

TAXPAYER’S RELIEF ACT OF 1997 - SELECTED ISSUES

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I. TAX RELIEF ACT OF 1997

A. Capital Gains

1. NEW RATES

- a) The capital gains tax rate for individuals, estates and trusts is reduced from 28% to 20% for assets sold after May 6, 1997, and held longer than 18 months.
 - (1) Collectibles such as artwork, trading cards, stamp collections, memorabilia are excluded from these lower rates.
 - (2) For sales between May 6 and July 28, the holding period is 12 months.
 - (3) For those in the 15% tax bracket, currently couples with adjusted gross income ("AGI") of \$41,200, the tax is reduced from 15% to 10%.
 - (4) Pass-through entities (mutual funds, S corporations, partnerships, estates and trusts) may pass through these capital gains to their owners or beneficiaries.

2. EXCEPTIONS

- a) Small business stock (certain stock held for 5 years in a small business) that qualifies for the 50% exclusion is not eligible for the new rates. But if the stock is sold between 18 and 60 months, and thus is ineligible for the 50% exclusion, then the new rates will apply.
- b) Assets held between 12 and 18 months are taxed at the old rates.
- c) Assets held less than 12 months are short-term capital gains and, in general, are taxed as ordinary income.

3. LOWER RATES AFTER DECEMBER 31, 2000

- a) In general, rates drop from 20% to 18% (and from 10% to 8%) for assets acquired after December 31, 2000 and held for at least 5 years.
- b) Taxpayers may apply these lower rates to assets held on December 31, 2000, by electing to treat the asset as sold on January 2, 2001, for its fair market value and paying the tax on the gain.
 - (1) Taxpayers cannot recognize a loss under these rules.
 - (2) Under this election, the 5-year holding period would begin on January 2, 2001.
 - (3) In general, taxpayers will not elect to pay an immediate tax unless the gain was negligible.

4. INSTALLMENT SALES

- a) According to the legislative history, these new rates apply to installment payments received after May 6, 1997.

5. HOLDING PERIOD

- a) The holding period begins the day after an asset is acquired and ends on the date of sale.
- b) The number of months is determined by using the same day in each month that the holding period began.
 - (1) For example, an asset purchased on August 14, 1997, has an initial holding period of August 15th and a new month begins on the 15th day of each subsequent month. Therefore, the 18-month holding period is reached on February 15, 1999.

6. RECAPTURE OF REAL ESTATE DEPRECIATION

- (1) Gain caused by real estate depreciation will be taxed at 25%. These reductions apply to all taxpayers and are not restricted by AGI.
- (2) This could negatively impact those owning apartment houses and those who have used a home-office deduction for their residences.
 - (a) If a taxpayer acquired a property through a series of Sec. 1031 exchanges, he might not have the records necessary to compute the depreciation recapture.
 - (b) The adjusted basis in the present property is the value used to compute the gain on sale.
 - (i) Example: If a taxpayer buys a property for 100x, improves it by 50x and then depreciates it by 80x, the adjusted basis would be 70x ($100 + 50 = 150 - 80 = 70$). If the taxpayer then exchanged the property for another property worth 200x, he'd carryover his 70x basis. If he then depreciated the property 20x and sold it for 250X, would the depreciation recapture be the current 20x or 100x (prior plus the current depreciation)?

7. OBSERVATIONS

- a) The capital gains cut is significant for those owning stock and highly appreciated real property.
- b) Those who have depreciated their real property will be subject to a 25% capital gains tax on that depreciation.
 - (1) This value, however, may have no relation to prior depreciation taken with respect to the properties that were subject to the Sec. 1031 exchange provisions.

B. Taxation of Transactions That Eliminate Risk of Loss

1. ELIMINATION OF RISK

- a) With the new 18-month holding requirement for capital gains treatment, many taxpayers would be tempted to lock-in gains and wait the 18-month period by selling "short against the box" (selling short the identical securities) to eliminate a risk of loss during the holding period. Congress, however, has put a stop to this technique.
- b) The new law requires gain recognition (but not loss recognition) upon the constructive sale of any "appreciated financial position" in stock, a partnership interest or debt other than on certain straight debt instruments.

(1) In general, a taxpayer engages in a constructive sale when he enters into a short sale, an offsetting notional principal contract (a complicated hedging transaction of limited interest to most taxpayers), or a futures or forward contract, with respect to the same or substantially identical property. The sale occurs when the taxpayer acquires the related long position.

2. SHORT-TERM HEDGE EXCEPTION

- a) Some limited exceptions apply to short-term hedging transactions that are closed in the 90-day period ending with the 30th day after the close of the taxable year.

3. EFFECTIVE DATE

- a) The effective date is transactions occurring after June 8, 1997.

C. Sale of a Principal Residence:

1. THE NEW RULE

- a) Profits from the sale of a principal residence may be excluded up to \$250,000 for individuals and \$500,000 for couples, provided the home was owned and used as a residence for 2 of 5 years preceding the sale.

- b) The exclusion is limited to home sales occurring every 2 years or longer.

(1) Note: Taxpayers with profits exceeding these limitations will pay capital gains on sale. This will adversely affect those with gains over \$500,000 in their residences.

(2) Current tax-free rollover provisions (IRC Sec. 1034) and the once-in-a-lifetime exclusion of \$125,000 (IRC Sec. 121) have been eliminated.

(3) Sales of a remainder interest may qualify for this exclusion.

- c) Married couple who each own their principal residence may exclude \$250,000 on the sale of a residence, provided they filed separate returns.

- (1) If it's a new marriage and one spouse sold a residence within 2 years before the marriage, the other spouse may exclude up to \$250,000 in gain on a residence owned prior to the marriage.
- d) A partial exclusion is available if a residence is sold prior to the two-year-use requirement, because of a change in employment, health or unforeseen circumstances.
- e) Generally, it is a percentage determined by the months of use prior to sale, divided by 24.
 - (1) Example: If a taxpayer sells a house for \$50,000 and met 12 months of the use test, then \$25,000 would be excluded ($\$50,000 \times 12/24 = \$25,000$).
- f) For those living in a nursing home, the ownership and use test is lowered to 1 out of 5 years prior to entering a facility.
 - (1) Time spent in the nursing home still counts toward ownership time and use of the residence.
 - (a) For example, if a taxpayer owns and lives in a home for 1 year, resides in a nursing home for 10 years, then sells the residence, the exclusion will apply.
- g) The exclusion does not apply to depreciation allowable on residences after May 6, 1997.
 - (1) Therefore, taxpayers should reconsider using a portion of their homes as offices, since the depreciation will be taxed at 25%.
- h) Residences which have been depreciated (usually through the home office deduction) must recapture the depreciation at a 25% capital gain.
 - (1) This amount, however, should not diminish the \$500,000 tax-free portion.
 - (2) Example: If a married couple sells a home with an adjusted basis of \$100,000 for \$750,000 and \$50,000 is subject to recapture, their taxes should be determined as follows: Taxable gain: $\$750,000 - \$100,000 = \$650,000$. Amount subject to 25% capital gain = \$50,000; amount tax-free: \$500,000, amount subject to 20% capital gain = \$100,000.

2. EFFECTIVE DATES

- a) The effective date is for all sales or exchanges of principal residences occurring after May 6, 1997.
- b) Taxpayers may elect to apply present law to sales occurring --
 - (1) after August 5, 1997,
 - (2) before August 5, 1997, pursuant to a binding contract entered into before that date, or

(3) where the replacement property was acquired before the date of enactment and the rollover provisions would otherwise apply.

3. HOME OFFICE DEDUCTION

a) The home office deduction has been expanded to include an office used to conduct administrative and managerial activities of the taxpayer's trade or business, provided there is no other fixed location where the taxpayer conducts these services.

(1) This provision effectively overrules the Supreme Court decision in Commissioner v. Soliman, 113 S. Ct. 701 (1993) which disallowed a home office deduction to an anesthesiologist who practiced at several hospitals, but used a room in his home exclusively for administrative and managerial activities related to his profession.

b) Taxpayers should exercise caution regarding the home office deduction, given the adverse treatment of real estate depreciation.

(1) Depreciation deductions incurred through a home office deduction will be taxed at a 25% capital gains rate, whereas, gain from the sale of a principal residence will be untaxed up to \$500,000 for couples (\$250,000 for individuals) under the new rules.

D. Traditional IRAs

1. NEW AGI LIMITATIONS

a) AGI limitations for contributions to IRAs (currently \$25,000 for individuals and \$40,000 for couples) will increase at \$5,000 per year for individuals and \$10,000/year for couples in 1998, 2002, 2003 and 2004.

(1) After 2004, the AGI limitations will be \$50,000 for individuals and \$80,000 for joint filers.

2. PENALTY-FREE WITHDRAWALS

a) Penalty-free withdrawals are permitted for first-time home purchases to a maximum of \$10,000 or educational expenses (without limitation).

3. SPOUSAL PARTICIPATION

a) If one spouse is an active participant in an employer-sponsored retirement plan, the other spouse is now eligible for an IRA deduction to a maximum of \$2,000.

b) This benefit phases out for couples with AGI between \$150,000 and \$160,000.

5. EXPANDED INVESTMENTS

a) Beginning January 1, 1998, the general prohibition against investment in collectibles has been lifted for permitted certain platinum coins and certain gold, silver, platinum or palladium bullion.

E. The New Roth Accounts (aka “IRA Plus” Account)

1. A “BACK-LOADED” IRA

- a) The new “IRA Plus” account is an IRA with a twist: Investors cannot deduct the contributions, but earnings accumulate tax-free. However, unlike a traditional IRA which had distributions that were tax deferred, the IRA Plus distributions will never be taxed.
- b) Contributions to the Roth IRA must be made with compensation on an after-tax basis and there is an overall annual limitation of \$2,000 for contributions to all IRA’s for individuals and \$4,000 for couples.

2. REQUIREMENTS

- a) Withdrawals cannot occur until the account is at least 5 years old.
- b) Distributions may be made to --
 - (1) The owner after age 59 ½;
 - (2) The designated beneficiary after the owner’s death;
 - (3) The owner prior to age 59 ½ if the owner is disabled; and
 - (4) The owner prior to age 59 ½ for qualified first-time homebuyer expenses.
- c) There is a phase-out of eligibility starting at AGIs of \$95,000 to \$110,000 for individuals and \$150,000 to \$160,000 for couples.
- d) Early withdrawal is permitted for first-time homebuyer expenses, subject to a \$10,000 lifetime cap and educational expenses.

3. CONVERSION OF IRA TO ROTH ACCOUNT

- a) Investors with regular IRAs may convert them to IRA Plus accounts.
 - (1) The conversion will be taxed as an IRA distribution, but without penalty for early withdrawal.
 - (2) Contributions made to existing IRAs with after-tax dollars are not taxed on this rollover.
- b) Taxpayers with less than \$100,000 in AGI (determined prior to the conversion) are eligible to rollover an IRA into an IRA Plus account. This limitation applies to both single and joint filers.
- c) The tax is spread ratably over 4 years.

4. OBSERVATIONS

- a) One may contribute to a Roth IRA even if the taxpayer is covered by another retirement plan.

- b) Assets held in a 401K plan are not eligible for rollover treatment unless they are rolled over to a regular IRA first (which can only occur if there is a distributing event in the 401K plan) and then from the rollover IRA to the Roth IRA.
- c) Does it make sense to pay the up-front tax to achieve tax-free distributions? Payment of the up-front tax makes sense in the following situations --
 - (1) If you believe tax rates will be higher in the future;
 - (2) If one has a large estate and payment of the tax will reduce the size of the estate,
 - (3) If the named beneficiary is young and distributions are within the timing and control of the beneficiary, then the tax-free build up could be tremendous. Also, it depends on the income level of the beneficiary.
 - (a) Example: A Roth IRA left to a doctor in the highest tax bracket makes sense.

F. Estate Taxes

1. EXEMPTION CREDIT INCREASE

- a) The current \$600,000 unified estate and gift tax credit will increase to \$1,000,000 over the next 10 years as follows:

Year	Unified Credit Equivalent
1998	\$625,000
1999	\$650,000
2000	\$675,000
2001	\$675,000
2002	\$700,000
2003	\$700,000
2004	\$850,000
2005	\$950,000
2006	\$1,000,000

2. ANNUAL GIFTS

- a) The annual gift tax exclusion will be indexed for inflation for gifts made after December 31, 1998.

3. FAMILY-OWNED BUSINESS AND FARMS

a) Increase Exemption Credit

- (1) Next year, a new exemption for family-owned businesses goes into effect. In addition to the unified credit, there will be an exemption for a family owned business (regardless of the entity), not to exceed \$1,300,000 (including the unified credit).
- (2) The business must comprise at least 50% of the value of the estate, be an active trade or business in the U.S.
 - (a) The business valuation is reduced for cash and marketable securities held in excess of working capital needs.
 - (b) The decedent must have been a U.S. citizen or resident at the time of death and the business must be located in the U.S.
- (3) The business must be owned 50% or more by one family, 70% or more by two families or 90% or more by three families, as long as the decedent's family owned at least 30% of the trade or business.
- (4) The family members must have owned and materially participated in the business 5 out of the 8 years preceding the decedent's death, and must continue to materially participate in the business for at least 5 years of any 8-year period within 10 years of the decedent's death.
 - (a) Material participation means physical work and participation in management decisions.
- (5) There are complicated recapture provisions if these requirements are not met.

G. Repeal of the Alternative Minimum Tax for Small Business

1. SMALL BUSINESS CORPORATION AMT EXCEPTION

- a) The dreaded alternative minimum tax has been eliminated for corporations with average gross receipts of less than \$5 million for the 3-year period commencing January 1, 1994 (called a "small business corporation").
- b) A small business corporation will continue its status until its average gross receipts reach \$7,500,000.
- c) This provision is effective for tax years beginning after December 31, 1997.