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Highlights of 2002 Tax Changes

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Introduction

This publication highlights tax law changes that take effect in 2002, 2003, and later years. The chapters are divided into separate sections based on when the changes take effect.

Changes covered in this publication include the following.

- Tax benefits for education, including the new tuition and fees deduction and educator expenses deduction.
- Pension changes such as higher contribution and benefit limits for retirement plans, the tax credit for certain pension plan startup costs, an increased SEP contribution limit, catch-up contributions, and deemed individual retirement arrangements (IRAs).
- An increase in the allowable amount of IRA contributions.
- Extension of the welfare-to-work credit and work opportunity credit.
- Free Internet filing options.
- How you report interest and dividends.

See the discussion of each topic for more information.

Adjusting your withholding or estimated tax payments for 2003. If your tax for 2003 will be more or less than your 2002 tax, you may need to adjust your withholding or estimated tax payments accordingly. If your tax will decrease, you can get the benefit of lower taxes throughout the year. If you will owe more tax, you can 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 forms and publications.

To adjust your....	Get Form...	And Publication...
Withholding	**W−4,** *Employee's Withholding Allowance Certificate*	**919,** *How Do I Adjust My Tax Withholding?*
Estimated tax payments	**1040−ES,** *Estimated Tax for Individuals*	**505,** *Tax Withholding and Estimated Tax*

Photographs of missing children. The Internal Revenue Service is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in this publication on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling **1−800−THE−LOST (1−800−843−5678)** if you recognize a child.

Comments and suggestions. We welcome your comments about this publication and your suggestions for future editions.

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1.

Tax Changes for Individuals

2002 Changes

IRS *e-file*

You may be able to file a paperless tax return. Paperless filing is easier than you think and it's available to most taxpayers who file electronically. You can file electronically, sign electronically, and get your refund or even pay electronically. IRS *e-file* offers accurate, safe, and fast alternatives to filing on paper.

For 2002, 99% of all forms and schedules can be *e-filed.* You can now *e-file* a return for a decedent. Even returns with a foreign address can be *e-filed.*

Free Internet filing options. More taxpayers can now prepare and *e-file* their individual income tax returns free using commercial tax preparation software accessible through **www.irs.gov** or **www.firstgov.gov**. The IRS is partnering with the tax software industry to offer free preparation and filing services to a significant number of taxpayers.

More information. For information on IRS *e-file* and to see if you qualify for the free Internet filing options, visit the IRS web site at **www.irs.gov**.

Reduced Income Tax Rates

For 2002, the 27.5%, 30.5%, 35.5%, and 39.1% tax rates are reduced to 27%, 30%, 35%, and 38.6%, respectively.

10% tax rate. A portion of your income that would be subject to a 15% tax rate is subject to a reduced rate of 10%. The 10% tax rate is reflected in the tax tables and tax rate schedules. You do not have to make a separate computation or figure a credit to get the benefits of this rate.

Standard Deduction Amount Increased

The standard deduction for taxpayers who do not itemize deductions on Schedule A of Form 1040 is, in most cases, higher for 2002 than it was for 2001. 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 *2002 Standard Deduction Tables* are shown in Publication 501, *Exemptions, Standard Deduction, and Filing Information.*

Limit on Itemized Deductions Increased

If your adjusted gross income is above a certain amount, you lose all or part of your itemized deductions. In 2002, this amount is increased to $137,300 ($68,650 if married filing separately). In 2001, the amount was $132,950 ($66,475 if married filing separately). For more information and a worksheet to figure the amount you can deduct, see the instructions for line 28 of Schedule A (Form 1040).

Exemption Amount Increased

The amount you can deduct for each exemption has increased from $2,900 in 2001 to $3,000 in 2002.

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 the phaseout begins depends on your filing status. For 2002, the phaseout begins at

$103,000 for married persons filing separately, $137,300 for single individuals, $171,050 for heads of household, and $206,000 for married persons filing jointly. If your adjusted gross income is above the amount for your filing status, use the *Deduction for Exemptions Worksheet* in the Form 1040 instructions to figure the amount you can deduct for exemptions.

Standard Mileage Rate Increased

Business-related mileage. For 2002, the standard mileage rate for the cost of operating your car, van, pickup, or panel truck is increased to 36½ cents a mile for all business miles.

Car expenses and use of the standard mileage rate are explained in chapter 4 of Publication 463, *Travel, Entertainment, Gift, and Car Expenses.*

Medical and move-related mileage. For 2002, the standard mileage rate for the cost of operating your car for medical reasons or as part of a deductible move is increased to 13 cents a mile. See *Transportation* under *What Medical Expenses Are Deductible* in Publication 502, *Medical and Dental Expenses*, or *Travel by car* under *Deductible Moving Expenses* in Publication 521, *Moving Expenses*.

Survivor Benefits for Public Safety Officers

For tax years beginning after 2001, a survivor annuity received by the spouse, former spouse, or child of a public safety officer killed in the line of duty will generally be excluded from the recipient's income regardless of the date of the officer's death. Survivor benefits received before 2002 are excludable only if the officer died after 1996. The exclusion provision applies to a chaplain killed in the line of duty after September 10, 2001. For more information, see *Public safety officers,* in Publication 559, *Survivors, Executors, and Administrators.*

Retirement Planning Services

The tax treatment of qualified retirement planning services has been clarified. Beginning in 2002, if your employer has a qualified retirement plan, qualified retirement planning services provided for you (or your spouse) by your employer are not included in your income. For more information, see *Retirement Planning Services* in Publication 525, *Taxable and Nontaxable Income*.

Tax Benefits When Selling Your Home

New rules apply to excluding gain from the sale of your main home in certain situations. In most cases, the new rules make it easier to exclude your gain from income. These new rules may apply if:

- You had more than one home,
- You sold vacant land adjacent to your main home,
- You used part of the home sold for nonresidential purposes, such as for a home office, or
- You did not meet the ownership and use tests or sold the home within 2 years of an earlier home sale, but the primary reason for the sale was a change in place of employment, health, or unforeseen circumstances. Unforeseen circumstances include death, divorce, and the September 11, 2001, terrorist attacks.

For more information, see Publication 523, *Selling Your Home.*

Frequent Flyer Miles

Frequent flyer miles are a benefit provided under an airline frequent flyer program. They are also used as a promotional benefit through rental car programs and hotels.

The IRS has announced it will not claim that any taxpayer has understated his or her federal tax liability by reason of the receipt or personal use of frequent flyer miles or other in-kind promotional benefits attributable to the taxpayer's business or official travel. Any future guidance on the taxability of these benefits will be applied prospectively.

This relief does not apply to travel or other promotional benefits in the following three situations:

- When they are converted to cash,
- When they are used as compensation (payment for your services), or
- When they are used for tax avoidance purposes.

Reporting Interest and Dividends

Interest or ordinary dividend income that exceeds a certain amount must be reported on a separate schedule. For 2002, this amount has increased. If you file Form 1040A, you must now attach Schedule 1 to your return if your interest or dividend income is more than $1,500; if you file Form 1040, you must now attach Schedule B to your return if your interest or dividend income is more than $1,500. Before 2002, you had to attach Schedule 1 or Schedule B if your interest or dividend income was more than $400.

For more information, see the instructions for the schedule you are filing.

Tax Benefits for Education

Educator Expenses

If you are an eligible educator, you can deduct as an adjustment to income up to $250 in qualified expenses. You can deduct these expenses even if you do not itemize deductions on Schedule A (Form 1040). This adjustment to income is for expenses paid or incurred in tax years beginning during 2002 or 2003. Previously these expenses were

deductible only as a miscellaneous itemized deduction subject to the 2% of adjusted gross income limit.

For more information, see your Form 1040 or Form 1040A instructions. You cannot deduct these expenses if you file Form 1040EZ.

Hope and Lifetime Learning Credits

Beginning in 2002, the following changes apply to Hope and lifetime learning (education) credits. For more information, see chapters 1 and 2 in Publication 970, *Tax Benefits for Education*.

Education credits coordinated with Coverdell ESA and QTP withdrawals. You may be able to claim an education credit in the same year in which you receive a distribution from a Coverdell education savings account (ESA) or a qualified tuition program (QTP). Previously, you had to waive the tax-free treatment of the withdrawal in order to take an education credit.

Income limits for credit reduction increased. The amount of your education credit is phased out (gradually reduced) if your modified adjusted gross income (MAGI) is between $41,000 and $51,000 ($82,000 and $102,000 if you file a joint return). You cannot claim an education credit if your MAGI is $51,000 or more ($102,000 or more if you file a joint return). This is an increase from the 2001 limits of $40,000 and $50,000 ($80,000 and $100,000 if filing a joint return).

Student Loan Interest Deduction

Beginning in 2002, the following changes apply to the deduction of interest you pay on a student loan. For more information, see chapter 3 of Publication 970, *Tax Benefits for Education*.

60-month limit eliminated. You are no longer limited to deducting interest paid during the first 60 months that interest payments are required.

Income limits on phaseout of deduction increased. The amount of your student loan interest deduction will be phased out (gradually reduced) if your modified adjusted gross income (MAGI) is between $50,000 and $65,000 ($100,000 and $130,000 if you file a joint return). You will not be able to take a deduction if your MAGI is $65,000 or more ($130,000 or more if you file a joint return). This is an increase from the 2001 limits of $40,000 and $55,000 ($60,000 and $75,000 if filing a joint return).

New modification to adjusted gross income (AGI). When figuring your modified adjusted gross income (MAGI) for purposes of the interest deduction phaseout (see above), you now must add back to your AGI any qualified tuition and fees deduction (discussed later) claimed on Form 1040 or 1040A.

New adjustment to qualified higher education expenses. When figuring your qualified higher education expenses for purposes of the student loan interest deduction, you must reduce the total amount paid for these expenses by certain tax-free amounts, which now include tax-free withdrawals from a QTP.

Tuition and Fees Deduction

Beginning in 2002, you may be able to deduct the expenses of higher education for yourself, your spouse, or a dependent, even if you do not itemize deductions on Schedule A, Form 1040. The expenses must be paid for an eligible student's enrollment or attendance at an eligible educational institution. The maximum deduction for 2002 is $3,000. If your modified adjusted gross income (MAGI) is more than $65,000 ($130,000 for joint returns), you cannot take the deduction. For information, see chapter 4 in Publication 970, *Tax Benefits for Education*.

Coverdell Education Savings Account (ESA)

Beginning in 2002, the following changes apply to Coverdell ESAs. For more information, see chapter 5 in Publication 970, *Tax Benefits for Education*.

Maximum contribution increased. The most you can contribute each year per beneficiary to a Coverdell ESA is increased from $500 to $2,000.

Income limits increased for married couples filing a joint return. If you are married and filing a joint return, the amount you can contribute to a Coverdell ESA will be phased out (gradually reduced) if your modified adjusted gross income (MAGI) is more than $190,000 but less than $220,000. You will not be able to contribute if your MAGI is $220,000 or more. In 2001, the limits for married taxpayers filing joint returns were $150,000 and $160,000.

Contribution due date extended. The final date on which you can make contributions to a Coverdell ESA for any year has been extended from the last day of the year to the due date of your return for that year (not including extensions). If you are a calendar year taxpayer, you generally have until April 15, 2003, to make your contribution for the 2002 tax year.

Contributions to both a Coverdell ESA and a qualified tuition program (QTP) allowed in same year. You can make contributions, without penalty, to a Coverdell ESA even if contributions are also being made to a QTP on behalf of the same designated beneficiary. Before 2002, contributions to the Coverdell ESA that were made in the same year as contributions to a QTP were subject to the additional tax on excess contributions.

Qualified education expenses broadened. Qualified education expenses include certain elementary and secondary education expenses, as well as certain expenses for special needs students. In 2001, the Coverdell ESA only applied to higher education expenses.

Limit on room and board changed. The limit on the amount that is considered reasonable for room and board expenses has changed. The maximum allowance is the greater of the following two amounts.

1) The allowance for room and board, as determined by the eligible educational institution, that was included in the cost of attendance (for federal financial aid purposes) for a particular academic period and living arrangement of the student.
2) The actual amount charged if the student is residing in housing owned or operated by the eligible educational institution.

Age limits waived for special needs beneficiaries. You can make contributions to a Coverdell ESA for a special needs beneficiary after his or her 18th birthday. Also, you can leave assets in a Coverdell ESA set up for a special needs beneficiary after he or she reaches age 30. Prior to 2002, there were no special rules for these beneficiaries.

Coverdell ESA coordinated with Hope and lifetime learning credits. You may be able to claim a Hope or lifetime learning credit in the same year in which the beneficiary takes a tax-free withdrawal from a Coverdell ESA. However, the beneficiary cannot use the expenses on which the credit is based to figure the taxable portion of the withdrawal from the Coverdell ESA. Previously, in order to claim an education credit, the designated beneficiary had to waive tax-free treatment of the withdrawal.

Coverdell ESA coordinated with QTP. If a designated beneficiary takes withdrawals from both a Coverdell ESA and a QTP in the same year, and the total withdrawn is greater than the beneficiary's adjusted qualified higher education expenses, those expenses must be allocated between the withdrawal from the Coverdell ESA and the withdrawal from the QTP before figuring how much of each withdrawal is taxable. Prior to 2002, the earnings portion of QTP distributions was fully taxable.

Definition of family members expanded. For purposes of rollovers and changes of designated beneficiaries, the definition of family members is expanded to include first cousins of the designated beneficiary.

Qualified Tuition Program (QTP)

Beginning in 2002, the following changes apply to QTPs. For more information, see chapter 6 in Publication 970, *Tax Benefits for Education*.

Name changed. Qualified state tuition programs (QSTPs) have been renamed qualified tuition programs (QTPs).

QTPs can be established and maintained by educational institutions. Before 2002, only a state (or an agency or instrumentality of a state) could establish and maintain a QTP. Now you can also make contributions to a QTP established and maintained by one or more eligible educational institutions (generally private colleges and universities). Earnings distributed from privately-sponsored QTPs before 2004 are not eligible for tax-free treatment.

Contributions to both a QTP and a Coverdell education savings account (ESA) allowed in same year. You can make contributions, without penalty, to a QTP even if contributions are also being made to a Coverdell ESA on behalf of the same beneficiary. Before 2002, contributions to the Coverdell ESA that were made in the same year as contributions to a QTP were subject to the additional tax on excess contributions.

Certain expenses of special needs students qualify. The definition of qualified higher education expenses has been expanded to include expenses of a special needs beneficiary that are necessary in connection with that person's enrollment or attendance at an eligible institution.

Limit on room and board changed. The limit on the amount that is considered reasonable for room and board expenses has changed. The maximum allowance is the greater of the following two amounts.

1) The allowance for room and board, as determined by the eligible educational institution, that was included in the cost of attendance (for federal financial aid purposes) for a particular academic period and living arrangement of the student.
2) The actual amount charged if the student is residing in housing owned or operated by the eligible educational institution.

Distributions from state-sponsored QTPs may be tax free. A distribution from a QTP established and maintained by a state (or an agency or instrumentality of the state) can be excluded from income if the amount distributed is used to pay qualified higher education expenses.

Qualified education expenses reduced by tax-free benefits. Before the taxability of any distribution from a QTP can be figured, the designated beneficiary must determine the amount of qualified education expenses that has been covered by other tax-free educational benefits. Only the remaining expenses are used to figure what portion of the distributed earnings is tax free. Tax-free educational assistance includes:

- Scholarships that are excluded from gross income,
- Veterans' educational assistance,
- Pell grants,
- Employer-provided educational assistance, and
- Any other nontaxable payments (other than gifts, bequests, or inheritances) received for education expenses.

QTP coordinated with Hope and lifetime learning credits. You may be able to claim a Hope or lifetime learning credit in the same year in which the beneficiary takes a tax-free distribution from a QTP. However, the QTP beneficiary cannot use the expenses on which the credit is based to figure the nontaxable portion of the QTP distribution.

Any part of the QTP distribution that is taxable only because an education credit was claimed is not subject to the 10% additional tax on taxable distributions.

QTP coordinated with Coverdell ESAs. If the designated beneficiary takes distributions from both a QTP and a Coverdell ESA in the same year, and the total distribution is more than the beneficiary's adjusted qualified higher education expenses, those expenses must be allocated between the distribution from the QTP and the distribution from the Coverdell ESA before figuring how much of each distribution is taxable. Prior to 2002, QTP distributions were fully taxable.

Tax-free rollovers of QTPs allowed to same beneficiary. Amounts in a QTP can be rolled over, tax free, to another QTP set up for the same designated beneficiary. However, only one tax-free rollover of credits or other amounts from one QTP to another QTP for the benefit of the same beneficiary can be made within any 12-month period.

Definition of family members expanded. For purposes of rollovers and changes of designated beneficiaries, the definition of family members is expanded to include first cousins of the designated beneficiary.

Early Withdrawals From IRAs

Beginning in 2002, the following changes apply to early withdrawals from an IRA made for the purpose of paying qualified higher education expenses. For more information, see chapter 7 in Publication 970, *Tax Benefits for Education*.

Certain expenses of special needs students qualify. The definition of qualified higher education expenses has been expanded to include expenses of a special needs beneficiary that are necessary in connection with that person's enrollment or attendance at an eligible institution.

Allowed expenses for room and board changed. The limit on the amount that is considered reasonable for room and board expenses has been changed. The maximum allowance is the greater of the following two amounts.

1) The allowance for room and board, as determined by the eligible educational institution, that was included in the cost of attendance (for federal financial aid purposes) for a particular academic period and living arrangement of the student.
2) The actual amount charged if the student is residing in housing owned or operated by the eligible educational institution.

Education Savings Bond Program

Beginning in 2002, the following changes apply to the education savings bond program. For more information, see chapter 8 in Publication 970, *Tax Benefits for Education*.

New modification to adjusted gross income (AGI). When figuring your modified adjusted gross income (MAGI) for purposes of the education savings bond program, you now must add back to your AGI any qualified tuition and fees deduction (discussed earlier) claimed on Form 1040 or 1040A.

Income limits for exclusion reduction increased. The amount of your interest exclusion will be phased out (gradually reduced) if your filing status is married filing jointly or qualifying widow(er) ***and*** your MAGI is between $86,400 and $116,400. You cannot take the deduction if your MAGI is $116,400 or more. For 2001, the limits that applied to you were $83,650 and $113,650.

If your filing status is single or head of household, your interest exclusion is phased out if your MAGI is between $57,600 and $72,600. You cannot take a deduction if your MAGI is $72,600 or more. For 2001, the limits that applied to you were $55,750 and $70,750.

New adjustment to qualified higher education expenses. When figuring your qualified higher education expenses for purposes of the education savings bond program, you must reduce the total amount of those expenses by certain benefits, which now include tax-free withdrawals from a QTP.

Pending Regulations Defining Special Needs Beneficiary

Publication 970 contains cautions about the definition of a special needs beneficiary. The regulations defining a "special needs beneficiary" have not yet been issued.

You may need this information if you or a student in your family has expenses for special services in connection with enrollment or attendance at an eligible elementary, secondary, or postsecondary school. Beginning in 2002, three education benefits — the Coverdell ESA, the QTP, and the early withdrawal from an IRA—have expanded their definitions of qualified higher education expenses to include expenses for special needs services required by special needs beneficiaries in connection with enrollment or attendance at an eligible educational institution. In the case of the Coverdell ESA, these expenses for special needs beneficiaries are also included in the definition of qualified elementary and secondary education expenses.

Employer-Provided Educational Assistance

The tax-free status of up to $5,250 of employer-provided educational assistance benefits each year has been extended through 2010. Beginning in 2002, it applies to both undergraduate- and graduate-level courses. For more information, see Publication 508, *Tax Benefits for Work-Related Education*.

Medical Savings Accounts (MSAs) Program Extended

A medical savings account (MSA) is a tax-exempt trust or custodial account with a financial institution (like a bank or an insurance company) in which you can save money for future medical expenses. To qualify for an MSA, you must be an employee of a small employer or self-employed. You must also have a high-deductible health plan and have no

other health insurance coverage except permitted coverage. The pilot program for MSAs that was scheduled to end December 31, 2002, has been extended until December 31, 2003. For more information, see Publication 969, *Medical Savings Accounts (MSAs).*

Obesity as a Disease

The cost of participation in a weight-loss program as a treatment for the disease of obesity is an amount paid for medical care. However, the cost of purchasing reduced-calorie diet foods is not a medical expense if these foods substitute for food you would normally consume to satisfy your nutritional requirements. For more information, see *Weight-Loss Program* under *What Medical Expenses Are Deductible* and under *What Expenses Are Not Deductible* in Publication 502, *Medical and Dental Expenses.*

Pending Legislation Regarding Charitable Contributions

There are cautions in Publication 17, *Your Federal Income Tax,* regarding legislation that was pending in the fall of 2002. At that time, Congress was considering legislation that would allow:

1) Individuals to deduct a portion of their charitable contributions even if they do not itemize deductions on Schedule A (Form 1040),
2) An enhanced deduction for charitable contributions made after 2002 of literary, musical, artistic, and scholarly compositions, and
3) Tax-free distributions from IRAs for charitable purposes.

None of these became law in 2002.

Depreciation and Section 179 Deduction

Special depreciation allowance. You can take a special depreciation allowance (or Liberty Zone depreciation allowance) for qualified property (or Liberty Zone property) you place in service during 2002 (and later years). The allowance is an additional deduction of 30% of the property's depreciable basis. See chapter 3 in Publication 946, *How To Depreciate Property.*

Increased section 179 deduction for enterprise zone businesses. You may be able to claim an increased section 179 deduction if your business qualifies as an enterprise zone business. The increase can be as much as $35,000 (up from $20,000) for 2002 and later years, but it cannot be more than the cost of qualified zone property that is section 179 property placed in service in an empowerment zone during the year. See chapter 2 in Publication 946.

For information on empowerment zones and enterprise communities, see Publication 954, *Tax Incentives for Empowerment Zones and Other Distressed Communities.*

Increased section 179 deduction for businesses in the New York Liberty Zone. You may be able to claim an increased section 179 deduction if you place property in service in the New York Liberty Zone (Liberty Zone). The increase can be as much as $35,000 for 2002, but it cannot be more than the cost of qualified property which is section 179 property placed in service during the year. See chapter 2 in Publication 946.

Reduced section 179 dollar limit for Liberty Zone property exceeding $200,000. Generally, you must reduce the dollar limit on the section 179 deduction for a year by the cost of qualifying section 179 property placed in service in the year that is more than $200,000. In 2002, you take into account only 50% (instead of 100%) of the cost of section 179 property that is qualified Liberty Zone property placed in service in the year. See chapter 2 in Publication 946.

Depreciation limits on business cars and electric vehicles. The total section 179 deduction and depreciation (including the special depreciation allowance) you can take on a car (that is not an electric vehicle) you use in your business and first place in service in 2002 is generally $7,660. For an electric vehicle, the amount is generally $22,980. For the maximum depreciation you can deduct in later years, see *Maximum Depreciation Deduction* in chapter 5 of Publication 946.

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. You can deduct a higher percentage if the meals take place during or incident to any period subject to the Department of Transportation's "hours of service" limits. (These limits apply to workers who are under certain federal regulations.) The percentage is 65% for 2002 and 2003. Business meal expenses are covered in chapter 1 of Publication 463, *Travel, Entertainment, Gift, and Car Expenses.*

Self-Employed Health Insurance Deduction

For 2002, this deduction increases to 70% of the amount paid for medical and qualified long-term care insurance for you and your family. For more information, see chapter 7 in Publication 535, *Business Expenses.*

Electric and Clean-Fuel Vehicles

The maximum clean-fuel vehicle deduction and qualified electric vehicle credit were scheduled to be 25% lower for 2002 and both were scheduled to be phased out completely by 2005. The full deduction and credit are now allowed for qualified property placed in service in 2002 and

2003. The phaseout of the deduction and the credit will begin in 2004, and no deduction or credit will be allowed for property placed in service after 2006. For more information about electric and clean-fuel vehicles, see chapter 12 in Publication 535, *Business Expenses.*

Self-Employment Tax

The self-employment tax rate on net earnings remains the same for 2002. 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).

Earnings limit. The maximum amount subject to the social security part for tax years beginning in 2002 has increased to $84,900. All net earnings of at least $400 are subject to the Medicare part.

New Health Insurance Credit

There is a new credit for health insurance premiums paid by certain workers who are displaced by foreign trade or who are receiving a pension from the Pension Benefit Guaranty Corporation. For more information, see *Health Insurance Credit* in Publication 502, *Medical and Dental Expenses,* and Form 8885, *Health Insurance Credit for Eligible Recipients.*

Tax Benefits for Adoption

Beginning in 2002, the following changes apply to the adoption credit and the exclusion from income of benefits from your employer's adoption assistance program. For more information, see Publication 968, *Tax Benefits for Adoption.*

Credit and exclusion extended. The exclusion and the part of the credit that were scheduled to end have been extended.

Dollar limit increased. In general, the maximum credit and exclusion were increased from $5,000 ($6,000 in the case of a child with special needs) to $10,000.

Expenses paid before 2002. The amount of expenses paid or incurred before 2002 that can be taken into account is limited to the pre-2002 dollar limits. This is true even if an adoption became final in 2002, or has not yet become final.

Example. You adopt a child with special needs in 2002. You paid $7,000 of qualified adoption expenses in 2001 and $3,000 of qualified adoption expenses in 2002. The maximum amount of expenses you can take into account for this adoption is $9,000 ($6,000 from 2001 plus $3,000 from 2002).

Income limit. The income limit based on modified adjusted gross income (AGI) is increased. The following table shows whether the income limit will affect your credit or exclusion.

IF your modified AGI is...	THEN the income limit...
$150,000 or less	will not affect your credit or exclusion.
$150,001 to $189,999	will reduce your credit or exclusion.
$190,000 or more	will eliminate your credit or exclusion.

Credit allowed against alternative minimum tax. The provision presently in effect allowing the credit to reduce alternative minimum tax as well as regular income tax has been extended. This provision was originally scheduled to expire in 2002.

Earned Income Credit (EIC)

The following paragraphs explain the changes to the credit for 2002. For more information, see Publication 596, *Earned Income Credit (EIC).*

New definition of earned income. Earned income no longer includes nontaxable employee compensation. Employee compensation is considered earned income and is used to figure the amount of your credit only if the compensation is taxable.

Elimination of modified adjusted gross income (AGI). You no longer need to figure modified AGI. Your credit is figured using your AGI, ***not*** modified AGI.

New rules for persons with same qualifying child. If a child meets the conditions to be a qualifying child of more than one person, only one person may treat that child as a qualifying child and claim the EIC using that child. You and the other person(s) can decide who will claim the credit using that qualifying child. But if you and the other person(s) cannot agree and more than one person claims the credit using the same child, the child can be treated as a qualifying child only by:

1) The parent, if only one of the persons is the child's parent,
2) The parent with whom the child lived the longest period of time during the year, if two of the persons are parents of the child and they do not file a joint return together,
3) The parent with the highest AGI, if the child lived with each parent for the same amount of time during the year and the child's parents do not file a joint return together, or
4) The person with the highest AGI, if none of the persons is the child's parent.

New rule for eligible foster child. An eligible foster child has to live with you for more than half of the year. Previously, the child must have lived with you the entire year.

Increased EIC on certain joint returns. A married person filing a joint return now may get more EIC than some-

one with the same income but a different filing status. As a result, the EIC table now has different columns for married persons filing jointly than for everyone else. When you look up your EIC in the EIC Table, be sure to use the correct column for your filing status.

Earned income amount is more. The maximum amount of income you can earn and still get the credit has increased. You may be able to take the credit if:

- You have more than one qualifying child and you earned less than $33,178 ($34,178 if married filing jointly),
- You have one qualifying child and you earned less than $29,201 ($30,201 if married filing jointly), or
- You do not have a qualifying child and you earned less than $11,060 ($12,060 if married filing jointly).

Your AGI also must be less than the amount in the above list that applies to you.

Investment income amount is more. The maximum amount of investment income you can have and still get the credit has increased to $2,550.

Reduction of EIC by alternative minimum tax eliminated. Your credit is no longer reduced by the amount of alternative minimum tax shown on your return.

Personal Credits Still Allowed Against Alternative Minimum Tax

The provision that allowed certain nonrefundable personal credits to reduce both your regular tax and any alternative minimum tax (AMT) has been extended and will be in effect for 2002 and 2003. This provision, as it applies to the AMT, was originally scheduled to expire after 2001. Without the extension, these credits could not have been used to reduce any AMT in 2002 or 2003.

5-Year Carryback for Net Operating Losses (NOLs)

If you have an NOL from a tax year ending during 2001 or 2002, you must generally carry back the entire amount of the NOL to the 5 tax years before the NOL year (the carryback period). However, you can still choose to use the previous carryback period of 2 or, if applicable, 3 tax years before the NOL year. You can also choose not to carry back an NOL and only carry it forward. For more information, see *When To Use an NOL* in Publication 536, *Net Operating Losses (NOLs) for Individuals, Estates, and Trusts.*

Tax-Exempt Bond Financing for Qualified Public Educational Facilities

The private activities for which state and local tax-exempt bonds may be issued have been expanded to include providing qualified public educational facilities.

A qualified public educational facility is any school facility that is:

1) Part of a public elementary school or a public secondary school, and
2) Owned by a private, for-profit corporation under a public-private partnership agreement with a state or local educational agency.

The issuer of the bond should be able to tell you whether the bond is tax-exempt.

Tax Shelter Disclosure Statement

For each ***reportable tax shelter transaction*** in which you participated directly or indirectly, you must attach a disclosure statement to your return for each year that your tax liability is affected by your participation in the transaction. In addition, for the first year a disclosure statement is attached to your return, you must send a copy to:

Internal Revenue Service
LM:PFTG:OTSA
Large & Mid-Size Business Division
1111 Constitution Avenue, NW
Washington, DC 20224.

Disclosure is required for a reportable transaction that is a listed transaction. A transaction is a listed transaction if it is the same as or substantially similar to a transaction determined to be a tax avoidance transaction and identified as a listed transaction in a notice, regulation, or other published guidance. For example, Notice 2001–51, in Internal Revenue Bulletin 2001–34, identifies certain listed transactions.

See section 1.6011–4T of the regulations for more details including:

- Definitions of “reportable transaction,” “listed transaction,” and “substantially similar.”
- Form and content of the disclosure statement.
- Filing requirements for the disclosure statement.

Certain transactions not previously classified as reportable transactions must also be disclosed if entered into after December 31, 2002. For more information, see Disclosure of Reportable Transactions *under* 2003 Changes.

Fast Track Mediation

The IRS now offers fast track mediation services to help taxpayers promptly resolve many disputes resulting from:

- Examinations (audits),
- Offers in compromise,
- Trust fund recovery penalties, and
- Other collection actions.

For more information, see Publication 3605, *Fast Track Mediation,* or visit **www.irs.gov/appeals.**

2003 Changes

Standard Mileage Rate

Business-related mileage. For 2003, the standard mileage rate for the cost of operating your car, van, pickup, or panel truck is decreased to 36 cents a mile for all business miles.

Car expenses and use of the standard mileage rate are explained in chapter 4 of Publication 463, *Travel, Entertainment, Gift, and Car Expenses.*

Medical and move-related mileage. For 2003, the standard mileage rate for the cost of operating your car for medical reasons or as part of a deductible move is decreased to 12 cents a mile. See *Transportation* under *What Medical Expenses Are Deductible* in Publication 502, *Medical and Dental Expenses*, or *Travel by car* under *Deductible Moving Expenses* in Publication 521, *Moving Expenses*.

Social Security and Medicare Taxes

For 2003, 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 2003 wages subject to the tax has increased to $87,000. For Medicare tax, all covered 2003 wages are subject to the tax. For information about these taxes, see Publication 15, *Circular E, Employer's Tax Guide.*

Household employees. The $1,300 social security and Medicare wage threshold for household employees has been increased to $1,400 for 2003. This means that if you pay a household employee cash wages of less than $1,400 in 2003, you do not have to report and pay social security and Medicare taxes on that employee's 2003 wages. For more information on household employment taxes, see Publication 926, *Household Employer's Tax Guide.*

Self-Employed Health Insurance Deduction

For 2003, this deduction increases to 100% of the amount paid for medical and qualified long-term care insurance for you and your family. For more information, see chapter 7 in Publication 535, *Business Expenses*.

Self-Employment Tax

The self-employment tax rate on net earnings remains the same for 2003. 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 2003 has increased to $87,000. All net earnings of at least $400 are subject to the Medicare part.

Depreciation and Section 179 Deduction

Increased section 179 deduction. The total cost of section 179 property that you can elect to deduct is increased from $24,000 to $25,000 beginning in 2003. For more information on the section 179 deduction, see chapter 2 in Publication 946, *How To Depreciate Property*.

Coverdell Education Savings Account (ESA)

There will be no additional tax on excess contributions if the excess (and earnings on that amount) is withdrawn before the beginning of the sixth month following the year of the contribution. Generally, a calendar year taxpayer will have until May 31, 2003, to withdraw an excess contribution for 2002. Previously, excess contributions (and earnings) had to be withdrawn by the due date (including extensions) for filing the beneficiary's tax return or, if no return was required, by April 15 of the following year. The Coverdell ESA is explained in chapter 5 of Publication 970, *Tax Benefits for Education*.

Lifetime Learning Credit

Beginning in 2003, the amount of qualified tuition and related expenses you may take into account in figuring the lifetime learning credit increases from $5,000 to $10,000. The credit will equal 20% of these qualified expenses, with the maximum credit being $2,000. The lifetime learning credit is explained in chapter 2 of Publication 970, *Tax Benefits for Education*.

Child and Dependent Care Credit Increase

Beginning in 2003, the following changes will be made to the child and dependent care credit. For details on this credit, see Publication 503, *Child and Dependent Care Credit.*

Credit percentage. The credit will be as much as 35% of your qualified expenses. The 35% rate will be reduced if your adjusted gross income is more than $15,000. For 2002, the credit could be no more than 30% of qualified expenses, and the 30% rate was reduced if adjusted gross income was more than $10,000.

Dollar limit. The limit on the amount of qualifying expenses will increase to $3,000 for one qualifying individual and to $6,000 for two or more qualifying individuals. For 2002, the amounts were $2,400 and $4,800 respectively.

Earned income amount for student-spouse or spouse not able to care for self. The amount of earned income your spouse, who is either a full-time student or not able to care for himself or herself, is treated as having earned is increased to $250 a month if there is one qualifying person and to $500 a month if there are two or more qualifying persons. For 2002, the amounts were $200 and $400 respectively.

Tax Benefits for Adoption Increased

Beginning in 2003, the maximum adoption credit or exclusion increases to $10,160. In the case of the adoption of a child with special needs, this amount will be allowed regardless of whether you have qualifying expenses. See Publication 968, *Tax Benefits for Adoption,* for more information.

Estimated Tax Requirements for Higher Income Taxpayers

For installment payments for tax years beginning in 2003, the estimated tax 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 have to pay the smaller of 90% of your expected tax for 2003 or ***110%*** of the tax shown on your 2002 return to avoid an estimated tax penalty. See Publication 505, *Tax Withholding and Estimated Tax,* for more information.

Health Insurance Credit

At a date to be announced in 2003, an older worker eligible for the alternative trade adjustment assistance program can qualify for the health insurance credit if he or she:

1) Is covered by a qualifying certification,
2) Is reemployed not more than 26 weeks after the date of separation from the adversely-affected employment,
3) Is at least 50 years of age,
4) Does not earn more than $50,000 a year in wages from reemployment,
5) Is employed on a full-time basis, and
6) Does not return to the employment from which he or she was separated.

More information will be available when the program begins.

Disclosure of Reportable Transactions

For each ***reportable transaction*** that you enter into after 2002 and in which you participated directly or indirectly, you must attach Form 8886, *Reportable Transaction Disclosure Statement,* to your return for each year that your tax liability is affected by your participation in the transaction. In addition, for the first year you disclose a reportable transaction, you must send a copy to:

Internal Revenue Service
LM:PFTG:OTSA
Large & Mid-Size Business Division
1111 Constitution Avenue, NW
Washington, DC 20224.

Reportable transaction. A reportable transaction is a transaction or series of transactions described in one or more of the following six categories.

1) **Listed transactions.** This category includes transactions that are the same as or substantially similar to one of the types of transactions that the IRS has determined to be a tax avoidance transaction. These transactions are identified by notice, regulation, or other form of published guidance as a listed transaction. For existing guidance, see the instructions for Form 8886. There may be subsequent guidance identifying additional listed transactions.
2) **Confidential transactions.** This category includes transactions that are offered under conditions of confidentiality. See section 1.6011-4T(b)(3) of the regulations for more information.
3) **Transactions with contractual protection.** This category includes transactions for which you have or expect to have contractual protection against the possibility that part or all of the intended tax benefits from the transaction will not be sustained.
4) **Loss transactions.** For individuals, this category includes transactions that result in, or are likely to result in, a gross loss (before netting any gain against it) of at least $2 million in any single tax year or $4 million in any combination of tax years. The loss amount is at least $50,000 for a single tax year if the loss involves a foreign currency transaction defined in section 988(c)(1) of the Internal Revenue Code. Different limits apply to corporations, partnerships, and S corporations.
5) **Transactions with significant book-tax differences.** This category includes transactions in which the treatment for federal income tax purposes of any income, deduction, or credit item or items from the transaction differs, or is reasonably expected to differ, by more than $10 million on a gross basis from the treatment of these items for book purposes in any tax year. This category applies only to:

a) Reporting companies under the Securities Exchange Act and related entities (as defined in sections 267(b) and 707(b) of the Internal Revenue Code), or

b) Business entities that have $100 million or more in gross assets, including the assets of all related entities (as defined in sections 267(b) and 707(b) of the Internal Revenue Code).

6) **Transactions with brief asset holding periods.** This category includes transactions with both of the following characteristics.

a) The transaction involves an asset(s) held by an investor for less than 45 days. To determine the asset's holding period, see section 246(c)(3) and (4) of the Internal Revenue Code.

b) The transaction results in a tax credit (including a foreign tax credit) exceeding $250,000.

More information. For more information and exceptions to these rules, see Form 8886 and its instructions.

For the disclosure rules that apply to transactions entered into before 2003, see *Tax Shelter Disclosure Statement* under *2002 Changes.*

At the time this publication was being prepared for print, the regulations relating to reportable transactions were expected to be revised. The revised regulations will permit taxpayers who entered into transactions after 2002 and before the filing date of the revised regulations to elect to apply the revised regulations instead of the rules described here.

Later Change

Special Liberty Zone Depreciation Allowance for New and Used Property

You can claim the special Liberty Zone depreciation allowance (an additional 30% depreciation deduction) for used property that you acquire after September 10, 2001, if the property meets the requirements for qualified Liberty Zone property. You will be able to claim the allowance for both new and used property that you acquire after September 10, 2004, provided the property meets the other requirements for qualified Liberty Zone property. See chapter 3 in Publication 946, *How To Depreciate Property*.

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Tax Changes for Businesses

2002 Changes

Nonaccrual-Experience Method

Under current law, if you perform services and use an accrual method of accounting, you do not accrue income that, based on experience, you expect to be uncollectible. Beginning in 2002, this rule only applies if you perform services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, and consulting, or your average annual gross receipts for the 3 prior tax years does not exceed $5,000,000. As under current law, the nonaccrual-experience method will not apply to amounts on which you charge interest or a late payment penalty. For more information, see *Nonaccrual-Experience Method* in chapter 11 of Publication 535, *Business Expenses.*

Approval Process for Change of Accounting Period

The Internal Revenue Service has issued new rules for getting approval to adopt, change, or retain an annual accounting period (tax year). Revenue Procedure 2002−37 contains the automatic approval procedures for corporations; Revenue Procedure 2002−38 contains the automatic approval procedures for partnerships, S corporations, and personal service corporations; Revenue Procedure 2002−39 contains the prior approval procedures for any taxpayer that cannot get approval under automatic procedures. These revenue procedures can be found in Internal Revenue Bulletin 2002−22. For more information on the new rules, see Publication 538, *Accounting Periods and Methods*.

Standard Mileage Rate Increased

Business-related mileage. For 2002, the standard mileage rate for the cost of operating your car, van, pickup, or panel truck is increased to 36½ cents a mile for all business miles.

Car expenses and use of the standard mileage rate are explained in chapter 4 of Publication 463, *Travel, Entertainment, Gift, and Car Expenses.*

Meal Expenses When Subject to "Hours of Service" Limits

For 2002 and 2003 you can deduct 65% of the reimbursed meals your employees consume while away from their tax home on business during, or incident to, any period subject to the Department of Transportation's "hours of service" limits. For more information, see chapter 13 in Publication 535, *Business Expenses.*

Self-Employed Health Insurance Deduction

For 2002, this deduction increases to 70% of the amount paid for medical and qualified long-term care insurance for you and your family. For more information, see chapter 7 in Publication 535, *Business Expenses*.

Environmental Cleanup Cost Deduction

The deduction for qualified environmental cleanup (remediation) costs was scheduled to expire for costs paid or incurred after 2001. It has been extended to include costs you pay or incur before 2004. For more information on the environmental cleanup cost deduction, see chapter 8 in Publication 535, *Business Expenses*.

Depreciation and Section 179 Deduction

Special depreciation allowance. You can take a special depreciation allowance (or Liberty Zone depreciation allowance) for qualified property (or Liberty Zone property) you place in service during 2002 (and later years). The allowance is an additional deduction of 30% of the property's depreciable basis. See chapter 3 in Publication 946, *How To Depreciate Property*.

Increased section 179 deduction for enterprise zone businesses. You may be able to claim an increased section 179 deduction if your business qualifies as an enterprise zone business. The increase can be as much as $35,000 (up from $20,000) for 2002 and later years, but it cannot be more than the cost of qualified zone property that is section 179 property placed in service in an empowerment zone during the year. See chapter 2 in Publication 946.

For information on empowerment zones and enterprise communities, see Publication 954, *Tax Incentives for Empowerment Zones and Other Distressed Communities*.

Increased section 179 deduction for businesses in the New York Liberty Zone. You may be able to claim an increased section 179 deduction if you place property in service in the New York Liberty Zone (Liberty Zone). The increase can be as much as $35,000 for 2002, but it cannot be more than the cost of qualified property which is section 179 property placed in service during the year. See chapter 2 in Publication 946.

Reduced section 179 dollar limit for Liberty Zone property exceeding $200,000. Generally, you must reduce the dollar limit on the section 179 deduction for a year by the cost of qualifying section 179 property placed in service in the year that is more than $200,000. In 2002, you take into account only 50% (instead of 100%) of the cost of section 179 property that is qualified Liberty Zone property placed in service in the year. See chapter 2 in Publication 946.

Depreciation limits on business cars and electric vehicles. The total section 179 deduction and depreciation (including the special depreciation allowance) you can take on a car (that is not an electric vehicle) you use in your business and first place in service in 2002 is generally $7,660. For an electric vehicle the amount is generally $22,980. For the maximum depreciation you can deduct in later years, see *Maximum Depreciation Deduction* in chapter 5 of Publication 946.

Marginal Production of Oil and Gas

The suspension of the taxable income limit on percentage depletion for the marginal production of oil and natural gas, which was scheduled to expire for tax years beginning after 2001, has been extended to tax years beginning before 2004. For more information on marginal production, see section 613A(c)(6) of the Internal Revenue Code.

Self-Employment Tax

The self-employment tax rate on net earnings remains the same for 2002. 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 2002 has increased to $84,900. All net earnings of at least $400 are subject to the Medicare part.

Credit for Employer-Provided Child Care

If you are an employer, you can receive a tax credit of 25% of your child care expenses and 10% of your qualified child care resource and referral expenses. This credit cannot be more than $150,000 each year.

Qualified child care expenses. Expenses that qualify for this credit include the following.

- Expenses to acquire, construct, rehabilitate, or expand depreciable property for use as a qualified child care facility. This property cannot be part of your or your employee's main home.
- Expenses to operate a qualified child care facility. These include costs related to training employees, scholarship programs, and any increased compensation to employees with higher levels of child care training.

- Expenses paid to a qualified child care facility under contract to provide child care services to your employees.

Qualified child care expenses do not include expenses in excess of the fair market value of the care.

Qualified child care resource and referral expenses. These expenses are amounts you paid or incurred under contract to provide child care resource and referral services to your employees. You cannot claim the credit on these expenses if the services offered discriminate in favor of your highly compensated employees.

More information. For more information, get Form 8882, *Credit for Employer-Provided Child Care Facilities and Services.*

Credit for Pension Plan Startup Costs

If you are an eligible employer who begins a new pension plan for your employees, you may be able to receive a tax credit of 50% of the first $1,000 of qualified startup costs of the plan. The credit is available for each of the first 3 years of the plan.

Eligible employer. You are an eligible employer if, during the preceding year, you had 100 or fewer employees who received at least $5,000 of compensation.

Qualified startup costs. Qualified startup costs are any ordinary and necessary expenses you pay to:

- Begin or administer an eligible employer plan, or
- Educate your employees about the plan.

Effective date. The tax credit for pension plan startup costs is allowed for plans that ***become effective*** after 2001.

More information. For more information, get Form 8881, *Credit for Small Employer Pension Plan Startup Costs.*

Welfare-to-Work Credit Extended

The welfare-to-work credit that was scheduled to expire for wages paid to individuals who began working for you after 2001 has been extended to include wages paid to qualified individuals who begin work for you in 2002 or 2003. For more information on the welfare-to-work credit, see Publication 954, *Tax Incentives for Empowerment Zones and Other Distressed Communities.*

Work Opportunity Credit Extended

The work opportunity credit that was scheduled to expire for wages paid to individuals who began working for you after 2001 has been extended to include wages paid to qualified individuals who begin work for you in 2002 or 2003. For more information about the work opportunity credit, see Publication 954, *Tax Incentives for Empowerment Zones and Other Distressed Communities.*

New York Liberty Zone Business Employee Credit

The work opportunity credit is expanded to include a new targeted group consisting generally of employees who perform substantially all their services:

- In the New York Liberty Zone, or
- Elsewhere in New York City for a business that relocated from the Liberty Zone due to the destruction or damage of its place of business by the September 11, 2001, terrorist attack.

This part of the work opportunity credit is called the New York Liberty Zone business employee credit. The credit is available to employers for wages paid to new employees and existing employees for work performed during 2002 or 2003. Certain limits apply. For more information, get Form 8884, *New York Liberty Zone Business Employee Credit.*

Electric and Clean-Fuel Vehicles

The maximum clean-fuel vehicle deduction and qualified electric vehicle credit were scheduled to be 25% lower for 2002 and both were scheduled to be phased out completely by 2005. The full deduction and credit are now allowed for qualified property placed in service in 2002 and 2003. The phaseout of the deduction and the credit will begin in 2004, and no deduction or credit will be allowed for property placed in service after 2006. For more information about electric and clean-fuel vehicles, see chapter 12 in Publication 535, *Business Expenses.*

Tax Incentives for Empowerment Zones and Renewal Communities

Beginning in 2002, certain tax benefits available to businesses in empowerment zones are increased or otherwise enhanced. In addition, businesses in areas that have been designated renewal communities become eligible for tax incentives such as a 15% renewal community employment credit, special cost recovery for commercial revitalization expenses, an increased section 179 deduction, and paying no tax on any capital gain from the sale of certain qualifying assets. For more information, see Publication 954, *Tax Incentives for Empowerment Zones and Other Distressed Communities.*

Qualified Zone Academy Bonds

State and local governments issue qualified zone academy bonds to raise funds for the use of qualified zone academies. The amount of bonds that may be issued was limited to $400 million each year for 1998, 1999, 2000, and 2001. This provision has been extended to provide for an additional $400 million of bonds to be issued each year for 2002 and 2003. For more information about qualified zone academy bonds, see Publication 954, *Tax Incentives for Empowerment Zones and Other Distressed Communities.*

Peanut Quota Buyout Program Payments

The marketing quota program for peanuts was repealed effective May 13, 2002. The USDA will pay eligible peanut quota holders for the loss in value of peanut quotas resulting from the repeal. The payments received by quota holders are subject to federal income tax. For more information, see chapter 4 in Publication 225, *Farmer's Tax Guide*.

Tax Shelter Disclosure Statement

For each ***reportable tax shelter transaction*** in which you participated directly or indirectly, you must attach a disclosure statement to your return for each year that your tax liability is affected by your participation in the transaction. This requirement now applies to individuals, trusts, partnerships, S corporations, and regular corporations. Previously, it only applied to regular corporations. A partnership or S corporation must attach a disclosure statement to its return for each year that any partner or shareholder's tax liability is affected or is reasonably expected to be affected by its participation in the transaction. In addition, for the first year a disclosure statement is attached to your return, you must send a copy to:

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Large & Mid-Size Business Division
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Washington, DC 20224.

Disclosure is required for a reportable transaction that is a listed transaction. A transaction is a listed transaction if it is the same as or substantially similar to a transaction determined to be a tax avoidance transaction and identified as a listed transaction in a notice, regulation, or other published guidance. For example, Notice 2001−51, in Internal Revenue Bulletin 2001−34, identifies certain listed transactions.

See section 1.6011−4T of the regulations for more details including:

- Definitions of "reportable transaction," "listed transaction," and "substantially similar."
- Form and content of the disclosure statement.
- Filing requirements for the disclosure statement.

Certain transactions not previously classified as reportable transactions must also be disclosed if entered into after December 31, 2002. For more information, see Disclosure of Reportable Transactions *under* 2003 Changes, *later.*

Electronic Form 1099

For tax years ending after March 9, 2002, Form 1099 can be issued electronically if the recipient consents to receive it that way.

Fast Track Mediation

The IRS now offers fast track mediation services to help taxpayers promptly resolve many disputes resulting from:

- Examinations (audits),
- Offers in compromise,
- Trust fund recovery penalties, and
- Other collection actions.

For more information, see Publication 3605, *Fast Track Mediation,* or visit **www.irs.gov/appeals**.

Tax Schedules for Corporations

If a corporation's total receipts for the tax year ***and*** its total assets at the end of the tax year are less than $250,000, it generally is no longer required to complete Form 1120 Schedules L, M−1, and M−2 (Parts III and IV of Form 1120−A). For more information, see the *Instructions for Forms 1120 and 1120−A*.

New Publication on Home-Based Business Tax Avoidance Schemes

The Internal Revenue Service has released Publication 4035, *Home-Based Business Tax Avoidance Schemes*. The schemes described in the publication claim to offer tax relief but actually result in illegal tax avoidance.

Reporting Deemed Sales of Assets Under Section 338

A corporation that is either an old target corporation or a new target corporation in a transaction involving the deemed sale of corporate assets under section 338 of the Internal Revenue Code must file new Form 8883, *Asset Allocation Statement Under Section 338,* to report information concerning the transactions. Form 8883 includes information previously reported on Form 8023, *Elections Under Section 338 for Corporations Making Qualified Stock Purchases.* Continue to file Form 8023 to make qualified stock purchase elections under section 338, in addition to filing Form 8883. Moving the information reporting for a section 338 transaction to the new Form 8883 makes it easier to file a timely election on Form 8023. For details, see the instructions for Form 8883 and Form 8023.

2003 Changes

Standard Mileage Rate

Business-related mileage. For 2003, the standard mileage rate for the cost of operating your car, van, pickup, or panel truck is decreased to 36 cents a mile for all business miles.

Car expenses and use of the standard mileage rate are explained in chapter 4 of Publication 463, *Travel, Entertainment, Gift, and Car Expenses.*

Self-Employed Health Insurance Deduction

For 2003, this deduction increases to 100% of the amount paid for medical and qualified long-term care insurance for you and your family. For more information, see chapter 7 in Publication 535, *Business Expenses*.

Social Security and Medicare Taxes

For 2003, 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 2003 wages subject to the tax has increased to $87,000. For Medicare tax, all covered 2003 wages are subject to the tax. For information about these taxes, see Publication 15, *Circular E, Employer's Tax Guide.*

Household employees. The $1,300 social security and Medicare wage threshold for household employees has been increased to $1,400 for 2003. This means that if you pay a household employee cash wages of less than $1,400 in 2003, you do not have to report and pay social security and Medicare taxes on that employee's 2003 wages. For more information on household employment taxes, see Publication 926, *Household Employer's Tax Guide.*

Depreciation and Section 179 Deduction

Increased section 179 deduction. The total cost of section 179 property that you can elect to deduct is increased from $24,000 to $25,000 beginning in 2003. For more information on the section 179 deduction, see chapter 2 in Publication 946, *How To Depreciate Property*.

Self-Employment Tax

The self-employment tax rate on net earnings remains the same for 2003. 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 2003 has increased to $87,000. All net earnings of at least $400 are subject to the Medicare part.

Disclosure of Reportable Transactions

For each ***reportable transaction*** that you enter into after 2002 and in which you participated directly or indirectly, you must attach Form 8886, *Reportable Transaction Disclosure Statement,* to your return for each year that your tax liability is affected by your participation in the transaction. A partnership or S corporation must attach Form 8886 to its return for each year that any partner or shareholder's tax liability is affected or is reasonably expected to be affected by its participation in the transaction. In addition, for the first year you disclose a reportable transaction, you must send a copy to:

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1111 Constitution Avenue, NW
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Reportable transaction. A reportable transaction is a transaction or series of transactions described in one or more of the following six categories.

1) **Listed transactions.** This category includes transactions that are the same as or substantially similar to one of the types of transactions that the IRS has determined to be a tax avoidance transaction. These transactions are identified by notice, regulation, or other form of published guidance as a listed transaction. For existing guidance, see the instructions for Form 8886. There may be subsequent guidance identifying additional listed transactions.
2) **Confidential transactions.** This category includes transactions that are offered under conditions of confidentiality. See section 1.6011-4T(b)(3) of the regulations for more information.
3) **Transactions with contractual protection.** This category includes transactions for which you have or expect to have contractual protection against the possibility that part or all of the intended tax benefits from the transaction will not be sustained.
4) **Loss transactions.** For individuals, this category includes transactions that result in, or are likely to result in, a gross loss (before netting any gain against it) of at least $2 million in any single tax year or $4 million in any combination of tax years. The loss amount is at least $50,000 for a single tax year if the loss involves a foreign currency transaction defined in section 988(c)(1) of the Internal Revenue Code. For corporations, this category includes trans-

actions that result in, or are likely to result in, a gross loss (before netting any gain against it) of at least $10 million in any single tax year or $20 million in any combination of tax years. For partnerships and S corporations, this category includes transactions that result in, or are likely to result in, a gross loss (before netting any gain against it) of at least $5 million in any single tax year or $10 million in any combination of tax years.

5) **Transactions with significant book-tax differences.** This category includes transactions in which the treatment for federal income tax purposes of any income, deduction, or credit item or items from the transaction differs, or is reasonably expected to differ, by more than $10 million on a gross basis from the treatment of these items for book purposes in any tax year. This category applies only to:
   a) Reporting companies under the Securities Exchange Act and related entities (as defined in sections 267(b) and 707(b) of the Internal Revenue Code), or
   b) Business entities that have $100 million or more in gross assets, including the assets of all related entities (as defined in sections 267(b) and 707(b) of the Internal Revenue Code).

6) **Transactions with brief asset holding periods.** This category includes transactions with both of the following characteristics.
   a) The transaction involves an asset(s) held by an investor for less than 45 days. To determine the asset's holding period, see section 246(c)(3) and (4) of the Internal Revenue Code.
   b) The transaction results in a tax credit (including a foreign tax credit) exceeding $250,000.

More information. For more information and exceptions to these rules, see Form 8886 and its instructions.

For the disclosure rules that apply to transactions entered into before 2003, see *Tax Shelter Disclosure Statement* under *2002 Changes.*

At the time this publication was being prepared for print, the regulations relating to reportable transactions were expected to be revised. The revised regulations will permit taxpayers who entered into transactions after 2002 and before the filing date of the revised regulations to elect to apply the revised regulations instead of the rules described here.

Later Changes

Extension of Placed-in-Service Date

To qualify for the special depreciation allowance, your property must meet certain tests, including the placed in service date test, as well as certain other requirements (covered in chapter 3 of Publication 946, *How To Depreciate Property*). To meet the placed in service date test, your property must generally be placed in service for use in your trade or business or for the production of income after September 10, 2001, and before January 1, 2005. However, certain property placed in service before January 1, 2006, may meet this test. Transportation property and property with a recovery period of 10 years or longer meet the test if one of the following applies.

- The property has an estimated production period of more than 2 years.
- The property has an estimated production period of more than 1 year and it costs more than $1 million.

Transportation property is any tangible personal property used in the trade or business of transporting persons or property.

For property that qualifies for the special depreciation allowance solely because of the one-year extension of the placed in service date, only the part of the basis attributable to manufacture, construction, or production before September 11, 2004, is eligible for the special depreciation allowance.

Special Liberty Zone Depreciation Allowance for New and Used Property

You can claim the special Liberty Zone depreciation allowance (an additional 30% depreciation deduction) for used property that you acquire after September 10, 2001, if the property meets the requirements for qualified Liberty Zone property. You will be able to claim the allowance for both new and used property that you acquire after September 10, 2004, provided the property meets the other requirements for qualified Liberty Zone property. See chapter 3 in Publication 946, *How To Depreciate Property*.

Depreciation of Property Used on Indian Reservations

The special depreciation rules that apply to qualified property used on an Indian reservation were scheduled to expire for property placed in service after 2003. These special rules have been extended to include property placed in service in 2004. For more information about these rules, see Publication 946, *How To Depreciate Property.*

Indian Employment Credit Extended

The Indian employment credit that was scheduled to expire for tax years beginning after 2003 has been extended to include a tax year beginning in 2004. For more information about this credit, see Publication 954, *Tax Incentives for Empowerment Zones and Other Distressed Communities.*

3.

IRAs and Other Retirement Plans

2002 Changes

New Retirement Savings Contributions Credit

For tax years beginning after 2001, if you are an eligible individual, you may be able to claim a credit for a percentage of your qualified retirement savings contributions, such as contributions to your traditional or Roth IRA or salary reduction contributions to your SEP or SIMPLE plan. To be eligible, you must be at least age 18 at the end of the year and not a student or an individual for whom someone else claims a personal exemption. Also, your adjusted gross income (AGI) must be below a certain amount.

For more information, see chapter 5 in Publication 590, *Individual Retirement Arrangements (IRAs),* and Form 8880, *Credit for Qualified Retirement Savings Contributions.*

Individual Retirement Arrangements (IRAs)

Beginning in 2002, the following changes apply to IRAs. For more information, see Publication 590, *Individual Retirement Arrangements (IRAs).*

Increased Traditional IRA Contribution and Deduction Limit

Generally, the most that can be contributed to your traditional IRA is the lesser of:

- Your taxable compensation, or
- ***$3,000*** (up from $2,000).

If you are age 50 or older by the end of 2002, the most that can be contributed to your traditional IRA generally is the lesser of:

- Your taxable compensation, or
- ***$3,500*** (up from $2,000).

Besides being able to contribute a larger amount for 2002, you may be able to deduct a larger amount. See *How Much Can I Deduct?* in chapter 1 of Publication 590.

Increased Roth IRA Contribution Limit

If contributions on your behalf are made only to Roth IRAs, your contribution limit generally is the lesser of:

- Your taxable compensation, or
- ***$3,000*** (up from $2,000).

If you are age 50 or older by the end of 2002 and contributions on your behalf are made only to Roth IRAs, your contribution limit generally is the lesser of:

- Your taxable compensation, or
- ***$3,500*** (up from $2,000).

However, if your modified AGI is above a certain amount, your contribution limit may be reduced.

Limit if Contributions to Both Traditional and Roth IRAs for Same Year

If contributions are made on your behalf for 2002 to both a Roth IRA and a traditional IRA, your contribution limit generally is the lesser of :

- Your taxable compensation minus all contributions (other than employer contributions under a SEP or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs, or
- ***$3,000*** (***$3,500*** if you are age 50 or older by the end of 2002) (up from $2,000) minus all contributions (other than employer contributions under a SEP or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs.

However, if your modified AGI is above a certain amount, your contribution limit may be reduced.

Modified AGI Limit for Traditional IRA Contributions Increased

If you are covered by a retirement plan at work, your deduction for contributions to a traditional IRA will be reduced (phased out) if your modified adjusted gross income (AGI) is between:

- $54,000 and $64,000 for a married couple filing a joint return or a qualifying widow(er),
- $34,000 and $44,000 for a single individual or head of household, or
- $−0− and $10,000 for a married individual filing a separate return.

For all filing statuses other than married filing separately, the upper and lower limits of the phaseout range increased by $1,000.

New Rollovers from a Traditional IRA

You can roll over, tax free, a distribution from your traditional IRA into a qualified plan, including a deferred compensation plan of a state or local government (section 457 plan) and a tax-sheltered annuity (section 403(b) plan). The part of the distribution that you can roll over is the part that would otherwise be taxable (includible in your income). Qualified plans may, but are not required to, accept such rollovers.

Rollovers of Distributions from Employer Plans

You can roll over both the taxable and nontaxable part of a distribution from a qualified plan into a traditional IRA. If you have both deductible and nondeductible contributions in your IRA, you will have to keep track of your basis so you will be able to determine the taxable amount once distributions from the IRA begin.

Change of Method Allowed in Computing IRA Distributions

Generally, if you begin receiving distributions from your traditional IRA before you are age 59½, you must pay a 10% additional tax on the part of those distributions that you must include in income. However, if you began receiving substantially equal periodic payments using a certain method, you generally do not have to pay the additional tax unless you change methods. You may now be able to change the method you use to calculate your distribution from the “fixed amortization method” or the “fixed annuitization method” to the required minimum distribution method and still not have to pay the additional tax.

Required Minimum Distributions

When determining the amount of a required minimum distribution for 2002, you can use the rules in either the 2001 or 2002 edition of Publication 590.

Qualified Plans

The following changes apply to qualified plans. For more information, see Publication 560, *Retirement Plans for Small Business.*

Deduction Limits Changed

For years beginning after 2001, the following deduction limits apply.

Profit-sharing plans. The maximum deduction for contributions to a profit-sharing plan is increased to 25% of the compensation paid or accrued during the year to your eligible employees participating in the plan. Compensation for figuring the deduction for contributions includes elective deferrals.

Defined benefit plans. The maximum deduction for contributions can be as much as the plan’s unfunded current liability.

Elective deferrals. Elective deferrals will not be subject to the deduction limits that apply to qualified plans. Also, elective deferrals are not taken into account when figuring the amount you can deduct for employer contributions that are not elective deferrals.

Elective Deferrals (401(k) Plans)

The limit on elective deferrals for participants in 401(k) plans (excluding SIMPLE plans) increases for tax years beginning after 2001, as follows.

Year	Limit
2002	$11,000
2003	12,000
2004	13,000
2005	14,000
2006 and later years	15,000

Note. The $15,000 limit is subject to adjustment after 2006 for cost-of-living increases.

Catch-up contributions. For tax years beginning after 2001, a plan can permit participants who are age 50 or older at the end of the calendar year to make catch-up contributions, as follows.

Year	Catch-Up Limit
2002	$1,000
2003	2,000
2004	3,000
2005	4,000
2006 and later years	5,000

Note. The $5,000 limit is subject to adjustment after 2006 for cost-of-living increases.

The catch-up contribution a participant can make for a year cannot exceed the lesser of the following amounts.

- The catch-up contribution limit.
- The excess of the participant’s compensation over the elective deferrals that are not catch-up contributions.

Limits on Contributions and Benefits

For years ending after 2001, the maximum annual benefit for a participant under a defined benefit plan increases to the lesser of the following amounts.

- 100% of the participant’s average compensation for his or her highest 3 consecutive calendar years.
- $160,000 (subject to cost-of-living increases after 2002).

For years beginning after 2001, a defined contribution plan's maximum annual contributions and other additions (excluding earnings) to the account of a participant increases to the lesser of the following amounts.

- 100% of the compensation actually paid to the participant.
- $40,000 (subject to cost-of-living increases after 2002).

Excise Tax for Nondeductible (Excess) Contributions

For years beginning after 2001, in figuring the 10% excise tax, you can choose not to take into account as nondeductible contributions for any year contributions to a defined benefit plan that are not more than the full funding limit figured without considering the current liability limit. Apply the overall limits on deductible contributions first to contributions to defined contribution plans and then to contributions to defined benefit plans. If you use this new exception, you cannot also use the exception under section 4972(c)(6) of the Internal Revenue Code.

Involuntary Payment of Benefits

A qualified plan may provide for the immediate distribution of a participant's benefit under the plan if:

- The participant's employment is terminated, and
- The present value of the benefit is not greater than $5,000.

For distributions made after 2001, benefits attributable to rollover contributions and earnings on the contributions can be ignored in determining the present value of these benefits.

For distributions made after the Department of Labor adopts final regulations implementing rules on fiduciary responsibilities relating to this provision, a plan must provide for the automatic rollover of any distribution of more than $1,000 to an IRA under this provision, unless the participant chooses otherwise. The plan administrator must notify the participant in writing that the distribution can be transferred to another IRA.

Plan Amendments To Conform to the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)

Generally, master and prototype plans are amended by sponsoring organizations. However, you may need to request a determination letter regarding a master or prototype plan you maintain that is a nonstandardized plan if you make changes to adopt some provisions enacted by EGTRRA. Your request should be made on the appropriate form (generally Form 5300, *Application for Determination for Employee Benefit Plan,* or Form 5307, *Application for Determination for Adopters of Master or Prototype or Volume Submitter Plans).* The request should be filed with Form 8717, *User Fee for Employee Plan Determination Letter Request,* and the appropriate user fee if the fee applies (see *User Fee,* next).

User Fee

The user fee for requesting a determination letter does not apply to certain requests made after 2001 by an eligible employer. An eligible employer is one who has 100 or fewer employees who received at least $5,000 of compensation from the employer during the preceding year. At least one of them must be a non-highly compensated employee participating in a qualified plan. For more information, see *User fee* under *Setting Up a Qualified Plan* in chapter 4 of Publication 560.

Simplified Employee Pensions (SEPs)

For years beginning after 2001, the following changes apply to SEPs. For more information, see Publication 560, *Retirement Plans for Small Business.*

Deduction Limit Increased

The maximum deduction for contributions to a SEP is increased to 25% of the compensation paid or accrued during the year to your eligible employees participating in the plan.

Elective deferrals under a SARSEP (discussed later) are not subject to this deduction limit. However, the combined deduction for a participant's elective deferrals and other SEP contributions cannot exceed $40,000. Also, elective deferrals are not taken into account when figuring the amount you can deduct for employer contributions that are not elective deferrals.

Compensation for figuring the deduction for employer contributions includes elective deferrals under a SARSEP.

Contribution Limit Increased

The annual limit on the amount of employer contributions to a SEP increases to the lesser of the following amounts.

- 25% of an eligible employee's compensation.
- $40,000 (subject to cost of living adjustments after 2002).

Elective Deferral (SARSEPs) Limit

The limit on elective deferrals for participants in SARSEPs will increase, and participants who are age 50 or older at the end of the plan year may be able to make catch-up contributions. For information about the new limit and catch-up contributions, see *Elective Deferrals (401(k) Plans)* under *Qualified Plans,* earlier.

Compensation limit. The maximum amount of an employee's compensation you can consider when figuring

SEP contributions (including elective deferrals) and the deduction for contributions increases to $200,000.

SIMPLE Plans

For years beginning after 2001, the following changes apply to SIMPLE plans. For more information, see Publication 560, *Retirement Plans for Small Business.*

Salary reduction contributions. The limit on salary reduction contributions to a SIMPLE plan increases after 2001, as follows.

Year	Limit
2002	$ 7,000
2003	8,000
2004	9,000
2005 and later years	10,000

Note. The $10,000 limit is subject to adjustment after 2005 for cost-of-living increases.

Catch-up contributions. A SIMPLE plan can permit participants who are age 50 or older at the end of the calendar year to make catch-up contributions, as follows.

Year	Catch-Up Limit
2002	$ 500
2003	1,000
2004	1,500
2005	2,000
2006 and later years	2,500

Note. The $2,500 limit is subject to adjustment after 2006 for cost-of-living increases.

The catch-up contribution a participant can make for a year cannot exceed the lesser of the following amounts.

- The catch-up contribution limit.
- The excess of the participant's compensation over the salary reduction contributions that are not catch-up contributions.

403(b) Plans

For years beginning after 2001, the following changes apply to 403(b) plans. For more information, see Publication 571, *Tax-Sheltered Annuity Plans (403(b) Plans) For Employees of Public Schools and Certain Tax-Exempt Organizations.*

Changes in figuring your maximum amount contributable (MAC). In years prior to 2002, the maximum amount contributable (MAC) to a 403(b) plan generally was the least of:

- The maximum exclusion allowance (MEA),
- The limit on annual additions, and
- The limit on elective deferrals.

The MEA has been repealed. Therefore, MAC is the lesser of the limit on annual additions or the limit on elective deferrals.

Church employees. Prior to 2002, certain church employees were allowed to use a minimum exclusion allowance instead of MEA to figure MAC. MAC for church employees for years beginning after 2001 generally is the lesser of the limit on annual additions or the limit on elective deferrals.

Changes to the limit on annual additions. The alternative limits on annual additions have been repealed. Therefore, you cannot use any of the following to figure your limit on annual additions.

- The year of separation from service limit.
- The any year limit.
- The overall limit.

Increased limit on annual additions. The limit on annual additions has increased to the lesser of $40,000 or your includible compensation for your most recent year of service. For 2001, the limit on annual additions was the lesser of $35,000 or 25% of your compensation.

Includible compensation for foreign missionaries. If you are a foreign missionary, your includible compensation for your most recent year of service does not include contributions made by the church during the year to your 403(b) account.

Increase in the limit on elective deferrals. The limit on elective deferrals has been increased from $10,500 to $11,000. The limit on elective deferrals will increase by $1,000 each year through 2006.

Catch-up contributions. If you are age 50 or older by the end of 2002, you may be permitted to make ***catch-up contributions*** to your 403(b) plan.

Figuring catch-up contributions. When figuring allowable catch-up contributions, combine all contributions made by your employer on your behalf to the following plans.

- Qualified retirement plans.
- 403(b) plans.
- Simplified employee pension (SEP) plans.
- SIMPLE plans.

The total amount of the catch-up contributions on your behalf to all plans maintained by your employer cannot be more than the annual limit. The limit is $1,000.

Rollovers to and from 403(b) plans. You can roll over, tax free, money and other property that would otherwise be taxable from an eligible retirement plan to a 403(b) plan.

Additionally, you can roll over, tax free, money and other property that would otherwise be taxable from a 403(b) plan to an eligible retirement plan.

If a distribution includes both pre-tax contributions and after-tax contributions, the portion of the distribution that is

rolled over is treated as consisting first of pre-tax amounts (contributions and earnings that would be includible in income if no rollover occurred).

Years of service for church employees and ministers. If you are a minister or church employee, treat all of your years of service as an employee of a church or a convention or association of churches as years of service with one employer. Prior law required church employees and ministers to figure years of service separately for each employer.

Foreign missionaries. If you are a foreign missionary, contributions to your 403(b) account will not be treated as exceeding the limit on annual additions if the contributions are not more than the greater of:

- $3,000, or
- Your includible compensation.

Direct trustee-to-trustee transfer. If you make a direct trustee-to-trustee transfer from your 403(b) account to a defined benefit governmental plan, the transferred amount is not includible in gross income if it is used to purchase permissive service credits or repay contributions and earnings that were previously refunded under a forfeiture of service credit under another plan maintained by a state or local government employer within the same state.

457 Plans

Beginning in 2002, the following changes apply to deferred compensation plans of state and local governments and tax-exempt organizations (section 457 plans). For more information, see Publication 525, *Taxable and Nontaxable Income*.

Limit on elective deferrals. The special limit on elective deferrals for section 457 plans no longer applies. Deferrals under these plans are subject to the general limit for elective deferrals ($11,000 for 2002). The special catch-up limit in the last 3 years before retirement is twice the general limit amount.

Catch-up contributions. You may be allowed catch-up contributions (additional elective deferrals) if you are age 50 or older by the end of the year.

Qualified domestic relations order (QDRO). If you receive a distribution or payment under a QDRO from a 457 plan in which your spouse or former spouse is a participant, you generally must pay tax on it. For distributions or payments before 2002, the plan participant generally would have had to pay the tax. Under the new law, the plan participant still must pay the tax if the distribution or payment is made to a child or other dependent. For more information about QDROs, see the discussion under *General Information* in Publication 575, *Pension and Annuity Income.*

When to include deferred amounts in income. Amounts in 457 plans are generally deferred from tax until paid to you. Before 2002, these amounts generally became subject to tax when paid or otherwise made available to you.

Rollovers. A 457 plan is a qualified retirement plan for rollover purposes. You may be able to roll over certain distributions to and from these plans. For more information about rollovers to and from qualified retirement plans, see *Rollovers* in Publication 575.

Tax on early distributions. The tax on early distributions may apply to a distribution from a 457 plan to the extent it is attributable to amounts rolled into the plan from another type of qualified retirement plan. For more information about the tax on early distributions, see *Tax on Early Distributions* in Publication 575.

Changes to the coordination rules between 403(b) plans and 457 plans. If you contribute to both a 403(b) plan and a 457 plan in the same year, you do not reduce the maximum deferral limit of the 457 plan by the amount of contributions made to your 403(b) account. If you contributed to a 457 plan in 2002, see your plan administrator for contribution limits.

Earned Income of Members of Recognized Religious Sects

For years beginning after 2001, earned income for retirement plans includes amounts received for services by self-employed members of recognized religious sects opposed to social security benefits who are exempt from self-employment tax.

Thrift Savings Plan

Catch-up contributions. Participants in the Thrift Savings Plan who are age 50 or older at the end of the plan year generally will be able to make catch-up contributions. The catch-up contribution a participant can make for a year cannot exceed specific limits.

Implementation of the catch-up contribution limits will take place at the earliest practicable date.

Rollovers

For distributions after 2001, the following changes apply to rollovers. For more information about rollovers, see Publication 575, *Pension and Annuity Income,* and Publication 590, *Individual Retirement Arrangements (IRAs).*

Eligible rollover distribution. You may be able to roll over the nontaxable part of a retirement plan distribution (such as your after-tax contributions) to another qualified retirement plan or traditional individual retirement account (IRA). The transfer must be made either through a direct rollover to a qualified plan that separately accounts for the taxable and nontaxable parts of the rollover or through a rollover to an IRA.

Hardship distributions not eligible for rollover. A hardship distribution from any retirement plan is not an eligible rollover distribution.

Waiver of the 60-day rollover requirement. To avoid having to include a distribution from a qualified trust or individual retirement plan in your income in the year of distribution, you generally must transfer it to an eligible retirement plan no later than the 60th day after the day you receive it. A similar rule applies to distributions from most annuity plans, tax-sheltered annuities and eligible government plans.

For distributions after 2001, this 60-day time limit can be waived under certain circumstances. Those circumstances are when the failure to waive the 60-day requirement would be against equity or good conscience, such as in the case of a casualty, disaster, or other events beyond your reasonable control.

Automatic waiver. The 60-day rollover requirement is waived automatically only if:

1) The financial institution receives the funds on your behalf before the end of the 60-day rollover period,
2) You followed all the procedures set by the financial institution for depositing the funds into an eligible retirement plan within the 60-day period (including giving instructions to deposit the funds into an eligible retirement plan),
3) The funds are not deposited into an eligible retirement plan within the 60-day rollover period solely because of an error on the part of the financial institution,
4) The funds are deposited into an eligible retirement plan within 1 year from the beginning of the 60-day rollover period, and
5) It would have been a valid rollover if the financial institution had deposited the funds as instructed.

If this applies to you, the 60-day time limit is automatically waived.

Waivers that must be applied for. If you do not qualify for an automatic waiver, you must apply to the IRS for a waiver of the 60-day rollover requirement. You apply by following the procedures for applying for a letter ruling. Those procedures are stated in Revenue Procedure 2003−4 found in Internal Revenue Bulletin 2003−1. You must also pay a user fee of $90 with the application.

In determining whether to grant a waiver, the IRS will consider all relevant facts and circumstances, including:

1) Whether errors were made by the financial institution, (other than those described under *Automatic waiver,* earlier),
2) Whether you were unable to complete the rollover due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country or postal error,
3) Whether you used the amount distributed (for example, in the case of payment by check, whether you cashed the check), and
4) How much time has passed since the date of distribution.

Amount. The rules regarding the amount that can be rolled over within the 60-day time period also apply to the amount that can be deposited due to a waiver. For example, if you received $6,000 from your IRA, the most that you can deposit into an eligible retirement plan due to a waiver is $6,000.

Rollovers by surviving spouses. An employee's surviving spouse who receives an eligible rollover distribution may roll it over into an eligible retirement plan, including an IRA, a qualified plan, a section 403(b) annuity, or a section 457 plan. A surviving spouse who received an eligible rollover distribution before 2002 could only roll it over into an IRA.

Expanded written explanation to rollover distribution recipient. Before making an eligible rollover distribution, the administrator of a qualified retirement plan must provide you with a written explanation of various qualified retirement plan rollover rules. Now, the explanation must also tell you how the distribution rules of the plan into which you roll over the distribution may differ from the rules that apply to the plan making the distribution in their restrictions and tax consequences. For more information about rollovers, see Publication 575.

2003 Changes

Individual Retirement Arrangements (IRAs)

For more information about IRAs, see Publication 590, *Individual Retirement Arrangements (IRAs).*

Deemed IRAs

For plan years beginning after 2002, a qualified plan (defined later) can maintain a separate account or annuity under the plan to receive voluntary employee contributions. If the separate account or annuity otherwise meets the requirements of a traditional IRA or Roth IRA, it is deemed a traditional IRA or Roth IRA. A deemed IRA is subject to IRA rules and not to qualified plan rules. Also, the deemed IRA and contributions to it are not taken into account in applying qualified plan rules to any other contributions under the plan. Voluntary employee contributions must be designated as such by employees covered under the plan. They are includible in income.

Qualified plan. For deemed IRA purposes, qualified plans are defined contribution plans, defined benefit plans, annuity plans described in section 403(a), 403(b) plans, or section 457 deferred compensation plans.

Amending the plan. If you want to provide for a deemed IRA, you will have to amend your plan. For information on amending your plan, see Revenue Procedure 2003−13 in Internal Revenue Bulletin 2003−4.

Modified AGI Limit for Traditional IRAs

For 2003, if you are covered by a retirement plan at work, your deduction for contributions to a traditional IRA will be reduced (phased out) if your modified adjusted gross income (AGI) is between:

- $60,000 and $70,000 for a married couple filing a joint return or a qualifying widow(er),
- $40,000 and $50,000 for a single individual or head of household, or
- $−0− and $10,000 for a married individual filing a separate return.

For all filing statuses other than married filing separately, the upper and lower limits of the phaseout range increase by $6,000. For more information, see *How Much Can I Deduct?* in chapter 1 of Publication 590.

Election to Change IRA Distribution Method

If you are a designated beneficiary who has elected to take the entire balance of an inherited IRA by the end of the fifth year following the year of the owner's death, you may now be able to change your election. You may switch to receiving the balance over your life expectancy. For more information, see *Switch from election to take balance by the end of the fifth year* under *Figuring the Required Minimum Distribution* in chapter 1 of Publication 590.

403(b) Plans

Increase in the limit on elective deferrals. For 2003, the limit on elective deferrals is increased from $11,000 to $12,000. The limit on elective deferrals will increase by $1,000 each year through 2006.

For more information about 403(b) plans, see Publication 571.

Simplified Rules for Required Minimum Distributions

There are new rules for determining the amount of a required minimum distribution for a year beginning after 2002. The new rules, including new life expectancy tables, have been incorporated into chapter 1 and appendix C of Publication 590.

Statement of Required Minimum Distribution

If a minimum distribution is required from your IRA for 2003, the trustee, custodian, or issuer that held the IRA at the end of 2002 must either report the amount of the required minimum distribution to you, or offer to calculate it for you. The report or offer must include the date by which the amount must be distributed. The report is due January 31, 2003. It can be provided with the year-end fair market value statement that you normally get each year. No report is required for section 403(b) contracts (generally tax-sheltered annuities) or for IRAs of owners who have died.

4. Exempt Organizations

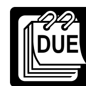
2002 Changes

Notice of Status — Form 8871

Form 8871, *Political Organization Notice of Section 527 Status*, is used by certain political organizations to notify the IRS that the organization is to be treated as a tax-exempt section 527 organization. The following changes have been made to the filing requirements of Form 8871.

- Political committees for a state or local candidate, and state or local committees of a political party are not required to file Form 8871.
- Organizations filing Form 8871 must disclose whether they intend to claim exemptions from filing Form 8872, *Political Organization Report of Contributions and Expenditures*, as a qualified state or local political organization (QSLPO), or Form 990 (Form 990−EZ) as a caucus or association of state or local officials.

Amended Form 8871. An amended Form 8871 must be filed within 30 days of a material change in any of the information reported on Form 8871.



For material changes that occurred between November 2, 2002 and December 2, 2002, the amended return should have been filed by the later of:

- 30 days after the material change, or
- December 17, 2002.

Failure to file an amended Form 8871 will cause the organization not to be treated as a tax-exempt section 527 organization. If an organization is not treated as a tax-exempt section 527 organization, the taxable income of the organization will be determined by including any ***exempt function income*** minus any deductions directly related to earning the taxable income, during the period beginning on the date of the material change and ending on the date that the amended Form 8871 is filed. Exempt function income includes contributions received, membership dues, and political fundraising receipts whether or not in a segregated fund.

Public inspection of Form 8871. The IRS will make all filed Forms 8871 available for public inspection on the IRS

web site at **www.irs.gov/polorgs.** Additionally, the organization must make available for public inspection a copy of Form 8871 during regular business hours at the organization's principal office and at each of its regional or district offices having at least 3 paid employees.

Report of Contributions and Expenditures — Form 8872

Generally, Form 8872 is filed by tax-exempt section 527 political organizations that accept contributions or make expenditures for an exempt function. The following changes have been made to the filing requirements of Form 8872.

- If an organization pays an individual $500 or more for the calendar year, the organization is required to disclose the date the individual was paid and the purpose of each expenditure on Form 8872.
- If an organization receives contributions of $200 or more from one contributor for the calendar year, the organization must disclose the date of the contributions.
- A qualified state or local political organization (QSLPO) is not required to file Form 8872.

Qualified state or local political organization. A state or local political organization may be a QSLPO if:

1) All of its political activities relate solely to any state or local public office (or office in a state or local political organization).
2) The state agency and the organization make the reports filed by the organization publicly available.
3) No federal candidate or office holder:
   a) Controls or materially participates in the direction of the organization,
   b) Solicits contributions to the organization, or
   c) Directs the disbursements of the organization.
4) It is subject to state laws that require it to report (and it does report) to a state agency information about contributions and expenditures that is similar to the information that the organization would otherwise be required to report to the IRS.

For additional information on QSLPOs, see Fact Sheet 2002-13 (FS 2002-13). The Fact Sheet is available on the IRS web site at **www.irs.gov.**

Public inspection of Form 8872. The IRS will make Form 8872 (including Schedules A and B) available for public inspection on the IRS web site at **www.irs.gov/polorgs.** Additionally, the organization must make available for public inspection a copy of Form 8872 during regular business hours at the organization's principal office and at each of its regional or district offices having at least 3 paid employees.

Annual Returns — Form 1120–POL and Form 990

Changes in filing Form 1120–POL. Political organizations, whether or not tax-exempt, are required to file Form 1120–POL if the organization has taxable income for the year in excess of $100. In previous years Form 1120–POL was required for organizations that had gross receipts of $25,000 or more.

Additionally, Form 1120–POL is no longer subject to public inspections.

Changes in filing Form 990 (Form 990–EZ). Generally, tax-exempt political organizations with gross receipts of $25,000 ($100,000 for a QSLPO) or more for the tax year are required to file Form 990 (Form 990–EZ) unless specifically excepted from filing the annual return. The following organizations are not required to file Form 990 (Form 990–EZ).

- A state or local committee of a political party, or a political committee of a state or local candidate.
- A caucus or association of state or local officials.
- An authorized committee of a candidate for federal office.
- A national political party campaign committee for a candidate seeking election or reelection to the U.S. House of Representatives or the U.S. Senate.
- A political organization that is required to report as a political committee under the Federal Election Campaign Act.
- A 501(c) organization with respect to any of its expenditures for influencing or attempting to influence the selection, nomination, election or appointment of any individual for a federal, state or local public office.

For more information, see the relevant forms and their instructions, and Fact Sheet 2002-13 (FS 2002-13) available on the IRS web site at **www.irs.gov.**

2003 Change

Report of Contributions and Expenditures

Organizations required to file Form 8872, *Political Organization Report of Contributions and Expenditures*, on or after June 30, 2003, must file the form electronically if the organization expects to have contributions or expenditures that are more than $50,000.

Form 8872 filed before June 30, 2003, can be filed electronically or by mail.

5. Estate and Gift Taxes

2002 Changes

Increased Estate Tax Applicable Exclusion Amount

An estate tax return for a U.S. citizen or resident needs to be filed only if the gross estate exceeds the applicable exclusion amount, listed below.

Year	Exclusion Amount
2002 and 2003	$1,000,000
2004 and 2005	1,500,000
2006, 2007, and 2008	2,000,000
2009	3,500,000

Increased Gift Tax Applicable Exclusion Amount

Beginning with gifts made in 2002, the applicable exclusion amount for lifetime gifts is fixed at $1 million.

Increased Annual Exclusion for Gifts

The annual exclusion for gifts of present interests made to a donee during the calendar year is increased to $11,000.

The annual exclusion for gifts made to spouses who are not U.S. citizens is increased to $110,000 ($112,000 for 2003).

Reduction of Maximum Estate and Gift Tax Rate

For estates of decedents dying, and gifts made, after 2001, the maximum rate for the estate tax and the gift tax is as follows.

Year	Maximum Tax Rate
2002	50%
2003	49%
2004	48%
2005	47%
2006	46%
2007, 2008, and 2009	45%

Repeal of Phaseout of Graduated Rates

For estates of decedents dying, and gifts made, after 2001, the benefit of the graduated rates is no longer phased out for estates and gifts in excess of $10 million.

Reduction of Credit for State Death Taxes

For estates of decedents dying in 2002, the credit allowed for state death taxes is limited to 75% of the amount that would otherwise be allowed. For estates of decedents dying in 2003 and 2004, the credit will be limited to 50% and 25% respectively.

For estates of decedents dying after 2004, the state death tax credit will be replaced with a deduction for state death taxes.

Changes to Installment Payment Provisions

For estates of decedents dying after 2001, several rules applicable to qualifying for installment payments of estate tax are changed.

- The allowable number of partners and shareholders in a closely held business is increased from 15 to 45.
- Stock in qualifying lending and finance businesses is treated as stock in an active trade or business company.
- The rules regarding non-readily-tradable stock and holding company stock are clarified.

Increase in Generation-Skipping Transfer (GST) Exemption

The generation-skipping transfer (GST) lifetime exemption increased to $1,100,000 ($1,120,000 for 2003). The annual increase can only be allocated to transfers made during or after the year of the increase.

6.

Excise Taxes

2003 Changes

New Tax Rates

The tax rates for gasohol and for gasoline removed or entered for the production of gasohol have increased for 2003. See Form 720, *Quarterly Federal Excise Tax Return*, for the new rates that apply to these fuels.

Air Transportation Taxes

For amounts paid in 2003, the tax on the use of international air travel facilities will be $13.40 per person for flights that begin or end in the United States, or $6.70 per person for domestic segments that begin or end in Alaska or Hawaii (applies only to departures). See Publication 510, *Excise Taxes for 2003*, for information on air transportation taxes.

Luxury Tax

The luxury tax on passenger vehicles does not apply after 2002.

7.

Foreign Issues

2002 Change

Foreign Earned Income Exclusion Increased

For 2002, the maximum foreign earned income exclusion is increased from $78,000 to $80,000. The maximum exclusion remains at $80,000 through 2007. See Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*, to see if you meet the requirements to exclude your foreign income.

8.

How To Get Tax Help

You can get help with unresolved tax issues, order free publications and forms, ask tax questions, and get more information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

Contacting your Taxpayer Advocate. If you have attempted to deal with an IRS problem unsuccessfully, you should contact your Taxpayer Advocate.

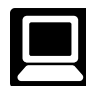
The Taxpayer Advocate represents your interests and concerns within the IRS by protecting your rights and resolving problems that have not been fixed through normal channels. While Taxpayer Advocates cannot change the tax law or make a technical tax decision, they can clear up problems that resulted from previous contacts and ensure that your case is given a complete and impartial review.

To contact your Taxpayer Advocate:

- Call the Taxpayer Advocate at **1–877–777–4778.**
- Call, write, or fax the Taxpayer Advocate office in your area.
- Call **1–800–829–4059** if you are a TTY/TDD user.

For more information, see Publication 1546, *The Taxpayer Advocate Service of the IRS.*

Free tax services. To find out what services are available, get Publication 910, *Guide to Free Tax Services.* It contains a list of free tax publications and an index of tax topics. It also describes other free tax information services, including tax education and assistance programs and a list of TeleTax topics.



Personal computer. With your personal computer and modem, you can access the IRS on the Internet at **www.irs.gov**. While visiting our web site, you can:

- See answers to frequently asked tax questions or request help by e-mail.
- Download forms and publications or search for forms and publications by topic or keyword.
- Order IRS products on-line.
- View forms that may be filled in electronically, print the completed form, and then save the form for recordkeeping.
- View Internal Revenue Bulletins published in the last few years.
- Search regulations and the Internal Revenue Code.
- Receive our electronic newsletters on hot tax issues and news.

- Learn about the benefits of filing electronically (IRS e-file).
- Get information on starting and operating a small business.

You can also reach us with your computer using File Transfer Protocol at **ftp.irs.gov.**

TaxFax Service. Using the phone attached to your fax machine, you can receive forms and instructions by calling **703–368–9694.** Follow the directions from the prompts. When you order forms, enter the catalog number for the form you need. The items you request will be faxed to you.

For help with transmission problems, call the FedWorld Help Desk at **703–487–4608.**

Phone. Many services are available by phone.

- *Ordering forms, instructions, and publications.* Call **1–800–829–3676** to order current and prior year forms, instructions, and publications.
- *Asking tax questions.* Call the IRS with your tax questions at **1–800–829–1040.** Or, if your question pertains to a partnership, corporate, estate, or trust return, call the Business and Specialty Tax Help Line at **1–800–829–4933.**
- *Solving problems.* Take advantage of Everyday Tax Solutions service by calling your local IRS office to set up an in-person appointment at your convenience. Check your local directory assistance or **www.irs.gov** for the numbers.
- *TTY/TDD equipment.* If you have access to TTY/TDD equipment, call **1–800–829–4059** to ask tax questions or to order forms and publications.
- *TeleTax topics.* Call **1–800–829–4477** to listen to pre-recorded messages covering various tax topics.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we use several methods to evaluate the quality of our telephone services. One method is for a second IRS representative to sometimes listen in on or record telephone calls. Another is to ask some callers to complete a short survey at the end of the call.

Walk-in. Many products and services are available on a walk-in basis.

- *Products.* You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Some IRS offices, libraries, grocery stores, copy centers, city and county governments, credit unions, and office supply stores have an extensive collection of products available to print from a CD-ROM or photocopy from reproducible proofs. Also, some IRS offices and libraries have the Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.
- *Services.* You can walk in to your local IRS office to ask tax questions or get help with a tax problem. Now you can set up an appointment by calling your local IRS office number and, at the prompt, leaving a message requesting Everyday Tax Solutions help. A representative will call you back within 2 business days to schedule an in-person appointment at your convenience.

Mail. You can send your order for forms, instructions, and publications to the Distribution Center nearest to you and receive a response within 10 workdays after your request is received. Find the address that applies to your part of the country.

- **Western part of U.S.:**
  Western Area Distribution Center
  Rancho Cordova, CA 95743–0001
- **Central part of U.S.:**
  Central Area Distribution Center
  P.O. Box 8903
  Bloomington, IL 61702–8903
- **Eastern part of U.S. and foreign addresses:**
  Eastern Area Distribution Center
  P.O. Box 85074
  Richmond, VA 23261–5074

CD-ROM for tax products. You can order IRS Publication 1796, *Federal Tax Products on CD-ROM,* and obtain:

- Current tax forms, instructions, and publications.
- Prior-year tax forms and instructions.
- Popular tax forms that may be filled in electronically, printed out for submission, and saved for recordkeeping.
- Internal Revenue Bulletins.

The CD-ROM can be purchased from National Technical Information Service (NTIS) by calling **1–877–233–6767** or on the Internet at **http://www.irs.gov/cdorders.** The first release is available in early January and the final release is available in late February.

CD-ROM for small businesses. IRS Publication 3207, *Small Business Resource Guide,* is a must for every small business owner or any taxpayer about to start a business. This handy, interactive CD contains all the business tax forms, instructions and publications needed to successfully manage a business. In addition, the CD provides an abundance of other helpful information, such as how to prepare a business plan,

finding financing for your business, and much more. The design of the CD makes finding information easy and quick and incorporates file formats and browsers that can be run on virtually any desktop or laptop computer.

It is available in March. You can get a free copy by calling **1–800–829–3676** or by visiting the website at **www.irs.gov/smallbiz.**

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To help us develop a more useful index, please let us know if you have ideas for index entries. See "Comments and Suggestions" in the "Introduction" for the ways you can reach us.

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