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Taxpayer Relief Act of 1997: Provisions Affecting Retirement Planning and Employee Benefits

Louis A. Mezzullo

TAXPAYER RELIEF ACT OF 1997:
PROVISIONS AFFECTING RETIREMENT PLANNING AND EMPLOYEE BENEFITS

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I. RETIREMENT PLANNING

A. Traditional IRAs.

1. The Act increases the income limits for active participants as follows (Act § 301, amending I.R.C. § 219(g)(3):

Filing Status	Year	Full Deduction Up To	No Deduction At and Over	Deduction Phase-Out Between
Single/Head of Household	1997	$25,000	$35,000	$25,000-$35,000
	1998	$30,000	$40,000	$30,000-$40,000
	1999	$31,000	$41,000	$31,000-$41,000
	2000	$32,000	$42,000	$32,000-$42,000
	2001	$33,000	$43,000	$33,000-$43,000
	2002	$34,000	$44,000	$34,000-$44,000
	2003	$40,000	$50,000	$40,000-$50,000
	2004	$45,000	$55,000	$45,000-$55,000
	2005 and later	$50,000	$60,000	$50,000-$60,000
Married-Joint Return/ Qualifying Widow(er) (IRA of Active Participant)	1997	$40,000	$50,000	$40,000-$50,000
	1998	$50,000	$60,000	$50,000-$60,000
	1999	$51,000	$61,000	$51,000-$61,000
	2000	$52,000	$62,000	$52,000-$62,000
	2001	$53,000	$63,000	$53,000-$63,000
	2002	$54,000	$64,000	$54,000-$64,000
	2003	$60,000	$70,000	$60,000-$70,000
	2004	$65,000	$75,000	$65,000-$75,000
	2005	$70,000	$80,000	$70,000-$80,000
	2006	$75,000	$85,000	$75,000-$85,000
	2007 and later	$80,000	$100,000	$80,000-$100,000
Married - Separate Return	1997 and later	Not Allowed	$10,000	$0 - $10,000
Married-Joint Return (IRA of Nonparticipant)	1997	$40,000	$50,000	$40,000-$50,000
	1998 and later	$15,000	$160,000	$150,000 - $160,000

2. The Act permits penalty-free withdrawals from individual retirement plans for higher educational expenses (Act § 203, adding I.R.C. § 72(t)(2)(E) and 72(t)(7)). See II.B.4. for a discussion of this provision.

3. The Act permits a spouse who is not an active participant in a qualified retirement plan to make tax deductible contributions to his or her own IRA even if his or her spouse is an active participant until the adjusted gross income reaches $150,000, when the amount deductible is reduced proportionately until adjusted gross income reaches $160,000.

B. <u>Roth IRAs</u> (Act § 302, adding I.R.C. § 408A.

1. The Act creates a new type of IRA called a Roth IRA.

    a. A Roth IRA is subject to all of the traditional IRA rules, except as specifically changed.

    b. Contributions to a Roth IRA can be made for tax years beginning after December 31, 1997.

2. There is no deduction for contributions to a Roth IRA.

3. The limit on contributions to a Roth IRA are the same as those that apply to traditional IRAs.

    a. However, the amount that can be contributed to a Roth IRA is reduced by contributions to a traditional IRA.

    b. The amount that can be contributed is phased out based on the modified adjusted gross income of the taxpayer or taxpayers according to the following schedule:

Filing Status	Full Contribution	No Contribution	Partial Contribution
Single/Head of Household	Up to $95,000	$110,000 or more	$95,000-$110,000
Married-Joint Return/Qualifying Widow(er)	Up to $150,000	$160,000 or more	$150,000-$160,000
Married-Separate Return	Not Allowed	$15,000 or more	$0-$15,000

c. Modified adjusted gross income is the taxpayer's (or taxpayers') adjusted gross income with the following adjustments:

(1) The following items are added:

(a) Foreign earned income exclusion;

(b) Foreign housing exclusion;

(c) Interest exclusion on U.S. savings bonds used to pay higher education expenses; and

(d) Adoption assistance exclusion.

(2) The following item is subtracted:

(a) Income from rolling over or converting a traditional IRA to a Roth IRA.

4. Contributions are permitted after age 70½ and a Roth IRA is not subject to the required minimum distribution rules while the account holder is alive.

a. Distributions are not required until after the account holder's death, when the minimum distribution rules will apply.

b. However, a spousal rollover into another Roth IRA will continue to defer distributions until the surviving spouse's death.

5. A traditional IRA can be rolled over or converted to a Roth IRA.

a. Current contributions for the year, plus earnings on the contributions, may be transferred from a traditional IRA to a Roth IRA without income recognition or being subject to the six percent penalty.

b. The amount rolled over is included in the individual's gross income.

c. If the rollover or conversion occurs in 1998, the income will be recognized ratably over four years beginning in 1998.

d. While a rollover conversion will not affect eligibility for Roth IRA contributions, it will be included in income for purposes of deductibility of traditional IRA contributions and the phase-out of itemized deductions and personal exemption.

e. Although a traditional IRA may be "converted" into a Roth IRA, it is unlikely that it will remain the same IRA account, since separate documents will likely be required for traditional IRAs and Roth IRAs.

f. Rollovers from traditional IRAs to Roth IRAs are not subject to the one per year limit and do not count as rollovers for that limit as it applies to traditional IRAs.

g. A traditional IRA transferred to a Roth IRA is treated as a rollover.

h. A rollover or conversion from a traditional IRA to a Roth IRA is not permitted if modified adjusted gross income exceeds $100,000 for the tax year.

i. A rollover or conversion from a traditional IRA to a Roth IRA is not allowed if a married couple is filing separately.

j. Although a qualified retirement plan benefit may not be rolled into a Roth IRA, an individual meeting other requirements may be able to roll the qualified retirement plan benefit into a traditional IRA, and then convert or roll the traditional IRA into a Roth IRA.

k. Section 5(b)(4) of the Technical Corrections Act would limit the ability to use a traditional IRA to Roth IRA conversion or rollover with an immediate subsequent distribution from the Roth IRA as a device to avoid paying the ten percent early withdrawal penalty tax on traditional IRAs or qualified retirement plan benefits.

6. Nonqualified distributions are treated as first made from contributions, and then from earnings.

a. Earnings are includible in taxable income and will be subject to a ten percent premature withdrawal penalty if made before age 59½ and would not otherwise satisfy one of the exceptions to the premature withdrawal additional income tax.

7. A qualified distribution will not be includible in taxable income.

   a. A qualified distribution can only be made after the five-year period that begins, in the case of an annual contribution, with the first year for which the contribution is made even if the contribution is made after the end of the year, and, in the case of a rollover or converted Roth IRA, with the year in which the rollover or conversion occurred.

   b. A qualified distribution must also meet a purpose test, which requires that the distribution:

      (1) Be made after 59½;

      (2) Be made after the death of the individual;

      (3) Be attributable to the individual's total and permanent disability; or

      (4) Be a qualified first-time homebuyer distribution.

   c. A qualified first-time homebuyer distribution is used for the costs of acquiring, constructing or reconstructing (including usual or reasonable settlement, financing or other closing costs) the principal residence of the Roth IRA owner or his or her spouse, a child, grandchild or an ancestor of the owner or spouse.

      (1) The individual for whom the home is being acquired (and if married, such individual's spouse) must not have had an ownership interest in a principal residence during the two-year period ending on the date of acquisition.

      (2) Individuals on extended active duty in the Armed Forces and individuals with homes in foreign countries may not qualify as a qualified first-time homebuyer if the period for tax-free rollover of gain on the sale of a prior residence has been suspended.

      (3) The amount distributed must be used within 120 days of the distribution for the payment of eligible costs.

      (4) If a distribution from a Roth IRA is not used for the costs of acquiring, constructing or reconstructing a

principal residence because of a delay or cancellation in the purchase or construction, and the distribution is rolled over to another Roth IRA within 120 days of the distribution, it will not be subject to income tax nor to the rule limiting rollovers to one in a year.

(5) The total lifetime amount that can qualify as a first-time homebuyer distribution from all of an individual's IRAs is $10,000.

8. Planning.

a. Whether to roll over traditional IRAs (or qualified retirement plans into traditional IRAs followed by a rollover to a Roth IRA) will be an important financial decision for many people.

b. The following variables will be important in making the decision:

(1) Tax rate at time of rollover (higher rates favor not rolling over).

(2) Tax rate at time of distribution (higher rates favor rolling over).

(3) Length of time to distribution (longer time favors rolling over).

(4) Distributions needed/not needed before death ("not needed" favors rollover).

(5) Investment earning rate (higher rates favor rollover).

c. An owner of a closely-held business who can control his or her income may be able to reduce his or her modified adjusted gross income for one year to below $100,000, allowing him or her to make a Roth IRA rollover.

d. Rollovers of qualified retirement plans to either a traditional IRA or a Roth IRA may not be favorable for individuals facing possible tort or contract liabilities because of the loss of the protection from creditors afforded to benefits held in an ERISA qualified pension plan under Patterson v. Shumate., 112 S. Ct. 2242 (1992).

(1) A state's shield law applicable to traditional IRAs may protect a Roth IRA from creditors, depending upon its wording.

C. Other Retirement Plan Provisions.

1. The "collectibles" in which an individually directed retirement plan account or an IRA may invest has been expanded, effective January 1, 1998, to include:

   a. Certain platinum coins; and

   b. Gold, silver, platinum, or palladium bullion meeting or exceeding the fineness needed for regulated futures contracts.

      (1) Bullion must be held by an IRA trustee.

   Act § 304, amending I.R.C. § 408(m).

2. The de minimis limit below which qualified retirement plans may make cash-out distributions is increased to $5,000 effective August 5, 1997. Act § 1071, amending I.R.C. § 411(9)(11) and ERISA § 203(e)(1).

3. Qualified parking expenses may be made subject to an election by the employee to receive that benefit or cash effective January 1, 1998. Act § 1072, amending I.R.C. § 132(f)(4).

4. The excise tax on prohibited transactions is increased to 15 percent effective August 5, 1997. Act § 1074, amending I.R.C. § 4975(a).

5. Recovery of employee contributions when distributions are being made in the form of an annuity over more than one life is extended by requiring assumption of a number of payments that takes into account the ages of both annuitants. Act § 1075, amending I.R.C. § 72(d)(1)(B).

   a. For example, assume a joint and survivor annuity with both annuitants age 65 at the starting date. Under the prior rule, 260 payments was used. Under the new rule, 360 payments will be used.

   b. The new rule is effective for annuities beginning after December 31, 1997.

6. Matching contributions on behalf of a self-employed individual will no longer be treated as elective deferrals for purposes of the dollar limit on elective deferrals to 401(k) plans or simple retirement accounts. Act § 1501, amending I.R.C. §§ 402(g) and 408(p).

   a. Effective for 401(k) plans after December 31, 1997.

   b. Effective for simple retirement accounts after December 31, 1996.

7. Plans may now offset benefits payable to a participant by certain amounts the participant is required to pay to the plan effective August 5, 1997. Act § 1502, amending ERISA § 206(d).

8. Summary Plan Descriptions and Summaries of Material Modifications are no longer required to be filed with the U. S. Department of Labor. Act § 1503, amending ERISA §§ 102 and 104.

   a. The Department of Labor may request copies of such documents.

   b. The requirements to supplying these documents to participate are unchanged.

   c. Effective August 5, 1997.

9. Governmental retirement plans are permanently excepted from most of the nondiscrimination requirements effective immediately and retroactively. Act § 1505, amending I.R.C. §§ 401(a)(5), 401(a)(26), 401(c)(2), 401(k)(3), and 403(b).

10. ESOPs as S corporation shareholders. Act §§ 1506 and 1523, amending various I.R.C. and ERISA sections.

   a. Employees receiving share distributions may be required to sell those shares back to the corporation. I.R.C. § 409(h).

   b. Shareholder-employees may sell their shares to an ESOP and the sale will not be a prohibited transaction, if the general requirements for the employer stock sale exemption are met. I.R.C. § 4975(f) and ERISA § 408(d).

   c. The ESOP's share of the corporation's earnings will not be unrelated business taxable income and therefore not be subject to income tax until distributed to the plan participants. I.R.C. § 512(e).

d. These provisions apply to taxable years beginning after December 31, 1997.

11. The definition of nondeductible contributions subject to a ten percent excise tax is modified, effective after December 31, 1997. Act § 1507, amending I.R.C. § 4972(c)(6).

12. Funding limits for defined benefit plans are liberalized. Act §§ 1508 and 1521, amending I.R.C. § 412, ERISA § 302, and Retirement Protection Act of 1994 § 769.

13. Acceptance of Rollovers. It is not necessary for a distributing plan to have a determination letter for the receiving plan to reasonably conclude the distributing plan is qualified. Because this provision is treated as a clarification, no effective date is stated. Act § 1509.

14. 401(k) Plans that are not ESOPs may not require employees to invest more than the greater of ten percent of their accounts or one percent of their compensation in employer stock or employer real estate. Effective for plan years beginning after December 31, 1998. Act § 1524, amending ERISA § 407(b).

II. EMPLOYEE BENEFIT AND EDUCATION RELATED ITEMS

A. Employee Benefit Items.

1. Clarification of Treatment of Home Office Use for Administrative and Management Activities (Act § 932, amending I.R.C. § 280A(c)(1)).

a. I.R.C. § 280A(c)(1) currently provides that expenses in connection with a home office will be deductible if it is used on a regular basis:

(1) As the principal place of business for any trade or business of the taxpayer;

(2) As a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business; or

(3) In the case of a separate structure which is not attached to the dwelling unit, in connection with the taxpayer's trade or business.

b. The Act provides that the term "principal place of business" includes a home office if:

(1) The office is used by the taxpayer for the administrative or management activities of any trade or business of the taxpayer; and

(2) There is no other fixed location of the trade or business where the taxpayer conducts substantial administrative or management activities of the trade or business.

c. The expanded definition of principal place of business will enable many taxpayers to deduct the cost of traveling to and from their homes to other locations at which they conduct business.

d. The House Committee Report offers the following guidance:

(1) Deductions will be allowed for a home office meeting the new two part test only if the office is exclusively used on a regular basis as the place of business by the taxpayer and, in the case of an employee, only if such exclusive use is for the convenience of the employer.

(2) The fact that the taxpayer also carries out administrative or management activities at sites that are not fixed locations of the business, such as a car or hotel room, will not affect the taxpayer's ability to claim a home office deduction.

(3) If a taxpayer conducts some administrative or management activities at a fixed location of the business outside the home, the taxpayer will still be eligible to claim a deduction so long as the administrative or management activities conducted at any fixed location of the business outside the home are not substantial (e.g., the taxpayer occasionally does minimal paperwork at another fixed location of the business).

(4) A taxpayer's eligibility to claim a home office deduction will not be affected by the fact that the taxpayer conducts substantial non-administrative or non-management business activities at a fixed location of the business outside the home (e.g., meeting with, or providing services to, customers, clients, or patients at a fixed location of the business away from home).

(5) If a taxpayer in fact does not perform substantial administrative or management activities at any fixed location of the business away from home, the second part of the test will be satisfied regardless of whether or not the taxpayer opted not to use an office away from home that was available for the conduct of such activities.

(a) However, in the case of an employee, the question whether an employee chose not to use suitable space made available by the employer for administrative activities is relevant to determining whether the present-law "convenience of the employer" test is satisfied.

(6) In cases where a taxpayer's use of a home office does not satisfy the provision's two part test, the taxpayer nonetheless may be able to claim a home office deduction under the present-law "principal place of business" exception.

e. The new rules are effective for taxable years beginning after 1998.

2. Health Insurance for Self-Employed Individuals (Act § 934, I.R.C. § 162(l)(1)(B)).

a. The Act changes the phase-in schedule for the portion of health insurance deductible for self-employed individuals as follows:

Years	Percentages
1997	40%
1998-1999	45%
2000-2001	50%
2002	60%
2003-2005	80%
2006	90%
2007 & thereafter	100%

B. Education Related Items.

1. Education Individual Retirement Accounts (Act § 213, adding new I.R.C. §§ 530, 4975, 6693(a), 4973, 26(b)(2), and 135(c)(2)).

a. The Act creates a new type of individual retirement account, called an education individual retirement account, which is tax exempt.

(1) The account is not designed for retirement.

(2) An education individual retirement account is not subject to the general rules for IRAs, except as those are specifically referenced or incorporated.

b. An education individual retirement account is a trust (or a custodial account if certain conditions are satisfied) created or organized in the United States exclusively for the purpose of paying the qualified higher education expenses of a designated beneficiary of the trust.

(1) The account must be designated as an education individual retirement account at the time it is created or organized.

c. The written governing instrument must satisfy the following requirements:

(1) No contribution will be accepted unless it is in cash.

(2) Contributions cannot be accepted after the designated beneficiary attains age 18.

(3) Except for rollover contributions, contributions may not exceed $500 in a taxable year.

(4) The trustee must be a bank or other approved person.

(5) Investments in life insurance contracts are prohibited.

(6) The assets may not be commingled unless in a common trust fund or common investment fund.

(7) Upon the death of the beneficiary, any balance to the credit of the beneficiary must be distributed within 30 days after the date of death to the estate of the beneficiary.

d. Qualified higher education expenses are tuition, fees, books, supplies and equipment required for enrollment or attendance at an eligible educational institution.

(1) Qualified higher education expenses include amounts paid or incurred to purchase tuition credits or certificates or to make contributions to a qualified state tuition program as defined in I.R.C. § 529(b).

(2) Room and board expenses that do not exceed federal financial aid guidelines are also qualified higher education expenses for students attending at least half-time.

(3) Eligible educational institutions are accredited post-secondary institutions offering bachelors, associate's, graduate or professional degrees and certain post-secondary vocational institutions eligible to participate in federal student aid programs.

(4) Qualified higher education expenses are reduced by payments for student education expenses that are excludible from gross income such as certain scholarship and veterans' assistance.

e. The $500 limit is for all education individual retirement accounts for any one designated beneficiary, although no mechanism is provided for coordinating contributions by multiple contributors to education individual retirement accounts for the benefit of a single designated beneficiary.

f. The following estate and gift tax treatment applies to education individual retirement accounts:

(1) Contributions are treated as completed gifts to the designated beneficiary that qualify for the annual exclusion as a present interest, but are not treated as a qualified transfer to an educational institution under I.R.C. § 2503(e).

(2) Amounts in an education individual retirement account are not included in the gross estate of any individual except with respect to amounts distributed on account of the death of the designated beneficiary.

(3) Distributions from an educational individual retirement account are generally not treated as taxable gifts.

(4) If the beneficiary's interest is rolled over to another beneficiary or there is a change in the beneficiary, no gift or generation-skipping transfer tax consequences result, provided that the two beneficiaries are the same generation.

(5) If a beneficiary's interest is rolled over to a beneficiary in a lower generation (e.g., parent to a child or aunt to a niece), the five-year averaging rule discussed below in connection with the gift tax treatment of qualified state tuition programs may be available to exempt up to $50,000 of the transferred amount.

g. The $500 annual dollar limitation on contributions is reduced by a fraction, the numerator of which is the excess of the contributor's modified adjusted gross income over $95,000 ($150,000 for a joint return) and the denominator of which is $15,000 ($10,000 for a joint return).

(1) Modified adjusted gross income is adjusted gross income plus exclusions under I.R.C. §§ 911, 931, and 933 (foreign source income, and income from certain U.S. possessions and Puerto Rico).

(2) The modified adjusted gross income amounts are not adjusted for inflation.

h. Distributions are not includible in gross income unless they exceed the qualified higher education expenses of the designated beneficiary.

(1) The designated beneficiary may elect not to exclude the distributions from gross income.

(2) The election may be advantageous if the Hope Scholarship Credit or the Lifetime Learning Credit may thereby be claimed.

i. Distributions exceeding qualified higher education expenses are includible in gross income.

(1) The amount treated as includible in gross income is the amount of the excess contributions times the percentage of the total account composed of earnings rather than contributions.

(2) An additional ten percent income tax is imposed on the amount of an excess distribution included in income, unless an exception applies.

(3) The ten percent tax does not apply if the distribution is:

(a) Made to a beneficiary (or to the estate of the designated beneficiary) on or after the death of the designated beneficiary;

(b) Attributable to the designated beneficiary's being disabled within the meaning of I.R.C. § 72(m)(7); or

(c) Made on account of, and not in excess of, certain scholarships, public education assistance, or payments for the designated beneficiary's educational expenses or which are attributable to the designated beneficiary's attendance at an eligible educational institution. Gifts and bequests do not count as payments for the designated beneficiary's education.

(4) The ten percent additional tax also does not apply if the distribution represents an excess contribution (i.e., exceeds $500 or the applicable contribution limit) and the distribution is received on or before the due date for the contributor's income tax return (including extensions) for the taxable year and the distribution is accompanied by the net income attributable to the excess contribution.

(a) Any net income attributable to the excess contribution will be includible in the contributor's gross income for the taxable year in which the excess contribution was made.

(5) A rollover contribution will not be includible in income.

(a) A rollover contribution is an amount that is paid into another education individual retirement account for the benefit of the same beneficiary or a member of the family of the beneficiary not later than the 60th day after the date of the payment or distribution.

(b) Only one rollover may be made from an education individual retirement account during a 12-month period.

(6) Any change of beneficiary of an education individual retirement account will not be treated as a distribution if the new beneficiary is a member of the family.

j. As with other individual retirement accounts, the education individual retirement account is applied without regard to any community property laws.

k. Excess contributions are subject to the six percent tax on excess contributions under I.R.C. § 4973.

l. A contribution cannot be made to an education individual retirement account on behalf of a beneficiary if an amount is contributed that year to a qualified state tuition program for the benefit of the same beneficiary.

m. This provision applies to taxable years beginning after December 31, 1997.

2. Hope Scholarship and Lifetime Learning Credits (Act § 201, adding I.R.C. §§ 25A, 6213(g)(2)(J), 6050S, 6724(d)(2)(Z), 6724(d)(1)(B)(ix), and 135(d)(2)).

a. Two new credits are available to individuals for education expenses: the Hope Scholarship Credit and the Lifetime Learning Credit, which must be elected by the taxpayer.

(1) Neither credit is available if distributions from an education individual retirement account made with respect to the individual during the taxable year was excludible from gross income.

(2) Only one of the credits may be elected with respect to the same eligible student for a taxable year.

b. The Hope Scholarship Credit.

(1) For each eligible student for whom an election is effective, the Hope Scholarship Credit is an amount equal to the sum of:

(a) 100 percent of education expenses paid by the taxpayer during the taxable year up to $1,000; plus

(b) 50 percent of education expenses in excess of $1,000, up to $2,000.

(2) Both dollar amounts are adjusted for inflation after 2001.

(3) The following requirements and limitations apply:

(a) The credit is only available for two taxable years with respect to each eligible student.

(b) The credit is only available for the first two years of post-secondary education for each eligible student.

(c) The credit is not available if the student has been convicted of a federal or state felony offense consisting of the possession or distribution of a controlled substance.

(d) The student must carry at least one-half the normal full-time workload for the course of study being pursued.

c. The Lifetime Learning Credit.

(1) The Lifetime Learning Credit for any taxpayer for any taxable year is an amount equal to 20 percent of so much of the education expenses paid by the taxpayer during the taxable year that does not exceed $10,000 ($5,000 for years beginning before 2003).

(2) The dollar limits are not adjusted for inflation.

(3) Education expenses for this credit include expenses with respect to any course of instruction at an eligible education institution to acquire or improve the job skills of the individual.

d. The amount of Hope Scholarship Credit or Lifetime Learning Credit is phased out, depending on the taxpayer's modified adjusted gross income.

(1) The credit is reduced by a fraction, the numerator of which is the excess of the taxpayer's modified adjusted gross income over $40,000 for a single taxpayer and $80,000 for a joint return and the denominator of which is $10,000 for a single taxpayer and $20,000 for a joint return.

(2) Modified adjusted gross income is adjusted gross income increased by exclusions under I.R.C. §§ 911, 931, and 933 (foreign source income or income from certain U.S. possessions and Puerto Rico).

(3) The dollar amounts of modified adjusted gross income are adjusted for inflation after 2001.

e. Education expenses defined.

(1) Education expenses are tuition and fees paid for the enrollment and attendance of

(a) The taxpayer;

(b) The taxpayer's spouse; or

(c) Any dependent of the taxpayer with respect to whom the taxpayer is allowed a personal exemption deduction;

at an eligible education institution for courses of instruction at such institution.

(2) Education expenses do not include:

(a) Expenses involving sports, games or hobbies unless the courses or other education is part of the individual's degree program; or

(b) Nonacademic fees, such as student activity fees, athletic fees, insurance expenses, or other expenses unrelated to an individual's academic course of instruction.

f. Education expenses are reduced by scholarships excluded from income, certain educational assistance received under federal programs, and other payments for education expenses (except for gifts and inheritances otherwise excludible under I.R.C. § 102) excluded from gross income.

g. Education expenses paid by an individual who could be claimed as a dependent by another taxpayer are not eligible for a credit against the individual's income tax but are treated as education expenses paid by the other taxpayer for purposes of the credits.

h. Education expenses paid during a taxable year for an academic period beginning during the first three months of the following year are treated as paid in the earlier year.

i. A married couple must file a joint return to claim either credit.

j. The Hope Scholarship Credit is available for expenses paid after December 31, 1997 in taxable years ending after that date, for education furnished in academic periods beginning after that date.

k. The Lifetime Learning Credit is available for expenses paid after June 30, 1998 in taxable years ending after that date for education furnished in academic periods beginning after that date.

3. Interest on Education Loans (Act § 202, adding new I.R.C. §§ 221 and 62(a)(1), and amending I.R.C. § 6050S(a)(2), (b)(2) and (e)).

a. Interest on education loans is deductible up to the following dollar amounts:

Taxable Years Beginning In:	Amount
1998	$1,000
1999	$1,500
2000	$2,000
2001	$2,500

b. The amount deductible is reduced by a fraction, the numerator of which is the excess of the taxpayer's modified adjusted gross income (as defined in I.R.C. § 221(b)(2)(C)), over $40,000 for a single taxpayer and $60,000 for a joint return, and the denominator of which is $15,000.

(1) The modified adjusted gross income amounts are adjusted for inflation after 2002.

c. A married couple must file a joint return to claim the deduction.

d. The deduction is not available for an individual who can be claimed as a dependent by another taxpayer.

e. Interest on an education loan is only deductible for the first 60 months (whether or not consecutive) in which interest payments are required.

(1) A loan used to refinance an education loan is treated the same as the education loan.

f. A loan eligible for the deduction is any indebtedness incurred to pay qualified education expenses on behalf of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer, and includes indebtedness used to refinance such a loan.

(1) A loan to a related party as defined in I.R.C. § 267(b) or 707(b)(1) is not eligible.

g. The deduction is available regardless of whether the taxpayer itemizes deductions.

h. The deduction is allowable for interest payments due and paid after 1997 regardless of when the loan was incurred; however, the 60-month period begins when the first interest payment was required.

4. Penalty-Free Withdrawals from Individual Retirement Plans for Higher Education Expenses (Act § 203, adding I.R.C. §§ 72(t)(2)(E) and 72(t)(7)).

   a. I.R.C. § 72(t) is amended to exempt from the ten-percent premature withdrawal additional tax distributions from an individual retirement plan for qualified higher education expenses for the taxpayer, the taxpayer's spouse, or any child or grandchild of the taxpayer or taxpayer's spouse.

   b. The exemption applies to distributions after 1997 for expenses paid after 1997 in taxable years ending after 1997 for education expenses in academic years beginning after 1997.

   c. Qualified higher education expenses are defined as described above for Education IRAs.

5. Modifications to Qualified State Tuition Programs (Act § 211, amending I.R.C. §§ 529 and 135, and adding I.R.C. § 6693(a)(2)(c)).

   a. In addition to a number of other changes to the rules concerning qualified state tuition programs under I.R.C. § 529, the Act provides specific rules for gift and estate tax consequences of contributions to and distributions from qualified tuition programs.

   b. A contribution to such a program is treated as a gift of a present interest eligible for the annual exclusion under I.R.C. § 2503(b).

      (1) The contribution does not qualify for the exclusion under I.R.C. § 2503(e)(2)(A) as a qualified transfer to an educational organization for the education or training of an individual.

      (2) If the contribution exceeds the annual exclusion amount, the donor may elect to treat the gift as being made ratably over a five-year period beginning with the year of the transfer.

(a) If the donor dies before the end of the five-year period, the balance attributable to subsequent years will be included in the donor's estate.

(b) A distribution from the program will not be treated as a taxable gift unless there is a change in the designated beneficiary and the new beneficiary is in a generation below the generation of the old beneficiary as determined under the generation-skipping tax provisions.

c. The amount held for the benefit of an individual in a qualified state tuition program will not be included in the individual's estate unless the amount is distributed from the program on account of the beneficiary's death.

6. Extension of Exclusion for Employer-Provided Education Assistance (Act § 221, amending I.R.C. § 127(d)).

a. I.R.C. § 127(d) formerly provided for an exclusion of up to $5,250 from income for expenses paid by an employer for courses beginning before July 1, 1997.

b. The Act extends the exclusion for courses beginning before June 1, 2000.