WILMERHALE

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The Taxpayer Relief Act of 1997

On August 5, 1997, President Clinton signed into law the Taxpayer Relief Act of 1997. The Act is expected to result in $151 billion in tax cuts and $56 billion in tax increases over the next five years. The Act affects a variety of specified transactions and taxpayers and is subject to numerous effective dates and transition rules. The following discussion is an overview of some of the provisions of the Act that are most likely to affect businesses and investors.

Rates on Long-Term Capital Gains for Individuals

The Act reduces the maximum tax rate for individuals on long-term capital gains from 28% to 20% for assets held for more than 18 months. The maximum tax rate for individuals on capital gains arising from the sale of assets held for more than one year but not more than 18 months remains at 28%. Assets acquired after 2000 and held for more than five years will be subject to a maximum 18% rate.

Gain on the sale of collectibles is not eligible for the 20% rate but continues to be subject to the maximum 28% rate. Gain on the sale of qualified small business stock as defined in Code Section 1202 continues to be eligible for the exclusion of 50% of the gain but remains subject to the maximum 28% rate (resulting in a 14% maximum rate).

Capital gain attributable to the depreciation on real estate held for more than 18 months that is not subject to recapture is taxed at 25%.

These new rates apply for purposes of computing both the regular income tax and the alternative minimum tax and generally apply to gains arising (and installment payments received) after May 6, 1997. Gains from sales after May 6, 1997 and before July 29, 1997 qualify for the new 20% maximum rate if the asset was held for more than one year at the time of sale.

Tax-Free Rollover of Investments in Qualified Small Business

The Act provides that an individual may defer recognition of gain on the sale of stock in a qualified small business by reinvesting the sale proceeds in another qualified small business within 60 days of the sale. The individual must have held the stock for at least six months. For this purpose, a qualified small business is a business that qualifies under Code Section 1202. This provision is effective for sales after August 5, 1997.

Gain from the Sale of a Principal Residence

The Act allows individuals to exclude up to $250,000 ($500,000 in the case of joint returns) of gain arising from the sale of a principal residence used as such for at least two years during the five years preceding the date of sale. The exclusion is available every two years with special adjustments made for unanticipated sales during the required holding period. This provision replaces the "rollover" and "one-time-exclusion" provisions formerly available to homeowners and is effective for sales occurring after May 6, 1997. A transition rule, however, permits taxpayers to elect to apply the prior law to sales occurring prior to August 5, 1997 or sales occurring pursuant to contracts executed prior to August 5, 1997.

Elimination of the Alternative Minimum Tax for Small Businesses

The Act repeals the corporate alternative minimum tax, effective for taxable years beginning after 1997, on a corporation with average annual gross receipts of less than $5 million for the three taxable years preceding its first tax year beginning after December 31, 1996. A corporation that meets the $5 million gross-receipts test will continue to be exempt from the alternative minimum tax so long as its average annual gross receipts as determined under a statutory formula do not exceed $7.5 million.

The Act also repeals for all taxpayers the alternative minimum tax adjustment resulting from the use of longer depreciable lives for computing depreciation deductions. This provision permits taxpayers to use the depreciable lives used for regular tax computations in determining the alternative minimum tax but retains adjustments resulting from the use of certain methods of accelerated depreciation. This repeal is effective for property placed in service after 1998. Property placed in service prior to 1999 continues to be subject to the alternate depreciation system for purposes of the alternative minimum tax.

Extension of Research Tax Credit

The Act revives and extends the tax credit for research and experimentation expenditures incurred after May 31, 1997 and before July 1, 1998.

Extension of Period for Contributing Certain Stock to Private Foundations

The Act revives and extends the fair-market-value deduction for taxpayers who contribute appreciated, publicly traded stock to private foundations after May 31, 1997 and before July 1, 1998.

Constructive Sales of Financial Positions

In an effort to eliminate the tax deferral provided by transactions such as "short sales against the box" and "equity swaps", the Act generally requires recognition of gain (but not loss) upon any constructive sale of an appreciated financial position in a stock, a partnership interest, or a debt instrument. A constructive sale can include, for example, a short sale, an offsetting notional principal contract, or a futures or forward contract. A constructive sale is not subject to treatment as a recognition event if the transaction is closed within 30 days of the end of the taxpayer's taxable year and the taxpayer's risk of loss with respect to the appreciated financial position is not reduced during the following 60 days. This provision is generally effective for constructive sales occurring after June 8, 1997. Special rules apply to constructive sales that occurred prior to June 9, 1997 and that are not closed by September 3, 1997.

Requirement of Gain Recognition on Certain Distributions of Controlled Corporation Stock

The Act restricts the ability of a corporation to distribute or "spin off" the stock of a controlled corporation on a tax-free basis. In particular, if, pursuant to a plan or arrangement in existence on the date of distribution, 50% or more of either the controlled corporation or the distributing corporation is acquired, then gain is recognized by the distributing corporation. Any acquisition within the 4-year period beginning 2 years before the date of distribution is presumably part of a plan and therefore the distribution would be subject to these restrictions.

If this provision applies, the distributing corporation must recognize gain as if it had sold the stock of the controlled corporation. An exception applies for certain transfers within an affiliated group. The provision is generally effective for distributions occurring after April 16, 1997.

Limitation of Corporate Dividends Received Deduction

The Act allows the dividends received deduction to corporations that receive dividends accrued or paid after September 4, 1997 only if the corporation held the stock for at least 46 days within the ninety day period beginning 45 days before the ex-dividend date.

The Act also provides that redemptions treated as dividends to a corporate stockholder because of the stockholder's ownership of stock options in the distributing corporation are taxable to the extent that the amount excluded pursuant to the dividends received deduction exceeds the holder's stock basis. This provision is generally effective for distributions after May 3, 1995.

Taxation of the Receipt of Certain Preferred Stock in Corporate Transactions

The Act treats certain preferred stock as taxable "boot" in some transactions that otherwise permit the receipt of stock without tax, including various types of reorganizations. This provision is generally effective for transactions occurring after June 8, 1997.

Modification of Carryforward and Carryback Provisions

The Act extends the number of years to which a corporation can carry forward a net operating loss from 15 to 20 and reduces the number of years to which a corporation can carry back a net operating loss from 3 to 2. These provisions apply to net operating losses for taxable years beginning after August 5, 1997.

Provisions Affecting International Transactions

The Act adds computer software to the list of products that are eligible for foreign sales corporation tax benefits. The provision applies to gross receipts attributable to periods after December 31, 1997.

The Act repeals the 35% excise tax on certain transfers of appreciated property to foreign corporations, trusts, estates, or partnerships. In place of the excise tax, the Act requires that the transferor recognize gain on transfers to foreign estates or trusts as if the assets were sold for fair market value. In addition, the Act provides regulatory authority to deny nonrecognition treatment for a transfer of appreciated property to a foreign corporation and to require gain recognition upon the transfer of appreciated property to a foreign partnership if the appreciation will be allocated to a foreign partner. These provisions became effective on August 5, 1997.

Estate and Gift Tax Relief

The Act increases the "unified credit" equivalent for calculating estate and gift taxes from $600,000 to $1 million by increments in each year from 1998 through 2006.

Additionally, under the Act a decedent's estate may exclude up to $1.3 million of value in a qualified family business interest owned by the decedent. This provision is effective with respect to estates of decedents dying after 1997.

Child Credit

The Act provides an annual credit for each child under age 18 in the amount of $400 in 1998 and $500 in 1999 and thereafter. The credit is phased out for taxpayers with incomes in excess of $110,000 for joint filers and in excess of $75,000 for single filers. The credit is allowable to the taxpayer who claims the child as a dependent.

Expansion of Individual Retirement Accounts

The Act increases the eligibility of taxpayers to make deductible contributions to individual retirement accounts by annually increasing the income phase-out range to between $80,000 and $100,000 for couples by 2007 and between $50,000 and $60,000 for singles by 2005.

The Act also creates a new type of retirement account, the "Roth IRA". Contributions to the Roth IRA are not deductible, but any permissible withdrawals of principal or earnings are tax free. Roth IRA's are available starting in 1998. Taxpayers may contribute up to $2,000 annually with the amount phased out for couples whose income is between $150,000 and $160,000 and singles whose income is between $95,000 and $110,000.

Repeal of Excise Tax on Retirement Plans' Excess Distributions and Accumulations

The Act repeals the 15% excise tax imposed on excess distributions from, and excess accumulations in, qualified retirement plans. The repeal applies to distributions received after December 31, 1996 and to excess accumulations of decedents dying after December 31, 1996.

Partnership Provisions

The Act provides a simplified flow-through of tax items to partners in partnerships having more than 100 partners that elect to have the new provisions apply. The Act also creates a new set of procedures for auditing such large partnerships.

In addition, the Act permanently extends the partnership status of certain publicly traded partnerships that were scheduled to become taxable as corporations for their taxable years beginning after 1997.

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