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tax and financial ISSUES

Congress Experiences Post Passage Anxiety

1997 produced the latest in a series of mind-numbing tax bills. The pattern is similar to past years where complicated and vague legislation is cobbled together with changes at the 11th hour, usually requiring clarifying legislation within the year of enactment. The Internal Revenue Service has difficulty in keeping up with all of this, and cannot churn out clarifying regulations fast enough for any coherent administration of the new laws.

1997 marked the death of the philosophy of the of the Tax Reform Act of 1986 -- to minimize the use the tax code for the purposes of social engineering. The 1997 act openly embraces the use of the code to encourage a wide range of activities from retirement savings to educational spending. This change has the support of both liberals and conservatives in Congress, as is evident from the grab bag of provisions. When a change in direction has this much support from both sides of the aisle, it promises to be around for a long time. Don't expect tax simplification any time soon.

This change in philosophy is even more curious in that we have been treated to the spectacle of having Congress carping about the complexity of the tax code and taxpayers' ability to cope with it, this right on the heels of the enactment of non-simplifying legislation. For lack of a better description, we term this about face "post passage anxiety." Look for some administrative reforms to be forced on the IRS, but nothing more. The legislators are having too much fun in parceling out tax goodies.

1997 Year End Tax Planning: Special Items

1) An entire universe of tax calculations is now phased in and indexed to inflation.

Most of the tax benefits enacted this year were not immediately effective. Some of the key IRA and estate tax changes occur over a 10 year period. An appendix to this newsletter lists 1997 law changes with delayed implementation. TAKE ACTION ONLY WHEN YOU ARE SURE OF THE EFFECTIVE DATE OF TAX LAW CHANGES.

2) Pay special attention to the taxation of capital gains, especially when considering how capital gains and losses will be netted.

There are now multiple maximum capital gains tax rates:

Gains on assets owned more than 18 months	20%
Gains on assets owned for more than one year, but 18 months or less	28%
Gains attributable to recapture of depreciation on real estate	25%
Gains on collectibles owned for more than one year	28%

In addition, if a taxpayer's regular tax on a gain would be taxed at a 15% rate, then the preferential 20% rate is reduced to 10%.

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The IRS has announced that the process of netting capital gains and losses will operate so that the gains and losses from each tax rate group will be netted. Net losses from the highest tax group will be netted first against gains from the highest tax group where gains are available. The process will continues until all losses are either netted out, offset against ordinary income (up to $3,000 per year), or carried forward to the next tax year.

It is likely that taxpayers having 20% type gains and capital losses from higher tax groups will realize only a 20% benefit from these losses because of the netting process. Only individuals with net capital gains in the 20% category will get the full benefit of the 20% rate.

This netting system also appears to require that capital loss carry forwards be layered by rate class so that similar netting computations can be done in future years.

Action: *Taxpayers must now be more careful about keeping track of the purchase dates of assets.*

3) Deductible IRA contributions for spouses without pension coverage are not effective until 1998.

Although the spousal IRA contribution limit has been increased to $2,000 effective for 1997, the increase in deductibility enacted this year will not take effect until 1998. Under prior law neither spouse could get an IRA deduction unless a) neither had pension coverage, or b) if either had pension coverage and Adjusted Gross Income was less than $40,000.

In a technical corrections bill that is now under consideration by Congress, IRA deductibility limits for spouses without pension coverage are being set for phaseout between $150,000 and $160,000 of Adjusted Gross Income, the same limits as for the new Roth IRA's.

Action: *Non-working spouses should determine the deductibility of their IRA contributions before making any contributions early in 1998.*

4) Beware of complications with Roth IRA conversions.

If funds from a regular IRA are rolled over into a Roth IRA in 1998, the amount converted is subject to tax, but the taxable income can be spread over 4 tax years. The benefit of doing these Roth IRA conversions is that future earnings on the IRA account will be permanently exempt from income taxes. Individuals taking early retirement and not immediately drawing on pensions and Social Security may find this a valuable option.

The technical corrections bill specifies that any withdrawals of Roth IRA conversions within 5 years of the date of conversion will be subject to a 10% early withdrawal tax, even if you are above age 59 1/2.

Action: *If you are thinking about making Roth IRA conversions, make sure that you don't need the cash for at least 5 years. If you do need the cash, make withdrawals from unconverted funds (those left in the regular IRA account).*

5) Effective for 1997, the family aggregation rules covering limitations on pension contributions were repealed.

These rules treated the wages earned by family members as earned by a single individual, making pensions unattractive for family owned and operated businesses.

Action: *Closely held businesses that employ multiple family members should review their pension options for 1997 before year end.*

6) Effective for 1997, the rules requiring aggregation of the pension plans of self-employed individuals for the purposes of meeting the minimum participation and non-discrimination requirements were repealed.

Action: *Self-employed individuals with ownership interests in multiple businesses should consider establishing Keogh plans for the 1997 tax year before December 31, 1997.*

7) Your estate planning strategy should be reexamined.

The excise tax on excess retirement plan distributions and accumulations was repealed effective for 1997. This encourages individuals to maintain tax deferrals in IRA accounts, but will increase estate tax exposure because the money in these accounts cannot be gifted without income be recognized by he donor.

Appreciated assets generally have their tax basis stepped up to fair market value at date of death, providing a permanent avoidance of income tax. (This step up does not apply to IRA accounts.) Individual have to weight the benefit of avoiding a future income taxes against their exposure to estate taxes that occurs when the assets are kept in their estates. The advantage seems to have moved in favor of individuals keeping their IRA accounts and gifting away appreciated assets.

Action: *Individual should review their estate plans, and in particular their asset retention strategies.*