User's Guide

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What it is

The article starting on this page is the basis for a live CLE program available by telephone conference call at 1 p.m. (ET) Nov. 19, at no additional cost to ABA members. Credit has been requested in states that approve a telephone format.

To participate

Read "These Taxing Times," and on Nov. 19 listen to the 1-hour program from any Touch-Tone tele- phone in the 50 states or District of Columbia.

This CLE program

1 p.m. (ET) Nov. 19, Samuel L. Braunstein and C. Wells Hall III give general practice lawyers some experts' advice and field questions about the new tax law.

Program co-sponsor

Tax Section.

To register

Call the ABA at (800) 285-2221 from 8:30 a.m. to 6:30 p.m. (ET) Mondays through Fridays, beginning Oct. 20. You will be asked for the membership number from your membership card or mailing label on the Journal. Registrations are accepted in the order received, to a limit of 1,000 phone connections.

Only one registration can be accepted per caller. Registrations for future programs cannot be accepted. Multiple participants in one office who do not need CLE credit should register under one name and listen by speakerphone or internal conference call to make more connections available for other ABA members.

After registering

You will receive by fax or e-mail an unpublished, toll-free telephone number to call for the program, a Personal Identification Number (PIN) to access it, a certificate of attendance and an evaluation form.

On the program date

Call the toll-free number a few minutes before 1 p.m. (ET) Nov. 19 and enter your PIN. After the program, return the evaluation form.

CLE credit

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Some limitations

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These TAXING TIMES

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Wide-ranging changes this year in federal tax law will force lawyers—whether tax practitioners or taxpayers—to master a daunting maze of new rules and calculations.

BY SAMUEL L. BRAUNSTEIN and C. WELLS HALL III

Get ready to lose sleep between now and April 15—"tax relief" is here again.

Over time, the Taxpayer Relief Act of 1997, which became law in July, may well deliver on the promise of its name, especially for taxpayers in moderate income ranges and above.

But getting there will not be easy, especially for lawyers and others advising individuals and businesses on just what the provisions of the law mean and how they will work. In many cases, tax practitioners still are sorting out the provisions themselves, even as clients clamor for answers.

What makes the 1997 tax law particularly difficult to absorb is that it is so sweeping in its detail.

The Taxpayer Relief Act does not change the fundamental structure or substance of the federal tax system. But in seeking relief for a wide range of individuals and businesses, it changes a lot of rules in many of the areas in which lawyers represent clients, such as real estate transactions, management of small businesses, securities investment and estate planning.

Further complicating the situation is the fact that many of the changes are being implemented in increments. Different rules, deduction amounts or exclusions will continue to change right into the next century.

The only easy assessment of the new tax law is that the appearance of simplicity may not be the reality. And even the rules being phased in that may eventually produce greater simplicities will cause transitional complexities.

For lawyers who are looking ahead to what the new tax rules will mean for their clients—or for their own financial decisions—here is an overview of some of the key areas in which the 1997 Taxpayer Relief Act is bringing significant changes.

Samuel L. Braunstein is a member of Braunstein & Todisco in Fairfield, Conn. He chairs subcommittees on continuing legal education, and business capital and finance of the Closely Held Businesses Committee in the ABA Section of Taxation. C. Wells Hall III, a partner at Moore & Van Allen in Charlotte, N.C., chairs the S Corporation Committee of the Taxation Section.

GRAPHIC BY BRENDA GRANNAN

Time Check

Contributing to the complexity of the Taxpayer Relief Act of 1997 is the number of dates on which provisions go into effect.

Some of the dates to watch for—but by no means all—are:

Jan. 1, 1997 Excise tax on excess distributions from retirement vehicles no longer applicable. Estate tax on excess retirement accumulations no longer applicable.

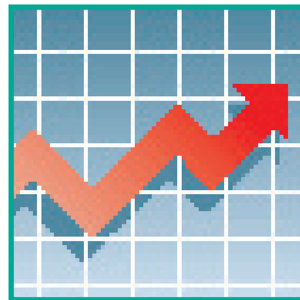
May 7, 1997 New maximum capital gains rate starts going into effect. A portion of the gain realized from the sale of a principal residence may be excluded from income.

Aug. 5, 1997 Rollover rules for gain from the sales of stock in small businesses become applicable.

Jan. 1, 1998 First incremental increase in unified credit for gift and estate taxes (increases will continue through 2006). Exclusion rules for interests in family-owned businesses become applicable. Reporting rules for payments to lawyers become effective.

Jan. 1, 1999 Indexing begins on annual gift tax exclusion. New rules for deductions for home office expenses become effective.

Capital Gains



Old Law: Gains from the sale of capital assets taxed at maximum rate of 28 percent.

New Law: Tax on gains from the sale of assets held for more than 18 months lowered to 20 percent maximum rate.

Changes in the rules on taxability of long-term gains on noncorporate capital assets, such as securities and real estate, may cause some of the biggest headaches for tax practitioners and their clients.

Under the Taxpayer Relief Act, three major changes become effective for tax years ending after May 6, 1997.

First, tax rates have generally been lowered, but phase-in dates and different rules on holding periods have made it harder to keep track of which rates apply:

- For sales of long-term capital assets after May 6, 1997, the maximum capital gains rate has been reduced from 28 percent for individuals, estates and trusts to a maximum rate of 20 percent. (For taxpayers in the 15 percent income tax bracket, the maximum rate on long-term capital gains is 10 percent.)
- If a capital asset was sold after May 6 but before July 29, 1997, the new lower rates will apply only if the asset was held for more than 12 months.
- If the asset was sold on July 29, 1997, or later, the lower rates apply if the asset was held for more than 18 months. But the 28 percent maximum rate continues to apply to assets sold after July 28, 1997, that were held more than 12 months but less than 18 months.

Eventually, the tax rates on capital gains will fall even further. The general maximum rate will be 18 percent (8 percent for taxpayers in the 15 percent income tax bracket) for the sale of qualifying assets purchased on Jan. 1, 2001, or later, and held by the taxpayer more than five years.

Secondly, holding periods for long-term capital assets have been considerably lengthened.

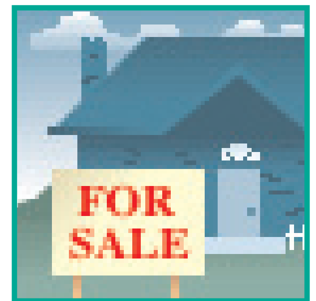
Formerly, assets held more than a year qualified for long-term status.

Under the new law, the general rule is that, for transactions occurring after July 28, 1997, the long-term capital gains rates will apply to sales of qualifying assets owned by the taxpayer more than 18 months.

Thirdly, changes have been made in the types of assets that qualify for the new maximum rates.

Sale of Principal Residence

Old Law: Gain on the sale of a principal residence could be deferred for tax purposes by "rolling over" the sales proceeds into a new residence of equal or greater value.



New Law: Exclusion will apply to gain on the sale of a principal residence.

Effective May 7, 1997, taxpayers who sell their principal residences may exclude from taxable income a portion of the gain realized on the sale.

For married taxpayers filing jointly, the exclusion limit is $500,000 of the realized gain, and for single taxpayers the exclusion limit is $250,000.

The new law effectively replaces two key provisions for home sales, which allowed the seller to "roll over" proceeds into a new residence of equal or greater value, and a one-time exclusion of up to $125,000 for taxpayers age 55 and older.

To qualify for tax treatment under the new law when selling a principal residence:

- The taxpayer must have owned and used the premises as a principal residence for at least two of the five years preceding the sale.
- The exclusion can only be used once every two years.

The exclusion is determined on an individual basis, so in the case of married taxpayers, one spouse's in-

GRAPHICS BY JEFF DIONISE

ability to use it will not automatically disqualify the other spouse from claiming it (but the limit in that case will be $250,000).

Example: A is unmarried and eligible for the $250,000 exclusion for selling a principal residence. B, also unmarried, had used the exclusion within the statutory two-year period. If A and B marry, A's exclusion of up to $250,000 would be available to them in filing a joint return. After using A's exclusion, they would be eligible for a new joint exclusion of up to $500,000 after two years pass.

In certain instances, taxpayers who do not otherwise qualify for the exclusion may still be entitled to a partial exclusion from the gain on the sale of principal residences if the sale is due to a change of place of employment, health reasons or other "unforeseen" circumstances, as provided for by regulations being issued by the Internal Revenue Service.

In addition, there is a special transitional rule that allows a partial exclusion of gain from the sale or exchange of a principal residence, even when there are no changes in circumstances.

In such cases, the taxpayer must have owned the residence on or before Aug. 5, 1997, and the sale or exchange must occur within two years of that date.

Taxpayers may elect not to apply the new rules in some circumstances if the transaction occurred on or before Aug. 5, 1997, or if a contract was in effect on or before that date.

Retirement Distribution Excise Tax

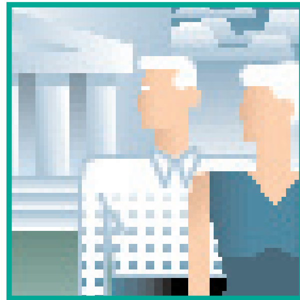
Old Law: A 15 percent excise tax was imposed on "excess" distributions and accumulations from retirement vehicles.

New Law: Excise tax repealed, generally effective after 1996.

Until 1996, a 15 percent excise tax was imposed on excess distributions from qualified retirement plans, tax shelter annuities and individual retirement arrangements. Legislation passed by Congress in 1996 suspended, but did not eliminate, the excise tax on excess distributions received in 1997, 1998 and 1999.

In addition, a separate 15 percent estate tax has continued to apply to excess retirement accumulations determined at death.

Prior to the 1996 legislation, the excise tax was triggered when the aggregate amount of retirement distributions from all qualified retirement plans during any calendar year exceeded $155,000 for 1996 ($150,000 for prior years) or five times that amount in the case of a qualifying lump sum distribution.



In the case of excess accumulations at the death of a taxpayer, the excise tax was based on the value in the retirement accounts in excess of the value of a hypothetical life annuity determined on the basis of the taxpayer's life expectancy at the date of his or her death.

These provisions caused much consternation for taxpayers who had planned for retirement and, through prudent investments, had accumulated large balances in their retirement plans.

The Taxpayer Relief Act repeals both the 15 percent excise tax on excess distributions effective for distributions received by taxpayers after Dec. 31, 1996, and the 15 percent estate tax on excess retirement accumulations effective for the estates of individuals dying after Dec. 31, 1996.

Other provisions of the new tax law prohibit excess contributions to retirement plans. But favorable investment performances in a plan will not be subject to any penalty taxes in addition to the normal income taxes that are imposed when distributions are made.

Of course, the balance in a retirement plan at death is still subject to the estate tax, unless the beneficiary is the surviving spouse, in which case the marital deduction will be available.

IRA Changes

Old Law: Employed workers and spouses each could contribute $2,000 to individual retirement accounts, subject to strict rules for deductibility of contributions, including a 10 percent penalty imposed on most withdrawals made before the taxpayer reached age 59½.

New Law: Employed workers and spouses each may contribute $2,000 per year to a new type of IRA. Contributions are nondeductible, but withdrawals are not subject to income or penalty taxes.

Action by Congress in the 1980s to eliminate tax breaks for contributions to individual retirement arrangements still strikes a raw nerve with many taxpayers. Provisions in the 1997 tax law may ease some of those hard feelings.

Effective Jan. 1, 1998, taxpayers may use individual retirement accounts in three ways:

First, traditional tax-deductible IRAs will be available to more taxpayers with higher income levels.

Under the new tax law, the adjusted gross income limits on who is eligible to make deductible IRA contributions will increase gradually to $80,000 for those married taxpayers filing jointly by 2007 and to $50,000 for single taxpayers by 2005.

Also, the prohibition in the prior law against those who are married making deductible contributions to IRAs if their spouses were active participants in employer-sponsored re-tirement plans will not apply under the new law unless the adjusted gross income of the married couple exceeds $150,000.

The new law also creates exceptions to the 10 percent penalty tax on early withdrawals from IRAs, provided the withdrawals are used to pay qualified higher education expenses or for the purchase of a first home.

A second change is the creation of the new Roth IRA (named for Senate Finance Committee Chairman William V. Roth Jr., R-Del.) to replace the old nondeductible IRA provisions.

No tax deduction is allowed for contributions to a Roth IRA, but the income continues to accumulate tax-free. Moreover, qualified distributions are not includable in income and are not subject to penalty taxes.

A qualified distribution requires that funds accumulate in the IRA for at least five years following the initial contribution and that withdrawals are made under one of the following conditions:

- The taxpayer has passed the age of 59½;
- The taxpayer or an immediate family member is purchasing a first principal residence (subject to a $10,000 lifetime limit);
- The taxpayer is experiencing long-term unemployment; or
- The taxpayer has died or is disabled.

A worker with employment earnings, and the worker's spouse, each may contribute $2,000 per year to a Roth IRA. Eligibility is phased out for married taxpayers filing jointly with an adjusted gross income starting at $150,000, with a complete elimination for incomes of $160,000 and above ($95,000 and $100,000, respectively, for single taxpayers).

Special provisions permit regular IRAs to be rolled over to Roth IRAs by taxpayers with adjusted gross income of less than $100,000.

(For a further discussion of the new Roth IRA, see "An Alternative to Traditional IRAs," page 92.)

Thirdly, an Education IRA has been created. As with the Roth IRA, no income tax deduction is available for contributions to Education IRAs.

When distributed, contributed amounts and earnings on them are not subject to income tax or the 10 percent early withdrawal tax, provided the distribution is used for qualified higher education expenses of designated beneficiaries.

Nondeductible contributions to the Education IRA are limited to $500 annually per beneficiary.

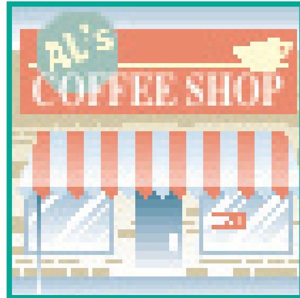
Contributions are phased out for married taxpayers filing jointly with adjusted gross income starting at $150,000 ($95,000 for single taxpayers).

Sales of Stock in Small Businesses

Old Law: Half the gain from the sale of stock—that has been held for more than five years—in a qualified small business could be excluded from taxes.

New Law: While the exclusion rule under the old law continues in effect, taxpayers also may elect to roll over the entire gain from the sale of qualified small business stock under certain conditions.

Under the new provision, an individual taxpayer may elect to roll over gain from the sale of qualified small business stock held for more than six months if the taxpayer purchases other small business stock within 60 days from the initial sale or exchange. The provision applies to stock sales made after Aug. 5, 1997.



Gain is recognized for tax purposes only to the extent that the amount actually realized on the sale exceeds the cost of the replacement stock reduced by any portion of such cost previously taken into account under the rule.

It should be remembered that:

- The rollover amount will reduce the basis of the replacement small business stock.
- The holding period of the replacement stock includes the holding period of the sold stock as regards a subsequent sale or exchange of the replacement stock.

To qualify for the special treatment afforded by the new provision, the stock being sold and the replacement stock being acquired both must qualify as small business stock under Section 1202(c) of the Internal Revenue Code. In addition, the replacement stock must meet an active business test.

While the 50 percent exclusion under IRC § 1202 continues, the new law contains provisions to prevent taxpayers from obtaining a double benefit from the sale or exchange of stock when the gain is not rolled over into new stock.

Increase in Unified Credit

Old Law: Unified credit for gift and estate taxes allowed taxpayers to transfer up to $600,000 during life or at death without paying taxes.

New Law: Beginning in 1998, unified credit amount will be increased until it reaches $1 million in 2006.

Since 1976, the gift tax and estate tax on transfers made by a taxpayer during life or at death have been calculated on the basis of a unified rate schedule. The unified credit has allowed an individual to shelter up to $600,000 in cumulative transfers from estate and gift taxes.

Beginning in 1998, the new law will increase the unified credit amount in increments from the current maximum of $600,000 to $1 million by 2006.

The increase in the credit amount will permit a married couple to pass up to $2 million to their children, free of federal estate and gift tax, by 2006.

But maximizing the use of the credits available to both spouses will require the coordination of their respective estate plans.

Through use of marital deduction formulas, the exemption can be fully used at the death of the first spouse with the balance of the estate qualifying for the marital deduction.

The marital deduction amount, whether outright or in trust, will be included in the estate of the surviving spouse.

Exclusion for Family-Owned Business

Old Law: No special estate tax exclusions provided for family businesses.

New Law: Executor of an estate may elect an exclusion of up to $1.3 million for interests in a qualified family-owned business that is otherwise includable in decedent's gross estate.

While the increase in the unified credit is phased in over the next decade, more immediate relief is available for the estates of individuals who die after 1997 with interests in qualified family-owned businesses.

The new law allows an executor to elect to exclude up to $1.3 million of the value of a qualified family-owned business interest if the interest makes up more than 50 percent of the decedent's estate, with certain adjustments and if certain other requirements are met. The exclusion may be taken to the extent that the amount does not exceed $1.3 million in aggregate with the available unified credit amount.

The requirement that the business make up more than half of the estate involves a number of adjustments to the values of the business and the estate. Careful planning may be required during the individual's lifetime to assure that the exclusion is available.

In addition, members of the decedent's family must own 50 percent of the business to qualify for the exclusion. To meet this requirement, the interests in the business owned by the decedent, decedent's spouse, and other immediate family members, may be counted.

Further, if 70 percent of a business is owned by two families, or 90 percent is owned by three families, the decedent's family only needs to own 30 percent of the business.

Finally, some surviving member of the decedent's family must "materially participate" in the business for at least five years in any eight-year period preceding the decedent's death in order for the exclusion to apply. An heir is defined to include a nonfamily member who has been employed by the business for 10 years preceding the decedent's death.

During the 10 years following the decedent's death, an heir who receives a business interest cannot dispose of any portion of his or her interest (except to another family member or through a qualified conservation contribution defined in the law) without triggering the estate tax.

Indexing Annual Gift Tax Exclusion

Old Law: Taxpayers could exclude $10,000 of gifts per year to each individual donee (for married couples, $20,000 may be gifted to each donee).

New Law: After 1998, annual exclusion amount will be indexed annually.

This change in the law will be significant for many wealthy and high-net-worth taxpayers. Indexing will be rounded to the lowest multiple of $1,000, so the next adjustment (based on the inflation rate) will result in an annual exclusion of, say, $11,000.

Example: A taxpayer has four children and six grandchildren, which gives the taxpayer 10 annual donee exclusions—20 exclusions if the taxpayer's spouse consents to joint gifts. Under the tax laws, the taxpayer and the spouse could give $200,000 in gifts that may be excluded from tax. If the annual exclusion amount is indexed to $11,000, the annual gift subject to tax exclusion would increase to $220,000.

Annual exclusions must be for gifts of "present interests" rather than "future interests."

Rules for Home Office Deductions

Old Law: Deductions for home office expenses allowed only if home qualified as taxpayer's "principal place of business."

New Law: Effective Jan. 1, 1999, deductions allowed for expenses, including taxes, utilities and depreciation, for home offices used for "administration" or "management" of businesses.

By changing the definition of a "principal place of business," the act broadens the base of taxpayers who may be able to take deductions for at least some of the costs of working out of their homes.

Starting in 1999, a home office will qualify as a taxpayer's principal place of business, for which deductions may be claimed if:

- The taxpayer uses the office to conduct the administrative or management activities of the taxpayer's trade or business.
- There is no other fixed location where the taxpayer conducts those activities.

If the new definition applies, taxpayers also may be able to deduct the cost of traveling to and from their homes to other locations where they conduct their trade or business.

A number of other changes include reporting requirements for real estate transactions and certain charitable gifts; deductions for stock contributed to charitable organizations; deductibility of health insurance premiums for the self-employed; contributions to 401(k) plans for the self-employed; the alternative minimum tax for small corporations; and even informational returns for payments to lawyers by businesses.

As the tax season heats up, lawyers advising clients on tax issues and related matters can expect to be inundated with questions about the impact of the changes brought on by the new tax law.

When that happens, lawyers who have done their homework will be awfully glad they did. ■