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Highlights of 1997 Tax Changes

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Introduction

This publication highlights many tax law changes that take effect in 1997 and 1998. Each chapter is divided into separate sections for each year.

Taxpayer Relief Act of 1997. Many provisions of this legislation are discussed in this publication. They include the following items.

Beginning in 1997:

1) Lower capital gains tax rates.
2) An exclusion of up to $250,000 ($500,000 on a joint return) on gain from the sale of your home.

Beginning in 1998:

1) A new child tax credit for each qualifying child under age 17.
2) Two new credits for qualifying higher education costs.
3) A new individual retirement account called an education IRA for paying higher education expenses.
4) A new individual retirement account (or annuity) called a Roth IRA in which, if you satisfy the requirements, earnings grow tax free and withdrawals are tax free.
5) Increases to the amount of an estate that is exempt from estate tax.

See the later discussion of each topic for more information.

At the time this publication went to print, Congress was considering changes to several provisions discussed in this publication.

Adjusting your withholding or estimated tax payments for 1998. If there will be a significant change in the tax you owe for 1998, you should adjust your withholding or estimated tax payments accordingly.

New credits such as the child tax credit, Hope credit, and the lifetime learning credit, discussed later in this publication, may reduce your 1998 tax. By adjusting your withholding or estimated tax payments now, you can get the benefit of the lower taxes throughout the year, instead of waiting until you file your tax return in 1999.

Certain provisions, however, may increase your 1998 tax. For example, you may owe additional tax if you convert a traditional IRA to a new Roth IRA. In this case, you may need to increase your withholding or estimated tax payments to avoid a penalty when you file your tax return.

See the following table for forms and publications that will help you adjust your withholding or estimated tax payments. See chapter 8 for information on ordering these forms and publications from the IRS.

To adjust your....	Get form...	And publication...
Withholding	**W–4,** *Employee's Withholding Allowance Certificate*	**919,** *Is My Withholding Correct for 1998?*
Estimated tax payments	**1040–ES,** *Estimated Tax for Individuals*	**505,** *Tax Withholding and Estimated Tax*

You can also get Form W–4 from your employer.

1.

Tax Changes for Individuals

Useful Items

You may want to see:

Publication

- ☐ **463** Travel, Entertainment, Gift, and Car Expenses
- ☐ **501** Exemptions, Standard Deduction, and Filing Information
- ☐ **502** Medical and Dental Expenses
- ☐ **508** Educational Expenses
- ☐ **523** Selling Your Home
- ☐ **525** Taxable and Nontaxable Income
- ☐ **535** Business Expenses
- ☐ **544** Sales and Other Dispositions of Assets
- ☐ **550** Investment Income and Expenses
- ☐ **556** Examination of Returns, Appeal Rights, and Claims for Refund
- ☐ **596** Earned Income Credit
- ☐ **919** Is My Withholding Correct for 1998?

Form (and Instructions)

- ☐ **W–4** Employee's Withholding Allowance Certificate
- ☐ **1040** U.S. Individual Income Tax Return
- ☐ **1040X** Amended U.S. Individual Income Tax Return
- ☐ **2106** Employee Business Expenses
- ☐ **6251** Alternative Minimum Tax – Individuals

1997 Changes

Standard Deduction Amount Increased

The standard deduction for most taxpayers who do not itemize deductions on Schedule A of Form 1040 is higher for 1997 than it was for 1996. The amount depends on your filing status, whether you are 65 or older or blind, and whether an exemption can be claimed for you by another taxpayer. The *1997 Standard Deduction Tables* are shown in Publication 501.

Exemption Amount Increased

The amount you can deduct for each exemption has increased from $2,550 in 1996 to $2,650 in 1997.

You lose all or part of the benefit of your exemptions if your adjusted gross income is above a certain amount. The amount at which this phaseout begins depends on your filing status. For 1997, the phaseout begins at $90,900 for married persons filing separately, $121,200 for unmarried individuals, $151,500 for heads of household, and $181,800 for married persons filing jointly. If your adjusted gross income is above this amount, use the *Deduction for Exemptions Worksheet* in the Form 1040 instructions to figure the amount you can deduct for exemptions.

Social Security Numbers for Dependents

For 1997, you must list the social security number (SSN) of every person for whom you claim an exemption. Enter this number in column (2) of line 6c of your Form 1040 or Form 1040A. If you do not enter a number, or if you list an incorrect number, the exemption may be disallowed.

If the person does not have and cannot get an SSN, enter that person's individual taxpayer identification number (ITIN) or adoption taxpayer identification number (ATIN).

If your child was born and died in 1997 and you do not have an SSN for the child, you can attach a copy of the child's birth certificate instead and enter “DIED” in column (2).

For more information on exemptions, ITINs, and ATINs, see Publication 501.

Limit on Itemized Deductions Increased

You lose all or part of the benefit of your itemized deductions if your adjusted gross income is above a certain amount. In 1997, this amount is increased to $121,200 ($60,600 if you are married filing separately). See Publication 501 for more information.

Earned Income Credit

The following paragraphs explain the 1997 changes to the earned income credit. For more information, see Publication 596.

Amount of credit. The maximum amount of the credit has increased for 1997. The most you can receive is:

- $2,210 if you have one qualifying child,
- $3,656 if you have more than one qualifying child, or
- $332 if you do not have a qualifying child.

Amount of earned income. The maximum amount you can earn and still get the credit has increased for 1997. You can get the credit if you earn less than:

- $25,760 and you have one qualifying child,
- $29,290 and you have more than one qualifying child, or
- $9,770 and you do not have a qualifying child.

Amount of investment income. The maximum amount of investment income you can have and still get the credit has increased for 1997. You can have up to $2,250 of investment income.

Social security number (SSN). If either you, your spouse (if filing a joint return), or any qualifying child does not have an SSN, you cannot claim the credit. For the earned income credit, an SSN means a number issued by the Social Security Administration to a U.S. citizen or to a person who has permission from the Immigration and Naturalization Service to work in the United States.

You cannot get the credit if either you, your spouse, or qualifying child has one of the following numbers.

1) *An individual taxpayer identification number (ITIN).*
2) *A taxpayer identification number for pending adoptions (ATIN).*

Earned income credit denied. Beginning in 1997, the earned income credit will be denied for a period of years if you erroneously claim it because of fraud or reckless or intentional disregard of rules or regulations. Also, if you are denied the earned income credit as a result of deficiency procedures, you must recertify your eligibility before you claim it again.

Lower Capital Gains Rates

The maximum rate of tax on a net capital gain is lower for most sales after May 6, 1997. A “net capital gain” is the amount by which your net long-term capital gain for the year is more than your net short-term capital loss.

Previously, the maximum rate of tax on a net capital gain was 28%. Under the new law, the maximum rate may be 10%, 20%, 25%, or 28%, or a combination of those rates, as shown in the following table.

Maximum rate is . . .	For . . .
28%	• Gain on a sale before May 7, 1997, of property held more than one year • Gain on a sale after July 28, 1997, of property held more than one year but not more than 18 months • A collectibles gain
25%	• Unrecaptured section 1250 gain on a sale after May 6, 1997, and before July 29, 1997, of property held more than one year • Unrecaptured section 1250 gain on a sale after July 28, 1997, of property held more than 18 months
20%	• Gain on a sale after May 6, 1997, and before July 29, 1997, of property held more than one year (unless 28%, 25%, or 10% rate applies) • Gain on a sale after July 28, 1997, of property held more than 18 months (unless 28%, 25%, or 10% rate applies)
10%	• Gain on a sale that would qualify for the 20% maximum rate except that, if there were no maximum capital gains rates, the gain would be taxed at the 15% regular tax rate

The term “sale” includes a trade, involuntary conversion, and installment payment received.

You may also find *Table 1* helpful in finding your maximum capital gains rate for 1997.

Collectibles gain. This is gain from the sale of a work of art, rug, antique, metal, gem, stamp, coin, or alcoholic beverage held more than one year.

Unrecaptured section 1250 gain. Generally, this is the part of any capital gain from selling section 1250 property (real property) that is due to depreciation. For more information about section 1250 property, see Publication 544.

Using the Maximum Rates

The part of a net capital gain subject to each maximum rate is determined under the following rules.

1) Long-term capital gains are netted with long-term capital losses in the following groups.

   a) A ***28% group,*** consisting of gains and losses on the types of transactions described in the table above in the section for gains subject to the 28% maximum rate, plus long-term capital loss carryovers.

   b) A ***25% group,*** consisting of unrecaptured section 1250 gains described in the table above in

Table 1. **What Is Your Maximum Capital Gains Rate for 1997?**

IF the sale* took place . . .	AND the capital asset was held . . .	AND your gain . . .	THEN your maximum capital gains rate is . . .
Before May 7, 1997	More than one year	Is from selling any type of capital asset	28%
After May 6, 1997, but **before** July 29, 1997	More than one year	1) Is a collectibles gain	28%
		2) Is an unrecaptured section 1250 gain	25%
		3) Is not a gain to which *(1), (2),* or *(4)* applies	20%
		4) Would be taxed, if there were no maximum capital gains rates, at the 15% regular tax rate — and *(1)* and *(2)* don't apply	10%
After July 28, 1997	More than one year but not more than 18 months	Is from selling any type of capital asset	28%
After July 28, 1997	More than 18 months	1) Is a collectibles gain	28%
		2) Is an unrecaptured section 1250 gain	25%
		3) Is not a gain to which *(1), (2),* or *(4)* applies	20%
		4) Would be taxed, if there were no maximum capital gains rates, at the 15% regular tax rate — and *(1)* and *(2)* don't apply	10%

* The term "sale" includes a trade, involuntary conversion, and installment payment received.

the section for gains subject to the 25% maximum rate.

c) A ***20% group,*** consisting of gains and losses on the types of transactions described in the table on page 3 in the sections for gains subject to the 20% or 10% maximum rate.

2) A net short-term capital loss reduces any net gain from the 28% group, then any gain from the 25% group, and finally any net gain from the 20% group.

3) A net loss from the 28% group reduces any gain from the 25% group, and then any net gain from the 20% group.

4) A net loss from the 20% group reduces any net gain from the 28% group, and then any gain from the 25% group.

Figure your tax in Part IV of Schedule D (Form 1040). You must use Part IV if both of the following are true.

1) You have a net capital gain. You have a net capital gain if both lines 16 and 17 of Schedule D are gains. (Line 16 is your net long-term capital gain or loss. Line 17 is your net long-term capital gain or loss combined with any net short-term capital gain or loss.)

2) Your taxable income on Form 1040, line 38, is more than zero.

For an example of how to figure your tax using the maximum capital gains rates, see the *Comprehensive Example* in chapter 4 of Publication 550.

Alternative minimum tax. These new maximum capital gains rates are also used in figuring alternative minimum tax. You can use the new Part IV of **Form 6251** to figure your tentative minimum tax using the new lower rates. See the instructions for Form 6251 for more details on this change.

Changes for Years After 1997

After 1997, there will be further changes to these rules.

1998. The taxable part of a gain from certain sales or trades after August 11, 1998, of qualified small business stock, up to the gain excluded from those sales, will be subject to the maximum capital gains rate of 28%. For information about qualified small business stock, see chapter 4 of Publication 550. The exclusion of gain is discussed later under *1998 Changes*.

2001. Beginning in the year 2001, the 10% maximum capital gains rate will be lowered to 8% for "qualified 5-year gain."

Qualified 5-year gain. This is long-term capital gain from the sale of property you held for more than 5 years that would otherwise be subject to the 10% or 20% maximum capital gains rate.

2006. Beginning in the year 2006, the 20% maximum capital gains rate will be lowered to 18% for qualified 5-year gain from property with a holding period that begins after 2000.

Taxpayers who own certain stock on January 1, 2001, can choose to treat the stock as sold and repurchased on January 2, 2001, if they pay tax for 2001 on any resulting gain.

Sale of Your Home

If you sell your main home after May 6, 1997, you may qualify to exclude all or part of any gain on the sale from your income. This means that if you qualify, you will not have to pay tax on the gain up to the limit described under *Amount of exclusion,* next. To qualify, you must meet the ownership and use tests described later.

This new exclusion generally replaces the old "rollover" rules and the one-time $125,000 exclusion for taxpayers age 55 and older. Those rules generally apply to sales before May 7, 1997.

Amount of exclusion. You can exclude gain on the sale of your main home after May 6, 1997, up to:

1) $250,000, or

2) $500,000 if all the following are true.

   a) You are married and file a joint return for the year.

   b) Either you or your spouse meets the ownership test.

   c) Both you and your spouse meet the use test.

   d) During the 2-year period ending on the date of sale, neither you nor your spouse excluded gain from the sale of another home (not counting sales before May 7, 1997).

Ownership and use tests for sales after May 6, 1997. You can claim the exclusion if, during the 5-year period ending on the date of the sale, you have:

1) Owned the home for at least 2 years (the ownership test), ***and***

2) Lived in the home as your main home for at least 2 years (the use test).

If you owned and used the property as your main home for less than 2 years, you may be able to claim a reduced exclusion. See *Reduced Exclusion* in chapter 4 of Publication 523.

Choosing to use old rules. You can choose to treat your gain under the old rules (for sales before May 7, 1997) rather than the new rules described here if any of the following statements are true.

1) You sold your home before August 6, 1997.

2) You sold your home after August 5, 1997, under a contract that was binding on that date.

3) You sold your home after August 5, 1997, and you bought a new home on or before that date (or under a binding contract that was in effect on that date) that would enable you to postpone gain on the sale under the old rules.

More information. For more information on the sale of your home, see Publication 523.

Adoption Expenses

Beginning in 1997, you may be able to take a new tax credit for qualifying expenses paid to adopt an eligible child. The adoption credit is a nonrefundable credit that you subtract from your tax liability.

Also, beginning in 1997, through 2001, money or other benefits received from your employer for qualifying adoption expenses under an adoption assistance program may be excludable from your gross income.

The new credit and exclusion are explained in Publication 968, *Tax Benefits for Adoption.*

Repeal of Death Benefit Exclusion

Beneficiaries of an employee who died before August 21, 1996, could exclude from income up to $5,000 of the death benefits paid by or on behalf of an employer because of the employee's death. This exclusion is not available for beneficiaries of employees who died after August 20, 1996.

Employer-Provided Educational Assistance

The exclusion from income of up to $5,250 of employer-provided educational assistance benefits, which expired for tax years beginning after May 31, 1997, has been reinstated retroactively and extended. It will now expire for courses beginning after May 31, 2000. See *Employer-Provided Educational Assistance* in Publication 508 for more information.

Cancellation of Debt on Student Loans

Previously, debt canceled on certain student loans did not have to be included in income. This exclusion has been expanded. If your loan was canceled after August 5, 1997, you do not have to include the canceled debt in income if both of the following are true.

1) The loan was made by an educational institution as part of its program designed to encourage students to serve in occupations or areas with unmet needs.

2) The services provided are for or under the direction of a governmental unit or a tax-exempt section 501(c)(3) organization.

You also do not have to include any of the canceled debt in income if the loan was made by an educational institution or a tax-exempt section 501(c)(3) organization to refinance another student loan if cancellation of that other loan would not require you to include any amount in income.

Exception. You will have income if your student loan is canceled because of services performed for an educational institution.

More information. For more information about the cancellation of debt on student loans, see *Student loans* in Publication 525.

Life Insurance Paid Before Death

Beginning in 1997, certain payments received under a life insurance contract on the life of a terminally or chronically ill individual before the individual's death (an accelerated death benefit) can be excluded from income. If any portion of the death benefit under the contract is sold or assigned to a viatical settlement provider, the amount received on the sale or assignment is also excluded from income. Generally, a viatical settlement provider is one who regularly engages in the business of buying or taking assignment of life insurance contracts on the lives of insured individuals who are terminally or chronically ill and meets other requirements. Accelerated death benefits are discussed in detail in Publication 525.

Deceased Public Safety Officers

Amounts received as a survivor annuity on the life of a public safety officer who was killed in the line of duty after December 31, 1996, generally are not taxable. Public safety officers include law enforcement officers, firefighters, and rescue squad or ambulance crew members. See Publication 525 for more information.

Rollover of Gain From Sales of Small Business Stock

Beginning in 1997, you can choose to roll over capital gain from the sale of qualified small business stock held more than 6 months. You can make this choice only for a sale after August 5, 1997, and only if you buy other qualified small business stock during the 60-day period beginning on the date of the sale. This replacement stock must continue to meet the active business requirement for qualified small business stock for at least the first 6 months after you buy it.

If you make this choice, you recognize capital gain only up to the amount realized from the sale minus the cost of the replacement stock you bought during the 60-day period (and did not take into account for an earlier sale of qualified small business stock). Any remaining capital gain is postponed. Your basis for the replacement stock is its cost less the gain postponed. Your holding period for the replacement stock includes your holding period for the stock sold, except for the purpose of applying the 6-month holding period requirement for choosing to roll over the gain on its sale.

For information about qualified small business stock, including the active business requirement, see *Sales of Small Business Stock* in chapter 4 of Publication 550.

Postponement of Gain on Involuntary Conversions

A new rule applies to property involuntarily converted after June 8, 1997, if that property was owned by an individual, a partnership (other than certain partnerships with C corporation partners), a trust, an estate, or an S corporation. Under this rule, you cannot postpone reporting gain if both of the following are true.

1) You acquire replacement property or stock from a related party.

2) Your total realized gain for the tax year on the involuntarily converted properties on which there are realized gains is more than $100,000.

You cannot offset the gains with any losses when determining whether your total gain is more than $100,000.

If the property is owned by a partnership, the $100,000 limit applies to the partnership and each partner. If the property is owned by an S corporation, the $100,000 limit applies to the S corporation and each shareholder.

Exception. This rule does not apply if the related party acquired the property from an unrelated party during the replacement period.

More information. For more information about involuntary conversions due to condemnations, see chapter 1 in Publication 544. For more information about involuntary conversions due to casualties or thefts, see Publication 547, *Casualties, Disasters, and Thefts (Business and Nonbusiness)*.

Termination of Certain Rights or Obligations

The cancellation, lapse, expiration, or other termination of a right or obligation with respect to property that is a capital asset (or that would be a capital asset if you acquired it) is treated as a sale if it takes place after September 4, 1997. Any gain or loss is treated as a capital gain or loss.

In the case of terminations before September 5, 1997, this rule applied only if the right or obligation was with respect to:

1) Personal property (generally not including stock) of a type that is actively traded, or

2) Section 1256 contracts.

For information about capital assets and section 1256 contracts, see chapter 4 of Publication 550.

Constructive Sales of Appreciated Financial Positions

Beginning in 1997, you are treated as having made a constructive sale when you enter into certain transactions involving an appreciated financial position in stock, a partnership interest, or certain debt instruments. You must recognize gain as if the position were

disposed of at its fair market value on the date of the constructive sale. Then, when you close the transaction, you reduce your gain (or increase your loss) by the gain recognized on the constructive sale. This new rule generally applies to constructive sales after June 8, 1997.

You are generally treated as having made a constructive sale of an appreciated financial position if you (or a related person, in some cases) do any of the following.

1) Enter into a short sale of the same or substantially identical property.

2) Enter into an offsetting notional principal contract relating to the same or substantially identical property.

3) Enter into a futures or forward contract to deliver the same or substantially identical property.

4) Acquire the same or substantially identical property (if the appreciated position is a short sale, an offsetting notional principal contract, or a futures or forward contract).

For more information, see chapter 4 of Publication 550.

Short Sale of Worthless Property

If you enter into a short sale of property and the property becomes substantially worthless, you must recognize gain as if the short sale were closed when the property became substantially worthless. This is different from the general rule that you do not realize gain or loss from a short sale until you deliver property to close the short sale. This new rule does not apply to a short sale of property that became worthless before August 6, 1997.

For more information about short sales, see chapter 4 of Publication 550.

Capital Gains From Real Estate Investment Trusts

For tax years beginning after August 5, 1997, a real estate investment trust (REIT) can keep its long-term capital gains and pay the tax on them in the same way as a mutual fund. Your share of these gains and the tax paid on them will be reported to you on Form 2439, *Notice to Shareholder of Undistributed Long-Term Capital Gains.*

Report an undistributed capital gain as a long-term capital gain on line 11 of Schedule D (Form 1040). The REIT should tell you how much of the gain is a 28% rate gain and how much is an unrecaptured section 1250 gain. (For information about these terms, see *Lower Capital Gains Rates,* earlier.) If it does not, the entire amount is a 28% rate gain.

For more information about how a shareholder reports income from a REIT, see Publication 550.

Self-Employed Health Insurance Deduction

For tax years beginning in 1997, the part of your self-employed health insurance premiums you can deduct as an adjustment to income increases to 40%. The deductible percentage increases for later tax years as shown in the following table.

Tax Years	Deductible Percentage
1998 and 1999	45%
2000 and 2001	50%
2002	60%
2003 through 2005	80%
2006	90%
After 2006	100%

For more information on the self-employed insurance deduction, see chapter 10 in Publication 535.

Medical Savings Accounts

For tax years beginning after 1996, you may be able to make deductible contributions to a medical savings account. If you are an employee of a small business (generally fewer than 50 employees) or self-employed and you are covered only by a high-deductible health plan, you may be eligible to participate. See Publication 969, *Medical Savings Accounts (MSAs),* for more information.

Qualified Long-Term Care Insurance

Beginning in 1997, qualified long-term care insurance contracts are generally treated as accident and health insurance contracts. If you receive amounts from these qualified contracts (other than policyholder dividends or premiums), you can generally exclude them from income as amounts received for personal injury or sickness. Publication 525 has more information about income. If you pay premiums for qualified long-term care insurance, you can deduct them as a medical expense, up to certain limits. Publication 502 has more information about medical expenses.

Employee Business Expenses

Standard meal allowance. When you travel away from home for business reasons, you can deduct the cost of your meals and incidental expenses. Instead of keeping track of the actual costs, you may be able to use the optional standard meal allowance. In 1997, the allowance for most areas in the United States increased from $26 to $30 per day.

Days of departure and return. For the days you depart for and return from a business trip, you can now claim 3/4 of the standard meal allowance rather than prorating on the basis of 6-hour quarters.

Travel expenses are discussed in chapter 1 of Publication 463.

Standard mileage rate. If you use your car in your business, you can figure your deduction for business use based on either your actual costs or the optional standard mileage rate. The standard mileage rate for the cost of operating your car in 1997 is 31½ cents a

mile for each business mile. The special rate for rural mail carriers is $47\frac{1}{4}$ cents a mile. Business car expenses are discussed in chapter 4 of Publication 463.

The standard mileage rate for medical and moving expenses remains at 10 cents a mile, and the standard mileage rate for charitable contributions remains at 12 cents a mile. See Publication 502, Publication 521, *Moving Expenses,* or Publication 526, *Charitable Contributions,* for more information on those expenses.

Depreciation limits on business cars. If you use your car in your business, you may be able to deduct the business part of the operating costs of your car, including depreciation. Your deductible depreciation is limited, based on the year you place the car in service. Generally, for a car you use in your business and first place in service in 1997, the maximum depreciation you can claim in 1997 is $3,160. Business car expenses are discussed in chapter 4 of Publication 463.

Exceptions for clean-fuel cars. There are two exceptions to the depreciation limits for cars that run on clean fuel. Clean-fuel cars are discussed in chapter 15 of Publication 535. The exceptions follow.

1) Amounts you pay (such as for retrofit parts and components) to modify a car to run on clean fuel are not subject to the depreciation limit on cars. Only the cost of the car before modification is subject to the limit. This means you can claim an additional depreciation deduction for the amount you pay to modify a car to permit it to run on clean fuel. This rule applies to modifications placed in service after August 5, 1997.

2) If you place in service after August 5, 1997, a car that was produced to run on electricity, your depreciation limit for 1997 is increased to a maximum of $9,480.

Federal crime investigations. Beginning in 1997, if you are a federal employee participating in a federal crime investigation, you are not subject to the 1-year rule for deducting temporary travel expenses. This means you may be able to deduct travel expenses even if you are away from your tax home for more than one year.

To qualify, the Attorney General must certify you are traveling:

1) For the federal government,

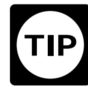
2) In a temporary duty status, and

3) To investigate or provide support services for the investigation of a federal crime.

Travel expenses are discussed in chapter 1 of Publication 463.

Officials paid on a fee basis. You generally deduct employee business expenses as a miscellaneous itemized deduction on Schedule A (Form 1040). Beginning in 1997, if you are a fee-basis official, you may be able to claim your expenses in performing services in that job as an adjustment to gross income. This means you can deduct those expenses whether or not you itemize your other deductions.

To qualify as a fee-basis official, you must be employed by a state or local government and be paid in whole or in part on a fee basis. See the instructions for **Form 2106** for information on how to report these expenses on your tax return.



This rule for fee-basis officials is retroactive to 1987 and you can file an amended return on **Form 1040X** *for any year affected by this change. However, you generally must file Form 1040X within three years from the time you filed the return or within two years from the time you paid the tax, whichever is later.*

Donation of Appreciated Stock

The special rule allowing a deduction for the full fair market value of qualified appreciated stock given to certain private foundations before June 1, 1997, has been extended, but only for contributions made before July 1, 1998.

Self-Employment Tax

The self-employment tax rate on net earnings remains the same for calendar year 1997. This rate, 15.3%, is a total of 12.4% for social security (old-age, survivors, and disability insurance), and 2.9% for Medicare (hospital insurance).

The maximum amount subject to the social security part for tax years beginning in 1997 has increased to $65,400. All net earnings of at least $400 are subject to the Medicare part.

District of Columbia First-Time Homebuyer Credit

You may be able to receive a credit of up to $5,000 if you are a first-time buyer of a main home in the District of Columbia. You are considered a first-time buyer if you (and your spouse if you file jointly) did not have an ownership interest in a main home in the District of Columbia for at least a year prior to owning the new home. The credit is phased out for individuals with modified adjusted gross income between $70,000 and $90,000 ($110,000 and $130,000 if you file a joint return). Only purchases from August 5, 1997, to December 31, 2000, qualify for this credit. Use **Form 8859** to figure the credit to report on line 44 of Form 1040.

Private Delivery Services

Your return is filed on time if it is properly addressed and postmarked by the due date. You can now use a private delivery service designated by the IRS to meet this requirement. Or, you can still use the U.S. Postal Service. If you use a designated private delivery service to send your return, the postmark date is generally the date the private delivery service records in its data base or marks on the mailing label. The private delivery service can tell you how to get written proof of this date.

The IRS publishes a list of designated private delivery services in September of each year. The list published in September 1997 includes only the following:

1) Airborne Express (Airborne):

a) Overnight Air Express Service

b) Next Afternoon Service

c) Second Day Service

2) DHL Worldwide Express (DHL):

a) DHL “Same Day” Service

b) DHL USA Overnight

3) Federal Express (FedEx):

a) FedEx Priority Overnight

b) FedEx Standard Overnight

c) FedEx 2Day

4) United Parcel Service (UPS):

a) UPS Next Day Air

b) UPS Next Day Air Saver

c) UPS 2nd Day Air

d) UPS 2nd Day Air A.M.

Private delivery services cannot deliver items to P.O. boxes. You must use the U.S. Postal Service to mail any item to an IRS P.O. box address.

Interest and Penalties

Underpayment of tax in disaster areas. Certain individuals living in an area declared a disaster area by the President during 1997 were given an extension of time to file their returns and pay their tax. These individuals will not be charged certain penalties or interest on the tax owed for the extension period.

If you owe tax on your return and do not qualify for this relief, you will be charged interest from the due date of your return to the date you pay the tax, even if you get an extension of time to file the return.

Abatement of interest. The IRS's authority to abate (lower) interest has been expanded to cover interest due to an unreasonable error or delay by an IRS official performing a ***managerial act.*** These acts include extensive delays caused by the IRS losing records or by IRS personnel transferring, being on extended training, or being on extended leave (due to illness or otherwise). This provision applies to interest on taxes you owe for tax years beginning after July 30, 1996.

For more information on your rights as a taxpayer, see *Your Rights as a Taxpayer* at the end of this publication and Publication 556.

Extension of interest-free period. The interest-free period for paying the amount shown on a notice and demand received after 1996 is 21 calendar days after the date of notice and demand if you owe less than $100,000 and 10 business days if you owe $100,000 or more.

Previously, the interest-free period applied to all payments made within 10 days of the date of notice and demand.

For more information on payments, see Publication 556.

Estimated tax penalty waived if due to new law. For estimated tax payments due before January 16, 1998, you will not have to pay a penalty for failure to pay estimated income tax to the extent your underpayment was created or increased by a provision of the Taxpayer Relief Act of 1997.

Joint Return After Separate Returns

If certain requirements are met, married persons who filed separate returns can file an amended return as married filing jointly. For tax years beginning after July 30, 1996, you no longer have to pay the tax in full before you can change from separate returns to a joint return.

Tax Court Proceedings

Tax Court can consider taxes paid within 3-year period. For tax years ending after August 5, 1997, and in certain situations, the Tax Court can consider taxes paid during the 3-year period preceding the date of the notice of deficiency for determining any refund due to a nonfiler. Previously, this period was 2 years.

This means that if you do not file your return, and you receive a notice of deficiency in the third year after the due date (with extensions) of your return and file suit with the Tax Court to contest the notice of deficiency, you may be able to receive a refund of excessive amounts paid within the 3-year period preceding the date of the notice of deficiency.

90-day limit for awarding administrative costs and attorney fees. For civil actions or proceedings started after August 5, 1997, a taxpayer who seeks an award of administrative costs must apply within 90 days of the date on which the final decision of the IRS as to the determination of the tax, interest, or penalty is mailed to the taxpayer. Also, if an award of administrative costs was denied by the IRS, the taxpayer must petition the Tax Court within 90 days after the date of the IRS denial notice.

Previously, no time limit was specified for seeking an award of administrative costs and attorney fees.

For more information on cost recovery, see *Appeals to the Courts* in Publication 556.

Overpayment determinations. Beginning August 5, 1997, new law clarifies that the IRS can appeal a Tax Court order to refund an overpayment in the same way it can appeal a decision of the Tax Court. The law also clarifies that the Tax Court cannot decide the validity or merits of the credits or offsets (e.g., collection of delinquent child support or student loan payments) made by the IRS that reduce or eliminate a refund to which the taxpayer was otherwise entitled.

Previously, it was not clear whether the Tax Court's order to refund an overpayment could be appealed. It was equally unclear whether the Court could decide the appropriateness of credits or offsets against a taxpayer's refund.

For more information on appeal rights and claims for refund, see Publication 556.

Redetermination of interest. A taxpayer can now file a ***motion*** to seek a redetermination of interest by the Tax Court. This redetermination can be made for either interest paid on underpayments or interest received from the IRS on overpayments.

Previously, a taxpayer filed a ***petition*** with the Tax Court for a redetermination of interest. The benefit to taxpayers is that they can now supplement an original deficiency action (to have the Tax Court redetermine an IRS deficiency determination) with a motion for redetermination of interest.

For more information on interest payments, see Publication 556.

Jurisdiction for determination of employment status. Beginning August 5, 1997, the Tax Court can review IRS ***employment status determinations*** (for example, whether individuals hired by a taxpayer are in fact employees of that taxpayer or independent contractors). Tax Court review can take place only if, in connection with an audit of any person, there is an actual controversy involving a determination by the IRS as part of an examination that:

1) One or more individuals performing services for that person are employees of that person, or
2) That person is not entitled to relief under section 530(a) of the Revenue Act of 1978. (See *Note,* later, for more information about section 530(a)).

The following statements also apply.

1) A Tax Court petition to review these determinations can be filed only by the person for whom the services are performed.
2) If the taxpayer receives an IRS determination notice by certified or registered mail, the request for Tax Court review must be filed within 90 days of the date of mailing of that notice.
3) If during the Tax Court proceeding, the taxpayer begins to treat as an employee an individual whose employment status is at issue, the Tax Court will not consider that change in its decision.
4) Assessment and collection of tax is suspended while the Tax Court review is taking place.
5) The new legislation provides for de novo review by the Tax Court (rather than review of the administrative record).
6) At the taxpayer's request and with the Tax Court's agreement, small case procedures are available to simplify the case resolution process when the amount at issue is $10,000 or less for each calendar quarter involved.

Previously, the Tax Court's jurisdiction did not extend to employment tax matters.

Note. Section 530(a) is a provision of the Revenue Act of 1978. Briefly, this section relieves an employer of certain employment tax responsibilities for individuals treated as independent contractors and not as employees. It also provides certain benefits to taxpayers under audit or involved in administrative or judicial proceedings.

More information. For more information on taking a case to Tax Court, see *Appeal Rights* in Publication 556.

Net Worth Requirements for Recovery of Certain Costs

For litigation and administrative cost recovery proceedings beginning after August 5, 1997, the net worth requirements (limits) of estates and trusts are the same as those for individuals. In addition, individuals who filed a joint return are treated as separate individuals in determining net worth limits.

Previously, it was not clear which net worth limits applied to estates and trusts or to individuals as joint filers.

For more information on cost recovery and net worth requirements, see *Appeals to the Courts* in Publication 556.

1998 Changes

Child Tax Credit

Beginning in 1998, you may be entitled to a child tax credit for each of your qualifying children.

Qualifying child. To qualify, the child must be:

1) Under age 17,
2) A citizen or resident of the United States,
3) Someone you can claim as a dependent, and
4) Your:
   a) Son or daughter,
   b) Stepson or stepdaughter,
   c) Grandchild, or
   d) Eligible foster child (defined in Publication 501).

You must provide the name and identification number (usually a social security number) of each qualifying child on your tax return.

Amount of credit. For 1998, you can claim a maximum credit of $400 for each qualifying child. This amount increases to $500 for each qualifying child in 1999.

Limits on credit. The credit is limited if your modified adjusted gross income (modified AGI) is above a certain amount. The amount at which this phaseout begins depends on your filing status. Generally, your credit is limited to your tax liability unless you have 3 or more qualifying children.

What is your modified AGI? For most taxpayers, modified AGI is generally the same as AGI. For 1997, AGI is shown on line 16 of Form 1040A and on line 33 of Form 1040.

If you excluded income earned abroad or income from Puerto Rico, Guam, American Samoa, or the Northern Mariana Islands, modified AGI is figured by adding the excluded amounts to the AGI shown on your 1998 tax return.

What are the phaseout amounts? The phaseout amount for each filing status is shown in the following table.

Filing Status	Amount
Married filing jointly	$110,000
Head of household	75,000
Single	75,000
Married filing separately	55,000

Figuring the credit. To figure your 1998 child tax credit you must:

1) Multiply $400 by the number of your qualifying children.

2) Reduce the amount in *(1)* by $50 for each $1,000 (or fraction of $1,000) that your modified AGI is above the phaseout amount for your filing status.

You can use the following worksheet to figure your 1998 credit.

Child Tax Credit Worksheet 1998

Line	Description	Entry
1	Enter the number of children eligible for the child tax credit . . 1.	
2	Multiply the number on line 1 by $400 . . . 2.	
3	Enter your modified adjusted gross income . . . . 3.	
4	Enter — $75,000 if you are single or head of household — $110,000 if you are married filing jointly or — $55,000 if you are married filing separately 4.	
5	Subtract line 4 from line 3. If less than zero, enter zero . . . . . 5.	
6	Divide line 5 by $1,000. Increase any fraction to the next larger whole number . . . . 6.	
7	Multiply line 6 by $50 . . . . 7.	
8	Subtract line 7 from line 2. If less than zero, enter zero. This is your 1998 child tax credit . . . 8.	

Example 1. In 1998, Bill and Mary Allen have two dependent children under age 17. The children are qualifying children for purposes of claiming the child tax credit. Bill and Mary have modified AGI of $34,000. Their child tax credit is $800 ($400 x 2). Because their modified AGI is less than the phaseout amount for their filing status ($110,000), they are entitled to the full credit.

Example 2. Susan Smith is single and has two dependent children under age 17. The children are qualifying children for purposes of the child tax credit. Susan's modified AGI for 1998 is $77,500. She files her tax return as head of household. Because Susan's modified AGI is more than $75,000 (the phaseout amount for her filing status), her child tax credit will be limited. She completes the following worksheet to figure her credit of $650.

Child Tax Credit Worksheet 1998

Line	Description	Entry
1	Enter the number of children eligible for the child tax credit . . 1.	2
2	Multiply the number on line 1 by $400 . . . 2.	800
3	Enter your modified adjusted gross income . . . . 3.	77,500
4	Enter — $75,000 if you are single or head of household — $110,000 if you are married filing jointly or — $55,000 if you are married filing separately 4.	75,000
5	Subtract line 4 from line 3. If less than zero, enter zero . . . . . 5.	2,500
6	Divide line 5 by $1,000. Increase any fraction to the next larger whole number . . . . 6.	3
7	Multiply line 6 by $50 . . . . 7.	150
8	Subtract line 7 from line 2. If less than zero, enter zero. This is your 1998 child tax credit . . . 8.	650

Changing your withholding. If you can claim the child tax credit on your 1998 income tax return, you may have too much tax withheld from your wages during the year. To check your withholding, fill out a 1998 **Form W-4.** If you can claim more withholding allowances, file the new Form W-4 with your employer so that less income tax will be withheld.

Most taxpayers can change their withholding by completing the Personal Allowances Worksheet on page 1 of Form W-4. See line G of the *Personal Allowances Worksheet* of the 1998 Form W-4. Other taxpayers can convert the credit amount into a withholding allowance by using the appropriate table in Publication 919 and then completing Form W-4.

Additional child tax credit for families with 3 or more children. If you have 3 or more qualifying children and your tax liability is less than your allowable child tax credit, part of your credit may be refundable. This means you could get a refund of the credit even if you did not have any income tax withheld.

Earned Income Credit

Beginning in 1998, your modified adjusted gross income used to limit your earned income credit also includes:

1) Tax-exempt interest, and

2) Nontaxable distributions from a pension, annuity, or individual retirement arrangement (IRA), unless rolled over into a similar type of plan during the period allowed for rollovers.

Also, 75% of your business losses must be added back to adjusted gross income to figure modified AGI. Previously, you had to add back 50% of your business losses. See Publication 596 for more information.

Higher Education Tax Credits

Beginning in 1998, you may be able to claim two new tax credits for higher education costs. They are:

1) The Hope scholarship credit (Hope credit), and

2) The lifetime learning credit.

This publication provides general information on these credits. Additional information and examples can be found in Publication 970, *Tax Benefits for Higher Education.* Publication 970 should be available in March 1998.

The amount of each credit is determined by the amount you pay for qualified tuition and related expenses for eligible students and the amount of your modified adjusted gross income. These credits are nonrefundable.

Married persons must file a joint tax return to claim the higher education credits. If you are **married filing a separate tax return,** *you cannot claim the credits.*

The credits can first be claimed on your 1998 tax return that you file in 1999. The instructions for the 1998 tax forms will explain how to claim the credits on your tax return.

You **cannot** *use any amount you paid in 1997 when figuring higher education credits for your 1998 tax return.*

Qualifying expenses. Qualified tuition and related expenses are tuition and fees required for enrollment or attendance at an eligible educational institution. They ***do not include*** books, room and board, student activities, athletics (unless the course is part of the student's degree program), insurance, equipment, transportation, or other similar personal, living, or family expenses.

Eligible student. You, your spouse, or an eligible dependent can be an eligible student. The student must be enrolled at an eligible educational institution for at least one academic period (semester, trimester, or quarter) during the year.

An ***eligible dependent*** is a person for whom you claim a dependency exemption. It generally includes your unmarried child who is under age 19 or who is a full-time student under age 24 if you supply more than half the child's support for the year. (See Publication 501 for details on dependency exemptions.)

An ***eligible educational institution*** generally includes any accredited public, nonprofit, or proprietary postsecondary institution.

No double benefit allowed. If you claim a deduction for higher education expenses on your tax return, you cannot claim a credit for those same expenses. Similarly, if you pay higher education expenses with a ***tax-free*** scholarship, Pell grant, or employer-provided educational assistance, you cannot claim a credit for those amounts. You can, however, claim a credit for expenses paid with the student's earnings, loans, gifts, inheritances, and personal savings.

Education individual retirement arrangement (IRA). You may be able to contribute up to $500 each year to an education IRA for a child under age 18. See chapter 3 for more information.

For any tax year an eligible student receives a tax-free distribution from an education IRA, you **cannot** *claim the Hope or lifetime learning credit for that student for that tax year.*

Changing your withholding. You can reduce your federal income tax withholding throughout the year based on your estimated higher education tax credit(s). After you figure your estimated 1998 credit(s), see Publication 919. You should check your withholding again during the year if there are changes to your personal or financial situation that would affect your expected 1998 tax liability, including your allowable higher education tax credits.

Hope Credit

For expenses paid ***after*** December 31, 1997, for academic periods beginning after that date, you may be able to claim a Hope credit of up to $1,500 for the qualified tuition and related expenses paid for ***each*** eligible student (defined earlier). This credit can be claimed for only ***two*** tax years for each eligible student.

Additional qualifications for the Hope credit. To claim the Hope credit, the eligible student must also meet all the following requirements.

1) Be enrolled in one of the first two years of postsecondary education (generally, the freshman or sophomore years of college).

2) Be enrolled in a program that leads to a degree, certificate, or other recognized educational credential.

3) Be taking at least one-half of the normal full-time work load for his or her course of study for at least one academic period beginning during the calendar year.

4) Be free of any felony conviction for possessing or distributing a controlled substance.

Amount of credit. The Hope credit is 100% of the first $1,000 ***plus*** 50% of the next $1,000 you pay for each eligible student's qualified tuition and related expenses. The maximum Hope credit you can claim in 1998 is $1,500 times the number of eligible students. This means you can claim the full $1,500 for each eligible student for whom you pay at least $2,000 of qualified

expenses. However, the credit may be reduced based on your modified adjusted gross income. See *Income Phaseout,* later.

How to figure the Hope credit. You can use the following worksheet to figure your 1998 Hope credit before the phaseout.

Hope credit:

1. Amount paid for qualified expenses in 1998 .... 1. ______
2. Enter the ***lesser*** of line 1 or $2,000 .... 2. ______

Note: *If line 2 is $2,000, skip lines 3 through 5 and enter $1,500 on line 6.*

3. Enter the ***lesser*** of $1,000 or line 2 .... 3. ______
4. Subtract line 3 from line 2 .... 4. ______
5. Multiply line 4 by 50% .... 5. ______
6. Add lines 3 and 5 but do not enter more than $1,500. This is your 1998 Hope credit (before phaseout) ..... 6. ______

Lifetime Learning Credit

For expenses paid ***after*** June 30, 1998, for academic periods beginning after that date, you may be able to claim a lifetime learning credit of up to $1,000 for the total qualified tuition and related expenses paid during the tax year for ***all*** eligible students (defined earlier) who are enrolled in eligible educational institutions. Unlike the Hope credit:

1) The lifetime learning credit is not based on the student's workload. It is allowed for one or more courses.
2) The lifetime learning credit is not limited to students in the first two years of postsecondary education.
3) Expenses for graduate-level degree work are eligible.
4) There is no maximum period for which the lifetime learning credit can be claimed for each eligible student.
5) The amount you can claim as a lifetime learning credit does not vary (increase) based on the number of eligible students for whom you pay qualified expenses.

Amount of credit. The lifetime learning credit is 20% of the first $5,000 ($10,000 after 2002) you pay for qualified tuition and related expenses for all eligible students. The maximum lifetime learning credit you can claim for 1998 is $1,000 (20% times $5,000). However, that amount may be reduced based on your modified adjusted gross income. See *Income Phaseout,* later.

How to figure the lifetime learning credit. You can use the following worksheet to figure your 1998 lifetime learning credit before the phaseout.

Lifetime learning credit:

1. Amount paid for qualified expenses after June 1998 1. ______
2. Enter the ***lesser*** of line 1 or $5,000 .... 2. ______
3. Multiply line 2 by 20%. This is your 1998 lifetime learning credit (before phaseout) .... 3. ______

Choosing Which Credit To Claim

For each eligible student, you can elect for any tax year only ***one*** of the credits ***or*** the exclusion for a qualified distribution from an education IRA. (See *Education IRA* in chapter 3 for more information.) For example, if you elect to take the Hope credit for a child on your 1998 tax return, you cannot, for that same child, also claim the lifetime learning credit or the exclusion for a qualified distribution from an education IRA for 1998.

You can claim the Hope credit for the first two years of a child's postsecondary education and claim the lifetime learning credit for that same child in later tax years.

For any year you pay qualified expenses for more than one eligible student, you can elect to take a credit on a per-student, per-year basis. This means that, for example, you can claim the Hope credit for one child and the lifetime learning credit for another child in the same tax year.

Income Phaseout

Your education credits are phased out or reduced ratably if your modified adjusted gross income is between $40,000 and $50,000 ($80,000 and $100,000 for married taxpayers filing jointly). These modified adjusted gross income limits may be adjusted for inflation after 2001.

You cannot claim any higher education credits if your modified adjusted gross income is over $50,000 ($100,000 for married taxpayers filing jointly).

For most taxpayers, ***modified adjusted gross income*** is your adjusted gross income (AGI) as figured on your federal income tax return. However, you must make adjustments to your AGI if you have income earned abroad or from certain U.S. territories or possessions.

How the phaseout works. The phaseout or reduction works on a sliding scale. You reduce the total of your education credits by a fraction. The numerator is your modified adjusted gross income that is over $40,000 ($80,000 for married taxpayers filing jointly) and the denominator is $10,000 ($20,000 for married taxpayers filing jointly).

More information. See Publication 970 for more information on these credits and other tax benefits for higher education.

Deductible Student Loan Interest

You may be able to deduct interest you pay on a qualified student loan. This applies to loan interest payments due and paid after 1997.

You may be able to deduct this interest even if you took out the loan before 1998. Regardless of when you took out the loan, you can deduct only interest paid during the first 60 months that interest payments are required. Months when you do not have to make payments because your loan is deferred or in forbearance do not count against the 60-month period.

Example. You took out a qualified student loan in 1993. You make a payment on the loan every month as required, beginning October 1, 1993. You can deduct the interest on your first nine payments for 1998. You cannot deduct the interest on any later payments because they are after the 60-month period (October 1, 1993 – September 30, 1998).

Your interest deduction for 1998 cannot be more than $1,000 and is subject to the limit described later.

Claiming the deduction. This deduction is an adjustment to income, so you can claim it even if you do not itemize your deductions on Schedule A (Form 1040).

You cannot claim the deduction if:

1) Another taxpayer claims you as a dependent, or

2) Your filing status is married filing a separate return.

Change in dependency status. You cannot deduct interest on a student loan for any year you are claimed as a dependent on another person's tax return. But you can, subject to the other requirements explained here, deduct payments made in a later year when you are no longer claimed as a dependent.

Qualified student loan. This is a loan you took out to pay qualified higher education expenses. The expenses must have been:

1) For you, your spouse, or a person who was your dependent when you took out the loan,

2) Paid or incurred within a reasonable time before or after you took out the loan, and

3) For education furnished during a period when the recipient was an eligible student.

Qualified higher education expenses. These expenses are the costs of attending an eligible educational institution, including graduate school. Generally, these costs include tuition, fees, room and board, books, equipment, and other necessary expenses, such as transportation. You must reduce these costs by the following items.

1) Nontaxable employer-provided educational assistance benefits.

2) Nontaxable distributions from an education individual retirement account.

3) U.S. savings bond interest that is nontaxable because you paid qualified higher educational expenses.

4) Qualified scholarships that are nontaxable.

5) Veterans' educational assistance benefits.

6) Any other nontaxable payments (other than gifts, bequests, or inheritances) received for educational expenses.

Eligible educational institution. Generally, this means either of the following.

1) A college, university, vocational school, or other postsecondary educational institution eligible to participate in Department of Education student aid programs. This category includes virtually all accredited public, nonprofit, and proprietary postsecondary institutions.

2) An institution conducting an internship or residency program leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility that offers postgraduate training.

Eligible student. An eligible student is one who:

1) Is enrolled in a degree, certificate, or other program (including a program of study abroad that is approved for credit by the institution at which the student is enrolled) leading to a recognized educational credential at an eligible educational institution, and

2) Is carrying at least one-half the normal full-time work load for the course of study the student is pursuing.

Loan from related person. You cannot deduct interest on a loan you get from a related person. Related persons include your brothers and sisters, half-brothers and half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.). Related persons also include certain corporations, partnerships, trusts, and exempt organizations.

Refinanced loan. If you refinance a qualified student loan, the new loan can also be a qualified student loan. But refinancing a loan does not extend the 60-month period described earlier.

Maximum deduction. Your deduction for 1998 cannot be more than $1,000. This limit increases to $1,500 for 1999, $2,000 for 2000, and $2,500 for 2001 and later years.

Limit on deduction. Your deduction may be limited, depending on your modified adjusted gross income (AGI). The following table explains when the limit applies.

Table 2. **Limit on Student Loan Interest Deduction**

IF your filing status is ...	AND your modified AGI is ...	THEN ...
Single, head of household, or qualifying widow(er)	$40,000 or less	You can deduct all your interest, up to $1,000.
	More than $40,000, but not more than $55,000	Your deduction is limited, as explained later under *Figuring the limit.*
	More than $55,000	You cannot claim this deduction.
Married filing jointly	$60,000 or less	You can deduct all your interest, up to $1,000.
	More than $60,000, but not more than $75,000	Your deduction is limited, as explained later under *Figuring the limit.*
	More than $75,000	You cannot claim this deduction.

Modified AGI. For purposes of this deduction, modified AGI means AGI figured before this deduction for student loan interest and modified by adding back any of the following items.

1) U.S. savings bond interest that is nontaxable because you paid qualified higher educational expenses.
2) Nontaxable employer-provided adoption assistance benefits.
3) Foreign earned income exclusion.
4) Foreign housing exclusion or deduction.
5) Exclusion of income for bona fide residents of American Samoa.
6) Exclusion for income from Puerto Rico.

Figuring the limit. To figure the limit, multiply your deduction (before the limit) by a fraction. The numerator is your modified AGI minus $40,000 ($60,000 in the case of a joint return). The denominator is $15,000. Subtract the result from your deduction (before the limit). This result is the amount you can deduct.

Example 1. During 1998 you paid $900 interest on a qualified student loan. Your 1998 modified AGI is $70,000, and you are filing a joint return. You must reduce your deduction (before the limit) by $600:

$$\$900 \times \frac{\$70,000 - \$60,000}{\$15,000} = \$600$$

You can deduct $300 ($900 – $600).

Example 2. The facts are the same as *Example 1* except that you paid $1,600 interest. Your maximum deduction for 1998 is $1,000. You must reduce your maximum deduction by $667:

$$\$1,000 \times \frac{\$70,000 - \$60,000}{\$15,000} = \$667$$

You can deduct $333 ($1,000 – $667).

No double benefit. You cannot deduct as interest on a student loan any amount you can deduct under any other provision of the tax law (for example, as home mortgage interest).

State Tuition Programs

Certain states and agencies maintain programs that allow people to purchase credits or certificates or make contributions to an account for future education. Beginning January 1, 1998, the following changes have been made regarding the taxation of these state-sponsored programs.

1) The definition of an ***eligible education institution*** is expanded to include accredited postsecondary educational institutions offering credit toward any postsecondary degree or credential. The institution must be eligible to participate in Department of Education student aid programs.
2) The definition of ***member of the family*** has been expanded and now includes the following members.

Parent	Brother-in-law
Grandparent	Sister-in-law
Brother	Son-in-law
Sister	Daughter-in-law
Stepbrother	Brother of a parent
Stepsister	Sister of a parent
Stepmother	Son of a sibling
Stepfather	Daughter of a sibling
Stepdaughter	Stepson
Mother-in-law	Half brother
Father-in-law	Half sister

The definition also includes the spouse of any person listed above.

For more information on state tuition programs, see Publication 525.

Education Savings Bond Program

You can exclude interest on qualified U.S. savings bonds from your gross income if you have qualified higher educational expenses during the redemption year. Beginning in 1998, when figuring the interest you can exclude, include any contribution to a qualified state tuition program as a qualified higher educational expense. Do not include any expense you use to claim the Hope credit or the lifetime learning credit.

For more information about the exclusion of interest on qualified U.S. savings bonds, including the definition of "qualified higher educational expenses," see *Education Savings Bond Program* in chapter 1 of Publication 550.

Standard Deduction of Dependents

For 1998, the standard deduction of a dependent is the greater of $700, or the dependent's earned income ***plus $250,*** but not more than the regular standard deduction amount for the dependent's filing status.

Employee Business Expenses

Standard mileage rate. For 1998, the optional standard mileage rate for the cost of operating your car for business increases to 32½ cents a mile for each business mile.

Rural mail carriers. Beginning in 1998, the higher standard mileage rate for rural mail carriers is repealed. If you are a rural mail carrier, you may be able to treat the qualified reimbursement you receive in 1998 as your allowable expense. Because the qualified reimbursement is treated as paid under an accountable plan, your employer should not include the reimbursement in your income. And, since the reimbursement equals the expense, you have no deduction to report on your tax return.

A “qualified reimbursement” is a reimbursement that meets both of the following conditions.

1) It is given as an equipment maintenance allowance (EMA) to employees of the United States Postal Service.

2) It is figured at the rate in the 1991 collective bargaining agreement. Any later agreement cannot increase the qualified reimbursement amount by more than the rate of inflation.

Car expenses, reimbursements, and accountable plans are discussed in Publication 463.

Meal expenses when subject to “hours of service” limits. Generally, you can deduct only 50% of your business-related meal expenses while traveling away from your tax home for business purposes. Beginning in 1998, if you consume the meals during or incident to any period subject to the Department of Transportation's hours of service limits, you can deduct a higher percentage. The percentage is 55% for 1998 and 1999, and it gradually increases to 80% by the year 2008.

Individuals subject to the Department of Transportation's hours of service limits include the following persons.

1) Certain air transportation workers (such as pilots, crew, dispatchers, mechanics, and control tower operators) who are under Federal Aviation Administration regulations.

2) Interstate truck operators and bus drivers who are under Department of Transportation regulations.

3) Certain railroad employees (such as engineers, conductors, train crews, dispatchers, and control operations personnel) who are under Federal Railroad Administration regulations.

4) Certain merchant mariners who are under Coast Guard regulations.

For more information on business meal expenses, see Publication 463.

Employer-Provided Parking

Before 1998, you had to include in income the fair market value of parking you received from your employer if you received it in place of compensation. For tax years beginning after 1997, you can exclude up to $170 per month of employer-provided parking, even if you choose it instead of cash or your employer reduces your compensation to provide the parking. The $170 is indexed for inflation.

Using Your Car for Charity

Beginning in 1998, the standard mileage rate you can deduct for the use of your car in giving services to a charitable organization increases from 12 cents per mile to 14 cents per mile.

Exclusion of Gain From Sales of Small Business Stock

Beginning in 1998, you may have to pay tax on only one-half of your gain from the sale or exchange of qualified small business stock. This applies only to stock originally issued after August 10, 1993, which you held for more than 5 years.

For information about qualified small business stock, see *Sales of Small Business Stock* in chapter 4 of Publication 550.

Exclusion of Gain From District of Columbia Enterprise Zone Assets

Beginning in 1998, if you acquire a District of Columbia Enterprise Zone (DC Zone) asset and hold it more than 5 years, you will not have to include any qualified capital gain from its sale or exchange in your gross income. This exclusion applies to an interest in, or property of, certain businesses operating in the District of Columbia. See chapter 2 for more information on this exclusion.

Social Security and Medicare Taxes

For 1998, the employer and employee will continue to pay:

1) 6.2% each for social security tax (old-age, survivors, and disability insurance), and

2) 1.45% each for Medicare tax (hospital insurance).

Wage limits. For social security tax, the maximum amount of 1998 wages subject to the tax has increased to $68,400. For Medicare tax, all covered 1998 wages are subject to the tax. There is no wage base limit. For information about these taxes and amounts to withhold, see Publication 15 (Circular E).

Self-Employment Tax

The self-employment tax rate on net earnings remains the same for calendar year 1998. This rate, 15.3%, is a total of 12.4% for social security (old-age, survivors, and disability insurance), and 2.9% for Medicare (hospital insurance).

The maximum amount subject to the social security part for tax years beginning in 1998 will increase to $68,400. All net earnings of at least $400 are subject to the Medicare part.

Former insurance salespersons. Former insurance salespersons may not be subject to self-employment tax (SE tax) on amounts received after 1997. A salesperson's payments from an insurance company for services performed for that company are exempt from SE tax if all the following requirements are met.

1) The amounts are received after the salesperson's agreement to perform services for the company has ended.
2) The salesperson performs no services for the company after the service agreement ends and before the end of the tax year.
3) The salesperson enters into a covenant not to compete against the company for at least the 1-year period beginning on the date the service agreement ended.
4) The payment depends primarily on policies sold by or credited to the account of the salesperson during the last year of the service agreement or on the extent to which those policies remain in force for some period after the service agreement ends, or both.
5) The payment does not depend to any extent on the length of service or overall earnings from services performed for the company (regardless of whether eligibility for payment depends on length of service).

Household Employment Taxes

The following changes may apply to you if you have a household employee in 1998. For more information on household employment taxes, see Publication 926, *Household Employer's Tax Guide.*

Social security and Medicare wage threshold increased to $1,100. The $1,000 social security and Medicare wage threshold has been increased to $1,100 for 1998. This means that if you pay a household employee cash wages of less than $1,100 in 1998, you do not have to report and pay social security and Medicare taxes on that employee's 1998 wages.

Estimated tax penalty may apply to household employment taxes. Beginning in 1998, the estimated tax penalty may apply to household employers who:

1) Do not prepay household employment taxes, and
2) Either:
   a) Will have federal income tax withheld from pay, pensions, annuities, etc., or
   b) Would be required to make estimated tax payments (to avoid the penalty) even if no household employment taxes were owed.

To prepay household employment taxes, you may increase your withholding or make estimated tax payments, as listed below.

1) If you are employed, you can ask your employer to withhold more federal income tax from your wages.
2) If you receive a pension or annuity, you can ask the payer to withhold more federal income tax from your benefits.
3) You can make estimated tax payments to the IRS, or increase your payments if you already make them.

For more information, see:

1) Publication 505, *Tax Withholding and Estimated Tax.*
2) **Form 1040–ES,** *Estimated Tax Payments for Individuals.*

Alternative Minimum Tax

There are two changes that affect the alternative minimum tax (AMT) for individuals.

Increased exemption amount. For tax years beginning after 1997, the AMT exemption amount for a child under age 14 is increased to a minimum of $5,000. The child's exemption amount is also no longer dependent on the parent's alternative minimum taxable income.

New election for foreign tax credit limit. You can elect to use a simpler computation for figuring the AMT foreign tax credit limit. This computation uses regular foreign-source taxable income, instead of requiring the computation of AMT foreign-source taxable income. You can only make this election for the first tax year beginning after 1997 for which you claimed an AMT foreign tax credit. The election applies to all later tax years unless revoked with the consent of the Secretary of the Treasury.

Estimated Tax

You will not be subject to the estimated tax penalty unless the amount you owe with your 1998 return is $1,000 or more (up from $500).

Safe harbor for higher income individuals. For estimated tax payments for tax years beginning in 1998, the safe harbor for higher income individuals (other than farmers and fishermen) has been modified. If your adjusted gross income is more than $150,000 ($75,000 if married filing a separate return), you will no longer have to pay the smaller of 90% of your expected tax for 1998 or ***110%*** of the tax shown on your 1997 return to avoid an estimated tax penalty. The general rule will apply to you. Under the general rule, the estimated tax you must pay to avoid a penalty is the smaller of:

1) 90% of your expected tax for 1998, or

2) ***100%*** of the tax shown on your 1997 return (provided your 1997 return covered all 12 months).

More information. For more information on estimated tax, see Publication 505, *Tax Withholding and Estimated Tax*.

2. Tax Changes for Businesses

Useful Items

You may want to see:

Publication

- ☐ **463** Travel, Entertainment, Gift, and Car Expenses
- ☐ **535** Business Expenses
- ☐ **541** Partnerships
- ☐ **542** Corporations
- ☐ **544** Sales and Other Dispositions of Assets
- ☐ **550** Investment Income and Expenses
- ☐ **946** How To Depreciate Property
- ☐ **954** Tax Incentives for Empowerment Zones and Enterprise Communities

1997 Changes

Estimated Tax Penalty Waived If Due to New Law

For estimated tax payments due before January 16, 1998, you will not have to pay a penalty for failure to pay estimated income tax to the extent your underpayment was created or increased by a provision of the Taxpayer Relief Act of 1997.

Construction Allowances

If you enter into a lease after August 5, 1997, you can now exclude from income any construction allowance you receive (in cash or as a rent reduction) from your landlord:

1) Under a short-term lease of retail space, and

2) For the purpose of constructing or improving qualified long-term real property for use in your business at that retail space.

Amount excludable. You can exclude the construction allowance up to the amount you spent for construction or improvements. You must include in income any remaining construction allowance.

Short-term lease. A short-term lease is a lease (or other agreement for occupancy or use) of retail space for 15 years or less. The following rules apply in determining whether the lease is for 15 years or less.

1) Take options to renew into account when figuring whether the lease is for 15 years or less. But do not take into account any option to renew at fair market value, determined at the time of renewal.

2) Two or more successive leases that are part of the same transaction (or a series of related transactions) for the same or substantially similar retail space are treated as one lease.

Retail space. Retail space is real property leased, occupied, or otherwise used by you as a tenant in your business of selling tangible personal property or services to the general public.

Qualified long-term real property. Qualified long-term real property is nonresidential real property that is part of, or otherwise present at, your retail space and that reverts to the landlord when the lease ends.

Consistent treatment by landlord. The qualified long-term real property constructed or improved in connection with any amount excluded from the tenant's income under the rules discussed here must be treated as nonresidential real property of the landlord.

Like-Kind Exchanges of Personal Property

A new rule applies to exchanges of property after June 8, 1997. Under this new rule, personal property used predominantly in the United States cannot be exchanged tax free for personal property used predominantly outside the United States. The exchange does not qualify as a like-kind exchange and you must recognize gain or loss on the exchange. For more information, see *Like-Kind Exchanges* in chapter 1 of Publication 544.

Termination of Certain Rights or Obligations

The cancellation, lapse, expiration, or other termination of a right or obligation with respect to property that is a capital asset (or that would be a capital asset if you acquired it) is treated as a sale if it takes place after September 4, 1997. Any gain or loss is treated as a capital gain or loss.

In the case of terminations before September 5, 1997, this rule applied only if the right or obligation was with respect to:

1) Personal property (generally not including stock) of a type that is actively traded, or

2) Section 1256 contracts.

For information about capital assets and section 1256 contracts, see chapter 4 of Publication 550.

Postponement of Gain on Involuntary Conversions

A new rule applies to property involuntarily converted after June 8, 1997, if that property was owned by an individual, a partnership (other than certain partnerships with C corporation partners), a trust, an estate, or an S corporation. Under this rule, you cannot postpone reporting gain if both of the following are true.

1) You acquire replacement property or stock from a related party.

2) Your total realized gain for the tax year on the involuntarily converted properties on which there are realized gains is more than $100,000.

You cannot offset the gains with any losses when determining whether your total gain is more than $100,000.

If the property is owned by a partnership, the $100,000 limit applies to the partnership and each partner. If the property is owned by an S corporation, the $100,000 limit applies to the S corporation and each shareholder.

Exception. This rule does not apply if the related party acquired the property from an unrelated party during the replacement period.

More information. For more information about involuntary conversions due to condemnations, see chapter 1 in Publication 544. For more information about involuntary conversions due to casualties or thefts, see Publication 547, *Casualties, Disasters, and Thefts (Business and Nonbusiness).*

Self-Employed Health Insurance Deduction

For tax years beginning in 1997, the part of your self-employed health insurance premiums you can deduct as an adjustment to income increases to 40%. The deductible percentage increases for later tax years as shown in the following table.

Tax Years	Deductible Percentage
1998 and 1999	45%
2000 and 2001	50%
2002	60%
2003 through 2005	80%
2006	90%
After 2006	100%

For more information on the self-employed insurance deduction, see chapter 10 in Publication 535.

Net Operating Loss (NOL) Carrybacks and Carryforwards

For an NOL occurring in a tax year beginning after August 5, 1997:

1) The period to which you can carry an NOL back is decreased from 3 to 2 tax years.

2) The period to which you can carry an NOL forward is increased from 15 to 20 tax years.

However, you can still carry the part of an NOL that is an eligible loss back 3 tax years. Eligible losses are generally those from:

1) Casualties,

2) Thefts, or

3) Farm losses or small business losses attributable to Presidentially declared disasters.

For more information on NOLs, see Publication 536, *Net Operating Losses.*

Standard Mileage Rate

If you use your car in your business, you can figure your deduction for business use based either on your actual costs or the optional standard mileage rate. The standard mileage rate for the cost of operating your car in 1997 is 31½ cents a mile for each business mile. The special rate for rural mail carriers is 47¼ cents a mile. Business car expenses are discussed in chapter 4 of Publication 463.

The standard mileage rate for medical and moving expenses remains at 10 cents a mile, and the standard mileage rate for charitable contributions remains at 12 cents a mile. See Publication 502, *Medical and Dental Expenses,* Publication 521, *Moving Expenses,* or Publication 526, *Charitable Contributions,* for more information on those expenses.

Depreciation and the Section 179 Deduction

Depreciation limits on business cars. If you use your car in your business, you may be able to deduct the business part of the operating costs of your car, including depreciation. Your deductible depreciation is limited, based on the year you place the car in service. Generally, for a car you use in your business and first place in service in 1997, the maximum depreciation, including the section 179 deduction, you can claim in 1997 is $3,160. Business car expenses are discussed in chapter 4 of Publication 463.

Exceptions for clean-fuel cars. There are two exceptions to the depreciation limits for cars that run on clean fuel. Clean-fuel cars are discussed in chapter 15 of Publication 535. The exceptions follow.

1) Amounts you pay (such as for retrofit parts and components) to modify a car to run on clean fuel are not subject to the depreciation limit on cars. Only the cost of the car before modification is subject to the limit. This means you can claim an additional depreciation deduction for the amount you pay to modify a car to permit it to run on clean fuel. This rule applies to modifications placed in service after August 5, 1997.

2) If you place in service after August 5, 1997, a car that was produced to run on electricity, your depreciation limit for 1997 is increased to a maximum of $9,480.

Income forecast method of depreciation. Previously, the IRS had taken the position that you could use the income forecast method of figuring depreciation only for television and motion picture films, video tapes, sound recordings, book manuscript rights, patents, master recordings, and other property of a similar character. It did not allow you to use the method for consumer durable property subject to rent-to-own contracts.

New law clarifies that, effective for property placed in service after August 5, 1997, you can use the income forecast method only for the following property:

1) Motion picture films,
2) Video tapes,
3) Sound recordings (such as discs, tapes, or other phonorecordings),
4) Copyrights,
5) Books,
6) Patents, and
7) Other property to be specified in the Income Tax Regulations.

For more information, see chapter 12 in Publication 535.

Rent-to-own property. Qualified rent-to-own property placed in service before August 6, 1997, is depreciated over 5 years. Qualified rent-to-own property placed in service after August 5, 1997, is now depreciated over 3 years.

For more information on rent-to-own property, see chapter 3 in Publication 946.

Increases to section 179 deduction. The total cost of section 179 property that you can elect to deduct for 1997 is increased from $17,500 to $18,000. For tax years after 1997, this amount increases as shown below.

Tax Year	Maximum Deduction
1998	$18,500
1999	19,000
2000	20,000
2001 and 2002	24,000
After 2002	25,000

For more information on the section 179 deduction, see chapter 2 in Publication 946.

Interest Expense

A new rule reduces interest deductions allocable to the unborrowed policy cash values of certain life insurance, endowment, or annuity contracts issued after June 8, 1997. Generally, this does not apply to a contract held by an individual. See Internal Revenue Code section 264(f) for the proration rules and other information, including exceptions to this rule.

Interest on Loans for Life Insurance Policies

No deduction is allowed for interest paid or accrued on debt incurred with respect to any life insurance, annuity, or endowment contract that:

1) Is issued after June 8, 1997, and
2) Covers any individual, unless that individual is a key person.

For more information, see chapter 8 in Publication 535.

Nondeductible Life Insurance Premiums

For contracts issued after June 8, 1997, you generally cannot deduct premiums on any life insurance policy, endowment contract, or annuity contract, if you are directly or indirectly a beneficiary. For contracts issued before June 9, 1997, you cannot deduct the premiums if you are directly or indirectly a beneficiary and the life insurance policy covers an officer, employee, or other person financially interested in your trade or business.

For more information on deducting life insurance premiums, see chapter 10 in Publication 535.

Fringe Benefit Nondiscrimination Rules

Nondiscrimination rules apply to the exclusion of certain fringe benefits from the income of a highly compensated employee. For tax years beginning after 1996, the definition of a “highly compensated employee” has changed.

A highly compensated employee is now defined as an employee who:

1) Was a 5% owner at any time during the year or the preceding year, or
2) Was paid more than $80,000 by the employer for the preceding year.

When applying requirement *(2),* you can choose to include only employees who were also in the top 20% of employees when ranked by pay for the preceding year.

For more information on fringe benefit nondiscrimination rules, see chapter 4 in Publication 535.

Group Health Plan Requirements

Generally effective for plan years beginning after June 30, 1997, you (or the plan, if a multi-employer plan) may be subject to an excise tax if your plan does not meet new accessibility, portability, and renewability requirements. These requirements generally:

1) Limit the circumstances under which plans can deny coverage for preexisting conditions,
2) Bar group health plans from using an individual's health status to exclude him or her from coverage, and

3) Guarantee continued health coverage to an employer under a multi-employer plan.

For more information, see chapter 5 in Publication 535.

Medical Savings Accounts

For tax years beginning after 1996, you may be able to make contributions to a medical savings account (MSA) for your employees if you have a small business (generally fewer than 50 employees). You can also open an MSA if you are self-employed. In either case you must have only a high-deductible health plan. For more information, see Publication 969, *Medical Savings Accounts (MSAs)*.

Educational Assistance Program

Each year you can exclude from an employee's wages up to $5,250 you pay or incur under an educational assistance program. This exclusion, which expired for tax years beginning after May 31, 1997, has been reinstated retroactively and extended. It will now expire for expenses paid with respect to courses beginning after May 31, 2000.

For more information on educational assistance programs, see chapter 5 in Publication 535.

Adoption Assistance Program

Beginning in 1997, you can set up an adoption assistance program for the benefit of your employees. The costs are generally deductible on your business tax return. Adoption assistance programs are explained in Publication 968, *Tax Benefits for Adoption.*

General Business Credit

The following paragraphs explain the changes to the general business credit for 1997.

Orphan drug credit. The orphan drug credit has been permanently extended. For more information about this credit, see **Form 8820.**

Research credit. The changes to the research credit are as follows. They apply to expenses paid or incurred after May 31, 1997.

Expiration date. The credit was set to expire on May 31, 1997, but has been extended for expenses paid or incurred before July 1, 1998.

Alternative incremental credit. You can elect this credit for any tax year beginning after June 30, 1996. This election will apply to that tax year and all later years unless you have IRS approval to revoke it.

If you elect this credit, all qualified research expenses paid or incurred during the first 24-month period beginning with the first month of your tax year are treated as qualified research expenses for purposes of computing this credit. You must reduce the 24 months by the number of full months after June 1996 (and before the first month of the tax year for which you elect the alternative incremental credit) during which you paid or incurred any amount taken into account in determining the regular research credit.

More information. For more information about the research credit, see **Form 6765.**

Work opportunity credit. The changes to the work opportunity credit are as follows. These changes are effective for qualified individuals who begin work for you after September 30, 1997.

Expiration date. The credit was set to expire on September 30, 1997, but has been extended to qualified first-year wages you pay to individuals who begin work for you before July 1, 1998.

Targeted groups. The requirements for two of the targeted groups have changed, and a new targeted group has been added.

- The requirement for receipt of assistance for a qualified IV-A recipient has changed from 9 ***consecutive*** months during the 18-month period ending on the hiring date to ***any*** 9 months during that period. This targeted group represents recipients of Aid to Families with Dependent Children or any successor program.
- A qualified veteran must be a veteran who is certified as being a member of a family receiving assistance under a food stamp program under the Food Stamp Act of 1977 for at least a 3-month period during the 15-month period ending on the hiring date.
- Qualified individuals who receive supplemental security income (SSI) benefits under the Social Security Act are now a targeted group.

Percentage of wages allowed as a credit. The credit has increased to 40% of qualified first-year wages paid to a qualified individual who works for you for at least 400 hours. If an individual works less than 400 hours but at least 120 hours, the credit is only 25% of qualified first-year wages. No credit is allowed if the number of hours worked is less than 120. There is no longer a separate minimum employment period for a qualified summer youth employee.

More information. For more information about the work opportunity credit, see **Form 5884.**

Self-Employment Tax

The self-employment tax rate on net earnings remains the same for calendar year 1997. This rate, 15.3%, is a total of 12.4% for social security (old-age, survivors, and disability insurance), and 2.9% for Medicare (hospital insurance).

The maximum amount subject to the social security part for tax years beginning in 1997 has increased to $65,400. All net earnings of at least $400 are subject to the Medicare part.

Farmers

Weather-related sales of livestock. If you sell or exchange livestock after December 31, 1996, because of drought, flood, or other weather-related conditions, the sale or exchange may qualify for special tax treatment. Previously, only sales or exchanges due to drought

conditions qualified for special tax treatment. If you meet certain requirements, you may be able to:

1) Elect to postpone for one year reporting gain, if any, from a sale or exchange of livestock, including poultry. See chapter 4 in Publication 225, *Farmer's Tax Guide,* for details.
2) Treat as an involuntary conversion the sale or exchange of livestock (other than poultry) held for draft, breeding, or dairy purposes. See chapter 13 in Publication 225 for details.

Uniform capitalization rules. Changes have been made to the uniform capitalization rules for determining the basis of property produced in a farming business. For more information, see the regulations under section 263A of the Internal Revenue Code.

Alternative minimum tax. Cash-basis farmers are now permitted to use the installment method of accounting for alternative minimum tax purposes on the disposition of farm property. This clarification applies retroactively to tax years beginning in 1987 or later. See the instructions for **Form 6251,** *Alternative Minimum Tax – Individuals.*

Tax Return Preparers

Beginning with 1997 income tax returns and claims for refund, income tax return preparers are subject to a $100 penalty for each failure to exercise due diligence in determining a taxpayer's eligibility for the earned income credit (EIC) or any allowable EIC.

Notice 97–65 (published in Internal Revenue Bulletin 1997–51) describes the due diligence standard for 1997 income tax returns and claims for refund. The notice is available on the IRS Internet web site at: **www.irs.ustreas.gov**.

Real Estate Investment Trusts

For tax years beginning after August 5, 1997, a real estate investment trust (REIT) can keep its long-term capital gains and pay the tax on them, in the same way as a mutual fund. The REIT must report to each shareholder the shareholder's share of these gains and the tax paid on them on **Form 2439,** *Notice to Shareholder of Undistributed Long-Term Capital Gains.*

The REIT must also tell the shareholder how much of an undistributed capital gain is a 28% rate gain and how much is an unrecaptured section 1250 gain. For information on figuring these amounts, see Notice 97–64 in Internal Revenue Bulletin 1997–47. For information on how the shareholder reports these amounts, see Publication 550.

Partnerships

The following changes affect special rules that apply to partnerships. For more information on these rules, see Publication 541.

Recognition period for precontribution gain. For appreciated property contributed to a partnership after June 8, 1997, the period in which a contributing partner must recognize precontribution gain is extended from 5 years to 7 years. However, the 5-year period will continue to apply to property contributed to a partnership under a written binding contract in effect on June 8, 1997, and at all times thereafter before the contribution if the contract provides for a contribution of a fixed amount of property.

Sale of partnership interest. For a sale or exchange of a partnership interest after August 5, 1997, it is no longer necessary that inventory be substantially appreciated before it generates ordinary income (rather than capital gain). Under the new rule, the amount attributable to both inventory and unrealized receivables is treated as realized from the sale or exchange of property that is not a capital asset. However, the new rule does not apply to any sale or exchange under a written contract that is in effect on June 8, 1997, and at all times thereafter before the sale or exchange.

Allocated basis of distributed properties. For a distribution of partnership properties after August 5, 1997, the method of allocating a partner's basis in the partnership among the properties received has been changed. The allocation is no longer based on the partnership's proportionate basis. Instead, basis is allocated first on the unrealized appreciation or depreciation of the distributed properties. Any remaining basis is allocated based on the fair market value of the distributed properties.

Corporations

The following changes affect special tax rules that apply to corporations. For more information on these rules, see Publication 542.

Businesses taxed as corporations. The rules you must use to determine whether your business is taxed as a corporation changed for businesses formed after 1996. However, if your business was formed before 1997 and taxed as a corporation under the old rules, it will generally continue to be taxed as a corporation.

The following businesses formed after 1996 are taxed as corporations.

1) A business formed under a federal or state law that refers to the business as a corporation, body corporate, or body politic.
2) A business formed under a state law that refers to the business as a joint-stock company or joint-stock association.
3) An insurance company.
4) Certain banks.
5) A business wholly owned by a state or local government.
6) A business specifically required to be taxed as a corporation by the Internal Revenue Code. (For example, certain publicly traded partnerships.)
7) Certain foreign businesses.
8) Any other business formed after 1996, if an election to be taxed as a corporation is filed for the business

on Form 8832 within 75 days of the date it is formed.

For more information, see the instructions for **Form 8832**, *Entity Classification Election.*

New holding period for dividends-received deduction. The holding period for the dividends-received deduction has been changed. Generally, for dividends received or accrued after September 4, 1997, a corporation cannot take a deduction for dividends received from:

1) A corporation whose stock has been held less than 46 days during the 90-day period beginning 45 days before the stock becomes ex-dividend with respect to the dividend, or
2) A corporation whose preferred stock has been held less than 91 days during the 180-day period beginning 90 days before the stock becomes ex-dividend with respect to the dividend if the dividends received on it are for a period or periods totaling more than 366 days.

Nonqualified preferred stock not treated as stock. Generally effective for transfers made after June 8, 1997, a person who transfers property to a corporation and receives nonqualified preferred stock must treat such stock as property or money (instead of stock) received. This means that the person may need to recognize at least part of any gain realized on the transfer of the property to the corporation even if that person controls the corporation.

Preferred stock is stock that is limited and preferred as to dividends and does not participate in corporate growth to any significant extent. Preferred stock is nonqualified if it has ***any*** of the following characteristics.

1) The holder of the stock can require the issuer or a related person to redeem or purchase the stock.
2) The issuer or a related person is required to redeem or purchase the stock.
3) The issuer or a related person has the right to redeem or repurchase the stock and, as of the issue date, it is more likely than not that that right will be exercised.
4) The dividend rate of the stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices.

S Corporations

The following changes affect special rules that apply to S corporations. For more information on these rules, see the instructions for the listed form.

Invalid or late S corporation election. The instructions for Form 2553, *Election by a Small Business Corporation,* explain the relief for an invalid or late S corporation election, effective for tax years beginning after 1982.

Subdivision of real property. For tax years beginning after 1996, an S corporation is eligible for the rules under Internal Revenue Code section 1237 that apply to real property subdivided for sale by noncorporate taxpayers.

Other changes affecting S corporations. See the instructions for **Form 1120S,** *U.S. Income Tax Return for an S Corporation,* for more information on the following changes.

1) The increase in permitted shareholders (from 35 to 75).
2) Electing small business trusts and certain financial institutions are now permitted to be shareholders.
3) The increase in the post-death qualification period for certain trusts (from 60 days to 2 years).
4) S corporations are now permitted to own subsidiaries.
5) The election to close the tax year can be made by the affected shareholders and the corporation, rather than all shareholders, when a shareholder terminates his or her interest in the corporation.
6) The repeal of consolidated audit procedures.
7) Adjustments to basis for distributions made by the corporation are now taken into account ***before*** applying the loss limitation for the year.
8) The elimination of certain accumulated earnings and profits.
9) For re-election of S corporation status after a previous termination, do not take into account any termination in a tax year beginning ***before 1997*** for purposes of the 5-year waiting period.

Empowerment Zones and Enterprise Communities

You may qualify for special tax incentives if you operate a business in a distressed area designated as an empowerment zone or an enterprise community. For more details about these incentives and the following changes, see Publication 954.

Additional empowerment zones. Additional empowerment zones can be designated. However, these designations will not take effect before the year 2000.

Enterprise zone business. For tax years beginning after August 4, 1997, the definition of the term "enterprise zone business" has been changed to make it easier for a business to qualify for the increased section 179 deduction. This increased amount applies to qualified zone property placed in service by an enterprise zone business.

These terms are defined in Publication 954.

New tax-exempt bond financing. Special tax-exempt bond financing is available to finance property in both enterprise communities and empowerment zones. For bonds issued after August 5, 1997, new rules make it

easier for a business to qualify for this special tax-exempt bond financing.

Small Business Ombudsman

The Small Business and Agriculture Regulatory Enforcement Ombudsman and 10 Regional Fairness Boards were established to receive comments from small business about federal agency enforcement actions. The Ombudsman will annually evaluate enforcement activities and rate each agency's responsiveness to small business. If you wish to comment on the enforcement actions of IRS, call 1–888–REG–FAIR (1–888–734–3247).

1998 Changes

941 TeleFile

Beginning with the first quarter of 1998, many employers will be able to file **Form 941** by phone. If you receive TeleFile materials with your first quarter Form 941 package, check page TEL-1 of the *941 TeleFile Instructions* to see if you qualify for this alternative method of filing. There is no charge for the call. During the call, 941 TeleFile:

1) Provides step-by-step instructions over the phone.
2) Repeats all your entries so you can check their accuracy.
3) Does the math for you. It figures your tax liability and any overpayment or balance due.

Electronic Deposits of Taxes

You must make electronic deposits for ***all*** depository tax liabilities that occur after December 31, 1997, if:

1) Your Medicare, social security, railroad retirement, and withheld income taxes were more than $50,000 in 1996, or
2) You did not deposit employment taxes, but you had deposits of other depository taxes (such as excise taxes) that were more than $50,000 in 1995 or 1996.

If you were required to deposit by electronic funds transfer in prior years, continue to do so in 1998. You must use the Electronic Federal Tax Payment System (EFTPS) to make electronic deposits. Even if you do not have to make electronic deposits, you may voluntarily participate in EFTPS. To enroll in EFTPS, call 1–800–945–8400 or 1–800–555–4477. For general information about EFTPS, call 1–800–829–1040.

Penalty for not using EFTPS. If you are required to make deposits by electronic funds transfer and fail to do so, you may be subject to a 10% penalty. However, if you are first required to use EFTPS after June 30, 1997, no penalty for failure to use EFTPS will be imposed before July 1, 1998.

Standard Mileage Rate

For 1998, the optional standard mileage rate for the cost of operating your car for business increases to 32½ cents a mile for each business mile. The special rate for rural mail carriers is repealed. See *Rural mail carriers* in chapter 1.

Meals When Subject to “Hours of Service” Limits

Generally, you can deduct only 50% of the business-related meal expenses you reimburse your employees when they travel away from their tax home for business purposes. However, beginning in 1998, if you or your employees consume meals during or incident to any period subject to the Department of Transportation's hours of service limits, you can deduct a higher percentage. The percentage is 55% for 1998 and 1999, and it gradually increases to 80% by the year 2008.

Individuals subject to the Department of Transportation's hours of service limits include the following persons.

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

For more information on deducting meal expenses, see chapter 16 in Publication 535.

Meals Furnished to Employees

For tax years beginning after 1997, your annual revenue from meals you furnish to employees on your business premises and for your convenience is considered to equal your direct operating costs of providing these meals. A meal is considered provided for your convenience if you provide it for a substantial noncompensatory business reason. This change may allow your eating facility for employees to qualify as a de minimis fringe benefit. As a de minimis fringe benefit, your deduction for meals provided in the facility is not limited to 50% of the cost of furnishing the meals. For more information, see chapters 3 and 4 in Publication 535.

Depletion of Oil and Gas Property

Suspension of taxable income limit. For tax years beginning after 1997, percentage depletion on the marginal production of oil or natural gas will no longer be limited to taxable income from the property figured without the depletion deduction. This income limit is reinstated for tax years beginning after 1999.

Marginal production. This term means domestic crude oil or domestic natural gas produced during any tax year from a property that is either of the following.

1) A stripper well property for the calendar year in which the tax year begins. Property for which the production is 15 barrel equivalents or less is a stripper well property. To figure the barrel equivalents, divide the average daily production of domestic crude oil and domestic natural gas from producing wells on the property for the calendar year by the number of wells.
2) A property from which substantially all the production during the calendar year is heavy oil. The term "heavy oil" means, as used here, domestic crude oil produced from any property if the crude oil had a weighted average gravity of 20 degrees API or less (corrected to 60 degrees Fahrenheit).

For more information on depletion, see chapter 13 in Publication 535.

Depletion allowance figured by partnership. For partnership tax years beginning after 1997, an electing large partnership generally must figure the depletion allowance for the partnership's oil and gas property, instead of each of the partners in the partnership.

More information. For more information on depletion, see chapter 13 in Publication 535. For more information on electing large partnerships, see sections 771–776 of the Internal Revenue Code.

Qualified Parking in Place of Pay

For tax years beginning after 1997, you can exclude qualified parking from an employee's wages even if you provide it in place of pay. You cannot exclude from an employee's wages any other qualified transportation fringe benefit that you provide in place of pay. For information on fringe benefits, see chapter 4 in Publication 535.

Group Health Plan Requirements

For plan years beginning on or after January 1, 1998, you (or the plan, if a multi-employer plan) may be subject to an excise tax if your plan does not meet certain new requirements. These requirements generally:

1) Obligate plans to pay for a minimum hospital stay for mothers and newborns if the plan otherwise provides maternity benefits, and
2) Prevent certain special limits from being placed on mental health benefits.

For more information on this excise tax, see chapter 5 in Publication 535.

Mother and Newborn Hospital Stays

Your plan generally cannot restrict benefits for a mother or newborn's hospital stay following birth to less than the following amounts.

1) 48 hours following a normal delivery.
2) 96 hours following a delivery by caesarean section.

However, these minimum stay requirements do not apply when the attending provider, in consultation with the mother, decides to discharge the mother or her newborn child sooner. These requirements also do not apply if the plan does not provide benefits for a hospital stay following either a normal delivery or a delivery by caesarean section.

For more information about these requirements, see section 9811 of the Internal Revenue Code.

Mental Health Benefits

If your plan provides both medical and surgical benefits and mental health benefits:

1) It cannot impose an annual or aggregate lifetime limit on mental health benefits if it does not impose one on substantially all medical and surgical benefits.
2) If the plan does provide an annual or aggregate lifetime limit on medical and surgical benefits, the plan must either:
   a) Include mental health benefits under the same limit, or
   b) Use a separate limit for mental health benefits that is at least as much as this limit.

For more information about these requirements, see section 9812 of the Internal Revenue Code.

General Business Credit

The following paragraphs explain the changes to the general business credit for 1998.

Carryback and Carryforward of Unused Credit

The years to which you can carry back and carry forward the unused credit have changed. You must carry the unused credit back to the first tax year before the year the credit arises. If you have an unused credit after carrying it back, carry it forward to each of the 20 years after the year the credit arises. This change applies to credits arising in tax years beginning after December 31, 1997.

Welfare-to-Work Credit

The welfare-to-work credit is a new credit employers can take for qualified wages they pay to qualified long-term family assistance recipients who begin work after December 31, 1997, and before May 1, 1999.

The credit is available only during the first 2 years of employment. In the first year of employment, the credit is 35% of the first $10,000 of qualified wages paid to an employee. In the second year, the credit is 50% of the first $10,000 of qualified wages paid to that employee.

Qualified wages. Qualified wages are generally wages subject to the Federal Unemployment Tax Act (FUTA) without regard to the $7,000 limit. (But see *Special rules for agricultural and railroad employees* later.) More than

half the wages you pay must be for work done by employees in your trade or business. For purposes of the credit, qualified wages also generally include the following amounts which are normally excludable from the employee's gross income.

1) Amounts received for medical care under accident and health plans.
2) Employer contributions to accident and health plans.
3) Amounts excludable under an educational assistance program (or that would be excludable but for the expiration of the program).
4) Amounts excludable under a dependent care assistance program.

Qualified wages do not include the following items.

1) Wages that were paid to an employee during any period when you received payments for that employee from a federally funded on-the-job training program.
2) Wages for which you received work supplementation payments under the Social Security Act.
3) Wages for services of replacement workers during a strike or lockout.

Special rules for agricultural and railroad employees. You can take the credit for agricultural employees who meet the other requirements if their services qualify under FUTA as agricultural labor for more than half of any pay period. Base your credit for each employee on the first $10,000 in wages subject to social security and Medicare taxes paid or incurred for that person during the year.

You can take the credit for railroad employees who meet the other requirements if more than half of their wages qualify under the Railroad Unemployment Insurance Act (RUIA). Base your credit for each employee on the first $833.33 per month of RUIA wages paid or incurred to that person.

Qualified long-term family assistance recipient. A qualified long-term family assistance recipient is an individual who is certified by a state employment security agency (SESA) as meeting one of the following requirements.

1) The individual is a member of a family that has received assistance payments from AFDC or a successor program for at least 18 consecutive months ending on the hiring date.
2) The individual is a member of a family that receives assistance payments from AFDC or a successor program for any 18 months (whether or not consecutive) beginning after August 5, 1997, and is hired not more than two years after the end of the earliest 18-month period.
3) The individual is a member of a family that stops being eligible for assistance payments after August 5, 1997, because federal or state law limits the maximum period that assistance is payable, and the individual is hired not more than 2 years after that eligibility for assistance ends.

You must receive certification from your SESA before claiming the credit. To receive certification, submit **Form 8850,** Pre-Screening Notice and Certification Request for the Work Opportunity and Welfare-to-Work Credits, *to your SESA no later than the 21st day after the employee begins work for you.*

In addition to being certified as a qualified long-term family assistance recipient, the employee must meet all the following rules.

1) The employee must work for you for at least:
   a) 180 days, or
   b) 400 hours.
2) The employee cannot be your relative.
3) The employee cannot be an employee you rehired unless he or she was a qualified long-term family assistance recipient when employed earlier.

Coordination with the work opportunity credit. If you take the welfare-to-work credit for an employee during the tax year, you cannot take the work opportunity credit for that employee during that tax year.

More information. For more information about the welfare-to-work credit, see **Form 8861.**

Election to Average Farm Income

For tax years beginning after 1997 and before 2001, an individual farmer can elect to average all or part of his or her taxable “farm income” over 3 years.

Definition of farm income. This is income from the trade or business of farming. It also includes income from the sale or disposition of property, other than land, regularly used for a substantial period in a farming business. A farming business includes operating a nursery or sod farm and raising or harvesting ornamental trees or trees bearing fruit, nuts, or other crops.

How to figure the tax. If you elect to average farm income, you will figure the current year's tax in the following steps.

1) Subtract the elected part of your current year's taxable farm income (elected farm income) from your total taxable income.
2) Figure the tax on the amount in step *(1)* using the current year's tax tables or tax rate schedules.
3) For each of the 3 previous years, make the following computations.
   a) Add one-third of the current year's elected farm income to your taxable income for that year.
   b) Figure the tax on the amount in *(a)* using the tax tables or tax rate schedules for that year.
   c) Subtract that year's actual tax from the tax in *(b).*

4) Add the amounts in step *(3)(c)* to the amount in step *(2).* The result is the tax for the current year.

Example. Mike White, a single farmer, sold some of his farm machinery and more corn than usual in 1998. His 1998 taxable income is $50,000, of which $30,000 is from his farming business. Since his income is higher than in previous years, he elects to average his $30,000 farm income over the 3 previous years. He figures his 1998 tax as shown in the following table.

		1998 Tax
1998 Tax Return:		
Taxable income	$50,000	
Minus: Elected farm income	− 30,000	
	$20,000	
Tax on $20,000 (1998 tax tables)		$3,004
1997 Tax Return:		
Taxable income	$ 0	
Plus: 1998 farm income (1/3)	+ 10,000	
	$10,000	
Tax on $10,000 (1997 tax tables)	$1,504	
Minus: Actual tax	− 0	+ 1,504
1996 Tax Return:		
Taxable income	$5,000	
Plus: 1998 farm income (1/3)	+ 10,000	
	$15,000	
Tax on $15,000 (1996 tax tables)	$2,254	
Minus: Actual tax	− 754	+ 1,500
1995 Tax Return:		
Taxable income	$10,000	
Plus: 1998 farm income (1/3)	+ 10,000	
	$20,000	
Tax on $20,000 (1995 tax tables)	$3,004	
Minus: Actual tax	− 1,504	+ 1,500
Total 1998 tax		**$7,508**

If Mike had not averaged his farm income, his 1998 tax would have been $10,712.

Alternative Minimum Tax (AMT)

Certain small corporations. For tax years beginning after 1997, the tentative minimum tax of certain small corporations will be zero. A corporation is a small corporation for this purpose if its average annual gross receipts for the 3-tax-year period (or, if shorter, the period of existence) ending with:

1) Its first tax year beginning after December 31, 1996, are $5 million or less, ***and***
2) Each later tax year up to and including the current tax year are $7.5 million or less.

For these tests, gross receipts for a short tax year are annualized.

For more information on corporations, see Publication 542.

Foreign tax credit. You can elect to use a simpler computation for figuring the AMT foreign tax credit limit. This computation uses regular foreign-source taxable income, instead of requiring the computation of AMT foreign-source taxable income. You can only make this election for the first tax year beginning after 1997 for which you claim an AMT foreign tax credit. The election applies to all later tax years unless revoked with the consent of the Secretary of the Treasury.

Social Security and Medicare Taxes

For 1998, the employer and employee will continue to pay:

1) 6.2% each for social security tax (old-age, survivors, and disability insurance), and
2) 1.45% each for Medicare tax (hospital insurance).

Wage limits. For social security tax, the maximum amount of 1998 wages subject to the tax has increased to $68,400. For Medicare tax, all covered 1998 wages are subject to the tax. There is no wage base limit. For information about these taxes and amounts to withhold, see Publication 15 (Circular E).

Self-Employment Tax

The self-employment tax rate on net earnings remains the same for calendar year 1998. This rate, 15.3%, is a total of 12.4% for social security (old-age, survivors, and disability insurance), and 2.9% for Medicare (hospital insurance).

The maximum amount subject to the social security part for tax years beginning in 1998 will increase to $68,400. All net earnings of at least $400 are subject to the Medicare part.

Former insurance salespersons. Former insurance salespersons may not be subject to self-employment tax (SE tax) on amounts received after 1997. A salesperson's payments from an insurance company for services performed for that company are exempt from SE tax if all the following requirements are met.

1) The amounts are received after the salesperson's agreement to perform services for the company has ended.
2) The salesperson performs no services for the company after the service agreement ends and before the end of the tax year.
3) The salesperson enters into a covenant not to compete against the company for at least the 1-year period beginning on the date the service agreement ended.
4) The payment depends primarily on policies sold by or credited to the account of the salesperson during the last year of the service agreement or on the extent to which those policies remain in force for some period after the service agreement ends, or both.
5) The payment does not depend to any extent on the length of service or overall earnings from services performed for the company (regardless of whether eligibility for payment depends on length of service).

Closing of Partnership Tax Year

For partnership tax years beginning after 1997, the partnership's tax year closes with respect to a partner whose entire interest in the partnership is terminated, whether by death, sale or exchange, or liquidation. Previously, the partnership's tax year closed only with

respect to a partner who sold, exchanged, or liquidated his or her entire interest in the partnership. For more information, see Publication 541.

District of Columbia Enterprise Zone

You may qualify for special tax incentives if you operate a business in a distressed area designated as an empowerment zone or an enterprise community. Effective January 1, 1998, parts of Washington, D.C. are treated as an empowerment zone. For more information, see Publication 954.

Exclusion of Gain From District of Columbia Enterprise Zone Assets

Beginning in 1998, if you acquire a District of Columbia Enterprise Zone (DC Zone) asset and hold it more than 5 years, you will not have to include any qualified capital gain from its sale or exchange in your gross income. This exclusion applies to an interest in, or property of, certain businesses operating in the District of Columbia.

DC Zone Asset

A DC Zone asset is any of the following.

1) DC Zone business stock.
2) DC Zone partnership interest.
3) DC Zone business property.

DC Zone business stock. DC Zone business stock is any stock in a U.S. corporation that is originally issued after December 31, 1997, if all the following requirements are met.

1) You acquired the stock before January 1, 2003, at its original issue solely in exchange for cash. This requirement is also met if you acquired the stock from another person in whose hands it was DC Zone business stock.
2) The corporation was a DC Zone business (or was being organized as a DC Zone business) at the time the stock was issued.
3) The corporation qualified as a DC Zone business during substantially all your holding period for the stock. This requirement is also met if the corporation ceased to qualify as a DC Zone business after the 5-year period beginning on the date you acquired the stock (but your qualified capital gain will be limited, as explained later).

Redemptions of business stock. Stock will not qualify as DC Zone business stock if the issuing corporation makes certain redemptions of its stock within two years before or two years after the date the stock was issued. For details, see Internal Revenue Code sections 1400B(b)(2)(B) and 1202(c)(3).

DC Zone partnership interest. A DC Zone partnership interest is any capital or profits interest in a U.S. partnership that is originally issued after December 31, 1997, if all the following requirements are met.

1) You acquired the partnership interest from the partnership before January 1, 2003, solely in exchange for cash. This requirement is also met if you acquired the partnership interest from another person in whose hands it was a DC Zone partnership interest.
2) The partnership was a DC Zone business (or was being organized as a DC Zone business) at the time you acquired the partnership interest.
3) The partnership qualified as a DC Zone business during substantially all your holding period for the partnership interest. This requirement is also met if the partnership ceased to qualify as a DC Zone business after the 5-year period beginning on the date you acquired the partnership interest (but your qualified capital gain will be limited, as explained later).

Redemptions of DC Zone partnership interest. A partnership interest will not qualify as a DC Zone partnership interest if the partnership makes certain acquisitions of its partnership interests within two years before or two years after the date the partnership interest was issued. For details, see Internal Revenue Code sections 1400B(b)(2)(B) and 1202(c)(3).

DC Zone business property. DC Zone business property is tangible property that meets all the following requirements.

1) You acquired the property after December 31, 1997, and before January 1, 2003.
2) You did not acquire the property from a related person or member of a controlled group of which you are a member.
3) Your basis in the property is not determined either by its adjusted basis in the hands of the person from whom you acquired it or under the stepped-up basis rules for property acquired from a decedent.
4) You were the first person to use the property in the DC Zone. This requirement is also met if you acquired the property from another person in whose hands it was DC Zone business property.
5) Substantially all the use of the property was in your DC Zone business during substantially all your holding period for that property. This requirement is also met if you stopped using the property in your DC Zone business, or your business ceased to qualify as a DC Zone business, after the 5-year period beginning on the date you acquired the property (but your qualified capital gain will be limited, as explained later).

Special rule for substantially improved buildings. Buildings (and land on which they are located) will be treated as having met requirements *(1)* through *(4)* above if you substantially improved the buildings before January 1, 2003. The buildings will be treated as substantially improved only if, during any 24-month period beginning after December 31, 1997, your additions to the basis of the property exceed the greater of the following amounts.

1) The adjusted basis of the property at the beginning of the 24-month period.

2) $5,000.

DC Zone business. A DC Zone business for this exclusion is an enterprise zone business as defined in Internal Revenue Code section 1397B, with the following exceptions.

1) The 35% zone resident employee requirements of sections 1397B(b)(6) and 1397B(c)(5) do not apply.

2) The 50% of gross income requirements of sections 1397B(b)(2) and 1397B(c)(1) are increased to 80%.

3) No area other than the DC Zone can be treated as an empowerment zone or enterprise community.

For this purpose, the DC Zone is treated as including all census tracts in the District of Columbia with a poverty rate of 10% or more.

Qualified Capital Gain

Qualified capital gain is any gain recognized on the sale or exchange of a DC Zone asset that is a capital asset or property used in a trade or business as defined in section 1231(b) of the Internal Revenue Code (generally real property or depreciable personal property). But it does not include any of the following gains.

1) Gain attributable to periods before January 1, 1998, or after December 31, 2007.

2) Section 1245 gain. See chapter 4 in Publication 544.

3) Section 1250 gain if section 1250 applied to ***all*** depreciation rather than the additional depreciation. See chapter 4 in Publication 544.

4) Gain attributable to real property or an intangible asset that is not an integral part of a DC Zone business.

5) Gain attributable, directly or indirectly, or in whole or in part, to a transaction with a related party. For the definition of a related party, see chapter 2 in Publication 544.

Other rules. Rules similar to certain rules in section 1202 of the Internal Revenue Code apply to the following.

1) Interests in pass-through entities. See Code section 1202(g).

2) Certain tax-free transfers. See Code section 1202(h).

3) Contributions to capital after the original stock issuance date. See Code section 1202(i)(2).

4) Short positions. See Code section 1202(j).

Reporting Certain Purchases of Fish

You will need to file Form 1099–MISC for 1998 if you:

1) Are in the trade or business of purchasing fish for resale, and

2) Pay $600 or more in cash during 1998 to a commercial fisherman for fish, shellfish (such as clams and mussels), crustacea (such as lobsters, crabs, and shrimp), or other forms of aquatic life.

For information on filing the form and the records you must keep, see the 1998 instructions for **Form 1099–MISC.**

Business Use of Your Home

You can currently deduct expenses for the business use of your home if you use part of your home exclusively and regularly as your principal place of business and meet certain other requirements. Beginning in ***1999,*** new rules allow your home office to qualify as your principal place of business if:

1) You use it exclusively and regularly for administrative or management activities of your trade or business, and

2) You have no other fixed location where you conduct substantial administrative or management activities of your trade or business.

The expanded definition of “principal place of business” will not affect the other tests you must meet to claim expenses for the business use of your home. You still must use the business part of your home both exclusively and regularly for your trade or business. If you are an employee, you must also qualify under the convenience-of-the-employer test. Therefore, if your employer provides suitable work space for administrative or management activities, you must consider this fact when determining whether you meet the convenience-of-the-employer test.

The expanded definition of principal place of business does not take effect until 1999. For the current definition of principal place of business and other requirements you must meet to deduct home office expenses, see Publication 587, Business Use of Your Home (Including Use by Day-Care Providers).

3.

IRAs and Other Retirement Plans

Useful Items

You may want to see:

Publication

- ☐ **560** Retirement Plans for Small Business (SEP, Keogh, and SIMPLE Plans)
- ☐ **571** Tax-Sheltered Annuity Programs for Employees of Public Schools and Certain Tax-Exempt Organizations
- ☐ **575** Pension and Annuity Income
- ☐ **590** Individual Retirement Arrangements (IRAs)

1997 Changes

Repeal of 15% Additional Tax on Excess Distributions

If you receive excess retirement distributions from a qualified retirement plan (including IRAs) after December 31, 1996, you are no longer subject to the additional 15% excise tax on excess distributions. See Publication 575 for more information.

Individual Retirement Arrangements (IRAs)

Beginning in 1997, several rules for traditional IRAs (IRAs other than Roth IRAs, SIMPLE IRAs, or education IRAs) have changed. See Publication 590 for more information on these changes.

Contributions to spousal IRA. In the case of a married couple filing a joint return, up to $2,000 can be contributed to each spouse's IRA for years beginning after 1996, even if one spouse has little or no compensation. This means that the total combined contributions that can be made to both IRAs can be as much as $4,000 for the year. Previously, if one spouse had no compensation or elected to be treated as having no compensation, the total combined contributions to both IRAs could not be more than $2,250. See *Contribution Limits* in chapter 3 of Publication 590.

Deduction limits for contributions. In the case of a married couple who files a joint return showing unequal compensation, the limit on the deductible contributions to the IRA of the spouse with less compensation is the smaller of the following amounts.

1) $2,000.
2) The total taxable compensation of both spouses reduced by any deduction allowed for contributions to IRAs of the spouse with more compensation.

The deduction for contributions to both spouses' IRAs may be further limited if either spouse is covered by an employer retirement plan. See *Deduction Limits* in chapter 3 of Publication 590.

Early withdrawals for certain medical expenses. Beginning in 1997, the 10% additional tax on premature distributions (early withdrawals) from an IRA will not apply to distributions up to the amount you pay for unreimbursed medical expenses that are more than 7½% of your adjusted gross income.

This 10% tax may not apply to distributions up to the amount you paid for medical insurance for yourself, your spouse, and your dependents.

See *Age 59½ Rule* in chapter 5 of Publication 590.

Prohibited transactions. The tax on a prohibited transaction that takes place after August 5, 1997, has increased from 10% to 15%. For more information on prohibited transactions, see Publication 590.

Other Retirement Plans

SIMPLE Retirement Plans

Beginning in 1997, you may be able to set up a savings incentive match plan for employees (SIMPLE). You can set up a SIMPLE plan if you have 100 or fewer employees and meet other requirements. See *SIMPLE Plans* in Publication 560.

Exception to exclusive plan requirement. Generally, a SIMPLE plan must be the only retirement plan of an eligible employer. However, an employer can adopt a SIMPLE IRA plan for noncollectively bargained employees even if he or she maintains a qualified plan for collectively bargained employees. For more information about the requirements that must be met to set up a SIMPLE IRA, see *SIMPLE Plans* in Publication 560.

SIMPLE IRAs. New law clarifies that, beginning in 1997, matching contributions made to a SIMPLE IRA on behalf of a self-employed individual are not treated as elective employer contributions. For more information about employer matching contributions to SIMPLE IRAs, see Publication 560.

Repeal of SARSEPs

Beginning in 1997, an employer is no longer allowed to establish a salary reduction simplified employee pension (SARSEP). However, participants (including new participants hired after 1996) in a SARSEP that was established before 1997 can continue to elect to have their employer contribute part of their pay to the plan. See *Simplified Employee Pension (SEP)* in Publication 560.

Keogh Plans

The following tax law changes affect Keogh plans. They are discussed in detail in Publication 560.

Aggregation rules repealed. Beginning in 1997, the special aggregation rules that apply to self-employed individuals are eliminated.

New definition of "leased employee." Beginning in 1997, the definition of "leased employee" is changed to include the requirement that the individual perform services under the primary direction or control of the recipient. This definition is used to determine whether a leased employee must be treated as a common-law employee of the recipient of the services (employer) for certain plan qualification requirements. This Keogh plan qualification rule also applies to SEPs.

Waiver of minimum waiting period for joint and survivor annuities. For plan years beginning after 1996, a plan participant may elect to waive (with spousal consent) the 30-day election period if the retirement distribution begins more than 7 days after a written explanation of the qualified joint and survivor annuity is provided. For more information, see *Survivor benefits* in Publication 560.

Minimum Required Distribution Rule Modified

Beginning in 1997, the definition of the required beginning date used to figure the minimum required distribution from qualified retirement plans takes into account whether a plan participant has retired. The required beginning date of a participant (other than a 5% owner) who is still employed after age 70½ is April 1 of the calendar year that follows the calendar year in which he or she retires. This change does not apply to IRAs or 5% owners. For years prior to 1997, a participant in a qualified plan or an IRA was required to start receiving distributions by April 1 of the year following the calendar year in which he or she reached age 70½.

Transition rule. If you reached age 70½ before 1997, but had not retired from employment with the company maintaining the plan before January 1, 1997, you may have already started to receive minimum required distributions. Beginning in 1997, your plan may allow you to elect to stop receiving such required distributions until you retire.

Involuntary Cashout Ceiling Raised

If your participation in a qualified plan terminates, the plan may "cash out" your benefit without your consent (or that of your spouse, if applicable) if the present value of your benefit is not more than $5,000. The previous limit was $3,500.

The higher cashout limit is effective for plan years beginning after August 5, 1997.

New Definition of Highly Compensated Employee

Beginning in 1997, a highly compensated employee for purposes of a simplified employee pension (SEP) is any employee who meets either of the following two conditions.

1) The employee owns (or owned last year) more than 5% of the capital or profits interest in the employer (if not a corporation); or more than 5% of the outstanding stock, or more than 5% of the total voting power of all stock, of the employer corporation.
2) The employee's compensation from the employer for last year was more than $80,000 and (if the employer elects to apply this clause for last year) the employee was in the top 20% when ranked on the basis of last year's compensation.

SEPs are discussed in Publications 560 and 590.

Self-Employed Ministers

Beginning in 1997, the definitions of ***includible compensation*** and ***years of service*** have changed for self-employed ministers. See Publication 571 for the new definitions.

Certain ministers treated as employed by tax-exempt organization. A duly ordained or licensed minister of a church who is working as a minister or chaplain, but is self-employed or is working for an employer that is not a qualified tax-exempt organization, is treated as employed by a qualified tax-exempt organization for purposes of participating in a church plan (tax-sheltered annuity plan). See *Employees of Certain Tax-Exempt Organizations* in Publication 571 for more information.

Contributions by self-employed ministers. Contributions made by a self-employed minister who is treated as employed by a qualified tax-exempt organization to a retirement income account treated as a tax-sheltered annuity are deductible up to the limits for elective contributions to tax-sheltered annuities. For this purpose, all plans in which the minister participates are treated as one plan. See *Exclusion Limits* in Publication 571 for more information.

1998 Changes

Traditional IRAs

Beginning in 1998, four rules for traditional IRAs (IRAs other than Roth IRAs, SIMPLE IRAs, or education IRAs) have changed. Generally, you can now do the following.

1) Ignore, in most situations, your spouse's participation in an employer plan in determining your IRA deduction.
2) Have a higher modified adjusted gross income and still claim a deduction for contributions to your IRA.
3) Make penalty-free early withdrawals from your IRA for qualified:
   a) Higher education expenses, or
   b) Acquisition costs of a first home.

4) Invest IRA funds in certain platinum coins and gold, silver, palladium, and platinum bullion.

Spouse Covered by Employer Plan

Beginning in 1998, even if your spouse is covered by an employer-sponsored retirement plan, you may be able to deduct all your contributions to an IRA if you are not covered by an employer plan. The deduction is still limited to $2,000 (which must be reduced if your modified adjusted gross income (AGI) on a joint return is more than $150,000 but less than $160,000). Your deduction is eliminated if your modified AGI on a joint return is $160,000 or more. Modified AGI is the AGI on your return figured without taking any IRA deduction, foreign earned income exclusion, foreign housing exclusion or deduction, or exclusion of series EE bond interest shown on **Form 8815.**

Figure your reduction by subtracting $150,000 from your modified AGI and dividing the result by $10,000. For more information on deductible contributions, see Publication 590.

Modified AGI Limit Increased

For 1998, if you are covered by a retirement plan at work, your IRA deduction will not be reduced (phased out) unless your modified adjusted gross income (AGI) is within the range listed below for your filing status.

1) $50,000 to $60,000 (previously $40,000 to $50,000) for a married couple filing a joint return or a qualifying widow(er).
2) $30,000 to $40,000 (previously $25,000 to $35,000) for a single individual (or head of household).
3) $–0– to $10,000 (no change) for a married individual filing a separate return.

You cannot claim an IRA deduction if your modified AGI is equal to or more than the high end of your phaseout range. For more information on figuring your IRA deduction when you are subject to the AGI limit, see Publication 590.

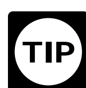
Increases after 1998. For years beginning after 1998, the low and high of each phaseout range (except for separate returns) will increase by $1,000 each year through 2002. After 2002, there will be larger increases.

Penalty-Free Early Withdrawals

Beginning in 1998, you can take distributions from your IRA to pay qualified higher education expenses or to buy, build, or rebuild a main home. You will owe income tax on at least part of the distribution, the same as with other IRA distributions, but you will not have to pay the 10% additional tax on early withdrawals. Generally, if you take distributions from your IRA before you reach age 59½, you must pay the 10% additional tax.

Withdrawals for higher education expenses. To qualify as a penalty-free withdrawal for higher education expenses, a distribution must meet the following requirements.

1) It must be used to pay qualified higher education expenses (defined later) for education furnished at an eligible education institution (defined later) to any of the following family members:
   a) You,
   b) Your spouse,
   c) Your or your spouse's children, or
   d) Your or your spouse's grandchildren.
2) It must be used to pay qualified higher education expenses remaining after the following ***reductions***.
   a) Tax-free distributions from an education IRA.
   b) Any qualified scholarships, such as a Pell Grant, that are excludable from income.
   c) Certain educational assistance allowances, such as employer-provided educational assistance, provided under federal laws.
   d) Any payment (other than a gift, bequest, or devise) due to enrollment at an eligible education institution that is excludable under federal law.
3) It must not be more than the qualified higher education expenses for the year that are remaining after the adjustments described in item *(2)*.



Expenses paid from the following sources can be included in the expenses used to determine the penalty-free IRA withdrawal you can make. The sources are:

1) An individual's earnings,

2) A loan,

3) A gift,

4) An inheritance given to the student or the individual making the withdrawal, and

5) Personal savings (including savings from a qualified state tuition program).

Qualified higher education expenses. Qualified higher education expenses are tuition, fees, books, supplies and equipment required for the enrollment or attendance of a student at an eligible education institution. In addition, if the individual is at least a half-time student, room and board are considered qualified higher education expenses.

Eligible education institution. This is any college, university, vocational school, or other postsecondary educational institution eligible to participate in the student aid programs administered by the Department of Education. It includes virtually all accredited, public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions. The education institution should be able to tell you if it qualifies under that law.

Table 3. **You Can Contribute to a Roth IRA**

IF you have taxable compensation and your filing status is ...	AND your modified AGI is less than ...
Married filing jointly	$160,000
Married filing separately—and you lived with your spouse during the year	$15,000
Single, head of household, or married filing separately—and you did not live with your spouse at any time during the year	$110,000

You can also take these penalty-free distributions from a Roth IRA.

Qualified first-time homebuyer distribution. To qualify for penalty-free withdrawal treatment as a first-time homebuyer distribution, a distribution must meet the following requirements.

1) It must be used to pay qualified acquisition costs (defined later) before the close of the 120th day after the day you received it.
2) It must be used to pay qualified acquisition costs for the main home of a first-time homebuyer (defined later) who is any of the following:
   a) Yourself,
   b) Your spouse,
   c) Your or your spouse's child,
   d) Your or your spouse's grandchild, or
   e) Your or your spouse's parent or other ancestor.
3) When added to all your prior qualified first-time homebuyer distributions, if any, the total distributions cannot be more than $10,000.

Qualified acquisition costs. Qualified acquisition costs include the following items.

1) Costs of acquiring, constructing, or reconstructing a home.
2) Any usual or reasonable settlement, financing, or other closing costs.

First-time homebuyer. A first-time homebuyer is, generally, any individual (and his or her spouse, if married) who had no present ownership interest in a main home during the 2-year period ending on the date the individual acquires the main home to which these rules apply.

Date of acquisition. The date of acquisition is the date that:

1) The first-time homebuyer enters into a binding contract to acquire the main home to which these rules apply, or
2) Construction or reconstruction of the main home to which these rules apply begins.

Investment in Certain Coins and Bullion

Beginning in 1998, your IRA can invest in certain platinum coins and gold, silver, and platinum bullion. These investments will not be considered an investment in collectibles and will not be treated as a distribution from your IRA, if:

1) The platinum coins are minted and issued by the Treasury Department, and
2) The bullion is issued by the Treasury Department and it meets or exceeds the minimum fineness standards for contracts traded on authorized boards of trade in the United States.

Roth IRA

Beginning in 1998, regardless of your age, you may be able to establish and contribute to a new individual retirement account or annuity called a Roth IRA. Unlike a ***traditional IRA,*** you cannot deduct contributions to a Roth IRA. But, if you satisfy the requirements, earnings grow tax free and withdrawals are tax free.

A traditional IRA is any IRA that is not a Roth IRA, SIMPLE IRA, or education IRA.

Can I Contribute to a Roth IRA?

Generally, you can contribute to a Roth IRA if you have taxable compensation and your modified AGI (defined later) is less than the amount shown for your filing status in *Table 3.*

Can I contribute to a Roth IRA for my spouse? You can contribute to a Roth IRA for your spouse provided the contributions satisfy the spousal IRA limit discussed in chapter 3 of Publication 590 and your modified AGI (defined later) is less than the amount shown for your filing status in *Table 3.*

Compensation. Compensation includes wages, salaries, tips, professional fees, bonuses, and other amounts received for providing personal services. It also includes commissions, self-employment income, and taxable alimony and separate maintenance payments.

Modified AGI. Modified AGI is your adjusted gross income (AGI) as shown on your return modified as follows:

Table 4. **Your Contribution Limit Is Reduced**

IF your filing status is ...	AND your modified AGI is between ...
Married filing a joint return	$150,000 and $160,000
Married filing separately—and you lived with your spouse during the year	$0 and $15,000
Single, head of household, or married filing separately—and you did not live with your spouse at any time during the year	$95,000 and $110,000

1) Subtract any income resulting from a rollover from an IRA (other than a Roth IRA) into a Roth IRA or a conversion of an IRA (other than a Roth IRA) to a Roth IRA.
2) Add the following deduction and exclusions:
   a) Foreign earned income exclusion.
   b) Foreign housing exclusion or deduction.
   c) Exclusion of series EE bond interest shown on Form 8815.
   d) Exclusion of adoption expenses.

Contribution Limit

The contribution limit for Roth IRAs depends on whether you contribute only to Roth IRAs or to both traditional IRAs and Roth IRAs.

Roth IRAs only. If you contribute only to Roth IRAs, the contribution limit is the lesser of $2,000 or your taxable compensation. If your modified AGI is above a certain amount, you may have to reduce this limit, as explained later in *Contribution limit reduced.*

Roth IRAs and traditional IRAs. If you contribute to both Roth IRAs and traditional IRAs established for your benefit, the contribution limit for Roth IRAs must be reduced by all contributions for the year to all traditional IRAs. If your modified AGI is above a certain amount, you may have to reduce this limit as explained next.

Contribution limit reduced. If your modified AGI is above a certain amount, your contribution limit is gradually reduced. Use *Table 4* to determine if this reduction applies to you.

Figuring the reduction. If your modified AGI is within the range shown in *Table 4* for your filing status, figure your reduced contribution limit as follows:

1) Start with your modified AGI.
2) Subtract from the amount in *(1):*
   a) $150,000 if filing a joint return.
   b) $–0– if married filing a separate return, and you lived with your spouse at any time during the year.
   c) $95,000 if single, head of household, or married filing a separate return, and you lived apart from your spouse the entire year.
3) Divide the result in *(2)* by $15,000 ($10,000 if filing a joint return).
4) Multiply your contribution limit (before reduction by this adjustment but after reduction for any contributions to traditional IRAs) by the result in *(3).*
5) Subtract the result in *(4)* from your contribution limit before this reduction. The result is your reduced contribution limit.

Round your reduced contribution limit up to the nearest $10. If your reduced contribution limit is more than $0, but less than $200, increase the limit to $200.

Example. You are a single individual with taxable compensation of $113,000. You want to make the maximum allowable contribution to your Roth IRA for 1998. Your modified AGI for 1998 is $100,000. You have not contributed to any traditional IRA, so your contribution limit before the modified AGI reduction is $2,000. You figure your reduced Roth IRA contribution of $1,340 as follows:

1) Modified AGI = $100,000
2) $100,000 − $95,000 = $5,000
3) $5,000 ÷ $15,000 = .3333
4) $2,000 (contribution limit before adjustment) × .3333 = $667
5) $2,000 − $667 = $1,340 (This is your reduced Roth IRA contribution limit of $1,333 rounded up to the nearest $10.)

When Can I Contribute?

You can make contributions to a Roth IRA for a year at any time during the year or by the due date of your return for that year (***not*** including extensions).

Is There an Age Limit for Contributions?

Contributions can be made to your Roth IRA regardless of your age.

What If I Contribute Too Much?

If you make an ***excess contribution*** to a Roth IRA, a 6% penalty tax applies to the excess.

Excess contributions. These are the contributions to your Roth IRAs for a year that equal the total of:

1) Amounts contributed for the tax year to your Roth IRAs (other than qualified rollover contributions described later) that are more than your contribution limit for the year, plus
2) Any excess contributions for the preceding year, reduced by the total of:
   a) Any distributions out of your Roth IRAs for the year, plus
   b) Your contribution limit for the year minus contributions to your Roth IRAs for the year.

For purposes of determining excess contributions, any contribution that is withdrawn on or before the due date (including extensions) for filing your tax return for the year is treated as an amount not contributed if you also withdraw any earnings on the contributions.

Can I Move Amounts From Other IRAs Into a Roth IRA?

You may be able to move (roll over) amounts from either a traditional IRA or another Roth IRA into a Roth IRA.

Rollover from traditional IRA. You ***cannot*** roll over amounts from a traditional IRA into a Roth IRA during a year if:

1) Your modified AGI (explained earlier) for the year is more than $100,000, or
2) You are married and filing a separate return for the year.

Allowable rollovers. You can withdraw all or part of the assets from a traditional IRA and reinvest them (within 60 days) in a Roth IRA. If properly (and timely) rolled over, the 10% additional tax on early withdrawals will not apply. You must roll over into the Roth IRA the same property you received from the traditional IRA. You can roll over part of the withdrawal into a Roth IRA and keep the rest of it. The amount you keep will generally be taxable (except for the part that is a return of nondeductible contributions) and may be subject to the 10% tax on early withdrawals. See Publication 590 for more information on withdrawals from traditional IRAs and the tax on early withdrawals.

Amounts that must be distributed from a traditional IRA during a particular year under the required distribution rules (discussed in Publication 590) are not eligible for rollover treatment.

If you inherited a traditional IRA from someone other than your spouse, you cannot roll it over.

Income. You must include in your gross income amounts you withdraw from a traditional IRA that you would have to include in income if you had not rolled them over into a Roth IRA.

Withdrawals before 1999. If you roll over into a Roth IRA an amount you withdraw from a traditional IRA before 1999, any withdrawal that you must include in income is included ratably over the 4-year period beginning in the year of withdrawal.

Conversions. The conversion of a traditional IRA to a Roth IRA is treated as a rollover from a traditional IRA into a Roth IRA.

Transfer of contributions. You can transfer contributions made to a traditional IRA into a Roth IRA without having to include them in your gross income if all the following apply.

1) You transfer the contributions by the due date (not including extensions) for filing your tax return for the year you made the contributions to the traditional IRA.
2) You also transfer any earnings on the contributions.
3) You do not claim a deduction for the contributions.

Rollover from a Roth IRA. You can withdraw all or part of the assets from a Roth IRA and reinvest them (within 60 days) in another Roth IRA. If properly (and timely) rolled over, the 10% additional tax on early withdrawals will not apply. You must roll over into the second Roth IRA the same property you received from the first one. You can roll over part of the withdrawal and keep the rest of it. The amount you keep is a distribution. See *Are Distributions From My Roth IRA Taxable?* later.

Waiting period. You can take a distribution from a Roth IRA and roll part or all of it over into another Roth IRA only once in any 1-year period. The 1-year period begins on the date you receive the distribution, not on the date you roll it over into the second Roth IRA.

Are Distributions From My Roth IRA Taxable?

You do not include ***qualified distributions*** from your Roth IRA in your gross income. You may have to include part of other distributions in your income.

What are qualified distributions? A qualified distribution generally is any payment or distribution:

1) Made on or after the date you reach age 59½,
2) Made because you are disabled,
3) Made to a beneficiary or to your estate after your death, or
4) That is a ***qualified special purpose distribution,*** defined later.

Exception (5-year rule). A distribution is not a qualified distribution if either of the following applies.

1) It is made within the 5-tax-year period beginning with the first tax year for which a contribution was made to a Roth IRA set up for your benefit.
2) In the case of a distribution allocable to an allowable rollover from an IRA other than a Roth IRA (or income earned on the amount rolled over)), it is made within the 5-tax-year period beginning with the tax year in which you made the rollover contribution.

Table 5. **Education IRAs At a Glance**

Do not rely on this chart alone. It provides only general highlights. See the text for definitions of terms in bold type and for more complete explanations.

Question	Answer
What is an **education IRA?**	An IRA that is set up to pay the **qualified higher education expenses** of a designated beneficiary.
Where can it be established?	It can be opened in the United States at any bank or other IRS-approved entity that offers education IRAs.
Who can an education IRA be set up for?	Any child who is under age 18.
Who can contribute to an education IRA?	Generally, any individual (including the beneficiary) whose **modified adjusted gross income** for the year is not more than $110,000 ($160,000 for married taxpayers filing jointly).

Qualified special purpose distribution. This is a qualified first-time homebuyer distribution used to buy, build, or rebuild the main home of a first-time homebuyer who is either the person for whom the Roth IRA was set up, the spouse of that person, or the child, grandchild, or ancestor of that person or that person's spouse.

Am I required to take distributions when I reach age 70½? You are not required to take distributions from your Roth IRA at any age.

Which distributions are taxable? Part of any distribution that is not a qualified distribution may be taxable. To figure the taxable part, add the distribution to all previous distributions from the Roth IRA. Subtract from that total all contributions made to the Roth IRA. The result, if greater than zero, is the taxable part of the distribution. For this purpose, all your Roth IRAs are treated as one account.

Education IRA

Beginning in 1998, you may be able to contribute up to $500 each year to an education individual retirement account (education IRA or Ed IRA) for a child under age 18. Contributions to an education IRA are not deductible.

Any individual (including the child) can contribute to a child's education IRA if the individual's ***modified adjusted gross income*** (defined later) is not more than $110,000 ($160,000 on a joint return). The $500 maximum contribution for each child is gradually reduced if the individual's modified adjusted gross income is between $95,000 and $110,000 (between $150,000 and $160,000 on a joint return). See *Contributions,* later.

There is no limit on the number of education IRAs that can be established designating the same child as the beneficiary. However, total contributions for the child during any tax year cannot be more than $500.

Amounts deposited in the accounts grow tax free until distributed (withdrawn).

If, for a year, withdrawals from an account are not more than a child's ***qualified higher education expenses*** (defined later) at an eligible educational institution (defined later), the child will not owe tax on the withdrawals. See *Distributions,* later, for more information.

What Is an Education IRA?

An education IRA is a trust or custodial account created only for the purpose of paying the qualified higher education expenses (defined later) of the designated beneficiary of the account. To be treated as an education IRA, the account must be designated as an education IRA when it is created.

Trust requirements. The document creating and governing the trust must be in writing and must satisfy the following requirements.

1) The trust must be created or organized in the United States.
2) The trustee must be a bank or an entity approved by the IRS.
3) The trust must provide that the trustee can only accept a contribution that:
    a) Is in cash,
    b) Is made before the beneficiary reaches age 18, and
    c) Would not result in total contributions for the tax year (not including rollover contributions) being more than $500.
4) Money in the account cannot be invested in life insurance contracts.
5) Money in the account cannot be combined with other property except in a common trust fund or common investment fund.

Table 6. **Education IRA Contributions At a Glance**

Do not rely on this chart alone. It provides only general highlights. See the text for definitions of terms in bold type and for more complete explanations.

Question	Answer
Are contributions deductible?	No.
Why should someone contribute to an education IRA?	It is a new tax benefit for families saving for higher education costs.
What is the **contribution limit?**	$500 each year for each child.
What if more than one education IRA has been opened for the same child?	The annual contribution limit is $500 for each child, no matter how many education IRAs are set up for that child.
What if more than one individual makes contributions for the same child?	The contribution limit is $500 per child, no matter how many individuals contribute.
Can contributions other than cash be made to an education IRA?	No.
When can a taxpayer first contribute to an education IRA?	1998.
When must contributions stop?	No contributions can be made to a child's education IRA after he or she reaches age 18.

6) If the beneficiary dies, any balance in the account must be distributed to the beneficiary's estate within 30 days after the date of death.

Qualified higher education expenses. These are expenses required for the enrollment or attendance of the designated beneficiary at an eligible educational institution. The term "qualified higher education expenses" means expenses for:

1) Tuition,
2) Fees,
3) Books,
4) Supplies, and
5) Equipment.

The term also includes:

1) Amounts contributed to a qualified state tuition program. (See Publication 525, *Taxable and Nontaxable Income.*)
2) Room and board if the designated beneficiary is at least a half-time student at an eligible educational institution. A student is enrolled at least half-time if he or she is enrolled for at least half the full-time academic workload for the course of study the student is pursuing as determined under the standards of the institution where the student is enrolled. Room and board is limited to:
   a) The school's posted room and board charge for students living on-campus, or
   b) $2,500 each year for students living off-campus and not at home.

Eligible educational institution. This is any college, university, vocational school, or other postsecondary educational institution eligible to participate in the student aid programs administered by the Department of Education. It includes virtually any accredited public, nonprofit, or proprietary (privately owned profit-making) postsecondary institution.

Contributions

Any individual (including the designated beneficiary) can contribute to a child's education IRA if the individual's modified adjusted gross income for the tax year is less than $110,000 ($160,000 for married taxpayers filing jointly).

Contributions can be made to one or several education IRAs for the same child provided that the total contributions are not more than the ***contribution limit*** (defined later) for a tax year.

Qualified state tuition program. No contributions can be made to an education IRA on behalf of a beneficiary if any amount is contributed during the tax year to a qualified state tuition program on behalf of the same beneficiary.

Contribution limit. The maximum total contribution for each child is $500 for a tax year. This includes contributions to all the child's education IRAs from all sources other than rollovers. See *Rollovers and Other Transfers,* later.

Table 7. **Education IRA Withdrawals At a Glance**

Do not rely on this chart alone. It provides only general highlights. See the text for definitions of terms in bold type and for more complete explanations.

Question	Answer
Is a withdrawal from an education IRA to pay for a designated beneficiary's qualified higher education expenses tax-free?	Generally, the withdrawal is tax-free to the designated beneficiary to the extent the amount of the withdrawal does not exceed the designated beneficiary's qualified higher education expenses.
After the designated beneficiary completes his or her education at an **eligible educational institution,** may amounts remaining in the education IRA be withdrawn?	Yes. Also, certain transfers to **members of the designated beneficiary's family** are permitted.
Does the designated beneficiary need to be enrolled for a minimum number of courses to take a tax-free withdrawal to pay qualified higher education expenses.	No.

Reduced limit for certain contributors. If your modified adjusted gross income is between $95,000 and $110,000 (between $150,000 and $160,000 for married taxpayers filing jointly), the $500 maximum contribution for each child is gradually reduced. If your modified adjusted income is $110,000 or more ($160,000 or more for married taxpayers filing jointly), you cannot contribute to anyone's education IRA.

Example. Paul, a single individual, had modified adjusted gross income of $96,500 for the year. For Paul, the maximum contribution for each child is reduced to $450, figured as follows.

1) $96,500 − $95,000 = $1,500
2) $1,500 ÷ $15,000 = 10%
3) 10% × $500 = $50
4) $500 − $50 = $450

Modified adjusted gross income. Your modified adjusted gross income for the purpose of determining the maximum contribution limit is the adjusted gross income shown on your return, increased by the following exclusions from your income.

1) Foreign earned income of U.S. citizens or residents living abroad.
2) Housing costs of U.S. citizens or residents living abroad.
3) Income from sources within:
   a) Puerto Rico,
   b) Guam,
   c) American Samoa, or
   d) The Northern Mariana Islands.

Other contribution rules. You can contribute only cash to an education IRA. You cannot contribute to an education IRA after the beneficiary reaches his or her 18th birthday.

Additional tax on excess contributions. A ***6%*** penalty tax applies to:

1) Contributions that are more than $500 for the tax year for a designated beneficiary, and
2) Any contributions to the account if any amount is also contributed to a qualified state tuition program on behalf of the same beneficiary in the same tax year.

The penalty does not apply if the excess contributions (and any earnings on them) are withdrawn before the tax return for the year is due.

Distributions

In general, the designated beneficiary of an education IRA can take tax-free withdrawals to pay qualified higher education expenses. The withdrawals are tax free to the extent the withdrawal does not exceed the designated beneficiary's qualified higher education expenses. See *Rollovers and Other Transfers,* later.

Tax treatment. The tax treatment of distributions (withdrawals) from an education IRA depends, in part, on the qualified higher education expenses that a designated beneficiary has in a tax year.

Distribution not more than expenses. Generally, a withdrawal is tax free to the designated beneficiary if it is not more than his or her qualified higher education expenses in a tax year.

Distributions more than expenses. Generally, if the total withdrawals for a tax year are more than the qualified higher education expenses, a portion of the amount withdrawn is taxable to the beneficiary.

The taxable portion is the amount that represents earnings that have accumulated tax free in the account. Figure the taxable amount as shown in the following steps.

1) Multiply the amount withdrawn by a fraction, the numerator of which is the total contributions in the account and the denominator of which is the total balance in the account before the withdrawal(s).
2) Subtract the amount figured in *(1)* from the total amount withdrawn during the year. This is the amount of earnings included in the withdrawal(s).
3) Multiply the amount of earnings figured in *(2)* by a fraction, the numerator of which is the qualified higher education expenses paid during the year and the denominator of which is the total amount withdrawn during the year.
4) Subtract the amount figured in *(3)* from the amount figured in *(2).* This is the amount the beneficiary must include in income.

Example. You receive a $6,000 distribution from an education IRA to which $10,000 has been contributed. The balance in the IRA before the withdrawal was $12,000. You had $4,500 of qualified higher education expenses for the year. Using the steps above, figure the taxable portion of your withdrawal as follows.

1) $6,000 × $10,000 ÷ $12,000 = $5,000
2) $6,000 − $5,000 = $1,000
3) $1,000 × $4,500 ÷ $6,000 = $750
4) $1,000 − $750 = $250 that you must include in income as withdrawn earnings not used for the expenses of higher education.

Additional tax. Generally, if you receive a taxable distribution, you must pay a ***10%*** additional tax on the amount included in income.

Exceptions. The 10% additional tax does not apply to distributions that are:

1) Made to a beneficiary or to the estate of the designated beneficiary on or after the death of the designated beneficiary.
2) Made because the designated beneficiary is disabled (as defined in Publication 590).
3) Made because the designated beneficiary received a qualified scholarship excludable from gross income, an educational assistance allowance, or payment for the designated beneficiary's educational expenses that is excludable from gross income under any law of the United States to the extent the distribution is not more than the scholarship, allowance, or payment.

The 10% additional tax also does not apply to a distribution that is a return of an excess contribution. For the additional tax not to apply, the distribution must be made before the due date of the contributor's return (including extensions) and it must include any net income attributable to that contribution. That net income also must be included in the contributor's gross income for the tax year the contribution was made.

Rollovers and Other Transfers

Any amount withdrawn from an education IRA and rolled over to another education IRA for the benefit of the same designated beneficiary or certain members of the designated beneficiary's family is not taxable. An amount is rolled over if it is paid to another education IRA within 60 days after the date of the withdrawal.

Only one rollover per education IRA is allowed during a 12-month period ending on the date of the payment or distribution.

The designated beneficiary can be changed from one child to a member of that child's family without triggering any tax consequences. Members of the designated beneficiary's family include the designated beneficiary's:

1) Children and their descendents.
2) Stepchildren and their descendents.
3) Brothers and sisters and their children.
4) Parents and grandparents.
5) Stepparents.
6) Spouses of all the family members listed above.

Transfer incident to divorce. The transfer of a designated beneficiary's interest in an education IRA to his or her spouse or former spouse under a divorce or separation instrument is not a taxable transfer. After the transfer, the interest will be treated as an education IRA in which the spouse or former spouse is the designated beneficiary.

Transfer because of death. The tax treatment of these transfers depends on whether you are the surviving spouse or another designated beneficiary.

Surviving spouse. If your spouse was a designated beneficiary of an education IRA and you receive the education IRA as a result of the death of your spouse, you can treat the education IRA as your own.

Someone other than surviving spouse. If you are someone other than the surviving spouse and you receive an education IRA as the result of the death of the IRA holder, the distribution to you is taxable at its fair market value. You cannot treat the IRA as your own.

The Hope credit and lifetime learning credit cannot be claimed for a student's qualified higher education expenses in the same tax year in which the student takes a tax-free withdrawal from an education IRA. However, the student may waive the tax-free treatment of the education IRA distribution and elect to pay any tax that would otherwise be owed on the distribution so that the student or the student's parents may claim a Hope credit or lifetime learning credit for qualified higher education expenses paid in the same tax year.

Other Retirement Plans

New Recovery Method

For annuity starting dates beginning after 1997, a new method is used to figure the tax-free portion of an annuity payable over the lives of more than one individual (joint and survivor annuity). New law requires that the recovery factors (the number of anticipated monthly payments used to recover the tax-free investment in the contract or basis) be determined by combining the ages of the annuitants. The following table shows the number of payments required to recover the investment in the annuity under this new rule.

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

The method that applied for annuity starting dates beginning before 1998 is discussed in Publication 575, *Pension and Annuity Income.* Under that method, the number of payments was based on the primary annuitant's age at the annuity starting date. It did not matter whether the annuitant received a single life annuity or a joint and survivor annuity.

Section 403(b) Plans

The following provisions affect tax-sheltered annuity programs for employees of public schools and certain tax-exempt organizations (section 403(b) plans).

Includible compensation. Beginning in 1998, for purposes of figuring your exclusion allowance, which is the amount of employer contributions (including elective deferrals) to your tax-sheltered annuity you can exclude from income, your includible compensation includes the following items.

1) Elective deferrals (employer's contributions made on your behalf under a salary reduction agreement).
2) Amounts your employer contributed or deferred under a section 125 cafeteria plan.
3) Amounts contributed or deferred under a section 457 nonqualified deferred compensation plan (state or local government or tax-exempt organization plan).

For more information on includible compensation, see Publication 571.

Contributions of employed ministers. Beginning in 1998, contributions made to a church plan on behalf of a duly ordained, commissioned, or licensed minister employed by an employer other than the church are excluded from the minister's gross income if they would have been excluded had the minister been an employee of the church.

For purposes of this rule, a minister of a church also includes:

1) A self-employed minister, and
2) A minister employed by an organization other than a tax-exempt organization that shares a common religious bond with the minister.

For more information on the exclusion of contributions to church plans, see Publication 571.

Section 401(k) Plans

Beginning in 1998, matching contributions made to a qualified cash or deferred arrangement (section 401(k) plan) in which a self-employed individual participates will no longer be treated as elective contributions subject to the limit on elective deferrals. Matching contributions for partners and other self-employed individuals will receive the same treatment as matching contributions for other employees.

Previously, matching contributions made to a 401(k) plan on behalf of a self-employed individual were treated as additional elective contributions. These contributions were subject to the $9,500 limit on elective deferrals.

For more information about the treatment of employee and employer contributions to a Keogh plan, see *Keogh Plans* in Publication 560.

4. Gifts, Estates, and Trusts

Useful Items

You may want to see:

Publication

☐ **559** Survivors, Executors, and Administrators

Form (and Instructions)

☐ **706** United States Estate (and Generation-Skipping Transfer) Tax Return

☐ **1041** U.S. Income Tax Return for Estates and Trusts

1997 Changes

Gift Tax Return Not Required

You do not need to file a gift tax return if the only gifts you made during the year were deductible gifts to charities. This exception applies only to gifts made after August 5, 1997, of:

1) Your entire interest in the property, if no other interest has been transferred for less than adequate consideration or for other than a charitable use, or

2) A qualified conservation contribution that is a restriction (granted forever) on the use of real property.

Estate Tax on Excess Retirement Accumulations

For estates of decedents dying after 1996, the estate tax will no longer include the tax on excess accumulations in retirement plans. This tax was figured on Schedule S (Form 706), which will be deleted from the next revision of **Form 706.**

65-Day Rule for Estate Distributions

For tax years beginning after August 5, 1997, an executor can elect to treat distributions paid or credited by the estate within 65 days after the close of the estate's tax year as having been paid or credited on the last day of that tax year.

For more information on distributions from an estate, see Publication 559.

Distributable Net Income

For estates of decedents dying after August 5, 1997, the separate shares rule applies if the estate has more than one beneficiary and the beneficiaries have substantially separate and independent shares. Under this rule, the separate shares are treated as separate estates for the sole purpose of determining the distributable net income allocable to a beneficiary.

For more information on distributable net income, see Publication 559.

Consistent Treatment of Estate and Trust Items

Beneficiaries must generally treat estate or trust items the same way on their individual returns as they are treated on the estate's or trust's income tax return. This rule applies to returns filed after August 5, 1997.

Previously, consistency rules were not specified for beneficiaries of estates and trusts.

For more information on reporting items received from an estate, see Publication 559.

Estates and Beneficiaries Treated as Related Persons

For tax years beginning after August 5, 1997, the definition of related persons has been changed to include an estate and a beneficiary of that estate. Various tax provisions are affected by this change, including the one that denies a deduction for a loss on the sale or exchange of property between the parties. Also, any gain on the sale or exchange of depreciable property between the parties is treated as ordinary income. This change does not apply to a sale or exchange to satisfy a pecuniary bequest.

For more information, see Publication 559.

Accumulation Distribution Rules for Trusts

For tax years beginning after August 5, 1997, the accumulation distribution rules will not apply to a qualified trust. For this purpose, a qualified trust does not include a foreign trust or, with certain exceptions, a trust created before March 1, 1984. See the **Form 1041** instructions for more information.

Net Worth Requirements for Recovery of Certain Costs

For litigation and administrative cost recovery proceedings beginning after August 5, 1997, the net worth requirements (limits) of estates and trusts are the same as those for individuals. Previously, it was not clear which net worth limits applied to estates and trusts or to individuals as joint filers.

For more information on cost recovery and net worth requirements, see *Appeals to the Courts* in Publication 556.

1998 Changes

Unified Credit Increases

The unified credit for gift and estate taxes increases to $202,050 for gifts made in 1998 and for the estates of decedents dying in 1998. Previously, this amount was $192,800.

The following table lists the unified credit for years after 1998.

Year	Unified Credit
1999	$211,300
2000 and 2001	220,550
2002 and 2003	229,800
2004	287,300
2005	326,300
After 2005	345,800

Estate Tax Return Filing Requirement Increases

Generally, an estate tax return must be filed for the estate of a U.S. citizen or resident dying in 1998 if the gross estate is more than $625,000. Previously, this amount was $600,000.

The following table lists the filing requirement for estates of decedents dying after 1998.

Year of Death	Filing Requirement
1999	$ 650,000
2000 and 2001	675,000
2002 and 2003	700,000
2004	850,000
2005	950,000
After 2005	1,000,000

New Exclusion From Gross Estate

For estates of decedents dying after 1997, the executor can elect to exclude the adjusted value of a qualified family-owned business interest, up to a limited amount, from the gross estate. For more information, see section 2033A of the Internal Revenue Code.

5.

Excise Taxes

Useful Items

You may want to see:

Publication

- ☐ **378** Fuel Tax Credits and Refunds
- ☐ **510** Excise Taxes for 1998

1997 Changes

This chapter highlights changes to the rules for certain excise taxes. Some of the changes that took effect in 1997 were not included in Publication 510, *Excise Taxes for 1997,* because the law changed after it was published. However, Publication 510, *Excise Taxes for 1998,* explains these changes and other changes effective in 1998.

Air Transportation Taxes

The following air transportation taxes were reinstated for amounts paid in the period March 7, 1997, through September 30, 1997. This period has been extended through September 30, 2007. These taxes are on:

1) Transportation of persons by air.
2) Use of international air travel facilities.
3) Transportation of property by air.

For transportation beginning after September 30, 1997, new rates and other changes apply to items *(1)* and *(2).* See Publication 510.

Emergency medical air transportation. The exemption from the air transportation taxes for emergency medical transportation provided by a fixed-wing aircraft applies on a flight-by-flight basis. In addition, aviation fuel used by these aircraft while providing this transportation is exempt from the excise tax. These provisions apply starting August 27, 1996.

Skydiving flights. The air transportation taxes do not apply to amounts paid after September 30, 1997, for air transportation exclusively for skydiving. Effective October 1, 1997, these flights are treated as noncommercial aviation and the fuel used is subject to the excise tax on aviation gasoline or aviation fuel.

Fuel Taxes

Various provisions relating to the excise taxes on fuels have been changed.

Leaking Underground Storage Tank Trust Fund (LUST) tax reinstated. The .1 cent per gallon Leaking Underground Storage Tank Trust Fund (LUST) tax is reinstated starting October 1, 1997. It generally applies to gasoline, diesel fuel, special motor fuels (other than liquefied petroleum gas and liquefied natural gas), aviation fuels, and fuels used on inland waterways.

See Publication 510 for the rates.

Aviation fuels. The taxes on aviation gasoline and aviation fuel (other than gasoline) were increased for the period March 7, 1997, through September 30, 1997. This period has been extended through September 30, 2007.

Refund to producer of prior tax paid. A registered aviation fuel producer who buys tax-paid aviation fuel after September 30, 1997, is eligible for a refund of that tax under certain conditions.

Credit or refund for commercial aviation. The credit or refund for fuel used in commercial aviation applies to the tax paid on aviation fuel after March 6, 1997. This applies to aviation gasoline and aviation fuel (other than gasoline). See Publication 378.

Special motor fuels. Effective October 1, 1997, new tax rates took effect for certain special motor fuels. The fuels and the new rates per gallon are as follows:

Fuel	Rate
Liquefied petroleum gas	13.6¢
Liquefied natural gas	11.9¢
Methanol fuel produced from natural gas	9.25¢

Diesel fuel used in boats. The tax on diesel fuel used or sold for use in boats had been suspended through December 31, 1997. Effective January 1, 1998, this tax does not apply to diesel fuel used or sold for use in any boat.

Gasoline chain retailers. A gasoline wholesale distributor who buys gasoline tax paid and then sells it to the ultimate purchaser for an exempt purpose can claim a credit or refund for the tax paid. For sales after August 5, 1997, a wholesale distributor includes any person who makes retail sales of gasoline at 10 or more retail motor fuel outlets.

Communications Tax

The 3% communications tax now applies to ***prepaid telephone cards.*** The face amount of the card is treated as the amount paid for communications services when a card is transferred by a telecommunications carrier to any person who is not a carrier. This applies to amounts paid after October 31, 1997.

Manufacturers' Taxes

Provisions relating to the manufacturers' excise tax have been changed.

Arrows. The tax on arrows has been changed to a tax on the component parts of an arrow (shaft, point, nock, and vane). The tax on each part is 12.4% of the sales price. Previously, the tax was 11% of the sales price of the completed arrow. The changes apply to sales after September 30, 1997.

Vaccines. The tax on vaccines has been changed to a single rate of 75 cents per dose on each taxable vaccine component. The tax on a vaccine that contains more than one component is 75 cents times the number of components. Previously, different rates applied depending on the type of vaccine. In addition, the following vaccines are now taxable:

1) Any HIB vaccine.
2) Any vaccine against hepatitis B.
3) Any vaccine against chicken pox.

These changes are effective for sales after August 5, 1997.

The amount of any claim for credit or refund of the vaccine tax filed before January 1, 1999, cannot be more than an amount figured using the new rate.

Heavy Truck Tax

The retail tax on heavy trucks, trailers, and tractors applies to parts and accessories installed within 6 months after the vehicle is first placed in service. For vehicles sold after August 5, 1997, the tax will apply to these parts and accessories only if the total cost, including installation, during that period is more than $1,000 (up from $200).

Luxury Tax

For 1997, the luxury tax on a passenger vehicle is 8% of the sales price that exceeds the base amount of $36,000. However, for sales after August 5, 1997, the base amount is increased for the following vehicles.

1) For an electric vehicle, the base amount is increased by 50%.
2) For a clean-fuel vehicle, the base amount is increased by the amount the price of the vehicle increases due to the installation of retrofit parts and components that permit the vehicle to be propelled by a clean-burning fuel.

Separate purchase of parts and accessories. The following changes to the luxury tax apply to the purchase and installation of parts and accessories.

1) The rate is reduced from 10% to 8% for sales and installations after August 5, 1997.
2) The tax does not apply to retrofit parts and accessories bought and installed after August 5, 1997, that permit the vehicle to be propelled by a clean-burning fuel.
3) The tax will apply only if the total cost, including installation, is more than $1,000 (up from $200) for vehicles bought after August 5, 1997.

1998 Changes

Ozone-Depleting Chemicals

The exemption of imported recycled halon–1211 from the ozone-depleting chemicals tax, scheduled to take effect on January 1, 1998, has been repealed. The tax on ozone-depleting chemicals will continue to apply to imported recycled halon–1211.

Kerosene

Starting July 1, 1998, the taxation and dyeing requirement rules of diesel fuel generally will apply to kerosene. For more information, see Publication 510. For information on credit and refund provisions, see Publication 378.

A floor stocks tax of 24.4 cents per gallon applies to kerosene held by any person on July 1, 1998. The tax must be paid by August 31, 1998. However, there are exceptions to the tax. See Publication 510 for more information.

Heavy Truck Tax

Two changes to the tax on heavy trucks, trailers, and tractors take effect on January 1, 1998.

Repairs and modifications. Repairs and modifications of a vehicle are not treated as the manufacture or production of the vehicle unless the cost of the repairs and modifications is more than 75% of the cost of a comparable new vehicle. This includes modifications that change the transportation function of a vehicle or restore a wrecked vehicle to a functional condition. Generally, this provision does not apply to a vehicle that was not subject to the tax when it was new.

Tires. In determining the sales price of a vehicle for applying this tax, the retail fair market value of tires can no longer be excluded. A credit is allowed against the retail tax for any manufacturers' tax imposed on the tires. For information on these taxes, see Publication 510.

Luxury Tax

For 1998, the luxury tax on a passenger vehicle is reduced to 7% of the sales price that exceeds the base amount. This 7% rate also applies to separately purchased parts and accessories. The base amounts are the same as in 1997. For information on these amounts, see *Luxury Tax,* earlier.

Tax Deposits Delayed

The due dates for depositing certain excise taxes have been delayed until October 5, 1998. This applies to the taxes on fuels and on the transportation of property by air that would normally be deposited during the period

of August 1, 1998, through September 30, 1998. The delayed due date also applies to the taxes on the transportation of persons by air and use of international air travel facilities that would normally be deposited during the period August 15, 1998, through September 30, 1998.

6. Exempt Organizations

1998 Changes

Expanded Coverage for High-Risk Pools

Beginning in 1998, a tax-exempt, state-sponsored organization may provide medical care coverage to spouses and dependents of a high-risk individual as well as to the high-risk individual. See chapter 4 in Publication 557, *Tax-Exempt Status for Your Organization*, for more information about these organizations.

Worker's Compensation Act Organizations

Beginning in 1998, an organization (including a mutual insurance company) that provides workmen's compensation will qualify for exemption under Internal Revenue Code section 501(c)(27) if it meets all the following requirements.

1) The organization must be created by state law and be organized and operated under state law exclusively to provide the following items.
   a) Worker's compensation insurance because it is required by state law or because state law provides significant disincentives if the employer does not purchase it, and
   b) Related coverage incidental to worker's compensation insurance.
2) The organization must provide worker's compensation insurance to any employer in the state that wants it and meets other reasonable requirements. The insurance must be for employees in the state or temporarily assigned out-of-state.
3) A state executive branch official or state legislature (or both) must appoint the majority of the organization's board of directors or other comparable oversight body.
4) The state must extend its full faith and credit to the initial debt of the organization or provide the initial operating capital for that organization.
5) The assets of the organization must revert back to the state if the organization dissolves, or the state must have a law that does not permit any such organization to dissolve.

See chapter 4 in Publication 557 for more information about these organizations.

Income From Sponsorship Activities

Beginning in 1998, the activity of soliciting and receiving qualified sponsorship payments by an exempt organization is not an unrelated trade or business and the payments are not subject to the tax on unrelated business income. A qualified sponsorship payment is, generally, any payment received from a person engaged in a trade or business for which the person will receive no substantial benefit other than the use or acknowledgment of the person's business name, logo, or product lines in connection with the organization's activities. "Use or acknowledgment" does not include advertising the sponsor's products or services. A payment does not qualify if any of the following apply.

1) The amount is contingent on the level of attendance at an event, on broadcast ratings, or on other factors indicating the degree of public exposure to an event.
2) It entitles the payer to the use or acknowledgment of the business name, logo, or product lines in the organization's periodical.
3) It is made in connection with any qualified convention or trade show activity.

For more information, see *Excluded Trade or Business Activities* in chapter 3 of Publication 598, *Tax on Unrelated Business Income of Exempt Organizations.*

7. Foreign Issues

1997 Changes

Foreign Tax Credit

You cannot claim a foreign tax credit for withholding tax on dividends paid or accrued after September 4, 1997, if the dividends are:

1) On stock you held for less than 16 days during a 30-day holding period, or
2) On preferred stock you held for less than 46 days during a 90-day holding period if the dividend is for a period or periods totaling more than 366 days.

This special rule does not apply to dividends received before September 5, 1997.

For more information, see *Taxes Imposed on Certain Dividends* in Publication 514, *Foreign Tax Credit for Individuals.*

1998 Changes

Foreign Tax Credit

Your foreign tax credit is subject to a limit based on your taxable income from foreign sources. You figure the limit and the credit on **Form 1116,** *Foreign Tax Credit (Individual, Estate, Trust or Nonresident Alien Individual).* Beginning in 1998, you will not be subject to this limit and may be able to claim the credit without using Form 1116 if the following requirements are met.

1) You are an individual.

2) Your only foreign source income for the tax year is passive income (dividends, interest, royalties, etc.) that is reported to you on a payee statement (such as a Form 1099–DIV or 1099–INT).

3) Your qualified foreign taxes for the tax year are not more than $300 ($600 if filing a joint return) and are reported on a payee statement.

4) You elect this procedure for the tax year.

If you make this election, you cannot carry back or carry over any unused foreign tax to or from this tax year.

For more information on the foreign tax credit, see Publication 514.

Foreign Earned Income Exclusion

Beginning in 1998, the amount of foreign earned income you may be able to exclude from gross income has increased. To qualify for the exclusion, you must meet either the bona fide residence test or the physical presence test and you must have a tax home in a foreign country or countries throughout your period of residence or presence. The foreign earned income exclusion is explained in Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad.*

Before 1998 the maximum amount of foreign earned income you could exclude was $70,000. For 1998 and later years, the maximum amount you can exclude is shown in the table below.

Tax Year	Maximum Exclusion
1998	$72,000
1999	74,000
2000	76,000
2001	78,000
2002 and after	80,000

Beginning in 2008, the $80,000 amount will be adjusted for inflation.

8. How To Get More Information

You can get help from the IRS in several ways.

Free publications and forms. To order free publications and forms, call 1–800–TAX–FORM (1–800–829–3676). You can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address. Your local library or post office may also have the items you need.

For a list of free tax publications, order Publication 910, *Guide to Free Tax Services.* It also contains an index of tax topics and related publications and describes other free tax services available from the IRS, including tax education and assistance programs.

If you have access to a personal computer and modem, you can also get many forms and publications electronically. See *Quick and Easy Access to Tax Help and Forms* in your income tax package for details.

Tax questions. You can call the IRS with your tax questions. Check your income tax package or telephone book for the local number, or you can call 1–800–829–1040.

TTY/TDD equipment. If you have access to TTY/TDD equipment, you can call 1–800–829–4059 to ask tax questions or to order forms and publications. See your income tax package for details.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we evaluate the quality of our “800 number” telephone services in several ways.

1) A second IRS representative sometimes monitors live telephone calls. That person only evaluates the IRS assistor and does not keep a record of any taxpayer's name or tax identification number.

2) We sometimes record telephone calls to evaluate IRS assistors objectively. We hold these recordings no longer than one week and use them only to measure the quality of assistance.

3) We value our customers' opinions. Throughout this year, we will be surveying our customers for their opinions on our service.

Tax Items* available on Internet and by FAX.** *Tax Items,* short explanations of one tax topic, are now available on the Internet or by FAX. Printed copies are ***not available from IRS distribution centers. They are an alternative to ordering the complete publication on that topic or downloading it from the Internet. For example, if you only need information about the support test for a dependent, you may be able to find your answer quickly in *Tax Item 2187* instead of reading Publication 501.

On the Internet. You can find *Tax Items* on the IRS home page at **www.irs.ustreas.gov**. Using the Internet number in *Table 8,* you can download and print any *Item* or simply read it on your computer.

By FAX. To order an *Item* by FAX, call **(703) 368–9694** from the telephone on your FAX machine. Do not use your desk telephone. Follow the recorded instructions and enter the FAX number from *Table 8* for the *Item* you choose.

Your comments. Please let us know what you think of the *Items* you read. Your comments and suggestions will help when we add new *Items.* You can write to us at the following address:

Internal Revenue Service
Tax Forms and Publications Division T:FP
1111 Constitution Ave., N.W.
Washington, D.C. 20224

Table 8. **Titles and Numbers of *Tax Items***

Title	Internet Number	FAX Number
Penalties	2186	24731
*Support Test and Worksheet for Dependency Exemption**	2187	24732
Request for IRS To Figure Taxable Part of Annuity	2188	24733
Worksheets To Figure Taxable Social Security and Equivalent Railroad Retirement Benefits	2189	24734
Deduction or Credit for Amounts You Repaid	2190	24735
Unemployment Compensation	2191	24736

***Caution.** This *Item* does not cover children of divorced or separated parents or multiple support agreements. Instead, see Publication 504, *Divorced or Separated Individuals.*

Your Rights as a Taxpayer

The first part of this section explains some of your most important rights as a taxpayer.

The second part explains the examination, appeal, collection, and refund processes.

I. Declaration of Taxpayer Rights

Protection of your rights. IRS employees will explain and protect your rights as a taxpayer throughout your contact with us.

Privacy and confidentiality. The IRS will not disclose to anyone the information you give us, except as authorized by law. You have the right to know why we are asking you for information, how we will use it, and what happens if you do not provide requested information.

Professional and courteous service. If you believe that an IRS employee has not treated you in a professional manner, you should tell that employee's supervisor. If the supervisor's response is not satisfactory, you should write to your IRS District Director or Service Center Director.

Representation. You may either represent yourself, or with proper written authorization, have someone else represent you in your place. You can have someone accompany you at an interview. You may make sound recordings of any meetings with our examination or collection personnel, provided you tell us in writing 10 days before the meeting.

Payment of only the correct amount of tax. You are responsible for paying only the correct amount of tax due under the law — no more, no less.

Help from the Problem Resolution Program. The Problem Resolution Program (administered by the **Taxpayer Advocate**) can help you with unresolved tax problems and can offer you special help if you have a significant hardship as a result of a tax problem. For more information, write to the Taxpayer Advocate at the District Office or Service Center where you have the problem, or call 1–800–829–1040 (1–800–829–4059 for TTY/TDD users).

Appeals and judicial review. If you disagree with us about the amount of your tax liability or certain collection actions, you have the right to ask the IRS Appeals Office to review your case. You may also ask a court to review your case.

Relief from certain penalties. The IRS will waive penalties when allowed by law if you can show you acted reasonably and in good faith or relied on the incorrect advice of an IRS employee.

II. Examinations, Appeals, Collections, and Refunds

Examinations (Audits)

We accept most taxpayers' returns as filed. If we inquire about your return or select it for examination, it does not suggest that you are dishonest. The inquiry or examination may or may not result in more tax. We may close your case without change; or, you may receive a refund.

By mail. We handle many examinations and inquiries by mail. We will send you a letter with either a request for more information or a reason why we believe a change to your return may be needed. If you give us the requested information or provide an explanation, we may or may not agree with you, and we will explain the reasons for any changes. Please do not hesitate to write us about anything you do not understand. If you cannot resolve a question through the mail, you can request a personal interview with an examiner.

By interview. If we notify you that we will conduct your examination through a personal interview, or you request such an interview, you have the right to ask that the examination take place at a reasonable time and place that is convenient for both you and the IRS. At the end of your examination, the examiner will give you a report if there are any proposed changes to your tax return. If you do not agree with the report, you may meet with the examiner's supervisor.

Repeat examinations. If we examined your tax return for the same items in either of the 2 previous years and proposed no change to your tax liability, please contact us as soon as possible so we can determine if we should discontinue the repeat examination. Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund,* will give you more information about the rules and procedures of an IRS examination.

Appeals

If you do not agree with the examiner's findings, you can appeal them to an Appeals Office. Most differences can be settled without expensive and time-consuming court trials. Your appeal rights are explained in detail in Publication 5, *Appeal Rights and Preparation of Protests for Unagreed Cases.* If you do not wish to use our Appeals Office or disagree with its findings, you can take your case to the U.S. Tax Court, U.S. Court of Federal Claims, or the U.S. District Court where you live. If the court agrees with you on most issues in your case, and finds that our position was largely unjustified, you may be able to recover some of your administrative and litigation costs. You will not be eligible to recover these costs unless you tried to resolve your case administratively, including going through our Appeals system, and you gave us all the information necessary to resolve the case.

Collections

Publication 594, *Understanding the Collection Process,* explains your rights and responsibilities regarding payment of federal taxes. It is

divided into several sections that explain the procedures in plain language. The sections include:

1) *When you have not paid enough tax.* This section describes tax bills and explains what to do if you think your bill is wrong.

2) *Making arrangements to pay your bill.* This covers making installment payments, delaying collection action, and submitting an offer in compromise.

3) *What happens when you take no action to pay.* This covers liens, releasing a lien, levies, releasing a levy, seizures and sales, and release of property. Publication 1660, *Collection Appeal Rights (for Liens, Levies and Seizures),* explains your rights to appeal liens, levies and seizures and how to request these appeals.

Refunds

You may file a claim for refund if you think you paid too much tax. You must generally file the claim within 3 years from the date you filed your return or 2 years from the date you paid the tax, whichever is later. The law generally provides for interest on your refund if it is not paid within 45 days of the date you filed your return or claim for refund. Publication 556, *Examination of Returns, Appeals Rights, and Claims for Refund,* has more information on refunds.

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