit

Explanation of New Law. A taxpayer who fraudulently claims the earned income credit (EIC) **is ineligible to claim the EIC for a subsequent period of 10 years.**

- In addition, a taxpayer who erroneously claims the EIC due to reckless or intentional disregard of rules or regulations is ineligible to claim the EIC **for a subsequent period of two years.**

- These sanctions are in addition to any other penalty imposed under present law. The determination of fraud or of reckless or intentional disregard of rules or regulations **are made in a deficiency proceeding (which provides for judicial review).**

New Evidence of Eligibility Must Be Provided

Explanation of New Law. Under the Act, a taxpayer who has been denied the EIC as a result of deficiency procedures is ineligible to claim the EIC in subsequent years **unless evidence of eligibility for the credit is provided by the taxpayer.**

- To demonstrate current eligibility, the taxpayer is required to **meet evidentiary requirements** established by the Secretary of the Treasury.
- Failure to provide this information when claiming the EIC is **treated as a mathematical or clerical error.**
- If a taxpayer is recertified as eligible for the credit, the taxpayer is not required to provide this information in the future unless the IRS again denies the EIC as a result of a deficiency procedure.
- Ineligibility for the EIC under the provision is subject to review by the courts.

IRS Deficiency Procedures

The IRS must follow deficiency procedures when investigating other types of questionable EIC claims. Under these procedures, contact letters are first sent to the taxpayer. If the necessary information is not provided by the taxpayer, a statutory notice of deficiency is sent by certified mail, notifying the taxpayer that the adjustment will be assessed unless the taxpayer files a petition in Tax Court within 90 days. If a petition is not filed within that time and there is no other response to the statutory notice, the assessment is made **and the EIC is denied.**

Return Preparers

Explanation of New Law. Return preparers are required to fulfill certain due diligence requirements with respect to returns they prepare claiming the EIC. The penalty for failure to meet these requirements is $100. This penalty is in addition to any other penalty imposed under present law.

Miscellaneous

35. Clarified Statute of Limitations for Items from Pass-Through Entities

[I.R.C. §6501]

Explanation of New Law. The Act clarifies that the return that starts the running of the statute of limitations for a taxpayer is the return of the taxpayer **and not** the return of another person from whom the taxpayer has received an item of income, gain, loss, deduction, or credit.

Effective Date. The provision is effective for taxable years beginning after the date of enactment (after August 5, 1997).

36. Medical Savings Accounts

[I.R.C. §220]

Definition of Permitted Coverage

Present Law. Under present law, in order to be eligible to have an MSA an individual must be covered under a high-deductible health plan and no other health plan, except for plans that provide certain permitted coverage. **Medicare supplemental plans are one of the types of permitted coverage, even though an individual covered by Medicare is not eligible to have an MSA.**

Explanation of New Law. Under the Act, Medicare supplemental plans would be **deleted** from the types of permitted coverage an individual may have and still qualify for an MSA.

Taxation of Distributions

Present Law. Under present law, in order to be eligible to have a medical savings account ("MSA") an individual must be covered under a high-deductible health plan and no other health plan, except for plans that provide certain permitted coverage and must be either (1) a self-employed individual, or (2) employed by a small employer. **Distributions from an MSA for the medical expenses of the MSA account holder and his or her spouse or dependents are generally excludible from income.**

However, in any year for which a contribution is made to an MSA, withdrawals from the MSA are excludible from income only if the individual for whom the expenses were incurred **was an eligible individual for the month in which the expenses were incurred.** This rule is designed to ensure that MSAs are 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.

Explanation of New Law. The Act clarifies that, in any year for which a contribution is made to an MSA, withdrawals from the MSA are excludible from income only if the individual for whom the expenses were incurred was covered under a high-deductible health plan (and no other health plan except for plans that provide certain permitted coverage) **in the month in which the expenses were incurred.**

That is, the individual for whom the expenses were incurred does not have to be self-employed or employed by a small employer in order for a withdrawal for medical expenses to be excludible.

Effective Date. Taxable years beginning after December 31, 1996.

Procedure and Filing

37. Delayed Imposition of Penalties for Failure to Make Payments Electronically Through EFTPS

[No Code section—Act §831]

Present Law. The Code requires the development and implementation of an electronic fund transfer system to remit these taxes and convey deposit information directly to the Treasury (Code §6302(h)This requirement was enacted in 1993.). The Electronic Federal Tax Payment System (EFTPS) was developed by the Treasury in response to this requirement.The Treasury had earlier developed TAXLINK as the prototype for EFTPS. TAXLINK has been operational for several years; EFTPS is currently operational. Employers currently using TAXLINK will ultimately be required to participate in EFTPS. Employers must enroll with one of two private contractors hired by the Treasury. After enrollment, employers generally initiate deposits either by telephone or by computer.

The new system is phased in over a period of years by increasing each year the percentage of total taxes subject to the new EFTPS system. For fiscal year 1994, 3% of the total taxes are required to be made by electronic fund transfer. These percentages increased gradually for fiscal years 1995 and 1996. For fiscal year 1996, the percentage was 20.1% (30% for excise taxes and corporate estimated tax payments). For fiscal year 1997, these percentages increased significantly, to 58.3% (60% for excise taxes and corporate estimated tax payments). The specific implementation method required to achieve the target percentages is set forth in Treasury regulations. Implementation began with the largest depositors.

The Treasury had originally implemented the 1997 percentages by requiring that all employers who deposit more than $50,000 in 1995 must begin using EFTPS by January 1, 1997. The Small Business Job Protection Act of 1996 provided that the increase in the required percentages for fiscal year 1997 (which, pursuant to Treasury regulations, was to take effect on January 1, 1997) **would not take effect until July 1, 1997.**§1809 of P.L. 104-188. This was done to provide additional time prior to implementation of the 1997 requirements so that employers could be better informed about their responsibilities.

On June 2, 1997, the IRS announced that it will not impose penalties through **December 31, 1997,** on businesses that make timely deposits using paper federal tax deposit coupons while converting to the EFTPS system.

New Law.

prior to July 1, 1998, by **the group of taxpayers who were first required to use this system after June 30, 1997** (those who deposited more than $50,000 in 1995).

Note: A timely deposit must be made to **avoid** a late deposit penalty.

38. Clarification of Period for Filing Claims for Refunds

[I.R.C. §6512]

Background. In ***Commissioner v. Lundy,*** 116 S. Ct. 647 (1996), the taxpayer had not filed a return, but received a notice of deficiency within three years after the date the return was due and challenged the proposed deficiency in Tax Court. The Supreme Court held that the taxpayer could not recover overpayments attributable to withholding during the tax year, because no return was filed and the two-year "look back" rule applied. Since overwithheld amounts are deemed paid as of the date the taxpayer's return was first due (i.e., more than two years before the notice of deficiency was issued), such overpayments could not be recovered. By contrast, if the same taxpayer had filed a return on the date the notice of deficiency was issued, and then claimed a refund, the three-year "look back" rule would apply, and the taxpayer could have obtained a refund of the overwithheld amounts.

Explanation of New Law. The Act permits taxpayers who initially fail to file a return, but who receive a notice of deficiency and file suit to contest it in Tax Court during the third year after the return due date, to obtain a refund of excessive amounts paid within the three-year period prior to the date of the deficiency notice.

Effective Date. The provision applies to claims for refund with respect to tax years ending after the date of enactment (after August 5, 1997).

Alternative Minimum Tax

39. New Capital Gain Rates Apply to Both Regular Tax and the Alternative Minimum Tax

Explanation of New Law. Under the Act, the maximum rate of tax on the net capital gain of an individual is reduced from 28% to 20%. In addition, any net capital gain which otherwise would be taxed at a 15% rate is taxed at a rate of 10%. These rates apply for purposes of **both the regular tax and the minimum tax.**

Note: The tax on the net capital gain attributable to any long-term capital gain from the sale or exchange of collectibles will remain at a maximum rate of 28%.

Effective for the First Time in 1998 and Later Years

Individuals

40. Child Tax Credit

Size of Credit. The Act provides a $500 ($400 for taxable year 1998) **nonrefundable** tax credit for each qualifying child **under the age of 17.** The availability of the credit depends on the child's age at the end of the taxable year.

Qualifying Child. A qualifying child is defined as an individual for whom the taxpayer can claim a dependency exemption and who is a son or daughter of the taxpayer (or descendent of either), a stepson or stepdaughter of the taxpayer, or an eligible foster child of the taxpayer.

Phaseout of Credit Based on AGI. For taxpayers with modified AGI in excess of certain thresholds, the sum of the otherwise allowable child credit and the otherwise allowable dependent care credit is **phased out.** The phaseout rate is $50 for each $1,000 of modified AGI (or fraction thereof) in excess of the threshold. For married taxpayers filing joint returns, the threshold is $110,000. For taxpayers filing single or head of household returns, the threshold is $75,000. For married taxpayers filing separate returns, the threshold is $55,000. These thresholds are not indexed for inflation.

Example 1. The taxpayers have a modified AGI in 1998 of $120,000, file jointly, and have one qualifying child.

Credit = $400 minus $50 for each $1,000 over the threshold amount (50 × 10 = $500).
No credit is available to the taxpayers in 1998.

Example 2. Same facts as Example 1, except they have two qualifying children.

Credit = $800 minus $50 × 10 = $300

Maximum Allowable Child Credit. In general, in the case of a taxpayer with qualifying children, the amount of the child credit equals $500 (1999 and later years) times the number of qualifying children.

Exception: Supplemental Child Credit Amount. In the case of a taxpayer with one or two qualifying children, a portion of the child credit may be treated as a **supplemental child credit amount.** This amount equals the **excess of** (1) $500 [$400 for 1998] times the number of qualifying children up to the excess of the taxpayer's income tax liability (net of applicable credits other than the earned income credit) over the taxpayer's tentative minimum tax liability (determined without regard to the alternative minimum foreign tax credit) **over** (2) the sum of the taxpayer's regular income tax liability (net of applicable credits other than the earned income credit) and the employee share of FICA (and one-half of the taxpayer's SECA tax liability, if applicable) reduced by any earned income credit amount. In no case will the total amount of the allowable child credit **exceed the amount** that would result from its calculation as a nonrefundable personal credit.

Example 3. Assume there are two qualifying children and an earned income of $25,000 in 1998.

	(1) $400 × 2 = $800
[Limitation]	(2) Regular tax liability (net of all credits other than EIC)
	over minimum tax liability = $700
	over
	(3) $700 + $1,920 FICA minus EIC of $900 = $1,720
	Step 2 of $700 minus Step 3 of $1,720 eqauls zero.

Conclusion. Taxpayers qualify for the full credit in 1998. There is no supplemental credit because the EIC ($900) is less than the employee's share of the FICA tax ($1,920).

In the case of a taxpayer with three or more qualifying children, the maximum amount of the child credit for each taxable year **cannot exceed the greater of:** (1) the excess of the taxpayer's regular tax liability (net of applicable credits other than the earned income credit) over the taxpayer's tentative minimum tax liability (determined without regard to the alternative minimum foreign tax credit), or (2) an amount equal to the **excess** of the **sum** of the taxpayer's regular income tax liability (net of applicable credits other than the earned income credit) and the employee share of FICA (and one-half of the taxpayer's SECA tax liability, if applicable) **reduced by** the earned income credit. To the extent that the amount determined under (2) is **greater than** the amount determined under (1), the difference is treated as a **supplemental child credit amount.**

Refundable Child Credit Amount. In the case of a taxpayer with three or more qualifying children, if the amount of the allowable child credit as computed under the computation described immediately above exceeds the taxpayer's regular tax liability before the computation, **then the excess is a refundable tax credit.**

Example 4. Assume the same facts as in Example 3, except there are three children.

Credit = $400 × 3 = $1,200

(1) $700
or
(2) $700 + $1,920 FICA minus EIC of $900 = $1,720.

Since (2) does exceed (1) there is **no supplemental child credit** amount. But since (2) is more than (1) a refundable credit amount of $1,200 – $700 = **$500** plus the EIC amount is allowed.

Effective Date. Generally, the child tax credit is effective for taxable years beginning after December 31, 1997.

41. Treatment of Certain Reimbursed Expenses of Rural Letter Carriers' Vehicles

[I.R.C. §162(o)]

Present Law. A taxpayer who uses his or her automobile for business purposes may deduct the business portion of the actual operation and maintenance expenses of the vehicle, plus depreciation (subject to the limitations of §280F). Alternatively, the taxpayer may elect to utilize a standard mileage rate in computing the deduction allowable for business use of an automobile that has not been fully depreciated. Under this election, the taxpayer's deduction equals the applicable rate multiplied by the number of miles driven for business purposes and is taken in lieu of deductions for depreciation and actual operation and maintenance expenses.

An employee of the U.S. Postal Service may compute his or her deduction for business use of an automobile in performing services involving the collection and delivery of mail on a rural route by using, for all business use mileage, 150% of the standard mileage rate.

Rural letter carriers are paid an equipment maintenance allowance (EMA) to compensate them for the use of their personal automobiles in delivering the mail. The tax consequences of the EMA are determined by comparing it with the automobile expense deductions that each carrier is allowed to claim (using either the actual expenses method or the 150% of the standard mileage rate). If the EMA exceeds the allowable automobile expense deductions, the **excess generally is subject to tax.** If the EMA falls short of the allowable automobile expense deductions, a deduction is allowed only to the extent that the sum of this shortfall and all other miscellaneous itemized deductions exceeds 2% of the taxpayer's adjusted gross income.

New Law. The Act **repeals** the special rate for Postal Service employees of 150% of the standard mileage rate. **In its place,** the Act requires that the rate of reimbursement provided by the Postal Service to rural letter carriers be considered to be equivalent to their expenses. **The rate of reimbursement that is considered to be equivalent to their expenses is the rate of reimbursement contained in the 1991 collective bargaining agreement, which may be increased by no more than the rate of inflation.**

Effective Date. The provision is effective for taxable years beginning after December 31, 1997.

42. Increase in Standard Mileage Rate for Purposes of Computing Charitable Deduction

[I.R.C. §170(i)]

Present Law. In general, individuals who itemize their deductions may deduct charitable contributions. For purposes of computing the charitable deduction for the use of a passenger automobile, the standard mileage rate is 12 cents per mile [§170(i)].

New Law. The Act increases this mileage rate to **14 cents per mile** (not indexed for inflation), effective for taxable years beginning **after December 31, 1997.**

43. Modifications to Standard Deduction of Dependents; AMT Treatment of Certain Minor Children

[I.R.C. §§63, 59, 6103]

Present Law

Standard Deduction of Dependents. The standard deduction of a **taxpayer** for whom a dependency exemption is allowed on another taxpayer's return **cannot exceed the lesser of** (1) the standard deduction for an individual taxpayer (projected to be $4,250 for 1998) of (2) the greater of $500 (indexed)The indexed amount is projected to be $700 for 1998. or the dependent's earned income [§63(c)(5)].

Taxation of Unearned Income of Children under Age 14. The tax on a portion of the unearned income (e.g., interest and dividends) of a child under age 14 is the additional tax that the child's custodial parent would pay if the child's unearned income were included in that parent's income. That portion of the child's unearned income that is taxed at the parent's top marginal rate is the amount by which the child's unearned income **is more than** the sum of (1) $500Projected to be $700 for 1998. (indexed) plus (2) the greater of (a) $500Projected to be $700 for 1998. (indexed) or (b) the child's itemized deductions directly connected with the production of the unearned income [§1(g)].

Alternative Minimum Tax (AMT) Exemption for Children under Age 14. Single taxpayers are entitled to an exemption from the alternative minimum tax ("AMT") of $33,750. **However, in the case of a child under age 14, his exemption from the AMT, in substance, is the unused alternative minimum tax exemption of the child's custodial parent, limited to the sum of earned income and $1,400** [§59(j)].

Explanation of New Law

Standard Deduction of Dependents. The bill **increases** the standard deduction for a taxpayer with respect to whom a dependency exemption is allowed on another taxpayer's return to the lesser of (1) the standard deduction for individual taxpayers or (2) the greater of: (a) $500 (indexed for inflation as under present law), or (b) the individual's earned income plus $250. The $250 amount is indexed for inflation after 1998.

Alternative Minimum Tax Exemption for Children under Age 14. The Act increases the AMT exemption amount for a child under age 14 to the lesser of (1) $33,750 or (2) the sum of the child's earned income plus $5,000. The $5,000 amount is indexed for inflation after 1998.

Effective Date. The provision is effective for taxable years beginning **after** December 31, 1997.

Business Deductions

44. Home Office Deduction: Clarification of Definition of Principal Place of Business

[I.R.C. §280A]

Effective Date. The Act provision is effective for taxable years beginning **after** December 31, 1998.

Present Law. A taxpayer's business use of his or her home may give rise to a deduction for the business portion of expenses related to operating the home (e.g., a portion of rent or depreciation and repairs).

Code §280A(c)(1) provides, however, that business deductions generally are allowed only with respect to a portion of a home that is used exclusively and regularly in one of the following ways:

1. As the **principal place of business** for a trade or business;
2. As a place of business used to meet with patients, clients, or customers in the normal course of the taxpayer's trade or business; or
3. In connection with the taxpayer's trade or business, if the portion so used constitutes a separate structure not attached to the dwelling unit.

In the case of an employee, the Code further requires that the business use of the home **must be for the convenience of the employer** [§280A(c)(1)].If an employer provides access to suitable space on the employer's premises for the conduct by an employee of particular duties, then, if the employee opts to conduct such duties at home as a matter of personal preference, the employee's use of the home office is not "for the convenience of the employer." See e.g., ***W. Michael Mathes,*** (1990) T.C. Memo 1990 483. These rules apply to houses, apartments, condominiums, mobile homes, boats, and other similar property used as the taxpayer's home [§280A(f)(1)].

Under Internal Revenue Service (IRS) rulings, the deductibility of expenses incurred for local transportation between a taxpayer's home and a work location sometimes depends on whether the taxpayer's home office qualifies under §280A(c)(1) as a principal place of business(see **Rev. Rul.** 94 47, 1994 29 I.R.B. 6).

Prior to 1976, expenses attributable to the business use of a residence were deductible whenever they were "appropriate and helpful to the taxpayer's business."

In 1976, Congress adopted §280A, in order to provide a narrower scope for the home office deduction, but did not define the term "principal place of business."

In ***Commissioner v. Soliman,*** 113 S.Ct. 701 (1993), the Supreme Court reversed lower court rulings and upheld an IRS interpretation of §280A that disallowed a home office deduction for a self-employed anesthesiologist who practiced at several hospitals but was not provided office space at the hospitals. Although the anesthesiologist used a room in his home exclusively to perform administrative and management activities for his profession (i.e., he spent two or three hours a day in his home office on bookkeeping, correspondence, reading medical journals, and communicating with surgeons, patients, and insurance companies), the Supreme court upheld the IRS position that the "principal place of business" for the taxpayer was not the home office, because the taxpayer performed the **"essence of the professional service"** at the hospitals.In response to the Supreme Court's decision in ***Soliman,*** the IRS revised its Publication 587, Business Use of Your Home, to more closely follow the comparative analysis used in ***Soliman*** by focusing on the following two primary factors in determining whether a home office is a taxpayer's principal place of business: (1) the relative importance of the activities performed at each business location; and (2) the amount of time spent at each location. Because the taxpayer did not meet with patients at his home office and the room was not a separate structure, a deduction was not available under the second or third exception under §280A(c)(1) (described above).

Section 280A(c)(2) contains a special rule that allows a home office deduction for business expenses related to a space within a home that is used on a regular (even if not exclusive) basis as a storage unit for the inventory or product samples of the taxpayer's trade or business of selling products at retail or wholesale, but only if the home is the sole fixed location of such trade or business.

Home office deductions may not be claimed if they create (or increase) a net loss from a business activity, although such deductions may be carried over to subsequent taxable years [§280A(c)(5)].

Reasons for Change. "The Committee believes that the Supreme Court's decision in ***Soliman*** unfairly denies a home office deduction to a growing number of taxpayers who manage their business activities from their homes. Thus, the statutory modification adopted by the Committee will reduce the present-law bias in favor of taxpayers who manage their business activities from outside their home, thereby enabling more taxpayers to work efficiently at home, save commuting time and expenses, and spend additional time with their families. Moreover, the statutory modification is an appropriate response to the computer and information revolution, which has made it more practical for taxpayers to manage trade or business activities from a home office."

Explanation of New Law. Section 280A is amended to specifically provide that a home office qualifies as the "principal place of business" if:

1. The office is used by the taxpayer to conduct administrative or management activities of a trade or business **and**
2. There is no other fixed location of the trade or business where the taxpayer conducts **substantial administrative or management activities** of the trade or business.

As under present law, deductions will be allowed for a home office meeting the above two-part test only if the office is exclusively used on a regular basis as a place of business by the taxpayer and, in the case of an employee, only if such exclusive use is for the convenience of the employer.

Summary. Thus, under the Act, a home office deduction is allowed (subject to the present-law "convenience of the employer" rule governing employees) if a portion of a taxpayer's home is exclusively and regularly used to conduct administrative or management activities for a trade or business of the taxpayer, who does not conduct substantial administrative or management activities at any other fixed location of the trade or business, regardless of whether administrative or management activities connected with his trade or business (e.g., billing activities) are performed by others at other locations.

- The fact that a taxpayer **also carries out administrative or management activities at sites that are not fixed locations of the business, such as a car or hotel room, will not affect the taxpayer's ability to claim a home office deduction under the Act.**

- Moreover, if a taxpayer conducts some administrative or management activities at a fixed location of the business outside the home, the taxpayer still will be eligible to claim a deduction so long as the administrative or management activities conducted at any fixed location of the business outside the home **are not substantial** (e.g., the taxpayer **occasionally** does minimal paperwork at another fixed location of the business).

- In addition, a taxpayer's eligibility to claim a home office deduction under the Act will not be affected by the fact that the taxpayer conducts substantial **nonadministrative** or **nonmanagement** business activities **at a fixed location of the business outside the home** (e.g., meeting with, or providing services to, customers, clients, or patients at a fixed location of the business away from home).
- If a taxpayer in fact does not perform substantial administrative or management activities at any fixed location of the business away from home, **then the second part of the test will be satisfied, regardless of whether or not the taxpayer opted not to use an office away from home that was available for the conduct of such activities.**
- **However,** in the case of an employee, the question whether an employee chose not to use suitable space made available by the employer for administrative activities **is relevant** to determining whether the **present-law convenience of the employer's test is satisfied.**
- In cases where a taxpayer's use of a home office does not satisfy the provision's two-part test, the

taxpayer nonetheless may be able to claim a home office deduction under the present-law "principal place of business" exception or any other provision of §280A.

45. Increased Deductibility of Business Meal Expenses for Individuals Subject to Federal Hours of Service

[I.R.C. §274(n)(3)]

Explanation of New Law. **The Act increases to 80% the deductible percentage of the cost of food and beverages consumed while away from home by an individual during, or incident to, a period of duty subject to the hours of service limitations of the Department of Transportation.**

Individuals subject to the hours of service limitations of the Department of Transportation include:

1. Certain air transportation employees such as pilots, crew, dispatchers, mechanics, and control tower operators pursuant to Federal Aviation Administration regulations,
2. Interstate truck operators and interstate bus drivers pursuant to Department of Transportation regulations,
3. Certain railroad employees such as engineers, conductors, train crews, dispatchers, and control operations personnel pursuant to Federal Railroad Administration regulations, and
4. Certain merchant mariners pursuant to Coast Guard regulations.

The increase in the deductible percentage is phased in according to the following schedule:

Taxable Years Beginning in:	Deductible Percentage
1998, 1999	55
2000, 2001	60
2002, 2003	65
2004, 2005	70
2006, 2007	75
2008 and thereafter	80

Effective Date. The provision is effective for taxable years beginning **after 1997.**

46. Clarification of De Minimis Fringe Benefit Rules to No-Charge Employee Meals

[I.R.C. §132]

Present Law. In general, subject to several exceptions, only 50% of business meal and entertainment expenses are allowed as a deduction [§274(n)]. Under one exception, the value of meals that are excludible from employees' incomes as a de minimis fringe benefit [§132] **are fully deductible** by the employer.

In addition, the courts that have considered the issue have held that if meals are provided for the convenience of the employer pursuant to §119 they are **fully deductible** (***Boyd Gaming Corp. v. Commissioner*** and ***Gold Coast Hotel & Casino v. IRS***).

Explanation of Act. The Act provides that meals that **are excludible** from employees' incomes because they are provided for the convenience of the employer pursuant to §119 of the Code are excludible as a de minimis fringe benefit and therefore are **fully deductible by the employer.** [No inference is intended as to whether such meals are fully deductible under present law.]

Note: The requirements of I.R.C §132(e)(2) have to be met.

Effective Date. The provision is effective for taxable years beginning **after** December 31, 1997.

Individual Retirement Accounts

47. Individual Retirement Arrangements

[I.R.C. §219(g) and (g)(3)(B)]

Present Law. If an individual (or, if married, the individual's spouse) is an active participant in an employer-sponsored retirement plan, the $2,000 IRA deduction limit is phased out over the following levels of adjusted gross income (AGI): $25,000 to $35,000 in the case of a single taxpayer, and $40,000 to $50,000 in the case of married taxpayers.

New Law. Under the Act, the **deductible** IRA income phaseout limits are increased as follows:

Taxable Years Beginning in:	Phaseout Range
Joint Returns	
1998	$50,000– $60,000
1999	$51,000– $61,000
2000	$52,000– $62,000
2001	$53,000– $63,000
2002	$54,000– $64,000
2003	$60,000– $70,000
2004	$65,000– $75,000
2005	$70,000– $80,000

2006	$75,000– $85,000
2007 and thereafter	$80,000–$100,000
Single Taxpayers	
1998	$30,000–$40,000
1999	$31,000–$41,000
2000	$32,000–$42,000
2001	$33,000–$43,000
2002	$34,000–$44,000
2003	$40,000–$50,000
2004	$45,000–$55,000
2005 and thereafter	$50,000–$60,000

- An individual is not considered to be an active participant in an employer-sponsored retirement plan merely because the individual's spouse is such an active participant.
- However, under the Act, the maximum deductible IRA contribution for an individual who is not an active participant, but whose spouse is, is phased out for taxpayers with AGI between $150,000 and $160,000.

The following examples illustrate the income phaseout rules.

Example 1. Suppose for a year W is an active participant in an employer-sponsored retirement plan, and W's husband, H, is not. Further assume that the combined AGI of H and W for the year is $200,000. Neither W nor H is entitled to make deductible contributions to an IRA for the year.

Example 2. Same as Example 1, except that the combined AGI of W and H is $125,000. H can make deductible contributions to an IRA. However, a deductible contribution could not be made for W.

Example 3. H and W have an AGI of $49,500 in 1997. H is an active participant in an employer-sponsored plan. They cannot make a deductible IRA contribution in 1997. In 1998 they can make a deductible contribution up to $4,000 because of the change in the AGI phaseout levels where one or both taxpayers are active participants.

Effective Date. The provisions are effective for taxable years beginning after December 31, 1997.

48. Ten-Percent Additional Tax on Early Distributions from Qualified Retirement Plans

[I.R.C. §72(t)]

Summary. The 10% early distribution tax on distributions from an IRA does not apply to certain qualified distributions **after 1997.**

Caution. Subparagraph (t)(2)(E), following, is effective for distributions after 12/31/97, with respect to expenses paid after such date (in taxable years ending after such date), for education furnished in academic periods beginning after such date.

(E) Distributions from individual retirement plans for higher education expenses. Distributions to an individual from an individual retirement plan to the extent such distributions do not exceed the qualified higher education expenses of the taxpayer for the taxable year.

Caution. Subparagraph (t)(2)(F), following, is effective for payments and distributions in taxable years beginning after 12/31/97.

(F) Distributions from certain plans for first home purchases. Distributions to an individual from an individual retirement plan which are qualified first-time homebuyer distributions.

First-time homebuyer; other definitions.

(i) First-time homebuyer. The term "first-time homebuyer" means any individual if¾

(I) such individual (and if married, such individual's spouse) had no present ownership interest in a principal residence during the 2-year period ending on the date of acquisition of the principal residence.

Note 1: The distribution for qualified higher education expenses applies to education furnished to the taxpayer, taxpayer's spouse, or any child or grandchild of the taxpayer.

Note 2: The qualified distribution for first-time homebuyers cannot exceed a lifetime amount of $10,000.

49. Roth IRA

[New I.R.C. §408A]

Effective Date. Taxable years beginning after December 31, 1997.

Summary. The Roth IRA is a new type of IRA. Contributions are not deductible, but qualified distributions, including the earnings on the contributions, are not taxable. Some commentators call this a "backloaded" IRA. As a result of the Roth IRA's special rules, many taxpayers will face a decision in 1998 to create and contribute to a Roth or a regular IRA.

Basic Provisions

1. **No deduction allowed.** No deduction is allowed for a contribution to a Roth IRA.

2. **Contributions permitted after age 70½.** Contributions to a Roth IRA may be made even after the individual for whom the account is maintained has attained age 70½.

Note: No mandatory minimum distributions are required, unlike the non-Roth IRA rules.

3. **Phaseout based on AGI.** The maximum contribution that can be made to a Roth IRA is phased out for individuals with AGI between $95,000 and $110,000 and for joint filers with AGI between $150,000 and $160,000.

Note: Individuals who can only make nondeductible contributions to a regular IRA should prefer the Roth IRA because qualified distributions from the Roth IRA are nontaxable, including the earnings.

4. **Taxation of distributions.** Qualified distributions from a Roth IRA **are not includible in income. Qualified distributions** are distributions (1) made after the five-taxable-year period beginning with the first taxable year for which a contribution was made, and (2) which are (a) made on or after the date on which the individual attains age 59½, (b) made a beneficiary on or after the death of the individual, (c) attributable to the individual's being disabled, or (d) for a qualified special-purpose distribution. **A qualified special-purpose distribution is a distribution for first-time home buyer expenses.** [See item #48.]
5. Conversions of an IRA to a Roth IRA can be made at any time. If the conversion is made before January 1, 1999, the amounts that would have been includible in income had the amounts converted been withdrawn are includible in income ratably over four years. **In any case, the 10% tax on early withdrawals does not apply.**
6. Only taxpayers with an AGI of less than $100,000 are eligible to roll over or convert an IRA into a Roth IRA.
7. An individual who cannot (or does not) make contributions to a deductible IRA or a Roth IRA can still make contributions to a **nondeductible IRA,** within the statutory limits.
8. In no case can contributions to all an individual's IRAs, including a Roth IRA, for a taxable year exceed $2,000.
9. **Remember,** there is no AGI phaseout for contributions to a regular IRA if the taxpayers (if filing jointly) or taxpayer (if filing as a single individual) does not actively participate in an employer-sponsored retirement plan.

Planning and Examples

1. Rollover distributions from an IRA to a Roth IRA are taxable (see item 4 above) but are not subject to the 10% tax for early withdrawals.
2. Distributions from a Roth IRA are considered as being made from contributions first.
3. Rollovers from a regular IRA to a Roth IRA have a number of tax consequences:
   a. To the extent that the amount in the regular IRA is taxable, tax must be paid in the year of the rollover (except that it is not subject to the 10% tax, and four-year averaging applies to those

b. If the amount in the IRA account is mostly nondeductible contributions and the earnings are not significant, the tax burden may not be substantial when a rollover to a Roth IRA occurs.

Example 1. Ace opened a regular IRA in 1994 and made $2,000 in nondeductible contributions for 1994, 1995, 1996, and 1997 ($8,000 total). The untaxed earnings at the time of the 1998 rollover are $560. The $560 that is taxable in 1998 will be spread over four years.

Example 2. Ace has a regular IRA balance in 1998 of $100,000, made up of deductible contributions and earnings. He is presently in a 39½% tax bracket, but after retirement he expects to be in a bracket no greater than 28% plus he plans to liquidate some capital assets. The tax burden on the rollover is likely greater than any benefits that can be gained from a rollover to a Roth.

Example 3. Ace in **Example 2** (age 59) expects to withdraw from his regular IRA at age 65 (date of retirement) and afterward and also to be in a lower tax bracket. Again, these facts argue against a conversion or rollover.

Example 4. Ace in **Example 2** tells you that he does not expect to ever need to withdraw funds from his regular IRA. Based on his life expectancy there could be an advantage in rolling over in 1998 and paying the tax in exchange for the result of having a 20–25-year period of earnings being nontaxable.

Example 5. Ace is only 39. Since he has a long time until retirement, even if he should need to withdraw funds at retirement, it may be advantageous for him to roll over to a Roth IRA.

Caution. A contribution to a Roth IRA for a taxpayer is limited to the lesser of $2,000 or 100% of the taxpayer's annual compensation **over** the aggregate amount of contribution to all other IRAs maintained for the benefit of that individual (whether deductible or not). New Code §408A(b) means a retirement plan as defined by I.R.C. §7701(a)(37). These are plans described in I.R.C. §408(a) or (b). The simple IRA (simplified employee pension) means an "individual retirement account or annuity" [I.R.C. §408(k)(1)], and I.R.C. §408(p)(1) states that a simple retirement account is an individual retirement plan as defined in I.R.C. §7701(a)(37). **Query: Will contributions to a SIMPLE IRA (even though employer-sponsored) reduce the amount that can be contributed to a Roth IRA?** The committee reports seem not to intend this application, but the new Code provision is silent. The **query** needs a clear answer from the IRS or a technical corrections bill provision. **The author's preliminary conclusion is that only regular IRAs will be included.**

Estate and Gift Tax

50. Installment Payments of Estate Tax Attributable to Closely Held Business

[I.R.C. §§6166, 2053, 6601]

New Law. **The Act reduces the 4% interest rate to 2% and makes the interest paid on estate**

taxes deferred under §6166 non-deductible for estate or income tax purposes.

- The 2% interest rate is imposed on the amount of deferred estate tax attributable to the **first $1,000,000** in taxable value of the closely held business (i.e., the first $1,000,000 in value in excess of the effective exemption provided by the unified credit and any other exclusions).
- The interest rate imposed on the amount of deferred estate tax attributable to the taxable value of the closely held business in excess of $1,000,000 is reduced to an amount equal to **45% of the rate applicable to underpayments of tax.**

Effective Date. **The provision is effective for decedents dying after December 31, 1997.** Estates deferring estate tax under current law may make a one-time election to use the lower interest rates and forgo the interest deduction for installments due after the date of the election (but such estates do not receive the benefit of the increase in the amount eligible for the §6601(j) interest rate—i.e., only the amount that was previously eligible for the 4% rate would be eligible for the 2% rate).

51. Estate and Gift Tax Unified Credit Exemption Increased to $1 Million by Year 2006

Explanation of Act. The Act increases the present-law unified credit beginning in 1998, from an effective exemption of $600,000 to an effective exemption of $1 million in 2006. The increase in the effective exemption is phased in according to the following schedule: the effective exemption is $625,000 for decedents dying and gifts made in **1998;** $650,000 in **1999;** $675,000 in **2000 and 2001;** $700,000 in **2002 and 2003;** $850,000 in **2004;** $950,000 in **2005;** and $1 million in **2006** and thereafter.

The Act does not index the effective exemption for inflation.

Effective Date. The provision is effective for decedents dying, and gifts made, after December 31, 1997.

52. Indexing of Certain Estate and Gift Tax Provisions

[I.R.C. §§2032A, 2503(b)(2), 2631(c)]

Explanation of New Law. The Act provides that, after 1998, the $10,000 **annual exclusion for gifts,** the $750,000 **ceiling on special use valuation,** the $1,000,000 **generation-skipping transfer tax exemption,** and the $1,000,000 ceiling on the **value of a closely held business eligible for the special low interest rate** (as modified below), are indexed annually for inflation. Indexing of the annual exclusion is rounded to the next lowest multiple of $1,000 and indexing of the other amounts is rounded to the next lowest multiple of $10,000.

Effective Date. The proposal is effective for decedents dying, and gifts made, after December 31, 1998.

53. Reduction in Estate Tax for Certain Land Subject to Permanent Conservation Easement

[I.R.C. §§2031, 1014, 2032A, 170]

Explanation of New Law

Reduction in Estate Taxes for Certain Land Subject to Permanent Conservation Easement. The Act allows an executor to elect to exclude from the taxable estate 40% of the value of any land subject to a qualified conservation easement that meets certain requirements. The amount excluded cannot exceed a certain amount—for example, $100,000 for deaths in 1998.

Effective Date. The estate tax exclusion applies to decedents dying after December 31, 1997. The rules with respect to the treatment of conservation easements under §2032A and with respect to retained mineral interests are effective for easements granted after December 31, 1997.

54. Modification of Generation-Skipping Transfer Tax for Transfers to Individuals with Deceased Parents

[I.R.C. §§2651, 2612]

Present Law. Under the "predeceased parent exception," a direct skip transfer to a transferor's grandchild is not subject to the generation-skipping transfer ("GST") tax if the child of the transferor who was the grandchild's parent is deceased at the time of the transfer [§2612(c)(2)]. This "predeceased parent exception" to the GST tax is not applicable to (1) transfers to collateral heirs, e.g., grandneices or grandnephews, or (2) taxable terminations or taxable distributions.

Explanation of New Law

- The Act extends the predeceased parent exception to transfers to collateral heirs, provided that the decedent has no living lineal descendants at the time of the transfer.

- **For example,** the exception would apply to a transfer made by an individual (with no living lineal heirs) to a grandniece where the transferor's nephew or niece who is the parent of the grandniece is deceased at the time of the transfer.

- In addition, the Act extends the predeceased parent exception (as modified by the change in the preceding paragraph) to taxable terminations and taxable distributions, provided that the parent of the relevant beneficiary was dead at the earliest time that the transfer (from which the beneficiary's interest in the property was established) was subject to estate or gift tax.
- **For example,** where a trust was established to pay an annuity to a charity for a term for years with a remainder interest granted to a grandson, the termination of the term for years would not be a taxable termination subject to the GST tax if the grandson's parent (who is the son or daughter of the transferor) is deceased at the time the trust was created and the transfer creating the trust was subject to estate or gift tax.

Effective Date. The provision is effective for generation-skipping transfers occurring after December 31, 1997.

55. Estate Tax Exclusion for Qualified Family-Owned Businesses

[I.R.C. §2033A]

Practitioner Warning. Although application of this new provision can result in a substantial exclusion of value for a decedent's estate, note that it is quite complicated, can be narrow in its application, and leaves a number of questions unanswered.

A. Generally

1. The new Code section applies to decedents dying after 12-31-1997.

2. The maximum amount excluded is the difference between $1,300,000 and the unified credit exemption then in effect ($625,000 for 1998).

Example 1. The decedent owns a qualified family business with a value of $2,000,000. The total exclusion under this provision is $675,000 for 1998 ($1,300,000 minus $625,000 for 1998).

Example 2. The business in Example 1 has a value of $500,000. The maximum exclusion is $500,000, not $675,000, for 1998.

B. Basic Qualification Requirements

1. The decedent was (at the date of the decedent's death) a citizen or resident of the United States,
2. The executor elects the application and files the **agreement,**
3. The sum of—

a. the adjusted value of the qualified family-owned business interests, **plus**
b. the amount of the gifts of such interests as determined, (see later explanation) exceeds **50 percent of the adjusted gross estate, and**

4. During the 8-year period ending on the date of the decedent's death there have been periods aggregating 5 years or more during which—
   a. such interests were owned by the decedent or a member of the decedent's family, **and**
   b. there was material participation [within the meaning of §2032A(3)(6)] by the decedent or a member of the decedent's family in the operation of the business to which such interests relate.
5. The qualified family-owned business interests are the interests which—
   a. are included in determining the value of the gross estate, and
   b. are acquired by any qualified heir from, or passed to any qualified heir from, the decedent [within the meaning of §2032A(e)(9)].

C. The 50% Test

1. The adjusted value of the family-owned business interests plus certain lifetime gifts must exceed 50% of the decedent's adjusted gross estate.
2. **Unlike** I.R.C §2032A, which only applies to land, I.R.C. §2033A includes all assets owned by the decedent that are used in a family-owned business—for example, machinery and equipment, inventory, breeding livestock, etc.
3. At least this 50% amount **must pass to or be acquired by** qualified heirs.

Note: For this purpose, qualified heirs include any individual who has been actively employed by the trade or business for at least 10 years prior to the date of the decedent's death, and members of the decedent's family. If a qualified heir is not a citizen of the United States, any qualified family-owned business interest acquired by that heir must be held in a trust meeting requirements similar to those imposed on qualified domestic trusts (under present-law §2056A(a)), or through certain other security arrangements that meet the satisfaction of the Secretary.

D. Includible Gift Amounts

- The amount of the includible gifts of qualified family-owned business interests is the excess of—

(A) the sum of—

(i) the amount of such gifts from the decedent to members of the decedent's family that were taxable gifts (gifts not qualifying for the annual exclusion and gifts to a spouse), plus

(ii) the amount of such gifts otherwise excluded under §2503(b) (those gifts qualifying for the annual exclusion), to the extent such interests are continuously held by members of such family (other than the decedent's spouse) between the date of the gift and the date of the decedent's death, over

(B) the amount of such gifts from the decedent to members of the decedent's family otherwise included in the gross estate.

E. Adjusted Gross Estate.

This is the gross estate (prior to this exclusion) reduced by:

(a) claims against the estate, and

(b) unpaid mortgages on, or any indebtedness in respect of, property where the value of the decedent's interest therein, undiminished by such mortgage or indebtedness, is included in the value of the gross estate [these are I.R.C. §2053(a)(3) and (4) amounts]

and increased by the sum of:

(a) the includible gift amount (described above) **and**

(b) the amount (if more than de minimis) of other transfers from the decedent to the decedent's spouse (at the time of the transfer) within 10 years of the date of the decedent's death, **plus**

(c) the amount of other gifts (not included under (a) or (b) above) from the decedent within 3 years of the date of death, other than gifts to members of the decedent's family otherwise excluded under §2053(b) (annual exclusion gifts)

over

the sum of the amounts described in (a), (b), and (c) above which are otherwise includible in the gross estate.

- [For purposes of the preceding sentence, the Secretary may provide that de minimis gifts to persons other than members of the decedent's family shall not be taken into account.]

F. Adjusted Value of the Qualified Family-Owned Business Interests

- The adjusted value of any qualified family-owned business interest is the value of such interest, reduced by the **excess of**—
  1. any amount deductible under paragraph (3) or (4) of § 2053(a) (claims against estate and mortgages (see above)), over
  2. the sum of—

     (A) any indebtedness on any qualified residence of the decedent the interest on which is deductible **plus**

     (B) any indebtedness to the extent the taxpayer establishes that the proceeds of such indebtedness were used for the payment of educational or medical expenses of the decedent, the decedent's spouse, or the decedent's dependents **plus**

     (C) any indebtedness not described in subparagraphs (A) or (B), to the extent the indebtedness **does not exceed** $10,000.

G. What Is a Qualified Family-Owned Business?

The term "qualified family-owned business interest" means—

1. An interest as a proprietor in **a trade or business carried on as a proprietorship,** or
2. An interest in an entity **carrying on a trade or business,** if—

   (i) at least—

   (I) 50% of such entity is owned (directly or indirectly) by the decedent and members of the decedent's family,

(II) 70% of such entity is owned by members of two families, or

(III) 90% of such entity is owned by members of three families, and

(ii) for purposes of subclause (II) or (III) of clause (i), **at least 30% of such entity is owned by the decedent and members of the decedent's family.**

BUT, it does not mean:

(A) any interest in a trade or business the principal place of business of which is not located in the United States,

(B) any interest in an entity, if the stock or debt of such entity or a controlled group (as defined in §267(f)(1)) of which such entity was a member **was readily tradable on an established securities market (as defined by the Secretary) at any time within three years of the date of the decedent's death,**

(C) any interest in a trade or business not described in §542(c)(2) (bank or savings and loan association), if more than 35% of the adjusted ordinary gross income of such trade or business for the taxable year which includes the date of the decedent's death **would qualify as personal holding company income (as defined in § 543(a)).**

Practitioner Note.

This could be a major limitation! Personal holding company income includes

(1) **Dividends, etc.** Dividends, interest, royalties (other than mineral, oil, or gas royalties or copyright royalties), and annuities.

(2) **Rents.** The adjusted income from rents; except that such adjusted income shall not be included if—

(A) such adjusted income constitutes 50% or more of the adjusted ordinary gross income, and

(B) the sum of—

(i) the dividends paid during the taxable year (determined under §562),

(ii) the dividends considered as paid on the last day of the taxable year under §563(d) (as limited by the second sentence of §563(b)), and

(iii) the consent dividends for the taxable year (determined under §565),

equals or exceeds the amount, if any, by which the personal holding company income for the taxable year (computed without regard to this paragraph and paragraph (6), and computed by including as personal holding company income copyright royalties and the adjusted income from mineral, oil, and gas royalties) exceeds 10% of the ordinary gross income.

Practitioner Note.

The rental provision is the most troubling: Cash rents of properties (even though to a family-owned entity) are likely to be personal holding company income, **or not meet the trade or business** requirement (**likewise triple or other kinds of net leases**).

In addition, cash rents of land will not meet the **"trade or business"** requirement of I.R.C §2033A—both pre- and post-death.

Note: The Senate Committee Report contained the following language:

If a qualified heir rents qualifying property to a member of the qualified heir's family on a net cash basis, and that family member materially participates in the business, the material participation requirement will be considered to have been met with respect to the qualified heir for purposes of this provision.

Practitioner Caution. However, again, if there is **no trade or business,** both pre- and post-death requirements do not seem to be met (clarification is necessary). The Code provision **does not** include the committee's language.

More about Passive Income, Cash, and Securities

1. **The value of a trade or business qualifying as a family-owned business interest is reduced to the extent the business holds passive assets or excess cash or marketable securities.**
2. Under the Act, the value of qualified family-owned business interests does not include any cash or marketable securities in excess of the reasonably expected day-to-day working capital needs of the trade or business.
3. **For this purpose,** it is intended that day-to-day working capital needs be determined based on a historical average of the business's working capital needs in the past, using an analysis similar to that set forth in ***Bardahl Mfg. Corp.,*** 24 T.C.M. 1030 (1965).
4. It is further intended that accumulations for capital acquisitions not be considered "working capital" for this purpose.
5. The value of the qualified family-owned business interests also does not include **certain other passive assets.**

6. **For this purpose,** passive assets include any assets that

   (a) produce dividends, interest, **rents,** royalties, annuities, and certain **other types of passive income** (as described in §543(a));
   (b) are an interest in a trust, partnership, or REMIC (as described in §954(c)(1)(B)(ii));
   (c) produce no income (as described in § 954(c)(1)(B)(iii));
   (d) give rise to income from commodities transactions or foreign currency gains (as described in §954(c)(1)(C) and (D));
   (e) produce income equivalent to interest (as described in §954(c)(1)(E)); or
   (f) produce income from notional principal contracts or payments in lieu of dividends (as described in new §§954(c)(1)(F) and (G), added elsewhere in the bill).

- In the case of a regular dealer in property, such property is not considered to produce passive income under these rules, and thus, is not considered to be a passive asset.

H. What about Post-Death Recapture Tax?

- **Tax treatment of failure to materially participate in business or dispositions of interests.**
  1. There is imposed an additional estate tax (recapture tax) if, within 10 years after the date of the decedent's death and before the date of the qualified heir's death—
     (A) the material participation requirements described in **§2032A(c)(6)(B) are not** met with respect to the qualified family-owned business interest which was acquired (or passed) from the decedent,
     (B) the qualified heir disposes of any portion of a qualified family-owned business interest [other than by a disposition to a member of the qualified heir's family or through a qualified conservation contribution under §170(h)],
     (C) the qualified heir loses U.S. citizenship.

The **conferees** clarify that a sale or disposition, in the ordinary course of business, of assets such as inventory or a piece of equipment used in the business (e.g., the sale of crops or a tractor) would not result in recapture of the benefits of the qualified family-owned business exclusion.

Warning. This statement was not included in the Code language.

Proportionate Recapture. **If a recapture event occurs with respect to any qualified family-owned business interest (or portion thereof), the amount of reduction in estate taxes attributable to that interest is determined on a proportionate basis.**

For example, if the decedent's estate included $2 million in qualified family-owned business interests and $1 million of such interests received beneficial treatment under this provision, **one-half of the value of the interest disposed of is deemed to have received the benefits provided under this Act.**

Note: Under the provision, members of an individual's family are defined using the same definition as is used for the special-use valuation rules of §2032A, and thus include (1) the individual's spouse, (2) the individual's ancestors, (3) lineal descendants of the individual, of the individual's spouse, or of the individual's parents, and (4) the spouses of any such lineal descendants.

Recapture Expanded Discussion

1. The benefit of the exclusions for qualified family-owned business interests is subject to recapture **if, within 10 years of the decedent's death and before the qualified heir's death, one of the following "recapture events" occurs:**
   (1) the qualified heir ceases to meet the material participation requirements (i.e., if neither the qualified heir nor any member of his or her family has materially participated in the trade or business for at least five years of any eight-year period);
   (2) the qualified heir disposes of any portion of his or her interest in the family-owned business, other than by a disposition to a member of the qualified heir's family or through a conservation contribution under §170(h);

(3) the principal place of business of the trade or business ceases to be located in the United States; or

(4) the qualified heir loses U.S. citizenship. A qualified heir who loses U.S. citizenship may avoid such recapture by placing the qualified family-owned business assets into a trust meeting requirements similar to a qualified domestic trust (as described in present-law section §2056A(a)), or through certain other security arrangements.

2. If one of the above recapture events occurs, an **additional tax is imposed on the date of such event.**
3. As under §2032A, each qualified heir is **personally liable for the portion of the recapture tax that is imposed with respect to his or her interest in the qualified family-owned business.**
4. **Thus, for example, if a brother and sister inherit a qualified family-owned business from their father, and only the sister materially participates in the business, her participation will cause both her and her brother to meet the material participation test.**
5. If she ceases to materially participate in the business within 10 years after her father's death (and the brother still does not materially participate), the sister and brother would both be liable for the recapture tax; that is, each would be liable for the recapture tax attributable to his or her interest.
6. The portion of the reduction in the estate taxes that is recaptured is dependent upon the number of years that the qualified heir (or members of the qualified heir's family) **materially participated in the trade or business after the decedent's death.**
7. If the qualified heir (or his or her family members) materially participated in the trade or business after the decedent's death for less than six years, 100 percent of the reduction in estate taxes attributable to that heir's interest is recaptured; if the participation was for at least six years but less than seven years, 80 percent of the reduction in estate taxes is recaptured; if the participation was for at least seven years but less than eight years, 60 percent is recaptured; if the participation was for at least eight years but less than 9 years, 40 percent is recaptured; and if the participation was for at least nine years but less than 10 years, 20 percent of the reduction in estates taxes is recaptured.
8. In general, there is no requirement that the qualified heir (or members of his or her family) continue to hold or participate in the trade or business more than 10 years after the decedent's death.
9. As under present-law §2032A, however, the 10-year recapture period may be **extended for a period of up to two years if the qualified heir does not begin to use the property for a period of up to two years after the decedent's death.**

Query: Does this mean "material participation"? There is no "qualified use" test in I.R.C. §2033A! There is no statutory path one can take to reach the conclusion that the two-year grace period applies to the material participation test. It is a provision without a cause.

I. What about the Ownership Test Where There Are Multiple Entities?

1. For purposes of applying the ownership tests **in the case of a corporation,** the decedent and members of the decedent's family are required to own the requisite percentage of the total

combined voting power of all classes of stock entitled to vote AND the requisite percentage of the total value of all shares of all classes of stock in the corporation. **In the case of a partnership,** the decedent and members of the decedent's family are required to own the requisite percentage of the capital interest, and the requisite percentage of the profits interest, in the partnership. **In the case of a trade or business that owns an interest in another trade or business** (i.e., "tiered entities"), **special look-through rules apply.**

2. Each trade or business owned (directly or indirectly) by the decedent and members of the decedent's family is **separately tested** to determine whether that trade or business meets the requirements of a qualified family-owned business interest.
3. In applying these tests, any interest that a trade or business owns in another trade or business is **disregarded in determining whether the first trade or business is a qualified family-owned business interest.**
4. The value of any qualified family-owned business interest held by an entity is treated as being proportionately owned by or for the entity's partners, shareholders, or beneficiaries. In the case of a multi-tiered entity, such rules are sequentially applied to look through each separate tier of the entity.
5. **For example,** if a holding company owns interests in two other companies, each of the three entities will be separately tested under the qualified family-owned business interest rules.
6. In determining whether the holding company is a qualified family-owned business interest, its ownership interest in the other two companies is disregarded.
7. Even if the holding company itself does not qualify as a family-owned business interest, the other two companies still may qualify if the direct and indirect interests held by the decedent and his or her family members satisfy the requisite ownership percentages and other requirements of a qualified family-owned business interest.
8. If either (or both) of the lower-tier entities qualify, the value of the qualified family-owned business interests owned by the holding company are treated as proportionately owned by the holding company's shareholders.

J. The Material Participation Requirement

1. **To qualify for the beneficial treatment provided under the Act,** the decedent (or a member of the decedent's family) must have **owned and materially participated in the trade or business for at least five of the eight years preceding the decedent's date of death.**
2. In addition, each qualified heir (or a member of the qualified heir's family) **is required to materially participate in the trade or business for at least five years of any eight-year period within ten years following the decedent's death.**
3. For this purpose, "material participation" is defined as under present-law §2032A (special use valuation) and the regulations promulgated thereunder. See, e.g., **Treas. Reg.** § 20.2032A-3.
4. Under such regulations, no one factor is determinative of the presence of material participation and the uniqueness of the particular industry (e.g., timber, farming, manufacturing, etc.) **must be considered.**

However:

Physical work and participation in management decisions are the principal factors to be considered. **For example,** an individual generally is considered to be materially participating in the business if he or she personally manages the business fully, regardless of the number of hours worked, as long as any necessary functions are performed. [Senate Committee Report]

Qualified Pension Plans

56. Basis Recovery Rules—Annuities

[I.R.C. §72(d)(1)(B)]

Present Law. Under present law, amounts received as an annuity under a tax-qualified pension plan generally are includible in income in the year received, except to the extent the amount received represents return of the recipient's investment in the contract (i.e., basis). The portion of each annuity payment that represents a return of basis **generally is determined by a simplified method.**

Under this method, the portion of each annuity payment that is a return to basis is equal to the employee's total basis as of the annuity starting date, divided by the number of anticipated payments under a specified table. The number of anticipated payments listed in the table is based on the age of the primary annuitant on the annuity starting date.

The present-law table applies to benefits based on the life of one annuitant. A separate table applies to benefits based on the life of more than one annuitant.

Effective Date. The provision is effective with respect to annuity starting dates after December 31, 1997.

A separate table applies to **benefits based on the life of more than one annuitant, as follows:**

Combined Age of Annuitants	Number of Payments
Not more than 110	410
More than 110 but not more than 120	360
More than 120 but not more than 130	310
More than 130 but not more than 140	260
More than 140	210

The Act clarifies that the new table applies to benefits based on the life of more than one annuitant, even if the amount of the annuity varies by annuitant. Thus, for example, the new table applies to a 50% joint and survivor annuity. The new table does not apply to an annuity paid on a single life merely because it has additional features, e.g., a term certain. (**See** **page 272** **for a copy of the single life table.**)

57. Special Rules for Church Plans

[I.R.C. §414]

Explanation of New Law. The Act provides that in the case of a contribution made to a church plan on behalf of a minister who is self-employed, the contribution will be excludible from the income of the minister to the extent that the contribution would be excludible if the minister was an employee of a church and the contribution was made to the plan.

Effective Date. The provision is effective for years beginning after December 31, 1997.

> **Note:** The Act does not alter present law under which amounts contributed for a minister in connection with §403(b), either by the minister's actual employer or by any church or convention or association of churches that is treated as the minister's employer under §414(e), are excluded from the minister's income, and amounts contributed in accordance with §403(b) by the minister (whether the minister is an employee or is self-employed) are deductible by the minister as provided in §404, taking into account the other special rules of §414(e).

Agriculture

58. Income Averaging for Farmers

[New Code §1301]

Present Law. The ability for an individual taxpayer to reduce his or her tax liability by averaging his or her income over a number of years was repealed by the Tax Reform Act of 1986.

New Law Summary. An individual taxpayer is allowed to elect to compute his or her current year tax liability by averaging, over the prior three-year period, all or a portion of his or her taxable income from the trade or business of farming.

Effective Date. The provision is effective for taxable years beginning **after** 12-31-97 and **before** January 1, 2001.

So, a qualifying farmer can elect to income-average in **1998, 1999, and 2000.**

New Law Explained. The provision operates such that an **electing eligible taxpayer** (1) designates all **or a portion** of his or her taxable income from the **trade or business of farming** from the current year as **"elected farm income";** (2) allocates one-third of such "elected farm income" to each of the prior three taxable years; and (3) determines his or her current year §1 tax liability (income tax only) by determining the sum of (a) his or her current year §1 liability **without the elected farm income allocated** to the three prior taxable years plus (b) **the increases** in the §1 tax for **each of the three prior taxable years** by taking into account the **allocable share** of the **elected farm income** for such years.

If a taxpayer elects the operation of the provision for a taxable year, the allocation of elected farm income among taxable years pursuant to the election shall apply for purposes of any election in a subsequent taxable year.

- **The provision does not apply for employment tax purposes, or to an estate or a trust. Further, the provision does not apply for purposes of the alternative minimum tax under §55. Finally, the provision does not require the recalculation of the tax liability of any other taxpayer, including a minor child required to use the tax rates of his or her parents under §1(g).**
- The election will be made in the manner prescribed by the Secretary of the Treasury and, except as provided by the Secretary, **shall be irrevocable.**
- In addition, the Secretary of the Treasury shall prescribe such regulations as are necessary to carry out the purposes of the provision, including regulations regarding the order and manner in which items of income, gain, deduction, **loss,** and credits (and any limitations thereon) **are to be taken into account for purposes of the provision** and the application of the provision to **any short taxable year.**
- It is expected that such regulations will deny the multiple application of items that carry over from one taxable year to the next (e.g., net operating loss or tax credit carryovers).

Definitions: I.R.C. §1301

(1) Elected farm income. (A) In general. The term "elected farm income" means so much of the taxable income for the taxable year—

(i) which is attributable to any farming business; and
(ii) which is specified in the election.

(B) Treatment of gains. For purposes of subparagraph (A) (above), gain from the sale or other disposition of property (**other than land**) regularly used by the taxpayer in such a farming business for a **substantial period** shall be treated as attributable to such a farming business.

(3) Farming business. The term "farming business" has the meaning given such term in §263A(e)(4).

Regulations under I.R.C. §263A(e)(4)

(4) Definitions—(i) *Farming business.*—(A) For purposes of this section, **a farming business means a trade or business involving the cultivation of land or the raising and harvesting of any agricultural or**

horticultural commodity. Examples include the trade or business of operating a nursery or sod farm; the raising or harvesting of crops; the raising or harvesting of trees bearing fruit, nuts or other crops; the raising of ornamental trees; and the raising, shearing, feeding, caring for, training, and management of animals.

(B) For purposes of this section, an evergreen tree that is more than 6 years old at the time it is severed from its roots is not treated as an ornamental tree regardless of the purpose for which it is sold.

(C) *(1)* For purposes of this section, the term **"farming business" does not include** the processing of commodities or products beyond those activities which are normally incident to the growing, raising or harvesting of such products.

*(2)***Thus, for example,** assume the taxpayer, a C corporation, is in the business of growing and harvesting wheat and other grains. The taxpayer processes grains that it has harvested in order to produce breads, cereals, and other similar food products, which it then sells to customers in the course of its business. Although the taxpayer **is in the farming business** with respect to the growing and harvesting of grain, the taxpayer **is not in the farming business** with respect to the processing of such grains to produce food products that it sells to customers.

*(3)***Similarly,** assume the taxpayer is in the business of raising poultry or other livestock. The taxpayer then uses such livestock in a meat processing operation in which the livestock are slaughtered, processed, and packaged or canned in preparation for their sale to customers. Although the taxpayer **is in the farming business** with respect to the raising of livestock, the taxpayer **is not in the farming business** with respect to the meat processing operation.

(4) However, under this section the term "farming business" does include processing activities which are normally incident to the growing, raising, or harvesting of agricultural products. For example, assume a taxpayer is in the business of growing fruits and vegetables. When the fruits and vegetables are ready to be harvested, the taxpayer picks, washes, inspects, and packages the fruits and vegetables for sale. Such activities are **normally incident** to the raising of these crops for farmers. The taxpayer will be considered to be in the business of farming with respect to the growing of fruits and vegetables, and the processing activities incident to their harvest.

Interpretive Questions and Planning

1. **Apparently** farm income reported on a Form 4835 constitutes qualified farm income.
2. The phrase "used...in...a farming business for a **substantial period**" is **not** defined. **Will machinery and equipment and breeding livestock have to meet the I.R.C. §1231 holding period requirements, or will a longer or shorter period apply to these assets?**
3. Land does not qualify, **but what about** I.R.C. §1231, §1245, and §1250 assets located on the land that is sold (e.g., buildings, tile, fences, and single-purpose structures)?
4. Although a farmer can elect income averaging each year for 1998, 1999, and 2000, the elected income spread over the prior three years **stays in those years as additional income,** thereby permanently increasing the taxable income of those years and potentially reducing or eliminating any tax benefit from electing averaging in subsequent years.
5. **A qualifying farmer does not have to elect to average all farm income qualifying as taxable.**

on this issue.

6. Should a farmer delay major sales of qualifying farm assets to 1998 and then average? It depends on the character of the gain and taxable income levels of 1997, 1996, and 1995 and projected taxable income in 1998.
7. A farmer is not in the trade or business of farming if he or she is cash renting his or her real estate.

Education-Related Provisions

59. HOPE and Lifetime-Learning Credits

[I.R.C. §§25A, 6050S]

HOPE Credit

How Much Is the HOPE Credit?

1. The HOPE nonrefundable credit rate is 100% on the first $1,000 of qualified tuition and fees, and 50% on the next $1,000 of qualified tuition and fees.
2. The HOPE credit is available only for tuition and fees required for the enrollment or attendance of an eligible student at an eligible institution.
3. For a taxable year, a taxpayer may elect with respect to an eligible student the HOPE credit, the 20% "Lifetime Learning" credit (discussed later), or the exclusion from gross income for certain distributions from an education IRA (discussed later).

Are There Income Phaseout Rules?

Yes

1. The HOPE credit amount that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between $40,000 and $50,000 ($80,000 and $100,000 for joint returns).
2. Modified AGI includes amounts otherwise excluded with respect to income earned abroad (or income from Puerto Rico or U.S. possessions).
3. Beginning in 2001, the income phaseout ranges will be indexed for inflation, rounded down to the closest multiple of $5,000.

Who Is a Dependent Student?

1. The credit can be claimed because of expenses incurred on behalf of the **taxpayer,** the **taxpayer's spouse**, or a **dependent** (as defined in I.R.C. §§151 and 152). So for this purpose a dependent

student is anyone who can be claimed as a dependent on the taxpayer's return **for the year the credit is claimed.**

2. If a student is claimed as a dependent by the parent or other taxpayer, the eligible student him- or herself is not entitled to claim a HOPE credit for that taxable year on the student's own tax return.
3. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student are treated as paid by the parent (or other taxpayer) for purposes of the provision.

Example. H, the parent, pays $1,000 of qualified expenses in year 1 and the student dependent pays $1,000 of qualified expenses in year 1. H is considered to have paid $2,000 for purposes of the credit.

What Is Required for a Student to Be Eligible for the Credit?

1. An eligible student for purposes of the HOPE credit is an individual who is enrolled in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an eligible educational institution.
2. The student must pursue a course of study on at least a **half-time basis.** (In other words, for at least one academic period that begins during the taxable year, the student must carry at least one-half the normal full-time workload for the course of study the student is pursuing.)
3. An eligible student **may not** have been convicted of a federal or state felony consisting of the possession or distribution of a controlled substance.

What Is an Eligible Educational Institution?

1. Eligible educational institutions are defined by reference to §481 of the Higher Education Act of 1965.
2. Such institutions generally are accredited postsecondary educational institutions offering credit toward a bachelor's degree, an associate's degree, or another recognized postsecondary credential.
3. Certain proprietary institutions and postsecondary vocational institutions also are eligible educational institutions.
4. The institution must be eligible to participate in Department of Education student aid programs.

What Is Qualified Tuition and Related Expenses?

1. The HOPE credit is available for "qualified tuition and related expenses," meaning tuition and fees required for the enrollment or attendance of an eligible student at an eligible educational institution.
2. Charges and fees associated with meals, lodging, student activities, athletics, insurance,

4. Qualified tuition and related expenses generally include only out-of-pocket expenses.
5. Qualified tuition and related expenses do not include expenses covered by educational assistance that is not required to be included in the gross income of either the student or the taxpayer claiming the credit.
6. Thus, total qualified tuition and related expenses are reduced by any scholarship or fellowship grants **excludable from** gross income under present law §117 and any other tax-free educational benefits received by the student during the taxable year.
7. No reduction of qualified tuition and related expenses is required for a gift, bequest, devise, or inheritance within the meaning of §102(a).
8. A HOPE credit is not allowed with respect to any education expense for which a deduction is claimed under §162 or any other section of the Code.
9. In addition, the Act amends present-law §135 (income from U.S. savings bonds used to pay higher education tuition and fees) to provide that the amount of qualified higher education expenses taken into account for purposes of that section is reduced by the amount of such expenses taken into account in determining the HOPE credit allowed to any taxpayer with respect to the student for the taxable year.

When Is the Credit Available?

1. The credit is available with respect to an **individual student for two taxable years, provided that the student has not completed the first two years of postsecondary education.**
2. **Note:** Beginning in 1998, the maximum credit amount of $1,500 will be indexed for inflation, rounded down to the closest multiple of $50.
3. The HOPE credit is available in the taxable year the expenses are paid, **subject to the requirement that the education commence or continue during that year or during the first three months of the next year.**
4. Qualified tuition expenses paid with the proceeds of a loan generally are eligible for the HOPE credit (rather than repayment of the loan itself).
5. There is **no credit available** for a taxpayer who is married and **does not** file a joint return.
6. The taxpayer must **elect** to claim the credit.
7.

Practitioner Note.

The credit is available only for the period it takes for the student to **complete the first two years of postsecondary education. But, the credit is available for only two taxable years during this period.**

8. The **Lifetime Learning credit** (discussed later) **is not available** for any year in which the HOPE credit is being claimed.

Example 1. H and W file a joint return and have a modified AGI of $78,000. In 1998 dependent child 1 is a first-year student, and dependent child 2 is a second-year student in college. They (H and W) pay $3,000 of college tuition for each of them in 1998. **What is their HOPE credit?** $3,000! (100% of the first $1,000 and 50% of the second $1,000 with a maximum credit of $1,500 per student).

Example 2. Same facts as in **Example 1,** except their modified AGI for 1998 is $101,000. Their HOPE credit is $0 because of the phaseout rule.

Example 3. Same facts in **Example 1,** except the expenses are paid in 1999 and dependent child 2 completed his second year of college during 1998. The credit is $1,500. However, the Lifetime Learning credit may apply to dependent child 2 (see discussion below).

Effective Date. The provision is effective for expenses paid after December 31, 1997, for education furnished in academic periods beginning after such date.

Lifetime Learning Credit for Qualified Tuition and Fees

Allowance of Credit

1. The Act provides that individual taxpayers are allowed to claim a nonrefundable "Lifetime Learning" credit against federal income taxes equal to 20% of qualified tuition and fees incurred during the taxable year on behalf of the taxpayer, the taxpayer's spouse, or any dependents.
2. For expenses paid after June 30, 1998, and prior to January 1, 2003, up to $5,000 of qualified tuition and fees **per taxpayer return** will be eligible for the 20% Lifetime Learning credit (i.e., the maximum credit **per taxpayer return** (not per student) will be $1,000)
3. For expenses paid after December 31, 2002, up to $10,000 of qualified tuition and fees **per taxpayer return** will be eligible for the 20% Lifetime Learning credit (i.e., the maximum credit per taxpayer return will be $2,000).

Phaseout Based on AGI

Same rules as HOPE credit.

Contrasts with HOPE credit

1. In contrast to the HOPE credit, a taxpayer may claim the Lifetime Learning credit for an **unlimited number of taxable years.**
2. Also in contrast to the HOPE credit, the maximum amount of the Lifetime Learning credit that may be claimed on a taxpayer's return will not vary based on the number of students in the taxpayer's family.
3. In contrast to the HOPE credit, qualified tuition and fees for purposes of the Lifetime Learning credit include tuition and fees incurred with respect to undergraduate or graduate-level (and

available with respect to any course of instruction at an eligible educational institution (whether enrolled in by the student on a full-time, half-time, or less than half-time basis) to acquire or improve job skills of the student.

[**Note:** Acquire **or** improve job skills.]

5. Different effective date (see below).

Question 1. *Who are dependent students?*

Answer 1. Same rules as for HOPE credit.

Question 2. *What are qualified tuition and fees?*

Answer 2. Same rules as for HOPE credit.

Question 3. *What are eligible education institutions?*

Answer 3. Same rules as for HOPE credit.

Question 4. *What if a HOPE credit is being claimed for the taxable year for the student?*

Answer 4. The Lifetime Learning credit is not available for tuition and fees paid for that student.

Question 5. *Do you have to make an election to take the credit?*

Answer 5. Yes, same as for the HOPE credit.

Question 6. *Are there any special rules?*

Answer 6. Yes, see below.

Coordination with Exclusions. An election does not take effect with respect to an individual for any taxable year if there is in effect for such taxable year an election under §530(d)(2)(C) (by the taxpayer or any other individual) **to exclude from gross income distributions from an education individual retirement account used to pay qualified higher education expenses of the individual.**

Note: This rule does not apply to the HOPE credit.

Question 7. *Do the same rules apply in terms of availability of the credit as apply to the HOPE credit?*

Answer 7. Yes (see the discussion for the HOPE credit).

Question 8. *Are there special election provisions?*

Answer 8. Yes. **Election of Lifetime Learning credit, HOPE credit,** or **exclusion from gross income for certain distributions from education IRAs.** A taxpayer may claim the Lifetime Learning credit for a taxable year with respect to one or more students, even though the taxpayer also claims a HOPE credit (or claims an exclusion from gross income for certain distributions from qualified state tuition programs or education IRAs) for that same taxable year with respect to other students.

Effective Date. The provision is effective for expenses paid after June 30, 1998, for education furnished in academic periods beginning after such date.

60. Educational IRAs

[I.R.C. §530]

Effective Date. Contributions after December 31, 1997.

Question 1. *What is an educational IRA?*

Answer 1. The term "education individual retirement account" means a trust created or organized in the United States exclusively for the purpose of paying the qualified higher education expenses of the designated beneficiary of the trust (and designated as an education individual retirement account at the time created or organized), **but only if the written governing instrument creating the trust meets the following requirements:**

(A) No contribution will be accepted—
- (i) unless it is in cash,
- (ii) after the date on which such beneficiary attains age 18, or
- (iii) except in the case of rollover contributions, if such contribution would result in **aggregate contributions** for the taxable year exceeding $500.

Question 2. *What are higher education expenses?*

Answer 2. See I.R.C. §529(e)(3)—generally, tuition, fees, books and required supplies and equipment, **and** room and board for students who are at least half-time.

Question 3. *What is a qualified educational institution?*

Answer 3. Basically the same as that for the Lifetime Learning credit.

Question 4. *Are there phaseouts?*

Answer 4. Yes. The contributor to the account, if single, cannot have a modified AGI of more than $110,000. Phaseout occurs between $95,000 and $110,000. For a contributor who files jointly, the phaseout is between $150,000 and $160,000.

Question 5. *What is the maximum contribution per year per beneficiary?*

Answer 5. $500 per calendar year—it appears that the contribution must be made during the contributor-taxpayer's calendar year. **Note: The modified AGI must be known before the end of the year, but** excess contributions can be returned before the due date of the contributor's tax return without penalty.

Question 6. *Does the contributor receive a tax deduction for the contribution?*

Answer 6. It appears that the contribution is **not deductible.** Eligible distributions are **not** taxable to the beneficiary, but these rules appear tricky in some distribution circumstances.

Question 7. *Is the distribution exclusion available if a HOPE credit or a Lifetime Learning credit is being claimed for the beneficiary for the tax year of distribution?*

Answer 7. No!

Question 8. *Can a contribution to the educational IRA be made in a year that contributions are made to a "qualified state tuition program" for that same beneficiary (I.R.C. §529)?*

Answer 8. No!

Question 9. *Who can be a contributor?*

Answer 9. Apparently anyone. But, the aggregate contributions to this account cannot exceed $500 each year.

Question 10. *What if the beneficiary dies?*

Answer 10. Upon the death of the designated beneficiary, any balance to the credit of the beneficiary shall be distributed within 30 days after the date of death to the estate of such beneficiary.

Note: This distribution is taxable, unless it is made to a surviving spouse.

61. Deduction for Interest on Education Loans

[New I.R.C. §221]

Explanation of New Law

1. Under the Act, certain individuals who have paid interest on qualified education loans may claim **an above-the-line deduction for such interest expenses.**
2. The maximum deduction is phased in over four years, with a $1,000 maximum deduction in 1998, $1,500 in 1999, $2,000 in 2000, and $2,500 in 2001.
3. The maximum deduction amount is not indexed for inflation.
4. In addition, the deduction is phased out ratably for individual taxpayers with modified AGI of $40,000–$55,000 ($60,000–$75,000 for joint returns); such income ranges will be indexed for inflation occurring after the year 2002.
5. The deduction is allowed only with respect to interest paid on a qualified education loan **during the first 60 months in which interest payments are required.**
6. Months during which the qualified education loan is in deferral or forbearance do not count against the 60-month period.
7. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year.
8. A qualified education loan generally is defined as any indebtedness incurred to pay for the qualified higher education expenses of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending (a) postsecondary educational institutions and certain vocational schools defined by reference to §481 of the Higher Education Act of 1965, or (b) institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training.
9. **Qualified higher education expenses are defined as the student's cost of attendance as defined in §472 of the Higher Education ACT of 1965** (generally, tuition, fees, **room and board,** and related expenses, reduced by (a) any amount excluded from gross income under §135 (i.e., United States savings bonds used to pay higher education tuition and fees), (b) any amount distributed from a qualified tuition program or education investment account (educational IRA) and excluded from gross income (under the provision described above), and (c) the amount of any scholarship or fellowship grants excludable from gross income under present-law §117, as well as any other tax-free educational benefits, such as employer-provided educational assistance that is excludable from the employee's gross income under §127.
10. Such expenses must be paid or incurred within a reasonable period before or after the indebtedness is incurred, and must be attributable to a period when the student **is at least a half-time student.**

11. To claim the interest deduction, married couples must file a joint return.
12. **Note:** The deduction is only permitted for interest paid during the first 60 months in which an interest payment is required.
13.

Any person in a trade or business or any governmental agency that receives $600 or more in qualified education loan interest from an individual during a calendar year must provide an information report on such interest to the IRS and to the payor.

Effective Date. The provision is effective for payments of interest due and paid after December 31, 1997, on any qualified education loan. Thus, in the case of already existing qualified education loans, interest payments qualify for the deduction to the extent that the 60-month period has not expired. For purposes of counting the 60 months, any qualified education loan and all refinancing (that is treated as a qualified education loan) of such loan are treated as a single loan.

62. Qualified State Tuition Programs Modified

[I.R.C. §529(c) and (e) and I.R.C. §135(c)(2)(c)]

Effective Date. January 1, 1998.

Present Law

Qualified State Prepaid Tuition Programs

1. Section 529 (**enacted as part of the Small Business Job Protection Act of 1996**) provides tax-exempt status to "qualified State tuition programs," meaning certain programs established and maintained by a state (or agency or instrumentality thereof) **under which persons may (a) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (b) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account.**
2. "Qualified higher education expenses" are defined as tuition, fees, books, supplies, and equipment required for enrollment or attendance at a college or university (or certain vocational schools).
3. Qualified higher education expenses **do not include** room and board expenses.
4. Section 529 also provides that no amount shall be included in the gross income of a contributor to, or beneficiary of, a qualified state tuition program with respect to any distribution from, or earnings under, such program, **except that** (a) amounts distributed or educational benefits provided to a beneficiary (e.g., when the beneficiary attends college) will be included in the beneficiary's gross income (unless excludable under another Code section) to the extent such

beneficiary, and (b) amounts distributed to a contributor (e.g., when a parent receives a refund) will be included in the contributor's gross income to the extent such amounts exceed contributions made by that person.

5. Contributions made to a qualified state tuition program are treated as incomplete gifts for federal gift tax purposes [§529(c)(2)].
6. Thus, any federal gift tax consequences are determined at the time that a distribution is made from an account under the program.
7. The waiver (or payment) of qualified higher education expenses of a designated beneficiary by (or to) an educational institution under a qualified state tuition program is treated as a qualified transfer for purposes of present-law §2503(e).
8. Amounts contributed to a qualified state tuition program (and earnings thereon) are includible in the contributor's estate for federal estate tax purposes in the event that the contributor dies before such amounts are distributed under the program [§529(c)(4)].

New Law

Qualified State Tuition Programs. The Act makes the following modifications to present-law §529, which governs the tax treatment of qualified state tuition programs.

A. **Room and board expenses.** The Act **expands** the definition of "qualified higher education expenses" under §529(e)(3) to **include room and board expenses** (meaning the minimum room and board allowance applicable to the student as determined by the institution in calculating costs of attendance for federal financial aid programs under §472 of the Higher Education Act of 1965) **for any period during which the student is at least a half-time student.**

B. **Eligible educational institution.**
   1. The Act expands the definition of "eligible educational institution" for purposes of §529 by defining such term by reference to §481 of the Higher Education Act of 1965.
   2. Such institutions generally are accredited postsecondary educational institutions offering credit toward a bachelor's degree, an associate's degree, a graduate-level or professional degree, or another recognized postsecondary credential.
   3. Certain proprietary institutions and postsecondary vocational institutions also are eligible institutions.
   4. The institution must be eligible to participate in Department of Education student aid programs.

C. **Definition of "member of family."** The Act expands the definition of the term "member of the family" for purposes of allowing tax-free transfers or rollovers of credits or account balances in qualified state tuition programs (and redesignations of named beneficiaries), so that the term means persons described in paragraphs (1) through (8) of §152(a)—e.g., sons, daughters, brothers, sisters, nephews and nieces, certain in-laws, etc.—and any spouse of such persons.

D. **Prohibition against investment direction.** The Act clarifies the present-law rule contained in

1. Under the Act (as under present law), no amount will be includible in the gross income of a contributor to, or beneficiary of, a qualified state tuition program with respect to any contribution to or earnings on such a program **until** a distribution is made from the program, at which time the earnings portion of the distribution (whether made in cash or in-kind) **will be includible in the gross income of the distributee.**
2. However, to the extent that a distribution from a qualified state tuition program is used to pay for qualified tuition and fees, the distributee (or another taxpayer claiming the distributee as a dependent) will be able to claim the HOPE credit or Lifetime Learning credit provided for by the Act with respect to such tuition and fees (assuming that the other requirements for claiming the HOPE credit or Lifetime Learning credit are satisfied and the modified AGI phaseout for those credits does not apply).

Effective Date. The modifications to §529 generally are effective **after December 31, 1997.** The expansion of the term "qualified higher education expenses" to cover certain room and board expenses is effective **as if included in the Small Business Job Protection Act of 1996 (enacted on August 20, 1996).**

F. **Estate and gift tax treatment.**

1. The Act, with respect to the estate and gift tax treatment of contributions to qualified state tuition programs and education IRAs, provides a special rule in the case of contributions that exceed the annual gift tax exclusion limit (presently $10,000 in the case of an individual or $20,000 in the case of a married couple that splits their gifts, but this amount is scheduled to increase under other provisions).
2. **For such contributions, the contributor may elect to have the contribution treated as if made ratably over a five-year period.**

Thus, for federal estate and gift tax purposes, any contribution to a qualified tuition program or education IRA will be treated as a **completed gift of a present interest** from the contributor to the beneficiary at the time of the contribution. Annual contributions are eligible for the present-law gift tax exclusion provided by Code §2503(b) and also are excludible for purposes of the generation-skipping transfer tax (provided that the contribution, when combined with any other contributions made by the donor to that same beneficiary, does not exceed the annual gift tax exclusion limit of $10,000, or $20,000 in the case of a married couple).

3. If a contribution in excess of $10,000 ($20,000 in the case of a married couple) is made in one year—which can occur only in the case of a qualified **state tuition program** and not an education IRA (which cannot receive contributions in excess of $500 per year)—**the contributor may elect to have the contribution treated as if made ratably over five years beginning in the year the contribution is made.**
4. **For example,** a $30,000 contribution to a qualified state tuition program would be treated as **five annual contributions of $6,000,** and the donor could therefore make up to $4,000 in other

6. A gift tax return must be filed with respect to any contribution in excess of the annual gift tax exclusion limit, and the election for five-year averaging **must be made on the contributor's gift tax return.**
7. If a donor making an over-$10,000 contribution dies during the five-year averaging period, the portion of the contribution that has not been allocated to the years prior to death is**includible** in the donor's estate.
8. **For example,** if a donor makes a $40,000 contribution, elects to treat the transfer as being made over a five-year period, and dies the following year, $8,000 would be allocated to the year of contribution, another $8,000 would be allocated to the year of death, and the remaining $24,000 would be includible in the estate.
9. If a beneficiary's interest is rolled over to another beneficiary, there are no transfer tax consequences if the two beneficiaries are in the same generation. If a beneficiary's interest is rolled over to a beneficiary in a lower generation (e.g., parent to child or uncle to niece), the five-year averaging rule described above may be applied to exempt up to $50,000 of the transfer from gift tax.
10. The federal estate and gift tax treatment of educational accounts has no effect on the actual rights and obligations of the parties pursuant to the terms of the contracts under state law.

Effective Date. The gift tax provisions are effective for contributions (or transfers) made after the date of enactment, and the estate tax provisions are effective for decedents dying after June 8, 1997.

Credits

63. Welfare-to-Work Tax Credit

[I.R.C. §51A]

New Law. The Act provides to employers a tax credit on the **first $20,000 of eligible wages** paid to qualified long-term family assistance (AFDC or its successor program) recipients **during the first two years of employment.** The credit is **35%** of the **first $10,000** of eligible wages in the first year of employment and **50% of the first $10,000 of eligible wages** in the second year of employment. **The maximum credit is $8,500 per qualified employee.**

Qualified long-term family assistance recipients are:

1. Members of a family that has received family assistance for at least 18 consecutive months ending on the hiring date;
2. Members of a family that has received family assistance for a total of at least 18 months (whether or not consecutive) after the date of enactment of this credit if they are hired within two years after the date that the 18-month total is reached; and

3. Members of a family who are no longer eligible for family assistance because of either federal or state time limits, if they are hired within two years **after the federal or state time limits made the family ineligible for family assistance.**

Eligible wages include cash wages paid to an employee plus amounts paid by the employer for the following: (1) educational assistance excludable under a §127 program (or that would be excludable but for the expiration of §127); (2) health plan coverage for the employee, but not more than the applicable premium defined under §4980B(f)(4); and (3) dependent care assistance excludable under §129.

Effective Date. The provision is effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 1998 and before May 1, 1999.

Note: Special rules for agricultural and railway labor. If a recipient is an employee to whom §51(h)(1) applies, rules similar to the rules of that section apply except that:

1. subparagraph (A) shall be applied by substituting "$10,000" for "$6,000" [for agricultural labor] and
2. subparagraph (B) shall be applied by substituting "$833.33" for "500" [for railway labor].

- **Coordination with work opportunity credit.** If a credit is allowed under this section to an employer with respect to an individual for any taxable year, then for purposes of applying §51 (work opportunity credit) to such employer, **such individual shall not be treated as a member of a targeted group for such taxable year.**
- The application of this new Code section is **elective.**
- **No deduction for wages is allowed** to the employer to the **extent of the credit** [I.R.C. §280C(a)].

64. Modified General Business Credit Carryback and Carryforward Rules

[I.R.C. §39]

Present Law. A qualified taxpayer is allowed to claim the rehabilitation credit, the energy credit, the reforestation credit, the work opportunity credit, the alcohol fuels credit, the research credit, the low-income housing credit, the enhanced oil recovery credit, the disabled access credit, the renewable electricity production credit, the empowerment zone employment credit, the Indian employment credit, the employer social security credit, and the orphan drug credit (collectively known as the general business credit), subject to certain limitations based on tax liability for the year. **Unused general business credits generally may be carried back three years and carried forward 15 years to offset tax liability of such years, subject to the same limitations.**

New Law. The Act limits the carryback period for the general business credit to one year and extends the carryforward period to 20 years.

Effective Date. The provision is effective for **credits arising** in taxable years beginning after December 31, 1997.

Partnerships

65. [Partnerships]—Electing Large Partnerships—Unified Partnership Audit Procedures

Practitioner Note.

Numerous provisions of the TRA of 1997 impact these items. They are not covered in this chapter.

66. Closing of Partnership Taxable Year with Respect to Deceased Partner

[I.R.C. §706]

Present Law

- The partnership taxable year closes with respect to a partner whose entire interest is sold, exchanged, or liquidated.
- **Such year, however, generally does not close upon the death of a partner.**
- Thus, a decedent's entire share of items of income, gain, loss, deduction, and credit for the partnership year in which death occurs is taxed to the estate or successor in interest rather than to the decedent on his or her final income tax return. [See ***Estate of Hesse v. Commissioner,*** 74 T.C. 1307, 1311 (1980).]

Reasons for Change. Legislative changes occurring since 1954 have required most partnerships to adopt a calendar year, **reducing the possibility of bunching.** Consequently, income and deductions are better matched if the partnership taxable year **closes upon a partner's death** and partnership items are reported on the decedent's last return.

Present law closes the partnership taxable year with respect to a deceased partner only if the partner's entire interest is sold or exchanged pursuant to an agreement existing at the time of death. By closing the taxable year automatically upon death, the provision reduces the need for such agreements.

Explanation of New Law. The Act provides that the taxable year of a partnership **closes with respect to a partner whose entire interest in the partnership terminates, whether by death, liquidation, or otherwise.**

The Act **does not change present law** with respect to the effect upon the partnership taxable year of a transfer of a partnership interest by a debtor to the debtor's estate (under Chapter 7 or 11 of Title 11, relating to bankruptcy).

Effective Date. The provision applies to partnership taxable years beginning **after** December 31, 1997.

Employment and Self-Employment taxes

67. Moratorium on Regulations; Self-Employment Taxes of Limited Partners

[I.R.C. §1402]

The Act provides that any regulations relating to the definition of a limited partner for self-employment tax purposes shall **not be issued or effective before July 1, 1998.**

68. Clarification of Exemption from Self-Employment Tax for Certain Termination Payments Received by Former Insurance Salespeople

[I.R.C. §1402]

Present Law. Certain insurance salespeople are independent contractors and therefore subject to tax under SECA.

Under case law, certain payments received by a former insurance salesperson who had sold insurance as an independent contractor are not net earnings from self-employment and therefore are not subject to SECA. See, e.g., ***Jackson v. Commissioner,*** 108 T.C. XXNo. 10 (1997); ***Gump v. U.S.,*** 86 F. 3d 1126 (CA FC 1996); ***Milligan v. Commissioner,*** 38 F. 3d 1094 (9th Cir. 1994).

Explanation of Act. **The Act codifies case law** by providing that net earnings from self-employment **do not include** any amount received during the taxable year from an insurance company on account of services performed by such individual as an insurance salesperson for such company**if** (1) **such amount is received after termination of the individual's agreement to perform services for the company,** (2) **the individual performs no services for the company after such termination and before the close of the taxable year,** (3) **the amount of the payment depends solely on policies sold by or credited to the account of the individual during the last year of the agreement and/or service and the extent to which such policies remain in force for some period after such termination, and does not depend on the length of service or overall earnings from services performed for the company** (however, the eligibility for the payment can be based on length of service or overall earnings), and (4)

the payments are conditioned upon the salesperson agreeing not to compete with the company for at least one year following such termination.

- The Act will also amend the Social Security Act to provide that such termination payments are not treated **as earnings** for purposes of determining Social Security benefits.

The provision is effective with respect to payments after December 31, 1997. No inference is intended that the proposal is **not** present law.

Earned Income Credit

69. Definition of AGI for Phasing Out the Earned Income Credit—Modified for Tax Years Beginning After 12-31-97

[I.R.C. §32(c)(5)(B)]

Committee Explanation—Congressional Intent—New Law

The Act modifies the definition of AGI used for phasing out the credit by **adding** two items of nontaxable income and changing the percentage of certain losses that are disregarded in calculating modified AGI. **The two items added are:** (1) tax-exempt interest and (2) nontaxable distributions from pensions, annuities, and individual retirement arrangements (but only if not rolled over into similar vehicles during the applicable rollover period). The Act also **increases** the amount of **net losses** disregarded from businesses, computed separately with respect to sole proprietorships (other than farming), sole proprietorships in farming, and other businesses from 50% to 75%.

The Amended §32 Code Language (New Law)

(B) Certain amounts disregarded [for purposes of calculating modified AGI]. An amount is described in this subparagraph if it is—

(i) the amount of losses from sales or exchanges of capital assets in excess of gains from such sales or exchanges to the extent such amount does not exceed the amount under §1211(b)(1),

(ii) the net loss from estates and trusts,

(iii) the excess (if any) of amounts described in subsection (i)(2)(C)(ii) over the amounts described in subsection (i)(2)(C)(i) (relating to nonbusiness rents and royalties),

(iv) 75% of the net loss from the carrying on of trades or businesses, computed separately with respect to—

(I) trades or businesses (other than farming) conducted as sole proprietorships,

(II) trades or businesses of farming conducted as sole proprietorships, and

(III) other trades or businesses

(v) interest received or accrued during the taxable year which is exempt from tax imposed by this chapter, and

(vi) amounts received as a pension or annuity, and any distributions or payments received from an individual retirement plan, by the taxpayer during the taxable year to the extent **not included** in gross income.

For purposes of clause (iv), there shall not be taken into account items which are attributable to a trade or business which consists of the performance of services by the taxpayer as an employee. Clause (vi) shall not include any amount which is not includible in gross income by reason of §402(c), 403(a)(4), 403(b), 408(d)(3), (4), or (5), or 457(e)(10).

The Current Conflict Between Congressional Intent and the Drafted Code Section

Items (v) and (vi) above are to be **disregarded** and not **included** in calculating modified AGI—**the opposite of the intent of Congress.** (**Expect a technical correction.**) Interestingly, it also appears that qualified rollovers were to be disregarded, but instead, by implication (see the last sentence above), are implicitly included in modified AGI (**another candidate for a technical correction**).

Effective Date. The provision is effective for taxable years beginning after December 31, 1997.

70. Workfare Payments—Earned Income Credit

[I.R.C. §32(c)(2)(B)(v)]

Workfare payments are not considered to be earned income.

The operative code provision is as follows.

(v) no amount described in subparagraph (A) received for service performed in work activities as defined in paragraph (4) or (7) of §407(d) of the Social Security Act to which the taxpayer is assigned under any state program under part A of title IV of such Act, but only to the extent such amount is subsidized under such state program.

Effective Date. Tax years after December 31, 1997, but based on committee comments **could be construed** as applying to tax years before 1998.

Estimated Tax

71. De Minimis Threshold for Estimated Tax Increased to $1,000 for Individuals

[I.R.C. §6654]

Present Law. The addition to tax for underpayment of estimated tax is not imposed where the total tax liability for the year, reduced by any withheld tax and estimated tax payments, is less than $500.

Explanation of New Law. The Act increases the $500 individual estimated tax de minimis threshold to $1,000.

Effective Date. The provision is effective for taxable years beginning after December 31, 1997.

72. Estimated Tax—Safe Harbor Tests

[I.R.C. §6654 and §6655]

Present Law. Under present law, an individual taxpayer generally is subject to an addition to tax for any underpayment of estimated tax. An individual generally **does not have an underpayment of estimated tax** if he or she makes timely estimated tax payments **at least equal** to:

1. 100% of the tax shown on the return of the individual for the preceding year (the "100% of last year's liability safe harbor") or
2. 90% of the tax shown on the return for the current year.

The "100% of last year's liability safe harbor" **is modified to be a "110% of last year's liability safe harbor" for any individual with an AGI of more than $150,000 as shown on the return for the preceding taxable year.**

New Law. The Act changes the "110% of last year's liability safe harbor" to be a "100% of last year's liability safe harbor" for taxable years **beginning in 1998;** a "105% of last year's liability safe harbor" for taxable years **beginning in 1999, 2000, and 2001;** and a "112% of last year's liability safe harbor" for taxable years **beginning in 2002.** For taxable years beginning in the year **2003** the percentage is **110%.** [Note: These rules also apply to estates and trusts.]

In addition, no estimated tax penalties will be imposed under §6654 or 6655 for any period before January 1, 1998, for any payment the due date of which is before January 16, 1998, with respect to an underpayment **to the extent the underpayment is created or increased by a provision of the TRA of**

1997.

Miscellaneous

73. Associations of Holders of Timeshare Interests to Be Taxed Like Other Homeowners Associations

[I.R.C. §528]

Explanation of New Law. The Act amends §528 (homeowners associations) to permit timeshare associations to qualify for taxation under that section. Timeshare associations would have to meet the requirements of §528 (e.g., the 60% gross income, 90% expenditure, and the nonprofit organizational and operational requirements). Timeshare associations electing to be taxed under §528 are subject to a tax on their "timeshare association income" at a rate of 32%.

Effective Date. The provision is effective for taxable years beginning after December 31, 1996.

74. Temporary Suspension of Taxable Income Limit on Percentage Depletion for Marginal Production

[I.R.C. §613A]

Background. Specific percentage depletion rules apply to oil and gas production from "marginal" properties. Marginal production is defined as domestic crude oil and natural gas production from stripper well property or from property substantially all of the production from which during the calendar year is heavy oil. Stripper well property is property from which the average daily production is 15 barrel equivalents or less, determined by dividing the average daily production of domestic crude oil and domestic natural gas from producing wells on the property for the calendar year by the number of wells.

Explanation of New Law. The 65%-of-net-income limitation is suspended for domestic oil and gas production from marginal properties during taxable years beginning **after** December 31, 1997, and **before** January 1, 2000.

Procedure and Filing

75. Reporting of Certain Payments Made to Attorneys

[I.R.C. §6045]

Present Law. Information reporting is required by persons engaged in a trade or business and making payments in the course of that trade or business of "rent, salaries, wages,...or other fixed or determinable gains, profits, and income" [Code §6041(a)].

Treasury Regulation §1.6041-1(d)(2) provides that attorney's fees are required to be reported if they are paid by a person in a trade or business in the course of a trade or business. Reporting is required to be done on Form 1099-MISC. **If, on the other hand, the payment is a gross amount and it is not known what portion is the attorney's fee, no reporting is required on any portion of the payment.**

Explanation of New Law. **The provision requires gross proceeds reporting on all payments to attorneys made by a trade or business in the course of that trade or business.**

It is anticipated that gross proceeds reporting would be required on Form 1099-B (currently used by brokers to report gross proceeds). **The only exception to this new reporting requirement would be for any payments reported on either Form 1099-MISC under §6041 (reports of payment of income) or on Form W-2 under §6051 (payments of wages).**

In addition, the present exception in the regulations exempting from reporting any payments made to corporations **will not apply to payments made to attorneys.**

Treasury Regulation §1.6041-3(c) exempts payments to corporations generally (although payments to most corporations providing medical services must be reported).

Reporting will be required under both Code §§6041 and 6045 (as proposed) for payments to corporations that provide legal services.

The exception of **Treas. Reg.** §1.6041-3(g) exempting from reporting payments of salaries or profits paid or distributed by a partnership to the individual partners would continue to apply to both sections (since these amounts are required to be reported on Form K-1).

First, the provision applies to payments made to attorneys regardless of whether the attorney is the exclusive payee.

Second, payments to law firms are payments to attorneys, and therefore are subject to this reporting provision.

Third, attorneys are required to promptly supply their TINs to persons required to file these information reports, pursuant to §6109. Failure to do so could result in the attorney being subject to penalty under §6723 and the payments being subject to backup withholding under §3406.

Fourth, the IRS should administer this provision so that there is no overlap between reporting under §6041 and reporting under §6045. For example, if two payments are simultaneously made to an attorney, one of which represents the attorney's fee and the second of which represents the settlement with the attorney's client, the first payment would be reported under §6041 and the second payment would not be reported under either §6041 or §6045, since it it known that the entire payment represents the settlement with the client (and therefore no portion of it represents income to the attorney).

Effective Date. The provision is effective for payments made after December 31, 1997. Consequently, the first information reports will be filed with the IRS (and copies will be provided to recipients of the payments) in 1999, with respect to payments made in 1998.

Alternative Minimum Tax

76. Repeal of the Alternative Minimum Tax for Small Businesses and Repeal of the Depreciation Adjustment for AMT Purposes

[I.R.C. §55 and 56]

Explanation of New Law

Repeal of the Corporate Alternative Minimum Tax for Small Businesses. The corporate alternative minimum tax is **repealed** for small business corporations for taxable years beginning **after December 31, 1997.**

A corporation that had average gross receipts of less than $5 million for the three-year period beginning **after December 13, 1994,** is a small business corporation **for any** taxable year **beginning after December 31, 1997.**

A corporation that meets the $5 million gross receipts test will continue to be treated as a small business corporation exempt from the alternative minimum tax so long as its average gross receipts **do not exceed $7.5 million.** A corporation that fails to meet the $7.5 million gross receipts test will become subject to corporate alternative minimum tax only with respect to preferences and adjustments that relate to transactions and investments entered into **after the corporation loses its status as a small business corporation.**

In addition, the alternative minimum tax credit allowable to a small business corporation may not exceed the corporation's regular tax liability (reduced by other credits) over 25% of the corporation's regular tax (reduced by foreign tax credits) **in excess of $25,000.**

Repeal of the Depreciation Adjustment. The alternative minimum tax adjustment relating to depreciation is **repealed for all taxpayers** for property ***placed in service*** **after December 31, 1998.**

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We thank you, Joe, for your care, compassion, creativity, and especially your outrageous sense of humor. We will miss you.

Allen Bock