HIGHLIGHTS OF THE 1997 TAX LAW

As you may know, in August, 1997, Congress passed a sweeping new tax law, called the Taxpayer Relief Act of 1977 (TRA). The TRA contains over 300 changes to the already complicated Internal Revenue Code. This article gives an overview of 13 of those changes that most directly affect home and business owners.

* Employer-provided educational assistance. Before the TRA, employees paid no income taxes on undergraduate tuition paid for by their employer, up to $5,250 per year. This exclusion, which was scheduled to expire on December 31, 1997, is now a permanent part of the Internal Revenue Code. This change enhances the value of this educational fringe benefit to your employees.

* Greater deductions for charitable donations of computer technology. The Internal Revenue Code presently allows tax deductions for charitable contributions. Generally, the deduction is limited to the taxpayer's "adjusted basis" in the donated item. *Adjusted basis* is the cost of the donated item minus any depreciation. Under the TRA, businesses that are incorporated as subchapter C corporations (C corporations) will be able to take augmented deductions for their charitable donations of computer equipment and software. The augmented deduction will be equal to the adjusted basis plus an amount equal to one-half the difference between the adjusted basis and the fair market value of the equipment or software. The time period during which you can make donations and benefit from the enhanced deduction is January 1, 1998, through December 31, 2000.

* Reduction in capital gains tax rate. Previously, if you sold your business, you would generally pay tax on the net sale proceeds at a rate of up to 28 percent. Under the TRA, for sales occurring after May 6, 1997, the maximum rate will be 20 percent if you have owned the assets for at least 18 months. The 28 percent maximum rate will still apply for assets owned less than 18 months. For property that you acquire on or after January 1, 2001, the 20 percent rate will decline to 18 percent. These changes will reduce your taxes if you sell your business.

* Expansion of Individual Retirement Accounts. Presently, for married couples, if either spouse is an active participant in an employer-sponsored retirement plan, depending on their family income level, their ability to take

a deduction for their IRA contribution may be curtailed or eliminated. However, starting on January 1, 1998, under TRA, this restriction on the deduction will be eliminated and may make it easier for married couples to invest in an IRA.

* Indexing of adjusted basis. As discussed above, your adjusted basis in property is the purchase price minus depreciation. Presently, when determining your adjusted basis, you are not allowed to consider the effects of inflation. Starting on January 1, 2001, the TRA will allow businesses (excluding C corporations) to increase the adjusted basis in their business assets (including their shares of common stock if their businesses are incorporated) that they have owned for more than three years. The increase will be based on an "inflation adjustment percentage" that will be published by the Internal Revenue Code. Your ability to increase your adjusted basis in your assets will reduce the amount of tax you will incur when you sell those assets.

* Exclusion of gain on the sale of your principal residence. Under the old law, if you sold your principal residence, you did not owe any tax on the gain from the sale if you used the proceeds to purchase a new principal residence within two years from the date of the sale. This is called the "rollover rule." Also, individuals who owned their residence for at least five years and who were at least 55 years old before the sale could, on a one-time basis, exclude $125,000 of gain from the sale. This is called the "one-time exclusion rule." Under the TRA, for sales occurring after May 6, 1997, the rollover rule and the one-time exclusion rule have been replaced. Instead, you will be able to exclude up to $250,000 (or $500,000 if you are married and file a joint return). You will be able to do this every two years. However, you will still be required to pay tax on the gain to the extent that you took a home-office deduction. (More information about the home office deduction rules is available at this site). !

* Increase in the unified credit. The Internal Revenue Code imposes extremely high taxes on gifts you make during your lifetime or to your heirs when you die. Some of these gifts are excluded from gift and estate taxes. Presently, everyone is allowed to make gifts during their lifetime or at their death worth up to $600,000 free of gift and estate taxes. This is called the "unified credit." Under the TRA, starting on January 1, 1998, the unified credit will, in stages, increase to $1,000,000 by the year 2006. This will

better enable small business owners to leave their businesses to their heirs tax-free. (Information about estate planning is available elsewhere on this site.)

* Annual exclusion for gifts. Presently, in addition to the unified credit, everyone is allowed to make an unlimited number of "small" gifts each year free of gift tax. None of these gifts can exceed $10,000. This is called the "annual exclusion." Starting on January 1, 1998, the value of gifts qualifying for the annual exclusion will be indexed for inflation. This will better enable small business owners to transfer all or part of their businesses over time to their heirs.

* Generation-skipping tax. Presently, you can make gifts worth up to $1,000,000 to your grandchildren or great-grandchildren free of gift and estate tax. This is called the "GST exclusion," and you can use it in addition to the unified credit and the annual exclusion. Starting on January 1, 1998, the GST exclusion will be indexed for inflation. Again, this will better enable small business owners to transfer all or part of their businesses over time to their heirs.

* Estate tax installment payments. Currently, if you die owning a small business, your heirs can take up to 14 years to pay the estate taxes attributable to the value of your business. This is called the "installment payment rule." The interest rate on the tax on the first $1,000,000 of the value of your small business is 4 percent. Starting on January 1, 1998, the $1,000,000 value will be indexed for inflation, and the interest rate on the first $1,000,000 (indexed for inflation) will be reduced to 2 percent. Along with the changes discussed above and below, this will ease the estate tax burden on your heirs who inherit your small business.

* Estate tax exclusion for family-owned businesses. Before the TRA, there was no special estate tax rule for family-owned businesses. Congress was concerned that the heirs of many family-owned business had to sell the business to pay the estate tax. Starting on January 1, 1998, under some complicated rules, the first $1,000,000 of value of many family-owned businesses will be excluded from estate tax. This exclusion can be used in addition to the unified credit and the installment payment rule and will further ease the estate tax burden on your heirs who inherit your small business. (More information about estate tax savings available to small business owners is available on this site.)

* Welfare-to-work tax credit. Presently, if you employ a member of a "targeted group" (persons in a family receiving AFDC or food stamps, certain ex-felons, "high risk" youth, "summer youth" employees, certain veterans, and vocational rehabilitation referrals), you can receive a tax credit of up to $2,100 per individual. Under the TRA, your credit may go up to $8,500 for individuals who begin working for you between January 1, 1998, and May 1, 1999.

* Home office deduction. Currently, you might be entitled to an income tax deduction if you regularly and exclusively use part of your home for your business in any one of the following ways: (1) as the location of the "principal place" of your business, (2) as a place where you meet clients or customers in the normal course of your business, or (3) "in connection" with your business if the part of your residence so used is a separate structure not attached to your dwelling (such as a garage). Business owners who conduct business at more than one location (and who do not meet clients or customers at home or who do not use a separate structure) sometimes have difficulty convincing the Internal Revenue Service (IRS) that their home office is their "principal place" of business. You are deemed to conduct business at more than one location if you do anything substantially related to your business away from your home office, such as regularly meeting vendors, clients, or customers at their offices. In that case, you must convince the IRS that your home-based activities are your "most important" business activities. (More information about the home office deduction is available on this site.)

Starting on January 1, 1998, your home office will qualify as your "principal place" of business if you exclusively and regularly use part of your home to conduct administrative or management activities for your business, provided that there is no other location at which you actually conduct "substantial" administrative or management activities. Whether you decline to use facilities that are available to you outside your home office to perform administrative or management tasks should not affect your deduction. Also, you should still qualify for the deduction even if you perform substantial non-administrative or non-management business activities (such as client or customer meetings) outside your home.

In conclusion, you may be able to save money under the new tax rules. You should consult with your tax advisor to make sure that you do not miss any of these opportunities.