NEW TAX LEGISLATION

PART 1: 2000 TAX LEGISLATION

FSC REPEAL AND EXTRATERRITORIAL INCOME EXCLUSION ACT OF 2000

In response to recent World Trade Organization (WTO) dispute settlement decisions, the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 repeals the provisions of the Internal Revenue Code relating to foreign sales corporations (FSCs). To comply with this WTO decision and to prevent U.S. workers and companies from being disadvantaged, the Act reforms current tax rules to exclude certain extraterritorial income from gross income. As under a territorial tax system, taxpayers with certain foreign trade income avoid double taxation of income through an exemption from U.S. taxation (rather than through a foreign tax credit relating to such income).

The Act generally applies to transactions after September 30, 2000. No new FSCs can be formed after September 30, 2000, and a limited transition period applies to existing FSCs.

INSTALLMENT TAX CORRECTION ACT OF 2000

H.R. 3594, the Installment Tax Correction Act of 2000, repeals the ban on using the installment method of accounting that was enacted in the Ticket to Work and Work Incentives Improvement Act of 1999. That ban prohibited accrual method taxpayers from using the installment method of accounting. The repeal of the ban is effective with respect to sales and other dispositions occurring on or after December 16, 1999—the effective date of the ban. Therefore, the Internal Revenue Code is to be applied and administered as if the ban had not been enacted.

COMMUNITY RENEWAL TAX RELIEF AND MEDICAL SAVINGS ACCOUNTS ACT OF 2000

On December 21, 2000, President Clinton signed H.R. 4577, Consolidated Appropriations Act 2001, which incorporates by reference, H.R. 5662, Community Renewal Tax Relief and Medical Savings Accounts Act of 2000 (Act). The Act includes the following provisions:

Extension of Certain Provisions

Act §§165, 201, and 202
[I.R.C. §170(e)(b) and 220]
Effective Date: The MSA provision is effective on December 21, 2000. The deduction for donation of computer technology provision is effective for contributions made after December 31, 2000.

- MSAs are renamed Archer MSAs and are extended through 2002.
- The enhanced deduction for donations of computer technology is broadened and extended through 2003.

The Act extends the following provisions:

1. Medical Savings Accounts. The Act extends the MSA program through 2002. The same rules that apply to the limit on MSAs for 1999 apply to 2000 and 2001. Thus, for example, the threshold level in those years is 750,000 taxpayers. MSAs are renamed as Archer MSAs.
2. Donations of Computer Technology. The Act extends the current enhanced deduction for donations of computer technology and equipment through December 31, 2003, and expands the enhanced deduction to include donations to public libraries. The Act provides that qualified contributions include gifts made no later than three years after the date the taxpayer acquired or substantially completed the construction of the donated property. Contributions may be made by a person that has reacquired the property (i.e., if a computer manufacturer reacquires the computer from the original user and then contributes it). Such reacquired property must be contributed within three years of the date the original construction of the property was substantially completed.

Capital Gain Election in 2001

Act §134(c)
[No change to I.R.C.]
Effective Date: Tax years ending after May 6, 1997.

> The election to recognize gain and start a new 5-year period for the 18% capital gains rate does not apply to property sold within one year of the election.

Taxpayers can elect to start a new holding period for recognized gain on assets held on January 1, 2001, in order to qualify for the 18% maximum capital gains rate on a subsequent sale. The election requires the taxpayer to recognize the gain as if the asset had been sold on January 1, 2001, for its fair market value. The taxpayer is treated as acquiring the asset on the same date for its fair market value. Consequently, the holding period begins after December 31, 2000, which qualifies the asset for the 18% maximum capital gains rate under I.R.C. §1(h), if the taxpayer holds the asset for more than five years. (This provision applies to capital assets and assets held for use in a trade or business.) See I.R.C §311(e) of Taxpayer Relief Act of 1997, discussed in the Investment Chapter at page 189.

The Act provides that an election to recognize gain or loss made pursuant to I.R.C. §311(e) of the Taxpayer Relief Act of 1997 does not apply to assets disposed of in a recognition transaction within one year of the date the election would otherwise have been effective. Thus, for example, if an asset is sold in 2001, no election may be made with respect to that asset. In addition, it is clarified that the deemed sale and repurchase by reason of the election is not taken into account in applying the wash-sale rules of I.R.C. §1091.

Example 1. Ben Plotten purchased 15 acres of land in 1995 for $20,000. On January 1, 2001, the land was worth $75,000. The county made some zoning changes on June 1, 2001, that reduced the value of the 15 acres to $50,000. Ben sold the land to a developer for $50,000. During 2001, Ben also realized a $25,000 short-term capital gain on the sale of some stock.

If Ben were allowed to make the mark-to-market election on the 15 acres of land to recognize the $55,000 of gain on January 1, 2001, increase his basis to $55,000 and start a new holding period, he would report the following on his 2001 income tax return:

Short-term transactions	
Short-term capital loss from sale of land: $50,000 – $75,000 =	$(25,000)
Short-term capital gain from sale of stock:	$ 25,000
Net short-term capital gain or (loss)	–0–
Long-term transactions	
Long-term capital gain from mark-to-market election: $75,000 – $20,000 =	$ 55,000
Net long-term capital gain	$ 55,000

However, the new legislation prohibits Ben from making the mark-to-market election. Therefore, he must report the following on his 2001 income tax return:

Short-term transactions	
Short-term capital gain from sale of stock:	$ 25,000
Net short-term gain or (loss)	$ 25,000
Long-term transactions	
Long-term capital gain from sale of land: $50,000 – $20,000 =	$ 30,000
Net long-term capital gain	$ 30,000

9

Innocent Spouse Rules

Act §313
[I.R.C. §6015]
Effective Date: December 21, 2000.

> Rules regarding the timing of requests and filings, jurisdiction of the courts, waiver of final determination, collection actions, and installment agreements are modified.

The Act makes several changes to the innocent spouse rules, including numerous technical corrections.

Timing of Request for Relief

To clear up confusion as to the appropriate point at which a request for innocent spouse relief should be made by the taxpayer and considered by the IRS, the Act clarifies the intended time by permitting the election under I.R.C. §6015(b) and (c) to be made at any point after a deficiency has been asserted by the IRS. The IRS is considered to have asserted a deficiency at the time it states that additional taxes may be owed. Most commonly, this occurs during the Examination process. It does not require an assessment to have been made, nor does it require the exhaustion of administrative remedies in order for a taxpayer to be permitted to request innocent spouse relief.

The consideration of innocent spouse relief requires that the IRS focus on the particular items causing a deficiency; until such items are identified, the IRS cannot consider these claims. Congress did not intend that taxpayers be prohibited from seeking innocent spouse relief until after an assessment has been made; Congress intended the proper time to raise and have the IRS consider a claim to be at the same point where a deficiency is being considered and asserted by the IRS. This is the least disruptive for both the taxpayer and the IRS since it allows both to focus on the innocent spouse issue while also focusing on the items that might cause a deficiency. It also permits every issue, including the innocent spouse issue, to be resolved in a single administrative and judicial process.

Allowance of Refunds

The prior placement in the statute of the provision for allowance of refunds may inappropriately suggest that the provision applies only to the United States Tax Court, whereas it was intended to apply administratively and in all courts. The Act clarifies this by moving the provision to its own subsection.

Nonexclusivity of Judicial Remedy

Some have suggested that the IRS Restructuring Act administrative and judicial process for innocent spouse relief was intended to be the exclusive avenue by which relief could be sought. The Act clarifies Congressional intent that the procedures of I.R.C. §6015(e) were intended to be additional, nonexclusive avenues by which innocent spouse relief could be considered.

Time for Filing a Petition With the Tax Court

Under prior legislation, the time period for seeking a redetermination in the Tax Court of innocent spouse relief begins on the date of the determination, as opposed to the day after the determination. This period is one day shorter than that generally applicable to petition the Tax Court with respect to a deficiency notice (I.R.C. §6213) and the period during which collection activities are prohibited and the limitations period is suspended. The Act clarifies the computation of this period and conforms it to the generally applicable 90-day period for petitioning the Tax Court. Conforming amendments are made as to the period for which collection activities are prohibited and collection limitations suspended.

Waiver of Final Determination upon Agreement As to Relief

Congress intended in enacting I.R.C. §6015 to provide a simple and efficient procedure by which the IRS could consider relief, and if relief was denied (in whole or in part) and the spouse requesting such relief did not agree with such denial, such issue could be considered by the Tax Court. Congress did not intend to require a rigid formal process when the IRS and the spouse requesting relief agreed on the extent of relief to be granted. The Act permits taxpayers and the IRS to enter into a written agreement in innocent spouse cases that allows for the taxpayer's liability to be immediately adjusted as agreed, and makes unnecessary a formal Notice of Determination or Tax Court review. This written agreement is to specify the details of the agreement between the IRS and the taxpayer as to the nature and extent of innocent spouse relief that will be provided.

Disputes Involving $50,000 or Less

The Act clarifies that the small case procedures of the Tax Court are available with respect to innocent spouse disputes and disputes continuing from the pre-levy administrative due process hearing. The small case procedures provide an accessible forum for taxpayers who have small claims with less formal rules of evidence and procedure. Use of the procedure is optional to the taxpayer, with the concurrence of the Tax Court.

Authority to Enjoin Collection Actions

While a dispute is pending under the pre-levy administrative due process hearing procedures, levy action is statutorily suspended for that period. The Tax Court and district courts are expressly granted authority to enjoin improper levy action in general, but that authority does not explicitly extend to improper levy action that occurs during the period when levy action is statutorily suspended under the administrative due process provisions. The Act clarifies the ability of the courts (including the Tax Court) to enjoin levy during the period that levy is required to be suspended with respect to a dispute under the pre-levy administrative due process hearing procedures.

Clarification of Permissible Extension of Limitations Period for Installment Agreements

The Act clarifies that the pertinent provisions of I.R.C. §6502 govern the permissible extension of the period of limitations in the context of installment agreements.

Kidnapped Children

9

Act §306(a)
[I.R.C. §151(c)]
Effective Date: Taxable years ending after December 21, 2000.

> The dependency exemption, child credit, surviving spouse filing status, head of household filing status, and earned income credit are available as if a missing child was still in the family.

The Act clarifies that the dependency exemption, the child credit, the surviving spouse filing status, the head of household filing status, and the earned income credit are available to an otherwise qualifying taxpayer with respect to a child who is presumed by law enforcement authorities to have been kidnapped by someone who is not a member of the family of such child or the taxpayer.

Generally, this treatment continues for all taxable years ending during the period that the child is kidnapped. However, this treatment ends for the taxable year ending after the calendar year in which it is determined that the child is dead (or, if earlier, the year in which the child would have attained age 18).

Transportation Benefits for Employees: Effect on Retirement Plans

Act §314(e)
[I.R.C. §§403(b)3(B); 414(5)(2), and 415(c)(3)(D)(ii)]
Effective Date: Years beginning after 1997.

> Qualified transportation benefits are treated the same as other salary reduction amounts for purposes of defining compensation under the qualified retirement plan rules.

Under prior law, salary reduction amounts are generally treated as compensation for purposes of the limits on contributions and benefits under qualified retirement plans. In addition, an employer can elect whether or not to include such amounts for nondiscrimination testing purposes. The IRS Reform Act permitted employers to offer a cash option in lieu of qualified transportation benefits.

The Act treats salary reduction amounts used for qualified transportation benefits the same as other salary reduction amounts for purposes of defining compensation under the qualified retirement plan rules.

Corrected Consumer Price Index

Act §308(i)
[No change to I.R.C.]
Effective Date: December 21, 2000

The Secretary of the Treasury is directed to prescribe new tax tables for 2001 that reflect the corrected CPI levels.

I.R.C. §1(f) provides for adjustments in the tax tables so that inflation will not result in tax increases. Numerous other provisions of the Code are indexed as well. I.R.C. §1(f) provides that inflation is measured by changes in the consumer price index (CPI) for the preceding year as published by the Department of Labor compared to the CPI for the calendar year 1992. I.R.C. §1(f) directs the Secretary to publish tables with applicable tax rates based upon calculated inflation adjustments by December 15 of the year before the year to which the tables are to apply.

On September 28, 2000, the Bureau of Labor Statistics (BLS) announced that the agency had discovered a computational error in quality adjustments of air conditioning as a part of the cost of housing, resulting in errors in the reported CPI between January 1999 and August 2000. The BLS reported that the CPI levels starting in January 1999, have been 0.0, 0.1, or 0.2 index points lower than the levels that would have been published without the error.

The Act authorizes the Secretary of the Treasury to use the corrected levels of the CPI for all purposes of the Code to which they might apply. The Act directs the Secretary to prescribe new tables reflecting the correct levels of the 1999 CPI for the 2001 tax year.

Practitioner Note. The IRS anticipated this legislation when it announced the 2001 inflation adjustments in Rev. Proc. 2001-13, 2001-3 IRB (December 18, 2000). In that revenue procedure, the IRS published inflation-adjusted rates that reflect the CPI correction in Part I and stated that these rates would apply if the legislation passed. Part II reported inflation-adjusted rates that would have applied if the legislation had not passed. In Notice 2001-12, 2001-3 I.R.B. the IRS announced that the Part I rates should be used since the legislation was enacted. The rates with the proper inflation adjustment as well as further revisions resulting from the 2001 Act are reported in the Tax Rates and Useful Tables Chapter at the end of this book.

Observation. The correction of the CPI also resulted in additional Social Security checks.

Environmental Remediation Costs

Act §162(b)
[I.R.C. §198(h)]
Effective Date: Expenditures incurred before January 1, 2004.

The definition of a qualified contaminated site for purposes of the deduction of environmental remediation costs is expanded, and the provision is extended through 2003.

Background. Under rules in place before the Act, taxpayers can elect to treat certain environmental remediation expenditures, that would otherwise be chargeable to a capital account, as deductible in the year paid or incurred (I.R.C. §198). The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site.

A "qualified contaminated site" generally is any property that: (1) is held for use in a trade or business, for the production of income, or as inventory; (2) is certified by the appropriate state environmental agency to be located within a targeted area; and (3) contains (or potentially contains) a hazardous substance (so-called "brownfields"). Targeted areas are defined as: (1) empowerment zones and enterprise communities as designated under present law; (2) sites announced before February 1997, as being subject to one of the 76 Environmental Protection Agency (EPA) Brownfields Pilots; (3) any population census tract with a poverty rate of 20% or more; and (4) certain industrial and commercial areas that are adjacent to tracts described in (3) above. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 cannot qualify as targeted areas.

Eligible expenditures are those paid or incurred before January 1, 2002.

New Law. The Act extends the expiration date for eligible expenditures to include those paid or incurred before January 1, 2004.

In addition, the Act eliminates the targeted area requirement, thereby, expanding eligible sites to include any site containing (or potentially containing) a hazardous substance that is certified by the appropriate state environmental agency. However, expenditures undertaken at sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 would continue to not qualify as eligible expenditures.

By extending and expanding I.R.C. §198, the bill is not intended to displace the general tax law principle regarding expensing versus capitalization of expenditures which continues to apply to environmental remediation efforts not specifically covered under I.R.C. §198.

The provision to extend the expiration date is effective upon the date of enactment–December 21, 2000. The provision to expand the class of eligible sites is effective for expenditures paid or incurred after the date of enactment–December 21, 2000.

Incentives for Investment in Community Renewal

Act §101(a)
[New I.R.C. §1400E]
Effective Date: Generally, January 1, 2002 through December 31, 2009.

> Tax incentives are provided for investments in "renewal communities" to be designated by the Secretary of HUD.

The Act authorizes the designation of 40 "renewal communities" within which special tax incentives would be available. The Secretary of HUD is authorized to designate up to 40 renewal communities from areas nominated by state and local governments. At least 12 of the designated communities must be in rural areas. Of the 12 rural renewal communities, one shall be an area within Mississippi, designated by the State of Mississippi, that includes at least one census tract within Madison County, Mississippi.

The following tax incentives generally are available during the period beginning January 1, 2002, and ending December 31, 2009.

Zero-Percent Capital Gain Rate. A zero-percent capital gains rate applies with respect to gain from the sale of a qualified community asset acquired after December 31, 2001, and before January 1, 2010, and held for more than five years. A "qualified community asset" includes: (1) qualified community stock (meaning original-issue stock purchased for cash in a renewal community business); (2) a qualified community partnership interest (meaning a partnership interest acquired for cash in a renewal community business); (3) qualified community business property (meaning tangible property originally used in a renewal community business by the taxpayer) that is purchased or substantially improved after December 31, 2001.

Renewal Community Employment Credit. A 15% wage credit is available to employers for the first $10,000 of qualified wages paid to each employee who (1) is a resident of the renewal community, and

(2) performs substantially all employment services within the renewal community in a trade or business for the employer.

The wage credit rate applies to qualifying wages paid after December 31, 2001, and before January 1, 2010. Wages that qualify for the credit are wages that are considered "qualified zone wages" for purposes of the empowerment zone wage credit (including coordination with the Work Opportunity Tax Credit). In general, any taxable business carrying out activities in the renewal community may claim the wage credit.

Commercial Revitalization Deduction. Each state is permitted to allocate up to $12 million of "commercial revitalization expenditures" to each renewal community located within the state for each calendar year after 2001 and before 2010. The appropriate state agency will make the allocations pursuant to a qualified allocation plan.

A **commercial revitalization expenditure** means the cost of a new building or the cost of substantially rehabilitating an existing building. The building must be used for commercial purposes and be located in a renewal community. In the case of the rehabilitation of an existing building, the cost of acquiring the building will be treated as qualifying expenditures only to the extent that such costs do not exceed 30% of the other rehabilitation expenditures. The qualifying expenditures for any building cannot exceed $10 million.

A taxpayer can elect either to (a) deduct one-half of the commercial revitalization expenditures for the taxable year the building is placed in service, or (b) amortize all the expenditures ratably over the 120-month period beginning with the month the building is placed in service. No depreciation is allowed for amounts deducted under this provision. The adjusted basis is reduced by the amount of the commercial revitalization deduction, and the deduction is treated as a depreciation deduction in applying the depreciation recapture rules (e.g., I.R.C. §1250). The commercial revitalization deduction is treated in the same manner as the low-income housing credit in applying the passive loss rules (I.R.C. §469). Thus, up to $25,000 of deductions (together with the other deductions and credits not subject to the passive loss limitation by reason of I.R.C. §469(i)) are allowed to an individual taxpayer regardless of the taxpayer's adjusted gross income. The commercial revitalization deduction is allowed in computing a taxpayer's alternative minimum taxable income.

Additional I.R.C. §179 Expensing. A renewal community business is allowed an additional $35,000 of I.R.C. §179 expensing for qualified renewal property placed in service after December 31, 2001, and before January 1, 2010. The I.R.C. §179 expensing allowed to a taxpayer is phased out by the amount by which 50% of the cost of qualified renewal property placed in service during the year by the taxpayer exceeds $200,000. The term "qualified renewal property" is similar to the definition of "qualified zone property" used in connection with empowerment zones.

Extension of Work Opportunity Tax Credit (WOTC). The bill expands the high-risk youth and qualified summer youth categories in the WOTC to include qualified individuals who live in a renewal community.

Effective Date. Renewal communities must be designated during the period beginning on the first day of the first month after the publication of regulations by HUD and ending on December 31, 2001. The tax benefits available in renewal communities are effective for the period beginning January 1, 2002, and ending December 31, 2009.

Empowerment Zone Provisions

Act §111
[I.R.C. §1391(h)]
Effective Date: Expenditures during the period January 1, 2002—December 31, 2009.

- The tax benefits for existing empowerment zones are extended and expanded.
- The Secretaries of HUD and Agriculture are authorized to designate nine additional empowerment zones.

The designation of empowerment zone status for Round I and II empowerment zones (other than the District of Columbia Enterprise Zone) is extended through December 31, 2009. In addition, the 20% wage credit is made available in all Round I and II empowerment zones for qualifying wages paid or incurred after December 31, 2001. The credit rate remains at 20% (rather than being phased down) through December 31, 2009, in Round I and Round II empowerment zones.

In addition, $35,000 (rather than $20,000) of additional I.R.C. §179 expensing is available for qualified zone property placed in service in taxable years beginning after December 31, 2001, by a qualified business in any of the empowerment zones. Businesses in the D.C. Enterprise Zone are entitled to the additional I.R.C. §179 expensing until the termination of the D.C. Enterprise zone designation.

Businesses located in Round I empowerment zones (other than the D.C. Enterprise Zone) also are eligible for the more generous tax-exempt bond rules that apply under present law to businesses in the Round II empowerment zones [I.R.C. §1394(f)]. The bill applies to tax-exempt bonds issued after December 31, 2001. Bonds that have been issued by businesses in Round I zones before January 1, 2002, are not taken into account in applying the limitations on the amount of new empowerment zone facility bonds that can be issued under the bill.

Nine New Empowerment Zones. The Secretaries of HUD and Agriculture are authorized to designate nine additional empowerment zones (Round III empowerment zones). Seven of the Round III empowerment zones will be located in urban areas, and two will be located in rural areas.

Businesses in the Round III empowerment zones are eligible for the same tax incentives that, under the bill, are available to Round I and Round II empowerment zones (i.e., a 20% wage credit, an additional $35,000 of I.R.C. §179 expensing, and the enhanced tax-exempt financing benefits presently available to Round II empowerment zones).

Effective Date. The extension of the existing empowerment zone designations is effective after December 21, 2000. The extension of the tax benefits to existing empowerment zones (i.e., the expanded wage credit, the additional I.R.C. §179 expensing, and the more generous tax-exempt bond rules) generally is effective after December 31, 2001. The new Round III empowerment zones must be designated by January 1, 2002, and the tax incentives with respect to the Round III empowerment zones generally are available during the period beginning on January 1, 2002, and ending on December 31, 2009.

New Markets Tax Credit for Community Development

Act §121
[I.R.C. §§38(b)(13); 39(d)(9); 45D, and 196(c)(9)]
Effective Date: Qualified investments made after December 31, 2000.

A new tax credit is allowed for qualified equity investments made to acquire stock in a selected community development entity.

The Act includes a provision that creates a new tax credit for qualified equity investments made to acquire stock in a selected community development entity (CDE). The maximum annual amount of qualifying equity investments is capped as follows:

Calendar Year	Maximum Qualifying Equity Investment
2001	$1.0 billion
2002–2003	$1.5 billion per year
2004–2005	$2.0 billion per year
2006–2007	$3.5 billion per year

The amount of the new tax credit to the investor (either the original purchaser or a subsequent holder) is:

1. A 5% credit for the year in which the equity interest is purchased from the CDE and the first two anniversary dates after the interest is purchased from the CDE
2. A 6% credit on each anniversary date thereafter for the following four years

The taxpayer's basis in the investment is reduced by the amount of the credit (other than for purposes of calculating the capital gain exclusion under I.R.C. §§1202, 1400B, and 1400F). The credit is subject to the general business credit rules.

Securities Futures Contracts

Act §401(a)
[New I.R.C. §§1234A and 1234B]
Effective Date: December 21, 2000.

> Character of gain or loss on the sale or exchange of a securities futures contract is the same as the character of gain or loss from the sale or exchange of property to which the contract relates.

The Act changes the tax treatment of securities futures contracts. Beginning on December 21, 2000, securities futures contracts will no longer be treated as I.R.C. §1256 contracts unless the taxpayer is a dealer in securities. That means holders of these contracts are not subject to the mark-to-market rules of I.R.C. §1256 and are not eligible for 60% long-term capital gain treatment under I.R.C. §1256. Instead, gain or loss on these contracts will be recognized under the general rules relating to the disposition of property.

A securities futures contract means a contract of sale for future delivery of a single security or a narrow-based security index—an index limited to a single market segment such as gold or silver.

Any gain or loss from the sale or exchange of a securities futures contract (other than a dealer securities futures contract) will be considered as gain or loss from the sale or exchange of property which has the same character as the property to which the contract relates has (or would have) in the hands of the taxpayer. Thus, if the underlying security would be a capital asset in the taxpayer's hands, then gain or loss from the sale or exchange of the securities futures contract would be capital gain or loss. The Act also provides that the termination of a securities futures contract that is a capital asset will be treated as a sale or exchange of the contract.

Capital gain treatment will not apply to contracts which themselves are not capital assets because of the exceptions to the definition of a capital asset relating to inventory [I.R.C. §1221(a)(1)] or hedging [I.R.C. §1221(a)(7)], or to any income derived in connection with a contract which would otherwise be treated as ordinary income.

Except as otherwise provided in regulations under I.R.C. §1092(b) (which treats certain losses from a straddle as long-term capital losses) and I.R.C. §1234B, as added by the Act, any capital gain or loss from the sale or exchange of a securities futures contract to sell property (i.e., the short side of a securities futures contract) will be short-term capital gain or loss. In other words, a securities futures contract to sell property is treated as equivalent to a short sale of the underlying property.

Wash-Sale Rules

The Act clarifies that, under the wash-sale rules, a contract or option to acquire or sell stock or securities includes options and contracts that are (or may be) settled in cash or property other than the stock or securities to which the contract relates. Thus, for example, the acquisition, within the period set forth in I.R.C. §1091, of a securities futures contract to acquire stock of a corporation could cause the taxpayer's loss on the sale of stock in that corporation to be disallowed, notwithstanding that the contract may be settled in cash.

Short-Sale Rules

In applying the short-sale rules, a securities futures contract to acquire property will be treated in manner similar to the property itself. Thus, for example, the holding of a securities futures contract to acquire property and the short sale of property which is substantially identical to the property under the contract, will result in the application of the rules of I.R.C. §1233(b). In addition, as stated above, a securities futures contract to sell is treated in a manner similar to a short sale of the property.

Straddle Rules

Stock which is part of a straddle at least one of the offsetting positions of which is a securities futures contract with respect to the stock or substantially identical stock will be subject to the straddle rules of I.R.C. §1092.

Treasury regulations under I.R.C. §1092 applying the principles of the I.R.C. §1233(b) and (d) short-sale rules to positions in a straddle will also apply. For example, assume a taxpayer holds a long-term position in actively traded stock (which is a capital asset in the taxpayer's hands) and enters into a securities futures contract to sell substantially identical stock (at a time when the position in the stock has not appreciated in value so that the constructive sale rules of I.R.C. §1259 do not apply). The taxpayer has a straddle. Treasury regulations prescribed under I.R.C. §1092(b) applying the principles of I.R.C. §1233(d) will apply, so that any loss on closing the securities futures contract will be a long-term capital loss under I.R.C. §1032. A corporation will not recognize gain or loss on transactions in securities futures contracts with respect to its own stock.

Holding Period

If property is delivered in satisfaction of a securities futures contract to acquire property (other than a contract to which I.R.C. §1256 applies), the holding period for the property will include the period the taxpayer held the contract, provided that the contract was a capital asset in the hands of the taxpayer.

Assumption of Liabilities by Controlled Corporations

Act §309
[I.R.C. §§357(d)(1) and 358(h)]
Effective Date: Assumptions of liability after October 18, 1999.

> The acceleration or duplication of losses through assumption of liabilities by a controlled corporation is limited.

The Act limits the acceleration or duplication of losses through assumption of liabilities by a controlled corporation. If the basis of stock (determined without regard to this provision) received by a transferor as part of a tax-free exchange with a controlled corporation exceeds the fair market value of the stock, then the basis of the stock received is reduced (but not below the fair market value) by the amount (determined as of the date of the exchange) of any liability that:

1. Is assumed in exchange for such stock
2. Did not otherwise reduce the transferor's basis of the stock by reason of the assumption

Except as provided by the Secretary of the Treasury, this provision does not apply where the trade or business with which the liability is associated is transferred to the corporation as part of the exchange, or where substantially all the assets with which the liability is associated are transferred to the corporation as part of the exchange.

Example 1. Assume a taxpayer transfers assets with an adjusted basis and fair market value of $100 to its wholly owned corporation and the corporation assumes $40 of liabilities (the payment of which would give rise to a deduction). Thus, the value of the stock received by the transferor is $60. Under present law, the basis of the stock would be $100. The provision requires that the basis of the stock be reduced to $60 (i.e., a reduction of $40).

Except as provided by the Secretary of the Treasury, no basis reduction is required if the transferred assets consisted of the trade or business, or substantially all the assets, with which the liability associated. The provision does not change the tax treatment with respect to the transferee corporation.

The Secretary of the Treasury is directed to prescribe rules providing appropriate adjustments, to prevent the acceleration or duplication of losses through the assumption of liabilities (as defined in the provision) in transactions involving partnerships. The Secretary may also provide appropriate adjustments in the case of transactions involving S corporations. In the case of S corporations, such rules may be applied instead of the otherwise applicable basis reduction rules.

The provision is effective for assumption of liabilities on or after October 19, 1999. Except as provided by the Secretary, the rule addressing transactions involving partnerships are effective with the same effective date. Any rules addressing transactions involving S corporations may likewise be effective for assumptions of liabilities on or after October 19, 1999, or such later date as may be prescribed in such rules.

PART 2: ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001

The Economic and Tax Relief Reconciliation Act of 2001 (2001 Act) includes almost 100 provisions that are beneficial to almost all taxpayers. However, the benefits are phased in over 10 years. That phase-in not only adds an enormous amount of complexity to applying the law for both tax compliance and planning but adds a significant degree of uncertainty about whether Congress will change the law before it is fully phased in. The uncertainty is further increased by the last section of the 2001 Act (I.R.C. §901), which repeals all of the 2001 Act changes at the end of 2010.

Given the uncertainty about what law will be in effect in future years, the following discussion of the 2001 Act is divided into two parts. The first part discusses the provisions that are in effect for 2001 or earlier years as well as provisions that are scheduled to be in effect for 2002. Practitioners will need to understand these provisions to report 2001 income taxes and to help clients with 2002 income tax planning.

The second part of the following discussion explains the most significant changes that are effective after 2002. While these provisions are more likely to be modified before they become effective, they indicate the types of changes in the law that are likely to be in place after 2002.

PROVISIONS EFFECTIVE IN 2002 OR BEFORE

Income Tax Rate Structure

Act §101
[I.R.C. §1]
Effective Date: Tax years beginning after December 31, 2000.

> Individual income tax rates are reduced over a 6-year period beginning July 1, 2001. A new 10% bracket is implemented as an advance credit for 2001 and as a sixth tax bracket in 2002 and thereafter.

New 10% Bracket. The 2001 Act establishes a new 10% income tax rate bracket for the first portion of taxable income currently taxed at 15%. This 10% rate bracket applies to taxable income up to the following amounts:

	Calendar Year	
	2001- 2007	2008
Single and married filing separately	$ 6,000	$ 7,000
Head of household	10,000	10,000
Married filing jointly	12,000	14,000

Practitioner Note. The new 10% bracket does not apply to trusts and estates.

After 2008, the taxable income levels for this new 10% bracket will be adjusted annually for inflation.

Practitioner Note. By making this 10% bracket for married taxpayers filing jointly twice the bracket amount for single taxpayers, Congress has eliminated a portion of the marriage penalty.

Advance Refund Checks. In lieu of incorporating this new 10% income tax rate bracket into the new 2001 wage withholding tables, the Department of Treasury issued refund checks to taxpayers. The 2001 advance refund amount is a maximum of $300 for single taxpayers and married taxpayers filing separately, $500 for heads of households, and $600 for married taxpayers filing jointly. Estates, trusts, dependents, and nonresident aliens are not eligible for this advance refund check.

Practitioner Note. Estates, trusts, dependents, and nonresident aliens are treated the same for the advance refund checks and the rate reduction credit (discussed below), but they are not treated the same for the 10% bracket beginning in 2002. Dependents and nonresident aliens are eligible for the 10% bracket beginning in 2002, but estates and trusts are not.

Refunds are based on the taxpayer's 2000 income tax return tax liability less the nonrefundable tax credits (e.g., child tax credit, education credits, child care credit). The advance refund is reduced for any outstanding government debt, such as back taxes, past-due student loans, or past-due child support obligations. Congress directed the Treasury to have the checks sent to taxpayers before October 1, 2001. However, taxpayers who have not filed a tax return for 2000 will not receive a 2001 advance payment check until the IRS processes their 2000 tax return. **No checks will be issued after December 31, 2001.**

Practitioner Note. The advance refund check is a reduction of tax and is **not** taxable income on the 2001 federal income tax return.

In the case of a change in a taxpayer's filing status from 2000 to 2001, an advance refund based on a joint return is attributed one half to each individual filing the return.

Rate Reduction Credit. Taxpayers who don't qualify for a refund check, or qualify for less than the maximum refund check may be eligible for a rate reduction credit on their 2001 tax return. Estates, trusts, dependents, and nonresident aliens are not eligible for this credit.

The 2001 Form 1040 will include a worksheet to calculate the rate reduction credit. This credit is claimed on line 50 of the 2001 Form 1040. Taxpayers whose advance payment is larger than the credit amount figured on the 2001 tax return will **not** have to pay back any difference.

Additional Tax Rate Reductions. Reductions of other income tax rates are phased-in over a 6-year period beginning July 1, 2001, as displayed in the following table:

Calendar Year	28% rate reduced to:	31% rate reduced to:	36% rate reduced to:	39.6% rate reduced to:
2001*	27.5%	30.5%	35.5%	39.1%
2002–2003	27.0%	30.0%	35.0%	38.6%
2004–2005	26.0%	29.0%	34.0%	37.6%
2006 and later	25.0%	28.0%	33.0%	35.0%

*New withholding tables beginning July 1, 2001, reflect tax rates of 27%, 30%, 35%, and 38.6%.

Practitioner Note. The 2002 withholding tables will incorporate the new 10% bracket in addition to the reductions in the other rates.

Regular Income Tax Rates for 2001

(see the Tax Rates and Useful Tables chapter at the end of this book for the complete tax schedules)

Single Individuals

Taxable Income	But Not Over	Old Rate	New Rate
Over $0	$ 27,050	15%	15%
Over $27,050	$ 65,550	28%	27.5%
Over $65,550	$136,750	31%	30.5%
Over $136,750	$297,350	36%	35.5%
Over $297,350	-------	39.6%	39.1%

Head of Household

Taxable Income	But Not Over	Old Rate	New Rate
Over $0	$ 36,250	15%	15%
Over $36,250	$ 93,650	28%	27.5%
Over $93,650	$151,650	31%	30.5%
Over $151,650	$297,350	36%	35.5%
Over $297,350	--------	39.6%	39.1%

Married Individuals Filing Joint Returns

Taxable Income	But Not Over	Old Rate	New Rate
Over $0	$ 45,200	15%	15%
Over $45,200	$109,250	28%	27.5%
Over $109,250	$166,500	31%	30.5%
Over $166,500	$297,350	36%	35.5%
Over $297,350	--------	39.6%	39.1%

Estates and Trusts

Taxable Income	But Not Over	Old Rate	New Rate
Over $0	$1,800	15%	15%
Over $1,800	$4,250	28%	27.5%
Over $4,250	$6,500	31%	30.5%
Over $6,500	$8,900	36%	35.5%
Over $8,900	--------	39.6%	39.1%

Example 1. Gary and Mary Jones file a joint return and have taxable income for 2001 of $95,000. Their taxes before any rate reductions would have been $20,724, calculated as follows:

$45,200 × 15%	$ 6,780
($95,000 – 45,200) × 28%	13,944
Total	$20,724

At the new rates, their taxes are $20,475, calculated as follows:

$45,200 × 15%	$ 6,780
($95,000 – 45,200) × 27.5%	13,695
Total	$20,475

They also received an advance refund check for $600, which represents the adjustment for the 10% tax rate on the first $12,000 of taxable income [(15% – 10%) × $12,000]. Gary and Mary's total tax savings as a result of the change in the 2001 income tax rate structure is $849, calculated as follows:

Tax under old law	$20,724
Tax under new law	20,475
Tax reduction	$ 249
Advanced refund check	600
Total tax savings	$ 849

9

Example 2. Casey Johnson, a single taxpayer, has taxable income for 2001 of $65,000. Her taxes before any rate reductions would have been $14,684, calculated as follows:

$27,050 × 15%	$ 4,058
($65,000 – 27,050) × 28%	10,626
Total	$14,684

At the new rates, her taxes are $14,494, calculated as follows:

$27,050 × 15%	$ 4,058
($65,000 – 27,050) × 27.5%	10,436
Total	$14,494

She also received an advance refund check for $300, which represents the first $6,000 of taxable income taxed at the 10% rate (15% – 10% × $6,000). Casey's tax savings as a result of the change in the 2001 income tax rate structure are $490, calculated as follows:

Tax under old law	$14,684
Tax under new law	14,494
Tax reduction	$ 190
Advanced refund check	300
Total tax savings	$ 490

Practitioner Note. The IRS provided the following worksheet for calculating the credit on the 2001 return in the Form 1040 instructions.

Excerpt From the 2001 Form 1040 Instructions

Rate Reduction Credit Worksheet—Line 47

Keep for Your Records

Before you begin:

√ If you received (before offset) an advance payment of your 2001 taxes equal to the amount shown below for your 2001 filing status, **stop.** You cannot take the credit because you have received the maximum amount of the credit.

- Single or married filing separately — $300
- Head of household — $500
- Married filing jointly or qualifying widow(er) — $600

√ If you, or your spouse if filing a joint return, can be claimed as a dependent on another person's return, **stop.** You cannot take the credit.

√ If you received Notice 1275, 1277, or 1278 showing the amount of your advance payment, have it available.

√ If you received (before offset) an advance payment and you filed a joint return for 2000, you and your spouse are each considered to have received one-half of the payment.

1. Enter the amount from Form 1040, line 39. If line 39 is zero or blank, **stop;** you cannot take the credit . . . **1.** ______

2. Enter the amount shown below for your filing status.
- Single or married filing separately — $6,000
- Head of household — $10,000
- Married filing jointly or qualifying widow(er) — $12,000

. . . . **2.** ______

3. Is the amount on line 1 less than the amount on line 2?

No. Enter: $300 if single or married filing separately; $500 if head of household; $600 if married filing jointly or qualifying widow(er).

Yes. Multiply the amount on line 1 by 5% (.05). Enter the result.

. . . . **3.** ______

4. Enter the amount from Form 1040, line 42 . . . . **4.** ______

5. Add the amounts from Form 1040, lines 43 through 46. Enter the total . . . **5.** ______

6. Subtract line 5 from line 4. If the result is zero or less, **stop;** you cannot take the credit . . . . . **6.** ______

7. Enter the **smaller** of line 3 or line 6 . . . . **7.** ______

8. Enter the amount, if any, of your advance payment (before offset). If filing a joint return, include your spouse's advance payment with yours . . . . **8.** ______

9. **Rate reduction credit.** Subtract line 8 from line 7. Enter the result here and, if more than zero, on Form 1040, line 47. If line 8 is more than line 7, you do not have to pay back the difference . . . . **9.** ______

Practitioner Note. A further change in the 15% tax rate bracket for married filing jointly is scheduled to begin in 2005 to provide some relief from the marriage penalty. See page 528.

Individual AMT Exemption

Act §701
[I.R.C. §55]
Effective Date: Tax years beginning after December 31, 2000.

The AMT exemptions are temporarily increased by $4,000 for MFJ and $2,000 for other taxpayers, except estates and trusts. The increase no longer applies beginning in 2005.

AMT Exemption Amounts. The Tax Relief Reconciliation Act of 2001 increases the alternative minimum tax (AMT) exemption amount for married couples filing a joint return and for surviving spouses by $4,000. The AMT exemption amounts for unmarried individuals and married individuals filing a separate return are increased by $2,000.

	Old Exemption Amount	New Exemption Amount
Married filing jointly	$45,000	$49,000
Surviving spouses	$45,000	$49,000
Single (other than surviving spouses)	$33,750	$35,750
Married filing separately	$22,500	$24,500

Phaseout of AMT Exemption Amount. The exemption amounts are phased out by an amount equal to 25% of the amount by which the individual's AMT income (regular taxable income + tax preferences and adjustments) exceeds:

1. $150,000 in the case of married individuals filing a joint return and surviving spouses
2. $112,500 in the case of other unmarried individuals
3. $75,000 in the case of married individuals filing separate returns or an estate or trust [I.R.C. §55(d)(3)]

These base amounts for the phaseout computation remain the same. But, the increased exemption amounts translate to an increase in the maximum amount of AMTI (AMT income) before the exemption is completely phased out. The following table shows this increase.

	Old AMTI	New AMTI
Married filing jointly	$330,000	$346,000
Surviving spouses	$330,000	$346,000
Single (other than surviving spouses)	$247,500	$255,500
Married filing separately	$165,000	$173,000

Example 1. Todd and Jan Lee have regular taxable income of $95,000 for 2001, and tax preferences and adjustments of $35,000. Using the tax rates for 2001, the regular tax on $95,000 is $20,475. Their AMTI of $130,000 ($95,000 + $35,000) is reduced by the appropriate exemption amount.

Old Law. Under the old law, the AMTI is reduced by $45,000, resulting in a tentative minimum tax of $22,100 (($130,000 – 45,000) × 26%), and an AMT liability of $1,625 ($22,100 – 20,475).

New Law. Under the new law, the AMTI is reduced by $49,000, resulting in a tentative minimum tax of $21,060 (($130,000 – $49,000) × 26%), and an AMT liability of $585 ($21,060 – 20,475). The increased exemption amount has saved the Lees $1,040 ($22,100 – 21,060).

9

Earned Income Credit—Marriage Penalty Relief and Simplification

Act §303
[I.R.C. §32]
Effective Date: Tax years beginning after December 31, 2001.

- The marriage penalty is reduced by increasing the phaseout range for MFJ.
- Earned income and AGI calculations are simplified.
- Requirements for qualifying child are relaxed.
- Tiebreaker rules are changed for parents.

Marriage Penalty Relief. The tax bill increases the beginning and ending of the earned income credit phaseout range for married individuals filing a joint return by the following amounts:

1. $1,000 for tax years 2002, 2003, and 2004
2. $2,000 for tax years 2005, 2006, and 2007
3. $3,000 for tax years 2008, 2009, and 2010

Example 1. Crystal has two qualifying children and $13,000 of earned income for 2001. Blake has no qualifying children and $18,000 of earned income for 2001.

Effect of Old Law. For 2001, Crystal qualifies for the maximum $4,008 earned income credit if she is unmarried. Blake does not qualify for any earned income credit if he is unmarried. If Crystal and Blake are married in 2001, they must file a joint tax return to claim the earned income credit. Their joint income is over the threshold phaseout amount, so the maximum credit is reduced as follows:

Maximum credit	$4,008
Phaseout	
($31,000 – $13,090) × 21.06%	3,772
Credit allowed	$ 236

Effect of New Law. Assuming no inflation adjustment in the threshold phaseout amount for 2002 and that Crystal and Blake have the same earned income for 2002 as they had in 2001, Crystal would still be allowed to claim the maximum $4,008 earned income credit in 2002 if she is unmarried. Blake does not qualify for any earned income credit if he is unmarried. If Crystal and Blake are married in 2002, the maximum credit is reduced as follows:

Maximum credit	$4,008
Phaseout	
($31,000 – $14,090) × 21.06%	3,561
Credit allowed	$ 447

Therefore, assuming no inflation adjustment, the new law will reduce the marriage penalty for Crystal and Blake by $3,772 – $3,561 = $211, but it has not eliminated the marriage penalty for them.

Maximum marriage penalty reduction. Since the phaseout percentages are 7.65% for couples with no children, 15.98% for couples with one child, and 21.06% for couples with two or more children, the maximum benefit couples will get from the increases in the phaseout amounts are as follows:

Years	Increase in Threshold Phaseout Amount	Number of qualifying children: None	One	Two or More
2002, 2003, & 2004	$ 1,000	$ 76.50	$ 159.80	$ 210.60
2005, 2006, & 2007	$ 2,000	$ 153.00	$ 319.60	$ 421.20
2008, 2009, & 2010	$ 3,000	$ 229.50	$ 479.40	$ 631.80

Nontaxable Employee Compensation. The definition of earned income now *excludes* nontaxable employee compensation previously included in the earned income credit calculation. Taxpayers will no longer include nontaxable employee compensation such as employer contributions for nontaxable fringe benefits, salary reduction contributions under a cafeteria plan, elective deferrals such as contributions to a 401(k) plan, meals and lodging provided for the convenience of the employer, and housing allowances in earned income.

This change may increase or decrease a taxpayer's earned income credit depending on whether the taxpayer's earned income falls in the phasein or phaseout range for the earned income credit.

Example 2. Denise has $8,000 of taxable earned income and $1,000 of nontaxable earned income in 2001. She has two qualifying children. Her earned income credit for 2001 is $9,000 × 40% = $3,600. Assuming the same earned income in 2002, her earned income credit would be $8,000 × 40% = $3,200. Therefore the new law reduces her earned income credit by $400.

Example 3. Earl has $16,000 of taxable earned income and $2,000 of nontaxable earned income in 2002. He has two qualifying children. Assuming no inflation adjustment in the threshold phaseout amount, the following table shows the effect of the new law on Earl's earned income credit.

	Old Law		New Law		Difference
Maximum Credit		$4,008		$4,008	
Phaseout	($18,000 – $14,090) × 21.06% =	823	($16,000 – $14,090) × 21.06% =	402	–421
Credit allowed		$3,185		$3,606	+421

9

Alternative Minimum Tax. The earned income credit is no longer reduced for taxpayers subject to the alternative minimum tax.

Adjusted Gross Income. The 2001 Act replaces modified adjusted gross income with adjusted gross income for purposes of the earned income credit. Congress made this change to simplify the earned income calculation, but the change will also affect the amount of earned income credit some taxpayers can claim.

This change affects:

1. The determination of who can claim a child as a qualifying child when adjusted gross income is the tiebreaker (see discussion of the tie breaking test later in this section)
2. The phaseout of the earned income credit

Example 4. Fran has $18,000 of earned income in 2002. Her adjusted gross income is $20,000 and her modified adjusted gross income is $24,000. She has two qualifying children. Assuming no inflation adjustment in the threshold phaseout amount, the following table shows the effect of the new law on Fran's earned income credit:

	Old Law		New Law		Difference
Maximum Credit		$4,008		$4,008	
Phaseout	($24,000 – $14,090) × 21.06% =	2,087	($20,000 – $14,090) × 21.06% =	1,245	– 842
Credit allowed		$1,921		$2,763	+842

Observation. If modified adjusted gross income is less than adjusted gross income, the new law could decrease the earned income credit for a taxpayer.

Relationship Test. The relationship test has been expanded to include descendants of stepchildren. Qualifying children now include the taxpayer's son, daughter, stepson, stepdaughter, brother, sister, and a descendant of any of these individuals. An eligible foster child satisfies the relationship test also.

Example 5. Marsha's stepdaughter, Amy (age 18), and Amy's son, John (age 1), lived with Marsha for 10 months during the year. Both Amy and John are qualifying children for purposes of Marsha's earned income credit. John would not have been a qualifying child under the prior definition of qualifying children.

Foster Child Residency Requirement. An eligible foster child no longer has to reside with a taxpayer for a full year in order to be a qualifying child. Instead, an eligible foster child is required to live with the taxpayer for more than one-half the year, the same as all other qualifying children.

Example 6. John, a foster child, resides with Betty for 8 months during the year. John is an eligible child for purposes of Betty's earned income credit. Under the old rule, John would not have been a qualifying child because he resided with Betty for less than one year.

Tie Breaking Test. Under the old law, if a child qualifies with respect to more than one person, the child is treated as a qualifying child of the person with the highest modified adjusted gross income.

Under the new law:

1. If one of the individuals is the child's parent, then the child is considered the qualifying child of the parent.
2. If both parents claim the child and are not filing a joint return, then the child is considered the qualifying child of the parent with whom the child resided for the longer period of time during the year.
3. If this period of time is the same for both parents, then the parent with the higher adjusted gross income will be eligible to claim the child.
4. If none of the taxpayers claiming the child is the child's parent, then the taxpayer with the highest adjusted gross income will be eligible to claim the child.

Example 7. For purposes of the earned income credit, Jim is a qualifying child to both Jim's grandmother and Jim's mother. Under the new tiebreaking test, Jim's mother is eligible to claim the child without regard to adjusted gross income.

Disqualification of Noncustodial Parents. Beginning in 2004, the IRS will be allowed to use math error authority to deny the earned income credit to noncustodial parents indicated by the Federal Case Registry of Child Support Orders.

Modifications to Child Tax Credit

Act §201
[I.R.C. §24]
Effective Date: The credit increase and refund provision are effective for tax years beginning after December 31, 2000. The offset of AMT is effective in tax years beginning after December 31, 2001.

- Credit is increased to $1,000 over 10 years ($600 for 2001 through 2004).
- Credit is refundable to the extent that 10% (15% for 2005 and after) of taxable earned income exceeds $10,000.
- Credit can offset AMT.

Under the prior tax law, a taxpayer may claim a $500 tax credit for each qualifying child under the age of 17. A qualifying child must be:

1. An individual for whom the taxpayer can claim a dependency exemption **and**
2. The taxpayer's son or daughter (or descendent of either), stepson or stepdaughter, or eligible foster child

The child tax credit is phased out by $50 for each $1,000 of modified adjusted gross income over $75,000 for single individuals and heads of households, $110,000 for married individuals filing joint returns, and $55,000 for married individuals filing separate returns. Modified adjusted gross income (MAGI) is defined as the taxpayer's total gross income plus excluded income of:

1. U.S. citizens or residents living abroad (I.R.C. §911)
2. Residents of Guam, American Samoa, and the Northern Mariana Islands (I.R.C. §931)
3. Residents of Puerto Rico (I.R.C. §933)

The Act increases the child tax credit to $1,000 per child, phased in over a 10 year period.

Taxable Year	Credit Amount Per Child
2001–2004	$ 600
2005–2008	$ 700
2009	$ 800
2010	$1,000

Example 1. Jarvis and Mavis Hughes, married taxpayers filing a joint return for 2001, have MAGI of $120,000 and two eligible children for the child tax credit. Since their MAGI exceeds the phaseout threshold by $10,000 ($120,000 – $110,000), the Hughes must reduce their eligible credit of $1,200 ($600 × 2) by $500 (($10,000 / $1,000) × $50). Their child tax credit for 2001 is $700 ($1,200 – $500), an increase of $200 over 2000.

In 2010, assuming that both qualifying children are still under the age of 17 and assuming no inflation adjustment to the phaseout threshold, the Hughes will be able to claim a child tax credit of $1,500 (($1,000 × 2) – $500), an increase of $1,000 over 2000.

Refundability. Prior to 2001, the child tax credit was a nonrefundable credit with a limited exception. For families with three or more qualifying children, the child tax credit was refundable up to the amount by which the taxpayer's social security taxes exceeded the taxpayer's earned income credit.

The 2001 Act makes the child tax credit refundable to the extent of 10% of the taxpayer's earned income in excess of $10,000 for the years 2001 to 2004. This percentage is increased to 15% for the years 2005 and after. The $10,000 amount will be adjusted for inflation beginning in 2002.

Families with three or more children are allowed a refundable credit for the greater of the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income credit, or the 10% (15% beginning in 2005) of the taxpayer's earned income in excess of $10,000.

Example 1: Jarvis and Mavis Hughes

Publication 972

Forms 1040, 1040A

USE this worksheet to figure the child tax credit.

Child Tax Credit Worksheet

Keep for Your Records

Before you begin: You will need any of the following forms that you are filing.

- √ Form 2555, Foreign Earned Income
- √ Form 2555-EZ, Foreign Earned Income Exclusion
- √ Form 4563, Exclusion of Income for Bona Fide Residents of American Samoa

Part 1

1. Number of qualifying children: 2 × ~~$500.~~ $600 Enter the result. — **1** 1,200

2. Enter the amount from Form 1040, line 34, or Form 1040A, line 19. — **2** 120,000

3. **1040 filers:** Enter the total of any—
- Exclusion of income from Puerto Rico, and
- Amounts from Form 2555, lines 43 and 48; Form 2555-EZ, line 18; and Form 4563, line 15.

1040A filers: Enter -0-. — **3**

4. Add lines 2 and 3. Enter the result. — **4** 120,000

5. Enter the amount shown below for your filing status.
- Married filing jointly - $110,000
- Single, head of household, or qualifying widow(er) - $75,000
- Married filing separately - $55,000

— **5** 110,000

6. Is the amount on line 4 more than the amount on line 5?

☐ **No.** Leave line 6 blank. Enter -0- on line 7.

☐ **Yes.** Subtract line 5 from line 4. If the result is not a multiple of $1,000, increase it to the next multiple of $1,000 (for example, increase $425 to $1,000, increase $1,025 to $2,000, etc.). — **6** 10,000

7. Multiply the amount on line 6 by 5% (.05). Enter the result. — **7** 500

8. Is the amount on line 1 more than the amount on line 7?

☐ **No.** STOP You cannot take the child tax credit on Form 1040, line 47, or Form 1040A, line 30. You also cannot take the additional child tax credit on Form 1040, line 62, or Form 1040A, line 39. Complete the rest of your Form 1040 or 1040A.

☒ **Yes.** Subtract line 7 from line 1. Enter the result. *Go to Part 2 on the next page.* — **8** 700

Example 2. Randy Smith has two children and an earned income of $20,000. He has no other income and is entitled to no other nonrefundable personal credits. His tax liability for 2001 is calculated in the following table.

Income	$ 20,000
Standard deduction	(4,400)
Personal exemptions (3 @ $2,900)	(8,700)
Taxable income	$ 6,900
Tax liability for $6,900 @ 15%	$ 1,035

The nonrefundable child tax credit is equal to $1,200 (2 × $600). For 2001, Mr. Smith's maximum allowable nonrefundable credit is limited to his tax liability of $1,035.

As changed by the Act, Mr. Smith is allowed a **refundable** credit equal to the lesser of $1,200 (2 × $600), or $1,000 (($20,000 – $10,000) × 10%). Mr. Smith's total child tax credit is $1,200, consisting of a $1,000 refundable credit and a $200 nonrefundable credit.

Example 3. Assume the same facts as in Example 2, except Mr. Smith has three children. His tax liability for 2001 is calculated in the following table.

Income	$ 20,000
Standard deduction	(4,400)
Personal exemptions (4 @ $2,900)	(11,600)
Taxable income	$ 4,000
Tax liability for $4,000 @ 15%	$ 600
Earned income credit	$ 2,553
Employee paid FICA (7.65%)	$ 1,530

The nonrefundable child tax credit is equal to $1,800 (3 × $600). For 2001, Mr. Smith's maximum allowable nonrefundable credit is limited to his tax liability of $600.

As changed by the Act, Mr. Smith is allowed a refundable credit equal to the **lesser** of $1,800 (3 × $600) **or** the greater of $1,000 (($20,000 – $10,000) × 10%) or the amount by which the employee-paid FICA exceeds the earned income credit, in this case $0 ($1,530 – $2,553). Mr. Smith's total child tax credit is $1,600, consisting of $1,000 refundable credit and $600 nonrefundable credit.

Alternative Minimum Tax. The refundable child tax credit will no longer be reduced by the amount of the alternative minimum tax. In addition, the Act allows the child tax credit to the extent of the full amount of the individual's regular income tax and alternative minimum tax.

Extension and Expansion of Adoption Tax Benefits

Act §202
[I.R.C. §23 and I.R.C. §137]
Effective Date: Tax years beginning after December 31, 2001 except as noted.

- Credit and exclusion limits are increased to $10,000 per child.
- The income phaseout range is increased to $150,000 – $190,000.
- Credit is allowed against AMT.

Adoption Credit—Current Dollar and Income Limitations. Under current law, a tax credit is allowed for qualified adoption expenses paid or incurred by a taxpayer. The maximum credit is $5,000 per eligible child ($6,000 for a special needs child). The credit is phased out ratably for taxpayers with modified adjusted gross income between $75,000 and $115,000.

Eligible Child. An eligible child is defined as an individual who:

1. Has not attained age 18
2. Is physically or mentally incapable of caring for himself or herself

Special Needs Child. A special needs child is an eligible child who is a citizen or resident of the United States whom a state has determined:

1. Cannot or should not be returned to the home of the birth parents, and
2. Has a specific factor or condition (such as the child's ethnic background, age, or membership in a minority or sibling group, or the presence of factors such as medical conditions, or physical, mental, or emotional handicaps) because of which the child cannot be placed with adoptive parents without adoption assistance

Qualified Adoption Expenses. Qualified adoption expenses include reasonable and necessary adoption fees, court costs, attorney fees, and other expenses that are directly related to the legal adoption of an eligible child. These expenses do not include expenses that were:

1. Incurred in violation of State or Federal law
2. Incurred for the adoption of a spouse's child
3. Incurred for carrying out any surrogate parenting arrangement
4. Reimbursed by the taxpayer's employer or any other person or organization

Timing of Credit. Qualified adoption expenses may be incurred in one or more taxable years.

1. The credit for expenses that are incurred or paid before the tax year in which the adoption becomes final is allowed the next tax year.
2. The credit for expenses incurred or paid in the year the adoption becomes final is allowed in year the expenses are incurred or paid.
3. The credit for expenses incurred or paid after the tax year in which the adoption becomes final is allowed in the tax year the expenses are incurred or paid.
4. In the case of a special needs child, the adoption credit is not allowed until the tax year in which the adoption becomes final.

> **Practitioner Note.** If the adoption of a special needs child is never finalized, no credit will be allowed.

Carryforward of Unused Credit. The adoption credit is a nonrefundable credit. Any excess credit may be carried forward five taxable years.

Adoption Assistance Programs. In addition to the adoption credit, an employee is allowed to exclude from gross income a maximum of $5,000 for qualified adoption expenses ($6,000 for a special needs child) paid or reimbursed by an employer under an adoption assistance program. A taxpayer may be eligible for both the adoption credit and the exclusion provided that these are not the same qualified adoption expenses. Unlike the credit, the exclusion from gross income cannot occur until the tax year in which the adoption becomes final.

> **Practitioner Note.** An employee who receives $3,000 from his or her employer for qualified adoption expenses in year 1, a year in which the adoption is not yet final, must include the $3,000 in his gross income for year 1. He or she may reduce his or her gross income in the tax year in which the adoption becomes final.

New Law. Under the new law, the following changes are made to the adoption credit and employer-provided assistance exclusion beginning January 1, 2002 (unless otherwise noted):

1. The maximum credit is increased to $10,000 per eligible child, including special needs children.
2. The exclusion from income for employer-provided adoption assistance is also increased to $10,000 per eligible child, including special needs children.
3. For tax years beginning after December 31, 2002, a $10,000 credit will be allowed in the year a special needs adoption is finalized, regardless of the amount of qualified adoption expenses. Also in 2003, a $10,000 exclusion will be allowed for assistance for a special needs adoption provided under an employer's adoption assistance program in the year the adoption is finalized, regardless of the amount of qualified adoption expenses.
4. The phaseout range is increased from between $75,000 and $115,000 to between $150,000 and $190,000 of modified adjusted gross income.
5. The adoption credit will be allowed permanently against the alternative minimum tax.
6. The maximum credit amount, the maximum exclusion amount, and the phaseout range will be adjusted annually for inflation beginning in 2003.

Example 1. Ken and Cindy Hayes began the process to adopt a child (not a special needs child) in 2000. They paid qualified adoption fees of $2,000. During 2001, the year in which the adoption became final, the Hayes paid additional qualified adoption fees of $7,000. During both years, their modified AGI is $105,000.

Answer 1. Current Law. (Effective for 2001) Under the current law, the adoption fees paid in 2000 are allowed as a credit in 2001. Since the adoption became final in 2001, the Hayes are also allowed a credit for the adoption expenses paid in 2001. Their credit amount is subject to a 75% reduction under the income limitation rule ($105,000 – $75,000 = $30,000 / $40,000 = 75%). The Hayes' allowable credit for 2001 is $1,250 ($5,000 maximum credit – (75% × $5,000)).

Answer 2. New Law. (Effective for 2002 through 2010) If the facts were the same as above except that the adoption process was started in 2001 rather than in 2000, the new law would apply to the credit calculation in 2002. The Hayes' total qualified adoption expenses of $9,000 are less than the maximum allowed of $10,000, and their modified AGI of $105,000 is less than the initial phaseout range amount of $150,000. Therefore, the Hayes' allowable credit for 2002 will be the full $9,000.

Practitioner Note. If a taxpayer has only paid or incurred $5,000 in qualified adoption expenses in a special needs child adoption, he or she will still be eligible for the full $10,000 allowable credit in the year that the adoption becomes final.

	Current Law (Effective in 2001)	New Law (Effective 2002-2010)
Maximum credit	$5,000 ($6,000 for a special needs child)	$10,000[1]
Maximum exclusion	$5,000 ($6,000 for a special needs child)	$10,000[2]
Phaseout range	$75,000 to $115,000	$150,000 to $190,000
Allowed against AMT?	No	Yes
Adjusted for inflation?	No	Yes

[1] Beginning in 2003, the taxpayer can claim a $10,000 credit in the year a special needs adoption is finalized regardless of whether the taxpayer has qualified adoption expenses.

[2] Beginning in 2003, the taxpayer can claim a $10,000 exclusion in the case of a special needs adoption regardless of whether the taxpayer has qualified adoption expenses.

Example 1, Answer 1

Form **8839**

Department of the Treasury
Internal Revenue Service

Qualified Adoption Expenses

▶ Attach to Form 1040 or 1040A.

▶ See separate instructions.

OMB No. 1545-1552

2001

Attachment Sequence No. 38

Name(s) shown on return: *Ken and Cindy Hayes*

Your social security number: *137 23 8839*

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

- **Eligible Child**
- **Employer-Provided Adoption Benefits**
- **Qualified Adoption Expenses**

Part I **Information About Your Eligible Child or Children—**You **must** complete this part. See the instructions for details, including what to do if you need more space.

1	(a) Child's name First	(a) Child's name Last	(b) Child's year of birth	Check if child was— (c) born **before** 1983 and was disabled	(d) a child with special needs	(e) a foreign child	(f) Child's identifying number
Child 1	*Jerry*	*Hayes*	*1996*	☐	☐	☐	*137 23 8840*
Child 2				☐	☐	☐	

Caution: *If the child was a foreign child, see* ***Special Rules*** *in the instructions for line 1, column (e), before you complete Part II or Part III. If you received* ***employer-provided adoption benefits,*** *complete Part III on the back next.*

Part II **Adoption Credit**

			Child 1	Child 2		
2	Enter $5,000 ($6,000 for a child with special needs)	2	*5,000*			
3	Did you file Form 8839 in a previous year? ☒ **No.** Enter -0-. ☐ **Yes.** See the instructions for the amount to enter.	3	*0*			
4	Subtract line 3 from line 2	4	*5,000*			
5	Enter the total **qualified adoption expenses** you paid in: • 2000 if the adoption was not final by the end of 2001. • 2000 and 2001 if the adoption was final in 2001. • 2001 if the adoption was final before 2001.	5	*9,000*			
6	Enter the **smaller** of line 4 or line 5	6	*5,000*			
7	Add the amounts on line 6. If zero, skip lines 8-11 and enter -0- on line 12				7	*5,000*
8	Enter your modified adjusted gross income (see instructions)	8		*105,000*		
9	Is line 8 more than $75,000? ☐ **No.** Skip lines 9 and 10, and enter -0- on line 11. ☒ **Yes.** Subtract $75,000 from line 8.	9		*30,000*		
10	Divide line 9 by $40,000. Enter the result as a decimal (rounded to at least three places). Do not enter more than "1.000"				10	× *.750*
11	Multiply line 7 by line 10				11	*3,750*
12	Subtract line 11 from line 7				12	*1,250*
13	Carryforward of adoption credit from prior years (see instructions)				13	*0*
14	Add lines 12 and 13. Then, see the instructions for the amount of credit to enter on Form 1040, line 48, or Form 1040A, line 31				14	*1,250*

For Paperwork Reduction Act Notice, see page 4 of instructions. Cat. No. 22843L Form **8839** (2001)

Example 1, Answer 2

Form **8839**

Department of the Treasury
Internal Revenue Service

Qualified Adoption Expenses

▶ Attach to Form 1040 or 1040A.

▶ See separate instructions.

OMB No. 1545-1552

20012

Attachment Sequence No. 38

Name(s) shown on return: *Ken and Cindy Hayes*

Your social security number: *137 23 8839*

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

- **Eligible Child**
- **Employer-Provided Adoption Benefits**
- **Qualified Adoption Expenses**

Part I **Information About Your Eligible Child or Children—**You **must** complete this part. See the instructions for details, including what to do if you need more space.

1	(a) Child's name First	(a) Child's name Last	(b) Child's year of birth	Check if child was— (c) born **before 1983** and was disabled	(d) a child with special needs	(e) a foreign child	(f) Child's identifying number
Child 1	*Jerry*	*Hayes*	*1996*	☐	☐	☐	*137 23 8840*
Child 2				☐	☐	☐	

Caution: *If the child was a foreign child, see **Special Rules** in the instructions for line 1, column (e), before you complete Part II or Part III. If you received **employer-provided adoption benefits,** complete Part III on the back next.*

Part II **Adoption Credit**

			Child 1	Child 2
2	Enter $5,000 ($6,000 for a child with special needs)	2	*10,000*	
3	Did you file Form 8839 in a previous year? ☒ **No.** Enter -0-. ☐ **Yes.** See the instructions for the amount to enter.	3	*0*	
4	Subtract line 3 from line 2	4	*10,000*	
5	Enter the total **qualified adoption expenses** you paid in: • 2000 if the adoption was not final by the end of 2001. • 2000 and 2001 if the adoption was final in 2001. • 2001 if the adoption was final before 2001.	5	*9,000*	
6	Enter the **smaller** of line 4 or line 5	6	*9,000*	

7	Add the amounts on line 6. If zero, skip lines 8-11 and enter -0- on line 12	7	*9,000*
8	Enter your modified adjusted gross income (see instructions) — 8: *105,000*		
9	Is line 8 more than $150,000? ☒ **No.** Skip lines 9 and 10, and enter -0- on line 11. ☐ **Yes.** Subtract $75,000 from line 8. — 9:		
10	Divide line 9 by $40,000. Enter the result as a decimal (rounded to at least three places). Do not enter more than "1.000"	10	× .
11	Multiply line 7 by line 10	11	*0*
12	Subtract line 11 from line 7	12	*9,000*
13	Carryforward of adoption credit from prior years (see instructions)	13	*0*
14	Add lines 12 and 13. Then, see the instructions for the amount of credit to enter on Form 1040, line 48, or Form 1040A, line 31	14	*9,000*

9

Allowance of Credit for Employer Expenses for Child Care Assistance

Act §205 2
[New I.R.C. §45F]
Effective Date: Tax years beginning after December 31, 2001.

> Employers may receive a tax credit of up to $150,000 for qualified child-care expenses.
>
> - A 25% credit applies to costs of building or operating a facility
> - A 10% credit applies to resource and referral services
> - The credit reduces deductions

Amount of Credit. The Act creates a new tax credit for child care expenses provided by businesses for their employees. These business taxpayers may receive a tax credit equal to 25% of qualified expenses for employee child care plus 10% of child care resource and referral services. The maximum total credit that may be claimed by a business taxpayer cannot exceed $150,000 per taxable year.

Example 1. Norton Fabrics, Inc., a manufacturer of upholstery fabric, is a calendar year taxpayer. In 2002, Norton establishes a child care program for its employees, and incurs $175,000 in qualified child care expenditures and $25,000 in qualified child care resource and referral expenditures. Norton's employer-provided child care credit for 2002 would be $46,250 (($175,000 × 25%) + ($25,000 × 10%)).

Qualified Child-Care Expenses. Qualified child-care expenses include costs paid or incurred:

1. To acquire, construct, rehabilitate, or expand property that is to be used as part of the taxpayer's qualified child-care facility
2. For the operation of the taxpayer's qualified child-care facility
3. Under a contract with a qualified child-care facility to provide child-care services for employees of the taxpayer

In addition, these qualified child-care expenses shall not include expenses in excess of the fair market value of such care.

> **Practitioner Note.** If credits are taken for expenses related to acquiring, constructing, rehabilitating, or expanding a facility, **the taxpayer's basis must be reduced by the amount of the credits.**

Qualified Child-Care Facility. To be a qualified child-care facility, the facility:

1. Must be used principally for child-care (unless it is the principal residence of the taxpayer)
2. Must meet all applicable state and local laws and regulations
3. Must have open enrollment to the taxpayer's employees, and
4. Must not discriminate in favor of highly compensated employees as defined in I.R.C. §414(q)

If the facility is the principal trade or business of the taxpayer, at least 30% of the children enrolled in the facility must be dependents of the taxpayer's employees.

Recapture of Acquisition and Construction Credit. Credits taken by a taxpayer for the expenses for acquiring, constructing, rehabilitating, or expanding a qualified facility are subject to recapture for the first ten years after the qualified child-care facility is placed in service.

Year of Recapture Event	Applicable Recapture Percentage
Years 1–3	100%
Year 4	85%
Year 5	70%
Year 6	55%
Year 7	40%
Year 8	25%
Years 9 and 10	10%
Years 11 and thereafter	0%

Note: Year 1 begins on the **first day of the tax year** in which the qualified child-care facility is placed in service by the taxpayer.

Practitioner Note. If there is a recapture amount with respect to any property whose basis was previously reduced by the credit, the basis of the property is **increased by the recapture amount.**

For purposes of this provision, the term **recapture even**t means (1) a cessation of the operation of the facility as a qualified child-care facility, or (2) a change in ownership, unless the person or business acquiring the facility agrees in writing to assume the potential recapture liability. In the case of the assumption of the recapture liability, the amount would be computed as if there had been no change in ownership. Recapture of the credit **does not apply** to a cessation of operation of the child-care facility as a result of a **casualty loss** to the extent that such loss is restored within a reasonable period of time.

Example 2. Norton Fabrics, Inc., opened its child-care facility to its employees on December 1, 2003. If Norton ceases to operate its child-care facility on November 1, 2006, it will be required to recapture 85% of the construction and acquisition credit.

Practitioner Note. In planning for employer-provided child-care, the taxpayer needs to be aware of the recapture penalty due to the severity of the recapture amount during the early years of the operation of the child-care facility.

General Business Credit. The employer-provided child-care credit is part of the general business credit (I.R.C. §38), and is subject to the I.R.C. §38 limitations and carryovers.

Employer-Provided Retirement Advice

Act §665
[I.R.C. §132(a)(7) and (m)]
Effective Date: Years beginning after December 31, 2001.

Qualified retirement planning services provided by an employer are excluded from income.

Background. There is no specific exclusion under present law for employer-provided retirement planning services. However, such services may be excludable as employer-provided educational assistance or a fringe benefit.

New Law. Beginning in 2002, qualified retirement planning services provided to an employee and his or her spouse by an employer maintaining a qualified plan are excludable from income and wages. The exclusion does not apply with respect to highly compensated employees unless the services are available on substantially the same terms to each member of the group of employees normally provided education and information regarding the employer's qualified plan. "Qualified retirement planning services" include retirement planning advice and information. The exclusion is not limited to information regarding the qualified plan. For example, the exclusion applies to advice and information regarding retirement income planning for an individual and his or her spouse and how the employer's plan fits into the individual's overall retirement income plan. On the other hand, the exclusion does not apply to services that may be related to retirement planning, such as tax preparation, accounting, legal, or brokerage services.

This provision clarifies the treatment of retirement advice provided in a nondiscriminatory manner. It is intended that the Secretary of the Treasury, in determining the application of the exclusion to highly compensated employees, may permit employers to take into consideration employee circumstances other than compensation and position in providing advice to classifications of employees. Thus, for example, the Secretary may permit employers to limit certain advice to individuals nearing retirement age under the plan.

Employer-Provided Educational Assistance

Act §411
[I.R.C. §127]
Effective Date: Courses beginning after December 31, 2001.

Graduate education is included in the exclusion for employer-provided educational assistance and the exclusion is made permanent.

Background. Educational expenses paid by an employer for its employees are generally deductible by the employer.

Employer-paid educational expenses are excludable from the gross income and wages of an employee if provided under an I.R.C. §127 educational assistance plan or if the expenses qualify as a working condition fringe benefit under I.R.C. §132. Under I.R.C. §127, an annual exclusion of up to $5,250 is allowed for employer-provided educational assistance. The exclusion does not apply to graduate courses beginning after June 30, 1996. The exclusion for employer-provided educational assistance for undergraduate courses expires with respect to courses beginning after December 31, 2001.

In order for the exclusion to apply, certain requirements must be satisfied. The educational assistance must be provided pursuant to a separate written plan of the employer. The educational assistance program must not discriminate in favor of highly compensated employees. In addition, not more than 5% of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance plan can be provided for the class of individuals consisting of more than %5 owners of the employer (and their spouses and dependents).

Educational expenses that do not qualify for the I.R.C. §127 exclusion may be excludable from income as a working condition fringe benefit. However, education expenses are generally not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business.

New Law. The provision extends the exclusion for employer-provided educational assistance to graduate education and makes the exclusion (as applied to both undergraduate and graduate education) permanent.

Modification of Education IRAs

Act §401
[I.R.C. §530]
Effective Date: Tax years beginning after December 31, 2001.

- Contribution limit is increased from $500 to $2,000.
- Distributions can be used for elementary and secondary school expenses.
- Dollar limits on room and board expenses have been removed.
- The phaseout range based on income for married taxpayers filing jointly (MFJ) is increased to $190,000 to $220,000.
- Age limits are removed for special needs beneficiaries.
- Deadline for contributions is extended to due date of return (without extensions).
- Distributions can be excluded in the same year an education credit is taken for different expenses.

Annual Contribution Limit. The 2001 Act increases the annual contribution limit to Education IRAs from $500 to $2,000 on behalf on any particular beneficiary.

Example 1. Clark's grandparents contribute the maximum amount allowed each year to an Education IRA for Clark beginning the year in which Clark was born until he reaches 18 years of age.

Current Law. Under the current law, this contribution amount is limited to $500 per year. Clark's grandparents get no deduction for the contributions. Assuming a 5.5% rate of interest, the Education IRA would have accumulated $14,741 to pay for Clark's qualified education expenses when he reaches age 18. The interest portion of $5,741 would represent tax-free savings.

New Law. Under the new law, the maximum contribution amount is $2,000 per year. Clark's grandparents get no deduction for the contributions. Assuming the same 5.5% rate of interest, the Education IRA would have accumulated $58,962 to pay for Clark's qualified education expenses when he reaches age 18. The interest portion of $22,962 represents tax-free savings.

Practitioner Note. Remember that unused balances in an Education IRA can be rolled over tax-free into Education IRAs for other family members. Any balance remaining in an education IRA is deemed to be distributed within 30 days after the date that the beneficiary reaches age 30 (or if the beneficiary dies before age 30, then within 30 days after the beneficiary's death).

Qualified Education Expenses. Under the old law, qualified education expenses that could be paid tax-free from an Education IRA referred to expenses for **higher education.** This definition has been expanded to include **"qualified elementary and secondary school expenses,"** meaning expenses for:

1. Tuition, fees, academic tutoring, special needs services, books, supplies, computer equipment and software, and other equipment in connection with the beneficiary's attendance at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12)
2. Room and board, uniforms, transportation, and supplementary items or services (such as extended day programs) as required or provided by such a school

9

Example 2. In 2002, Clarke is a junior in a public high school that require students to wear uniforms. He is taking a class that require him to have access to the Internet for his homework. He withdraws $2,000 from an Education IRA set up by his grandparents to pay the following expenses:

Computer and printer	$1,000
Educational software	200
Game software	100
Internet access	150
School uniform	300
Notebooks, pens, etc.	50
Bicycle	200
Total	$2,000

At the time Clarke withdrew the $2,000, the Education IRA had a balance of $5,000 of which $4,500 was from his grandparents' contributions and $500 was income on those contributions.

The cost of the game software and the bicycle are not qualified education expenses. Consequently, only $1,700 of the $2,000 withdrawl is excluded from income under the exclusion of qualified educational expenses. The $300 that was used for non-qualified expenses must be allocated pro-rata between contributions to the Education IRA and earnings on those contributions. Since 10% of the amount in the account was earnings at the time of withdrawl, 10% × $300 = $30 is treated as a withdrawl of earnings. That $30 must be included in Clarke's income for the year of the withdrawl and is subject to the additional 10% tax for withdrawls of earnings that are not used for qualified educational expenses.

Practitioner Note. Qualified higher education expenses continue to be defined in I.R.C. §529(e)(3).

Qualified Room and Board Expenses. Under the old law, a student living at home could be allocated up to $1,500 per academic year for room and board, and a student living off campus could be allocated up to $2,500 per academic year. The dollar limitation amounts for purposes of determining higher education qualified room and board expenses have now been eliminated.

Phaseout of Contribution Limit. The phaseout range for determining the contribution limit for married taxpayers filing jointly is increased to twice that of single taxpayers, beginning when modified adjusted gross income exceeds $190,000 ($95,000 for single taxpayers) and ending when modified adjusted gross income reaches $220,000 ($110,000 for single taxpayers). This range for married taxpayers filing jointly was previously $150,000 and $160,000, respectively. The $2,000 contribution limit is ratably reduced over the $30,000 phaseout range ($15,000 for single taxpayers).

Example 3. If Clark's grandparents have $154,000 of modified adjusted gross income, the limit on their contribution is calculated as follows. Under the current law (for 2001), they would only be allowed 60% ($300) of the maximum contribution limit (($154,000 – $150,000) / $10,000 phaseout range = 40% reduction to maximum contribution). Under the new law (effective 2002 through 2010) they would be eligible to make the maximum contribution.

Practitioner Note. The contribution phaseout rules do not apply to entities including corporations and tax-exempt organizations that make contributions to Education IRAs.

Special Needs Beneficiaries. The rule prohibiting contributions to an Education IRA after the beneficiary reaches age 18 does not apply in the case of a special needs beneficiary. Additionally, a deemed distribution of any balance in an Education IRA does not occur when a special needs beneficiary reaches age 30.

A special needs beneficiary is defined as an individual who because of a physical, mental, or emotional condition requires additional time to complete his or her education.

Timing of Contributions. The deadline for contributions to an Education IRA has been extended from the last day of the tax year to the due date of that contributor's tax return (not including extensions). Thus, a calendar year individual taxpayer generally may make contributions for a tax year until April 15 of the following year.

Extension of Time to Return Excess Contributions. A taxpayer now has until May 30 of the year following the tax year of the contribution to make a corrective withdrawal of excess contributions and avoid the 10% penalty tax and the 6% excise tax. The withdrawal must include not only the excess contribution, but also the earnings associated with that excess contribution.

Example 4. Clark's grandparents make a $2,200 contribution to Clark's Education IRA in 2002. The earnings on the excess contribution of $200 are $10. In order to avoid any penalty, a distribution of $210 must be made by May 30, 2003, and Clark must include the $10 interest portion in his 2002 gross income.

Coordination with Hope and Lifetime Learning Credits and Qualified Tuition Programs. Previously, a beneficiary was required to waive the tax-free treatment on distributions from an Education IRA in order to claim the education tax credits during the same tax year. Under the new law, a taxpayer can claim the Hope or Lifetime Learning credit **and** exclude from gross income amounts distributed from an Education IRA on behalf of the same student as long as the distribution is not used for the same qualified educational expenses for which the credit was claimed. Alternately, a taxpayer can elect to not claim the education credit.

The 6% excise tax on contributions made during the same tax year to a beneficiary's Education IRA and to a qualified tuition program is repealed.

If distributions from Education IRAs and qualified tuition programs exceed the beneficiary's qualified higher learning education expenses (after reducing these expenses by the amounts used in claiming the Hope or Lifetime Learning credit), the beneficiary is required to allocate the expenses between the distributions to determine the taxable amount.

9

Example 5. Melissa is a sophomore in college in 2002. In 2002, she incurred the following expenses:

Tuition	$2,000
Room and board	2,500
Books and supplies	600
Total	$5,100

Melissa used $800 of savings and withdrew $4,300 from her Education IRA to pay these expenses. The balance in Melissa's Education IRA at the time she withdrew the $4,300 was $7,500, of which $5,000 was from contributions and $2,500 was from income on those contributions. On her 2002 income tax return, Melissa used the $2,000 of tuition to claim a $1,500 Hope credit. Consequently, for purposes of the tax treatment of the withdrawl from her Education IRA, Melissa's qualified education expenses are:

Total qualified expenses	$5,100
Less expenses used for Hope credit	2,000
Balance	$3,100

Since Melissa's withdrawl exceeded the remaining qualified educational expenses, she must pro-rate the $1,200 excess between a return of contribution and a withdrawl of earning as follows:

Withdrawl from Education IRA	$4,300
Remaining qualified expenses	3,100
Excess withdrawl	$1,200
Proportion that is earnings ($2,500 ÷ $7,500	× .33
Amount subject to tax	$400

Melissa must include the $400 in her 2002 income and she must pay the additional 10% tax for non-qualified withdrawl of income from an Education IRA on that $400.

Example 6. If Melissa in the previous example withdrew $800 from a qualified tuition program instead of using $800 of her savings to pay part of the expenses, she would have $2,000 of combined excess withdrawls from her Education IRA and her qualified tuition program. Assume that 15% of the balance in her qualified tuition program was earnings at the time of the withdrawl.

The 2001 Act requires her to allocate that excess between her Education IRA and her qualified tuition program for purposes of calculating the tax on the excess. [I.R.C. §5299(c)(B)(vi) and I.R.C. §530(d)(2)(C)(ii)]. However, neither the 2001 Act nor the committee reports indicate how that allocation is to be made.

Melissa would minimize the taxes show owes on the excess if she allocates the first $800 to her qualified education program and the remaining $1,200 to her Education IRA as in the previous example. With this allocation her taxable income would be:

Excess withdrawl from tuition program	$ 800	
Portion that is earnings	.15	
Amount subject to tax		$120
Excess withdrawl from Education IRA	$1,200	
Portion that is earnings	.33	
Amount subject to tax		400
Total subject to tax		$520

Melissa must include the $520 in her 2002 income and pay the 10% additional tax on the fall $520.

Practitioner Note. Beginning in 2002, excess withdrawls of income from a qualified tuition program are subject to the same 10% additional tax as excess withdrawls of income from an Education IRA.

If Melissa is required to pro-rate the excess withdrawl between her Education IRA and her qualified tuition program, the excess would be allocated as follows:

Withdrawl from Education IRA	$4,300	
Withdrawl from tuition program	800	
Total withdrawls	$5,100	
Total excess withdrawl	$2,000	
Portion allocated to Education IRA ($4,300 ÷ $5,100)	× .84	
Excess from Education IRA	$1,680	
Portion that is earnings	× .33	
Amount included in income		$554
Total excess withdrawl	$2,000	
Portion allocated to tuition program ($800 ÷ $5,100)	× .16	
Excess from tuition program	$320	
Portion that is earnings	× .10	
Amount included in income		$32
Total included in income		$586

Deduction for Higher Education Expenses

Act §431
[New I.R.C. §222]
Effective Date: Payments made in taxable years beginning after December 31, 2001, and before January 1, 2006.

A deduction is allowed for qualified higher education expenses:

- $3,000 limit for 2002 and 2003 (zero for AGI above $65,000 ($130,000 MFJ))
- $4,000 limit for 2004 and 2005 ($2,000 for AGI above $65,000 ($130,000 MFJ); zero for AGI above $80,000 ($160,000 MFJ))
- A deduction and an education credit cannot be taken for the same student in the same year

New Law. The 2001 Act permits taxpayers an above-the-line deduction for qualified higher education expenses paid by the taxpayer during a taxable year. Qualified higher education expenses are defined in the same manner as for purposes of the Hope credit–tuition and academic fees

In 2002 and 2003, taxpayers with adjusted gross income that does not exceed $65,000 ($130,000 in the case of married couples filing joint returns) are entitled to a maximum deduction of $3,000 per year. Taxpayers with adjusted gross income above these thresholds would not be entitled to a deduction. In 2004 and 2005, taxpayers with adjusted gross income that does not exceed $65,000 ($130,000 in the case of married taxpayers filing joint returns) are entitled to a maximum deduction of $4,000 and taxpayers with adjusted gross income that does not exceed $80,000 ($160,000 in the case of married taxpayers filing joint returns) are entitled to a maximum deduction of $2,000.

Practitioner Note. The provision terminates at the end of 2005.

Taxpayers are not eligible to claim the deduction and a Hope or Lifetime Learning Credit in the same year with respect to the same student. However, a taxpayer may claim an exclusion for distributions from a qualified tuition plan, distributions from an education individual retirement account, or interest on education savings bonds, as long as both a deduction and an exclusion are not claimed for the same expenses.

9

Modifications to Qualified Tuition Programs

Act §402
[I.R.C. §529]
Effective Date: Taxable years beginning after December 31, 2001, except that the exclusion for distributions from a program established by a private institution is effective for taxable years beginning after December 31, 2003.

- Provision is expanded to include private educational institutions.
- First cousins are eligible family members.
- Nonqualified withdrawals are subject to a 10% additional tax.

The 2001 Act expands the definition of “qualified tuition program” to include certain prepaid tuition programs established and maintained by one or more eligible educational institutions (which may be private institutions) that satisfy the requirements under I.R.C. §529 (other than the prior-law state sponsorship rule). In the case of a qualified tuition program maintained by one or more private eligible educational institutions, persons are able to purchase tuition credits or certificates on behalf of a designated beneficiary (as set forth in I.R.C. §529(b)(1)(A)(i), but would not be able to make contributions to a savings account plan (as described in I.R.C. §529(b)(1)(A)(ii). Except to the extent provided in regulations, a tuition program maintained by a private institution is not treated as qualified unless it has received a ruling or determination from the IRS that the program satisfies applicable requirements.

Exclusion from Gross Income. Under the 2001 Act, an exclusion from gross income is provided for distributions made in taxable years beginning after December 31, 2001, from qualified state tuition programs to the extent that the distribution is used to pay for qualified higher education expenses. This exclusion from gross income is extended to distributions from qualified tuition programs established and maintained by an entity other than a state (or agency or instrumentality thereof) for distributions made in taxable years after December 31, 2003.

Qualified Higher Education Expenses. The 2001 Act modifies the definition of qualified higher education expenses to include expenses of a special needs beneficiary that are necessary in connection with his or her enrollment or attendance at the eligible education institution. The Act provides that, for purposes of the exclusion for distributions from qualified tuition plans, the maximum room and board allowance is the amount applicable to the student in calculating costs of attendance for federal financial aid programs under I.R.C. §472 of the Higher Education Act of 1965, as in effect on the date of enactment, or, in the case of a student living in housing owned or operated by an eligible educational institution, the actual amount charged the student by the educational institution for room and board.

Coordination with Hope and Lifetime Learning Credits. The 2001 Act allows a taxpayer to claim a Hope credit or Lifetime Learning credit for a taxable year and to exclude from gross income amounts distributed (both the principal and the earnings portions) from a qualified tuition program on behalf of the same student as long as the distribution is not used for the same expenses for which a credit was claimed.

Rollovers for Benefit of Same Beneficiary. The 2001 Act provides that a transfer of credits (or other amounts) from one qualified tuition program for the benefit of a designated beneficiary to another qualified tuition program for the benefit of the same beneficiary is not considered a distribution. This rollover treatment applies to a maximum of three such transfers with respect to the same designated beneficiary.

Member of Family. The 2001 Act provides that, for purposes of tax-free rollovers and changes of designated beneficiaries, a "member of the family" includes first cousins of the original beneficiary.

Monetary Penalty on Refunds Not Used for Qualified Higher Education Expenses. The 2001 Act repeals the rule that a qualified state tuition program must impose a more than de minimis monetary penalty on any refund of earnings not used for qualified higher education expenses of the beneficiary (except in certain circumstances). Instead, the Act imposes an additional 10% tax on the amount of a distribution from a qualified tuition plan that is includible in gross income (like the additional tax that applies to such distributions from Education IRAs). The same exceptions that apply to the 10% additional tax with respect to education IRAs apply.

A special rule applies because the exclusion for earnings on distributions used for qualified higher education expenses does not apply to qualified tuition programs of private institutions until 2004. Under the special rule, the additional 10% tax does not apply to any payment in a taxable year beginning before January 1, 2004, which is includible in gross income but used for qualified higher education expenses. Thus, for example, the earnings portion of a distribution from a qualified tuition program of a private institution that is made in 2003 and that is used for qualified higher education expenses is not subject to the additional tax, even though the earnings portion is includible in gross income. Conforming the penalty to the Education IRA provisions will make it easier for taxpayers to allocate expenses between the various education tax incentives.

For example, under the 2001 Act, a taxpayer who receives distributions from an Education IRA and a qualified tuition program in the same year is required to allocate qualified expenses in order to determine the amount excludable from income. Other interactions between the various provisions also arise under the conference agreement. For example, a taxpayer may need to know the amount excludable from income due to a distribution from a qualified tuition program in order to determine the amount of expenses eligible for the tuition deduction. The conferees expect that the Secretary of the Treasury will exercise the existing authority under I.R.C. §§529(d) and 530(h) to require appropriate reporting, e.g., the amount of distributions and the earnings portions of distributions (taxable and nontaxable) to facilitate the provisions of the conference agreement.

Student Loan Interest Deduction

Act §412
[I.R.C. §221]
Effective Date: Interest paid on qualified education loans after December 31, 2001.

- Income phaseout ranges are increased.
- The 60-month limit on student loan interest is eliminated.
- Voluntary interest payments are deductible.

The 2001 Act increases the income phaseout ranges for eligibility for the student loan interest deduction as follows:

	Present Law (before 2002)	New Law (after 2001)
All but MFJ	$30,000 to $55,000	$50,000 to $65,000
MFJ	$60,000 to $75,000	$100,000 to $130,000

Practitioner Note. The income phaseout ranges are adjusted annually for inflation after 2002.

The 2001 Act repeals both the limit on the number of months during which interest paid on a qualified education loan is deductible, and the restriction that voluntary payments of interest are not deductible.

Increase in Pension and IRA Contribution Limits

Act §§601, 611, 616, and 631
[I.R.C. §§219, 404, 408, 415]
Effective Date: Tax years beginning after December 31, 2001.

Limits on contributions to pension plans and IRAs are increased.

9

The limits on contributions to pension and individual retirement plans are increased as shown on the following table.

Year	IRAs	SIMPLE	457	401(k); 403(b); and SEP	Defined Contribution Plan	Defined Benefit Plan	Compensation Limit	Stock Bonus and Profit Sharing
2001	$2,000	$ 6,500	$ 8,500	$10,500	$35,000	$140,000	$170,000	15%
2002	$3,000	$ 7,000	$11,000	$11,000	$40,000	$160,000	$200,000	25%
2003	$3,000	$ 8,000	$12,000	$12,000	(2)	(3)	(3)	25%
2004	$3,000	$ 9,000	$13,000	$13,000	(2)	(3)	(3)	25%
2005	$4,000	$10,000	$14,000	$14,000	(2)	(3)	(3)	25%
2006	$4,000	(1)	$15,000	$15,000	(2)	(3)	(3)	25%
2007	$4,000	(1)	(1)	(1)	(2)	(3)	(3)	25%
2008	$5,000	(1)	(1)	(1)	(2)	(3)	(3)	25%
2009-2010	(1)	(1)	(1)	(1)	(2)	(3)	(3)	25%
2011 and after	(4)	(4)	(4)	(4)	(4)	(4)	(4)	15%

(1) The limit is adjusted annually for inflation in $500 increments.
(2) The limit is adjusted annually for inflation in $1,000 increments.
(3) The limit is adjusted annually for inflation in $5,000 increments.
(4) The 2001 Act provisions are repealed, which means rates return to the inflation-adjusted 2001 limits.

Elective Deferrals Not Taken into Account for Purposes of Deduction Limits

Act §614
[I.R.C. §404(n)]
Effective Date. The provision is effective for years beginning after December 31, 2001.

> Elective deferral contributions are not subject to the deduction limits and are not taken into account for any other employer contribution limits.

Background. Under current law, employer contributions to one or more qualified retirement plans are deductible subject to certain limits. In general, the deduction limit depends on the kind of plan.

In the case of a defined benefit pension plan or a money purchase pension plan, the employer generally may deduct the amount necessary to satisfy the minimum funding cost of the plan for the year. If a defined benefit pension plan has more than 100 participants, the maximum amount deductible is at least equal to the plan's unfunded current liabilities.

In the case of a profit-sharing or stock bonus plan, the employer generally may deduct an amount equal to 15% of compensation of the employees covered by the plan for the year.

If an employer sponsors both a defined benefit pension plan and a defined contribution plan that covers some of the same employees (or a money purchase pension plan and another kind of defined contribution plan), the total deduction for all plans for a plan year generally is limited to the greater of (1) 25% of compensation or (2) the contribution necessary to meet the minimum funding requirements of the defined benefit pension plan for the year (or the amount of the plan's unfunded current liabilities, in the case of a plan with more than 100 participants).

For purposes of the deduction limits, employee elective deferral contributions to an I.R.C. §401(k) plan are treated as employer contributions and, thus, are subject to the generally applicable deduction limits.

Subject to certain exceptions, nondeductible contributions are subject to a 10% excise tax.

New Law. Under the 2001 Act, elective deferral contributions are not subject to the deduction limits, and the application of a deduction limitation to any other employer contribution to a qualified retirement plan does not take into account elective deferral contributions.

Example 1. Kimberly elected to put $10,000 of her salary into her employer's 401(k) plan in 2001. That $10,000 contribution reduces the limit on her employer's contribution to her 401(k) by $10,000.

If Kimberly elects to put $10,000 of salary into her employer's 401(k) plan in 2002, it will not reduce the limit on her employer's contribution.

Effect on sole-proprietor 401(k)s. This change makes a 401(k) attractive for a sole proprietor who wants to put a large portion of his or her business income into retirement savings. Under current law, a sole proprietor can contribute almost the same amount to a Simple or SEP and avoid the extra cost of setting up a 401(k). Beginning in 2002, the extra cost of a 401(k) may be worthwhile because the total amount that can be contributed is increased substantially. The sole proprietor can elect the maximum $11,000 deferral as an employee. That deferral does not reduce the limit that the sole proprietor can contribute as an employer. The employer's limit is 25% of up to $200,000 of compensation.

Example 2. Sharon owns a business as a sole proprietor and has $100,000 of profits each year. If she had a 401(k) plan in 2001, she could elect to defer $10,500 of her before tax income into the 401(k) plan. In addition, her business could contribute the remainder of the contribution limit. That limit is 15% of her $100,000 compensation, reduced by her $10,500 elective deferral and one-half of her $12,648 of self-employment tax. Her contribution limit is:

Compensation	$100,000
Less elective deferral	10,500
Less 1/2 of $12,648	6,324
Balance	$ 83,176
Percentage	× .15
Limit	$ 12,476

Therefore, Sharon's business could contribute $12,476 – $10,500 = $1,976 in 2001.

In 2002, Sharon can elect to defer $11,000 of her before-tax income into the 401(k). That reduces her compensation for the contribution limit, but it does not reduce the limit. Assuming the same self-employment tax for 2002 as for 2001, the total contribution limit for 2002 is:

Elective deferral		$11,000
Compensation	$100,000	
Less elective deferral	11,000	
Less 1/2 of $12,648	6,324	
Balance	$ 82,676	
Percentage	× .25	
Employer limit		$20,669
Total contribution limit		$31,669

Employee Contributions to Defined Contribution Plans Limited to 100% of Compensation

Act §632
[I.R.C. §415(c)(1)]
Effective Date: Years beginning after December 31, 2001, except as noted.

- Contribution limit for defined contribution plan is increased to 100% of compensation.
- Contribution limit for I.R.C. §457 plans is increased to 50% of compensation for 2002–2009 and to 100% for 2010.

9

The provision regarding the regulations under I.R.C. §403(b)(2) is effective on the date of enactment. The provision regarding the repeal of the exclusion allowance applicable to tax-sheltered annuities is effective for years beginning after December 31, 2010.

Present Law. Present law imposes limits on the contributions that may be made to tax-favored retirement plans.

Defined contribution plans. In the case of a tax-qualified defined contribution plan, the limit on annual additions that can be made to the plan on behalf of an employee is the lesser of $35,000 (for 2001) or 25% of the employee's compensation [I.R.C. §415(c)]. Annual additions include employer contributions, including contributions made at the election of the employee (i.e., employee elective deferrals), after-tax employee contributions, and any forfeitures allocated to the employee. For this purpose, compensation means taxable compensation of the employee, plus elective deferrals, and similar salary reduction contributions. A separate limit applies to benefits under a defined benefit plan.

For years before January 1, 2000, an overall limit applied if an employee was a participant in both a defined contribution plan and a defined benefit plan of the same employer.

Tax-sheltered annuities. In the case of a tax-sheltered annuity (an "I.R.C. §403(b) annuity"), the annual contribution generally cannot exceed the lesser of the exclusion allowance or the I.R.C. §415(c) defined contribution limit. The exclusion allowance for a year is equal to 20% of the employee's includible compensation, multiplied by the employee's years of service, minus excludable contributions for prior years under qualified plans, tax-sheltered annuities or I.R.C. §457 plans of the employer.

In addition to this general rule, employees of nonprofit educational institutions, hospitals, home health service agencies, health and welfare service agencies, and churches may elect application of one of several special rules that increase the amount of the otherwise permitted contributions. The election of a special rule is irrevocable; an employee may not elect to have more than one special rule apply.

Under one special rule, in the year the employee separates from service, the employee may elect to contribute up to the exclusion allowance, without regard to the 25% of compensation limit under I.R.C. §415. Under this rule, the exclusion allowance is determined by taking into account no more than 10 years of service.

Under a second special rule, the employee may contribute up to the lesser of: (1) the exclusion allowance; (2) 25% of the participant's includible compensation; or (3) $15,000.

Under a third special rule, the employee may elect to contribute up to the I.R.C. §415(c) limit, without regard to the exclusion allowance. If this option is elected, then contributions to other plans of the employer are also taken into account in applying the limit.

For purposes of determining the contribution limits applicable to I.R.C. §403(b) annuities, includable compensation means the amount of compensation received from the employer for the most recent period which may be counted as a year of service under the exclusion allowance. In addition, includable compensation includes elective deferrals and similar salary reduction amounts.

Treasury regulations include provisions regarding application of the exclusion allowance in cases where the employee participates in an I.R.C. §403(b) annuity and a defined benefit plan. The Taxpayer Relief Act of 1997 directed the Secretary of the Treasury to revise these regulations, effective for years beginning after December 31, 1999, to reflect the repeal of the overall limit on contributions and benefits.

I.R.C. §457 plans. Compensation deferred under an eligible deferred compensation plan of a tax-exempt or state and local governmental employer (an "I.R.C. §457 plan") is not includible in gross income until paid or made available. In general, the maximum permitted annual deferral under such a plan is the lesser of (1) $8,500 (in 2001), or (2) 33-1/3% of compensation. The $8,500 limit is indexed for inflation.

New Law. The 2001 Act increases the limits for contributions to defined contribution plans and I.R.C. §457 plans.

Increase in defined contribution plan limit. The 2001 Act increases the 25% of compensation limitation on annual additions under a defined contribution plan to 100%.

I.R.C. §457 plans. The provision increases the 33 1/3% of compensation limitation on deferrals under an I.R.C. §457 plan to 50% for 2002 through 2010, and 100% for 2011 and thereafter.

Example 1. Kevin's salary is $100,000. In 2001, the limit on his contribution to his employer's defined contribution plan is the lesser of $35,000 or 25% of his $100,000 salary, which is $25,000.

In 2002, if Kevin's salary remains at $100,000, the limit on his contribution is the lesser of $40,000 or his $100,000 salary.

Additional Catch-Up Contributions

Act §601
[I.R.C. §219(b)(2)(B)]
Effective Date: Tax years beginning after December 31, 2001.

Individuals age 50 and older can make catch-up contributions to retirement plans.

The 2001 Act allows individuals who have attained age 50 to make additional catch-up contributions to retirement plans as follows. These contributions are in addition to the regularly applicable dollar limits but total contributions cannot exceed earnings. The increase in the IRA limit is also subject to the AGI phaseout limits. The catch-up contribution provision does not apply to after-tax employee contributions. In the case of an I.R.C. §457 plan, this catch-up rule does not apply during the participant's last three years before retirement (in those years, the regularly applicable dollar limit is doubled).

Catch-Up Contribution Limits

Year	IRA	SIMPLE	401(k); 403(b); 457; and SEP
2002	$ 500	$ 500	$1,000
2003	$ 500	$1,000	$2,000
2004	$ 500	$1,500	$3,000
2005	$ 500	$2,000	$4,000
2006 and after	$1,000	$2,500	$5,000

The following examples illustrate the application of the new provision, after the catch-up is fully phased-in (2006–2010).

Example 1. Ardyth is a highly compensated employee who is over 50 and who participates in an I.R.C. §401(k) plan sponsored by Ardyth's employer. The maximum annual deferral limit (without regard to the provision) is $15,000. After application of the special nondiscrimination rules applicable to I.R.C. §401(k) plans, the maximum elective deferral Ardyth may make for the year is $8,000. Under the provision, Ardyth is able to make additional catch-up salary reduction contributions of $5,000 for a total contribution of $13,000.

Example 2. Ben, who is over 50, is a participant in an I.R.C. §401(k) plan. Ben's compensation for the year is $30,000. The maximum annual deferral limit (without regard to the provision) is $15,000. Under the terms of the plan, the maximum permitted deferral is 10% of compensation or, in Ben's case, $3,000. Under the provision, Ben can contribute up to $8,000 for the year ($3,000 under the normal operation of the plan, and an additional $5,000 under the provision).

Faster Vesting for Matching Contributions

Act §632
[I.R.C. §411]
Effective Date: Contributions for plan years beginning after December 31, 2001 except as noted below.

More rapid vesting schedules apply to employer matching contributions.

Background. Under current law, a plan is not a qualified plan unless a participant's employer-provided benefit vests at least as rapidly as under one of two alternative minimum vesting schedules.

1. A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100% of the participant's accrued benefit derived from employer contributions upon the completion of 5 years of service.
2. A plan satisfies the second schedule if a participant has a nonforfeitable right to at least 20% of the participant's accrued benefit derived from employer contributions after 3 years of service, 40% after 4 years of service, 60% after 5 years of service, 80% after 6 years of service, and 100% after 7 years of service.

New Law. Beginning in 2002, more rapid vesting schedules apply to employer matching contributions. Under the provision, employer matching contributions are required to vest at least as rapidly as under one of the following two alternative minimum vesting schedules.

A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100% of employer matching contributions upon the completion of 3 years of service.

A plan satisfies the second schedule if a participant has a nonforfeitable right to 20% of employer matching contributions for each year of service beginning with the participant's second year of service and ending with 100% after 6 years of service.

Effective Date. The provision is effective for contributions for plan years beginning after December 31, 2001, with a delayed effective date for plans maintained pursuant to a collective bargaining agreement. The provision does not apply to any employee until the employee has an hour of service after the effective date. In applying the new vesting schedule, service before the effective date is taken into account.

Rollovers Among Various Types of Plans

Act §§641, 642, and 643
[I.R.C. §§402, 403(b), 408, and 457]
Effective Date: Distributions made after December 31, 2001, except as noted.

Rollovers are allowed among various retirement plans.

In General. The 2001 Act provides that eligible rollover distributions from qualified retirement plans, I.R.C. §403(b) annuities, and governmental I.R.C. §457 plans generally could be rolled over to any of such plans or arrangements. Similarly, distributions from an IRA generally are permitted to be rolled over into a qualified plan, I.R.C. §403(b) annuity, or governmental I.R.C. §457 plan. The direct rollover and withholding rules are extended to distributions from a governmental I.R.C. §457 plan, and such plans are required to provide the written notification regarding eligible rollover distributions. The rollover notice (with respect to all plans) is required to include a description of the provisions under which distributions from the plan to which the distribution is rolled over may be subject to restrictions and tax consequences different than those applicable to distributions from the distributing plan. Qualified plans, I.R.C. §403(b) annuities, and I.R.C. §457 plans would not be required to accept rollovers.

The elective withholding rules applicable to distributions from qualified plans and I.R.C. §403(b) annuities that are not eligible rollover distributions are also extended to distributions from governmental I.R.C. §457 plans. Thus, periodic distributions from governmental I.R.C. §457 plans that are not eligible rollover distributions are subject to withholding as if the distribution were wages and nonperiodic distributions from such plans that are not eligible rollover distributions are subject to withholding at a 10% rate. In either case, the individual may elect not to have withholding apply.

Some special rules apply in certain cases. A distribution from a qualified plan is not eligible for capital gains or averaging treatment if there was a rollover to the plan that would not have been permitted under present law. Thus, in order to preserve capital gains and averaging treatment for a qualified plan distribution that is rolled over, the rollover would have to be made to a "conduit IRA" as under present law, and then rolled back into a qualified plan. Amounts distributed from an I.R.C. §457 plan are subject to the early withdrawal tax to the extent the distribution consists of amounts attributable to rollovers from another type of plan. I.R.C. §457 plans are required to separately account for such amounts.

Rollover of After-Tax Contributions. The provision provides that employee after-tax contributions may be rolled over into another qualified plan or a traditional IRA. In the case of a rollover from a qualified plan to another qualified plan, the rollover is permitted to be accomplished only through a direct rollover. In addition, a qualified plan would not be permitted to accept rollovers of after-tax contributions unless the plan provides separate accounting for such contributions (and earnings thereon). After-tax contributions (including nondeductible contributions to an IRA) would not be permitted to be rolled over from an IRA into a qualified plan, tax-sheltered annuity, or I.R.C. §457 plan.

In the case of a distribution from a traditional IRA that is rolled over into an eligible rollover plan that is not an IRA, the distribution is attributed first to amounts other than after-tax contributions.

Expansion of Spousal Rollovers. The provision provides that surviving spouses may roll over distributions to a qualified plan, I.R.C. §403(b) annuity, or governmental I.R.C. §457 plan in which the surviving spouse participates.

Treasury Regulations. The Secretary of the Treasury is directed to prescribe rules necessary to carry out the provision. Such rules may include, for example, reporting requirements and mechanisms to address mistakes relating to rollovers. It is anticipated that the IRS would develop forms to assist individuals who roll over after-tax contributions to an IRA in keeping track of such contributions. Such forms could, for example, expand Form 8606–Nondeductible IRAs, to include information regarding after-tax contributions.

Effective Date. The provision is effective for distributions made after December 31, 2001. It is intended that the Secretary will revise the safe harbor rollover notice that plans may use to satisfy the rollover requirements. No penalty is imposed on a plan for a failure to provide the information required under the provision with respect to any distribution made before the date that is 90 days after the date the Secretary issues a new safe-harbor rollover notice, if the plan administrator makes a reasonable attempt to comply with such notice requirement. For example, the provision requires that the rollover notice include a description of the provisions under which distributions from the eligible retirement plan receiving the distribution may be subject to restrictions and tax consequences which are different from those applicable to distributions from the plan making the distribution. A plan is treated as making a reasonable good faith effort to comply with this requirement if the notice states that distributions from the plan to which the rollover is made may be subject to different restrictions and tax consequences than those that apply to distributions from the plan from which the rollover is made.

Plan Loans for S Corporation Owners, Partners, Members of LLCs, and Sole Proprietors

Act §612
[I.R.C. §4975(f)(6)]
Effective Date: Years beginning after December 31, 2001.

Owner-employees are allowed to receive loans from retirement plans.

Background. The Internal Revenue Code 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. Certain types of transactions are exempted from the prohibited transaction rules, including loans from the plan to plan participants, if certain requirements are satisfied.

The statutory exemptions to the prohibited transaction rules do not apply to certain transactions in which the plan makes a loan to an owner-employee. Loans to participants other than owner-employees are permitted if loans are available to all participants on a reasonably equivalent basis, are not made available to highly compensated employees in an amount greater than made available to other employees, are made in accordance with specific provisions in the plan, bear a reasonable rate of interest, and are adequately secured. In addition, the Code places limits on the amount of loans and repayment terms.

For purposes of the prohibited transaction rules, an owner-employee means (1) a sole proprietor, (2) a partner who owns more than 10% of either the capital interest or the profits interest in the partnership, (3) an employee or officer of a Subchapter S corporation who owns more than 5% of the outstanding stock of the corporation, and (4) the owner of an individual retirement arrangement (IRA). The term owner-employee also includes certain family members of an owner-employee and certain corporations owned by an owner-employee.

Under the Internal Revenue Code, a two-tier excise tax is imposed on disqualified persons who engage in a prohibited transaction. The first level tax is equal to 15% of the amount involved in the transaction. The second level tax is imposed if the prohibited transaction is not corrected by the earlier of:

1. The date of mailing a notice of deficiency with respect to the first level tax, or
2. The date of which the first level tax is assessed

The second level tax is equal to 100% of the amount involved.

New Law. The 2001 Act generally eliminates the special present-law rules relating to plan loans made to an owner-employee (other than the owner of an IRA). Thus, the general statutory exemption applies to such transactions. Prior law continues to apply with respect to IRAs.

Example 1. Linda owns a sole proprietorship that has 10 employees. The business set up a retirement plan for Linda and all of the employees. In 2001, a loan to any of the employees is not a prohibited transaction under I.R.C. §4975, but a loan to Linda is a prohibited transaction. Beginning in 2002, a loan to Linda is not a prohibited transaction.

Credit for Pension Plan Startup Costs for Small Employers

Act §619
[New I.R.C. §45E]
Effective Date: Costs paid or incurred in taxable years beginning after December 31, 2001, with respect to plans established after such date.

> A nonrefundable tax credit is allowed for administrative and retirement-education expenses incurred by a small business that adopts a qualified retirement plan. The credit is equal to 50% of the first $1,000 of qualified expenses.

The 2001 Act provides a nonrefundable income tax credit for 50% of the administrative and retirement-education expenses for any small business that adopts a new qualified defined benefit or defined contribution plan (including an I.R.C. §401(k) plan), SIMPLE plan, or simplified employee pension (SEP). The credit applies to 50% of the first $1,000 in administrative and retirement- education expenses for the plan for each of the first three years of the plan.

The credit is available to an employer that did not employ, in the preceding year, more than 100 employees with compensation in excess of $5,000. In order for an employer to be eligible for the credit, the plan must cover at least one employee who is not highly compensated. In addition, if the credit is for the cost of a payroll deduction IRA arrangement, the arrangement must be made available to all employees of the employer who have worked with the employer for at least three months.

The credit is a general business credit. The 50% of qualifying expenses that are effectively offset by the tax credit are not deductible; the other 50% of the qualifying expenses (and other expenses) are deductible to the extent permitted under present law.

Example 1. In 2002, Ace Buildings, LLC paid an accountant $800 to set up a SIMPLE IRA for its employees. Ace can claim a $400 ($800 × 50%) credit in 2002 and can deduct the remaining $400.

Credit for Elective Deferrals and IRA Contributions

Act §618
[New I.R.C. §25B]
Effective Date: Tax years beginning after December 31, 2001 and before January 1, 2007.

> A nonrefundable credit is allowed for contributions to a qualified retirement plan. The maximum credit is 50% of up to $2,000 of contributions. The credit is reduced to zero as AGI increases.

The 2001 Act provides a temporary nonrefundable tax credit for contributions made by eligible taxpayers to a qualified plan. The maximum annual contribution eligible for the credit is $2,000. The credit rate depends on the adjusted gross income (AGI) of the taxpayer (determined without regard to the foreign income exclusion and foreign housing exclusion or deduction (I.R.C. §911); the exclusion of income from American Samoa, Guam, or the Northern Mariana Islands (I.R.C. §931); and the exclusion of income form Puerto Rico (I.R.C. §933)). Only joint returns with AGI of $50,000 or less, head of household returns of $37,500 or less, and single returns of $25,000 or less are eligible for the credit. The AGI limits applicable to single taxpayers apply to married taxpayers filing separate returns. The credit is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The credit offsets alternative minimum tax liability as well as regular tax liability. The credit is available to individuals who are 18 or over, other than individuals who are full-time students or claimed as a dependent on another taxpayer's return.

The credit is available with respect to elective contributions to an I.R.C. §401(k) plan, §403(b) annuity, or eligible deferred compensation arrangement of a state or local government (I.R.C. §457 plan), SIMPLE, or SEP, contributions to a traditional or Roth IRA, and voluntary after-tax employee contributions to a qualified retirement plan. The present-law rules governing such contributions continue to apply.

The amount of any contribution eligible for the credit is reduced by taxable distributions received by the taxpayer and his or her spouse from any savings arrangement described above, or any other qualified retirement plan during the taxable year for which the credit is claimed, the two taxable years prior to the year the credit is claimed, and during the period after the end of the taxable year and prior to the due date for filing the taxpayer's return for the year. In the case of a distribution from a Roth IRA, this rule applies to any such distributions, whether taxable or not.

The credit rates based on AGI are as follows:

Married Filing Jointly		Head of Household		All Others		Applicable
Over	Not Over	Over	Not Over	Over	Not Over	Percentage
$ 0	$30,000	$ 0	$22,500	$ 0	$15,000	50
30,000	32,500	22,500	24,375	15,000	16,250	20
32,500	50,000	24,375	37,500	16,250	25,000	10
50,000		37,500		25,000		0

Example 1. Robert is not married and is not a head of household. In 2002 he has $20,000 of AGI and makes a $500 contribution to his IRA. He is allowed a $50 ($500 × 10%) credit under I.R.C. §25B.

Corporate Estimated Taxes

Act §801
[No amendment to IRC, but
I.R.C. §6655 is affected.]
Effective Date: June 6, 2001.

The due dates for corporate estimated taxes are delayed.

The 2001 Act delays corporate estimated taxes as follows:

1. The due date for corporate estimated tax payments due on September 17, 2001, is delayed until October 1, 2001.
2. The due date for 20% of the corporate estimated tax payments due on September 15, 2004, is delayed until October 1, 2004.

Estate and Gift Tax Applicable Exclusion Amount

Act §521
[I.R.C. §2010(c)]
Effective Date: Estates of descendents dying and gifts made after December 31, 2001.

The applicable exclusion amount is increased for gift and estate taxes.

The applicable exclusion amount is increased to $1 million in 2002, and then in steps, so that $3.5 million will be exempt from estate taxes in 2009. However, the gift tax is decoupled from the estate tax applicable exclusion amount so that only $1 million will be exempt from the gift tax. The applicable credit amount and the applicable exclusion amount for the estate and gift taxes are shown in the following table.

	Estate Tax		Gift Tax	
Year of Death or Gift	Applicable Exclusion Amount	Applicable Credit Amount	Applicable Exclusion Amount	Applicable Credit Amount
2001	$ 675,000	$ 220,550	$ 675,000	$ 220,550
2002	1,000,000	345,800	1,000,000	345,800
2003	1,000,000	345,800	1,000,000	345,800
2004	1,500,000	555,800	1,000,000	345,800
2005	1,500,000	555,800	1,000,000	345,800
2006	2,000,000	780,000	1,000,000	345,800
2007	2,000,000	780,000	1,000,000	345,800
2008	2,000,000	780,000	1,000,000	345,800
2009	3,500,000	1,455,800	1,000,000	345,800
2010	Repealed	Repealed	1,000,000	345,800
2011 and after	1,000,000	345,800	1,000,000	345,800

Estate and Gift Tax Rates

Act §511
[I.R.C. §2001(c)]
Effective Date: Estates of descendents dying and gifts made after December 31, 2001.

The highest estate and gift tax rates are reduced.

The 2001 Act reduces the tax rates over a 9-year period by reducing the rates for the highest estate and gift tax brackets. In addition, the 5% surcharge is repealed for gifts made and decedents dying after 2001. As noted above, in 2011, the 2001 Act is repealed, so rates return to those that would be in effect if the 2001 Act had not been enacted. These changes are summarized below.

Calendar Year	Highest Estate Tax Bracket	Highest Gift Tax Bracket
2001	60%*	60%*
2002	50%	50%
2003	49%	49%
2004	48%	48%
2005	47%	47%
2006	46%	46%
2007	45%	45%
2008	45%	45%
2009	45%	45%
2010	Repealed	35%
2011 and thereafter	60%*	60%*

*A 5% surtax is imposed in addition to the unified tax rates on amounts in excess of $10,000,000 to phaseout the benefit of the graduated tax rates. The surtax is imposed only until the average tax rate on the estate reaches 55%. Consequently, the highest marginal tax rate is 60% for amounts over $10,000,000 but not more than $17,184,000. The marginal tax rate drops back to 55% for amounts over $17,184,000.

Effect of the Estate and Gift Tax Changes

Compression of Tax Rates

The phase in of the increased exemption and the rate reductions reduce the number of effective estate and gift tax brackets. Beginning in 2002, there will be only five effective estate and gift tax brackets as follows:

Tax Bracket	Marginal Tax Rate
$1,000,001 to $1,250,000	41%
$1,250,001 to $1,500,000	43%
$1,500,001 to $2,000,000	45%
$2,000,001 to $2,500,000	49%
$2,500,001 and up	50%

Beginning in 2003, there will be only four effective gift and estate tax brackets as follows:

Tax Bracket	Marginal Tax Rate
$1,000,001 to $1,250,000	41%
$1,250,001 to $1,500,000	43%
$1,500,001 to $2,000,000	45%
$2,000,001 and up	49%

In 2004 and 2005, there will be only two effective estate tax brackets as follows:

Tax Bracket	Marginal Tax Rate
$1,500,001 to $2,000,000	45%
$2,000,001 and up	47% (2004) 48% (2005)

In 2006 through 2009, there will be an effective flat estate tax rate as follows:

Year	Tax Bracket	Flat Tax Rate
2006	$2,000,001 and up	46%
2007 and 2008	$2,000,001 and up	45%
2009	$3,500,000 and up	45%

In 2004 through 2009 there will be four effective gift tax brackets as follows:

Tax Bracket	Marginal Tax Rate
$1,000,001 to $1,250,000	41%
$1,250,001 to $1,500,000	43%
$1,500,001 to $2,000,000	45%
$2,000,001 and up	48% (2004) 47% (2005) 46% (2006) 45% (2007–2009)

Beginning in 2010, there will be an effective 35% flat gift tax rate of for taxable gifts over $1,000,000.

Decoupling the Estate and Gift Taxes

Under prior law, the estate and gift taxes were unified so that one rate schedule applied to accumulated gifts during a taxpayer's life and to accumulated lifetime gifts plus the taxable estate at the time of death. Beginning in 2004, the gift tax applicable exclusion amount is less than the estate tax applicable exclusion amount. This difference affects the dynamics of planning lifetime gifts and death transfers.

Under prior law, there were three estate and gift tax advantages to giving assets away during life rather than transferring them at death.

1. The annual exclusion exempts the first $10,000 of lifetime gifts of present interests to each donee each year.

> **Practitioner Note.** The $10,000 annual exclusion is indexed after 1998 in $1,000 increments. For 2001, the indexed amount remains at $10,000.

Example 1. Pam Olive gives $10,000 to each of her 10 grandchildren each year. Those gifts reduce her estate by $100,000 without using any of her applicable exclusion amount. There is no equivalent deduction under the estate tax.

2. Any appreciation in the value of the asset between the date of the gift and the date of death escaped the gift and estate taxes.

Example 2. Clarence Rogers owns a tract of land that is worth $260,000 on August 1, 2006. Prior to 2006, he made taxable gifts totaling $1,000,000. If Clarence gives the land to his daughter on August 1, 2006, under prior law, he would have owed $102,500 of federal gift taxes on the $250,000 taxable gift ($260,000–$10,000 annual exclusion). If the land increased in value to $500,000 by the time of his death in 2013, Clarence would have owed no further gift or estate taxes on the land. By contrast, if Clarence had waited until death to transfer the land to his daughter, under prior law, his estate would have owed $210,000 of estate taxes on the land.

3. The gift taxes paid on lifetime gifts reduce the taxable estate.

Example 3. Mike Rowave had an estate worth $10,000,000 in 2000, before he made a $1,250,000 taxable gift. The gift reduced his estate by not only the $1,250,000 gift, but also by the $227,750 gift tax on that gift. Therefore, if Mike died without any changes in the value of his estate, his taxable estate would have been $10,000,000 – $1,250,000 – $227,750 = $8,522,250. The total of his transfers that would be subject to the gift or estate tax would be $8,522,250 + $1,250,000 = $9,772,250. By contrast, if Mike waited until death to transfer all of his $10,000,000 estate, the full $10,000,000 would be subject to the estate tax.

Those three advantages remain under the new law, but there is now a disadvantage to lifetime gifts over transfers at death. The disadvantage is that accumulated lifetime taxable gifts over the $1,000,000 applicable exclusion amount will create a gift tax liability while the same amount transferred at death may be tax-free. The amount transferred at death may be tax-free because it is under the estate tax applicable credit amount or death occurs when there is no estate tax. Consequently, for purposes of gift and estate tax planning, taxpayers will now rarely want to make taxable gifts that trigger gift tax liability.

Example 4. If Mike from the previous example dies in 2010 and the new law has not been changed, there will be no estate tax on his estate whether he made the gift in 2000 or not. Consequently, making the gift caused him to pay unnecessary gift taxes.

Lifetime gifts that trigger gift tax liability may be warranted (for gift and estate tax planning) for taxpayers who are not expected to live until the repeal of the estate tax in 2010 and who have an estate that exceeds the applicable exclusion amount in the year of expected death.

Example 5. Sally Ryan has a $4,000,000 estate, is elderly, and is in poor health. She has an interest in a family business that is now worth $500,000, but is expected to be worth $1,000,000 in a few years. She wants her grandson, Bob, to have the business interest. Sally has made taxable gifts that accumulate to $675,000 prior to 2001. Sally is likely to live until 2002, but not many years beyond.

For gift and estate tax purposes, Sally should give the business interest to Bob in 2002, when the applicable exclusion amount has increased to $1,000,000. That will cause her to pay $67,650 of gift taxes on the $490,000 taxable gift ($500,000–$10,000 annual exclusion), but will reduce her estate by the potential $1,000,000 value of the business interest as well as the $67,650 of gift taxes. Assuming no other changes in the value of her estate, that reduction in value would reduce her estate tax by $323,092 if she dies in 2007 or 2008.

Special Use Valuation

Act §581
[I.R.C. §2032A]
Effective Date: June 7, 2001 for leases entered into after December 31, 1976.

> A window is provided for claiming a refund of I.R.C. §2032A recapture tax due to net cash lease.

Background. An executor can elect to value certain "qualified real property" used in farming or another qualifying closely held trade or business at its current-use value for estate tax purposes, rather than its fair market value. The maximum reduction in value for such real property is $750,000 (adjusted for inflation occurring after 1997; the inflation-adjusted amount for 2001 is $800,000). Real property generally can qualify for special-use valuation if at least 50% of the adjusted value of the decedent's gross estate consists of a farm or closely-held business assets (including both real and personal property) and at least 25% of the adjusted value of the gross estate consists of farm or closely-held business property. In addition, the property must be used in a qualified use (e.g., farming) by the decedent or a member of the decedent's family for five of the eight years before the decedent's death.

If, after a special-use valuation election is made, the heir who acquired the real property ceases to use it in its qualified use within 10 years of the decedent's death, an additional estate tax is imposed in order to recapture the entire estate-tax benefit of the special-use valuation.

The 1997 Taxpayer Relief Act retroactively allowed lineal descendants of the decedent to enter into net cash leases with a member of his or her family without triggering recapture of the estate taxes saved by the special use valuation election. The change was effective for leases entered into after December 31, 1976. However, many taxpayers were barred by the 3-year statute of limitations from claiming a refund or a credit for taxes paid before the law was changed.

New Law. The new law allows the taxpayers who paid the recapture tax because of a net cash lease that is retroactively allowed under the 1997 Act to file a claim for a refund or credit even though the statute of limitations has run. The claim has to be filed before June 7, 2002.

Example 1. Jacque Rhodes inherited 160 acres of farmland from her father in 1990. Her father's estate elected special use valuation on the land. In 1993, Jacque rented the land to her brother under a cash lease. The IRS assessed a $120,000 recapture tax because of the cash-lease.

Because the 3-year statute of limitations had run, Jacque was not allowed to claim a refund of the $120,000 when the 1997 Act retroactively allowed her to cash-lease the land to her brother without triggering the recapture tax.

The 2001 Act allows Jacque to file a claim for a refund of the $120,000 by June 7, 2002.

Conservation Easement Exclusion

Act §551
[I.R.C. §2031]
Effective Date: Estates of descendents dying after December 31, 2000.

The geographic location requirement for the estate tax exclusion for conservation easements is removed.

Background. An executor can elect to exclude from the taxable estate 40% of the value of any land subject to a qualified conservation easement, up to a maximum exclusion of $100,000 in 1998, $200,000 in 1999, $300,000 in 2000, $400,000 in 2001, and $500,000 in 2002 and thereafter [I.R.C. §2031(c)]. The exclusion percentage is reduced by two percentage points for each percentage point (or fraction thereof) by which the value of the qualified conservation easement is less than 30% of the value of the land (determined without regard to the value of such easement and reduced by the value of any retained development right).

A qualified conservation easement is one that meets the following requirements:

1. The land is located within 25 miles of a metropolitan area (as defined by the Office of Management and Budget) or a national park or wilderness area, or within 10 miles of an Urban National Forest (as designated by the Forest Service of the U.S. Department of Agriculture).
2. The land has been owned by the decedent or a member of the decedent's family at all times during the 3-year period ending on the date of the decedent's death.
3. A qualified conservation contribution [within the meaning of I.R.C. §170(h)] of a qualified real property interest [as generally defined in I.R.C. §170(h)(2)(C)] was granted by the decedent or a member of his or her family. For purposes of the provision, preservation of a historically important land area, or a certified historic structure does not qualify as a conservation purpose.

In order to qualify for the exclusion, a qualifying easement must have been granted by the decedent, a member of the decedent's family, the executor of the decedent's estate, or the trustee of a trust holding the land, no later than the date of the election. To the extent that the value of such land is excluded from the taxable estate, the basis of such land acquired at death is a carryover basis (i.e., the basis is not stepped-up to its fair market value at death). Property financed with acquisition indebtedness is eligible for this provision only to the extent of the net equity in the property.

Retained Development Rights. The exclusion for land subject to a conservation easement does not apply to any development right retained by the donor in the conveyance of the conservation easement. An example of such a development right would be the right to extract minerals from the land. If such development rights exist, the value of the conservation easement must be reduced by the value of any retained development right.

If the donor or holders of the development rights agree in writing to extinguish the development rights in the land, the development rights need not reduce the value of the easement. In such case, those persons with an interest in the land must execute the agreement no later than the earlier of (1) two years after the date of the decedent's death, or (2) the date of the sale of such land subject to the conservation easement. If such agreement is not entered into within this time, those with an interest in the land are personally liable for an additional tax, which is the amount of tax which would have been due on the retained development rights subject to the termination agreement.

Example 1. Lucy Landowner owns farmland that is within 25 miles of a metropolitan area. Her local Land Trust Commission would like to acquire a conservation easement on the land to manage development in the area. The land is worth $500,000 before the easement is transferred. The easement is worth $200,000 and the land without the easement is worth $300,000.

If Lucy donates the conservation easement to the Land Trust Commission, she will be allowed to claim a $200,000 charitable contribution deduction on her income tax return. That $200,000 is not subject to gift taxes and is removed from her estate for purposes of the federal estate tax.

At her death, her estate will be allowed to exclude $120,000 (40% of $300,000) from the value of her estate, which would reduce her estate taxes by $49,200 ($120,000 × 41%).

Practitioner Note. If the land was not within 25 miles of a metropolitan area or a national park or wilderness area, or within 10 miles of an Urban National Forest, Lucy would still qualify for the charitable contribution deduction and her estate would be reduced by the $200,000 value of the easement. The only tax benefit her estate would lose is the 40% deduction of the remaining value from her estate.

New Law. Effective for decedents dying after December 31, 2000, the new law expands the availability of qualified conservation easements by eliminating the requirement that the land be located within a certain distance from a metropolitan area, national park, wilderness area, or Urban National Forest. Thus, under the new law, a qualified conservation easement may be claimed with respect to any land that is located in the United States or its possessions. The new law also clarifies that the date for determining easement compliance is the date on which the donation was made.

Example 2. Under the new law, Lucy's estate would be eligible for the 40% deduction even if the land was not within 25 miles of a metropolitan area or a national park or a wilderness area, or within 10 miles of an Urban National Forest.

State Death Tax Credit

Act §§531 and 523
[I.R.C. §§ 2011 and 2058]
Effective Date: Estates of descendents dying after December 31, 2001.

The state death tax credit is phased out over four years and is replaced with a state death tax deduction.

Prior Law. A credit was allowed against the federal estate tax for any estate, inheritance, legacy, or succession taxes actually paid to any state or the District of Columbia with respect to any property included in the decedent's gross estate. The maximum amount of credit allowable for state death taxes was determined under a graduated rate table, the top rate of which was 16%, based on the size of the decedent's adjusted taxable estate. Most states impose a "pick-up" or "soak-up" estate tax, which serves to impose a state tax equal to the maximum federal credit allowed.

New Law. Under the new law, from 2002 through 2004, the state death tax credit allowable under present law is reduced as follows:

1. In 2002, the state death tax credit is reduced by 25% (from prior law amounts).
2. In 2003, the state death tax credit is reduced by 50% (from prior law amounts).

3. In 2004, the state death tax credit is reduced by 75% (from prior law amounts).

In 2005, the state death tax credit is repealed, after which there will be a deduction for death taxes (e.g., any estate, inheritance, legacy, or succession taxes) actually paid to any state or the District of Columbia, in respect of property included in the gross estate of the decedent. Such state taxes must have been paid and claimed before the later of:

1. Four years after the filing of the estate tax return
2. 60 days after a decision of the U.S. Tax Court determining the estate tax liability becomes final, if *a timely petition for redetermination of a deficiency has been filed with the Tax Court*
3. The expiration of the period of extension to pay estate taxes over time under I.R.C. §6166, or
4. If a timely claim for *a claim for refund or credit of an overpayment* of tax has been filed, the latest of
   a. 60 days from the date of mailing by certified mail or registered mail by the Secretary of the Treasury to the taxpayer of a notice of the disallowance of any part of such claim
   b. 60 days after a decision by any court of competent jurisdiction becomes final with respect to a timely suit instituted upon such claim, or
   c. Two years after a notice of the waiver of disallowance is filed under I.R.C. §6532(a)(3)

Observation. States that currently only have an estate tax that is equal to the federal estate tax credit for death taxes will have to amend their estate tax in order to collect any revenue from it after 2004.

Effect of the Change in Law

Under current law, the effect of a state "pick up" tax and the federal estate tax credit for state death taxes is to simply shift the tax liability from the federal government to the state government. Total liability is not changed.

Example 1. (Current law: effective for 2001). Mary Peters died in 2001 with a $1,000,000 taxable estate. She made no taxable gifts during her lifetime. Her state imposes an estate tax equal to the maximum credit for state death taxes. Her federal and state estate tax liability is calculated as follows:

	Computation Without State Death Tax	Computation With State Death Tax
Taxable estate	$1,000,000	$1,000,000
Tentative tax	345,800	345,800
Applicable credit amount	220,550	220,550
Tax before credit	$ 125,250	$ 125,250
State death tax credit	–0–	33,200
Federal estate tax due	$ 125,250	$ 92,050
Total federal and state	$ 125,250	$ 125,250

Note that the total of the federal and state estate taxes is the same as the federal estate tax that would be due if there were no state death tax.

The deduction will not provide the same tax benefit as the credit that it replaced. The deduction will reduce federal estate taxes by only the marginal federal estate tax rate rather than by 100% of the state death taxes.

Example 2. (New law: effective for 2002- 2010). Assume that Mary's state imposes a flat 4% estate tax when she dies in 2005 with a $2,000,000 gross estate. Mary made no taxable gifts during her lifetime. Mary's state estate tax is $80,000, but the deduction for that tax reduces her federal estate tax by only $36,000. Consequently, her total taxes are increased by $44,000.

	Computation Without State Death Tax	Computation With State Death Tax
Gross estate	$2,000,000	$2,000,000
State death tax deduction	–0–	80,000
Taxable estate	$2,000,000	$1,920,000
Tentative tax	780,800	744,800
Applicable credit amount	555,800	555,800
Federal estate tax due	$ 225,000	$ 189,000
Total federal and state	$ 225,000	$ 269,000

Installment Payment of Estate Tax

Act §571 and 572
[I.R.C. §6166]
Effective Date: Estates of descendents dying after December 31, 2001.

The requirements for installment payment of estate taxes are relaxed so that more estates will qualify.

Background. The estate tax generally is due within nine months of a decedent's death. However, an executor generally may elect to pay estate tax attributable to an interest in a closely held business in two or more installments (but no more than 10). An estate is eligible for payment of estate tax in installments if the value of the decedent's interest in a closely held business exceeds 35% of the decedent's adjusted gross estate (i.e., the gross estate less certain deductions). If the election is made, the estate may defer payment of principal and pay only interest for the first five years, followed by up to 10 annual installments of principal and interest. This provision effectively extends the time for paying estate tax by 14 years from the original due date of the estate tax.

A special 2% interest rate applies to the amount of deferred estate tax attributable to the first $1 million (adjusted annually for inflation occurring after 1998; the inflation-adjusted amount for 2001 is $1,060,000) in taxable value of a closely held business. The interest rate applicable to the amount of estate tax attributable to the taxable value of the closely held business in excess of $1 million is equal to 45% of the rate applicable to underpayments of tax under I.R.C. §6621 (i.e., 45% of the federal short-term rate plus three percentage points). Interest paid on deferred estate taxes is not deductible for estate or income tax purposes.

Example 1. At the time of her death on December 1, 2000, Irene owned a baking business that was worth $800,000. She had a $1 million taxable estate so the estate tax due on September 1, 2001, is $345,800 – $220,550 = $125,250. The executor of Irene's estate elects to pay the $100,200 ($125,250 × $800,000 ÷ $1 million) estate tax due on Irene's $800,000 business in installments under I.R.C. §6166. The executor elects to pay interest only for the first five years (at a rate of 2%) and to pay the $100,800 of tax in ten equal installments beginning five years after the due date of the estate tax return. The payments are as follows:

9

Date	Interest	Principal	Total
September 1, 2002	$ 2,004.00	$ 0	$ 2,004.00
September 1, 2003	$ 2,004.00	$ 0	$ 2,004.00
September 1, 2004	$ 2,004.00	$ 0	$ 2,004.00
September 1, 2005	$ 2,004.00	$ 0	$ 2,004.00
September 1, 2006	$ 2,004.00	$ 10,020.00	$ 12,024.00
September 1, 2007	$ 1,803.60	$ 10,020.00	$ 11,823.60
September 1, 2008	$ 1,603.20	$ 10,020.00	$ 11,623.20
September 1, 2009	$ 1,402.80	$ 10,020.00	$ 11,422.80
September 1, 2010	$ 1,202.40	$ 10,020.00	$ 11,222.40
September 1, 2011	$ 1,002.00	$ 10,020.00	$ 11,022.00
September 1, 2012	$ 801.60	$ 10,020.00	$ 10,821.60
September 1, 2013	$ 601.20	$ 10,020.00	$ 10,621.20
September 1, 2014	$ 400.80	$ 10,020.00	$ 10,420.80
September 1, 2015	$ 200.40	$ 10,020.00	$ 10,220.40
Total	$19,038.00	$100,200.00	$119,238.00

For purposes of these rules, an interest in a closely held business is:

1. An interest as a proprietor in a sole proprietorship
2. An interest as a partner in a partnership carrying on a trade or business if 20% or more of the total capital interest of such partnership is included in the decedent's gross estate, or the partnership had 15 or fewer partners, and
3. Stock in a corporation carrying on a trade or business if 20% or more of the value of the voting stock of the corporation is included in the decedent's gross estate, or such corporation had 15 or fewer shareholders. The decedent may own the interest directly or, in certain cases, ownership may be indirect, through a holding company. If ownership is through a holding company, the stock must be nonreadily tradable. If stock in a holding company is treated as business company stock for purposes of the installment payment provisions, the five-year deferral for principal and the 2% interest rate do not apply. The value of any interest in a closely held business does not include the value of that portion of such interest attributable to passive assets held by such business.

New Law. The new law expands the definition of a closely held business for purposes of installment payment of estate tax. **It increases from 15 to 45** the number of partners in a partnership and shareholders in a corporation that is considered a closely held business in which a decedent held an interest, and thus will qualify the estate for installment payment of estate tax.

The new law also expands availability of the installment payment provisions by providing that an estate of a decedent with an interest in a **qualifying lending and financing business** is eligible for installment payment of the estate tax. The new law also provides that an estate with an interest in a qualifying lending and financing business that claims installment payment of estate tax must make installment payments of estate tax (which will include both principal and interest) relating to the interest in a qualifying lending and financing business **over five years**.

The term "qualifying lending and finance business" means a lending and finance business, if:

1. Based on all the facts and circumstances immediately before the date of the decedent's death, there was substantial activity with respect to the lending and finance business, **or**
2. During at least 3 of the 5 taxable years ending before the date of the decedent's death, such business had
   a. At least one full-time employee substantially all of whose services were the active management of such business

b. ten full-time, nonowner employees substantially all of whose services were directly related to such business, **and**

c. $5,000,000 in gross receipts from activities that qualify as "lending and finance business" described below.

The term "lending and finance business" means a trade or business of:

1. Making loans
2. Purchasing or discounting accounts receivable, notes, or installment obligations
3. Engaging in rental and leasing of real and tangible personal property, including entering into leases and purchasing, servicing, and disposing of leases and leased assets
4. Rendering services or making facilities available in the ordinary course of a lending or finance business, and
5. Rendering services or making facilities available in connection with activities described in 1. through 4. carried on by the corporation rendering services or making facilities available, or another corporation which is a member of the same affiliated group [as defined in I.R.C. §1504 without regard to I.R.C. §1504(b)(3)].

The term "qualifying lending and finance business" does not include any interest in an entity, if the stock or debt of such entity or a controlled group [as defined in I.R.C. §267(f)(1)] of which such entity was a member was readily tradable on an established securities market or secondary market (as defined by the Secretary of the Treasury) at any time within 3 years before the date of the decedent's death.

Example 2. Marvin owned 60% of the shares in the local bank when he died on March 1, 2002. The shares were valued at $800,000 and his taxable estate was $1 million. Marvin's estate can elect the 5-year installment payment of estate taxes under I.R.C. §6166. Of the $125,250 of estate due on December 1, 2002, $100,200 is attributable to the shares of stock. That amount can be paid in five equal installments with interest at 2%. The payments will be as follows:

9

Date	Interest	Principal	Total
December 1, 2003	$ 2,004.00	$ 20,040.00	$ 22,044.00
December 1, 2004	$ 1,603.20	$ 20,040.00	$ 21,643.20
December 1, 2005	$ 1,202.40	$ 20,040.00	$ 21,242.20
December 1, 2006	$ 801.60	$ 20,040.00	$ 20,841.60
December 1, 2007	$ 400.80	$ 20,040.00	$ 20,040.00
Total	$ 6,012.00	$100,200.00	$106,212.00

The 2001 Act also clarifies that the installment payment provisions require that only the stock of holding companies, not that of operating subsidiaries, must be nonreadily tradable in order to qualify for installment payment of the estate tax. The new law also provides that an estate with a qualifying property interest held through holding companies that claims installment payment of estate tax must make all installment payments of estate tax (which will include both principal and interest) relating to a qualifying property interest held through holding companies over 5 years.

No inference is intended as to whether one or more of the specified activities of a qualified lending and financing business would be a trade or business eligible for installment payment of estate tax under present law.

GENERATION-SKIPPING TRANSFER TAX

Deemed Allocation of the Generation-Skipping Transfer Tax Exemption to Lifetime Transfers to Trusts That Are Not Direct Skips

Act §561(a)
[I.R.C. §2632(c)]
Effective Date: Transfers subject to estate or gift tax made after December 31, 2000, and to estate tax inclusion periods ending after December 31, 2000.

> The generation-skipping transfer tax exemption is automatically allocated to indirect skips.

Under the 2001 Act, the generation-skipping transfer tax exemption will be automatically allocated to transfers made during life that are "indirect skips." An indirect skip is any transfer of property (that is not a direct skip) subject to the gift tax that is made to a generation-skipping transfer trust.

Retroactive Allocation of the Generation-Skipping Transfer Tax Exemption

Act §561(a)
[I.R.C. §2632(d)]
Effective Date: Deaths of non-skip persons occurring after December 31, 2000.

> The generation-skipping transfer tax exemption can be allocated retroactively when there is an unnatural order of death.

Under the 2001 Act, the generation-skipping transfer tax exemption can be allocated retroactively when there is an unnatural order of death. If a lineal descendant of the transferor predeceases the transferor, then the transferor can allocate any unused generation-skipping transfer exemption to any previous transfer or transfers to the trust on a chronological basis. The provision allows a transferor to retroactively allocate the generation-skipping transfer exemption to a trust where a beneficiary (a) is a non-skip person, (b) is a lineal descendant of the transferor's grandparent or a grandparent of the transferor's spouse, (c) is a generation younger than the generation of the transferor, and (d) dies before the transferor. The exemption is allocated under this rule retroactively, and the applicable fraction and inclusion ratio would be determined based on the value of the property on the date that the property was transferred to trust.

Severing of Trusts Holding Property Having an Inclusion Ratio of Greater than Zero

Act §562
[I.R.C. §2642(a)]
Effective Date: Severances of trusts occurring after December 31, 2000.

> A trust can be severed into two or more trusts if certain requirements are met.

Under the 2001 Act, a trust can be severed in a "qualified severance." A qualified severance is defined as the division of a single trust and the creation of two or more trusts if (1) the single trust was divided on a fractional basis, and (2) the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust. If a trust has an inclusion ratio of greater than zero and less than one, a severance is a qualified severance only if the single trust is divided into two trusts, one of which receives a fractional share of the total value of all trust assets equal to the applicable fraction of the single trust immediately before the severance. In such case, the trust receiving such fractional share shall have an inclusion ratio of zero and the other trust shall have an inclusion ratio of one. Under the provision, a trustee may elect to sever a trust in a qualified severance at any time.

Modification of Certain Valuation Rules

Act §563
[I.R.C. §2642]
Effective Date: Transfers subject to estate or gift tax made after December 31, 2000.

The inclusion ratio is determined using the finally determined gift tax value or estate tax value.

Background. The generation-skipping tax exemption ($1.06 million for calendar year 2001) is implemented by I.R.C. §§2641 and 2642 by reducing the tax rate that applies to a generation-skipping transfer to reflect the generation-skipping exemption that is applied to the transfer. The inclusion ratio is determined using gift tax values for allocations of generation-skipping transfer tax exemption made on timely filed gift tax returns. The inclusion ratio generally is determined using estate tax values for allocations of generation-skipping transfer tax exemption made to transfers at death. Treas. Reg. §26.2642-5(b) provides that, with respect to taxable terminations and taxable distributions, the inclusion ratio becomes final on the later of the period of assessment with respect to the first transfer using the inclusion ratio or the period for assessing the estate tax with respect to the transferor's estate.

Example 1. Sally gave $100,000 to her granddaughter in a generation-skipping transfer. Sally elected to apply $75,000 of her generation-skipping exemption to the transfer. Consequently, the remaining 25% is taxed by reducing the tax rate by 75%.

Consequently, the tax rate on the $100,000 gift is $55\% \times (1 - 0.75) = 13.75\%$ and the generation-skipping tax is $\$100,000 \times .1375 = \$13,750$.

I.R.C. §2642 labels the fraction that is multiplied by the tax rate ($1 - 0.75 = 0.25$ in the above example) as the "inclusion ratio." It defines the inclusion ratio as 1 minus the applicable fraction. In general, the applicable fraction is the amount of the generation-skipping exemption applied to a transaction divided by the taxable amount of the transaction. (In the above example, it is $\$75,000 \div \$100,000 = 0.75$.

Observation. If the generation-skipping exemption applied to a transaction equals the taxable amount of the transaction, then the applicable fraction is 1 and the inclusion ratio is zero—which means there is no generation-skipping transfer tax on the transfer.

If the generation-skipping transfer exemption applied to a transfer is zero, then the applicable fraction is zero and the inclusion ratio is 1, which means the entire transfer is subject to the generation-skipping transfer tax.

New Law. The new law provides that in connection with timely and automatic allocations of generation-skipping transfer tax exemption, the value of the property for purposes of determining the inclusion ratio shall be its finally determined gift tax value or estate tax value depending on the circumstances of the transfer. In the case of a generation-skipping transfer tax exemption allocation deemed to be made at the conclusion of an estate tax inclusion period, the value for purposes of determining the inclusion ratio shall be its value at that time.

Relief from Late Elections

Act §564
[I.R.C. §2642]
Effective Date: Requests pending on, or filed after, December 31, 2000.

The Treasury Secretary can grant extensions of time to make the election to allocate the generation-skipping transfer tax exemption.

Background. An election to allocate generation-skipping transfer tax exemption to a specific transfer may be made at any time up to the time for filing the transferor's estate tax return. If an allocation is made on a gift tax return filed timely with respect to the transfer to trust, then the value on the date of transfer to the trust is used for determining generation-skipping transfer tax exemption allocation. However, if the allocation relating to a specific transfer is not made on a timely-filed gift tax return, then the value on the date of allocation must be used. There is no statutory provision allowing relief for an inadvertent failure to make an election on a timely-filed gift tax return to allocate generation-skipping transfer tax exemption.

New Law. The new law provides that the Treasury Secretary is authorized and directed to grant extensions of time to make the election to allocate generation-skipping transfer tax exemption and to grant exceptions to the time requirement, without regard to whether any period of limitations has expired. If such relief is granted, then the gift tax or estate tax value of the transfer to trust would be used for determining generation-skipping transfer tax exemption allocation.

In determining whether to grant relief for late elections, the Treasury Secretary is directed to consider all relevant circumstances, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Treasury Secretary deems relevant. For purposes of determining whether to grant relief, the time for making the allocation (or election) is treated as if not expressly prescribed by statute.

Substantial Compliance

Act §564
[I.R.C. §2642]
Effective Date: Transfers subject to estate or gift tax made after December 31, 2000.

Substantial compliance is sufficient to allocate the generation-skipping transfer tax exemption.

Prior Law. Under prior law, there was no statutory rule that provided that substantial compliance with the statutory and regulatory requirements for allocating generation-skipping transfer tax exemption will suffice to establish that generation-skipping transfer tax exemption was allocated to a particular transfer or trust.

New Law. The new law provides that substantial compliance with the statutory and regulatory requirements for allocating generation-skipping transfer tax exemption will suffice to establish that generation-skipping transfer tax exemption was allocated to a particular transfer or a particular trust. If a taxpayer demonstrates substantial compliance, then so much of the transferor's unused generation-skipping transfer tax exemption will be allocated to the extent it produces the lowest possible inclusion ratio. In determining whether there has been substantial compliance, all relevant circumstances will be considered, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Treasury Secretary deems appropriate.

CHANGES THAT FIRST TAKE EFFECT AFTER 2002

Repeal of Phaseout of Personal Exemption Deductions

Act §102
[I.R.C. §151]
Effective Date: Tax years beginning after December 31, 2005.

The phaseout of the personal exemption deduction will be gradually reduced after 2005 and eliminated after 2009.

Under present law, taxpayers with an adjusted gross income (AGI) over the threshold amount must reduce their personal exemption deduction amount by 2% for each $2,500 by which the taxpayers' AGI exceeds this amount. For married taxpayers filing separate returns, the phaseout rate is 2% for each $1,250. For 2001, the threshold amounts are $132,950 for single taxpayers, $166,200 for head of household taxpayers, $199,450 for married taxpayers filing joint returns, and $99,725 for married individuals filing separate returns.

The 2001 Act repeals the overall limitation on personal exemption deductions for all taxpayers over a 5-year phase-in period **beginning in 2006.** For 2006 and 2007, the limitation will be reduced by one-third. For 2008 and 2009, the limitation will be reduced by two-thirds. For 2010, the limitation will be fully repealed.

Phaseout of Personal Exemption Deduction Limitation

Years	Limitation on Personal Exemption Deductions
2006 and 2007	2/3 of current law limitation
2008 and 2009	1/3 of current law limitation
2010	No limitation

Example 1. Ronald and Rae McDonald, married taxpayers filing a joint return, have an AGI of $270,000 and can claim four exemption deductions.

If, in 2006, the inflation-adjusted threshold amount for the limitation on personal exemption deductions for married joint filers is $222,000, the McDonalds's must reduce their personal exemption deduction. Assuming the inflation-adjusted personal exemption deduction is $3,300, their personal exemption deduction before phaseout is $13,200 ($3,300 × 4). The excess amount of AGI reduces their personal exemption deduction by 20 (($270,000 – $222,000) = $48,000 / $2,500 = 19.2 rounded up) × 2% × $13,200, or $5,280. For 2006, this $5,280 is decreased to $3,520 ($5,280 × 2/3), reducing the McDonalds's personal exemption deduction to $9,680 ($13,200 – $3,520).

Assuming the same facts in 2008, the personal exemption deductions are decreased by only $1,760 ($5,280 × 1/3), reducing the McDonalds' personal exemption deduction to $11,440 ($13,200 – $1,760).

Assuming the same facts in 2010, no reduction in the personal exemption deduction is required. (Note that the threshold amount for the reduction in the personal exemption deduction will be adjusted for inflation, but was held constant in this example for comparison purposes.)

Phaseout of Overall Limitation on Itemized Deductions

Act §103
[I.R.C. §68]
Effective Date: Tax years beginning after December 31, 2005.

The limitation on itemized deductions will be phased out starting after 2005 and will be eliminated after 2009.

9

Under present law, taxpayers with an adjusted gross income (AGI) over the threshold amount must reduce their otherwise allowable deductions by the lesser of: (1) 3% of the amount of the taxpayer's AGI in excess of the threshold amount; or (2) 80% of the itemized deductions. This 80% limitation does not apply to medical expenses, investment interest expenses, casualty or theft losses, or allowable wagering losses. For 2001, the threshold amounts are $132,950 for single taxpayers, head of household taxpayers, and married taxpayers filing joint returns. For married taxpayers filing separate returns, this threshold amount is $66,475.

The 2001 Act repeals the overall limitation on itemized deductions for all taxpayers over a 5-year phasein period **beginning in 2006.** For 2006 and 2007, the limitation will be reduced by one-third. For 2008 and 2009, the limitation will be reduced by two-thirds. For 2010, the limitation will be fully repealed.

Phaseout of Itemized Deduction Limitation

Years	Limitation on Itemized Deductions
2006 and 2007	2/3 of current law limitation
2008 and 2009	1/3 of current law limitation
2010	No limitation

Example 1. Ronald and Rae McDonald, married taxpayers filing a joint return, have an AGI of $200,000. Their state income taxes, real estate taxes, mortgage interest and charitable contributions total $20,000. Their deductible medical expenses do not exceed the 7.5%-of-AGI floor.

If, in 2006, the inflation-adjusted threshold amount for the limitation on itemized deductions is $152,000, the McDonalds must reduce their otherwise allowable itemized deductions of $20,000. Three percent of the excess of AGI over the threshold amount, or $1,440 (($200,000 – $152,000) × 3%), is less than 80% of the itemized deductions, or $16,000 (80% × $20,000). For 2006, this $1,440 is decreased to $960 ($1,440 × 2/3), reducing the McDonalds's otherwise allowable itemized deductions to $19,040 ($20,000 – $960).

Assuming the same facts in 2008, the itemized deductions are decreased by only $480 ($1,440 × 1/3), reducing the McDonalds's otherwise allowable itemized deductions to $19,520 ($20,000 – $480).

Assuming the same facts in 2010, no reduction in allowable itemized deductions is required. (Note that the threshold amount for the limitation on itemized deduction will be adjusted for inflation, but was held constant in this example for comparison purposes.)

Practitioner Note. Cash-basis taxpayers whose incomes are above the AGI threshold amounts in 2005, 2007, or 2009 should consider shifting their itemized deductions to the following year by deferring the payment of these deductible expenses.

Refunds Disregarded in the Administration of Federal Programs and Federal Assisted Programs

Act §203
[I.R.C. §24]
Effective Date: No effective date given.

The refundable portion of the child tax credit does not constitute income.

The Act provides that the **refundable portion of the child tax credit does not constitute income.** This refund will not be treated as resources for purposes of determining eligibility or the amount or nature of benefits or assistance under any federal program or any state or local program financed with federal funds.

Expansion of Dependent Care Tax Credit

Act §204
[I.R.C. §21]
Effective Date: Tax years beginning after December 31, 2002.

- The maximum credit is increased from 30% to 35%.
- The income threshold for phaseout of the credit is increased from $10,000 to $15,000.
- The maximum eligible employment related expenses is increased from $2,400 to $3,000 for one qualifying individual and from $4,800 to $6,000 for two or more qualifying individuals.

The dependent care tax credit is a nonrefundable personal credit determined by multiplying the eligible employment-related expenses paid during the year for dependent care by the applicable percentage allowed by the tax law. The credit is equal to 30% of employment-related expenses, **excluding employer dependent assistance program payments,** for taxpayers with adjusted gross income (AGI) of $10,000 or less. The 30% credit rate is reduced by one percentage point for each $2,000 of AGI above $10,000. For taxpayers with over $28,000 AGI, the credit is 20% of these eligible employment-related expenses. Eligible employment-related expenses are limited to $2,400 for one qualifying individual and $4,800 for two or more qualifying individuals. A qualifying individual is:

1. A dependent of the taxpayer who is under the age of 13 and for whom the taxpayer is eligible to claim a dependency exemption, or
2. A dependent (including a spouse) of the taxpayer who is physically or mentally incapable of caring for himself or herself.

Tax Relief Impact. Beginning in 2003, the maximum credit rate is increased from 30% to 35%. The new income threshold for the phasedown of the credit increases from $10,000 to $15,000. Additionally, the maximum amount of eligible employment-related expenses increases from $2,400 to $3,000 for taxpayers with one qualifying individual, and from $4,800 to $6,000 for taxpayers with two or more qualifying individuals. For taxpayers with over $43,000 AGI, the credit is 20% of the eligible employment-related expenses.

Comparison of Applicable Credit Percentages

Adjusted Gross Income:		Adjusted Gross Income:	
Over:	**But not over:**	**Before 2003:**	**After 2002:**
$ 0	$ 10,000	30%	35%
10,000	12,000	29%	35%
12,000	14,000	28%	35%
14,000	15,000	27%	35%
15,000	16,000	27%	34%
16,000	17,000	26%	34%
17,000	18,000	26%	33%
18,000	19,000	25%	33%
19,000	20,000	25%	32%
20,000	21,000	24%	32%
21,000	22,000	24%	31%
22,000	23,000	23%	31%
23,000	24,000	23%	30%
24,000	25,000	22%	30%
25,000	26,000	22%	29%
26,000	27,000	21%	29%
27,000	28,000	21%	28%
28,000	29,000	20%	28%
29,000	31,000	20%	27%
31,000	33,000	20%	26%
33,000	35,000	20%	25%
35,000	37,000	20%	24%
37,000	39,000	20%	23%
39,000	41,000	20%	22%
41,000	43,000	20%	21%
43,000		20%	20%

9

Example 1. James Jones has AGI of $35,000, one qualifying dependent, and employment-related dependent care expenses of $2,800.

Current Law. In 2001, James's AGI exceeds $28,000, so he would be limited to the 20% credit. His nonrefundable credit for 2001 is $480 (20% × $2,400 limitation for qualified employment-related expenses).

New Law. In 2003, James's credit percentage is reduced from the maximum 35% credit by one percentage point for each $2,000 of AGI above $15,000, or 10%. His credit for 2003 is $700 (25% × $2,800). Note that his qualified employment-related expenses fall below the maximum allowable amount of $3,000.

Practitioner Note. This credit is not available to married taxpayers filing separate returns.

Standard Deduction—Marriage Penalty Relief

Act §301
[I.R.C. §63]
Effective Date: Tax years beginning after December 31, 2004.

The standard deduction for MFJ is increased to twice the standard deduction for unmarried taxpayers.

The Act increases the size of the standard deduction for a married couple filing a joint return to twice the size of the standard deduction for single filers. This increase is phased in over a 5-year period **beginning in 2005,** and is presented as a percentage of the standard deduction for single individuals.

Taxable Year	Applicable Percentage
2005	174
2006	184
2007	187
2008	190
2009 and thereafter	200

The exact standard deduction dollar amounts are unknown because of the inflation adjustments for the single individual deduction.

Example 1. Currently, the standard deduction for married individuals filing joint returns is approximately 167% of that of single individuals. If, in 2005, the standard deduction for single individuals is $5,000, then the standard deduction for married individuals filing joint returns will increase to $8,700 (174% of $5,000). This change will represent a decrease in taxable income of $350 ($8,700 – ($5,000 × 167%)). Assuming the married filers' marginal tax rate is 26%, this decrease in taxable income translates to a tax savings of $91.

In 2008, assuming the same standard deduction of $5,000 for single filers, the standard deduction for married filers will increase to $10,000 (200% of $5,000). This change will decrease taxable income by $1,650 ($10,000 – ($5,000 × 167%)). Assuming the married filers' marginal tax rate is 25%, this decrease in taxable income translates to a tax savings of $413. (Note that the standard deduction amount will be adjusted for inflation, but was held constant in this example for comparison purposes.)

Expansion of the 15% Rate Bracket for Married Couples Filing Joint Returns

Act §302
[I.R.C. §1(f)]
Effective Date: Tax years beginning after December 31, 2004.

The 15% tax bracket for MFJ is increased to twice the size of the 15% bracket for single individuals.

The 2001 Act increases the size of the 15% regular income tax bracket for a married couple filing a joint return to twice the size of the 15% bracket for single individuals. This increase is phased in over a 4-year period beginning in 2005. The following table shows the 15% bracket for joint filers as a percentage of the 15% bracket for single filers.

Taxable Year	Applicable Percentage
2005	180
2006	187
2007	193
2008 and thereafter	200

The exact bracket dollar amounts are unknown because of the inflation adjustments for the single individual rate schedules.

Example 1. Currently, the maximum taxable income in the 15% bracket for married individuals filing joint returns is approximately 167% of that of single individuals. If, in 2005, the maximum taxable income in the 15% bracket for single individuals is $30,100, then the maximum taxable income in the 15% bracket for married individuals filing joint returns will increase to $54,180 (180% of $30,100). This change will represent an increase of $3,913 ($54,180 – ($30,100 × 167%)) taxed in the 15% bracket instead of the 26% bracket then in effect, a tax savings of $430.

In 2008, assuming the same 15% bracket amount of $30,100 for single filers, the 15% bracket for married filers will increase to $60,200 (200% of $30,100). This change will represent an increase of $9,933 ($60,200 – ($30,100 × 167%)) taxed in the 15% bracket instead of the 25% bracket then in effect, a tax savings of $993. (Note that the 15% bracket amount will be adjusted for inflation, but was held constant in this example for comparison purposes.)

Practitioner Note. Although this change is aimed at reducing the marriage tax penalty, married couples with only one wage earner will also benefit significantly from the increased 15% bracket amount.

Date-of-Death Basis

Act §§541 and 542
[I.R.C. §§1014, 1022, 6018, 6075, and 6716]
Effective Date: Estates of decedents dying after December 31, 2009.

- The date-of-death value basis provision is repealed and replaced with a modified carryover basis provision.
- The carryover basis for property transferred at death can be increased up to the date-of-death fair market value, subject to limits.

9

Prior Law

Property Transferred at Death. Taxpayers who received property from a decedent's estate generally had an income tax basis in that property equal to the value of the property on the date of death, the decedent's death (or, if the alternate valuation date was elected, the earlier of 6 months after the decedent's death or the date the property was sold or distributed by the estate). This step up (or step down) in basis eliminated the recognition of income on any appreciation of the property that occurred prior to the decedent's death, and had the effect of eliminating the tax benefit from any unrealized loss.

In community property states, a surviving spouse's one-half share of community property held by the decedent and the surviving spouse (under the community property laws of any state, U.S. possession, or foreign country) generally was treated as having passed from the decedent, and thus was eligible for the date-of-death value basis. This rule applied if at least one-half of the whole community interest was includable in the decedent's gross estate.

If an estate elected to value assets under the special use valuation rules of I.R.C. §2032A, then the basis in those assets was the special use valuation.

Property representing income in respect of a decedent (IRD) had a carryover basis in the hands of taxpayer who received it from the decedent's estate rather than a basis equal to its date of death value. IRD is income that was earned by the decedent before death but was not included on the decedent's final income tax return because it was not paid before the date of death. Accrued interest, accrued dividends, retirement plans, and gain on installment sale payments due after the date of death are examples of IRD.

Property that was given to the decedent within one year of his or her death and is transferred to the donor or the donor's spouse as a result of the decedent's death has a carryover basis rather than a date-of-death value basis.

Property Transferred During Life. Property received from a donor of a lifetime gift took a carryover basis. That means the basis in the hands of the donee was the same as it was in the hands of the donor. The basis of property transferred by lifetime gift was also increased, but not above fair market value, by any gift tax paid by the donor. The basis of a lifetime gift, however, generally could not exceed the property's fair market value on the date of the gift. If the basis of the property was greater than the fair market value of the property on the date of gift, then, for purposes of determining loss in the hands of the donee, the basis was the property's fair market value on the date of gift.

Under prior law, a capital loss and net operating loss from business operations sustained by a decedent during his or her last taxable year were deductible only on the final return filed in his or her behalf. Such losses were not deductible by his or her estate.

New Law

Carryover Basis. Beginning in 2010, the date-of-death value basis rules are replaced by a new set of rules that apply the carryover basis rules that are currently used for gifts to assets that are received from an estate.

> **Practitioner Note.** Under the carryover basis rules, the character of gain on the sale of property received from a decedent's estate is carried over to the heir.

Example 1. Kathy owned a tractor at the time of her death that had a fair market value of $30,000. She had claimed $40,000 of depreciation on it and it had a $10,000 adjusted basis that carried over to her son, Tim. When Tim sells the tractor, he must treat the lesser of his gain or Kathy's $40,000 of depreciation as ordinary income.

Addition to Basis. However, the new rules also allow the executor of an estate to add certain amounts to the basis of assets. The executor can choose the assets to which basis will be added, but the basis of any asset cannot be increased to more than its fair market value on the date of death.

The amount that can be added to the basis is the sum of:

1. $1,300,000,
2. Any unused capital losses from the decedent's final tax year,
3. Any unused net operating losses from the decedent's final tax year, and
4. The amount of loss the decedent would have realized from the sale of assets immediately before death.

> **Practitioner Note.** If the decedent is a nonresident and is not a United States citizen, $60,000 is substituted for $1,300,000 in item 1 above and items 2 through 4 are not included in the limit on additional basis.

In addition, for property passing to a surviving spouse, an additional $3,000,000 can be added to basis.

The $1,300,000, $60,000, and $3,000,000 amounts are indexed for inflation beginning in 2011.

Observation. Taxpayers who did not owe gift and estate taxes under the prior law will not be adversely affected by the new carryover basis rules since their executors can increase the basis in their property up to its fair market value.

Example 2. At the time of his death in 2010, Darwin Rold was not married and owned the following assets with the basis and date-of-death value shown.

Asset	Fair Market Value on Date of Death	Basis	Difference Between Basis and FMV
Farmland	$1,500,000	$ 90,000	$1,410,000
ABC stock	1,000,000	50,000	950,000
XYZ stock	100,000	120,000	(20,000)

Darwin also had $10,000 of unused net operating loss carryovers and $15,000 of unused capital loss carryovers in his final tax year.

If the executor of Darwin's estate does not elect to increase the basis in the assets after Darwin's death, the bases of the farmland and ABC stock are the bases on the date of death shown above. The basis of the XYZ stock is its $100,000 fair market value on the date of death since that is less than Darwin's basis.

The executor of Darwin's estate could elect to increase the bases in assets by a total of:

Statutory amount	$1,300,000
Unrealized loss on XYZ stock	20,000
Unused net operating loss	10,000
Unused capital loss carryover	15,000
Total	$1,345,000

Since the basis of the XYZ stock equals its fair market value before the addition of basis, none of the addition can be added to the basis of the XYZ stock.

Darwin's executor can allocate the $1,345,000 increase between the farmland and the ABC stock in any manner she chooses. Therefore, some options are:

1. The basis of the farmland could be increased to $1,435,000 and the basis of the ABC stock could be left at $50,000
2. The basis of the ABC stock could be increased to $1,000,000 and the basis of the farmland could be increased to $485,000
3. Any combination between the above two options that result in a total $1,345,000 increase

To minimize the impact of income taxes for the recipients of the assets, the executor should allocate basis to those assets that will give the recipients the greatest benefit. That will usually mean allocating basis to assets in the following order:

1. Assets for which the basis affects ordinary income in the near future
   a. Inputs into a trade or business for which basis can be deducted

Example 3. Assume that Darwin had feed inventory at the time of his death and it passed to his daughter who used the feed in her farming business. Allocating basis to the feed would allow his daughter to deduct that basis in the next year when she used the feed in her farming business.

   b. Assets that will be sold in the near future and for which gain is ordinary income

9

Example 4. Assume that Darwin had feeder calves at the time of his death and they passed to his daughter who held them for sale in the ordinary course of her farming business. Allocating basis to the calves would allow her to offset her sale proceeds from the calves by that basis.

2. Assets that can be depreciated

Example 5. Assume Darwin had raised dairy cows at the time of his death and they passed to his daughter who uses them in her farming business. Allocating basis to the cows will allow his daughter to depreciate that basis.

3. Assets that will be sold and for which gain will be treated as capital gain

Example 6. If Darwin's ABC stock will be sold shortly after his death, basis allocated to the ABC stock will reduce the gain that has to be reported.

4. Assets that will be held until the death of the recipient

Example 7. If Darwin's farmland passes to his daughter, who will hold it until her death, she has no use for basis in the farmland, and its basis may be adjusted at her death to its fair market value. Therefore, allocating basis to the farmland at Darwin's death provides little benefit.

If property passes to a surviving spouse, the limit on the increase in basis is increased by $3,000,000.

Example 8. Assume Darwin had a surviving spouse, Nancy, and the ABC stock passed to her. Darwin's executor could allocate up to $1,345,000 of additional basis to the farmland and also increase the basis of the ABC stock by $950,000 to its fair market value.

Property Eligible for Additional Basis

Property must be acquired from the decedent to be eligible for the additional basis. Property acquired from the decedent is:

1. Property acquired by bequest, devise, or inheritance
2. Property acquired by the decedent's estate from the decedent
3. Property transferred by the decedent during his or her lifetime in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust
4. Property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change to the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust
5. Property passing from the decedent by reason of the decedent's death to the extent such property passed without consideration (e.g., property held as joint tenants with right of survivorship or as tenants by the entireties)
6. The surviving spouse's one-half share of certain community property held by the decedent and the surviving spouse as community property

In general, the basis of property may be increased above the decedent's adjusted basis in that property **only if the property is owned, or is treated as owned, by the decedent at the time of the decedent's death.**

In the case of property held as joint tenants or tenants by the entireties with the surviving spouse, one-half of the property is treated having been owned by the decedent and is thus eligible for the basis increase. In the case of property held jointly with a person other than the surviving spouse, the portion of the property attributable to the decedent's consideration furnished is treated as having been owned by the decedent and will be eligible for a basis increase. The decedent also is treated as the owner of property (which will be eligible for a basis increase) if the property was transferred by the decedent during his lifetime to a revocable trust that pays all of its income during the decedent's life to the decedent or at the direction of the decedent. The decedent also is treated as having owned the surviving spouse's one-half share of community property (which will be eligible for a basis increase) if at least one-half of the property was owned by, and acquired from, the decedent. Thus, similar to the prior law rule in I.R.C. §1014(b)(6), both the decedent's and the surviving spouse's share of community property could be eligible for a basis increase.

Property **not** eligible for a basis increase includes:

1. Property that was acquired by the decedent by gift (other than from his or her spouse) during the 3-year period ending on the date of the decedent's death
2. Property that constitutes a right to receive income in respect of a decedent
3. Stock or securities of a foreign personal holding company, and
4. Stock of a domestic international sales corporation (or former domestic international sales corporation)
5. Stock of a foreign investment company, and
6. Stock of a passive foreign investment company (except for which a decedent shareholder had made a qualified electing fund election)

Reporting Requirements

The new law imposes some new reporting requirements on taxpayers to help keep track of the basis in property.

Lifetime Gifts

A donor of property is required to provide information to the recipient of the property if a gift tax return is required for the gift. The donor must send a written statement to the recipient within 30 days of filing the gift tax return. The written statement must show:

1. The name, address and phone number of the donor who is required to file the return
2. The information reported on the return (e.g., fair market value and basis) with respect to the property received by the recipient

Transfers at Death

For transfers at death of noncash assets in excess of $1.3 million and for certain appreciated property received by a decedent within 3 years of death, the executor of the estate (or the trustee of a revocable trust) must report to the IRS:

1. The name and taxpayer identification number of the recipient of the property
2. An accurate description of the property
3. The adjusted basis of the property in the hands of the decedent and its fair market value at the time of death
4. The decedent's holding period for the property
5. Sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income

6. The amount of basis increase allocated to the property, and
7. Any other information as the Treasury Secretary may prescribe

Appreciated property received by the decedent within 3 years of death is subject to this reporting requirement only if:

1. The property is not eligible for the $1,300,000 or $3 million addition to basis, and
2. A gift tax return was required for the gift to the decedent.

Penalties for Failure to File Required Information

Any donor required to report the basis and character of any noncash property who fails to do so is liable for a penalty of $50 for each failure to report such information to a donee.

Any person required to report to the IRS transfers at death of noncash assets in excess of $1.3 million in value who fails to do so is liable for a penalty of $10,000 for the failure to report such information. Any person required to report to the IRS the receipt by a decedent of appreciated property within 3 years of death who fails to do so is liable for a penalty of $500 for the failure to report such information to the IRS. There also is a penalty of $50 for each failure to report such information to a beneficiary.

No penalty is imposed with respect to any failure that is due to reasonable cause. If any failure to report to the IRS or a beneficiary under the 2001 Act is due to intentional disregard of the rules, then the penalty is 5% of the fair market value of the property for which reporting was required, determined at the date of the decedent's death (for property passing at death) or determined at the time of gift (for a lifetime gift).

Transfer of Property Subject to a Liability

Act §542(a)
[I.R.C. §1022(g)]
Effective Date: Estates of decedents dying after December 31, 2009.

Gain is not recognized at the time of death for property that is subject to debt in excess of decedent's basis.

Background. A donor who gives property that is subject to a debt greater than its income tax basis is required to recognize gain to the extent the debt exceeded the basis. Since the new law applies the carryover basis rules for gifts to transfers at death, it could have applied the debt in excess of basis rules to transfers at death as well.

New Law. The 2001 Act clarifies that gain is not recognized at the time of death when the estate or heir acquires from the decedent property subject to a liability that is greater than the decedent's basis in the property. Similarly, the estate recognizes no gain on the distribution of such property to a beneficiary of the estate by reason of the liability.

Transfers of Property in Satisfaction of a Pecuniary Bequest

Act §542(d)(1)
[I.R.C. §1040]
Effective Date: Estates of decedents dying after December 31, 2009.

If an estate distributes property to satisfy a pecuniary bequest, it has to recognize gain on only the difference between the value of the property on the date of death and the value of the property on the date of the distribution.

Under prior law, gain or loss was recognized on the transfer of property in satisfaction of a pecuniary bequest (i.e., a bequest of a specific dollar amount) to the extent that the fair market value of the property at the time of the transfer exceeded the basis of the property, that generally is the basis stepped up to fair market value on the date of the decedent's death.

If the carryover basis for property transferred at death were used to calculate the gain on satisfaction of a pecuniary bequest, the estate would have to recognize not only the increase in value after the decedent's death but also the gain that was built into the property at the time of death. Consequently, the new law allows the estate to recognize gain measured by the **difference between the fair market value on the date of death and the fair market value on the date of the distribution.**

Example 1. Pedro Gonzales owned MNO stock that was worth $100,000 on the date of his death. His basis in the stock was $75,000.

If Pedro died before 2010, the basis in the stock is stepped up to the $100,000 date-of-death value so that only $10,000 of gain is recognized when it is distributed to satisfy the $110,000 pecuniary bequest.

If Pedro died in 2010 and the MNO stock received a $75,000 carryover basis, the estate realizes a $35,000 gain when it distributes the stock to satisfy a $110,000 bequest. However, the new law requires the estate to only recognize the $10,000 **difference between the date-of-death value and the date-of-distribution value.**

Income Tax Exclusion for the Gain on the Sale of a Principal Residence

Act §542(c)
[I.R.C. §121(d)(9)]
Effective Date: Property received from a decedent dying after December 31, 2009.

An estate or heir can use the decedent's $250,000 exclusion for gain on a principal residence.

Background. A taxpayer generally can exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. The exclusion is allowed each time a taxpayer sells or exchanges a principal residence that meets the eligibility requirements, but generally no more frequently than once every two years.

To be eligible, a taxpayer must have owned the residence and occupied it as a principal residence for at least two of the five years prior to the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or other unforeseen circumstances is allowed to exclude the fraction of the $250,000 ($500,000 if married filing a joint return) equal to the fraction of two years that these requirements are met.

New Law. The income tax exclusion of up to $250,000 of gain on the sale of a principal residence is extended to estates and heirs. Under the bill, if the decedent's estate or an heir sells the decedent's principal residence, $250,000 of gain can be excluded on the sale of the residence, provided the decedent used the property as a principal residence for two or more years during the 5-year period prior to the sale. In addition, if an heir occupies the property as a principal residence, the decedent's period of ownership and occupancy of the property as a principal residence can be added to the heir's subsequent ownership and occupancy in determining whether the property was owned and occupied for two years as a principal residence.

Observation. This provision can be combined with the additional basis rules discussed above to increase the amount of decedent's gain that is excluded upon sale of assets after the date of death.

Qualified Family-Owned Business Deduction

Act §521(d)
[I.R.C. §2057]
Effective Date: Estates of decedents dying after December 31, 2003.

The family-owned business interest deduction is repealed.

In 2004, the family-owned business deduction would no longer be effective under the new law since the applicable exclusion amount goes up to $1,500,000, and the combined value of the family-owned business exclusion and the applicable exclusion amount is limited to $1,300,000. Consequently, the family-owned business deduction is repealed effective for years beginning after December 31, 2003.

However, according to the Conference Committee report, the recapture provisions are left in place with respect to family-owned business deductions that were claimed prior to repeal of the deduction. Consequently, heirs who received property for which the family-owned business deduction was claimed will be subject to the recapture for the 10- (or 12-)year period following the decedent's death.

Practitioner Note. Contrary to the Committee Reports, the 2001 Act repeals the recapture provisions. A technical correction would cure this discrepancy.