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THE TAXPAYERS RELIEF ACT OF 1997

1997 and 1998 Income Tax Complications

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Introduction

Much ado about something (in the form of tax reduction) has also led to much of nothing (in tax simplification) for most American taxpayers. The Taxpayers Relief Act (TRA) of 1997, signed into law by President Clinton on August 5, 1997, includes changes that economically benefit many taxpayers. However, it has also made the preparation of annual tax returns increasingly complex for most. The professional tax preparer industry estimates that 75-80 percent of 1997 tax returns will be professionally prepared, up from 50 percent of 1996 returns. The following discussion highlights some major changes that affect both federal and state tax returns. With over 800 amendments attached to the TRA of 1997, a full discussion is impossible; readers are advised to seek detailed advice on their personal tax questions from their professional tax preparer or financial advisor.

Capital Gains Relief

Capital gains preferential treatment came to taxpayers via this act following eleven years of rumors. A maximum tax rate of 20 percent is now in effect on long-term capital gains for taxpayers in the 28 percent marginal tax bracket or higher. If the taxpayer's marginal income tax bracket is 15 percent, capital gains are further reduced to 10 percent. The tax rate for capital gains attributed to the depreciable portion of a long-term gain of real estate is 25 percent. A new definition of *long term* accompanies these new rates; an asset must be held for 18 months or longer to qualify for long-term treatment.

For 1997, several holding periods and tax rates apply depending upon the sale date of the asset. Table 1 summarizes rates and dates for capital gains affecting 1997 tax returns. For the 1997 tax year, a temporary term, *intermediate*, is in effect for capital gains. Intermediate capital gains refers to assets held longer than 12 but less than 18 months and sold after July 28, 1997. Following December 31, 2000, another holding period interval comes into play. Assets held for 60 months prior to sale and sold after December 31, 2000 enjoy a capital gains rate of 18 percent for taxpayers in the marginal 28-percent bracket; for taxpayers in the 15-percent bracket, the rate is 8 percent.

Capital losses are treated in a manner similar to the past. Losses still offset gains; however, long- term losses may be offset against gains in the highest tax bracket irrespective of their short- or long-term holding period. The $3,000 capital loss limitation still applies.

Table 1. Summary of Rates and Dates for Capital Gains

Sale Date	Holding Period	28 %Tax Rate*	15%Tax Rate**
Before 5/7/97	More than 12 Months	28%	15%
5/ 7/97 - 7/28/97	More than 12 Months	20%	10%
After 7/28/97	More than 12 but less than 18 Months	28%	15%
After 7/28/97	More than 18 months	20%	10%
After 12/ 31/00	More than 60 months	18%	8%

* Maximum tax rate on Capital Gain Income for taxpayers in the 28% or higher tax brackets
**Tax rates for persons in the 15% tax bracket

Schedule D, which is the form that taxpayers use to report capital gains on 1040 tax returns, will be very complicated. Mutual fund companies, for example, must provide their clients detailed information of fund transactions based on the client's pro rata share of holdings in the mutual fund. Similarly, any sales of business property or installment sale contracts will complicate the completion of Schedule D. With three holding periods for 1997 and various sales dates affecting the tax rate applied to capital gains, records of these transactions will be very important.

The TRA also greatly affects the sale of a taxpayer's principal residence. For most taxpayers, capital gains on their largest investment, their principal residence, could be rolled into the purchase of a replacement home, and the tax could be deferred under the old law. The new law repeals the rollover deferral of gain. This is effective for sales or exchanges of principal residences made after May 6, 1997. Instead of a rollover, a capital gain of $250,000 (or $500,000 for married filing joint taxpayers) on the sale of a principal residence is not recognized, i.e. is exempt. This tax-free exemption is available for taxpayers once every two years. The new law requires that the taxpayer owns and occupies the property as a principal residence at least two of the last five years before the sale or exchange. This provision will benefit many taxpayers, but particularly those living in areas with rapidly appreciating real estate markets. For sales of principal residences under contract, but not sold, prior to August 5, 1997, options are available to use either the old or new rules, whichever is to the taxpayers advantage.

Changes Affecting Agriculture

The Taxpayer Relief Act of 1997 made some specific changes that affect agriculture, but it did not address several issues of concern. One such question was "What income is to be excluded from the calculation of the Earned Income Credit?" Agricultural groups had lobbied to exclude income derived from the sale of livestock, as described in I.R.C. Section 1231(b)(3). However, income from the sale of cull breeding livestock is still included in the EIC calculation. Similarly, TRA failed to address the issue of rental income received by a general partner for property rented to the partnership. The IRS supports the position that this income is subject to self-employment tax since the general partner is an active and material participant through the partnership.

Alternative Minimum Tax (AMT) on deferred livestock, grain and other commodity sales was repealed under TRA. This issue received much press late in 1996.

Congress amended rules concerning the sale and replacement of certain animals sold due to weather-related conditions. The new rules provide more equitable treatment. Formerly, the regulations were drought specific and did not allow for other circumstances. The new legislation broadened the rules for sales and allowable replacement period of animals due to weather conditions other than drought but having the same affect to farm and ranch operations.

A revision of health and long-term care insurance now allows a 100 percent deductibility of these expenses, as an adjustment to income, by the year 2007. For 1997, forty percent is allowed as a deduction for self-employed persons. Regulations for meals provided to employees for the employer's convenience were liberalized. For employees required to remain on the premises during a meal period and the employer provides the meal, that expense is now 100 percent deductible. This is an increase from 50 percent deductible previously allowed. Carry back and carry forward periods for Net Operating Losses (NOLs) and business credits were modified to two years back and twenty years forward for NOLs and one year back and twenty years forward for unused business credits. Clarification and interpretation of Congress' intent on several other issues is forthcoming in a technical correction bill early this year.

Educational and Child Credits

TRA contains provisions to implement tax credits that are "family and education friendly." A child tax credit, effective January 1, 1998, allows $400 per child under the age of 17 by the end of 1998. The credit increases to $500 per child in 1999. These credits phase out deductions based on adjusted gross incomes of the parent(s), providing no benefit to higher income taxpayers. This credit may or may not be a refundable credit similar to the Earned Income Credit. A worksheet must be completed to determine if all or a portion of the credit is refundable. Persons who qualify for this credit in 1998 will need to adjust the tax withholding on their wages by filing a new W-4 form with their employer.

Credits for educational purposes, the Hope and Life-Long Learning Credits, were also included in this tax legislation. First, the Hope Credit provides 100 percent credit of the first $1000 and 50 percent on the second $1000 spent for tuition and fees for the taxpayer, spouse or dependent at any accredited post-secondary education institution. Community colleges, technical and trade schools benefit from this legislation, as do four-year schools. This credit is only available for the first two years of education beyond completion of secondary education. Books, room and board do not qualify as expenses eligible for this credit. There is no limit to the number of dependents (students) claimed under the Hope Credit by the taxpayer on his/her return.

Similarly, the Life-Long Learning Credit is available to the taxpayer, spouse, and any dependent. This credit is limited to 20 percent of the first $5000 of any educational expense (not just tuition and fees) beyond secondary school paid in 1998 to 2002. After January 1, 2003, this credit increases to 20 percent of the first $10,000. An important distinction is that the dollar limits are *per family* instead of per person.

Although the same individual cannot use the Hope and Life-Long Learning Credits, they are available for different persons within the same family. Phase-out limitations exist for both credits. For single taxpayers with Adjusted Gross Income (AGI) under $40,000, the full credit is available. Likewise married taxpayers filing joint with an AGI under $80,000 also receive the full credit. A partial credit is available for single taxpayers with AGI between $40,000 and $50,000. For married filing joint, the range is $80,000 to $100,000. However, the credit is unavailable to taxpayers whose incomes exceed the upper limits of the range of their filing status.

Retirement Changes and Opportunities

Along with the educational and child credits, TRA has legislation that broadens retirement investment opportunities. Two new IRAs were enacted: the first called the Roth IRA and the second the Educational IRA. The Roth IRA is similar to the familiar deductible IRA of old in that one may deposit $2000 annually for retirement, and the earnings in the account are tax deferred. That is where the similarity stops.

The Roth IRA is not deductible in the year a contribution is made, but earnings and distributions may be tax free upon withdrawal. Five stipulations will determine if the distribution is tax free: (1) distribution is made five years after the first contribution year; (2) owner is age 59 ½ or older; (3) distribution is made due to becoming disabled; (4) up to $10,000 may be withdrawn for a qualified first-time home purchase; (5) distribution is to an estate upon death of the owner. For tax-free status of distributions, the first stipulation and any of the remaining four must be met.

Owners of regular IRAs may wish to *rollover* to a Roth IRA as a long-term tax planning measure. These rollovers may be done without the 10 percent penalty for early withdrawal; however, tax must be paid on amounts rolled over. This may seem contrary to wise tax planning. However, if today's tax is estimated to be significantly lower than the tax on earnings and future distributions, then rolling over into a Roth IRA may reduce the total tax paid.

The Educational IRA is new under TRA. This IRA is to encourage savings for future education expenses. The child for whom the account is set up is the owner. Contributions are limited to $500 per year, per account and can be made only until the child's eighteenth birthday. The owner of the account must withdraw the funds completely by his/her thirtieth birthday. If the monies are not used, they may be rolled into a qualified retirement IRA under special provisions.

North Carolina Tax Changes and Credits

During 1997, the legislature revised the North Carolina tax code. Several of the changes mirrored federal regulations. First, withholding of state income tax on agricultural labor is necessary if the employer is required to withhold federal income tax. Secondly, taxpayers requesting an extension for filing state income tax returns are now required to pay only 90 percent of tax due by the original filing date instead of the total tax due with the extension. Credit increases for restoring historic structures and tax treatment of restored income were other changes made.

The legislature revised severance wages and broadened the application for excluding income from state taxation. Under the new law, the first $35,000 of severance wages may be excluded from state income taxation if the severance of employment was not the fault of the employee. This is an expansion of the law to cover corporate actions such as downsizing but not specifically closing a plant, as was the case under the old law. The effective date of this provision is January 1, 1998. The exclusion is also available for severance wages received after January 1, 1998 but resulting from an action by an employer occurring in the past.

Within the North Carolina tax code, there are over twenty-five tax credits available for use against income taxes. Several specifically benefit agriculture. The Conservation Tillage Equipment Credit provides the original purchaser of conservation equipment a 25 percent credit of purchase price to a maximum of $2,500. Unused credit may be carried forward five years, and the cost basis of the asset must be reduced by the amount of the credit. Another agricultural credit allows $1000 for property taxes paid on farm machinery. This credit is frequently missed because there is not a designated line on Form TC-400 for this credit. Every farm return in North Carolina should take this credit against North Carolina income tax. Gleaned Crops Credit is available to producers who allow gleaning of crops by charitable organizations. Poultry farmers who built compost units in 1997 can use the Poultry Composting Credit, repealed January 1, 1998. The credit is 25 percent of the cost and is limited to $1000 per installation.

The 1996 legislature enacted new credits for investing in business property that became fully effective in 1997. One such credit is an *investment tax credit* of 4 ½ percent up to $4,500 for tangible personal property assets placed into service after August 1, 1996. A second credit of 7 percent for investing in new business property is available for business owners in designated counties targeted for economic development.

Consultation with a qualified professional concerning these and other tax issues and how they may affect your individual situation is advised.

The May/June 1998 issue of the North Carolina State Economist will review changes in federal and North Carolina estate taxation and will highlight aspects of effective estate planning.

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