

THE TAXPAYER RELIEF ACT OF 1997:
A Summary for the Domestic Relations Practitioner

by

Allan H. Zerman

and

Cary J. Mogerman

ZERMAN & MOGERMAN, L.L.C.
Park Place, Suite 325
100 S. Brentwood Boulevard
Clayton, Missouri 63105
(314) 862-4444

Introduction

The Taxpayer Relief Act of 1997 (H.R. 2014; P.L. 105-34) (herein the "Act") has been characterized as the first major tax cut legislation in sixteen years.¹ It was passed in Congress on July 31, 1997 by an overwhelming bipartisan majority and signed into law by President Clinton on August 5, 1997. The Act provides significant, but frequently very complicated, tax cuts for most individual taxpayers in five key areas: Relaxation and expansion of rules pertaining to individual retirement accounts; education incentives; changes to the law regarding capital gains; and changes in the estate and gift and child tax credit rules.

This article is an attempt to summarize key tax law changes effected by the Act which promise to have a significant impact in many divorce cases.

1. Individual Retirement Accounts

The Act provides for additional types of individual retirement accounts, and provides for new uses of IRA funds without penalty in certain instances described therein.

a. The "Roth IRA"

The Roth IRA² is available beginning in 1998 and is funded with after-tax contributions. The tax benefits of this particular IRA are "backloaded": distributions are tax free if the payout is made after five years and occasioned by attaining age 59 1/2, death, disability,³ or to pay for certain

¹ 84 Standard Federal Tax Reports, "Taxpayer Relief Act of 1997: Law and Explanation," No. 42, Commerce Clearing House, August 13, 1997.

² §408A I.R.C. 1997.

³ §408A I.R.C. 1997.

first-time homebuyer expenses up to the first \$ 10,000.00.⁴

i. Phase-out provisions: Allowable contributions phase-out for single taxpayers with adjusted gross incomes between \$95,000 and \$110,000; for joint filers between \$ 150,000 and 160,000.⁵

ii. Key benefit: qualified distributions from them are not includable in gross income or subject to the additional 10% tax on early withdrawals; accordingly, these accounts provide for tax-free buildup of interest, dividends, and capital gains.

iii. Same limitations on contributions each year: \$2,000.00.

iv. Contributions may be made until age 70 1/2.

v. Act provides for conversion of existing IRAs to "Roth" IRAs, and the tax on the withdrawal necessary to accomplish the conversion may be spread over four years.

b. Education IRAs

The Act provides for a new, "education IRA."⁶ This is a trust or custodial account created exclusively for paying the qualified higher education expenses of the account holder. It allows taxpayers to make nondeductible annual contributions of up to \$500.00 per child; however, like the Roth IRA, the earnings and growth and withdrawals thereof are tax free.

i. Phase-out provisions: AGI must be below \$150,000 for joint filers, \$95,000 for singles. Note that the phase-out is per contributor, rather than an aggregate figure. Accordingly, two divorced parents could each contribute the \$500 maximum to a single IRA where, had they remained married, their contribution would be limited.

⁴ §§ 72(t)(2) and (8) I.R.C. 1997.

⁵ § 408A(c)(3)(C) I.R.C. 1997.

⁶ § 530 I.R.C. 1997.

ii. May only be used for qualified educational expenses, including tuition, fees, books, equipment, and, under certain limited circumstances, room and board.

iii. Contributions must be made before the beneficiary attains age 18, and the unused balance must be distributed to the beneficiary by age 30.

c. Expanded IRA Uses

The Act allows withdrawals from standard IRAs, without penalty but subject to ordinary income tax, for first-time home purchases (up to \$10,000) and education costs for the taxpayer, spouse, or any child or grandchild of the taxpayer or spouse.⁷

2. Capital Gains Amendments

a. Rate cut- Effective May 7, 1997, the top capital gains rate for individual taxpayers is lowered to 20% from the present 28% for investments held more than 18 months. For taxpayers in the 15% income bracket, the maximum net capital gains tax rate is an even lower 10%. After five years of holding the asset, the rates drop to 18% on assets *purchased after* December 31, 2000, and 8% on assets *sold after* December 31, 2000 for those in the 15% bracket.⁸

b. Gain on sale of principal residence- Homeowners may now exclude up to \$500,000.00 in gain from the sale of a principal residence (\$250,000.00 for single taxpayers) every two years.⁹ This provision replaces the rollover gain provisions of § 1034 and the one-time \$125,000.00 exclusion for taxpayers age 55 and older. For transfers incident to divorce, the time during which the taxpayer's spouse or former spouse owned the residence is added to the taxpayer's period of ownership for the application of this rule. Also, a taxpayer who owns the residence is

⁷ § 72(t)(2)(E) and 72(t)(7) I.R.C. 1997.

⁸ § 1(h) I.R.C. 1997.

⁹ § 121 I.R.C. 1997.

deemed to use it as a principal residence while the taxpayer's spouse or former spouse is given use of the residence during the separation or by the terms of the divorce.¹⁰ This provision eliminates a dangerous pitfall to the party who moved out of the residence *pendente lite* under the provisions of the old Section 1034.

c. Gains from sale of qualified small business stock are sheltered from taxation if the gain is reinvested in other qualified small business stock.

3. Child Tax Credit

The Act gives families with children under age 17 a tax *credit* of \$500 per child per year after 1998.¹¹ The credit is \$400 in 1998. The credit is phased out at higher income levels; the phase-out is graduated by reducing the credit in \$50.00 steps for each \$1,000 of AGI in excess of \$110,000 for joint filers, \$75,000 for single filers, and \$55,000 for marrieds filing separately.

i. Remember that *credits*, unlike *deductions*, offset tax liability dollar for dollar. That is, tax credits are deducted from the actual tax bill, whereas deductions serve to reduce taxable income.

ii. Although the Act does not specifically address divorce in this context, the attorney should consider maximizing the child tax credit in any prospective agreement.

4. Other Education Incentives

a. Education Tax Credits

i. Hope Scholarship credits¹²- Allowed for only the first two years of post-high school education for qualified tuition and related expenses (not including room and board).

¹⁰ § 121(d)(3)(A) & (B) I.R.C. 1997.

¹¹ § 24 I.R.C. 1997.

¹² § 25A I.R.C. 1997.

Maximum credit is \$1,500 per year, per student.

ii. Lifetime Learning Credit- This is a 20% credit that would be applied to the first \$5,000 of qualified expenses for college juniors and seniors, and graduate students or others pursuing job skill training.

iii. In order to claim the credit, *the parent must pay the the tuition and the student must be eligible to be claimed as a dependent on that parent's tax return.*¹³ Accordingly, where the parents are divorced and one parent pays the tuition while the other parent claims the dependency exemption provided by Code Section 152 (e) pursuant to a separation agreement or decree, the credit may be lost. Therefore, support agreements should be drafted to ensure that the parent paying the tuition also claims the dependency exemption.

iv. Phase-out range: between \$40,000 and \$50,000 for single taxpayers, between \$80,000 and \$100,000 for joint taxpayers.

v. The expenses must be those of the taxpayer, spouse, or dependents under age 24.

5. Estate and Gift Taxation

a. Unified Credit-The Act gradually enlarges the unified credit from the present \$600,000.00 to \$1,000,000.00 between now and 2006.

b. Family-owned farms and businesses now have an exclusion of up to \$1.3 million (which cannot be taken in addition to the unified credit) under certain circumstances.

¹³ § 25A(g)(3) I.R.C. 1997.

Conclusion

The changes made in the 1997 Act are substantial and they will affect families in divorce. Changes in capital gains rates and the treatment of gains on the sale of a principal residence will have a significant impact upon settlement negotiations and trial presentation in many divorce cases. Additionally, the Act contains sweeping changes to the IRA rules, and provides new tax benefits for education and for families with children. These benefits can and should be allocated in divorce agreements and decrees to the advantage of the parties and their children.