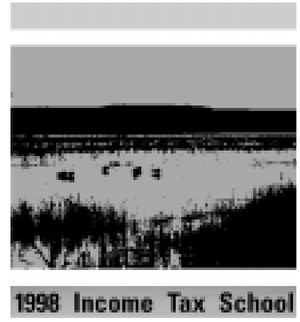
1997 TAXPAYER RELIEF ACT AND THE “1998 CORRECTION BILL”—IRS RESTRUCTURING AND REFORM ACT OF 1998



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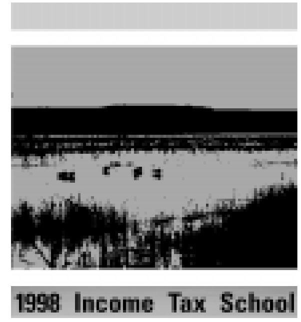

1997 TAXPAYER RELIEF ACT AND THE "1998 CORRECTION BILL"—IRS RESTRUCTURING AND REFORM ACT OF 1998

INTRODUCTION

The Taxpayer Relief Act of 1997 is a very complex tax act. There were drafting errors and drafting weaknesses in several important areas. Sometimes congressional intent and the drafted Code section differed. The **Restructuring and Reform Act of 1998** cleared up many of these problems and is incorporated in this chapter. In addition, the IRS has issued **Announcements, Revenue Procedures,** and **Regulations** that are quite helpful. **They (as of 09/15/98) are also incorporated 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, some 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.

The IRS Restructuring and Reform Act of 1998 will hereinafter be called the "1998 Act."

PROVISIONS 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)]

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 extended the special rule contained in §170(e)(5) for contributions of qualified appreciated stock made to private foundations for the period June 1, 1997, through June 30, 1998.

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3. DEDUCTION FOR LONG-TERM CARE INSURANCE OF SELF-EMPLOYED INDIVIDUALS

[I.R.C. §162]

Explanation of Act. The Act 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 expanded §108(f) so that an individual's gross income does not include forgiveness of any existing student loans **made by tax-exempt charitable organizations** (e.g., educational organizations or private foundations), but also including loans not made by educational organizations, **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.**

Prior to the "1998 Act," a loan qualified only if the organization making the loan had originally received the funds from the U.S., a state, or a tax-exempt public benefit corporation.

- As under old 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–the public work requirement. ["The 1998 Act" clarification]**
- In addition, in the case of loans made by tax-exempt charitable organizations, the student's work must fulfill a public service requirement. [**"The 1998 Act" clarification**]
- 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). [1997 Act and 1998 Act]

SALES AND EXCHANGES—INCLUDING RESIDENCE

5. GAIN ON SALE OF A PRINCIPAL RESIDENCE

[I.R.C. §§121 and 1034, **including "1998 Act" corrections**]

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.**

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Example 1. On May 10, 1998, 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.

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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)]. **Counted in years, or months, or days, the two years need not be consecutive.**

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. The new exclusion is mandatory; however 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.

Practitioner Note. The new law creates a tremendous planning opportunity. The new law specifically **does not take** into account the present use of the residence, only the 2-out-of-5-year test.

Example: Greg and Pam owned their previous residence from 1989 to 1995. In January 1996, they purchased and moved into a new home. After 01/01/96, they rented their previous residence, and they sold it on 07/01/98. Greg and Pam meet the 2-out-of-5-year test on the rental residence, even though the property is being rented at the time of sale. The only amount of gain subject to taxation was the gain attributable to the depreciation claimed after May 6, 1997, when the residence was rented.

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:

$$x \times \frac{y}{730\,\text{days}} = \text{excluded gain}$$

where x is the **total exclusion** under §121 gain [**as clarified by "the 1998 Act"**] 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 did not indicate whether the portion of the two-year period is to be calculated using days or months. The 1997 Form 2119 worksheet used a formula based on **days**.

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Example 2. Georgia bought her first home for $100,000 on January 1, 1997. Because of a change in employment, she sold her home on August 6, 1998, and moved to a new city. She netted $150,000 for her home after selling costs. [Also note the special transition rule on pages 660–661.]

The gain that Georgia can exclude is:

Amount realized	$150,000	
Basis	(100,000)	
Realized gain	$50,000	
Portion excluded:		
$\$250{,}000 \times \frac{584}{730}$	$200,000	allowable exclusion
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 (20% office in home) 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

Practitioner Caution. Example 3 may be a real tax trap. The author's reference to Zach not having an office in the home in the year he sold the home reflects **Rev. Rul.** 82-26, and its impact on I.R.C. 1034, Gain from Sale or Exchange of Residence. **Many practitioners are working with this same line of thought.**

However, the key point is that "not having the office in the year sold" was never part of I.R.C. §121 (the exclusion section). In fact, Reg. §1.121-5(e) provides the following example:

> Taxpayer A, an attorney, uses a portion of the property constituting his principal residence as a law office for a period in excess of 2 years of the 5 years preceding the sale of such residence. Accordingly, section 121 **does not apply** with respect to so much of the gain on the sale of the property as is allocable to the portion of the property used as a law office. [Remember that this regulation covered the law when 3 out of 5 was required instead of 2 out of 5.]

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Practitioner caution continued.
As a result, the probable **correct** answer to this problem is as follows:

	80% Residence	20% Office
Amount realized	$144,000	$36,000
Basis		
Unadjusted basis	(96,000)	(24,000)
Depreciation		(3,500)
Adjusted basis	96,000	20,500
Gain realized	$48,000	$15,500
Gain excluded under I.R.C. §121	$48,000	
Gain taxable under I.R.C. §1231		$15,500

Note. Since the 20% office portion **did not** meet the 2 out of 5 year test, **all** depreciation taken reduces the adjusted basis of the office. Had the office met the 2 out of 5 year test, the answer as provided in Example 3 would be correct.

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 4. Ike and Tina each owned a home for several years before they married on June 6, 1998. Neither has previously applied the new exclusion to the sale of a home. In September 1998, 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 5. 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, 1998, 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 6.

Note. Code §121(b)(2) as amended by the **"1998 Act"** permits an interesting result. Since this change is effective for sales after 05/06/97, it may affect how this kind of transaction was treated on the 1997 tax return. **We gave a different result in the 1997 Book.**

Cher moved into Sonny's house (which he owned and lived in for 7 years) when they were married on March 1, 1998. Neither had previously applied the new exclusion to the sale of a home. On June 30, 1998, Sonny sold the house and realized $300,000 of gain.

Sonny can exclude $250,000 of the $300,000 of gain.

If they file a joint 1998 return, Cher is also eligible for the exclusion. Sonny's ownership is attributable to her and since the home was sold prior to August 5, 1999 [see page 661 of this chapter], her exclusion formula is:

$$\frac{122\text{ days}}{730\text{ days}} \times \$250{,}000 = \$41{,}781$$

So, of the $300,000 gain, $291,481 is excluded. If they do not file a joint return, only $250,000 is excluded [Sonny's portion].

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Note. If the sale is on August 5, 1999, or later, Cher would have to meet the requirements on page 654, i.e., change of job, health, etc.

$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 7. Clarence and Gwen married on April 1, 1996, and lived together in home A, which Clarence had owned and lived in since 1986. On August 18, 1998, Clarence purchased home B and he and Gwen moved into home B, but Clarence did not sell home A. On September 1, 2000, 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, 2000. On January 24, 2001, 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 1986 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, 1996, until August 18, 1998. That is within five years of the January 24, 2001, sale date, so they both meet the two-out-of-the-last-five-years use requirement. Therefore, this requirement is met.
4. Clarence and Gwen **fail** the requirement that neither spouse has used the I.R.C. §121 provision within the last two years since Clarence used that provision on the sale of home B on September 1, 2000.

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.

Example 8. Assume the same facts as in Example 7, except that Clarence gave home A to Gwen in September 2000 and Gwen sold it on January 24, 2001. Since Gwen has a carryover basis from Clarence, she realizes the same $400,000 of gain he would have realized.

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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 9. Jack and Jill jointly owned a house, which they both lived in until their divorce on December 15, 1994. 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, 1998, 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)].

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 10. Bruce and Nancy's home was destroyed by a tornado on June 14, 1997. 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, 1998, they sold the new house.

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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 11. Bob and Kathy sold their home (which they had owned and where they had lived for five years) and moved to a new house on November 15, 1997. They rolled the gain from their old house to the new house under I.R.C. §1034. On August 20, 1998, 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 12. 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 13. Assume the same facts as in Example 12, 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.

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Transition Rules

Note: The exclusion for gain on sale of a principal residence under the 1997 Act generally applies to sales or exchanges occurring after May 6, 1997. A taxpayer may elect, however, to apply prior law to a sale or exchange (1) made before the date of enactment of the Act, (2) made after the date of enactment persuant to a binding contract in effect on such date, or (3) where a replacement residence was acquired on or before the date of enactment (or persuant to a binding contract in effect on the date of enactment) and the prior-law rollover provision would apply.

Technical Correction. "**The 1998 Act"** clarifies that a taxpayer may elect to apply prior law with respect to a sale or exchange on the **date of enactment of §312 of the 1997 Act.** [Aug. 5, 1997]

This election applies to sales after May 6, 1997, and on or before August 5, 1997, or sales on or after August 5, 1997, but pursuant to a binding contract in effect on August 5, 1997.

Taxpayers who sold their homes after May 6, 1997, and on or before August 5, 1997, could 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 met the I.R.C. §1034 requirements. Taxpayers may have wanted to make this election if they wanted to save the new I.R.C. §121 exclusion for another home sale within two years, or if they realized more gain on the current sale than could be excluded under I.R.C. §121.

Example 14. 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 did 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 law gave 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 15. Assume the same facts as Example 14 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 allowed the new I.R.C. §121 exclusion to apply to the sale of the old house, they would have been 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 elected 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.

Practitioner Note. The election to use the prior law for sales on or before August 5, 1997 can apparently be made on an amended return. Section 312(d)(2) of the '97 Act simply says, "At the election of the taxpayer..." without any limitations on when that election must be made. Similarly, the committee reports for the '97 and '98 Acts, IRS Publication 523, *Selling Your Home* and the instructions for the 1997 Form 2119 state that the taxpayer can elect to have the old rules apply without any limitations on the timing of the election. Making the election on an amended return is also considered with the '98 Act technical correction that includes sales on August 5, 1998 in the sales that are eligible for the election. The '98 Act makes no special provision for amending 1997 returns. Therefore, taxpayers must be able to make the election on amended returns or the '98 Act technical correction would have no effect since 1997 returns were filed by the time the '98 Act was enacted.

Important Practitioner Note: Sales after August 4, 1997, and before August 5, 1999–important transitional rule!

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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. **See Q&A, number 31, on pages 86–90.**

Additional Practitioner Note. This point is extremely important, as many practitioners think that in the absence of job change, health, or other "unforseen circumstances," the 2-year rule is absolute. **Not So!** This rule will allow owners to sell their principal residence held much less than 2 years and still qualify for exclusion of gain as long as they owned the residence on August 5, 1997.

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]

Old Law.

- Under §1033, gain realized by a taxpayer from certain **involuntary conversions** of property was deferred to the extent the taxpayer purchased property similar or related in service or use to the converted property within a specified replacement period of time.

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).

Practitioner Note-The effect of this provision is to restrict individual taxpayers who have a realized gain of **more** than $100,000 under I.R.C. §1033 from purchasing the replacement property **from a broadly-defined related party.**

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

CAPITAL GAINS AND LOSSES

7. CAPITAL GAINS AND LOSSES

Note: See Chapter 7 (Schedule D), starting at page 209, for in-depth examples of the new law!

[I.R.C. §1(h) (Various effective dates in 1997)] [Including changes made by **"The 1998 Act."**]

Old Law. Individuals were subject to a maximum rate of 28%. Gain from the disposition of **depreciable real property** was 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 follow.
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 was changed from more than 1 year to more than 18 months for transactions occurring after July 28, 1997 and before 1-1-1998.

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Note: "The 1998 Act" changed the holding period back to "more than 12 months" for sales on or after 1-1-1998 in order to qualify for long-term capital gain treatment.

4. After May 6, 1997, transactions involving I.R.C. §1250 property (basically, buildings) are 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) is subject to a **maximum rate** of 25%, subject to certain limitations (see pages 211 & 212 for an example). Excess depreciation is still recaptured as ordinary income. (See item 6 below.) If the sale of I.R.C. §1250 property occurs after July 28, 1997 and before 1-1-1998, the holding period to qualify for the 25% maximum is increased to more than 18 months. (See note above in 3.)
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%.

Note: If the building had been sold for $80,000, resulting in a gain of $60,000, $30,000 is subject to a maximum 25% tax rate and $30,000 is subject to the 20% rate structure.

Practitioner Note. "The 1998 Act" made a technical correction to I.R.C. §1(h)(7)(B), which limits the amount of gain included in the 25% rate gain. The amount of unrecaptured §1250 gain that is included is limited to the net §1231 gain for the year.

Illustration: In 1998, Bea Sness sold land used in her business for $80,000. Her basis in the land was $100,000. she also sold a building for $70,000 for which she had claimed $50,000 of straight-line depreciation and had a $20,000 adjusted basis. She had no unrecaptured §1231 losses from prior years. In addition to the above sales, she had $40,000 of taxable income.

Bea's net §1231 gain for the year is calculated as follows:

Gain from building	$50,000
Loss from land	(20,000)
Net gain	$30,000

Bea has $50,000 of gain on her building that is unrecaptured §1250 gain, but I.R.C. 1(h)(7)(B) limits the amount that is included in the maximum 25% rate gain to $30,000.

Bea's Form 4797 and Schedule D for 1998 are shown below.

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Practitioner Note. The 15% bracket is used up by income in the following order:

1. ordinary income I.R.C. §1(h)(A)
2. gain in the 25% category (I.R.C. §1(h)(1)(D))
3. gain in the 28% category (I.R.C. 1(h)(1)(E))
4. gain in the 20% (10%) category (I.R.C. §§1(h)(1)(B) and (C))

Form **4797** Department of the Treasury Internal Revenue Service (99)

Sales of Business Property
(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))
► Attach to your tax return. ► See separate instructions.

OMB No. 1545-0184 **1997** Attachment Sequence No. 27

Name(s) shown on return: Bea Sness — Identifying number: 162-01-1222

1 Enter here the gross proceeds from the sale or exchange of real estate reported to you for 1997 on Form(s) 1099-S (or a substitute statement) that you will be including on line 7, 10, or 20 1

Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Property Held More Than 1 Year

(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) GAIN or (LOSS) for entire year. Subtract (f) from the sum of (d) and (e)	(h) 28% RATE GAIN or (LOSS) * (see instr. below)
2 Land	10-10-88	9-9-98	80,000	-0-	100,000	<20,000>	

6 Gain, if any, from line 32, from other than casualty or theft	6	50,000
7 Combine lines 2 through 6 in columns (g) and (h). Enter gain or (loss) here, and on the appropriate line as follows:	7	30,000
Partnerships—Enter the gain or (loss) on Form 1065, Schedule K, lines 6a and 6b. Skip lines 8, 9, 11, and 12 below. **S corporations**—Report the gain or (loss) following the instructions for Form 1120S, Schedule K, lines 5 and 6. Skip lines 8, 9, 11, and 12 below, unless line 7, column (g) is a gain and the S corporation is subject to the capital gains tax. **All others**—If line 7, column (g) is zero or a loss, enter that amount on line 11 below and skip lines 8 and 9. If line 7, column (g) is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain or (loss) in each column as a long-term capital gain or (loss) on Schedule D and skip lines 8, 9, and 12 below.		
8 Nonrecaptured net section 1231 losses from prior years (see instructions)	8	-0-
9 Subtract line 8 from line 7. If zero or less, enter -0-. Also enter on the appropriate line as follows (see instructions):	9	30,000

S corporations—Enter only the gain in column (g) on Schedule D (Form 1120S), line 14, and skip lines 11 and 12 below.
All others—If line 9, column (g) is zero, enter the gain from line 7, column (g) on line 12 below. If line 9, column (g) is more than zero, enter the amount from line 8, column (g) on line 12 below, and enter the gain or (loss) in each column of line 9 as a long-term capital gain or (loss) on Schedule D.

Form 4797 (1997) 1998 — Page **2**

Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A Building	10-10-88	9-9-98

These columns relate to the properties on lines 19A through 19D. ►		Property A	Property B	Property C	Property D
20 Gross sales price (**Note:** See line 1 before completing.)	20	70,000			
21 Cost or other basis plus expense of sale	21	70,000			
22 Depreciation (or depletion) allowed or allowable	22	50,000			
23 Adjusted basis. Subtract line 22 from line 21	23	20,000			
24 Total gain. Subtract line 23 from line 20	24	50,000			

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30 Total gains for all properties. Add property columns A through D, line 24	30	50,000
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	-0-
32 Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6, column (g), and if applicable, column (h)	32	50,000

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SCHEDULE D (Form 1040) — Department of the Treasury, Internal Revenue Service (99)

Capital Gains and Losses

► Attach to Form 1040. ► See Instructions for Schedule D (Form 1040).
► Use Schedule D-1 for more space to list transactions for lines 1 and 8.

OMB No. 1545-0074 — 1998 — Attachment Sequence No. 12

Name(s) shown on Form 1040: Bea Sness — Your social security number: 162 01 1222

11	Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824	11	30,000
15	Combine lines 8 through 14 in column (g)	15	
16	Net long-term capital gain or (loss). Combine lines 8 through 14 in column (f). ► Next: Go to Part III on the back.	16	30,000

Schedule D (Form 1040) 1998 — Page 2

Part III Summary of Parts I and II

17	Combine lines 7 and 16. If a loss, go to line 18. If a gain, enter the gain on Form 1040, line 13	17	30,000 00

Part IV Tax Computation Using Maximum Capital Gains Rates

Proof 8/19/99

19	Enter your taxable income from Form 1040, line 39			19	70,000 00
20	Enter the smaller of line 16 or line 17 of Schedule D	20	30,000		
21	If you are filing Form 4952, enter the amount from Form 4952, line 4e	21			
22	Subtract line 21 from line 20. If zero or less, enter -0-	22	30,000		
23	Combine lines 7 and 15. If zero or less, enter -0-	23			
24	Enter the smaller of line 15 or line 23, but not less than zero	24			
25	Enter your unrecaptured section 1250 gain, if any (see page D-4)	25	30,000		
26	Add lines 24 and 25	26	30,000		
27	Subtract line 26 from line 22. If zero or less, enter -0-			27	-0-
28	Subtract line 27 from line 19. If zero or less, enter -0-			28	70,000
29	Enter the smaller of: • The amount on line 19, or • $25,350 if single; $42,350 if married filing jointly or qualifying widow(er); $21,175 if married filing separately; or $33,950 if head of household			29	25,350
30	Enter the smaller of line 28 or line 29			30	25,350
31	Subtract line 22 from line 19. If zero or less, enter -0-			31	40,000
32	Enter the larger of line 30 or line 31			32	40,000
33	Figure the tax on the amount on line 32. Use the Tax Table or Tax Rate Schedules, whichever applies ►			33	7,912
34	Enter the amount from line 29			34	25,350
35	Enter the amount from line 28			35	70,000
36	Subtract line 35 from line 34. If zero or less, enter -0-			36	-0-
37	Multiply line 36 by 10% (.10) ►			37	-0-
38	Enter the smaller of line 19 or line 27			38	-0-
39	Enter the amount from line 36			39	-0-
40	Subtract line 39 from line 38			40	-0-
41	Multiply line 40 by 20% (.20) ►			41	-0-
42	Enter the smaller of line 22 or line 25			42	30,000
43	Add lines 22 and 32	43	70,000		
44	Enter the amount from line 19	44	70,000		
45	Subtract line 44 from line 43. If zero or less, enter -0-			45	-0-
46	Subtract line 45 from line 42. If zero or less, enter -0-			46	30,000
47	Multiply line 46 by 25% (.25) ►			47	7,500
48	Enter the amount from line 19			48	70,000
49	Add lines 32, 36, 40, and 46			49	70,000
50	Subtract line 49 from line 48			50	-0-
51	Multiply line 50 by 28% (.28) ►			51	-0-
52	Add lines 33, 37, 41, 47, and 51			52	15,412
53	Figure the tax on the amount on line 19. Use the Tax Table or Tax Rate Schedules, whichever applies			53	16,570
54	**Tax on taxable income including capital gains.** Enter the smaller of line 52 or line 53 here and on Form 1040, line 40 ►			54	15,412

Illustration #1. Stretch and Shorty Gains are married and file a joint return. In 1998 they have $42,350 of taxable income, which consists of $16,350 of ordinary income (category 1 above), $8,000 of 25% rate gain (category 2 above), $6,000 of 28% rate gain (category 3 above), and $12,000 of adjusted net capital gain (gain subject to the 20% or 10% rate depending on the tax bracket–category 4 above). Since their total taxable income is no more

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than the $42,350 top end of the 15% bracket, their $12,000 of adjusted net capital gain is taxed at 10% and the remaining $30,350 of their taxable income is taxed at the 15% rate. **Total tax from the 1998 tax table is $5,756.**

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

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.**

8. **Capital Losses.** See the discussion starting on page 248 of this book. Essentially, **"The 1998 Act"** codified **Notice 97-59.** The relevant parts of that notice follows:

Notice 97-59

The definitions of net capital gain, net long-term capital gain or loss, and net short-term capital gain or loss were not changed by the **1997 Act.** However, under new §1(h), if a noncorporate taxpayer has a net capital gain, the taxpayer's long-term capital gains and losses are separated into three tax rate groups.

1. *The 28-percent group*. The 28-percent group consists of the following:
   a. capital gains and losses properly taken into account before May 7, 1997, from assets held for more than one year;
   b. capital gains and losses properly taken into account after July 18, 1997 [**and before 01/01/98**], from assets held for more than one year but not more than 18 months; [**It will be not more than one year for assets sold on 1-1-98 and after**] and
   c. capital gains and losses from **collectibles** (including works of art, rugs, antiques, metals, gems, stamps, coins, and alcoholic beverages) held for more than one year, **regardless of the date taken into account.**

   This group also includes long-term capital loss carryovers. For sales of certain small business stock after August 10, 1998, an amount equal to the gain excluded under §1202(a) is included in the 28-percent group.

2. *The 25-percent group*. The 25-percent group consists of unrecaptured §1250 gain (there are no losses in this group). Unrecaptured §1250 gain is long-term capital gain, not otherwise recaptured as ordinary income, attributable to prior depreciation of real property and which is from property held for more than one year (if taken into account after May 6, 1997, but before July 29, 1997), or for more than 18 months (if taken into account after July 28, 1997 [**and before 01/01/98**]). [**It will be more than one year for the sale of these assets sold 1-1-98 and after.**]
3. *The 20-percent group*. The 20-percent group (10% in the case of gain that would otherwise be taxed at 15 percent) consists of long-term gains and losses that are not in the 28-percent or 25-percent group. Thus, for 1997 a rate of 20 or 10 percent applies to net capital gain (other than collectibles gain) from capital assets held for more than one year (if taken into account after May 6 but before July 29), or for more than 18 months (if taken into account after July 28 [**and before 01/01/98**]). [**More than one year if sold on 1-1-98 or after**]

New §1(h) also applies to gains and losses that are characterized as capital under §1231.

Netting Gains and Losses. Within each group, gains and losses are netted to arrive at a net gain or loss taking into account the pending (**now new**) legislation, **"The 1998 Act"**. The following additional netting and ordering rules apply:

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1. *Short-term capital gains and losses.* As under old law, short-term capital losses (including short-term capital loss carryovers) **are applied first to reduce short-term capital gains,** if any, otherwise taxable at ordinary income rates. A net short-term capital loss **is then** applied to reduce any net long-term gain from the 28-percent group, **then to reduce gain** from the 25-percent group, and **finally to reduce** net gain from the 20-percent group.

2. *Long-term capital gains and losses.* A net loss from the 28-percent group (including long-term capital loss carryovers) **is used first to reduce gain** from the 25-percent group, **then to reduce net gain** from the 20-percent group. A net loss from the 20-percent group is used **first** to reduce net gain from the 28-percent group, then to **reduce gain** from the 25-percent group.

Any resulting net capital gain that is attributable to a particular rate group is taxed at that group's marginal tax rate.

Coordination with Other Provisions. **"The 1998 Act"** coordinates the multiple rates of new §1(h) with certain other provisions of the Code. Accordingly, the following rules apply:

1. *Holding periods.* Under prior law, certain inherited property, if disposed of within one year after the decedent's death, was deemed to have been held for more than one year under §1223(11) or (12). Such property, if disposed of within 18 months after the decedent's death, is now deemed to have been held for more than 18 months. [**Back to more than one year for sales on 1-1-98 and later**] A similar rule applies for certain patents described in §1235(a). Gain or loss from a §1256 contract, to the extent that it is treated as long-term capital gain or loss under §1256(a)(3), is now treated as attributable to property held for more than 18 months. [**Back to more than one year for 1998 and later years]** Rules similar to those of §1233(b) and (d) (involving short sales of substantially identical property) and §1092(f) (involving certain stock options) apply with respect to property held for more than one year but not more than 18 months. [**Back to more than one year for 1998 and later years**]

Note. The more than 18-month holding period was repealed for all these assets sold after 12/31/97 by **"The 1998 Act."**

2. *Recharacterized §1231 gains.* If a portion of the taxpayer's net §1231 gain for the year is recharacterized as ordinary income under §1231(c), the gain so recharacterized consists first of any net §1231 gain in the 28-percent group, then any §1231 gain in the 25-percent group, and finally any net §1231 gain in the 20-percent group.

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.**

Note To Present Law. Neither §267 nor §1239 previously treated an estate and a beneficiary of the estate as related persons.

Explanation of Act. 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.**

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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 Act. 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.

Practitioner Note. In the example above, all dividends would be distributed to that beneficiary on the estate's K-1.

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]

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 was not applicable to estates.

Explanation of Act. 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.

Practitioner Note. It is usually quite important to make the distributions during this period of time because of the highly progressive estate and trust tax rates. (See Chapter 6.) **This law change is very helpful to the tax return preparer.**

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]

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

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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 **but only to the GST tax separate trust rule. (The 1998 Act)**]

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).

Practitioner Note. See Chapter 6, page 201, for a discussion of **Revocable Living Trusts.**

12. REPEAL OF THROWBACK RULES APPLICABLE TO DOMESTIC TRUSTS

[I.R.C. §665]

The Internal Revenue Code had 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 was 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 was higher than those of the trust.

Explanation of Act. 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 and §644 is effective for distributions or sales made in taxable years beginning after August 5, 1997.

Practitioner Note. The highly progressive tax rates for estates and trusts eliminates the need for these complicated rules.

ESTATE AND GIFT TAX

13. GIFTS TO CHARITIES EXEMPT FROM GIFT TAX FILING REQUIREMENTS

[I.R.C. §6019]

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Explanation of Act. 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 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] [**As clarified by "The 1998 Act"**]

Act 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.]

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] [**As clarified by "The 1998 Act"**]

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.

Act

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 August 5, 1997).

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16. ESTATE TAX RECAPTURE FROM CASH LEASES OF SPECIALLY VALUED PROPERTY

[I.R.C. §2032A]

Explanation of Act. The Act provides that the cash lease of specially valued (§2032A) 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]

Explanation of Act. 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 grantor's gross estate.

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

For a discussion of Revocable Living Trusts, see page 201 of this book.

18. OPPORTUNITY TO CORRECT CERTAIN FAILURES UNDER §2032A [ESTATE TAX]

[I.R.C. §2032A]

Present Law. In 1984, §2032A was amended to provide that if an executor made a timely election that substantially complied with Treasury regulations but failed to provide all required information or the signatures of all persons required to enter into the agreement, the executor could supply the missing information within a reasonable period of time (not exceeding 90 days) **after notification** by the Treasury 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 Act

- 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.

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- **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]

Practitioner Note. Estate tax auditors may still be balking on this issue because of **lack of knowledge** of the new law and Congressional intent.

QUALIFIED PENSION PLANS

19. REPEAL OF EXCESS DISTRIBUTION AND EXCESS RETIREMENT ACCUMULATION TAXES

[I.R.C. §4980A]

Act. The Act permanently 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 and decedents dying after December 31, 1996.

20. TAX ON PROHIBITED TRANSACTION—QUALIFIED PLANS

[I.R.C. §4975(a)]

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.

Change in 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** August 5, 1997).

21. MATCHING CONTRIBUTIONS OF SELF-EMPLOYED INDIVIDUALS NOT TREATED AS ELECTIVE EMPLOYER CONTRIBUTIONS

[I.R.C. §§402, 408]

The Act. 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. In effect, a self-employed individual with sufficient net profit can make up to $10,000 of elective contributions to a 401(k)** *plus* **employer matching.**

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.**

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22. SALARY REDUCTION SIMPLIFIED EMPLOYEE PENSIONS ("SARSEPS")

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[I.R.C. §408]

Effective after December 31, 1996.

Explanation of Act. 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.

23. EMPLOYER CONTRIBUTIONS TO SIMPLE 401(K) PLANS NOT SUBJECT TO 15% LIMIT

[I.R.C. §404(a)(3)(A)]

Effective for tax years after December 31, 1996.

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.

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.

AGRICULTURE

24. REPEAL INSTALLMENT METHOD ADJUSTMENT FOR FARMERS

[I.R.C. §56]

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

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

Example. Farmer sells $30,000 of grain on November 1, 1998, on the installment method, the amount to be paid on January 10, 1999. The $30,000 is not 1998 AMT income. [**Note the retroactive date**]

25. TREATMENT OF LIVESTOCK SOLD ON ACCOUNT OF WEATHER-RELATED CONDITIONS

[I.R.C. §§451, 1033]

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

Practitioner Note. See page 337 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)]

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

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 were paid or incurred pursuant to an educational assistance program that met certain requirements. The exclusion **did not** apply to graduate-level courses beginning **after June 30, 1996.** The exclusion **expired after June 30, 1997.**

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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.

CREDITS

27. WORK OPPORTUNITY TAX CREDIT

[I.R.C. §51]

Old Law

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

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

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

Targeted Groups Eligible for the Credit

1. Families Receiving AFDC (IV-A Recipient).
2. Qualified Ex-Felon.
3. High-Risk Youth.
4. Vocational Rehabilitation Referral.
5. Qualified Summer Youth Employee.
6. Qualified Veteran.
7. Families Receiving Food Stamps.

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

Minimum Employment Period. No credit was 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).

Act—Extends the credit and makes other modifications

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.

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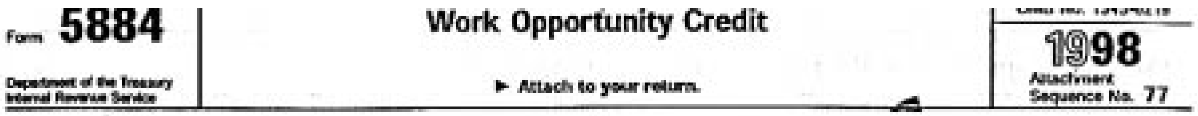
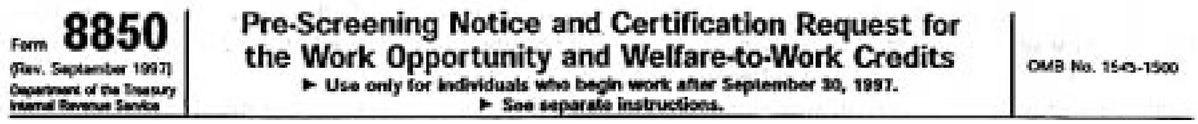
- I.R.C. §51 (2) **Qualified IV-A recipient.** (A) In general. The term "qualified IV-A recipient" means any individual who is certified by the designated local agency as being a member of a family receiving assistance under a IV-A program *for any 9 months during the 18-month period ending on the hiring 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.*


Form 5884
Department of the Treasury Internal Revenue Service
Work Opportunity Credit
► Attach to your return.
1998
Attachment Sequence No. 77


Form 8850
(Rev. September 1997)
Department of the Treasury Internal Revenue Service
Pre-Screening Notice and Certification Request for the Work Opportunity and Welfare-to-Work Credits
► Use only for individuals who begin work after September 30, 1997.
► See separate instructions.
OMB No. 1545-1500

28. RESEARCH TAX CREDIT EXTENDED

[I.R.C. §41]

The Act

With some modifications, the credit is extended.

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.

PARTNERSHIPS

29. BASIS ALLOCATION OF PROPERTIES DISTRIBUTED BY A PARTNERSHIP

[I.R.C. §732]

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

Old Law

Partner's Basis in Distributed Properties and Partnership Interest.

- Old 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.

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- 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, **old law** provided 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.
- **Old law** provided 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 Act. The Act modifies the basis allocation rules for distributee partners. Basically, the Act changes the method of allocating basis to multiple assets received by a partner from the partnership. Under the old law, basis was allocated based on the adjusted bases of the assets to the partnership. **The Act allocates basis to the assets based on the fair market value of the assets.**

Please see pages 330 and 331 of the LLCs and Partnerships chapter in the 1997 Farm Income Tax Book for a complete explanation of the changes and a comprehensive example.

30. TAX TREATMENT OF PARTNERSHIP INVENTORY

[I.R.C. §§724, 732, 735, 751]

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

Old Law. Under old 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)].

Act. 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). The effect of this change is that more distributions to partners in sale/exchange of partnership interests will result in ordinary income treatment.**

See pages 332 and 333 of the LLCs and Partnerships chapter in the 1997 Farm Income Tax Book for a thorough explanation of this law change.

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31. TIME FOR TAXING PRECONTRIBUTION GAIN WITH RESPECT TO APPRECIATED PROPERTY—PARTNERSHIPS

[I.R.C. §§704, 737]

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

Act

- 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 in the 1997 Farm Income Tax Book for a discussion of this law change.

EMPLOYMENT AND SELF-EMPLOYMENT TAXES

32. CLARIFICATION OF STANDARD TO BE USED IN DETERMINING TAX STATUS OF RETAIL SECURITIES BROKERS

[I.R.C. §3121]

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.

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.

33. TAX COURT JURISDICTION FOR DETERMINATION OF EMPLOYMENT STATUS

[I.R.C. §§7436, 7437]

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

Explanation of Act. 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.**

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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.

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 Act. 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 **is 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** (see below for temporary regulations).

- 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 Act. 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.

Note. Many of the software packages use the IRS-prepared EIC checklist.

Earned Income Credit (EIC) Eligibility Checklist

[See the 1998 instructions (not yet released) for the 1998 checklist. It will probably be quite similar to the 1997 version you used.]

Regulations–T.D. 8773

Explanation of Provisions. A taxpayer who has been denied the EIC, in whole or in part, as a result of deficiency procedures is ineligible to file a return claiming the EIC **subsequent to the denial until the taxpayer**

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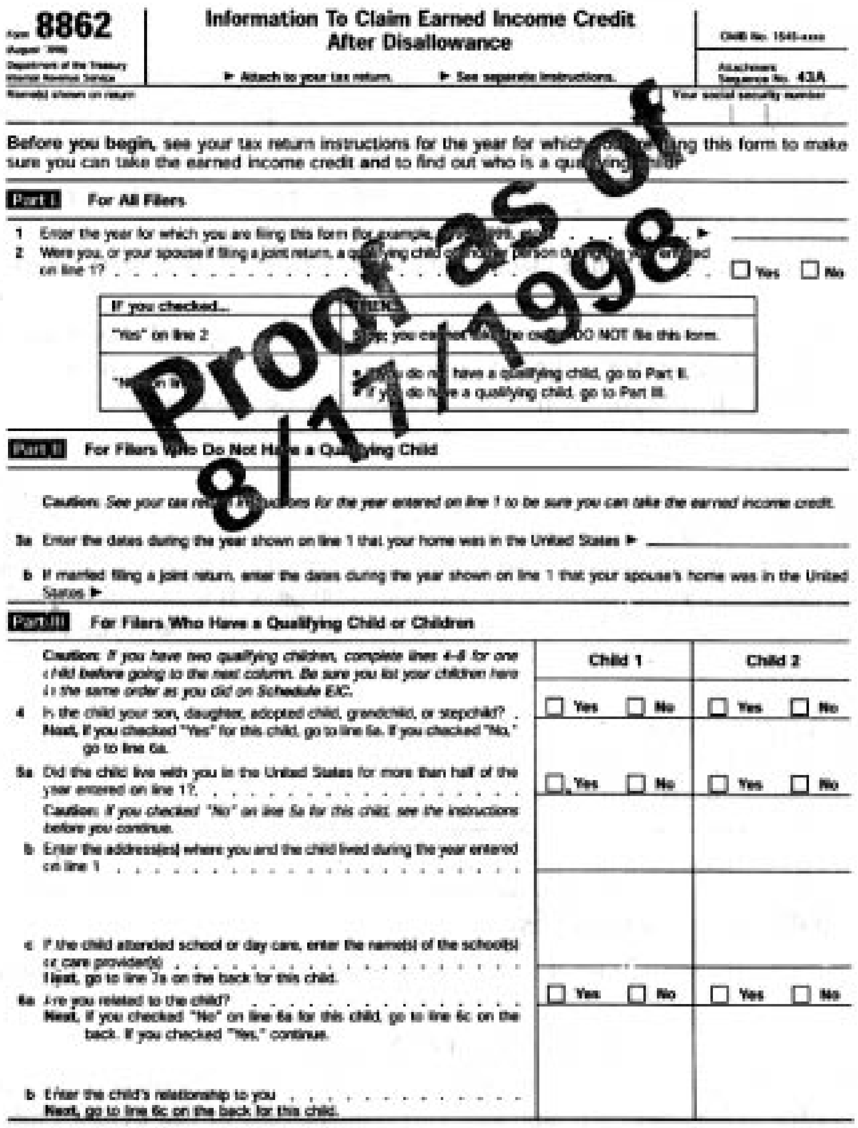
provides evidence of eligibility for the EIC. Deficiency procedures include administrative procedures (other than procedures related to mathematical or clerical errors) that result in an assessment of a deficiency in tax, whether or not a notice of deficiency is issued. To demonstrate current eligibility, the regulations require the taxpayers to complete **Form 8862, Information To Claim Earned Income Credit After Disallowance. If the taxpayer properly demonstrates eligibility for the EIC, the taxpayer is not required to submit Form 8862 in the future unless the IRS again denies the EIC as a result of the deficiency procedures.**

The regulations require the taxpayer to attach Form 8862 to the first income tax return on which the taxpayer claims the EIC after the EIC has been denied as a result of the deficiency procedures. The EIC is denied as a result of the deficiency procedures when an assessment of a deficiency is made (other than as a mathematical or clerical error under §6213(b)(1)).

The regulations provide that if two individuals marry after one has been denied the EIC as a result of the deficiency procedures, the eligibility requirements apply **when they file a joint return and claim the EIC.** For example, two unmarried taxpayers have qualifying children and claim the EIC. The taxpayers subsequently marry. For a taxable year preceding the marriage, one of the taxpayers was denied the EIC under the deficiency procedures and has not established eligibility for a subsequent year. **In this situation, if they claim the EIC for the taxable year in which they marry, the demonstration of eligibility rules will apply.**



Form 8862 — Information To Claim Earned Income Credit After Disallowance

▶ Attach to your tax return. ▶ See separate instructions.

Attachment Sequence No. 43A

Name(s) shown on return — Your social security number

Before you begin, see your tax return instructions for the year for which you are filing this form to make sure you can take the earned income credit and to find out who is a qualifying child.

Part I — For All Filers

1 Enter the year for which you are filing this form (for example, ...) ▶

2 Were you, or your spouse if filing a joint return, a qualifying child of another person during the year entered on line 1? ☐ Yes ☐ No

If you checked...	THEN...
"Yes" on line 2	Stop; you cannot take the credit. DO NOT file this form.
"No" on line 2	• If you do not have a qualifying child, go to Part II. • If you do have a qualifying child, go to Part III.

Proof as of 8/17/1998

Part II — For Filers Who Do Not Have a Qualifying Child

Caution: See your tax return instructions for the year entered on line 1 to be sure you can take the earned income credit.

3a Enter the dates during the year shown on line 1 that your home was in the United States ▶

b If married filing a joint return, enter the dates during the year shown on line 1 that your spouse's home was in the United States ▶

Part III — For Filers Who Have a Qualifying Child or Children

Caution: If you have two qualifying children, complete lines 4–6 for one child before going to the next column. Be sure you list your children here in the same order as you did on Schedule EIC.	Child 1	Child 2
4 Is the child your son, daughter, adopted child, grandchild, or stepchild? **Next,** If you checked "Yes" for this child, go to line 5a. If you checked "No," go to line 6a.	☐ Yes ☐ No	☐ Yes ☐ No
5a Did the child live with you in the United States for more than half of the year entered on line 1? *Caution: If you checked "No" on line 5a for this child, see the instructions before you continue.*	☐ Yes ☐ No	☐ Yes ☐ No
b Enter the address(es) where you and the child lived during the year entered on line 1		
c If the child attended school or day care, enter the name(s) of the school(s) or care provider(s). **Next,** go to line 7a on the back for this child.		
6a Are you related to the child? **Next,** If you checked "No" on line 6a for this child, go to line 6c on the back. If you checked "Yes," continue.	☐ Yes ☐ No	☐ Yes ☐ No
b Enter the child's relationship to you. **Next,** go to line 6c on the back for this child.		

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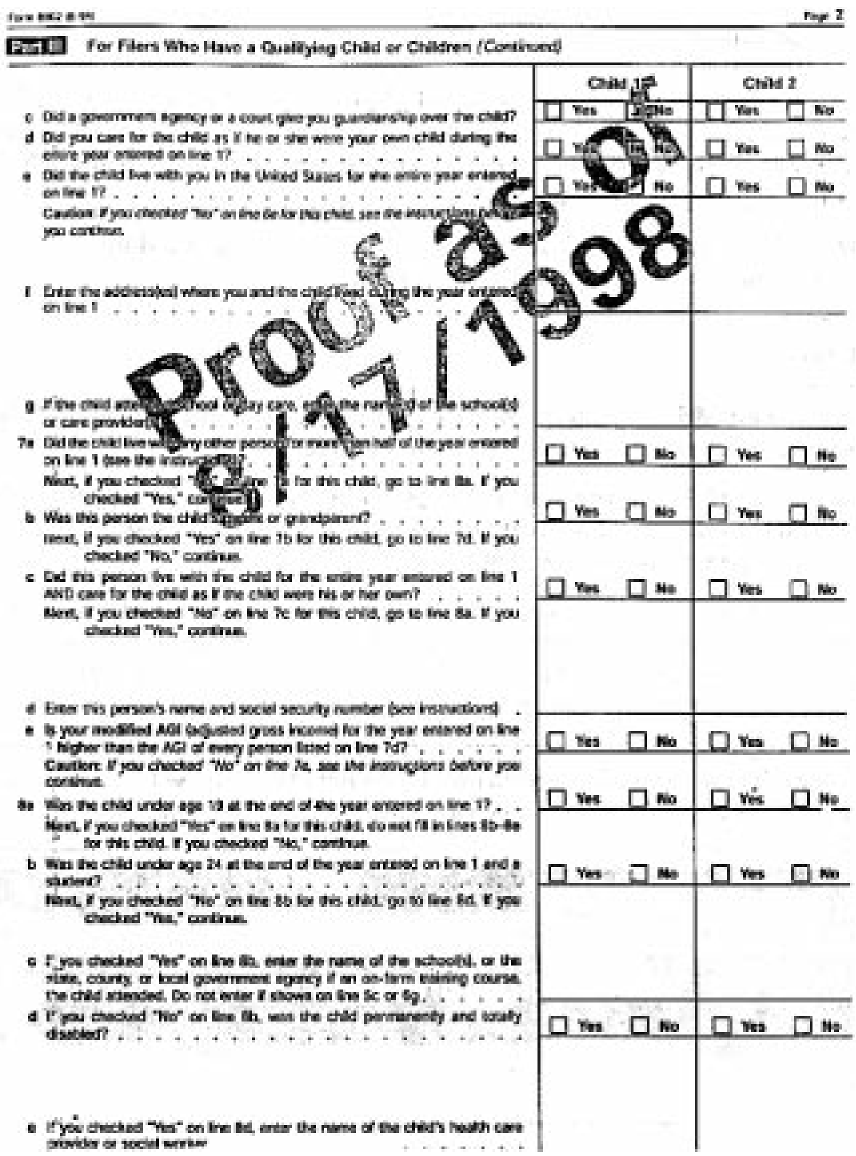
Form 8862 (8-98) Page 2

Part II For Filers Who Have a Qualifying Child or Children *(Continued)*

	Child 1	Child 2
c Did a government agency or a court give you guardianship over the child?	☐ Yes ☐ No	☐ Yes ☐ No
d Did you care for the child as if he or she were your own child during the entire year entered on line 1?	☐ Yes ☐ No	☐ Yes ☐ No
e Did the child live with you in the United States for the entire year entered on line 1? *Caution: If you checked "No" on line 6e for this child, see the instructions before you continue.*	☐ Yes ☐ No	☐ Yes ☐ No
f Enter the address(es) where you and the child lived during the year entered on line 1		
g If the child attended school or day care, enter the name(s) of the school(s) or care provider(s)		
7a Did the child live with any other person for more than half of the year entered on line 1 (see the instructions)? Next, if you checked "No" on line 7a for this child, go to line 8a. If you checked "Yes," continue.	☐ Yes ☐ No	☐ Yes ☐ No
b Was this person the child's parent or grandparent? Next, if you checked "Yes" on line 7b for this child, go to line 7d. If you checked "No," continue.	☐ Yes ☐ No	☐ Yes ☐ No
c Did this person live with the child for the entire year entered on line 1 AND care for the child as if the child were his or her own? Next, if you checked "No" on line 7c for this child, go to line 8a. If you checked "Yes," continue.	☐ Yes ☐ No	☐ Yes ☐ No
d Enter this person's name and social security number (see instructions)		
e Is your modified AGI (adjusted gross income) for the year entered on line 1 higher than the AGI of every person listed on line 7d? *Caution: If you checked "No" on line 7e, see the instructions before you continue.*	☐ Yes ☐ No	☐ Yes ☐ No
8a Was the child under age 19 at the end of the year entered on line 1? Next, if you checked "Yes" on line 8a for this child, do not fill in lines 8b–8e for this child. If you checked "No," continue.	☐ Yes ☐ No	☐ Yes ☐ No
b Was the child under age 24 at the end of the year entered on line 1 and a student? Next, if you checked "No" on line 8b for this child, go to line 8d. If you checked "Yes," continue.	☐ Yes ☐ No	☐ Yes ☐ No
c If you checked "Yes" on line 8b, enter the name of the school(s), or the state, county, or local government agency if an on-farm training course, the child attended. Do not enter if shown on line 5c or 6g		
d If you checked "No" on line 8b, was the child permanently and totally disabled?	☐ Yes ☐ No	☐ Yes ☐ No
e If you checked "Yes" on line 8d, enter the name of the child's health care provider or social worker		

Proof as of 6/17/1998

MISCELLANEOUS

35. CLARIFIED STATUTE OF LIMITATIONS FOR ITEMS FROM PASS-THROUGH ENTITIES

[I.R.C. §6501]

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

Explanation of Act. 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. [Like a partnership, for example.]

36. MEDICAL SAVINGS ACCOUNTS

[I.R.C. §220]

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

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Definition of Permitted Coverage

Old Law. Under old law, in order to be eligible to have an MSA an individual must have been covered under a high-deductible health plan and no other health plan, except for plans that provide certain permitted coverage. **Medicare supplemental plans were 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 are **deleted** from the types of permitted coverage an individual may have **and still qualify for an MSA.**

Taxation of Distributions

Old Law. **Distributions from an MSA for the medical expenses of the MSA account holder and his or her spouse or dependents were generally excludible from income.**

However, in any year for which a contribution was made to an MSA, withdrawals from the MSA were 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.**

Explanation of Act. 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.

PROCEDURE AND FILING

37. DELAYED IMPOSITION OF PENALTIES FOR FAILURE TO MAKE PAYMENTS ELECTRONICALLY THROUGH EFTPS

[No Code section–Act §831]

New Law. The Act provides that no penalty will be imposed solely by reason of a failure to use EFTPS 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.

Important Note: IRS news release IR-98-28 extended the deadline to January 1, 1999.

38. CLARIFICATION OF PERIOD FOR FILING CLAIMS FOR REFUNDS

[I.R.C. §6512]

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

Background.

This overrules the result in *Commissioner v. Lundy*, 116 S. Ct. 647 (1996).

Explanation of Act. 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.

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ALTERNATIVE MINIMUM TAX

39. NEW CAPITAL GAIN RATES APPLY TO BOTH REGULAR TAX AND THE ALTERNATIVE MINIMUM TAX

Explanation of Act. 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 [AS MODIFIED AND CLARIFIED BY "THE 1998 ACT"]

Overview. The Child Tax Credit includes three different components. The **Child Tax Credit** itself is a **nonrefundable** credit and is claimed on line 43 of Form 1040. The IRS provides worksheets to calculate this credit that are **not** to be attached and filed with the return.

The **Additional Child Tax Credit** is a **refundable** credit computed on new **Form** 8812 and claimed on line 60 of Form 1040. This credit can be claimed only by taxpayers with **three or more** qualifying children.

The **Supplemental Child Credit** works in conjunction with the **Child Tax Credit** and the **Earned Income Credit.** Generally, this component of the **Child Tax Credit** will result **only** when the taxpayer's EIC **exceeds** the taxpayer's employee share of FICA (and one-half of any SECA tax liability).

> **Note.** See the Education Credit section of this chapter for an example of the interaction of the Child Tax Credit, the Education Credits, and the AMT limitations.

General Discussion:

Child Tax Credit. The Act provides a $500 ($400 for taxable year 1998) **nonrefundable** tax credit for each qualifying child under the age of 17 **(as of December 31 of the year).**

Qualifying Child. A qualifying child is defined as an individual for whom the taxpayer claims a **dependency exemption** and who is a son or daughter of the taxpayer (or descendant of either), a stepson or stepdaughter of the taxpayer, or an eligible child of the taxpayer. The child must be a U.S. citizen or resident alien.

Phaseout of Credit Based on AGI. For taxpayers with modified AGI in excess of certain thresholds, the sum of the otherwise allowable child tax 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**

Example 3. Scott and Dawn Jackman are married and have two dependent children: Nicole, age 4, and Hannah, age 2. Both work full time. Scott's 1998 wages per his 1998 Form W-2 are $49,000 and Dawn's 1998 wages

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are $20,000. Their combined 1998 federal income tax withholding is $6,700. They paid $5,400 in 1998 to Carol Schultz for child care services she provided in her home.

Question 1. *What is the amount of their Child Tax Credit for 1998?*

Answer 1. $800. See Scott and Dawn's completed 1998 Forms 1040, 6251 (AMT), Schedule A, and their Child Tax Credit Worksheet for details.

1040 Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 1998
IRS Use Only—Do not write or staple in this space.
For the year Jan. 1–Dec. 31, 1998, or other tax year beginning , 1998, ending , 19 OMB No. 1545-0074

Label (See instructions on page 12.) Use the IRS label. Otherwise, please print or type.

Your first name and initial: Scott	Last name: Jackman	Your social security number: 000 00 0000
If a joint return, spouse's first name and initial: Dawn	Last name: Jackman	Spouse's social security number
Home address (number and street). If you have a P.O. box, see page 12.	Apt. no.	**IMPORTANT!** You must enter your SSN(s) above.
City, town or post office, state, and ZIP code. If you have a foreign address, see page 12.		

Presidential Election Campaign (See page 12.)
Do you want $3 to go to this fund? — Yes [ ] No [X]
If a joint return, does your spouse want $3 to go to this fund? — Yes [ ] No [X]
Note: Checking "Yes" will not change your tax or reduce your refund.

Filing Status (Check only one box.)
1 [ ] Single
2 [X] Married filing joint return (even if only one had income)
3 [ ] Married filing separate return. Enter spouse's social security no. above and full name here. ▶
4 [ ] Head of household (with qualifying person). (See page 12.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 [ ] Qualifying widow(er) with dependent child (year spouse died ▶ 19). (See page 12.)

Exemptions
6a [X] Yourself. If your parent (or someone else) can claim you as a dependent on his or her tax return, do not check box 6a.
b [ ] Spouse
No. of boxes checked on 6a and 6b: 2

c Dependents:

(1) First name	Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 13)
Nicole	Jackman	111 11 1111	daughter	✓
Hannah	Jackman	222 22 2222	daughter	✓

If more than six dependents, see page 13.
No. of your children on 6c who: • lived with you: 2 • did not live with you due to divorce or separation (see page 13): – Dependents on 6c not entered above
d Total number of exemptions claimed — Add numbers entered on lines above ▶ 4

7	Wages, salaries, tips, etc. Attach Form(s) W-2	7	69,000 00
22	Add the amounts in the far right column for lines 7 through 21. This is your total income ▶	22	69,000 00
33	Subtract line 32 from line 22. This is your adjusted gross income ▶	33	69,000 00

Tax and Credits

34	Amount from line 33 (adjusted gross income)	34	69,000 00
35a	Check if: [ ] You were 65 or older, [ ] Blind; [ ] Spouse was 65 or older, [ ] Blind. Add the number of boxes checked above and enter the total here ▶ 35a		
b	If you are married filing separately and your spouse itemizes deductions or you were a dual-status alien, see page 23 and check here ▶ 35b		
36	Enter the larger of your itemized deductions from Schedule A, line 28, OR standard deduction shown on the left. But see page 23 to find your standard deduction if you checked any box on line 35a or 35b or if someone can claim you as a dependent	36	16,225 00
37	Subtract line 36 from line 34	37	52,775 00
38	If line 34 is $93,400 or less, multiply $2,700 by the total number of exemptions claimed on line 6d. If line 34 is over $93,400, see the worksheet on page 24 for the amount to enter	38	10,800 00
39	Taxable income. Subtract line 38 from line 37. If line 38 is more than line 37, enter -0-	39	41,975 00
40	Tax. See page 24. Check if any tax from a [ ] Form(s) 8814 b [ ] Form 4972	40	6,296 00
41	Credit for child and dependent care expenses. Attach Form 2441 — 41: 960 00		
42	Credit for the elderly or the disabled. Attach Schedule R — 42		
43	Child tax credit (see page 25) — 43: 800 00		
44	Education credits. Attach Form 8863 — 44		
45	Adoption credit. Attach Form 8839 — 45		
46	Foreign tax credit. Attach Form 1116 if required — 46		
47	Other. Check if from a [ ] Form 3800 b [ ] Form 8396 c [ ] Form 8801 d [ ] Form (specify) — 47		
48	Add lines 41 through 47. These are your total credits	48	1,760 00
49	Subtract line 48 from line 40. If line 48 is more than line 40, enter -0- ▶	49	4,536 00

Standard Deduction for Most People — Single: $4,250; Head of household: $6,250; Married filing jointly or Qualifying widow(er): $7,100; Married filing separately: $3,550

Other Taxes

50	Self-employment tax. Attach Schedule SE	50	
51	Alternative minimum tax. Attach Form 6251	51	0
52	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	52	
53	Tax on IRAs, other retirement plans, and MSAs. Attach Form 5329 if required	53	
54	Advance earned income credit payments from Form(s) W-2	54	
55	Household employment taxes. Attach Schedule H	55	
56	Add lines 49 through 55. This is your total tax ▶	56	4,536 00

Payments

57	Federal income tax withheld from Forms W-2 and 1099 — 57: 6,700 00		
64	Add lines 57, 58, 59a, and 60 through 63. These are your total payments ▶	64	6,700 00

Refund

65	If line 64 is more than line 56, subtract line 56 from line 64. This is the amount you OVERPAID	65	2,164 00
66a	Amount of line 65 you want REFUNDED TO YOU ▶	66a	2,164 00

Proof as of 8/11/1998
Proof as of 8/11/1998

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Schedule A–Scott & Dawn Jackman (Summary)
Medical & Dental–$2725; **Taxes**–$5500; **Interest**–$8000; **Total**–$16,225

Child Tax Credit Worksheet—Line 43

► Keep for your records.

Do Not File

Proof as of 8/24/1998

1. $400.00 × 2 (Enter number of qualifying children). Multiply and enter the result . . . **1.** 800.00
2. Are you filing Form 2555, 2555-EZ, or 4563, or are you excluding income from Puerto Rico?
   - ☒ **No.** Enter the amount from Form 1040, line 34.
   - ☐ **Yes.** Enter your **modified AGI** (see page 25). . . . **2.** 69,000.00
3. Enter: $110,000 if married filing jointly; $75,000 if single, head of household, or qualifying widow(er); $55,000 if married filing separately . . . **3.** 110,000.00
4. Is line 2 above more than line 3?
   - ☒ **No.** Skip lines 4 and 5, enter -0- on line 6, and go to line 7.
   - ☐ **Yes.** Subtract line 3 from line 2 . . . **4.**
5. Divide line 4 by $1,000. If the result is not a whole number, round it up to the next higher whole number (for example, round 0.01 to 1) . . . **5.**
6. Multiply $50 by the number on line 5 . . . **6.** 0
7. Subtract line 6 from line 1. If zero or less, **stop**; you cannot take this credit . . . **7.** 800.00
8. Enter the amount from Form 1040, line 40 . . . **8.** 6296.00
9. Is line 1 above more than $800?
   - ☒ **No.** Add the amounts from Form 1040, lines 41, 42, and 44. Enter the total.
   - ☐ **Yes.** Enter the amount from the worksheet on page 33. . . . **9.** 960.00
10. Subtract line 9 above from line 8 . . . **10.** 5,336.00
11. Enter the smaller of line 7 or line 10 . . . ► **11.** 800.00
12. Are you reporting tax-exempt interest on Form 1040, line 8b, or are you claiming a net operating loss deduction on Form 1040, line 21?
    - ☒ **No.** Enter the amount from Form 1040, line 22.
    - ☐ **Yes.** Enter the total of the amount from Form 1040, line 22, plus any tax-exempt interest from private activity bonds issued after August 7, 1986, and net operating loss deduction. . . . **12.** 69,000.00
13. Are you filing **Schedule C, C-EZ, E, F, or D** (except to report only capital gain distributions)?
    - ☒ **No.** Go to line 14.
    - ☐ **Yes.** Complete Form 6251 through line 24, enter that amount on line 20 below, check "Yes" on line 20, and go to line 21.
14. Is line 12 above more than: $45,000 if married filing jointly or qualifying widow(er); $33,750 if single or head of household; $22,500 if married filing separately?
    - ☐ **No.** Skip lines 15 through 21 and go to line 22.
    - ☒ **Yes.** Go to line 15.
15. Is line 12 more than: $150,000 if married filing jointly or qualifying widow(er); $112,000 if single or head of household; $75,000 if married filing separately?
    - ☒ **No.** Go to line 16.
    - ☐ **Yes.** Complete Form 6251 through line 24, enter that amount on line 20 below, check "Yes" on line 20, and go to line 21.
16. Enter: $45,000 if married filing jointly or qualifying widow(er); $33,750 if single or head of household; $22,500 if married filing separately . . . **16.** 45,000.00
17. Subtract line 16 from line 12 . . . **17.** 24,000.00
18. Multiply line 17 by 26% (.26) . . . **18.** 6,240.00
19. Subtract line 18 from line 10. If zero or less, enter -0- . . . **19.** 0
20. Is line 11 more than line 19?
    - ☐ **No.** Skip lines 20 and 21 and go to line 22.
    - ☒ **Yes.** Complete Form 6251 through line 24 and enter that amount here . . . **20.** 3,900.00
21. Subtract line 20 from line 10. If zero or less, enter -0- . . . **21.** 1,436.00
22. **Child tax credit.**
    - If you checked "No" on line 14 or line 20, enter the amount from line 11 here and on Form 1040, line 43.
    - If you checked "Yes" on line 20, enter the smaller of line 11 or line 21 here and on Form 1040, line 43. If line 21 is the smaller amount, enter "AMT" on the dotted line next to line 43. . . . **22.** 800.00

TIP *If line 1 above is more than $800, you may be able to take the **Additional Child Tax Credit**. See page 31.*

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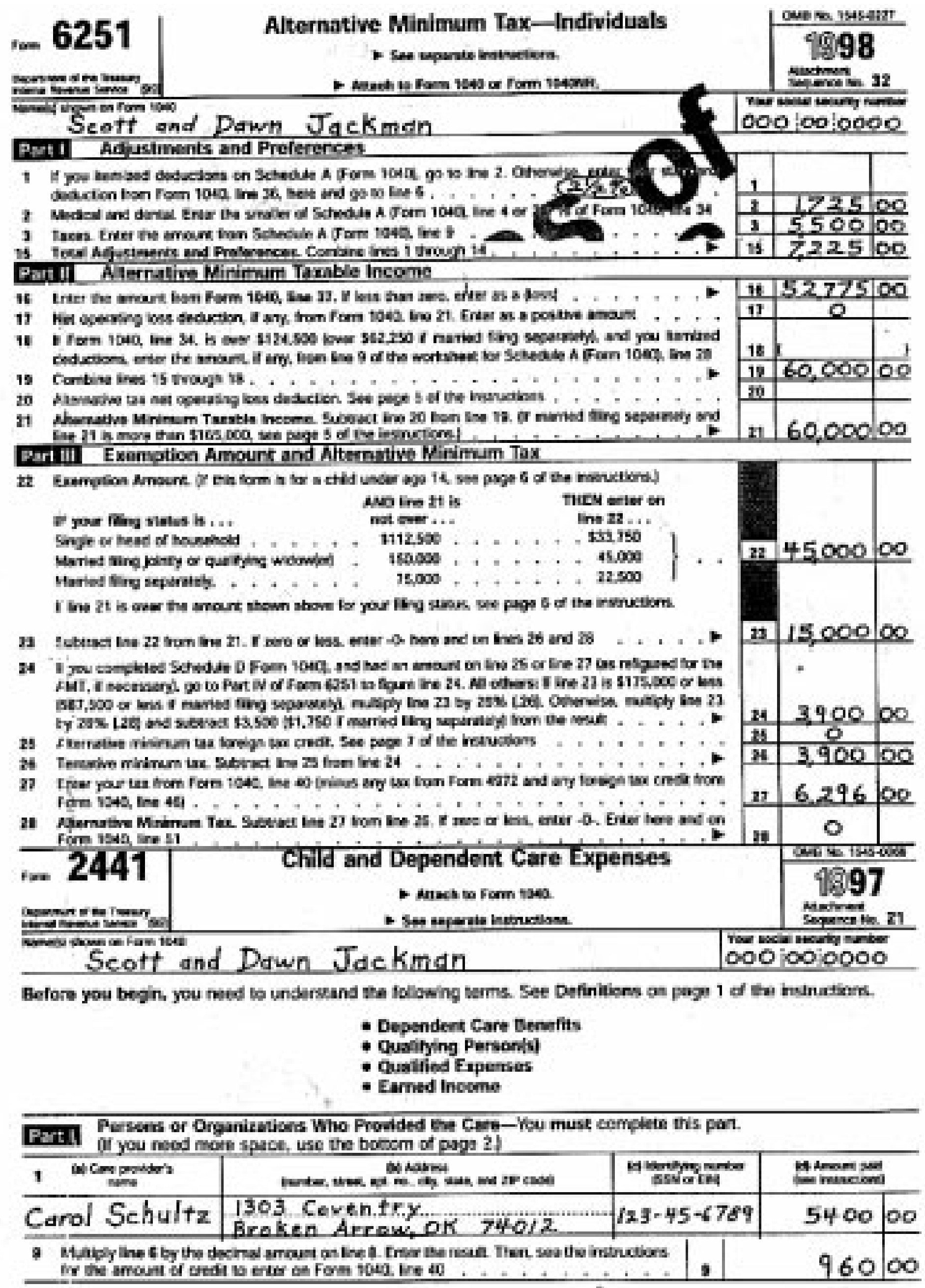
Note. Form 6251 will **not** be filed with the 1998 Form 1040 as line 26 below is **less than or equal to** line 40 of Form 1040.



Form **6251** — Department of the Treasury, Internal Revenue Service (99)

Alternative Minimum Tax—Individuals

▶ See separate instructions.

▶ Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0227 — **1998** — Attachment Sequence No. 32

Name(s) shown on Form 1040: Scott and Dawn Jackman — Your social security number: 000 00 0000

Part I — Adjustments and Preferences

1	If you itemized deductions on Schedule A (Form 1040), go to line 2. Otherwise, enter your standard deduction from Form 1040, line 36, here and go to line 6	1	
2	Medical and dental. Enter the smaller of Schedule A (Form 1040), line 4 or 2½% of Form 1040, line 34	2	1725 00
3	Taxes. Enter the amount from Schedule A (Form 1040), line 9	3	5500 00
15	Total Adjustments and Preferences. Combine lines 1 through 14 ▶	15	7,225 00

Part II — Alternative Minimum Taxable Income

16	Enter the amount from Form 1040, line 37. If less than zero, enter as a (loss) ▶	16	52,775 00
17	Net operating loss deduction, if any, from Form 1040, line 21. Enter as a positive amount	17	0
18	If Form 1040, line 34, is over $124,500 (over $62,250 if married filing separately), and you itemized deductions, enter the amount, if any, from line 9 of the worksheet for Schedule A (Form 1040), line 28	18	( )
19	Combine lines 15 through 18 ▶	19	60,000 00
20	Alternative tax net operating loss deduction. See page 5 of the instructions	20	
21	Alternative Minimum Taxable Income. Subtract line 20 from line 19. (If married filing separately and line 21 is more than $165,000, see page 5 of the instructions.) ▶	21	60,000 00

Part III — Exemption Amount and Alternative Minimum Tax

22 Exemption Amount. (If this form is for a child under age 14, see page 6 of the instructions.)

If your filing status is . . .	AND line 21 is not over . . .	THEN enter on line 22 . . .
Single or head of household	$112,500	$33,750
Married filing jointly or qualifying widow(er)	150,000	45,000
Married filing separately	75,000	22,500

If line 21 is over the amount shown above for your filing status, see page 6 of the instructions. — 22: 45,000 00

23	Subtract line 22 from line 21. If zero or less, enter -0- here and on lines 26 and 28 ▶	23	15,000 00
24	If you completed Schedule D (Form 1040), and had an amount on line 25 or line 27 (as refigured for the AMT, if necessary), go to Part IV of Form 6251 to figure line 24. All others: If line 23 is $175,000 or less ($87,500 or less if married filing separately), multiply line 23 by 26% (.26). Otherwise, multiply line 23 by 28% (.28) and subtract $3,500 ($1,750 if married filing separately) from the result ▶	24	3,900 00
25	Alternative minimum tax foreign tax credit. See page 7 of the instructions	25	0
26	Tentative minimum tax. Subtract line 25 from line 24 ▶	26	3,900 00
27	Enter your tax from Form 1040, line 40 (minus any tax from Form 4972 and any foreign tax credit from Form 1040, line 46)	27	6,296 00
28	Alternative Minimum Tax. Subtract line 27 from line 26. If zero or less, enter -0-. Enter here and on Form 1040, line 51 ▶	28	0

Form **2441** — Department of the Treasury, Internal Revenue Service (99)

Child and Dependent Care Expenses

▶ Attach to Form 1040.

▶ See separate instructions.

OMB No. 1545-0068 — **1997** — Attachment Sequence No. 21

Name(s) shown on Form 1040: Scott and Dawn Jackman — Your social security number: 000 00 0000

Before you begin, you need to understand the following terms. See **Definitions** on page 1 of the instructions.

- **Dependent Care Benefits**
- **Qualifying Person(s)**
- **Qualified Expenses**
- **Earned Income**

Part I — Persons or Organizations Who Provided the Care—You **must** complete this part. (If you need more space, use the bottom of page 2.)

1 (a) Care provider's name	(b) Address (number, street, apt. no., city, state, and ZIP code)	(c) Identifying number (SSN or EIN)	(d) Amount paid (see instructions)
Carol Schultz	1303 Coventry, Broken Arrow, OK 74012	123-45-6789	5400 00

9 Multiply line 6 by the decimal amount on line 8. Enter the result. Then, see the instructions for the amount of credit to enter on Form 1040, line 40 — 9: 960 00

Example 4. $\boxed{\text{A more difficult problem}}$ Ricardo and Camille Gherenbeck are married and have six dependent children who were under the age of 17 as of December 31, 1998. Ricardo is a manager for GTE. His wages were $69,000 in 1998. Camille did not work outside the home in 1998. She home-schools her six children, the oldest of whom was 12 and the youngest of whom was 6 as of December 31, 1998.

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Question 1. *What is the amount of the new Child Tax Credit for 1998?*

Answer 1. $400 per each qualifying child (apparently).

Excerpt from 1998 Form instructions

What's New for 1998?

New Child Tax Credits

Do you have a child who was under age 17 at the end of 1998?

If so, you may be able to claim either or both of these new credits:

- The Child Tax Credit
- The Additional Child Tax Credit

The total of these credits cannot be more than $400 for each qualifying child. Figure the child tax credit first. If you have three or more qualifying children and you are not able to [illegible] the full $400 child tax cred[illegible] you may be able to cl[illegible] credit.

The additional chi[illegible] credit is refundable; that is, it ma[illegible] you a refund even if you do not owe [illegible].

These credits are in additio[illegible] child and dependent care cre[illegible] earned income credit that you [illegible] able to claim.

Who Is a Qualifying Child? The child must be your dependent and must meet certain other requirements. See Qualifying Child for Child Tax Credit in the instructions for line 6c, column (4), on page 13.

Caution: *If the child meets those requirements, check column (4) on line 6c of your return.*

Where Do You Claim These Credits?

Child Tax Credit. If you have at least one qualifying child, follow the instructions on page 31 and figure the credit on the Child Tax Credit Worksheet. Do not attach the worksheet to your return. Enter the credit on Form 1040, line 43.

Additional Child Tax Credit. Use Form 8812 to figure this credit and attach it to your return. Enter the additional child tax credit on Form 1040, line 60.

Line 6c, Column (4)

Check this column if your dependent is a qualifying child for the child tax credit (defined below). If you have at least one qualifying child, you may be able to take the child tax credit on line 43.

Qualifying Child for Child Tax Credit. A qualifying child for purposes of the child tax credit is a child who:

- Is claimed as your dependent on line 6c, and
- Was under age 17 at the end of 1998, and
- Is your son, daughter, adopted child, grandchild, stepchild, or foster child, and
- Is a United States [illegible] alien.

Note: *The above [illegible] not the same as the re[illegible] a qualifying child for [illegible] earned income credit.*

A child placed with you b[illegible] authorized placement agency for [illegible] adoption is an adopted child [illegible] adoption is not final.

A grandchild is any descendant of your son, daughter, or adopted child and includes your great-grandchild, great-great-grandchild, etc.

A foster child is any child you cared for as your own child and who lived with you for all of 1998. A child who was born or died in 1998 is considered to have lived with you for all of 1998 if your home was the child's home for the entire time he or she was alive during 1998.

To find out who is a resident alien, use TeleTax topic 851 (see page 9) or see Pub. 519.

Question 2. *How do Ricardo and Camille calculate the amount of their allowable 1998 Child Tax Credit?*

Answer 2. Very carefully! This can be a time-consuming and confusing calculation. See the excerpt from the 1998 Form 1040 Instructions below.

Excerpt from 1998 Form 1040 Instructions

Line 43 **Child Tax Credit**

What Is the Child Tax Credit?

The child tax credit is a credit for people who have a qualifying child; it reduces tax people owe. The credit can be as much as $400 for each qualifying child.

How Do You Figure the Credit?

Use the Child Tax Credit Worksheet on page 26 to figure the amount of your credit. But before you begin, if you are claiming an education credit on Form 1040, line 44, complete Form 8863 and enter your credit on line 44.

You may also need to know the following information.

Modified AGI (adjusted gross income) is the amount from Form 1040, line 34, increased by the total of any:

- Exclusion of income from Puerto Rico, and
- Amount from Form 2555, lines 43 and 48; Form 2555-EZ, line 18; and Form 4563, line 15.

Forms 2555 and 2555-EZ relate to foreign earned income. Form 4563 relates to the exclusion of income for certain people who live in American Samoa.

What Are Schedules C, C-EZ, D, E, and F Used For? Schedules C and C-EZ are used to report the income and expenses of people who are self-employed. Schedule D is used to report capital gains and losses. Schedule E is used to report income (or loss) from rental real estate, royalties, partnerships, S corporations, trusts, etc. Schedule F is used to report profit or

Caution: *Make sure you checked column (4) of line 6c for each qualifying child.*

Who May Be Able To Take the Additional Child Tax Credit?

You may be able to take the additional child tax credit on Form 1040, line 60, if:

- You have three or more qualifying children, and
- The amount on line 7 of the Child Tax Credit Worksheet is more than your credit on Form 1040, line 43.

But first complete your return through line 59b.

Question 3. *What is the amount of their allowable Child Tax Credit for 1998?*

Answer 3. Their allowable 1998 Child Tax Credit is $776. It is reported on line 43 on page 2 of their 1998 Form 1040.

Question 4. *They had six qualifying children in 1998, and 6 × $400 per child equals $2,400. Why is their allowable Child Tax Credit limited to only $776?*

Answer 4. Due to the technically complex Child Tax Credit provisions of the 1997 Taxpayer Relief Act, Ricardo and Camille's 1998 tentative Child Tax Credit of $2,400 is reduced to $776. **The reason is the alternative minimum tax (AMT) factor.**

Their $69,000 adjusted gross income amount was reduced to a **taxable income of $31,175.** This was due to relatively **high** itemized deductions of **$16,225** and **$21,600** (8 total exemptions × $2,700) of exemptions. Their tax table tax of $4,676 minus the tentative AMT amount of $3,900 (line 24 on the 1998 Form 6251) **equals $776.**

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This $776 figure becomes a **limitation** to their tentative $2,400 Child Tax Credit amount. Their 1998 Child Tax Credit cannot exceed this $776 limitation.

The reason is that **unlike regular income tax, the Child Tax Credit does** *not* **reduce AMT liability.** The result is that most of Ricardo and Camille's tax savings from the Child Tax Credit **is offset by the AMT limitation!**

Question 5. *Do Ricardo and Camille qualify for the Additional Child Tax Credit shown on line 60 on their 1998 Form 1040?*

Answer 5. Yes. According to the 1998 Form 1040 Instructions which state:

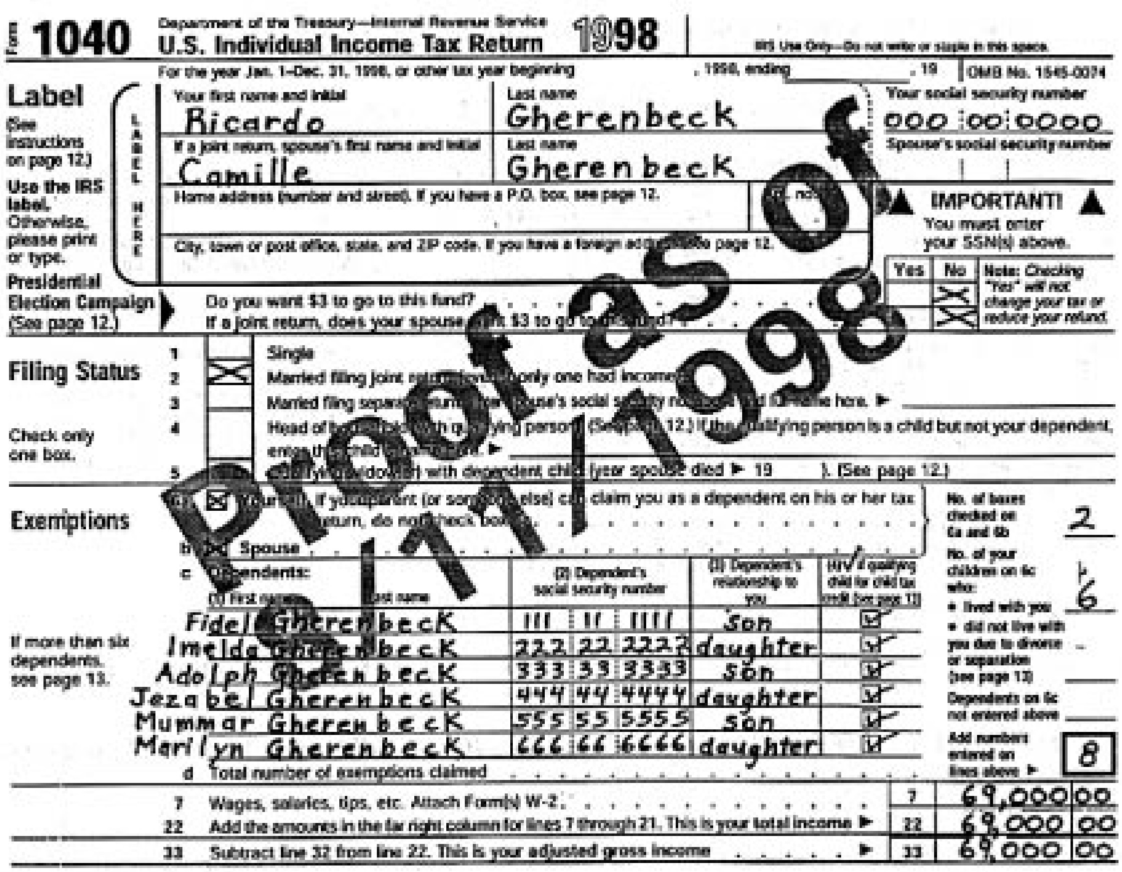
Who May Be Able to Take the Additional Child Tax Credit?

You may be able to take the additional child tax credit on Form 1040, line 60, if:

1. You have three or more qualifying children, and
2. The amount on line 7 of the **Child Tax Credit Worksheet** is **more** than your credit on Form 1040, line 43. But first complete the return through line 59b.

Since Ricardo and Camille meet both of these requirements, they are entitled to claim the **Additional Child Tax Credit on Form 8812.**

See Ricardo and Camille's completed 1998 Forms 1040, W-2 for Ricardo, 6251 (AMT), 8812 (Additional Child Tax Credit), Schedule A, and their Child Tax Credit Worksheets for details.



Form 1040 Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 1998

For the year Jan. 1–Dec. 31, 1998, or other tax year beginning , 1998, ending , 19 OMB No. 1545-0074

Label: Your first name and initial: Ricardo — Last name: Gherenbeck — Your social security number: 000 00 0000
If a joint return, spouse's first name and initial: Camille — Last name: Gherenbeck — Spouse's social security number

Home address (number and street). If you have a P.O. box, see page 12.
City, town or post office, state, and ZIP code. If you have a foreign address, see page 12.

IMPORTANT! You must enter your SSN(s) above.

Presidential Election Campaign (See page 12.) Do you want $3 to go to this fund? — No: X
If a joint return, does your spouse want $3 to go to this fund? — No: X
Note: Checking "Yes" will not change your tax or reduce your refund.

Filing Status (Check only one box.)
1 Single
2 X Married filing joint return (even if only one had income)
3 Married filing separate return. Enter spouse's social security no. above and full name here.
4 Head of household (with qualifying person). (See page 12.) If the qualifying person is a child but not your dependent, enter this child's name here.
5 Qualifying widow(er) with dependent child (year spouse died ▶ 19). (See page 12.)

Exemptions
6a X Yourself. If your parent (or someone else) can claim you as a dependent on his or her tax return, do not check box 6a.
b X Spouse
No. of boxes checked on 6a and 6b: 2

c Dependents:

(1) First name / Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 13)
Fidel Gherenbeck	111 11 1111	son	✓
Imelda Gherenbeck	222 22 2222	daughter	✓
Adolph Gherenbeck	333 33 3333	son	✓
Jezabel Gherenbeck	444 44 4444	daughter	✓
Mummar Gherenbeck	555 55 5555	son	✓
Marilyn Gherenbeck	666 66 6666	daughter	✓

No. of your children on 6c who: • lived with you: 6 • did not live with you due to divorce or separation (see page 13)
Dependents on 6c not entered above
Add numbers entered on lines above ▶ 8

If more than six dependents, see page 13.

d Total number of exemptions claimed

7 Wages, salaries, tips, etc. Attach Form(s) W-2 — 7 — 69,000 00
22 Add the amounts in the far right column for lines 7 through 21. This is your total income ▶ — 22 — 69,000 00
33 Subtract line 32 from line 22. This is your adjusted gross income ▶ — 33 — 69,000 00

Proof as of 7/1/1998

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Form 1040 (1998) Page 2

Tax and Credits	34	Amount from line 33 (adjusted gross income)			34	69,000 00
	35a	Check if: ☐ You were 65 or older, ☐ Blind; ☐ Spouse was 65 or older, ☐ Blind. Add the number of boxes checked above and enter the total here ▶ 35a				
	b	If you are married filing separately and your spouse itemizes deductions or you were a dual-status alien, see page 23 and check here ▶ 35b ☐				
Standard Deduction for Most People. Single: $4,250; Head of household: $6,250; Married filing jointly or Qualifying widow(er): $7,100; Married filing separately: $3,550	36	Enter the larger of your itemized deductions from Schedule A, line 28, OR standard deduction shown on the left. But see page 23 to find your standard deduction if you checked any box on line 35a or 35b or if someone can claim you as a dependent			36	16,225 00
	37	Subtract line 36 from line 34			37	52,775 00
	38	If line 34 is $93,400 or less, multiply $2,700 by the total number of exemptions claimed on line 6d. If line 34 is over $93,400, see the worksheet on page 24 for the amount to enter			38	21,600 00
	39	Taxable income. Subtract line 38 from line 37. If line 38 is more than line 37, enter -0-			39	31,175 00
	40	Tax. See page 24. Check if any tax from a ☐ Form(s) 8814 b ☐ Form 4972			40	4,676 00
	41	Credit for child and dependent care expenses. Attach Form 2441	41			
	42	Credit for the elderly or the disabled. Attach Schedule R	42			
	43	Child tax credit (see page 25) AMT	43	776 00		
	44	Education credits. Attach Form 8863	44			
	45	Adoption credit. Attach Form 8839	45			
	46	Foreign tax credit. Attach Form 1116 if required	46			
	47	Other. Check if from a ☐ Form 3800 b ☐ Form 8396 c ☐ Form 8801 d ☐ Form (specify)	47			
	48	Add lines 41 through 47. These are your total credits			48	776 00
	49	Subtract line 48 from line 40. If line 48 is more than line 40, enter -0- ▶			49	3,900 00
Other Taxes	50	Self-employment tax. Attach Schedule SE			50	
	51	Alternative minimum tax. Attach Form 6251			51	0
	52	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137			52	
	53	Tax on IRAs, other retirement plans, and MSAs. Attach Form 5329 if required			53	
	54	Advance earned income credit payments from Form(s) W-2			54	
	55	Household employment taxes. Attach Schedule H			55	
	56	Add lines 49 through 55. This is your total tax ▶			56	3,900 00
Payments	57	Federal income tax withheld from Forms W-2 and 1099	57	6,700 00		
Attach Forms W-2 and W-2G on the front. Also attach Form 1099-R if tax was withheld.	58	1998 estimated tax payments and amount applied from 1997 return	58			
	59a	Earned income credit. Attach Schedule EIC if you have a qualifying child b Nontaxable earned income: amount ▶ and type ▶	59a			
	60	Additional child tax credit. Attach Form 8812	60	1,624 00		
	61	Amount paid with Form 4868 (request for extension)	61			
	62	Excess social security and RRTA tax withheld (see page 37)	62			
	63	Other payments. Check if from a ☐ Form 2439 b ☐ Form 4136	63			
	64	Add lines 57, 58, 59a, and 60 through 63. These are your total payments ▶			64	8,324 00
Refund	65	If line 64 is more than line 56, subtract line 56 from line 64. This is the amount you OVERPAID			65	4,424 00
Have it directly	66a	Amount of line 65 you want REFUNDED TO YOU ▶			66a	4,424 00
	b	Routing number				

Proof as of 8/11/1998

1998 Schedule A summary for Ricardo and Camille Gherenbeck–
Medical–$2,725; **Taxes–**$5,500; **Interest–**$8,000; **Total** = $16,225

Note. Form 6251 will **not** be filed with the 1998 Form 1040 as line 26 below is **equal to or less** than line 40 of Form 1040.

15

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Form **6251** — **Alternative Minimum Tax—Individuals**

► See separate instructions.

► Attach to Form 1040 or Form 1040NR.

Department of the Treasury
Internal Revenue Service (99)

OMB No. 1545-0227 — **1998** — Attachment Sequence No. 32

Name(s) shown on Form 1040: Ricardo and Camille Gherenbeck — Your social security number: 000-00-0000

Part I — Adjustments and Preferences

Line	Description		Amount
1	If you itemized deductions on Schedule A (Form 1040), go to line 2. Otherwise, enter your standard deduction from Form 1040, line 36, here and go to line 6	1	
2	Medical and dental. Enter the smaller of Schedule A (Form 1040), line 4 or 2½% of Form 1040, line 34	2	1,725 00
3	Taxes. Enter the amount from Schedule A (Form 1040), line 9	3	5,500 00
14	Related adjustments	14	
15	**Total Adjustments and Preferences.** Combine lines 1 through 14 ►	15	7,225 00

Part II — Alternative Minimum Taxable Income

Line	Description		Amount
16	Enter the amount from Form 1040, line 37. If less than zero, enter as a (loss) ►	16	52,775 00
17	Net operating loss deduction, if any, from Form 1040, line 21. Enter as a positive amount	17	0
18	If Form 1040, line 34, is over \$124,500 (over \$62,250 if married filing separately), and you itemized deductions, enter the amount, if any, from line 9 of the worksheet for Schedule A (Form 1040), line 28	18	( )
19	Combine lines 16 through 18 ►	19	60,000 00
20	Alternative tax net operating loss deduction. See page 5 of the instructions	20	—
21	**Alternative Minimum Taxable Income.** Subtract line 20 from line 19. (If married filing separately and line 21 is more than \$165,000, see page 5 of the instructions.) ►	21	60,000 00

Part III — Exemption Amount and Alternative Minimum Tax

22 **Exemption Amount.** (If this form is for a child under age 14, see page 6 of the instructions.)

If your filing status is . . .	AND line 21 is not over . . .	THEN enter on line 22 . . .
Single or head of household	\$112,500	\$33,750
Married filing jointly or qualifying widow(er)	150,000	45,000
Married filing separately	75,000	22,500

If line 21 is over the amount shown above for your filing status, see page 6 of the instructions. — 22: 45,000 00

Line	Description		Amount
23	Subtract line 22 from line 21. If zero or less, enter -0- here and on lines 26 and 28 ►	23	15,000 00
24	If you completed Schedule D (Form 1040), and had an amount on line 25 or line 27 (as refigured for the AMT, if necessary), go to Part IV of Form 6251 to figure line 24. **All others:** If line 23 is \$175,000 or less (\$87,500 or less if married filing separately), multiply line 23 by 26% (.26). Otherwise, multiply line 23 by 28% (.28) and subtract \$3,500 (\$1,750 if married filing separately) from the result ►	24	3,900 00
25	Alternative minimum tax foreign tax credit. See page 7 of the instructions	25	0
26	Tentative minimum tax. Subtract line 25 from line 24 ►	26	3,900 00
27	Enter your tax from Form 1040, line 40 (minus any tax from Form 4972 and any foreign tax credit from Form 1040, line 46)	27	4,676 00
28	**Alternative Minimum Tax.** Subtract line 27 from line 26. If zero or less, enter -0-. Enter here and on Form 1040, line 51 ►	28	0

Gherenbeck

Line 9 of Child Tax Credit Worksheet on Page 32 (keep for your records)

Use this worksheet **only** if you checked "Yes" on line 9 of the worksheet on page 32.

1. Add the amounts from Form 1040, lines 41, 42, and 44. Enter the total . . . 1. -0-
2. Are you claiming any of the following credits: the adoption credit **(Form 8839)**, the mortgage interest credit **(Form 8396)**, or the District of Columbia first-time homebuyer credit **(Form 8859)**?

☒ **No.** Stop here; enter the amount from line 1 above on line 9 of the worksheet on page 32.

Note. Line 44 is Educational Credits.

Rest of worksheet deleted–does not apply to this problem.

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a Control number 22222 | Void | For Official Use Only ▶ OMB No. 1545-0008

b Employer identification number	1 Wages, tips, other compensation: 69,000.00	2 Federal income tax withheld: 6700.00
c Employer's name, address, and ZIP code: GTE, Inc.	3 Social security wages: 68,400.00	4 Social security tax withheld: 4240.80
	5 Medicare wages and tips: 69,000.00	6 Medicare tax withheld: 1000.50
	7 Social security tips	8 Allocated tips
d Employee's social security number: 000-00-0000	9 Advance EIC payment	10 Dependent care benefits
e Employee's name: Ricardo Gherenbeck	11 Nonqualified plans	12 Benefits included in box 1
	13	14 Other
f Employee's address and ZIP code	15 ☐ ☐ ☒ ☐ ☒	

W-2 Wage and Tax Statement 1998

Department of the Treasury—Internal Revenue Service

Gherenbeck

Child Tax Credit Worksheet—Line 43

▶ Keep for your records.

Do Not File

1. $400.00 × 6 (Enter number of qualifying children). Multiply and enter the result . . . . . 1. 2,400 | 00
2. Are you filing Form 2555, 2555-EZ, or 4563, or are you excluding income from Puerto [illegible]
   - ☒ No. Enter the amount from Form 1040, line 34.
   - ☐ Yes. Enter your modified AGI (see page 29). . . . . . . 2. 69,000 | 00
3. Enter: $110,000 if married filing jointly; $75,000 if single, head of household, or qualifying widow(er); $55,000 if married filing separ[illegible] . . . 3. [illegible],000 | 00
4. Is line 2 above more than line 3?
   - ☒ No. Skip lines 4 and 5, enter -0- on line 6, a[illegible] to line 7.
   - ☐ Yes. Subtract line 3 from line 2 . . . . 4.
5. Divide line 4 by $1,000. If the result is not a [illegible], round it up to the next higher whole number (for example[illegible]) . . . 5.
6. Multiply $50 by the number on line [illegible] 6. 0
7. Subtract line 6 from line 1. If [illegible] you cannot take the credit . . . . . 7. 2,400 | 00
8. Enter the amo[illegible] 1040[illegible] 8. 4,676
9. Is line 1 above more than $[illegible]?
   - ☐ No. Add [illegible] from Form 1040, line[illegible] and enter the total.
   - ☒ Yes. Enter t[illegible] amount from the w[illegible] . . . 9. 0
10. Subtract line 9 abo[illegible] from line 8 . . . . TAX . . . 10. 4,676
11. Enter the smaller of line [illegible] line 10 . . . . ▶ 11. 2,400 | 00
12. Are you reporting tax-e[illegible] [illegible] Form 1040, line 8b, or are you claiming a net operating [illegible] on Form 1040, line 21?
    - ☒ No. Enter the amoun[illegible] Form 1040, line 22.
    - ☐ Yes. Enter the total of the amount from Form 1040, line 22, plus any tax-exempt interest from private activity bonds issued after August 7, 1986, and net operating loss deduction. . . . 12. 69,000 | 00
13. Are you filing Schedule C, C-EZ, E, F, or D (except to report only capital gain distributions)?
    - ☒ No. Go to line 14.
    - ☐ Yes. Complete Form 6251 through line 24, enter that amount on line 20 below, check "Yes" on line 20, and go to line 21.
14. Is line 12 above more than: $45,000 if married filing jointly or qualifying widow(er); $33,750 if single or head of household; $22,500 if married filing separately?
    - ☐ No. Skip lines 15 through 21 and go to line 22.
    - ☒ Yes. Go to line 15.
15. Is line 12 more than: $150,000 if married filing jointly or qualifying widow(er); $112,000 if single or head of household; $75,000 if married filing separately?
    - ☒ No. Go to line 16.
    - ☐ Yes. Complete Form 6251 through line 24, enter that amount on line 20 below, check "Yes" on line 20, and go to line 21.
16. Enter: $45,000 if married filing jointly or qualifying widow(er); $33,750 if single or head of household; $22,500 if married filing separately . . . . 16. 45,000 | 00
17. Subtract line 16 from line 12 . . . . 17. 24,000 | 00
18. Multiply line 17 by 26% (.26) . . . . 18. 6,240 | 00
19. Subtract line 18 from line 10. If zero or less, enter -0- 19. 0
20. Is line 11 more than line 19?
    - ☐ No. Skip lines 20 and 21 and go to line 22.
    - ☒ Yes. Complete Form 6251 through line 24 and enter that amount here . . AMT TAX . . 20. 3,900 | 00
21. Subtract line 20 from line 10. If zero or less, enter -0- . . . . . Limitation . . 21. 776 | 00
22. Child tax credit.
    - If you checked "No" on line 14 or line 20, enter the amount from line 11 here and on Form 1040, line 43.
    - If you checked "Yes" on line 20, enter the smaller of line 11 or line 21 here and on Form 1040, line 43. If line 21 is the smaller amount, enter "AMT" on the dotted line next to line 43. . . . 22. 776 | 00

TIP *If line 1 above is more than $800, you may be able to take the **Additional Child Tax Credit**. See page 31.*

Proof as of 8/24/1998

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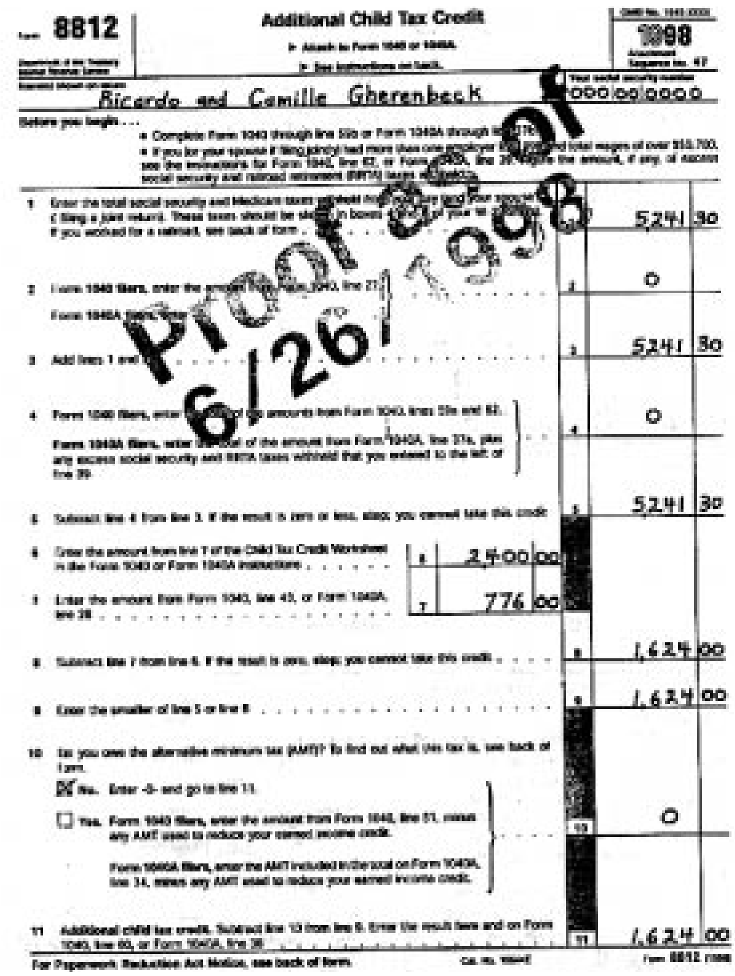
Form 8812 — Additional Child Tax Credit — 1998

Attach to Form 1040 or 1040A. See instructions on back.

Name(s) shown on return: Ricardo and Camille Gherenbeck — Your social security number: 000-00-0000

Proof of 6/26/1998

1	Enter the total social security and Medicare taxes withheld from you ... If you worked for a railroad, see back of form	5241.30
2	Form 1040 filers, enter the amount from Form 1040, line 27. Form 1040A filers, enter -0-	0
3	Add lines 1 and 2	5241.30
4	Form 1040 filers, enter the total of the amounts from Form 1040, lines 59a and 62. Form 1040A filers, enter the total of the amount from Form 1040A, line 37a, plus any excess social security and RRTA taxes withheld that you entered to the left of line 39	0
5	Subtract line 4 from line 3. If the result is zero or less, stop; you cannot take this credit	5241.30
6	Enter the amount from line 7 of the Child Tax Credit Worksheet in the Form 1040 or Form 1040A instructions	2,400.00
7	Enter the amount from Form 1040, line 43, or Form 1040A, line 28	776.00
8	Subtract line 7 from line 6. If the result is zero, stop; you cannot take this credit	1,624.00
9	Enter the smaller of line 5 or line 8	1,624.00
10	Do you owe the alternative minimum tax (AMT)? To find out what this tax is, see back of form. ☒ No. Enter -0- and go to line 11. ☐ Yes. Form 1040 filers, enter the amount from Form 1040, line 51, minus any AMT used to reduce your earned income credit. Form 1040A filers, enter the AMT included in the total on Form 1040A, line 34, minus any AMT used to reduce your earned income credit.	0
11	Additional child tax credit. Subtract line 10 from line 9. Enter the result here and on Form 1040, line 60, or Form 1040A, line 38	1,624.00

For Paperwork Reduction Act Notice, see back of form. — Form 8812 (1998)

Example 5. Chris and JoAnne White are married and have two dependent children: Nicole, age 4, and Hannah, age 2. Chris works full time. Chris's 1998 wages per his 1998 Form W-2 are $22,000. JoAnne does not work outside the home.

Question 1. *What is the amount of their Child Tax Credit, Additional Child Tax Credit, and Supplemental Child Tax Credit, if any?*

Answer 1. $619 – 16 = **$603**

1. Child Tax Credit (see worksheets)
2. Additional Tax Credit -0- (need three or more children to qualify)
3. Supplemental Tax Credit **$16.00,** figured as follows:

lesser of:

	(a)	$400	×	2	=			$800
or								
	(b)	$619	–	0	=			$619
$\boxed{\text{lesser}}$ is $619, minus								
	(c)	$619	+	$1,683 (Employee FICA and Medicare)	–	$1,699 (Computed EIC)	=	$603 [child care credit]

> $16 **Supplemental Child Tax Credit** plus EIC of $1,699 = $1,715

Since the Earned Income Credit ($1,699.00) is more than the taxpayer's share of FICA ($1,683.00), the **Supplemental Child Tax Credit** applies. Remember, the **Supplemental Child Tax Credit** generally applies only to situations where the taxpayer's **Earned Income Credit** exceeds the taxpayer's employee share of FICA (and one-half of any SECA tax liability).

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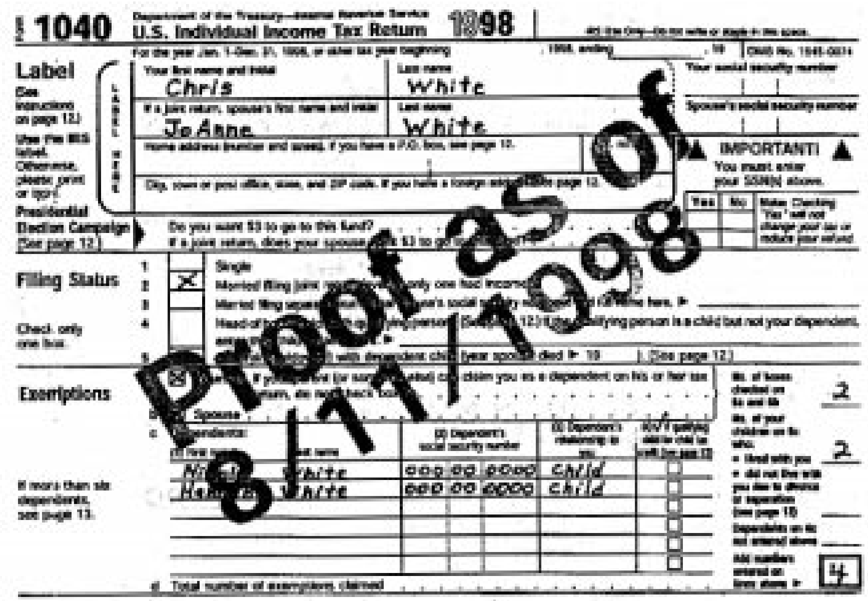
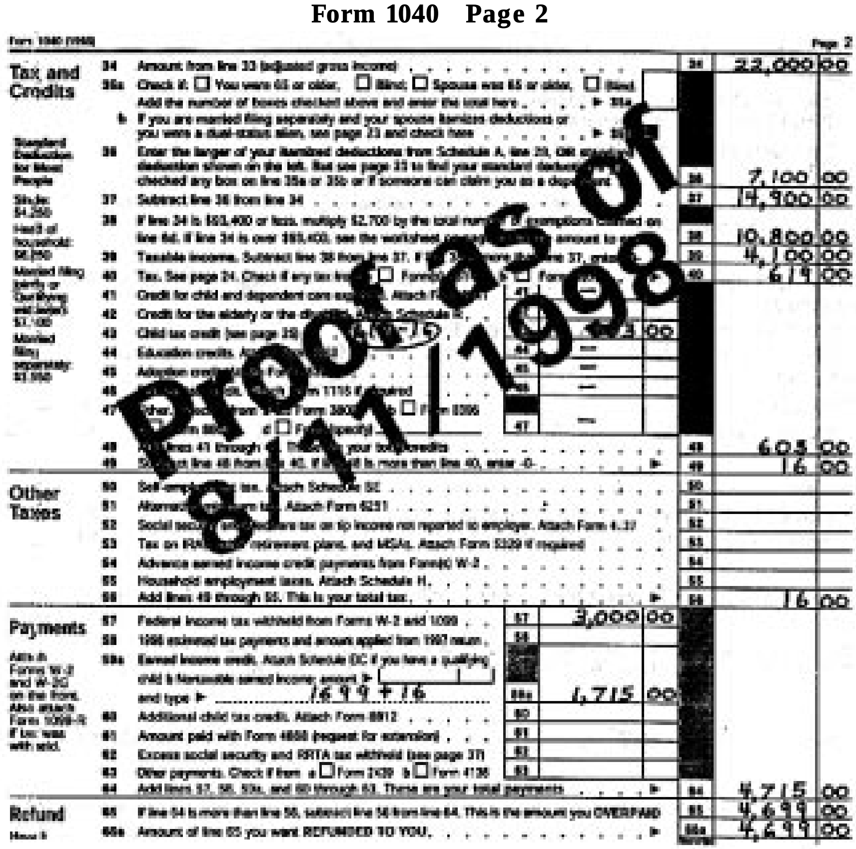
Practitioner Note. The Committee Reports make it clear that the Supplemental Credit will not increase the amount of the total Child Tax Credit for the year. In effect, the use of the **Supplemental Credit** increases the "refundable" element of the **Child Tax Credit** while reducing the "nonrefundable" element.

The difficult part of this problem is that the forms, **at the time of this writing,** do not correspond with the solution as provided by the Committee Reports.



Form 1040 Page 2



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White

Child Tax Credit Worksheet—Line 43

Do Not File

► Keep for your records.

1. $400.00 × 2 . Multiply and enter the result . . . . 1. 800|00
   Enter number of qualifying children
2. Are you filing Form 2555, 2555-EZ, or 4563, or are you excluding income from Puerto Rico?
   ☒ No. Enter the amount from Form 1040, line 34.
   ☐ Yes. Enter your modified AGI (see page 25). . . . . . . 2. 22,000|00
3. Enter: $110,000 if married filing jointly; $75,000 if single, head of household, or qualifying widow(er); $55,000 if married filing separately 3. 110,000|00
4. Is line 2 above more than line 3?
   ☒ No. Skip lines 4 and 5, enter -0- on line 6, and go to line 7.
   ☐ Yes. Subtract line 3 from line 2 . . . . 4.
5. Divide line 4 by $1,000. If the result is not a whole number, round it up to the next higher whole number (for example, round 0.01 to 1) . . . 5.
6. Multiply $50 by the number on line 5 . . . . 6. -0-
7. Subtract line 6 from line 1. If zero or less, stop here; you cannot take this credit . . . . 7. 800|00
8. Enter the amount from Form 1040, line 40 . . . . 8. 619|00
9. Is line 1 above more than $800?
   ☒ No. Add the amounts from Form 1040, lines 41, 42, and 44. Enter the total.
   ☐ Yes. Enter the amount from the worksheet on page 33. 9. 0
10. Subtract line 9 above from line 8 . . . . 10. 619|00
11. Enter the smaller of line 7 or line 10 . . . . ► 11. 619|00
12. Are you reporting tax-exempt interest on Form 1040, line 8b, or are you claiming a net operating loss deduction on Form 1040, line 21?
    ☒ No. Enter the amount from Form 1040, line 22.
    ☐ Yes. Enter the total of the amount from Form 1040, line 22, plus any tax-exempt interest from private activity bonds issued after August 7, 1986, and net operating loss deduction. . . 12. 22,000|00 [total income]
13. Are you filing Schedule C, C-EZ, E, F, or D (except to report only capital gain distributions)?
    ☒ No. Go to line 14.
    ☐ Yes. Complete Form 6251 through line 24, enter that amount on line 20 below, check "Yes" on line 20, and go to line 21.
14. Is line 12 above more than: $45,000 if married filing jointly or qualifying widow(er); $33,750 if single or head of household; $22,500 if married filing separately?
    ☒ No. Skip lines 15 through 21 and go to line 22.
    ☐ Yes. Go to line 15.
15. Is line 12 more than: $150,000 if married filing jointly or qualifying widow(er); $112,000 if single or head of household; $75,000 if married filing separately?
    ☐ No. Go to line 16.
    ☐ Yes. Complete Form 6251 through line 24, enter that amount on line 20 below, check "Yes" on line 20, and go to line 21.
16. Enter: $45,000 if married filing jointly or qualifying widow(er); $33,750 if single or head of household; $22,500 if married filing separately . . . 16.
17. Subtract line 16 from line 12 . . . . 17.
18. Multiply line 17 by 26% (.26) . . . . 18.
19. Subtract line 18 from line 10. If zero or less, enter -0- . . . . 19.
20. Is line 11 more than line 19?
    ☐ No. Skip lines 20 and 21 and go to line 22.
    ☐ Yes. Complete Form 6251 through line 24 and enter that amount here . . . . 20.
21. Subtract line 20 from line 10. If zero or less, enter -0- . . . . 21.
22. **Child tax credit.**
    - If you checked "No" on line 14 or line 20, enter the amount from line 11 here and on Form 1040, line 43.
    - If you checked "Yes" on line 20, enter the smaller of line 11 or line 21 here and on Form 1040, line 43. If line 21 is the smaller amount, enter "AMT" on the dotted line next to line 43. 22. 619|00

TIP *If line 1 above is more than $800, you may be able to take the Additional Child Tax Credit. See page 31.*

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Note: Does not have to be filed–no AMT.

Form **6251** — Department of the Treasury, Internal Revenue Service

Alternative Minimum Tax—Individuals

▶ See separate instructions.

▶ Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0227 — **1998** — Attachment Sequence No. 32

Name(s) shown on Form 1040: Chris & JoAnne White — Your social security number: 000:00:0000

Part I Adjustments and Preferences

1	If you itemized deductions on Schedule A (Form 1040), go to line 2. Otherwise, enter your standard deduction from Form 1040, line 36, here and go to line 6	1	7,100 00
15	Total Adjustments and Preferences. Combine lines 1 through 14 ▶	15	7,100 00

Part II Alternative Minimum Taxable Income

16	Enter the amount from Form 1040, line 37. If less than zero, enter as a (loss) ▶	16	14,900 00
17	Net operating loss deduction, if any, from Form 1040, line 21. Enter as a positive amount	17	
18	If Form 1040, line 34, is over $124,500 (over $62,250 if married filing separately), and you itemized deductions, enter the amount, if any, from line 9 of the worksheet for Schedule A (Form 1040), line 28	18	( )
19	Combine lines 15 through 18 ▶	19	22,000 00
20	Alternative tax net operating loss deduction. See page 5 of the instructions	20	
21	**Alternative Minimum Taxable Income.** Subtract line 20 from line 19. (If married filing separately and line 21 is more than $165,000, see page 5 of the instructions.) ▶	21	22,000 00

Part III Exemption Amount and Alternative Minimum Tax

22 **Exemption Amount.** (If this form is for a child under age 14, see page 6 of the instructions.)

IF your filing status is . . .	AND line 21 is not over . . .	THEN enter on line 22 . . .
Single or head of household	$112,500	$33,750
Married filing jointly or qualifying widow(er)	150,000	45,000
Married filing separately	75,000	22,500

If line 21 is over the amount shown above for your filing status, see page 6 of the instructions. — **22** 45,000 00

23	Subtract line 22 from line 21. If zero or less, enter -0- here and on lines 26 and 28 ▶	23	-0-
24	If you completed Schedule D (Form 1040), and had an amount on line 25 or line 27 (as refigured for the AMT, if necessary), go to Part IV of Form 6251 to figure line 24. All others: If line 23 is $175,000 or less ($87,500 or less if married filing separately), multiply line 23 by 26% (.26). Otherwise, multiply line 23 by 28% (.28) and subtract $3,500 ($1,750 if married filing separately) from the result ▶	24	-0-
25	Alternative minimum tax foreign tax credit. See page 7 of the instructions	25	-0-
26	Tentative minimum tax. Subtract line 25 from line 24 ▶	26	-0-
27	Enter your tax from Form 1040, line 40 (minus any tax from Form 4972 and any foreign tax credit from Form 1040, line 46)	27	619 00
28	**Alternative Minimum Tax.** Subtract line 27 from line 26. If zero or less, enter -0-. Enter here and on Form 1040, line 51 ▶	28	-0-

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)]

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

Old Law. An employee of the U.S. Postal Service could 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 were paid an equipment maintenance allowance (EMA) to compensate them for the use of their personal automobiles in delivering the mail.

Act. 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.**

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Practitioner Note. This will eliminate Form 2106 for many rural letter carriers. Clients should be alerted to maintain adequate records to substantiate **all** expenses if **excess** expenses are incurred.

42. INCREASE IN STANDARD MILEAGE RATE FOR PURPOSES OF COMPUTING CHARITABLE DEDUCTION

Law. In general, individuals who itemize their deductions may deduct charitable contributions. [I.R.C. §170(i)]

Act. For purposes of computing the charitable deduction for the use of a passenger automobile, the Act increases this mileage rate to **14 cents per mile**, 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]

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

Explanation of Act

Standard Deduction of Dependents The Act **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) $650 (indexed for inflation as under old law), or (b) the individual's earned income plus $250. The $250 amount is indexed for inflation after 1998.

Note. The real effect of this is that dependent children will be able to earn slightly more dividends/capital gains without being taxed.

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.

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:

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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)].[1] These rules apply to houses, apartments, condominiums, mobile homes, boats, and other similar property used as the taxpayer's home [§280A(f)(1)].

Important Note: 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).

Note: 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.[2] 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.

Note: 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 Law 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

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.
2. 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.

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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 Act. 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.**

Practitioner Note: The real beneficiary of this law change is the small contractor working out of his home (no other office). However, for self-employed persons with a regular office outside of their home, the new law offers little.

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.

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45. INCREASED DEDUCTIBILITY OF BUSINESS MEAL EXPENSES FOR INDIVIDUALS SUBJECT TO FEDERAL HOURS OF SERVICE

[I.R.C. §274(n)(3)]

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

Explanation of Act. **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.** However, the change is effective over a period of years as seen below.

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

These percentages are applied to both the standard meal allowances **or** the actual meal expenses claimed.

46. CLARIFICATION OF DE MINIMIS FRINGE BENEFIT RULES TO NO-CHARGE EMPLOYEE MEALS

[I.R.C. §132]

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

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.

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 old law.]

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

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The **"1998 Tax Bill"** adopted a numerical test in order for the meals provided to be for the "convenience of the employer." **If more than ½ of all employees** are furnished meals for the convenience of the employer, then all meals furnished to all employees on the business premises are treated as furnished for the convenience of the employer.

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Example: A hospital maintains a cafeteria on its premises where all of its 230 employees can get a free meal during their working hours. The hospital does this to have each of 120 employees on emergency call, and all of these 120 employees are at times called upon to perform services during their meal periods, but they rarely do. The hospital cafeteria meals are excluded from the income of all of the 230 employees since more than half of all of the employees (120 out of 230, or 52%) are furnished meals there so that they may be available for emergency calls during meal hour.

> **Note:** The employer is able to deduct 100% of the cost of the meals, and the employees are treated as receiving a nontaxable fringe benefit.

INDIVIDUAL RETIREMENT ACCOUNTS

47. TEN-PERCENT ADDITIONAL TAX ON EARLY DISTRIBUTIONS FROM QUALIFIED RETIREMENT PLANS

Using IRA Withdrawals to Pay Higher Education Expenses. Beginning January 1, 1998, a taxpayer may make withdrawals from an individual retirement account (IRA) to pay the qualified higher education expenses for the taxpayer, the taxpayer's spouse, or the child or grandchild of the taxpayer or taxpayer's spouse at an eligible educational institution. The taxpayer will owe federal income tax on the amount withdrawn, **but will not be subject to the 10% early withdrawal tax** that applies when amounts are withdrawn from an individual retirement account before the account holder reaches age 59½.

Q1. *When can an individual first make a withdrawal from an IRA to pay for qualified higher education expenses without paying the 10% early withdrawal tax?*

A1. On or after January 1, 1998, an individual can make withdrawals from his/her IRA to pay for qualified higher education expenses for academic periods beginning on or after January 1, 1998, without paying the 10% early withdrawal tax. See **Notice** 97-53. The 10% early withdrawal tax does not apply to a distribution from an IRA to the extent that the amount of the distribution does not exceed the qualified higher education expenses. Qualified higher education expenses **also include room and board if the student is enrolled at least half time.** Qualified higher education expenses paid with an individual's earnings, a loan, a gift, an inheritance given to the student or the individual making the withdrawal, or personal savings (including savings from a qualified state tuition program) are **included** in determining the amount of the IRA withdrawal which is not subject to the 10% early withdrawal tax. Qualified higher education expenses paid with a Pell Grant or other tax-free scholarship, a tax-free distribution from an Education IRA, or tax-free employer-provided educational assistance are **excluded.**

Q2. *What are the requirements for an "eligible educational institution?"*

A2. An "eligible educational institution" is any college, university, vocational school, or other postsecondary educational institution that is described in section 481 of the Higher Education Act of 1965.

Q3. *In addition to the Education IRA, TRA '97 also created the Roth IRA. May a taxpayer make a withdrawal from a Roth IRA to pay for his/her child's qualified higher education expenses without paying the 10% early withdrawal tax?*

A3. Yes. A taxpayer may make a withdrawal from a Roth IRA, as they can from other IRAs, to pay qualified education expenses without paying the 10% early withdrawal tax.

48. 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.

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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.** See page 709 for the rules.

Note: A distribution used to pay higher education expenses is not a qualified distribution from a Roth IRA, but it is taxable not subject to the 10% early withdrawal penalty.

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. **"The 1998 Act" allows 1998 rollovers to be fully taxed in 1998. [Taxpayer election]**
6. Only taxpayers with an AGI of less than $100,000 are eligible to roll over or convert an IRA into a Roth IRA. **"The 1998 Act" provided that minimum distributions required for regular IRAs are not included in the $100,000 limit.** [**NOR is the taxable amount on a rollover to a Roth.**]
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 a high AGI phaseout for deductible 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. Most 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 rollovers if made in 1998). **Note the new election to forgo the four-year spread.**
   - **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. Most likely, Ace will elect to report all $560 in 1998.

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%, and 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.

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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. [**Software using certain assumptions will aid the decision**]

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.

Practitioner Note: Caution is urged in any discussion of planning with a client concerning IRA conversions to Roth IRAs. Since a variety of software applications are available in the market, we suggest a careful analysis of the client's financial situation before providing advice on this matter.

FACTORS THAT FAVOR CONVERSION	FACTORS THAT INDICATE AGAINST CONVERSION
1. tax bracket higher at distribution	1. tax bracket lower at distribution
2. conversion would occur in 1998	2. conversion would occur after 1998
3. taxes will be paid from sources outside IRA	3. taxes will be paid with IRA funds
4. no penalties would be generated at conversion	4. penalties would be generated at conversion
5. long time period to withdrawal	5. short time period to withdrawal (particularly if the withdrawals will be within five years

The following examples illustrate the results of the combination of different assumptions in determining whether or not to convert a regular IRA into a Roth IRA during 1998. **All of the examples assume that the tax on conversion will be paid over a four year period rather than being paid in one year. The assumption that changes from one example to the next is the marginal tax bracket at the time of withdrawal.**

Note. Funds withdrawn from a regular IRA and used to pay the taxes on conversion will be subject to an early withdrawal penalty of 10% unless the taxpayer is at least age 59½. The examples illustrate the results **with and without this penalty.**

The taxpayer should consider conversion if the **future value** of the Roth IRA exceeds the **future value** of the Regular IRA.

Comment 1. In many cases there is no significant difference between the future value of the Regular IRA and the Roth IRA. The circumstances most favorable for the conversion into a Roth IRA are a higher tax bracket at withdrawal and the payment of taxes on conversion from funds outside the Regular IRA. It is difficult to imagine a set of circumstances that would favor conversion from a Regular IRA to a Roth IRA if the conversion causes both tax and penalty which are both paid from IRA funds.

Comment 2. There are numerous free websites that allow individuals to compare the results of conversion. Many of the major financial sites allow such a calculation. [e.g., www.vanguard.com & www.fidelity.com]

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Example 1-1 –$100,000 converted

Assumptions	
Amount converted [all taxable]	$100,000
Return on investment	9.00%
Current marginal tax bracket	31.00%
Marginal tax bracket at time of withdrawal	31.00%

Future Value of Account [after taxes]

	Years to withdrawal 5	10	15	20	25	30
If no conversion occurs:						
Future value of Regular IRA	$106,165	$163,348	$251,331	$386,704	$594,993	$915,470
If entire balance converted and:						
-Tax paid with funds from IRA [assumes no penalty due]						
Future value of Roth IRA	$108,550	$167,018	$256,977	$395,391	$608,358	$936,035
-Tax paid with funds outside the IRA						
Future value of Roth IRA	$153,862	$236,736	$364,248	$560,441	$862,308	$1,326,768
Less future value of funds used to pay tax currently	($41,898)	($56,626)	($76,532)	($103,436)	($139,797)	($188,940)
	$111,965	$180,110	$287,716	$457,006	$722,511	$1,137,828
-Tax paid with funds from IRA [assumes 10% penalty also due]						
Future value of Roth IRA	$90,779	$139,674	$214,906	$330,660	$508,762	$782,793

Example 1-2

Assumptions	
Amount converted [all taxable]	$100,000
Return on investment	9.00%
Current marginal tax bracket	31.00%
Marginal tax bracket at time of withdrawal	15.00%

Future Value of Account [after taxes]

	Years to withdrawal 5	10	15	20	25	30
If no conversion occurs:						
Future value of Regular IRA	$130,783	$201,226	$309,611	$476,375	$732,962	$1,127,753
If entire balance converted and:						
-Tax paid with funds from IRA [assumes no penalty due]						
Future value of Roth IRA	$108,550	$167,018	$256,977	$395,391	$608,358	$936,035
-Tax paid with funds outside the IRA						
Future value of Roth IRA	$153,862	$236,736	$364,248	$560,441	$862,308	$1,326,768
Less future value of funds used to pay tax currently	($41,898)	($56,626)	($76,532)	($103,436)	($139,797)	($188,940)
	$111,965	$180,110	$287,716	$457,006	$722,511	$1,137,828
-Tax paid with funds from IRA [assumes 10% penalty also due]						
Future value of Roth IRA	$90,779	$139,674	$214,906	$330,660	$508,762	$782,793

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Example 1-3

Assumptions	
Amount converted [all taxable]	$100,000
Return on investment	9.00%
Current marginal tax bracket	31.00%
Marginal tax bracket at time of withdrawal	36.00%

Future Value of Account [after taxes]

	Years to withdrawal 5	10	15	20	25	30
If no conversion occurs:						
Future value of Regular IRA	$98,472	$151,511	$233,119	$358,682	$551,877	$849,131
If entire balance converted and:						
-Tax paid with funds from IRA [assumes no penalty due]						
Future value of Roth IRA	$108,550	$167,018	$256,977	$395,391	$608,358	$936,035
-Tax paid with funds outside the IRA						
Future value of Roth IRA	$153,862	$236,736	$364,248	$560,441	$862,308	$1,326,768
Less future value of funds used to pay tax currently	($41,898)	($56,626)	($76,532)	($103,436)	($139,797)	($188,940)
	$111,965	$180,110	$287,716	$457,006	$722,511	$1,137,828
-Tax paid with funds from IRA [assumes 10% penalty also due]						
Future value of Roth IRA	$90,779	$139,674	$214,906	$330,660	$508,762	$782,793

Example 1-1 -$20,000 converted

Assumptions	
Amount converted [all taxable]	$20,000
Return on investment	9.00%
Current marginal tax bracket	28.00%
Marginal tax bracket at time of withdrawal	15.00%

Future Value of Account [after taxes]

	Years to withdrawal 5	10	15	20	25	30
If no conversion occurs:						
Future value of Regular IRA	$26,157	$40,245	$61,922	$95,275	$146,592	$225,551
If entire balance converted and:						
-Tax paid with funds from IRA [assumes no penalty due]						
Future value of Roth IRA	$22,587	$34,753	$53,472	$82,273	$126,587	$194,770
-Tax paid with funds outside the IRA						
Future value of Roth IRA	$30,772	$47,347	$72,850	$112,088	$172,462	$265,354
Less future value of funds used to pay tax currently	($7,665)	($10,492)	($14,362)	($19,658)	($26,908)	($36,832)
	$23,107	$36,855	$58,488	$92,430	$145,553	$228,521
-Tax paid with funds from IRA [assumes 10% penalty also due]						
Future value of Roth IRA	$19,079	$29,355	$45,167	$69,495	$106,926	$164,519

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Example 1-2

Assumptions	
Amount converted [all taxable]	$20,000
Return on investment	9.00%
Current marginal tax bracket	28.00%
Marginal tax bracket at time of withdrawal	28.00%

Future Value of Account [after taxes]

	Years to withdrawal 5	10	15	20	25	30
If no conversion occurs:						
Future value of Regular IRA	$22,156	$34,090	$52,452	$80,704	$124,172	$191,055
If entire balance converted and:						
-Tax paid with funds from IRA [assumes no penalty due]						
Future value of Roth IRA	$22,587	$34,753	$53,472	$82,273	$126,587	$194,770
-Tax paid with funds outside the IRA						
Future value of Roth IRA	$30,772	$47,347	$72,850	$112,088	$172,462	$265,354
Less future value of funds used to pay tax currently	($7,665)	($10,492)	($14,362)	($19,658)	($26,908)	($36,832)
	$23,107	$36,855	$58,488	$92,430	$145,553	$228,521
-Tax paid with funds from IRA [assumes 10% penalty also due]						
Future value of Roth IRA	$19,079	$29,355	$45,167	$69,495	$106,926	$164,519

Example 1-3

Assumptions	
Amount converted [all taxable]	$20,000
Return on investment	9.00%
Current marginal tax bracket	28.00%
Marginal tax bracket at time of withdrawal	36.00%

Future Value of Account [after taxes]

	Years to withdrawal 5	10	15	20	25	30
If no conversion occurs:						
Future value of Regular IRA	$19,694	$30,302	$46,624	$71,736	$110,375	$169,826
If entire balance converted and:						
-Tax paid with funds from IRA [assumes no penalty due]						
Future value of Roth IRA	$22,587	$34,753	$53,472	$82,273	$126,587	$194,770
-Tax paid with funds outside the IRA						
Future value of Roth IRA	$30,772	$47,347	$72,850	$112,088	$172,462	$265,354
Less future value of funds used to pay tax currently	($7,665)	($10,492)	($14,362)	($19,658)	($26,908)	($36,832)
	$23,107	$36,855	$58,488	$92,430	$145,553	$228,521
-Tax paid with funds from IRA [assumes 10% penalty also due]						
Future value of Roth IRA	$19,079	$29,355	$45,167	$69,495	$106,926	$164,519

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The Proposed Regulations, dated 09/03/98, provide the following questions and answers to many of the issues that have been raised about Roth IRAs. These regulations incorporate the **1998 Act Technical Corrections.**

§1.4O8A-1. Roth IRAs in general, REG-115393-98, 9/3/98

Q-1. *What is a Roth IRA?*

A-1. (a) A Roth IRA is a new type of individual retirement plan that individuals can use, beginning in 1998. Key Point ☞ (b) Roth IRAs are treated like traditional IRAs except where the Internal Revenue Code specifies different treatment. For example, aggregate contributions (other than by a conversion or other rollover) to all an individual's Roth IRAs are not permitted to exceed $2,000 for a taxable year. **Further, income earned on funds held in a Roth IRA is generally not taxable.** Similarly, the rules of §408(e), such as the loss of exemption of the account where the owner engages in a prohibited transaction, apply to Roth IRAs in the same manner as to traditional IRAs.

Q-2. *What are the significant differences between traditional IRAs and Roth IRAs?*

Key Point ☞ **A-2.** There are several significant differences between traditional IRAs and Roth IRAs under the Internal Revenue Code. For example, eligibility to contribute to a Roth IRA is subject to special modified AGI (adjusted gross income) limits; **contributions to a Roth IRA are never deductible;** qualified distributions from a Roth IRA **are not includible in gross income;** the required minimum distribution rules under §408(a)(6) and (b)(3) (which generally incorporate the provisions of §410(a)(9)) **do not apply** to a Roth IRA during the lifetime of the owner; and **contributions to a Roth IRA can be made after the owner has attained age 70½.** [Reg. §l.408A-1.]

§ 1.408A-2. Establishing a Roth IRA, REG-115393-98, 9/3/98.

Q-1. *Who can establish a Roth IRA?*

A-1. Except as provided in A-3 of this section, only an **individual** can establish a Roth IRA. In addition, in order to be eligible to contribute to a Roth IRA for a particular year, an individual must satisfy certain compensation requirements and adjusted gross income limits (see § 1.408A-3 A-3).

Q-2. *How is a Roth IRA established?*

A-2. A Roth IRA can be established with any bank, insurance company, or other person authorized in accordance with §1.408-2(e) to serve as a trustee with respect to IRAs. The document establishing the Roth IRA must clearly designate the IRA as a Roth IRA, and this designation cannot be changed at a later date. Thus, an IRA that is designated as a Roth IRA **cannot later be treated as a traditional IRA.** However, see § 1.408A-5 for rules for recharacterizing certain IRA contributions.

Q-3. *Can an employer or an association of employees establish a Roth IRA to hold contributions of employees or members?*

A-3. **Yes.** Pursuant to §408(c), an employer or an association of employees can establish a trust to hold contributions of employees or members made under a Roth IRA. Each employee's or member's account in the trust is treated as a separate Roth IRA that is subject to the generally applicable Roth IRA rules.

Key Point ☞ **Q-4.** *What is the effect of a surviving spouse of a Roth IRA owner treating an IRA as his or her own?*

A-4. If the surviving spouse of a Roth IRA owner treats a Roth IRA as his or her own as of a date, from that date forward, the Roth IRA is treated as though it were **established for the benefit of the surviving spouse and not the original Roth IRA owner.** Thus, **for example,** the surviving spouse is treated as the Roth IRA owner for purposes of applying the minimum distribution requirements under §408(a)(6) and (b)(3). Similarly, the surviving spouse is treated as the Roth IRA owner rather than a beneficiary for purposes of determining the amount of any distribution from the Roth IRA that is includible in gross income and whether the distribution is subject to the 10% additional tax under §72(t). [Reg. §1.408A-2.]

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§1.408A-3. Contributions to Roth IRAs, REG-115393-98, 9/3/98.

Q-1. *What types of contributions are permitted to be made to a Roth IRA?*

Key Point ☞ **A-1.** There are two types of contributions that are permitted to be made to a Roth IRA: **regular contributions** and **qualified rollover contributions** (including conversion contributions). The term regular contributions means contributions **other than** qualified rollover contributions.

Q-2. *When are contributions permitted to be made to a Roth IRA?*

Key Point ☞ **A-2.** **(a)** The provisions of §408A are effective for taxable years beginning on or after January 1, 1998. Thus, the first taxable year for which contributions are permitted to be made to a Roth IRA by an individual is the individual's taxable year beginning in 1998.

(b) Regular contributions for a particular taxable year must generally be contributed **by the due date (not including extensions)** for filing a Federal income tax return for that taxable year. (See § 1.408A-5 regarding recharacterization of certain contributions.)

Q-3. *What is the maximum aggregate amount of regular contributions an individual is eligible to contribute to a Roth IRA for a taxable year?*

A-3. **(a)**The maximum aggregate amount that an individual is eligible to contribute to all his or her Roth IRAs as a regular contribution for a taxable year **is the same as the maximum for traditional IRAs:** $2,000 or, if less, that individual's compensation for the year.

Key Point ☞ **(b)** For Roth IRAs, the **maximum amount** described in paragraph (a) of this A-3 is **phased out between certain levels of modified AGI.** For an individual who is not married, the dollar amount is phased out ratably between modified AGI of $95,000 and $110,000; for a married individual filing a joint return, between modified AGI of $150,000 and $160,000; and for a married individual filing separately, between modified AGI of $0 and $10,000. **For this purpose, a married individual who has lived apart from his or her spouse for the entire taxable year and who files separately is treated as not married.** Under §408A(c)(3)(A), in applying the phase-out, the maximum amount is rounded up to the next higher multiple of $10 and is not reduced below $200 until completely phased out.

(c) If an individual makes regular contributions to both traditional IRAs and Roth IRAs for a taxable year, the maximum limit for the Roth IRA is the lesser of–

(1) The amount described in paragraph (a) of this A-3 **reduced by the amount contributed to traditional IRAs for the taxable year;** and

Key Point ☞ **(2)** The amount described in paragraph (b) of this A-3. Employer contributions, including elective deferrals, made under a SEP or SIMPLE IRA Plan on behalf of an individual (including a self-employed individual) **do not reduce the amount of the individual's maximum regular contribution.**

(d) The rules in this A-3 are illustrated by the following examples:

Example 1. In 1998, unmarried, calendar-year taxpayer B, age 60, has modified AGI of $40,000 and compensation of $5,000. For 1998, B can contribute a maximum of $2,000 to a traditional IRA, a Roth IRA, or a combination of traditional and Roth IRAs.

Key Point ☞ Example 2. The facts are the same as in **Example 1.** However, assume that B violates the maximum regular contribution limit by contributing $2,000 to a traditional IRA and $2,000 to a Roth IRA for 1998. **The $2,000 to B's Roth IRA would be an excess contribution to B's Roth IRA for 1998 because an individual's contributions are applied first to a traditional IRA, then to a Roth IRA.**

Example 3. The facts are the same as in **Example 1,** except that B's compensation is $900. The maximum amount B can contribute to either a traditional IRA or a Roth (or a combination of the two) for 1998 is $900.

Example 4. In 1998, unmarried, calendar-year taxpayer C, age 60, has modified AGI of $100,000 and compensation of $5,000. For 1998, C contributes $800 to a traditional IRA and $1,200 to a Roth IRA. Because C's $1,200 Roth IRA contribution does not exceed the phased-out maximum Roth IRA contribution of $1,340 and because C's total IRA contributions do not exceed $2,000, **C's Roth IRA contribution does not exceed the maximum permissible contribution.**

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Q-4. *How is compensation defined for purposes of the Roth IRA contribution limit?*

A-4. For purposes of the contribution limit described in A-3 of this section, an individual's compensation **is the same as that used to determine the maximum contribution an individual can make to a traditional IRA.** This amount is defined in §219(f)(1) to include wages, commissions, professional fees, tips, and other amounts received for personal services, as well as taxable alimony and separate maintenance payments received under a decree of divorce or separate maintenance. Compensation also includes earned income as defined in §401(c)(2), but does not include any amount received as a pension or annuity or as **deferred compensation.** In addition, under §219(c), a married individual filing a joint return is permitted to make an IRA contribution by treating his or her spouse's higher compensation as his or her own, but only to the extent that the spouse's compensation is not being used for purposes of the spouse making a contribution to a Roth IRA or a deductible contribution to a traditional IRA.

Q-5. *What is the significance of modified AGI and how is it determined?*

Key Point ☞ **A-5.** Modified AGI is used for purposes of the phase-out rules described in A-3 of this section and for purposes of the $100,000 modified AGI limitation described in §1.408A-4 A-2(a) (relating to eligibility for conversion). As defined in §408A(c)(3)(C)(i), modified AGI is the same as adjusted gross income under §219(g)(3)(A) (used to determine the amount of deductible contributions that can be made to a traditional IRA by an individual who is an active participant in an employer-sponsored retirement plan), **except that any conversion is disregarded in determining modified AGI.** For example, the deduction for contributions to an IRA is not taken into account for purposes of determining adjusted gross income under §219 and thus **does not apply** in determining modified AGI for Roth IRA purposes.

Key Point ☞ **Q-6.** *Is a required minimum distribution from an IRA for a year included in income for purposes of determining modified AGI?*

A-6. **(a)Yes.** For taxable years beginning before January 1, 2005, any required minimum distribution from an IRA under §408(a)(6) and (b)(3) (which generally incorporate the provisions of §401(a)(9)) is included in income for purposes of determining modified AGI.

(b) For taxable years beginning **after December 31, 2004,** and solely for purposes of the $100,000 limitation applicable to conversions, modified AGI **does not include** any required minimum distributions from an IRA under §408(a)(6) and (b)(3).

Q-7. *Does an excise tax apply if an individual exceeds the aggregate regular contribution limits for Roth IRAs?*

A-7. **Yes.** §4973 imposes an annual 6-percent excise tax on aggregate amounts contributed to Roth IRAs that exceed the maximum contribution limits described in A-3 of this section. Any contribution that is distributed, together with net income, from a Roth IRA on or before the tax return due date (plus extensions) for the taxable year of the contribution **is treated as not contributed.** Net income described in the previous sentence is includible in gross income for the taxable year in which the contribution is made. §4973 applies separately to an individual's Roth IRAs and other IRAs. [Reg. §1.408A-3.]

§1.408A-4. Converting amounts to Roth IRAs, REG-115393-98, 9/3/98.

Q-1. *Can an individual convert an amount in his or her traditional IRA to a Roth IRA?*

Key Point ☞ **A-1.** **(a)Yes**. An amount in a traditional IRA may be converted to an amount in a Roth IRA if two requirements are satisfied. **First,** the IRA owner must satisfy the modified AGI limitation described in A-2(a) of this section and, if married, the joint filing requirement described in A-2(b) of this section. **Second, the amount contributed to the Roth IRA must satisfy the definition of a qualified rollover contribution in §408A(e) (i.e., it must satisfy the requirements for a rollover contribution as defined in §08(d)(3), except that the one-rollover-per-year limitation in §408(d)(3)(B) does not apply).**

(b) **An amount can be converted by any** of **three methods–**

(1) An amount distributed from a traditional IRA is contributed (rolled over) to a Roth IRA within 60 days after the distribution;

(2) An amount in a traditional IRA is transferred in a trustee-to-trustee transfer from the trustee of the traditional IRA to the trustee of the Roth IRA; or

(3) An amount in a traditional IRA is transferred to a Roth IRA maintained by the same trustee.

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(c) Any converted amount is treated as a distribution from the traditional IRA and a qualified rollover contribution to the Roth IRA for purposes of §408 and §408A, even if the conversion is accomplished by means of a trustee-to-trustee transfer or a transfer between IRAs of the same trustee.

Q-2. *What are the modified AGI limitation and joint filing requirements for conversions?*

Key Point ☞ **A-2.** **(a)** An individual with modified AGI **in excess of $100,000** for a taxable year **is not** permitted to convert an amount to a Roth IRA during that taxable year. This $100,000 limitation applies to the taxable year that the funds are paid from the traditional IRA, rather than the year they are contributed to the Roth IRA.

(b) If the individual is married, he or she is permitted to **convert** an amount to a Roth IRA during a taxable year only if the individual and the individual's spouse **file a joint return, for the taxable year** that the funds are paid from the traditional IRA. In this case, the modified AGI subject to the $100,000 limit is the modified AGI derived from the joint return using the couple's combined income. **The only exception** to this joint filing requirement is for an individual who has lived apart from his or her spouse for the entire taxable year. If the married individual has lived apart from his or her spouse for the entire taxable year, then such individual can treat himself or herself as not married for purposes of this paragraph, file a separate return and be subject to the $100,000 limit on his or her separate modified AGI. **In all other cases, a married individual filing a separate return is not permitted to convert an amount to a Roth IRA, regardless of the individual's modified AGI.**

Key Point ☞ **Q-3.** *Is a remedy available to an individual who, intending to make a conversion, contributes amounts from a traditional IRA to a Roth IRA, but who is ineligible to make a conversion (a failed conversion)?*

A-3. **(a)** **Yes.** See §1.408A-5 for rules permitting a failed conversion amount to be recharacterized as a contribution to a traditional IRA. If the requirements in §1.408A-5 are satisfied, the failed conversion amount will be treated as having been contributed to the traditional IRA and not to the Roth IRA.

(b) If the contribution is not recharacterized in accordance with §1.408A-5, the contribution will be treated as a regular contribution to the Roth IRA and, thus, an excess contribution subject to the excise tax under §4973 to the extent that it exceeds the individual's regular contribution limit. Additionally, the distribution from the traditional IRA will not be eligible for the 4-year spread and will be subject to the additional tax under §72(t) (unless an exception under that section applies).

Q-4. *Do any special rules apply to a conversion of an amount in an individual's SEP IRA or SIMPLE IRA to a Roth IRA?*

A-4. **(a)** An amount in an individual's **SEP IRA** can be converted to a Roth IRA on the same terms as an amount in any other traditional IRA.

(b) An amount in an individual's **SIMPLE IRA** can be converted to a Roth IRA on the same terms as a conversion from a traditional IRA, except that an amount distributed from a SIMPLE IRA during the 2-year period described in §72(t)(6), which begins on the date that the individual first participated in any SIMPLE IRA Plan maintained by the individual's employer, **cannot be converted to a Roth IRA.** Pursuant to §408(d)(3)(G), a distribution of an amount from an individual's SIMPLE IRA during this 2-year period is not eligible to be rolled over into an IRA that is not a SIMPLE IRA and thus cannot be a qualified rollover contribution. This 2-year period of §408(d)(3)(G) applies separately to the contributions of each of an individual's employers maintaining a SIMPLE IRA Plan.

(c) **Once an amount in a SEP IRA or SIMPLE IRA has been converted to a Roth IRA, it is treated as a contribution to a Roth IRA for all purposes. Future contributions under the SEP or under the SIMPLE IRA Plan may not be made to the Roth IRA.**

Q-5. *Can amounts in other kinds of retirement plans be converted to a Roth IRA?*

Key Point ☞ **A-5.** **No.** Only amounts in another IRA can be converted to a Roth IRA. For example, amounts in a qualified plan or annuity plan described in §§401(a) or 403(a) **cannot be converted directly to a Roth IRA.** Also, amounts held in an annuity contract or account described in §403(b) **cannot be converted directly to a Roth IRA.**

Q-6. *Can an individual who has attained at least age 70½ by the end of a calendar year convert an amount distributed from a traditional IRA during that year to a Roth IRA before receiving his or her required minimum distribution with respect to the traditional IRA for the year of the conversion?*

Key Point ☞ **A-6.** **(a)** **No.** In order to be eligible for a conversion, an amount first must be eligible to be rolled over. **Section 408(d)(3) prohibits the rollover of a required minimum distribution.** If a minimum

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distribution is required for a year with respect to an IRA, the first dollars distributed during that year are treated as consisting of the required minimum distribution until an amount equal to the required minimum distribution for that year has been distributed.

(b) As provided in A-1(c) of this section, any amount converted is treated as a distribution from a traditional IRA and a rollover contribution to a Roth IRA and not as a trustee-to-trustee transfer for purposes of §408 and §408A. **Thus, in a year for which a minimum distribution is required (including the calendar year in which the individual attains age 70½, an individual may not convert the assets of an IRA (or any portion of those assets) to a Roth IRA to the extent that the required minimum distribution for the traditional IRA for the year has not been distributed.**

(c) If a required minimum distribution is contributed to a Roth IRA, it is treated as having been distributed, subject to the normal rules under §408(d)(1) and (2), and then contributed as a regular contribution to a Roth IRA. The amount of the required minimum distribution is not a conversion contribution.

Key Point ☞ **Q-7.** *What are the tax consequences when an amount is converted to a Roth IRA?*

A-7. **(a)**Any amount that is converted to a Roth IRA is includible *i***n gross income** as a distribution according to the rules of §408(d)(1) and (2) for the taxable year in which the amount is distributed or transferred from the traditional IRA. Thus, any portion of the distribution or transfer that is treated as a return of basis under §408(d)(1) and (2) is not includible in gross income as a result of the conversion.

(b) The 10-percent additional tax under §72(t) generally **does not apply** to the taxable conversion amount. But see § 1.408A-6 A-5 for circumstances under which the taxable conversion amount would be subject to the additional tax under §72(t).

(c) Pursuant to §408A(e), a conversion is not treated as a rollover for purposes of the one-rollover-per-year rule of §408(d)(3)(B).

Key Point ☞ **Q-8.** *Is there an exception to the income-inclusion rule described in A-7 of this section for 1998 conversions?*

A-8. Yes. In the case of a distribution (including a trustee-to-trustee transfer) from a traditional IRA on or before December 31, 1998, that is converted to a Roth IRA, **instead of having the entire taxable conversion amount includible in income in 1998, an individual includes in gross income for 1998 only one quarter of that amount and one quarter of that amount for each of the next 3 years. This 4-year spread also applies if the conversion amount was distributed in 1998 and contributed to the Roth IRA within 60 days, but after December 31, 1998.** However, see § 1.408A-6 A-6 for special rules requiring acceleration of inclusion if an amount subject to the 4-year spread is distributed from the Roth IRA before 2001.

Key Point ☞ **Q-9.** *Is the taxable conversion amount included in income for all purposes?*

A-9. Except as provided below, any taxable conversion amount includible **in gross income** for a year as a result of the conversion (regardless of whether the individual is using a 4-year spread) is included in income for all purposes. Thus, for example, it is counted for purposes of determining the taxable portion of social security payments under §86 and for purposes of determining the phase-out of the $25,000 exemption under §469(i) relating to the disallowance of passive activity losses from rental real estate activities. **However, as provided in §l.408A-3 A-5, the taxable conversion amount (and any resulting change in other elements of adjusted gross income) is disregarded for purposes of determining modified AGI for §408A.**

Key Point ☞ **Q-l0.** *Can an individual who makes a 1998 conversion elect not to have the 4-year spread apply and instead have the full taxable conversion amount includible in gross income for 1998?*

A-10. **Yes.** Instead of having the taxable conversion amount for a 1998 conversion included over 4 years as provided under A-8 of this section, an individual can elect to include the full taxable conversion amount in income for 1998. The election is made on Form 8606 and cannot be made or changed after the due date (including extensions) for filing the 1998 Federal income tax return.

Q-11. *What happens when an individual who is using the 4-year spread dies before the full taxable conversion amount has been included in gross income?*

A-11. **(a)**If an individual who is using the 4-year spread described in A-8 of this section dies before the full taxable conversion amount has been included in gross income, then the remainder must be included in the individual's gross income **for the taxable year that includes the date of death.**

(b) **However,** if the sole beneficiary of all the decedent's Roth IRAs is the decedent's spouse, then the spouse can elect to continue the 4-year spread. Thus, the spouse can elect to include in gross income the

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same amount that the decedent would have included in each of the remaining years of the 4-year period. Where the spouse makes such an election, the amount includible under the 4-year spread for the taxable year that includes the date of the decedent's death remains includible in the decedent's gross income and is reported on the decedent's final Federal income tax return. The election is made on either Form 8606 or Form 1040, in accordance with the instructions to the applicable form, for the taxable year that includes the decedent's date of death and cannot be changed after the due date (including extensions) for filing the Federal income tax return for the spouse's taxable year that includes the decedent's date of death.

Key Point ☞ **Q-12.** *Can an individual convert a traditional IRA to a Roth IRA if he or she is receiving substantially equal periodic payments within the meaning of §72(t)(2)(A)(iv) from that traditional IRA?*

A-12. **Yes.** Not only is the conversion amount itself **not subject** to the early distribution tax under §72(t), but the conversion amount **is also not treated as a distribution** for purposes of determining whether a modification within the meaning of §72(t)(4)(A) has occurred. However, if the original series of substantially equal periodic payments does not continue to be distributed in substantially equal periodic payments from the Roth IRA after the conversion, the series of payments will have been modified and, if this modification occurs within 5 years of the first payment or prior to the individual becoming disabled or attaining age 59½, the taxpayer will be subject to the recapture tax of §72(t)(4)(A).

Key Point ☞ **Q-13.** *Can a 1997 distribution from a traditional IRA be converted to a Roth IRA in 1998?*

A-13. **No.** An amount distributed from a traditional IRA in 1997 that is contributed to a Roth IRA in 1998 would not be a conversion contribution. See A-3 of this section regarding the remedy for a failed conversion. [Reg. §1.408A-4.]

§1.408A-5. Recharacterized contributions, REG-115393-98, 9/3/98

[This section is not included - see the Regs.]

§1.408A-6. Distributions, REG-115393-98, 9/3/98.

Q-1. *How are distributions from Roth IRAs taxed?*

Key Point ☞ **A-1.** **(a)** The taxability of a distribution from a Roth IRA generally depends on whether or not the distribution is a qualified distribution. This A-1 provides rules for qualified distributions and certain other nontaxable distributions. A-4 of this section provides rules for the taxability of distributions that are not qualified distributions.

(b) A distribution from a Roth IRA is not includible in the owner's gross income if it is a qualified distribution or to the extent that it is a return of the owner's contributions to the Roth IRA (determined in accordance with A-8 of this section). **A qualified distribution is one that is both–**

(1) Made after a 5-taxable-year period (defined in A-2 of this section); and

(2) Made on or after the date on which the owner attains age 59½, made to a beneficiary or the estate of the owner on or after the date of the owner's death, attributable to the owner's being disabled within the meaning of §72(m)(7), or to which §72(t)(2)(F) applies (exception for first-time home purchase).

(c) An amount distributed from a Roth IRA **will not** be included in gross income to the extent it is rolled over to another Roth IRA on a tax-free basis under the rules of §§408(d)(3) and 408A(e).

(d) Excess contributions that are returned to the Roth IRA owner in accordance with §408(d)(4) (corrective distributions) **are not includible in gross income,** but any net income required to be distributed under §408(d)(4) together with the excess contribution is includible in gross income for the taxable year in which the excess contribution was made.

Q-2. *When does the 5-taxable-year period described in A-1 of this section (relating to qualified distributions) begin and end?*

Key Point ☞ **A-2.** The 5-taxable-year period described in A-1 of this section begins on the first day of the individual's taxable year for which the first regular contribution is made to any Roth IRA of the individual or, if earlier, the first day of the individual's taxable year in which the first conversion contribution is made to any Roth IRA of the individual. The 5-taxable-year period ends on the last day of the individual's fifth consecutive taxable year beginning with the taxable year described in the preceding sentence. For example, if an individual whose taxable year is the calendar year makes a first-time-regular Roth IRA contribution any time between January 1, 1998, and April 15, 1999, for l998, the 5-taxable-year period begins on January 1, 1998. Thus, each Roth IRA owner has only one 5-taxable-year period

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described in A-1 of this section for all the Roth IRAs of which he or she is the owner. Further, because of the requirement of the 5-taxable-year period, no qualified distributions can occur before taxable years beginning in 2003.

Q-3. *If a distribution is made to an individual who is the sole beneficiary of his or her deceased spouse's Roth IRA and the individual is treating the Roth IRA as his or her own, can the distribution he a qualified distribution based on being made to a beneficiary on or after the owner's death?*

A-3. **No.** If a distribution is made to an individual who is the sole beneficiary of his or her deceased spouse's Roth IRA and the individual is treating the Roth IRA as his or her own, then, in accordance with §1.408A-2 A-4, the distribution is treated as coming from the individual's own Roth IRA and not the deceased spouse's Roth IRA. Therefore, for purposes of determining whether the distribution is a qualified distribution, it is not treated as made to a beneficiary on or after the owner's death.

Key Point ☞ **Q-4.** *How is a distribution from a Roth IRA taxed if it is not a qualified distribution?*

A-4. A distribution that is not a qualified distribution, and is neither contributed to another Roth IRA in a qualified rollover contribution nor constitutes a corrective distribution, is includible in the owner's gross income to the extent that the amount of the distribution, when added to the amount of all previous distributions from the owner's Roth IRAs (whether or not they were qualified distributions), exceeds the owner's contributions to all his or her Roth IRAs. **For purposes of this A-4, any amount distributed as a corrective distribution is treated as if it was never contributed.**

Key Point ☞ **Q-5.** *Will the additional tax under §72(t) apply to the amount of a distribution that is not a qualified distribution?*

A-5. **(a)** The 10% additional tax under §72(t) will apply (unless the distribution is excepted under §72(t)) to any distribution from a Roth IRA includible in gross income.

(b) The 10% additional tax under §72(t) also applies to a nonqualified distribution, even if it is not then includible in gross income, to the extent it is allocable to a conversion contribution, **if the distribution is made within the 5-taxable-year period beginning with the first day of the individual's taxable year in which the conversion contribution was made.** The 5-taxable-year period ends on the last day of the individual's fifth consecutive taxable year beginning with the taxable year described in the preceding sentence. For purposes of applying the tax, only the amount of the conversion includible in gross income as a result of the conversion is taken into account. The exceptions under §72(t) also apply to such a distribution.

(c) The 5-taxable-year period described in this A-5 for purposes of determining whether §72(t) applies to a distribution allocable to a conversion contribution is separately determined for each conversion contribution, and need not be the same as the 5-taxable-year period used for purposes of determining whether a distribution is a qualified distribution under A-1(b) of this section. For example, if a calendar-year taxpayer who received a distribution from a traditional IRA on December 31, 1998, makes a conversion contribution by contributing the distributed amount to a Roth IRA on February 25, 1999 in a qualifying rollover contribution and makes a regular contribution for 1998 on the same date, the 5-taxable-year period for purposes of this A-5 begins on January 1, 1999, while the 5-taxable-year period for purposes of A-1(b) of this section begins on January 1, 1998.

Key Point ☞ **Q-6.** *Is there a special rule for taxing distributions allocable to a 1998 conversion?*

A-6. **Yes. In the case of a distribution from a Roth IRA in 1998, 1999 or 2000 of amounts allocable to a 1998 conversion with respect to which the 4-year spread for the resultant income inclusion applies (see §l.408A-4 A-8), any income deferred as a result of the election to years after the year of the distribution is accelerated so that it is includible in gross income in the year of the distribution up to the amount of the distribution allocable to the 1998 conversion (determined under A-8 of this section). This amount is in addition to the amount otherwise includible in the owner's gross income for that taxable year as a result of the conversion.** However, this rule will not require the inclusion of any amount to the extent it exceeds the total amount of income required to be included over the 4-year period. The acceleration of income inclusion described in this A-6 applies in the case of a surviving spouse who elects to continue the 4-year spread in accordance with §1.408A-4 A-11(b).

Q-7. *Is the 5-taxable-year period described in A-1 of this section redetermined when a Roth IRA owner dies?*

A-7. **(a)** **No.** The beginning of the 5-taxable-year period described in A-1 of this section is not redetermined when the Roth IRA owner dies. Thus, in determining the 5-taxable-year period, the period the Roth IRA

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is held in the name of a beneficiary, or in the name of a surviving spouse who treats the decedent's Roth IRA as his or her own, includes the period it was held by the decedent.

(b) The 5-taxable-year period for a Roth IRA held by an individual as a beneficiary of a deceased Roth IRA owner is determined independently of the 5-taxable-year period for the beneficiary's own Roth IRA. However, if a surviving spouse treats the Roth IRA as his or her own, the 5-taxable-year period with respect to any of the surviving spouse's Roth IRAs (including the one that the surviving spouse treats as his or her own) ends at the earlier of the end of either the 5-taxable-year period for the decedent or the 5-taxable-year period applicable to the spouse's own Roth IRAs.

Key Point ☞ **Q-8.** *How is it determined whether an amount distributed from a Roth IRA is allocated to regular contributions, conversion contributions, or earnings?*

A-8 **(a)** Any amount distributed from an individual's Roth IRA is treated as made in the following order (determined as of the end of a taxable year and exhausting each category before moving to the following category)–

(1) From regular contributions;

(2) From conversion contributions, on a first-in-first-out basis; and

(3) From earnings.

(b) To the extent a distribution is treated as made from a particular conversion contribution, it is treated as made first from the portion, if any, that was includible in gross income as a result of the conversion.

Key Point ☞ **Q-9.** *Are there special rules for determining the source of distributions under A-8 of this section?*

A-9 **Yes.** For purposes of determining the source of distributions, the following rules apply:

(a) All distributions from all an individual's Roth IRAs made during a taxable year are aggregated.

(b) All regular contributions made for the same taxable year to all the individual's Roth IRAs are aggregated and added to the undistributed total regular contributions for prior taxable years. Regular contributions for a year include contributions made in the following taxable year that are identified as made for the taxable year. For example, a regular contribution made in 1999 for 1998 is aggregated with the contributions made in 1998 for 1998.

(c) All conversion contributions received during the same taxable year by all the individual's Roth IRAs are aggregated. Notwithstanding the preceding sentence, all conversion contributions made by an individual during 1999 that were distributed from a traditional IRA in 1998 and with respect to which the 4-year spread applies are treated for purposes of A-8(b) of this section as contributed to the individual's Roth IRAs prior to any other conversion contributions made by the individual during 1999.

(d) A distribution from an individual's Roth IRA that is rolled over to another Roth IRA of the individual is disregarded for purposes of determining the amount of both contributions and distributions.

(e) Any amount distributed as a corrective distribution (including net income), as described in A-1(d) of this section, is disregarded in determining the amount of contributions, earnings, and distributions.

(f) If an individual recharacterizes a contribution made to a traditional IRA (FIRST IRA) by transferring the contribution to a Roth IRA (SECOND IRA) in accordance with §1.408A-5, then, pursuant to §1.408A-5 A-3, the contribution to the Roth IRA is taken into account for the same taxable year for which it would have been taken into account if the contribution had originally been made to the Roth IRA and had never been contributed to the traditional IRA. Thus, the contribution to the Roth IRA is treated as contributed to the Roth IRA on the same date and for the same taxable year that the contribution was made to the traditional IRA.

(g) If an individual recharacterizes a regular or conversion contribution made to a Roth IRA (FIRST IRA) by transferring the contribution to a traditional IRA (SECOND IRA) in accordance with §1.408A-5, then pursuant to §1.408A-5 A-3, the contribution to the Roth IRA and the recharacterizing transfer are disregarded in determining the amount of both contributions and distributions for the taxable year with respect to which the original contribution was made to the Roth IRA.

(h) Pursuant to §1.408A-5 A-3, the effect of income or loss (determined in accordance with §1.408A-5 A-2) occurring after the contribution to the FIRST IRA is disregarded in determining the amounts described in paragraphs (f) and (g) of this A-9. Thus, for purposes of paragraphs (f) and (g) of this A-9, the amount of the contribution is determined based on the original contribution.

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Q-I0. *Are there examples to illustrate the ordering rules described in A-8 and A-9 of this section?*

Key Point ☞ **A-10. Yes. The following examples illustrate the ordering rules in A-8 and A-9:**

Example 1. In 1998, individual B converts $80,000 in his traditional IRA to a Roth IRA. B has a basis of $20,000 in the conversion amount and so must include the remaining $60,000 in gross income. He decides to spread the $60,000 income by including $15,000 in each of the 4 years 1998–2001, under the rules of §1.408A-4 A-8. B also makes a regular contribution of $2,000 in 1998. If a distribution of $2,000 is made to B anytime in 1998, it will be treated as made entirely from the regular contributions, so there will be no Federal income tax consequences as a result of the distribution.

Example 2. The facts are the same as in **Example 1,** except that the distribution made in 1998 is $5,000. The distribution is treated as made from $2,000 of regular contributions and $3,000 of conversion contributions that were includible in gross income. As a result, B must include $18,000 in gross income for 1998: $3,000 as a result of the acceleration of amounts that otherwise would have been included in later years under the 4-year-spread rule and $15,000 includible under the regular 4-year-spread rule. In addition, because the $3,000 is allocable to a conversion made within the previous 5 taxable years, the 10-percent additional tax under §72(t) would apply to this $3,000 distribution as if it were includible in gross income for 1998, unless an exception applies. Under the 4-year-spread rule, B would now include in gross income $15,000 for 1999 and 2000, but only $12,000 for 2001, because of the accelerated inclusion of the $3,000 distribution.

Example 3. The facts are the same as in **Example 1,** except that B makes an additional $2,000 regular contribution in 1999 and he does not take a distribution in 1998. In 1999, the entire balance in the account, $90,000 ($84,000 of contributions and $6,000 of earnings), is distributed to B. The distribution is treated as made from $4,000 of regular contributions, $60,000 of conversion contributions that were includible in gross income, $20,000 of conversion contributions that were not includible in gross income, and $6,000 of earnings. Because a distribution has been made within the 4-year-spread period, B must accelerate the income inclusion under the 4-year-spread rule and must include in gross income the $45,000 remaining under the 4-year-spread rule in addition to the $6,000 of earnings. Because $60,000 of the distribution is allocable to a conversion made within the previous 5 taxable years, it is subject to the 10-percent additional tax under §72(t) as if it were includible in gross income for 1999, unless an exception applies. The $6,000 allocable to earnings would be subject to the tax under §72(t), unless an exception applies. Under the 4-year-spread rule, no amount would be includible in gross income for 2000 or 2001 because the entire amount of the conversion that was includible in gross income has already been included.

Example 4. The facts are the same as in **Example 1,** except that B also makes a $2,000 regular contribution in each year 1999 through 2002 and he does not take a distribution in 1998. A distribution of $85,000 is made to B in 2002. The distribution is treated as made from the $10,000 of regular contributions (the total regular contributions made in the years 1998-2002), $60,000 of conversion contributions that were includible in gross income, and $15,000 of conversion contributions that were not includible in gross income. As a result, no amount of the distribution is includible in gross income; however, because the distribution is allocable to a conversion made within the previous 5 years, the $60,000 is subject to the 10-percent additional tax under §72(t) as if it were includible in gross income for 2002, unless an exception applies.

Example 5. The facts are the same as in **Example 4,** except no distribution occurs in 2002. In 2003, the entire balance in the account, $170,000 ($90,000 of contributions and $80,000 of earnings), is distributed to B. The distribution is treated as made from $10,000 of regular contributions, $60,000 of conversion contributions that were includible in gross income, $20,000 of conversion contributions that were not includible in gross income, and $80,000 of earnings. As a result, for 2003, B must include in gross income the $80,000 allocable to earnings, unless the distribution is a qualified distribution; and if it is not a qualified distribution, the $80,000 would be subject to the 10-percent additional tax under §72(t), unless an exception applies.

Example 6. Individual C converts $20,000 to a Roth IRA in 1998 and $15,000 (in which amount C had a basis of $2,000) to another Roth IRA in 1999. No other contributions are made. In 2003, a $30,000 distribution, that is not a qualified distribution, is made to C. The distribution is treated as made from $20,000 of the 1998 conversion contribution and $10,000 of the 1999 conversion contribution that was includible in gross income. As a result, for 2003, no amount is includible in gross income; however, because $10,000 is allocable to a conversion contribution made within the previous 5 taxable years, that amount is subject to the 10-percent additional tax under §72(t) as if the amount were includible in gross income for 2003, unless an exception applies. The result would be the same whichever of C's Roth IRAs made the distribution.

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Example 7. The facts are the same as in **Example 6,** except that the distribution is a qualified distribution. The result is the same as in **Example 6,** except that no amount would be subject to the 10-percent additional tax under §72(t), because, to be a qualified distribution, the distribution must be made on or after the date on which the owner attains age 59½, made to a beneficiary or the estate of the owner on or after the date of the owner's death, attributable to the owner's being disabled within the meaning of §72(m)(7), or to which §72(t)(2)(F) applies (exception for a first-time home purchase). Under §72(t)(2), each of these conditions is also an exception to the tax under §72(t).

Example 8. Individual D makes a $2,000 regular contribution to a traditional IRA on January 1, 1999, for 1998. On April 15, 1999, when the $2,000 has increased to $2,500, D recharacterizes the contribution by transferring the $2,500 to a Roth IRA (pursuant to §1.408A-5 A-l). In this case, D's regular contribution to the Roth IRA for 1998 is $2,000. The $500 of earnings is not treated as a contribution to the Roth IRA. The results would be the same if the $2,000 had decreased to $1,500 prior to the recharacterization.

Example 9. In December l998, individual E receives a distribution from his traditional IRA of $300,000 and in January 1999 he contributes the $300,000 to a Roth IRA as a conversion contribution. In April 1999, when the $300,000 has increased to $350,000, E recharacterizes the conversion contribution by transferring the $350,000 to a traditional IRA. In this case, E's conversion contribution for 1998 is $0, because the $300,000 conversion contribution and the earnings of $50,000 are disregarded. The results would be the same if the $300,000 had decreased to $250,000 prior to the recharacterization. Further, since the conversion is disregarded, the $300,000 is not includible in gross income in 1998.

Q-11. *If the owner of a Roth IRA dies prior to the end of the 5-taxable-year period described in A-1 of this section (relating to qualified distributions) or prior to the end of the 5-taxable-year period described in A-5 of this section (relating to conversions), how are different types of contributions in the Roth IRA allocated to multiple beneficiaries?*

A-11. Each type of contribution is allocated to each beneficiary on a pro-rata basis. Thus, for example, if a Roth IRA owner dies in 1999, when the Roth IRA contains a regular contribution of $2,000, a conversion contribution of $6,000 and earnings of $1,000, and the owner leaves his Roth IRA equally to four children, each child will receive one quarter of each type of contribution. Pursuant to the ordering rules in A-8 of this section, an immediate distribution of $2,000 to one of the children will be deemed to consist of $500 of regular contributions and $1,500 of conversion contributions.

Q-12. *How do the withholding rules under §3405 apply to Roth IRAs?*

A-12. Distributions from a Roth IRA are distributions from an individual retirement plan for purposes of §3405 and thus are designated distributions unless one of the exceptions in §3405(e)(1) applies. Pursuant to §3405(a) and (b), nonperiodic distributions from a Roth IRA are subject to 10-percent withholding by the payor and periodic payments are subject to withholding as if the payments were wages. However, an individual can elect to have no amount withheld in accordance with §3405(a)(2) and (b)(2).

Key Point ☞ **Q-13.** *Do the withholding rules under §3405 apply to conversions?*

A-13. **Yes. A conversion by any method described in §l.408A-4 A-1 is considered a designated distribution subject to §3405.** However, a conversion occurring in 1998 by means of a trustee-to-trustee transfer of an amount from a traditional IRA to a Roth IRA established with the same or a different trustee **is not required to be treated as a designated distribution** for purposes of §3405. Consequently, **no withholding** is required with respect to such a conversion (without regard to whether or not the individual elected to have no withholding).

Key Point ☞ **Q-14.** *What minimum distribution rules apply to a Roth IRA?*

A-14. **(a)** **No minimum distributions are required** to be made from a Roth IRA under §408(a)(6) and (b)(3) (which generally incorporate the provisions of §410(a)(9)) while the owner is alive. The post-death minimum distribution rules under §401(a)(9)(B) that apply to traditional IRAs with the exception of the at-least-as-rapidly rule described in §401(a)(9)(B)(i), also apply to Roth IRAs.

(b) The minimum distribution rules apply to the Roth IRA as though the Roth IRA owner died before his or her required beginning date. Thus, generally, the entire interest in the Roth IRA must be distributed by the end of the fifth calendar year after the year of the owner's death unless the interest is payable to a designated beneficiary over a period not greater than that beneficiary's life expectancy and distribution commences before the end of the calendar year following the year of death. If the sole beneficiary is the

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decedent's spouse, such spouse may delay distributions until the decedent would have attained age 70½ or may treat the Roth IRA as his or her own.

(c) Distributions to a beneficiary that are not qualified distributions will he includible in the beneficiary's gross income according to the rules in A-4 of this section.

Q-15. *Does §401(a)(9) apply separately to Roth IRAs and individual retirement plans that are not Roth IRAs?*

Key Point ☞ **A-15.** **Yes. An individual required to receive minimum distributions from his or her own traditional or SIMPLE IRA cannot choose to take the amount of the minimum distributions from any Roth IRA.** Similarly, an individual required to receive minimum distributions from a Roth IRA cannot choose to take the amount of the minimum distributions from a traditional or SIMPLE IRA. In addition, an individual required to receive minimum distributions as a beneficiary under a Roth IRA can only satisfy the minimum distributions for one Roth IRA by distributing from another Roth IRA if the Roth IRAs were inherited from the same decedent.

Q-16. *How is the basis of property distributed from a Roth IRA determined for purposes of a subsequent disposition?*

A-16. The basis of property distributed from a Roth IRA is its fair market value (FMV) on the date of distribution, whether or not the distribution is a qualified distribution. Thus, for example, if a distribution consists of a share of stock in XYZ Corp. with an FMV of $40.00 on the date of distribution, for purposes of determining gain or loss on the subsequent sale of the share of XYZ Corp. stock, it has a basis of $40.00.

Key Point ☞ **Q-17.** *What is the effect of distributing an amount from a Roth IRA and contributing it to another type of retirement plan other than a Roth IRA?*

A-17. Any amount distributed from a Roth IRA and contributed to another type of retirement plan (other than a Roth IRA) is treated as a distribution from the Roth IRA that is neither a rollover contribution for purposes of §408(d)(3) nor a qualified rollover contribution within the meaning of §408A(e) to the other type of retirement plan. This treatment also applies to any amount transferred from a Roth IRA to any other type of retirement plan unless the transfer is a recharacterization described in §1.408A-5.

Q-18. *Can an amount be transferred directly from an education IRA to a Roth IRA (or distributed from an education IRA and rolled over to a Roth IRA)?*

A-18. **No** amount may be transferred directly from an education IRA to a Roth IRA. A transfer of funds (or distribution and rollover) from an education IRA to a Roth IRA constitutes a distribution from the education IRA and a regular contribution to the Roth IRA (rather than a qualified rollover contribution to the Roth IRA).

Key Point ☞ **Q-19.** *What are the Federal income tax consequences of a Roth IRA owner transferring his or her Roth IRA to another individual by gift?*

A-19. A Roth IRA owner's transfer of his or her Roth IRA to another individual by gift constitutes an assignment of the owner's rights under the Roth IRA. At the time of the gift, the assets of the Roth IRA are deemed to be distributed to the owner and, accordingly, are treated as no longer held in a Roth IRA. In the case of any such gift of a Roth IRA made prior to October 1, 1998, if the entire interest in the Roth IRA is reconveyed to the Roth IRA owner prior to January 1, 1999, the Internal Revenue Service will treat the gift and reconveyance as never having occurred for estate tax, gift tax, and generation-skipping tax purposes and for purposes of this A-19. [**Reg.** §1.408A-6.]

§1.408A-7. Reporting, REG-115393-98, 9/3/98.

Key Point ☞ **Q-1.** *What reporting requirements apply to Roth IRAs?*

A-1. **Generally, the reporting requirements applicable to IRAs other than Roth IRAs also apply to Roth IRAs except that, pursuant to §408A(d)(3)(D), the trustee of a Roth IRA must include on Forms 1099-R and 5498 additional information as described in the instructions thereto.** Any conversion of amounts from an IRA other than a Roth IRA to a Roth IRA is treated as a distribution for which a Form 1099-R must be filed by the trustee maintaining the non-Roth IRA. In addition, the owner of such IRAs must report the conversion by completing Form 8606. In the case of a recharacterization described in §1.408A-5 A-1, IRA owners must report such transactions in the manner prescribed in the instructions to the applicable Federal tax forms.

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Q-2. *Can a trustee rely on reasonable representations of a Roth IRA contributor or distributee for purposes of fulfilling reporting obligations?*

A-2. A trustee maintaining a Roth IRA is permitted to rely on reasonable representations of a Roth IRA contributor or distributee for purposes of fulfilling reporting obligations. [**Reg.** §1.408A-7.]

§ 1.408A-8. Definitions, REG-115393-98, 9/3/98.

Q-1. *Are there any special definitions that govern in applying the provisions of §§1.408A-1 through 1.408A-7 and this section?*

Key Point ☞ **A-1Yes,** the following definitions govern in applying the provisions of §§1.408A-l through l.408A-7 and this section. Unless the context indicates otherwise, the use of a particular term excludes the use of the other terms. The definitions are as follows:

(a) Different types of IRAs

(1) *IRA*. Sections 408(a) and (b), respectively, describe an individual retirement account and an individual retirement annuity. The term IRA means an IRA described in either section 408(a) or (b), including each IRA described in paragraphs (a)(2) through (5) of this A-1. However, the term IRA does not include an education IRA described in section 530.

(2) *Traditional IRA*. The term traditional IRA means an individual retirement account or individual retirement annuity described in **§**408(a) or (b), respectively. This term includes a SEP IRA but does not include a SIMPLE IRA or a Roth IRA.

(3) *SEP IRA*. Section 408(k) describes a simplified employee pension (SEP) as an employer-sponsored plan under which an employer can make contributions to IRAs established for its employees. The term SEP IRA means an IRA that receives contributions made under a SEP. The term SEP includes a salary reduction SEP (SARSEP) described in section 408(k)(6).

(4) *SIMPLE IRA*. Section 408(p) describes a SIMPLE IRA Plan as an employer-sponsored plan under which an employer can make contributions to SIMPLE IRAs established for its employees. The term SIMPLE IRA means an IRA to which the only contributions that can be made are contributions under a SIMPLE IRA Plan or rollovers or transfers from another SIMPLE IRA.

(5) *Roth IRA*. The term Roth IRA means an IRA that meets the requirements of §408A.

(b) Other defined terms or phrases

(1) *(1) 4-year spread*. The term 4-year spread is described in §l.408A-4 A-8.

(2) *Conversion*. The term conversion means a transaction satisfying the requirements of §1.408A-4 A-1.

(3) *Conversion amount or conversion contribution*. The term conversion amount or conversion contribution is the amount of a distribution and contribution with respect to which a conversion described in § l.408A-4 A-1 is made.

(4) *Modified AGI*. The term modified AGI is defined in § l.408A-3 A-5.

(5) *Recharacterization*. The term recharacterization means a transaction described in §1.408A-5 A-1.

(6) *Recharacterized amount or recharacterized contribution*. The term recharacterized amount or recharacterized contribution means an amount or contribution treated as contributed to an IRA other than the one to which it was originally contributed pursuant to a recharacterization described in § 1.408A-5 A-1.

(7) *Taxable conversion amount*. The term taxable conversion amount means the portion of a conversion amount includible in income on account of a conversion, determined under the rules of section 408(d)(1) and (2).

(8) *Tax-free transfer*. The term tax-free transfer means a tax-free rollover described in section 402(c), 402(e)(6), 403(a)(4), 403(a)(5), 403(b)(8), 403(b)(10) or 408(d)(3), or a tax-free trustee-to-trustee transfer.

(9) *Treat* an *IRA as his or her own*. The phrase treat an IRA as his or her own means to treat an IRA of a surviving spouse for which one is the beneficiary as his or her own IRA after the death of the IRA owner in accordance with the terms of the IRA instrument or in the manner provided in the regulations under section 408(a)(6) or (b)(3).

(10) *Trustee*. The term trustee includes a custodian or issuer (in the case of an annuity) of an IRA (except where the context clearly indicates otherwise). [Reg. §1.408A-8]

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§1.408A-9. Effective Date, REG-115393-98, 9/3/98.

Q-1. *To what taxable years do §§1.408A-1 through 1.408A-8 apply?*

A-1. Sections 1.408A-1 through 1.408A-8 apply to taxable years beginning on or after January 1, 1998. [**Reg.** §1.408A-9.]

When creating a Roth IRA, or converting to a Roth IRA, these are several forms (and instructions) to consider.

Form **5305-R** (January 1998) Department of the Treasury Internal Revenue Service	**Roth Individual Retirement Trust Account** (Under Section 408A of the Internal Revenue Code)	**DO NOT File with the Internal Revenue Service**
Form **5305-RA** (January 1998) Department of the Treasury Internal Revenue Service	**Roth Individual Retirement Custodial Account** (Under section 408A of the Internal Revenue Code)	**DO NOT File With the Internal Revenue Service**
Form **5305-RB** (May 1998) Department of the Treasury Internal Revenue Service	**Roth Individual Retirement Annuity Endorsement** (Under section 408A of the Internal Revenue Code)	**DO NOT File with the Internal Revenue Service**

ESTATE AND GIFT TAX

50. INSTALLMENT PAYMENTS OF ESTATE TAX ATTRIBUTABLE TO CLOSELY HELD BUSINESS

[I.R.C. §§6166, 2053, 6601]

Act. 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.**
- **"The 1998 Act"** provides that the 2% rate does not apply to non-readily tradable or holding company interests [see §6116(b)(7)(A)(ii)].

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).

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Rev. Proc. 98-15

This revenue procedure applies to estates of decedents dying before January 1, 1998, that properly elect under §6166 to defer payment of estate taxes, and that wish to elect to apply the new reduced interest rates of §6601(j), as amended, and forgo the estate tax and income tax deductions for interest paid on deferred estate tax. The new rates and the nondeductibility provision apply automatically in the case of decedents dying after December 31, 1997.

Section 4. Procedure

.01 Making a §503(d)(2) Election. After August 5, 1997, but before January 1, 1999, an estate may make a §503(d)(2) election by writing a letter to the Service Center where the next installment of estate tax or interest is due. If an estate of a descendent dying before January 1, 1998, has not filed an estate tax return as of January 26, 1998, the letter may be attached to the estate tax return. No §503(d)(2) election may be made before a §6166 election is made. The letter must include the following information:

1. the decedent's name;
2. the estate's EIN;
3. a statement that the letter is an election under §503(d)(2) of the Taxpayer Relief Act of 1997; and
4. the due date of the installment of estate tax or interest for which the election is to be effective.

The letter must be signed and dated by the executor. Once made, the §503(d)(2) election cannot be modified or revoked.

.02 Effective Date of the § 503(d)(2) Election. Generally, a §503(d)(2) election is effective beginning with the first installment of estate tax or interest due on or after the date the election is filed with the appropriate Service Center. However, a §503(d)(2) election made by April 27, 1998, will be effective beginning with any installment, designated by the executor, due after August 5, 1997, and on or before April 27, 1998. Any assessment that was proper when made, but that becomes excessive as a result of the election, will be abated. Future installments due will be calculated and any overpayment of an installment of either tax or interest will be applied to the next installment in accordance with §6403.

51. ESTATE AND GIFT TAX UNIFIED CREDIT EXEMPTION INCREASED TO $1 MILLION BY YEAR 2006

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

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.

52. INDEXING OF CERTAIN ESTATE AND GIFT TAX PROVISIONS

[I.R.C. §§2032A, 2503(b)(2), 2631(c)]

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

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,** [applies to all generation skipping transfers. Existing trusts can make late allocations. **(The 1998 Act)** see I.R.C. §2631(c)(1)], and the $1,000,000 **ceiling on the value of a closely held business eligible for the special low interest rate**, are indexed annually for inflation.

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53. REDUCTION IN ESTATE TAX FOR CERTAIN LAND SUBJECT TO PERMANENT CONSERVATION EASEMENT

[I.R.C. §§2031, 1014, 2032A, 170]

See pages 355–358 of this book for a thorough analysis.

Explanation of Act

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]

Act

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

- 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. In addition, the Act extends the predeceased parent exception 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.

55. ESTATE TAX EXCLUSION FOR QUALIFIED FAMILY-OWNED BUSINESSES

[I.R.C. §2057]–As substantially modified by **"The 1998 Act". It is now a deduction!**

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. Do note that since this is a deduction, the qualifying property will receive a date of death stepped up basis unlike §2032A qualifying assets.

A. Generally

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

Practitioner Note. **The IRS Restructuring and Reform Act of 1998** made several modifications to the Qualified Family-Owned Business Interest (QFOBI) exclusion. These modifications clarify some of the ambiguities under the prior law.

If an executor elects to use the qualified family-owned business interest (QFOBI) deductions, the maximum amount excluded is the difference between $1,300,000 and the unified credit exemption then in effect ($625,000 for 1998). So, the §2057 amount and the unified exemption equivalence can never exceed a total of $1,300,000. This election will allow taxpayers to maximize the benefit of the applicable exclusion amount and the QFOBI deduction.

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Estates that are greater than $1.3 million will reduce total estate tax liability by claiming the full $675,000 QFOBI deduction. The bigger the estate, the greater the tax savings since the difference between the estate's highest bracket and lowest bracket is greater.

Example 1. Esther Washington has an estate worth $2,175,000 and has $690,000 of assets that are QFOBI. If Esther dies in 2002 and her estate is still valued as above, her personal representative should elect the full $675,000 QFOBI deduction. That election will limit her applicable exclusion amount to $625,000 (rather than the $700,000 that is otherwise available that year). However, the $75,000 that is claimed as a QFOBI deduction rather than an applicable exclusion amount will come out of the 45% estate tax bracket rather than the 37% bracket. Therefore, estate taxes will be reduced by $6,000.

By contrast, if the estate is $1.3 million or less, the QFOBI election should be made only to shield the assets that exceed the applicable exclusion amount. That election will minimize the assets that are subject to the 10 year recapture tax under I.R.C. is §2057(f)(1).

Example 2. Assume that Esther Washington's estate from Example 1 is $1.3 million and her QFOBI is $690,000. If Esther dies in 2002, her $700,000 applicable exclusion amount should be used to shield that much of her estate and the QFOBI deduction should be used to shield the remaining $600,000. This will reduce her estate taxes to zero and will subject only $600,000 of her assets to the 10 year recapture tax under I.R.C. §2057(f)(1).

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**

Note. What about inventory and machinery owned by sole proprietor–the 5 of 8 year test?

   - **(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, including a trust if all **(presumably)** beneficiaries are qualified heirs **(and have a present interest)** which, from, the decedent [within the meaning of §2032A(e)(9)]. [Same rule on transfers to corporations or partnerships if all **(presumably)** members or shareholders are qualified heirs.]

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. §2057 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.

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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

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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–

1. 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.

E. Adjusted Gross Estate. This is the gross estate (prior to this deduction) 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:

C. the includible gift amount (described above) **and**

D. 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**

Practitioner note. To qualify for the deduction, the decedent must meet the 50% test. Major gifts to a spouse increases the adjusted gross estate and may create a situation where the 50% at death test cannot be met even though these gifts are not otherwise included in the estate.

E. 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–

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(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

3. 90% of such entity is owned by members of three families, and

4. 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.**

Note. For purposes of the preceding sentence, a decedent shall be treated as engaged in a trade or business if any member of the decedent's family is engaged in such trade or business.

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 limitation!** Personal holding company income for **this purpose** 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 such adjusted income constitutes 50% or more of the adjusted ordinary gross income.
3. That portion of an interest in a trade or business that is attributable to–
   - **i.** cash or marketable securities, or both, in excess of the reasonably expected day-to-day working capital needs of such trade or business, and
   - **ii.** any other assets of the trade or business (other than assets used in the active conduct of a trade or business described in section 542(C)(2)), (a bank) which produce, or are held for the production of *personal holding company income (as defined in subparagraph (C)* or income described in section 954(C)(1) (foreign personal holding company) (determined without regard to subparagraph (A) thereof and by substituting "trade or business" for "controlled foreign corporation").

Important Note. In the case of a lease of property on a net cash basis by the decedent to a member of the decedent's family, income from such lease shall not be treated as personal holding company income for purposes of subparagraph (C) (above), and such property shall not be treated as an asset described in subparagraph (D)(ii), (labled 3 above) if such income and property would not be so treated if the lessor had engaged directly in the activities engaged in by the lessee with respect to such property.

Practitioner note. **The 1998 Act** clarifies the requirement that assets be used in a trade or business by the decedent for five out of the eight years before death and by the qualified heir for 10 years after death. Under the **1998 Act,** the trade or business requirement is met if the assets **are rented to a family member or (presumably) to a family-owned entity who uses the assets in an active trade or business.**

Example 3. Larry Landowner rented his farm to his daughter, Fran, for cash for five of the eight years before his death. Fran used the land in a farm business in which she materially participated. The land is a QFOBI.

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Fran and her brother, Ross, inherit Larry's land equally. Ross rents his half of the land to Fran, who continues to use it in the farming business, in which she materially participates for 10 years after Larry's death. Neither Fran nor Ross will be subject to the recapture tax under I.R.C. 2057.

Practitioner note. Under the 1997 Act, an interest in a trade or business was not a QFOBI if more than 35% of the adjusted ordinary income of the trade or business would qualify as personal holding company rental type income. **The 1998 Act clarifies that rental income from a net lease to a family member who uses the asset in a trade or business is not treated as personal holding company rental income for purposes of the QFOBI deduction.**

Example 4. The rent Larry received in Example 3 **is not** treated as personal holding company rental income for purposes of the QFOBI deduction.

Further 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.

The 1998 Act clarifies that the QFOBI must pass to a qualified heir in order to qualify for the deduction. Rules similar to the rules of I.R.C. §2032(A)(g) apply. [I.R.C. §2057(i)(3)(l)]

Property that passes in trust is considered to have passed from the decedent to a qualified heir only to the extent that the qualified heir has a present interest in the trust property. **"The 1998 Act"** clarifies that if all **(presumably)** beneficiaries of a trust are qualified heirs, then property passing to the trust may be treated as having passed to a qualified heir.

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.**

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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.

The 1998 Act clarifies that the QFOBI must pass to a qualified heir in order to qualify for the deduction. Rules similar to the rules of I.R.C. section 2032(A)(g) apply. [I.R.C. section 2057(I)(3)(l)]

I. 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:**
   a. 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);
   b. 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); [**Also see §2032A recapture rules. Presumably a sale of an interest in an entity that is a disqualified transfer will trigger some recapture**].
   c. the principal place of business of the trade or business ceases to be located in the United States; or
   d. 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.

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J. The Material Participation Requirement [See the Regulations for I.R.C. §2032A]

Practitioners who do estate planning should study Schedule T of the Form 706 (July, 1998) and the related instructions. They are helpful in understanding this complicated provision.

Form 706 (Rev. 7-98)

Estate of:

SCHEDULE T.—Qualified Family-Owned Business Interest Deduction

For details on the deduction, including trades and businesses that do not qualify, see page 20 of the separate instructions for Form 706.

Part 1.—Election

Note: The executor is deemed to have made the election under section 2057 if he or she files Schedule T and deducts any qualifying business interests from the gross estate.

Part 2.—General Qualifications

QUALIFIED PENSION PLANS

56. BASIS RECOVERY RULES—ANNUITIES

[I.R.C. §72(d)(1)(B)]

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

See page 600 for a good application of the new rule.

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.

57. SPECIAL RULES FOR CHURCH PLANS

[I.R.C. §414]

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

Explanation of Act. 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.

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

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58. INCOME AVERAGING FOR FARMERS

[New Code §1301]

See pages 301–310 of this book for a discussion of this topic. Watch for needed regulations to be released about 11-1-1998.

EDUCATION-RELATED PROVISIONS

59. HOPE AND LIFETIME-LEARNING CREDITS

[I.R.C. §§25A, 6050S] Notice 97-60

Beginning January 1, 1998, taxpayers may be eligible to claim a **nonrefundable** Hope Scholarship Credit against their federal income taxes. The Hope Scholarship Credit may be claimed for the qualified tuition and related expenses of each student in the taxpayer's family (i.e., the taxpayer, the taxpayer's spouse, or an eligible dependent) who is enrolled at least half-time in one of the first two years of postsecondary education and who is enrolled in a program leading to a degree, certificate, or other recognized educational credential. The amount that may be claimed as a credit is generally equal to: (1) 100% of the first $1,000 of the taxpayer's out-of-pocket expenses for each student's qualified tuition and related expenses, plus (2) 50% of the next $1,000 of the taxpayer's out-of-pocket expenses for each student's qualified tuition and related expenses. Thus, the maximum credit a taxpayer may claim for a taxable year is $1,500 multiplied by the number of students in the family who meet the enrollment criteria described above.

The amount a taxpayer may claim as a **Hope Scholarship Credit** is **gradually reduced** for taxpayers who have **modified adjusted gross income** between $40,000 ($80,000 for married taxpayers filing jointly) and $50,000 ($100,000 for married taxpayers filing jointly). Taxpayers with modified adjusted gross income over $50,000 ($100,000 for married taxpayers filing jointly) **may not** claim the **Hope Scholarship Credit.** Both the dollar limitation on the expenses for which the credit may be claimed and the modified adjusted gross income limitation will be indexed for inflation in 2002 and years thereafter.

The Hope Scholarship Credit may be claimed for payments of qualified tuition and related expenses made **on or after January 1, 1998,** for academic periods beginning **on or after** January 1, 1998. Therefore, the first time taxpayers will be able to claim the credit is when they file their 1998 tax returns in 1999. **The Hope Scholarship Credit is not available for any amount paid in 1997.**

Section One

Key Point ☞ **Q1.** *Who may claim the Hope Scholarship Credit?*

A1. An individual paying qualified tuition and related expenses at a postsecondary educational institution may claim the credit, provided the student whose expenses are being paid and the institution meet certain eligibility requirements.

Key Point ☞ **Q2.** *May an individual claim a Hope Scholarship Credit for paying qualified tuition and related expenses for other family members?*

A2. Yes. An individual may claim the credit for his/her own qualified tuition and related expenses and the qualified tuition and related expenses of his/her spouse and other eligible dependents (including children) **for whom the dependency exemption is claimed.** Generally, a parent may claim the dependency exemption for his/her unmarried child if: (1) the parent supplies more than half the child's support for the taxable year, and (2) the child is under age 19 or is a full-time student under age 24.

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Key Point ☞ **Q3.** *What are the eligibility requirements for the student?*

A3. A student is eligible for the Hope Scholarship Credit if: (1) for at **least one academic period** (e.g., semester, trimester, quarter) beginning during the calendar year, the student is enrolled at least **half-time** in a program leading to a degree, certificate, or other recognized educational credential and is enrolled in one of the first two years of postsecondary education, and (2) the student is free of any conviction for a Federal or State felony offense consisting of the possession or distribution of a controlled substance. For purposes of the Hope Scholarship Credit, a student will be considered to be enrolled at least half-time if the student is enrolled for at least half the full-time academic workload for the course of study the student is pursuing as determined under the standards of the institution where the student is enrolled. The institution's standard for a full-time workload must equal or exceed the standards established by the Department of Education under the Higher Education Act and set forth in 34 C.F.R. §674.2(b).

Q4. *What are the eligibility requirements for the institution?*

A4. The college, university, vocational school, or other postsecondary educational institution where the student is enrolled must be an institution that is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088) and, therefore, eligible to participate in the student aid programs administered by the Department of Education. This category includes virtually all accredited public, nonprofit, and proprietary postsecondary institutions. **(The same eligibility requirements for institutions apply for the Lifetime Learning Credit, described in the next section.)**

Key Point ☞ **Q5.** *The Hope Scholarship Credit may be claimed only for amounts spent on "qualified tuition and related expenses." Which expenses are included in qualified tuition and related expenses?*

A5. The term "qualified tuition and related expenses" means the **tuition and fees** an individual is required to pay in order to be enrolled at or attend an eligible institution. Amounts paid for any course or other education involving sports, games, or hobbies are not eligible for the credit, unless the course or other deduction is part of the student's degree program. Charges and fees associated with room, board, student activities, athletics, insurance, books, equipment, transportation, and similar personal, living, or family expenses are not qualified tuition or related expenses. **(The same definition of "qualified tuition and related expenses" applies for the Lifetime Learning Credit, described in the next section.)**

Key Point ☞ **Q6.** *The Hope Scholarship Credit is available only if a taxpayer's "modified adjusted gross income" is below a specified amount. How does a taxpayer know what his/her modified adjusted gross income is?*

A6. **For most taxpayers, modified adjusted gross income is the same as adjusted gross income.** Taxpayers compute adjusted gross income as part of completing a Federal income tax return. For those few taxpayers who earn income abroad or receive income from certain American territories or possessions, modified adjusted gross income will be greater than adjusted gross income.

Q7. *May a nonresident alien claim the Hope Scholarship Credit?*

A7. Generally no. There is an exception for certain nonresident aliens who are married to U.S. citizens or resident aliens. Nonresident aliens should consult a U.S. tax advisor to determine whether the exception applies to them. (The same rules apply to the Lifetime Learning Credit, described in the next section.)

Key Point ☞ **Q8.** *Are qualified tuition and related expenses for graduate-level degree work eligible for the Hope Scholarship Credit?*

A8. **No. However, the Lifetime Learning Credit is available for these expenses.** (See Sec. 2, Q&A5.)

Key Point ☞ **Q9.** *May an individual claim a Hope Scholarship Credit for more than one family member?*

A9. **Yes. Furthermore, the credit is calculated on a per student, rather than a per family, basis. For example,** if an individual whose modified adjusted gross income is $35,000 pays over $2,000 in qualified tuition and related expenses for himself and over $2,000 in qualified tuition and related expenses for his dependent child, and both he and his dependent child meet the eligibility requirements, the individual may claim a Hope Scholarship Credit of $3,000 (i.e., a credit of $1,500 for his expenses plus a credit of $1,500 for his child's expenses).

Key Point ☞ **Q10.** *May both the parent and a dependent child claim the Hope Scholarship Credit for the child's qualified tuition and related expenses in the same year?*

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A10. **No.** Either the parent or the child, but not both, may claim the credit for the child's expenses in a particular year. If an individual claims the child as a dependent on his/her Federal income tax return for the year, only the individual may claim the Hope Scholarship Credit for the child's qualified tuition and related expenses. **If no one claims the child as a dependent on a Federal income tax return for the year, only the child may claim the Hope Scholarship Credit for the child's expenses.** (The same rules relating to individuals and dependents apply for the Lifetime Learning Credit, described in the next section.)

Key Point ☞ **Q11.** *If a married taxpayer files a separate return, may the taxpayer claim a Hope Scholarship Credit on his/her income tax return?*

A11. **No.** Married taxpayers may claim the credit only if the taxpayer and the taxpayer's spouse file a **joint return** for the taxable year. **(The same rules apply for the Lifetime Learning Credit.**)

Key Point ☞ **Q12.** *How does a parent claim a Hope Scholarship Credit for the qualified tuition and related expenses of a dependent child?*

A12. The parent may claim the credit on his/her tax return even if the child files his/her own tax return. **When a child is claimed as a dependent on a parent's return, any qualified tuition or related expenses paid by the child during the year are treated as if the parent had paid them.** Therefore, these expenses are included in calculating the parent's Hope Scholarship Credit. A child may not claim a Hope Scholarship Credit on his/her tax return for a particular year if the child's parent claims the child as a dependent in that same year. **(The same rules apply for the Lifetime Learning Credit)**

Key Point ☞ **Q13.** *What is the maximum Hope Scholarship Credit a taxpayer may claim for an eligible student?*

A13. Until 2002 (when the dollar limitations are indexed for inflation), for each student who meets the eligibility requirements, the credit amount is **100% of the first $1,000** of the taxpayer's out-of-pocket expenses for qualified tuition and related expenses, **plus 50% of the next $1,000** of the taxpayer's out-of-pocket expenses for qualified tuition and related expenses. **Therefore, the maximum credit amount for the expenses of an eligible student is $1,500.** If the taxpayer is claiming a credit for more than one person, the credit amount for each student in the taxpayer's family is **added together** to determine the maximum total credit the taxpayer may claim.

Key Point ☞ **Q14.** *The amount a taxpayer may claim as a Hope Scholarship Credit is gradually reduced for taxpayers with modified adjusted gross income between $40,000 and $50,000 (between $80,000 and $100,000 for married taxpayers filing jointly). How does this reduction work?*

A14. The reduction works on a sliding scale that reflects where the taxpayer's modified adjusted gross income is in the phase-out range. For example, until 2002 if an eligible student (who is not anyone's dependent for tax purposes) pays $2,000 or more in qualified tuition and related expenses in a particular year, and the student's modified adjusted gross income for the year is $45,000 (half way along the $10,000 phase-out range), the credit amount for the student is limited **to $750.** By contrast, if the same student's modified adjusted gross income was $35,000, the credit amount for the student would be the maximum **$1,500.**

Key Point ☞ **Q15.** *How does a taxpayer claim the Hope Scholarship Credit?*

A15. **The first year that the credit will be available is 1998.** Thus, taxpayers will not be able to claim the credit until they file their 1998 tax returns in 1999. Instructions accompanying the 1998 tax forms (for returns required to be filed in 1999) will explain how to calculate the credit and how to claim it on the tax return.

Key Point ☞ **Q16.** *Is there a limit to the number of times a taxpayer may claim the Hope Scholarship Credit for each student?*

A16. **Yes.** The credit may be claimed in **no more than two years for each student.** Thus, for example, a couple with a child who starts as a freshman in the fall of 1998, continues as a sophomore in 1999, and meets the eligibility requirements may claim the credit for their child's expenses in 1998 and again in 1999. **After 1999,** neither the parents, the student, nor anyone else may claim any additional Hope Scholarship Credits for this student's qualified tuition and related expenses. **However, in 2000 and thereafter, the Lifetime Learning Credit may be available for this child's expenses.** Furthermore, if the couple has another child who starts as a freshman in the fall of 1999, the couple may claim the **Hope Scholarship Credit** for that child's expenses in 1999 and one additional year.

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Key Point ☞ **Q17.** *May an individual claim both the Hope Scholarship Credit and the Lifetime Learning Credit for a student's expenses in a single taxable year?*

A17. **No.** For each year in which a student meets the eligibility requirements for the Hope Scholarship Credit, the student's expenses may be used as the basis for a Hope Scholarship Credit or a Lifetime Learning Credit, but not both. If, for example, an eligible student pays more than $2,000 in qualified tuition and related expenses during the calendar year, the student (or the individual claiming the student as a dependent) **may not claim the Hope Scholarship Credit for the first $2,000 of expenses and the Lifetime Learning Credit for the rest.**

Key Point ☞ **Q18.** *If a couple has two children, one who is a freshman and one who is a junior, may the couple claim a Hope Scholarship Credit for the freshman's expenses and a Lifetime Learning Credit for the junior's expenses?*

A18. **Yes.** Assuming the applicable eligibility requirements have been met for each credit, a taxpayer may claim the Hope Scholarship Credit for one student's expenses and the Lifetime Learning Credit for another student's expenses in the same year.

Key Point ☞ **Q19.** *May a parent or student claim a Hope Scholarship Credit for tuition paid in advance of when the academic period begins?*

A19. **Generally, the credit is available only for payments of qualified tuition and related expenses that cover an academic period beginning in the same calendar year as the payment is made.** (An academic period begins on the first day of classes, and does not include periods of orientation, counseling, or vacation.) An exception, however, allows a parent or student to claim a Hope Scholarship Credit for payments of qualified tuition and related expenses made during the calendar year to cover an academic period that begins in January, February, or March of the following taxable year. Because the Hope Scholarship Credit does not apply to expenses paid before January 1, 1998, this exception does not apply to tuition paid in 1997 to cover academic periods beginning in 1998.

Key Point ☞ **Q20.** *If a student (who is not claimed as a dependent on anyone's Federal income tax return) pays qualified tuition and related expenses using a combination of a Pell Grant, a loan, a gift from a family member, and some personal savings, what expenses may be taken into account in calculating the Hope Scholarship Credit the student may claim?*

A20. **The student may take into account only "out-of-pocket" expenses in calculating the credit.** Qualified tuition and related expenses paid with the student's earnings, a loan, a gift, an inheritance, or personal savings (including savings from a qualified state tuition program) **are taken into account** in calculating the credit amount. **However,** qualified tuition and related expenses paid with a Pell Grant or other tax-free scholarship, a tax-free distribution from an Education IRA, or tax-free employer-provided educational assistance are not taken into account in calculating the credit amount. (The same rules apply for the Lifetime Learning Credit).

Key Point ☞ **Q21.** *May a student's parents claim the Hope Scholarship Credit for the student's expenses for a taxable year in which the student takes money out of an Education IRA on a tax-free basis?*

A21. **No.** If a student is receiving a tax-free distribution from an Education IRA in a particular taxable year, **none** of that student's expenses may be claimed as the basis for a Hope Scholarship Credit for that taxable year. **However, the student may waive the tax-free treatment of the Education IRA distribution and elect to pay any tax that would otherwise be owed on the Education IRA distributions received in any taxable year so that the student or the student's parents may claim a Hope Scholarship Credit for expenses paid in the same year the Education IRA distributions are received.**

Lifetime Learning Credit for Qualified Tuition and Fees

Notice 97-60

Section 2. **Lifetime Learning Credit.** Beginning on July 1, 1998, taxpayers may be eligible to claim a **nonrefundable** Lifetime Learning Credit against their federal income taxes. The **Lifetime Learning Credit** may be claimed for the qualified tuition and related expenses of the students in the taxpayer's family (i.e., the taxpayer, the taxpayer's spouse, or an eligible dependent) who are enrolled in eligible educational institutions. **Through 2002, the amount that may be claimed as a credit is equal to 20% of the taxpayer's first $5,000 of out-of-pocket qualified tuition and related expenses for all the students in the family.** After 2002, the credit amount is equal to 20% of the taxpayer's first $10,000 of out-of-pocket qualified tuition and related expenses. Thus, the maximum credit a taxpayer may claim for a taxable year is $1,000 through 2002 and $2,000 thereafter. These amounts are not indexed for inflation.

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If the taxpayer is claiming a Hope Scholarship Credit for a particular student, none of that student's expenses for that year may be applied toward the Lifetime Learning Credit. The amount a taxpayer may claim as a Lifetime Learning Credit is **gradually reduced** for taxpayers who have modified adjusted gross income between $40,000 ($80,000 for married taxpayers filing jointly) and $50,000 ($100,000 for married taxpayers filing jointly). Taxpayers with modified adjusted gross income over $50,000 ($100,000 for married taxpayers filing jointly) may not claim a Lifetime Learning Credit. The modified adjusted gross income limitation will be indexed for inflation in 2002 and years thereafter. **The definition of modified adjusted gross income is the same as it is for purposes of the Hope Scholarship Credit.** (See Sec. 1, Q&A6.)

The Lifetime Learning Credit may be claimed for payments of qualified tuition and related expenses made on or after July 1, 1998, for academic periods beginning on or after July 1, 1998. Therefore, the first time taxpayers will be able to claim the credit will be when they file their 1998 tax returns in 1999. The Lifetime Learning Credit is not available for any amount paid in 1997.

Key Point ☞ **Q1.** *Who may claim the Lifetime Learning Credit?*

A1. An individual paying qualified tuition and related expenses at a postsecondary educational institution may claim the credit, provided the institution is an eligible educational institution. **Unlike the Hope Scholarship Credit, students are not required to be enrolled at least half-time** in one of the first two years of postsecondary education. Nonresident aliens generally are not eligible to claim the Lifetime Learning Credit. (See Sec. 1, Q&A7.)

Key Point ☞ **Q2.** *May an individual claim a Lifetime Learning Credit for paying qualified tuition and related expenses for other family members?*

A2. **Yes.** An individual may claim the credit for his/her own qualified tuition and related expenses and the qualified tuition and related expenses of his/her spouse and other eligible dependents (including children) **for whom the dependency exemption is allowed.** Generally, a parent may claim the dependency exemption for his/her unmarried child if: (1) the parent supplies more than half the child's support for the taxable year, and (2) the child is under age 19 or is a full-time student under age 24.

Q3. *What are the eligibility requirements for the institution?*

A3. They are the same requirements that apply for the Hope Scholarship Credit. (See Sec. 1, Q&A4.)

Key Point ☞ **Q4.** *Is the Lifetime Learning Credit available for a student taking only one course?*

A4. **Yes.** For example, a student who has just graduated from high school and is taking a single course at a community college may claim the Lifetime Learning Credit if the student comes within the income limits and is not claimed as a dependent by someone else.

Key Point ☞ **Q5.** *Are qualified tuition and related expenses for graduate-level education eligible for the Lifetime Learning Credit?*

A5. **Yes.**

Key Point ☞ **Q6.** *May an individual claim a Lifetime Learning Credit for more than one family member?*

A6. **Yes. However, unlike the Hope Scholarship Credit, the Lifetime Learning Credit is calculated on a per family, rather than a per student, basis.** Therefore, the maximum available credit does not vary with the number of students in the family. For example, if in 1999 a married individual whose modified adjusted gross income is $35,000 pays $5,000 of qualified tuition and related expenses to attend an eligible educational institution, the individual may claim a $1,000 Lifetime Learning Credit. If in the same year the individual also pays another $2,000 in qualified tuition and related expenses for his spouse to attend an eligible educational institution, the individual's Lifetime Learning Credit is still $1,000.

Key Point ☞ **Q7.** *May both the parent and a dependent child claim the Lifetime Learning Credit for the child's qualified tuition and related expenses in the same year?*

A7. **No.** Either the parent or the child, but not both, may claim the credit for the child's expenses in a particular year. If an individual claims the child as a dependent on his/her Federal income tax return for the year, only the individual may claim the Lifetime Learning Credit for the child's qualified tuition and related expenses. If no one claims the child as a dependent on a Federal income tax return for the year, only the child may claim the Lifetime Learning Credit for the child's expenses.

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Key Point ☞ **Q8.** *How does a parent claim a Lifetime Learning Credit for the qualified tuition and related expenses of a dependent child?*

A8. The parent may claim the credit on his/her Federal income tax return even if the child files his/her own tax return. **When a child is claimed as a dependent on the parent's return, any qualified tuition and related expenses paid by the child during the year are treated as if the parent had paid them and, therefore, are included in calculating the parent's Lifetime Learning Credit.** A child may not claim a Lifetime Learning Credit on his/her tax return for any year if the child's parent claims the child as a dependent in that same year. Also, a married taxpayer who does not file a joint return is not eligible to claim the Lifetime Learning Credit. (See Sec. 1, Q&A11.)

Key Point ☞ **Q9.** *What is the maximum Lifetime Learning Credit a taxpayer may claim?*

A9. The credit is equal to 20% of the taxpayer's out-of-pocket expenses for qualified tuition and related expenses of all eligible family members, up to a maximum of $5,000 in expenses annually through 2002. Thus, the maximum Lifetime Learning Credit a taxpayer may claim through 2002 is $1,000. After 2002, the credit is equal to 20% of the taxpayer's out-of-pocket expenses up to a maximum of $10,000 in expenses. Thus, the maximum Lifetime Learning Credit a taxpayer may claim after 2002 is $2,000. The maximum credit does not change even if the taxpayer is claiming a credit for the expenses of more than one student in the family.

Q10. *What does the term "qualified tuition and related expenses" mean for purposes of the Lifetime Learning Credit?*

A10. The term "qualified tuition and related expenses" for purposes of the Lifetime Learning Credit has the **same meaning** as it does for purposes of the **Hope Scholarship Credit.** (See Sec. 1, Q&A5.)

Q11. *If a student (who is not claimed as a dependent on anyone's Federal income tax return) pays qualified tuition and related expenses using a combination of a Pell Grant, a loan, a gift from a family member, and some personal savings, what expenses may be taken into account in calculating the Lifetime Learning Credit the student may claim?*

A11. The student may take into account only "out-of-pocket" expenses in calculating the Lifetime Learning Credit. Qualified tuition and related expenses paid with the student's earnings, a loan, a gift, an inheritance, or personal savings (including savings from a qualified state tuition program) **are taken into account** in calculating the credit amount. **However,** qualified tuition and related expenses paid with a Pell Grant or other tax-free scholarship, a tax-free distribution from an Education IRA, or tax-free employer-provided educational assistance are not taken into account in calculating the credit amount.

Q12. *How does a taxpayer claim the Lifetime Learning Credit?*

A12. The first year that the credit will be available is 1998. Taxpayers will not be able to claim the credit until they file their 1998 returns in 1999. Instructions accompanying the 1998 tax forms (for returns required to be filed in 1999) will explain how to calculate the credit and how to claim it on the tax return.

Key Point ☞ **Q13.** *Is there a limit on the number of years in which a Lifetime Learning Credit may be claimed, as there is for the Hope Scholarship Credit?*

A13. No. Unlike the Hope Scholarship Credit, there is no limit to the number of years in which a Lifetime Learning Credit may be claimed for each student. Thus, for example, an individual who enrolls in one college-level class every year would be able to claim the Lifetime Learning Credit for an unlimited number of years, provided the individual meets the income limits and is taking the classes at institutions that meet the eligibility requirements. (See Q&A3 in this section.)

Key Point ☞ **Q14.** *May a parent or student claim a Lifetime Learning Credit for tuition paid in advance of when the academic period begins?*

A14. Generally, the credit is available only for payments of qualified tuition and related expenses that cover an academic period beginning in the same calendar year in which payment is made. (An academic period begins on the first day of classes, and does not include periods of orientation, counseling, or vacation.) An exception, however, allows a parent or student to claim a Lifetime Learning Credit for payments of qualified tuition and related expenses made during the calendar year to cover an academic period that begins in January, February, or March of the following taxable year. Because the Lifetime Learning Credit does not apply to expenses paid before January 1, 1998, this exception does not apply to tuition paid before that date to cover academic periods beginning before or after that date.

Key Point ☞ **Q15.** *May a student or a student's parents take the Lifetime Learning Credit for the student's expenses in a taxable year in which the student takes money out of an Education IRA on a tax-free basis?*

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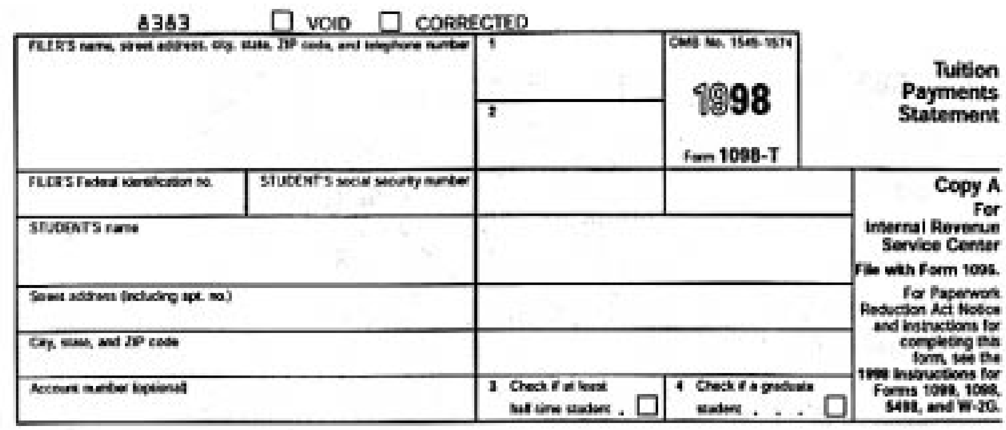
A15. **No.** If a student is receiving a tax-free distribution from an Education IRA in a particular taxable year, none of that student's expenses may be claimed as the basis for a Lifetime Learning Credit for that year. However, the student may waive the tax-free treatment of the Education IRA distribution and elect to pay any tax that would otherwise be owed on the Education IRA distributions so that the student or the student's parents may claim a Lifetime Learning Credit for expenses paid in the same year the Education IRA distributions are received.

Notice 97-73

Information Reporting Relating to Qualified Tuition and Related Expenses. Section 6050S(a) requires eligible educational institutions that receive payments of qualified tuition and related expenses or make reimbursement or refunds of qualified tuition and related expenses to submit **an annual information report to the Service with respect to each student on whose behalf the payments are received or the reimbursements or refunds are made.**

Section 6050S(a) also requires each person engaged in a trade or business who makes a reimbursement or refund of qualified tuition and related expenses **to submit an annual information report to the Service with** respect to each student on whose behalf the reimbursements or refunds are paid.

Information Required for 1998. Eligible educational institutions required under this notice to file information returns for 1998 must properly complete **Form 1098-T, Tuition Payments,** for each student with respect to whom information reporting is required. For 1998, a properly completed Form 1098-T filed with the Service must include:


8383 VOID CORRECTED
FILER'S name, street address, city, state, ZIP code, and telephone number
1
2
OMB No. 1545-1574
1998
Form 1098-T
Tuition Payments Statement
FILER'S Federal identification no.
STUDENT'S social security number
STUDENT'S name
Street address (including apt. no.)
City, state, and ZIP code
Account number (optional)
3 Check if at least half time student
4 Check if a graduate student
Copy A For Internal Revenue Service Center
File with Form 1096.
For Paperwork Reduction Act Notice and instructions for completing this form, see the 1998 Instructions for Forms 1099, 1098, 5498, and W-2G.

Although in the future institutions will be required to provide the additional information specified in §6050S (e.g., the amount of qualified tuition and related expenses received and/or reimbursed), the IRS **will not impose penalties on an institution that does not provide this information for 1998.**

When to File. The information returns required under §6050S for 1998 must be sent to the Service by **March 1, 1999.**

Notice 98-46 [**"The 1998 Act"** modifications]

Information returns: Higher education tuition: Hope Scholarship credit: Lifetime Learning credit: Guidance.—The IRS has announced that, for 1999, eligible educational institutions must follow the rules set forth in Notice 97-73 for information reporting required by Code §6050S to assist in determining the Hope Scholarship credit and the Lifetime Learning credit that may be claimed under Code §25A. Pursuant to Code §6050S, as amended by the **Internal Revenue Service Restructuring and Reform Act of 1998**, institutions must file the specified information returns with the IRS and provide a corresponding statement to the individuals named on the information return indicating the data that has been reported. Guidance provided in Notice 97-73 will apply to Code §6050S until regulations are issued. Notice 97-73 is **modified.**

The requirements of §6050S are generally described in Notice 97-73, along with specific information reporting requirements for 1998.

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However, as a result of amendments to §6050S made by the Internal Revenue Service Restructuring and Reform Act of 1998, certain information reporting requirements under §6050S have been clarified or changed. **First,** the amendments clarify that §6050S requires institutions to report the aggregate amount of payments made with respect to each student for qualified tuition and related expenses without any amounts being subtracted for qualified scholarships or other tax-free educational assistance received with respect to the student. **Further,** §6050S(b)(2)(C), as amended, specifically requires that the amount of any grant received by the student for payment of costs of attendance and processed by the institution making the information return be reported as a separate item. Section 6050S(b)(2)(C) was also amended to clarify that an institution must report only the aggregate amount of reimbursements and refunds of qualified tuition and related expenses paid to a student by the institution (and not by any other party). **Finally,** §6050S(a) was amended to clarify that only eligible educational institutions and persons engaged in a trade or business of making payments to individuals under insurance arrangements are required to report information under §6050S. **In all other respects, the requirements of §6050S remain the same as described in Notice 97-73.**

Example 1. James and Ionna Jenkins are married and have two children in college in 1998. Jim, Jr., is a senior and Rosemary is a sophomore. Both were in college for both semesters during 1998. The Jenkins' AGI is $78,000. For 1998, the Jenkins paid the following amounts for qualified tuition and fees. The Jenkins' taxable income is $50,975.

Jim, Jr.	$6,000	all attributable to post 07/30/98 education
Rosemary (full-time)	$4,000	

Answer. The Jenkins' total education credit is $2,500. See Form 8863. **Note: your software will complete a from 6251 but it does not limit the credit in this example.**

Example 1

Form **8863** — **Education Credits (Hope and Lifetime Learning Credits)** — 1998

Name(s) shown on return: James & Ionna Jenkins — Your social security number: 000 00 0000

Part I Hope Credit

1 (a) Name of student First, Last	(b) Student's social security number	(c) Qualified expenses (but do not enter more than $2,000 for each student). See instructions	(d) Enter the smaller of the amount in column (c) or $1,000	(e) Subtract column (d) from column (c)	(f) Enter one-half of the amount in column (e)
Rosemary Jenkins	000 00 0000	2,000 00	1000 00	1000 00	500 00
2 Add the amounts in columns (d) and (f)			1,000 00		500 00
3 Add the amounts on line 2, columns (d) and (f)					3 1,500 00

Part II Lifetime Learning Credit

Caution: You cannot take the Hope credit and the lifetime learning credit for the same student.

4 (a) Name of student First, Last	(b) Student's social security number	(c) Qualified expenses (after June 30, 1998). See instructions
James Jenkins Jr.	000 00 0000	6,000 00

5 Add the amounts on line 4, column (c) and enter the total	5	6,000 00
6 Enter the smaller of line 5 or $5,000	6	5,000 00
7 Multiply line 6 by 20% (.20)	7	1,000 00

Part III Allowable Education Credits

8 Add lines 3 and 7	8	2,500 00
9 Enter: $100,000 if married filing jointly; $50,000 if single, head of household, or qualifying widow(er)	9	100,000 00
10 Enter the amount from Form 1040, line 34 (or Form 1040A, line 19)*	10	78,000 00
11 Subtract line 10 from line 9. If line 10 is equal to or more than line 9, stop; you cannot take any education credits	11	22,000 00
12 Enter: $20,000 if married filing jointly; $10,000 if single, head of household, or qualifying widow(er)	12	20,000 00
13 If line 11 is equal to or more than line 12, enter the amount from line 8 on line 14 and go to line 15. If line 11 is less than line 12, divide line 11 by line 12. Enter the result as a decimal (rounded to at least three places)	13	×
14 Multiply line 8 by line 13	14	2,500 00
15 Enter your tax from Form 1040, line 40 (or Form 1040A, line 25)	15	8,769 00
16 Enter the total, if any, of your credits from Form 1040, lines 41 and 42 (or from Form 1040A, lines 26 and 27)	16	—
17 Subtract line 16 from line 15. If line 16 is equal to or more than line 15, stop; you cannot take any education credits	17	8769 00
18 Tentative minimum tax limit. See instructions for the amount to enter	18	5793 00
19 Subtract line 18 from line 17. If line 18 is equal to or more than line 17, stop; you cannot take any education credits	19	2976 00
20 Education credits. Enter the smaller of line 14 or line 19 here and on Form 1040, line 44 (or Form 1040A, line 29)	20	2,500 00

*See Pub. 970 for the amount to enter if you are filing Form 2555, 2555-EZ, or 4563, or are excluding income from Puerto Rico.

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Example 2. Assume the same facts as in Example 1, except the Jenkins' AGI is $90,000. Their taxable income is $62,975.

Answer. The Jenkins' total education credit is only $1,250. See Form 8863.

Note: your software will do a form 6251 but it does not limit the credit in this example. The reduction is due to the AGI phaseout.

Example 2

Form **8863** — Department of the Treasury, Internal Revenue Service

Education Credits (Hope and Lifetime Learning Credits)

► See instructions.

OMB No. 1545-XXXX — **1998** — Attachment Sequence No. 93

Name(s) shown on return: James R. & Jonna Jenkins — Your social security number: 000 00 0000

Proof 25 of 8/24/1998

Part I — Hope Credit

1 (a) Name of student (First, Last)	(b) Student's social security number	(c) Qualified expenses (but do not enter more than $2,000 for each student). See instructions	(d) Enter the smaller of the amount in column (c) or $1,000	(e) Subtract column (d) from column (c)	(f) Enter one-half of the amount in column (e)
Rosemary Jenkins	000 00 0000	2,000 00	1,000 00	1,000 00	500
2 Add the amounts in columns (d) and (f)		**2**	1,000 00		500

3 Add the amounts on line 2, columns (d) and (f) ► **3** 1,500

Part II — Lifetime Learning Credit

4 (a) Name of student (First, Last)	(b) Student's social security number	(c) Qualified expenses (after June 30, 1998). See instructions
James Jenkins Jr.	000 00 0000	6,000 00

Caution: *You cannot take the Hope credit and the lifetime learning credit for the same student.*

5	Add the amounts on line 4, column (c) and enter the total	5	6,000 00
6	Enter the smaller of line 5 or $5,000	6	5,000 00
7	Multiply line 6 by 20% (.20) ►	7	1,000 00

Part III — Allowable Education Credits

8	Add lines 3 and 7	8	2,500 00
9	Enter: $100,000 if married filing jointly; $50,000 if single, head of household, or qualifying widow(er)	9	100,000 00
10	Enter the amount from Form 1040, line 34 (or Form 1040A, line 19)*	10	90,000 00
11	Subtract line 10 from line 9. If line 10 is equal to or more than line 9, stop; you cannot take any education credits	11	10,000 00
12	Enter: $20,000 if married filing jointly; $10,000 if single, head of household, or qualifying widow(er)	12	20,000 00
13	If line 11 is equal to or more than line 12, enter the amount from line 8 on line 14 and go to line 15. If line 11 is less than line 12, divide line 11 by line 12. Enter the result as a decimal (rounded to at least three places)	13	× .500
14	Multiply line 8 by line 13 ►	14	1,250 00
15	Enter your tax from Form 1040, line 40 (or Form 1040A, line 25)	15	12,128 00
16	Enter the total, if any, of your credits from Form 1040, lines 41 and 42 (or from Form 1040A, lines 26 and 27)	16	—
17	Subtract line 16 from line 15. If line 16 is equal to or more than line 15, stop; you cannot take any education credits	17	12,128 00
18	Tentative minimum tax limit. See instructions for the amount to enter	18	8,912 00
19	Subtract line 18 from line 17. If line 18 is equal to or more than line 17, stop; you cannot take any education credits ►	19	3,216 00
20	**Education credits.** Enter the smaller of line 14 or line 19 here and on Form 1040, line 44 (or Form 1040A, line 29) ►	20	1,250 00

*See Pub. 970 for the amount to enter if you are filing Form 2555, 2555-EZ, or 4563, or are excluding income from Puerto Rico.

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Example 3. Now let's mix up a problem with both the Education Credits and the Child Tax Credits. David and Camille Rivera have four children. Chris, age 7, and Kiki, age 9, are both in grade school. Rich is age 19 and is a college freshman. Lannie is 22 and is a senior. David and Camille paid the following qualified education expenses in 1998:

Rich	$4,000
Lannie	$6,000

David and Camille's total income and AGI is $78,000, and their taxable income is $45,540.

Answer. The Education Credit is reduced from $2,500 to $1,236 due to the AMT. The Child Tax Credit is reduced from $800 to -0- for the same reason. [The AMT limit first reduces the Education Credit and then the Child Care Credit.]

Practitioner note. When your software shows this result don't be surprised.

Example 3

Form 8863 — Department of the Treasury, Internal Revenue Service

Education Credits (Hope and Lifetime Learning Credits)

▶ See instructions.

OMB No. 1545-XXXX — 1998 — Attachment Sequence No. 93

Name(s) shown on return: David & Camille Rivera — Your social security number: 000 00 0000

Proof 8/24/1998

Part I Hope Credit

1 (a) Name of student (First, Last)	(b) Student's social security number	(c) Qualified expenses (but do not enter more than $2,000 for each student). See instructions	(d) Enter the smaller of the amount in column (c) or $1,000	(e) Subtract column (d) from column (c)	(f) Enter one-half of the amount in column (e)
Richard Rivera	000 00 0000	2,000.00	1,000.00	1,000.00	500.00

2 Add the amounts in columns (d) and (f) — 1,000.00 — 500.00

3 Add the amounts on line 2, columns (d) and (f) ▶ 3 — 1,500.00

Part II Lifetime Learning Credit

4 Caution: You cannot take the Hope credit and the lifetime learning credit for the same student.

(a) Name of student (First, Last)	(b) Student's social security number	(c) Qualified expenses (after June 30, 1998). See instructions
Lannie Rivera	000 00 0000	6,000.00

5 Add the amounts on line 4, column (c) and enter the total — 5 — 6,000.00

6 Enter the smaller of line 5 or $5,000 — 6 — 5,000.00

7 Multiply line 6 by 20% (.20) ▶ 7 — 1,000.00

Part III Allowable Education Credits

8 Add lines 3 and 7 — 8 — 2,500.00

9 Enter: $100,000 if married filing jointly; $50,000 if single, head of household, or qualifying widow(er) — 9 — 100,000.00

10 Enter the amount from Form 1040, line 34 (or Form 1040A, line 19)* — 10 — 78,000.00

11 Subtract line 10 from line 9. If line 10 is equal to or more than line 9, stop; you cannot take any education credits — 11 — 22,000.00

12 Enter: $20,000 if married filing jointly; $10,000 if single, head of household, or qualifying widow(er) — 12 — 20,000.00

13 If line 11 is equal to or more than line 12, enter the amount from line 8 on line 14 and go to line 15. If line 11 is less than line 12, divide line 11 by line 12. Enter the result as a decimal (rounded to at least three places) — 13 — ×

14 Multiply line 8 by line 13 ▶ 14 — 2,500.00

15 Enter your tax from Form 1040, line 40 (or Form 1040A, line 25) — 15 — 7,242.00

16 Enter the total, if any, of your credits from Form 1040, lines 41 and 42 (or from Form 1040A, lines 26 and 27) — 16 — —

17 Subtract line 16 from line 15. If line 16 is equal to or more than line 15, stop; you cannot take any education credits — 17 — 7,242.00

* 18 Tentative minimum tax limit. See instructions for the amount to enter — 18 — 6,006.00

19 Subtract line 18 from line 17. If line 18 is equal to or more than line 17, stop; you cannot take any education credits ▶ 19 — 1,236.00

20 **Education credits.** Enter the smaller of line 14 or line 19 here and on Form 1040, line 44 (or Form 1040A, line 29) ▶ 20 — 1,236.00

*See Pub. 970 for the amount to enter if you are filing Form 2555, 2555-EZ, or 4563, or are excluding income from Puerto Rico.

*** The instructions for Form 8863 were not available at the time the book was printed. It appears that line 18 above flows from line 24, Form 6251.**

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Example 3 [Form 6251]

Example 3 | Form 6251 |

Part III — Exemption Amount and Alternative Minimum Tax | Line 21 is $68,100 |

22 **Exemption Amount.** (If this form is for a child under age 14, see page 6 of the instructions.)

If your filing status is . . .	AND line 21 is not over . . .	THEN enter on line 22 . . .
Single or head of household	$112,500	$33,750
Married filing jointly or qualifying widow(er)	150,000	45,000
Married filing separately	75,000	22,500

If line 21 is over the amount shown above for your filing status, see page 6 of the instructions. — 22 | 45,000

23 Subtract line 22 from line 21. If zero or less, enter -0- here and on lines 26 and 28 . . . ▶ 23 | 23,100

24 If you completed Schedule D (Form 1040), and had an amount on line 25 or line 27 (as refigured for the AMT, if necessary), go to Part IV of Form 6251 to figure line 24. All others: If line 23 is $175,000 or less ($87,500 or less if married filing separately), multiply line 23 by 26% (.26). Otherwise, multiply line 23 by 28% (.28) and subtract $3,500 ($1,750 if married filing separately) from the result . . . ▶ 24 | 6,006

25 Alternative minimum tax foreign tax credit. See page 7 of the instructions . . . 25 | —

26 Tentative minimum tax. Subtract line 25 from line 24 . . . ▶ 26 | 6,006

27 Enter your tax from Form 1040, line 40 (minus any tax from Form 4972 and any foreign tax credit from Form 1040, line 46) . . . 27 | 7,242

28 **Alternative Minimum Tax.** Subtract line 27 from line 26. If zero or less, enter -0-. Enter here and on Form 1040, line 51 . . . ▶ 28 | —

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13600G Form **6251**

40 Tax. See page 24. Check if any tax from a ☐ Form(s) 8814 b ☐ Form 4972 — 40 | 7,242

41 Credit for child and dependent care expenses. Attach Form 2441 — 41

42 Credit for the elderly or the disabled. Attach Schedule R — 42

43 Child tax credit (see page 25) — 43

44 Education credits. Attach Form 8863 — 44 | 1,236

Proof as of 8/24/1998

Example 3 Child Tax Credit Worksheet

Child Tax Credit Worksheet—Line 43

▶ Keep for your records. Do Not File

1. $400.00 × 2 (Enter number of qualifying children). Multiply and enter the result . . . 1. 800.00
2. Are you filing Form 2555, 2555-EZ, or 4563, or are you excluding income from Puerto Rico?
   - ☒ No. Enter the amount from Form 1040, line 34.
   - ☐ Yes. Enter your modified AGI (see page 25). . . . 2. 78,000.00
3. Enter: $110,000 if married filing jointly; $75,000 if single, head of household, or qualifying widow(er); $55,000 if married filing separately . . . 3. 110,000.00
4. Is line 2 above more than line 3?
   - ☒ No. Skip lines 4 and 5, enter -0- on line 6, and go to line 7.
   - ☐ Yes. Subtract line 3 from line 2 . . . 4.
5. Divide line 4 by $1,000. If the result is not a whole number, round it up to the next higher whole number (for example, round 0.01 to 1) . . . 5.
6. Multiply $50 by the number on line 5 . . . 6. 0
7. Subtract line 6 from line 1. If zero or less, stop; you cannot take the credit . . . 7. 800.00
8. Enter the amount from Form 1040, line 40 . . . 8. 7,242.00
9. Is line 1 above more than $800?
   - ☒ No. Add the amounts from Form 1040, lines 41, 42, and 44. Enter the total.
   - ☐ Yes. Enter the amount from the worksheet on page 26. . . . 9. 1,236.00
10. Subtract line 9 above from line 8 . . . 10. 6,006.00
11. Enter the smaller of line 7 or line 10 . . . ▶ 11. 800.00
12. Are you reporting tax-exempt interest on Form 1040, line 8b, or are you claiming a net operating loss deduction on Form 1040, line 21?
   - ☒ No. Enter the amount from Form 1040, line 22.
   - ☐ Yes. Enter the total of the amount from Form 1040, line 22, plus any tax-exempt interest from private activity bonds issued after August 7, 1986, and net operating loss deduction. . . . 12. 78,000.00
13. Are you filing Schedule C, C-EZ, E, F, or D (except to report only capital gain distributions)?
   - ☒ No. Go to line 14.
   - ☐ Yes. Complete Form 6251 through line 24, enter that amount on line 20 below, check "Yes" on line 20, and go to line 21.
14. Is line 12 above more than: $45,000 if married filing jointly or qualifying widow(er); $33,750 if single or head of household; $22,500 if married filing separately?
   - ☐ No. Skip lines 15 through 21 and go to line 22.
   - ☒ Yes. Go to line 15.
15. Is line 12 more than: $150,000 if married filing jointly or qualifying widow(er); $112,500 if single or head of household; $75,000 if married filing separately?
   - ☒ No. Go to line 16.
   - ☐ Yes. Complete Form 6251 through line 24, enter that amount on line 20 below, check "Yes" on line 20, and go to line 21.
16. Enter: $45,000 if married filing jointly or qualifying widow(er); $33,750 if single or head of household; $22,500 if married filing separately . . . 16. 45,000.00
17. Subtract line 16 from line 12 . . . 17. 33,000.00
18. Multiply line 17 by 26% (.26) . . . 18. 8,580.00
19. Subtract line 18 from line 10. If zero or less, enter -0- . . . 19. —
20. Is line 11 more than line 19?
   - ☐ No. Skip lines 20 and 21 and go to line 22.
   - ☒ Yes. Complete Form 6251 through line 24 and enter that amount here . . . 20. 6,006.00
21. Subtract line 20 from line 10. If zero or less, enter -0- . . . 21. —
22. Child tax credit.
   - If you checked "No" on line 14 or line 20, enter the amount from line 11 here and on Form 1040, line 43.
   - If you checked "Yes" on line 20, enter the smaller of line 11 or line 21 here and on Form 1040, line 43. If line 21 is the smaller amount, enter "AMT" on the dotted line next to line 43. . . . 22. —

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60. EDUCATIONAL IRAs

[I.R.C. §530]

Notice 97-60

Section 3. Education IRAs. Beginning January 1, 1998, taxpayers may deposit up to $500 per year into an Education IRA for a child under age 18. Parents, grandparents, other family members, friends, and a child him/herself may contribute to the child's Education IRA, **provided that the total contributions for the child during the taxable year do not exceed the $500 limit. Amounts deposited in the account grow tax-free until distributed, and the child will not owe tax on any withdrawal from the account if the child's qualified higher education expenses at an eligible educational institution for the year equal or exceed the amount of the withdrawal.**

If the child does not need the money for postsecondary education, the account balance can be **rolled over** to the Education IRA of certain family members who can use it for their higher education. Amounts withdrawn from an Education IRA **that exceed** the child's qualified higher education expenses in a taxable year are generally subject to income tax and to an additional tax of 10%. **The Hope Scholarship Credit and Lifetime Learning Credit may not be claimed for a student's expenses in a taxable year in which the student takes a tax-free withdrawal from an Education IRA.**

Key Point ☞ **Q1.** *What is an Education IRA?*

A1. An Education IRA is a trust or custodial account that is created or organized in the United States exclusively for the purpose of paying the qualified higher education expenses of the designated beneficiary of the account. The account must be designated as an Education IRA when it is created in order to be treated as an Education IRA for tax purposes.

Key Point ☞ **Q2.** *For whom may an Education IRA be established?*

A2. An Education IRA may be established for the benefit of any child under age 18. Contributions to the Education IRA will not be accepted **after the designated beneficiary reaches his/her 18th birthday.**

Key Point ☞ **Q3.** *Where may an individual open an Education IRA?*

A3. An individual may open an Education IRA with any bank, or other entity that has been approved to serve as a nonbank trustee or custodian of an individual retirement account (IRA), and the bank or entity is offering Education IRAs. Other entities that wish to offer Education IRAs but are not approved to serve as IRA trustees or custodians may seek approval by following the same IRS procedures used for approval of other IRA nonbank trustees. See Notice 97-57, 197-43 I.R.B. 19 (October 27, 1997).

Key Point ☞ **Q4.** *When may a taxpayer start contributing to an Education IRA for a child?*

A4. A taxpayer may start making contributions on January 1, 1998, or at any time thereafter.

Key Point ☞ **Q5.** *How much may be contributed to a child's Education IRA?*

A5. Up to $500 per year in aggregate contributions may be made for the benefit of any child. The contributions may be placed in a single Education IRA or in multiple Education IRAs.

Key Point ☞ **Q6.** *What happens if more than $500 is contributed to an Education IRA on behalf of a child in a calendar year?*

A6. Aggregate contributions for the benefit of a particular child in excess of $500 for a calendar year are treated **as excess contributions.** If the excess contributions (and any earnings attributable to them) **are not withdrawn** from the child's account (or accounts) **before the tax return for the year is due,** the excess contributions are subject to a 6% excise tax for each year the excess amount remains in the account.

Key Point ☞ **Q7.** *May contributions other than cash be made to a child's Education IRA?*

A7. **No.** Education IRAs are permitted to accept contributions made in cash only.

Key Point ☞ **Q8.** *May contributors take a deduction for contributions made to an Education IRA?*

A8. **No.**

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Key Point ☞ **Q9.** *Are there any restrictions on who can contribute to an Education IRA?*

A9. Any individual may contribute up to $500 to a child's Education IRA **if the individual's modified adjusted gross income for the taxable year is no more than $95,000 ($150,000 for married taxpayers filing jointly).** (See Sec. 1, Q&A6 for a description of modified adjusted gross income.) The $500 maximum contribution per child is gradually reduced for individuals with modified adjusted gross income between $95,000 and $110,000 (between $150,000 and $160,000 for married taxpayers filing jointly). For example, an unmarried taxpayer with modified adjusted gross income of $96,500 in a taxable year could make a maximum contribution per child of $450 for that year. Taxpayers with modified adjusted gross income above $110,000 ($160,000 for married taxpayers filing jointly) cannot make contributions to anyone's Education IRA.

Key Point ☞ **Q10.** *May a child contribute to his/her own Education IRA?*

A10. **Yes.**

Key Point ☞ **Q11.** *Does a taxpayer have to be related to the designated beneficiary in order to contribute to the designated beneficiary's Education IRA?*

A11. **No.**

Key Point ☞ **Q12.** *How many Education IRAs may a child have?*

A12. There is no limit on the number of Education IRAs that may be established designating a particular child as beneficiary. **However, in any given taxable year the total aggregate contributions to all the accounts designating a particular child as beneficiary may not exceed $500.**

Key Point ☞ **Q13.** *May a designated beneficiary take a tax-free withdrawal from an Education IRA to pay qualified higher education expenses if the designated beneficiary is enrolled less than full-time at an eligible educational institution?*

A13. **Yes.** Whether the designated beneficiary is enrolled full-time, half-time, or less than half-time, he/she may take a tax-free withdrawal to pay qualified higher education expenses.

Key Point ☞ **Q14.** *What happens when a designated beneficiary withdraws assets from an Education IRA to pay for college?*

A14. Generally, the withdrawal is tax-free to the designated beneficiary to the extent the amount of the withdrawal does not exceed the designated beneficiary's qualified higher education expenses.

Key Point ☞ **Q15.** *What are "qualified higher education expenses?"*

A15. "Qualified higher education expenses" mean expenses for tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the designated beneficiary at an eligible educational institution. Qualified higher education expenses also include amounts contributed to a qualified state tuition program. **Qualified higher education expenses also include room and board** (generally the school's **posted room and board charge, or $2,500 per year for students living off-campus and not at home)** if the designated beneficiary is at least a **half-time student** at an eligible educational institution. The standards for determining whether a student is enrolled at least half-time are the same as those used for the **Hope Scholarship Credit.** (See Sec. 1, Q&A3.)

Q16. *What is an eligible educational institution?*

A16. An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution that is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088) and, therefore, eligible to participate in the student aid programs administered by the Department of Education. This category includes virtually all accredited public, nonprofit, and proprietary postsecondary institutions. (The same eligibility requirements for institutions apply for the Hope Scholarship Credit, the Lifetime Learning Credit, and early withdrawals from IRAs for qualified higher education expenses. (See Sec. 1, Q&A4, Sec. 2, Q&A3, and Sec. 4, Q&A2.))

Key Point ☞ **Q17.** *What happens if a designated beneficiary withdraws an amount from an Education IRA but does not have any qualified higher education expenses to pay in the taxable year he/she makes the withdrawal?*

15

A17. Generally, if a designated beneficiary withdraws an amount from an Education IRA and does not have any qualified higher education expenses during the taxable year, **a portion of the distribution is taxable.** The taxable portion is the portion that represents earnings that have accumulated tax-free in the account. The taxable portion of the distribution is also subject to a 10% additional tax unless an exception applies.

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Key Point ☞ **Q18.** *Is a distribution from an Education IRA taxable if the distribution is contributed to another Education IRA?*

A18. Any amount distributed from an Education IRA and rolled over to another Education IRA for the benefit of the same designated beneficiary or certain members of the designated beneficiary's family **is not taxable.** An amount is rolled over if it is paid to another Education IRA on a date within 60 days after the date of the distribution. Members of the designated beneficiary's family include the designated beneficiary's children and their descendants, stepchildren and their descendants, siblings and their children, parents and grandparents, stepparents, and spouses of all the foregoing. The $500 annual contribution limit to Education IRAs does not apply to these rollover contributions. For example, an older brother who has $2,000 left in his Education IRA after he graduates from college can roll over the full $2,000 balance to an Education IRA for his younger sister who is still in high school without paying any tax on the transfer.

Key Point ☞ **Q19.** *What happens to the assets remaining in an Education IRA after the designated beneficiary finishes his/her postsecondary education?*

A19. **There are two options.** The amount remaining in the account may be withdrawn for the designated beneficiary. The designated beneficiary will be subject to both income tax and the additional 10% tax on the portion of the amount withdrawn that represents earnings if the designated beneficiary does not have any qualified higher education expenses in the same taxable year he/she makes the withdrawal. **Alternatively,** if the amount in the designated beneficiary's Education IRA is withdrawn and rolled over (as described in Q&A18 of this section) to another Education IRA for the benefit of a member of the designated beneficiary's family, the amount rolled over will **not be taxable.**

Key Point ☞ **Q20.** *Rather than rolling over money from one Education IRA to another, may the designated beneficiary of the account be changed from one child to another without triggering a tax?*

A20. **Yes,** provided: (1) the terms of the particular trust or custodial account permit a change in designated beneficiaries (each trustee or custodian will control whether options like this one are available in the accounts they offer), and (2) the new designated beneficiary is a member of the previous designated beneficiary's family. (See Q&A18 in this section.)

Key Point ☞ **Q21.** *May a student or the student's parents claim the Hope Scholarship Credit or Lifetime Learning Credit for the student's expenses in a taxable year in which the student receives money from an Education IRA on a tax-free basis?*

A21. **No. If a student is receiving a tax-free distribution from an Education IRA in a particular taxable year, none of that student's expenses may be claimed as the basis for a Hope Scholarship Credit or Lifetime Learning Credit for that year.** However, the student may waive the tax-free treatment of the Education IRA distribution and elect to pay any tax that would otherwise be owed on an Education IRA distribution so that the student or the student's parents may claim a Hope Scholarship Credit or Lifetime Learning Credit for expenses paid in the same year the Education IRA distributions are received.

Q22. *May contributions be made to both a qualified state tuition program and an Education IRA on behalf of the same designated beneficiary in the same taxable year?*

A22. No. Any amount contributed to an Education IRA on behalf of a designated beneficiary during any taxable year in which an amount is also contributed to a qualified state tuition program on behalf of the same beneficiary will be treated as an excess contribution to the Education IRA. (See Q&A6 in this section for the treatment of excess contributions.)

Educational IRAs: "1998 Tax Bill"

The technical corrections bill of 1998 clarified the following points with respect to educational IRAs.

1. Any balance remaining in an education IRA will be deemed to be distributed within 30 days after the date that the designated beneficiary **reaches age 30** (or, if earlier, within 30 days of the date that the beneficiary dies).
2. In the event of the death of the designated beneficiary, the balance remaining in an education IRA may be distributed **(without imposition of the additional 10% tax)** to any other beneficiary (i.e., contingent) or to the estate of the deceased designated beneficiary. (If any member of the family of the deceased beneficiary becomes the new designated beneficiary of the education IRA, then no tax or penalty will be imposed on such redesignation and the account will continue to be treated as an education IRA.)

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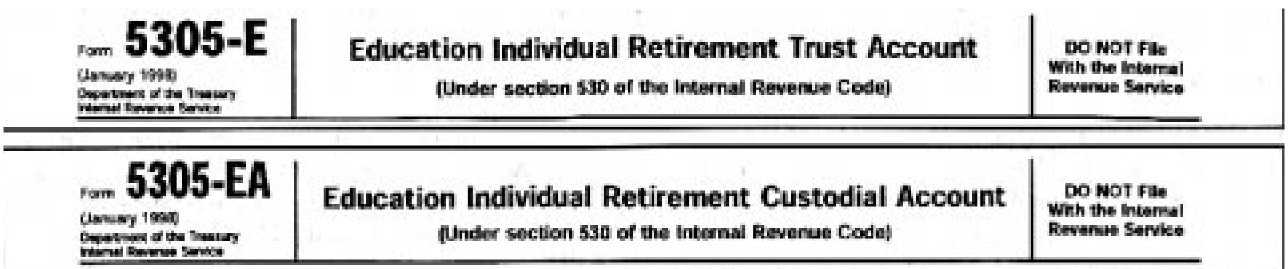
3. The 10% penalty **will not apply** to a distribution from an educational IRA which is taxable due to the taxpayer's election to claim the Hope or Lifetime Learning credit with respect to the beneficiary.
4. The 10% penalty **will not apply** to the distribution of any contribution to an education IRA made during a taxable year if such distribution is made on or before the date that a return is required to be filed (including extensions) by the beneficiary for the taxable year during which the contribution was made (if no return was required by April 15th of the following year).
5. The excess contribution penalty applies for each year that an excess contribution remains in an education IRA **(and not merely the year that the excess contribution is made).**
6. In order for taxpayers to establish an education IRA, the designated beneficiary must be a "life-in-being."
7. Distributions from education IRAs are treated as representing a pro-rata share of the principal (nondeductible contributions) and accumulated earnings in the account. **(No first in first out as in Roth IRAs.)**
8. If any qualified higher education expenses are taken into account for determining the exclusion for distributions from an education IRA, then those same higher education expenses **do not** qualify for–
   a. Deductions under §162 (trade or business) or any other section, or
   B. Exclusion under §135 (Savings Bond interest), or
   C. Credits (Education Credits).
9. The bill conforms the definition of "eligible education institution" under §135 (Savings Bond interest) to the broader definition of that term under present law §530 (Education IRAs) and §529 (Qualified State tuition programs).

Note: Several tax forms and instructions need to be studied.


Form 5305-E (January 1998) Department of the Treasury Internal Revenue Service — Education Individual Retirement Trust Account (Under section 530 of the Internal Revenue Code) — DO NOT File With the Internal Revenue Service

Form 5305-EA (January 1998) Department of the Treasury Internal Revenue Service — Education Individual Retirement Custodial Account (Under section 530 of the Internal Revenue Code) — DO NOT File With the Internal Revenue Service

61. DEDUCTION FOR INTEREST ON EDUCATION LOANS

[New I.R.C. §221]

Notice 97-60

Student Loan Interest Deduction. Beginning January 1, 1998, taxpayers who have taken loans to pay the cost of attending an eligible educational institution for themselves, their spouse, or their dependent generally may deduct interest they pay on these student loans. **The maximum deduction each taxpayer is permitted to take increases from $1,000 in 1998 to $2,500 in 2001 and thereafter.** The following table summarizes the yearly increases.

Year	Maximum Deduction
1998	$1,000
1999	$1,500
2000	$2,000
2001 and thereafter	$2,500

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The deduction is available only for interest payments made during the first 60 months in which interest payments are required on the loan. The student loan interest deduction is available for interest payments due and made on or after January 1, 1998. Thus, the first time taxpayers will be able to claim the deductions is when they file their 1998 tax returns in 1999. No student loan interest deduction will be allowed for interest due or paid before 1998.

Section 3

Key Point ☞ Q1. *Are there limits on what qualifies as a student loan?*

A1. Yes. The loan must have been used to pay the costs of attendance at an eligible educational institution for a student enrolled at least half-time in a program leading to a degree, certificate, or other recognized educational credential. An eligible education institution is any college, university, vocational school, or other postsecondary educational institution that is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088) and, therefore, eligible to participate in the student aid programs administered by the Department of Education. This category includes virtually all accredited public, nonprofit, and proprietary postsecondary institutions. For purposes of the student loan interest deduction, eligible educational institutions also include institutions that conduct an internship or residency program leading to a degree or certificate awarded by an institution of higher education, a hospital, or a health care facility that offers postgraduate training.

Key Point ☞ Q2. *Is a student loan interest deduction available if the student loan is not federally guaranteed or otherwise subsidized?*

A2. Yes. As long as the loan was used to pay the costs of attendance at an eligible educational institution and the other eligibility requirements are met, the deduction is available for the interest on the loan. The deduction does not depend on whether the loan is federally guaranteed or subsidized.

Key Point ☞ Q3. *What costs are included in the costs of attendance?*

A3. Costs of attendance include all items that are included in costs of attendance for purposes of calculating a student's financial need in accordance with the Higher Education Act. Thus, they include tuition, fees, **room, board,** books, equipment, and other necessary expenses, such as transportation. Costs of attendance include more items than are included in qualified tuition and related expenses for purposes of the Hope Scholarship and Lifetime Learning Credits. (See Sec. 1, Q&A5 and Sec. 2, Q&A10.)

Key Point ☞ Q4. *Is the deduction available for interest paid on loans used to pay for graduate school?*

A4. Yes.

Key Point ☞ Q5. *Are there any limits on who may take the student loan interest deduction?*

A5. Yes, there are income restrictions. To claim the maximum deduction, a taxpayer must have modified adjusted gross income of $40,000 or less ($60,000 for married taxpayers filing jointly). The amount of the taxpayer's deduction is gradually reduced for taxpayers with modified adjusted gross income between $40,000 and $55,000 (between $60,000 and $75,000 for married taxpayers filing jointly). For example, for 1998, the maximum deduction that a single taxpayer with modified adjusted gross income of $47,500 could take would be $500. Taxpayers with modified adjusted gross income above $55,000 ($75,000 for married taxpayers filing jointly) may not claim the student loan interest deduction. The modified adjusted gross income limitations are indexed for inflation after 2002.

Key Point ☞ Q6. *May former students whose loans are already in repayment deduct the interest they pay on a student loan on or after January 1, 1998?*

A6. Yes, but they may deduct only those payments made during the first 60 months that interest payments are required on a loan. If interest payments on a student loan were first required before January 1, 1998, the months in which those payments were required count against the 60-month time limit for that loan. The 60-month period may run out at different times for different loans.

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Key Point **Q7.** *May a parent claim the student loan interest deduction if the parent borrows to pay his/her child's costs of attending college?*

A7. **Yes.** An individual may claim the student loan interest deduction if the individual borrows money to pay the costs of attending college for certain members of the individual's family or household (including his/her children) and incurs the debt in a year in which the individual supplies more than half of the student's support.

Q8. *If an individual has paid more than $1,000 in interest on student loans in 1998 and is otherwise eligible to take the maximum student loan interest deduction, how large a deduction may the individual claim?*

A8. The individual's student loan interest deduction for 1998 is $1,000, provided the individual's modified adjusted gross income falls below the point where the deduction is reduced or eliminated.

Key Point **Q9.** *Does an individual have to itemize his/her income tax deductions to claim the student loan interest deduction?*

A9. **No.** The student loan interest deduction is available regardless of whether an individual elects to take the standard deduction or to itemize deductions. Instructions accompanying the 1998 tax forms (for returns required to be filed in 1999) will explain how to compute and claim the deduction.

Key Point **Q10.** *If a student is claimed as a dependent by his/her parent in a particular taxable year, may the student take the student loan interest deduction for student loan interest that he/she pays in that year?*

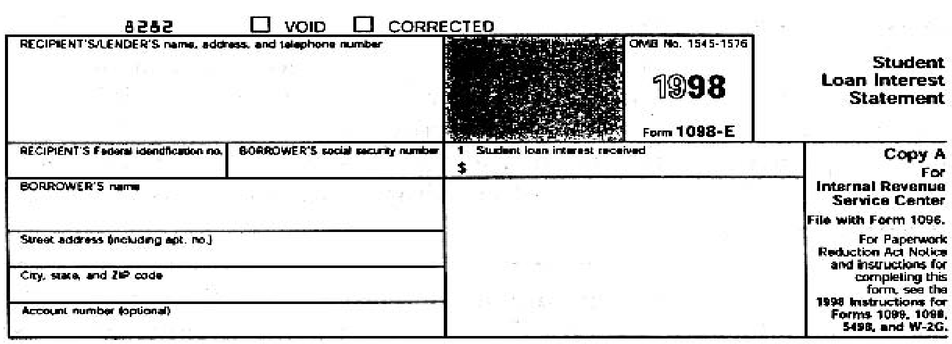
A10. **No.** The student may not claim the student loan interest deduction in any taxable year in which he/she is claimed as a dependent on another taxpayer's Federal income tax return. However, if the student continues to pay interest on a student loan and meets the other eligibility requirements, the student may claim the student loan interest deduction for payments made in a later year when the student is no longer a dependent on his/her parent's Federal income tax form.

Q11. *Are there any tax benefits available if the student repays his/her loan by performing community service rather than making cash payments?*

A11. There may be. Loan forgiveness provided in return for community service is tax-free when it is part of certain lending programs run by Federal, state, or local governments, educational institutions, or charitable organizations. Students should consult a tax advisor to determine whether they qualify.

Information Reporting Relating to Student Loan Interest.

Sec. 6050S(a) requires information reporting by any person engaged in a trade or business who, in the course of that trade or business, receives from any individual interest aggregating $600 or more for any calendar year on one or more qualified education loans.



8282 VOID CORRECTED

RECIPIENT'S/LENDER'S name, address, and telephone number

OMB No. 1545-1576

1998

Form 1098-E

Student Loan Interest Statement

RECIPIENT'S Federal identification no. | BORROWER'S social security number

1 Student loan interest received $

BORROWER'S name

Street address (including apt. no.)

City, state, and ZIP code

Account number (optional)

Copy A For Internal Revenue Service Center

File with Form 1096.

For Paperwork Reduction Act Notice and instructions for completing this form, see the 1998 Instructions for Forms 1099, 1098, 5498, and W-2G.

"The 1998 Tax Act" clarifies that the student loan interest deduction may be claimed only by a taxpayer who is "legally obligated" to make the interest payments pursuant to the terms of the loan.

In addition, a "qualified education loan" means any indebtedness incurred ***solely*** **to pay qualified higher education expenses. Thus, revolving lines of credit generally would not constitute qualified education loans unless the borrower agreed to use the line of credit to pay** ***only*** **qualifying education expenses.**

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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.

Act

Qualified State Tuition Programs. The Act makes the following modifications to old-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".

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 **[as clarified by "The 1998 Act"].**

D. Prohibition against investment direction. The Act clarifies the rule contained in §529(b)(5) that qualified state tuition programs **may not allow contributors or designated beneficiaries to direct the investment of contributions to the program** (or earnings thereon) by specifically providing that contributors and beneficiaries **may not "directly or indirectly" direct** the investment of contributions to the program (or earnings thereon).

E. Interaction with HOPE credit and Lifetime Learning credit.

1. Under the Act, **no amount** will be **includable** 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.

Note: Interesting estate planning opportunities!

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

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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.

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).

2. 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.**
3. **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 transfers to the beneficiary each year without a gift tax return filing requirement.
4. Under this rule, a donor may contribute up to $50,000 every five years ($100,000 in the case of a married couple) with no gift tax filing consequences, assuming no other gifts are made from the donor to the beneficiary in the five-year period.
5. 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.**
6. 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.
7. **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.
8. 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.

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]

Act. 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.**

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Qualified long-term family assistance recipients are defined in §51A

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: **There are special rules for agricultural and 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 that 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)].


Form 8861
Department of the Treasury
Internal Revenue Service
Welfare-to-Work Credit
► Attach to your return.
OMB No. 1545-1569
1998
Attachment
Sequence No. 107

64. MODIFIED GENERAL BUSINESS CREDIT CARRYBACK AND CARRYFORWARD RULES

[I.R.C. §39]

Old Law. A qualified taxpayer was allowed to claim the general business credit subject to certain limitations based on tax liability for the year. **Unused general business credits generally could 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]

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

Old Law

- The partnership taxable year closed with respect to a partner whose entire interest was sold, exchanged, or liquidated. **Such year, however, generally did not close upon the death of a partner.**

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- Thus, a decedent's entire share of items of income, gain, loss, deduction, and credit for the partnership year in which death occurred was 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).]

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

The Act. 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.**

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]

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

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.

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)]

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

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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. **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%. **[As clarified by the "1998 Act"].**

The Amended §32 Code Language (Act) [As Amended by "The 1998 Act"]

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

70. WORKFARE PAYMENTS—EARNED INCOME CREDIT

[I.R.C. §32(c)(2)(B)(v)] [As corrected and clarified by **"The 1998 Act"**]

Effective Date. Tax years after December 31, 1997.

Workfare payments are not considered to be earned income for any Earned Income Credit purpose.

71. SECTION 1045: ROLLOVER OF GAIN FROM QUALIFIED SMALL BUSINESS STOCK TO ANOTHER QUALIFIED SMALL BUSINESS STOCK

Rev. Proc. 98-48

Section 4. Effective Date. This revenue procedure is effective for sales of QSB stock occurring after August 5, 1997.

Section 1. Purpose. This revenue procedure provides procedures for taxpayers to make an election under §1045 of the Internal Revenue Code ("§1045 election") to defer recognition of certain gain on the sale of qualified small business stock ("QSB stock").

Section 2. Background

.01. Sec. 1045(a), **amended by "The 1998 Act",** generally allows a taxpayer other than a C corporation to elect **not to recognize** gain from the sale of QSB stock held by the taxpayer for **more than six months. If the taxpayer makes the election under §1045 and this revenue procedure, gain from such sale is recognized only to the extent that the amount realized on the sale exceeds:**

(1) the cost of any QSB stock that the taxpayer purchases during the 60-day period beginning on the date of sale, **reduced by**

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(2) any portion of the cost of the replacement QSB stock that was previously taken into account under §1045. However, the election is not available to defer any gain on the sale that is treated as ordinary income for purposes of the Code.

.02. Under §1045(b), "qualified small business stock" has the same meaning as provided in §1202(c).

.03. Sec. 1045(b)(5) provides that, for QSB stock held through passthrough entities, rules similar to the rules of §1202(g) apply for purposes of §1045.

Section 3. Procedure

Key Point ☞ .01 *Time for Making the Election.* **A §1045 election must be made on or before the later of December 31, 1998, or the due date (including extensions) for filing the income tax return for the taxable year in which the QSB stock is sold.**

.02 *Manner of Making the Election.* **(1)** *In general.* Except as provided in §3.02(2) of this revenue procedure, the election is made by:

- **a.** reporting the entire gain from the sale of QSB stock on Schedule D, Capital Gains and Losses, of the return in accordance with the instructions for Schedule D;
- **B.** writing "sec. 1045 rollover" directly below the line on which the gain is reported; and
- **C.** entering the amount of the gain deferred under §1045 on the same line as (b) above, as a loss, in accordance with the instructions for Schedule D.

(2) *Transition rule.* If gain is reportable on a return filed before October 21, 1998, and the return does not satisfy the requirements of §3.02(1) of this revenue procedure but discloses the gain and includes an affirmative statement to the effect that a §1045 election applies to the gain, the requirements of §3.02(1) will be treated as satisfied and an amended return **is not required** to make the §1045 election. Otherwise, an original or amended return satisfying the requirements of §3.02(1) of this revenue procedure is required to make the §1045 election with respect to such gain.

.03 *Scope of the Election.* If a person has more than one sale of QSB stock in a taxable year that qualifies for the §1045 election, the person may make a §1045 election **for any one or more of those sales.**

.04 *Revocation.* A §1045 election is revocable only with the prior written consent of the Commissioner. To obtain the Commissioner's consent, the person who made the §1045 election must submit a request for a private letter ruling in accordance with the provisions of Rev. Proc. 98-1, 1998-1 IRB 7 (or its successor).

ESTIMATED TAX

72. DE MINIMIS THRESHOLD FOR ESTIMATED TAX INCREASED TO $1,000 FOR INDIVIDUALS

[I.R.C. §6654]

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

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

73. ESTIMATED TAX—SAFE HARBOR TESTS

[I.R.C. §6654 and §6655]

Old Law. An individual generally **did not have an underpayment of estimated tax** penalty if he or she made 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.

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[The "100% of last year's liability safe harbor" **was 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.]**

Act. 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.**]

MISCELLANEOUS

74. ASSOCIATIONS OF HOLDERS OF TIMESHARE INTERESTS TO BE TAXED LIKE OTHER HOMEOWNERS ASSOCIATIONS

[I.R.C. §528]

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

Explanation of Act. The Act amends §528 (homeowners associations) to permit timeshare associations to qualify for taxation under that section at a rate of 32%.

75. TEMPORARY SUSPENSION OF TAXABLE INCOME LIMIT ON PERCENTAGE DEPLETION FOR MARGINAL PRODUCTION

[I.R.C. §613A]

Explanation of Act. 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.

76. EARNED INCOME CREDIT—IDENTIFICATION REQUIREMENTS

[IRC §32(c)(1)(F) and (G) and §32(c)(3)(A) and (D)]

As provided by **"The 1998 Act"**

1. A child is a qualifying child even though the identification requirement is not met.
2. However, the child is not taken into account for purposes of claiming the credit.

[Effective for returns due after September 21, 1996, for **eligibility** and December 31, 1998, for who is a **qualifying child.**]

Practitioner Note: This would change the result of the case discussed on page 433 of this book.

77. NET OPERATING LOSSES

The Taxpayer Relief Act of 1997 reduced the carryback period for most NOLs from three years to two and increased the carryforward period from 15 to 20 years. These changes are effective for NOLs that arise in tax years beginning **after August 5, 1997**. Therefore, the changes are effective for calendar year taxpayers **beginning in 1998.**

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EXCEPTIONS TO THE TWO-YEAR CARRYBACK

The TRA of 1997 **retained** the three-year carryback for the portion of the NOL that is an "eligible loss." An eligible loss includes:

1. Personal (as opposed to business) losses from fire, storm, shipwreck, or other casualty or from theft.
2. Losses attributable to a Presidentially declared disaster area for:
   a. A farming business.
   B. Corporations, partnerships, limited liability companies, and sole proprietorships that have no more than $5,000,000 of annual average gross receipts for each three-taxable-year period ending after December 31, 1985.

PROCEDURE AND FILING

78. REPORTING OF CERTAIN PAYMENTS MADE TO ATTORNEYS

[I.R.C. §6045]

Effective Date. The provision is effective for payments made **after December 31, 1997.**

Explanation of Act. **The Act 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.**

- **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 is known that the entire payment represents the settlement with the client (and therefore no portion of it represents income to the attorney).

ALTERNATIVE MINIMUM TAX

79. REPEAL OF THE ALTERNATIVE MINIMUM TAX FOR SMALL BUSINESSES AND REPEAL OF THE DEPRECIATION ADJUSTMENT FOR AMT PURPOSES

[I.R.C. §55(e)(1) and 56]

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Explanation of Act [As amended by "The 1998 Act"]

Repeal of the Corporate Alternative Minimum Tax for Small Businesses. The corporate alternative minimum tax is repealed for certain small business corporations for taxable years beginning **after December 31, 1997. Practitioner Note:** the $5 million test is substituted for the $7.5 test only in certain circumstances. See the code section.

A corporation that had average gross receipts of less than $5 million for **each of the** three-year periods beginning **after December 31, 1993,** is a small business corporation for the 3 taxable years after that date.

After the 3 years it is exempt from the alternative minimum tax so long as its average gross receipts for each of the applicable years **does 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.**

80. DEPRECIATION METHOD—AMT AND MACRS

Very important Practitioner Note: "The 1998 Act" allows a taxpayer to elect to use AMT depreciation for regular tax purposes using the regular tax life instead of the alternate depreciation lives of the ADS for assets placed in service after 1998.

The Act

Act §6006(b). Election to use AMT depreciation for regular tax purposes:
[Code §168(c)(227)]

Present Law. For regular tax purposes, depreciation deductions for certain shorter-lived tangible property may be determined using the 200% declining balance method over 3-, 5-, 7-, or 10-year recovery periods (depending on the type of property). **For alternative minimum tax ("AMT") purposes, depreciation on such property placed in service after 1986 and before 1999 is computed by using the 150% declining balance method over the longer class lives prescribed by the alternative depreciation system of §168(g).** A taxpayer may elect to use the methods and lives applicable to AMT depreciation for regular tax purposes.

Practitioner Note Continued:
The 1997 Act conformed the recovery periods (but not the methods) used for purposes of the AMT depreciation to the recovery periods used for purposes of the regular tax, for property placed in service **after 1998.** The 1997 Act did not make a conforming change to the election to use the pre-1998 AMT recovery methods and recovery periods for regular tax purposes.

Explanation of Provision. For property placed in service after 1998, a taxpayer would be allowed to elect, for regular tax purposes, to compute depreciation on tangible personal property otherwise qualified for the 200% declining balance method by using the **150% declining balance method over the recovery periods applicable to the regular tax (rather than the longer class lives of the alternative depreciation system of §168(g)) to avoid an AMT adjustment. (Straight-line depreciation can still be claimed for regular tax purposes over the regular life for assets placed in service after 1998.)**

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