Tax Bulletin

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Federal Tax Legislation 1998: The Year in Review

In 1998, Congress and the President were particularly active in the area of tax reform, enacting several new laws that will have an impact not only on the manner in which businesses and individuals are taxed but also on the manner in which they plan their affairs. Most of this legislative activity occurred during the latter half of the year.

Of foremost importance, on July 22, 1998, the President signed into law the Internal Revenue Service Restructuring and Reform Act of 1998 (the "1998 Reform Act"). Despite the targeted nature of its title, the 1998 Reform Act affects more than the structure of the Internal Revenue Service. Indeed, it also affects businesses and investors in a variety of ways by, among other things, expanding and clarifying many of the more significant business-favorable provisions of the Taxpayer Relief Act of 1997 (the "1997 Act").

Also of great importance, on October 21, 1998, the President signed into law the Omnibus Consolidated and Emergency Supplemental Appropriations Act, which included two tax-related sub-titles, the Tax and Trade Relief Extension Act of 1998 (the "1998 Tax Extension Act") and the Internet Tax Freedom Act (the "Internet Act"). The 1998 Tax Extension Act resurrects and extends several tax provisions that previously had expired and clarifies various provisions of the 1998 Reform Act. The Internet Act limits state taxation of Internet access and electronic commerce.

This Bulletin summarizes some of the more important federal 1998 legislative developments. It is not intended as a detailed explanation of these developments or as an exhaustive summary of all of the newly enacted provisions.

Long-Term Capital Gains Holding Periods for Individuals

The 1998 Reform Act eliminates the requirement that an individual hold an asset for more than 18 months in order to obtain the lowest rate of tax applicable to capital gains. In lieu of this requirement, effective for tax years ending after December 31, 1997, an individual generally will qualify for the lowest rate of tax applicable to capital gains by holding assets for more than one year. Thus, most capital assets that are held by an individual for more than one year now qualify for capital gains taxation at a maximum rate of 20%. (The same rates generally apply to estates and trusts as well.)

Still excluded from taxation at the lower 20% rate are gain on the sale of collectibles and the taxable portion of any gain on the sale of qualified small business stock (usually 50%). These gains are taxed at a maximum rate of 28%. Also, gain attributable to depreciation on real estate that is not subject to recapture is taxed at a maximum rate of 25%.

Due to the different tax rates in effect since passage of the 1997 Act, capital gains and losses are subject to a complicated netting process, which can result in an increase or decrease of up to 8% in an individual's tax liability, depending on when the individual realizes the various gains and losses. Thus, in certain situations, a long-term capital loss can be used to offset capital gains taxed at either the 28% rate, the 25% rate, or the 20% rate, depending on the timing of the various recognition events. Nevertheless, because, under the 1998 Reform Act, most capital gains are now taxed at a maximum rate of 20%, the complicated netting process created by the 1997 Act should be relevant to fewer taxpayers and hence, less important.

Tax-Free Rollover of Gain on Sale of Qualified Small Business Stock

As a result of the 1997 Act, certain individuals can defer the tax on - or "roll over" - their gains from the sale of "qualified small business stock" if they reinvest the sale proceeds in other qualified small business stock within 60 days of the sale. For this purpose, stock is treated as "qualified small business stock" only if it satisfies certain statutory requirements, including that the issuer be a domestic C corporation that does not have aggregate gross assets in excess of $50 million prior to or immediately after the issuance of the stock.

Under the 1998 Reform Act, certain partnerships and S Corporations also are permitted to roll over their gains from the sale of qualified small business stock. Nevertheless, partners and S corporation shareholders who do not meet specific holding-period requirements or that are themselves corporations are not eligible for rollover treatment.

Tax Treatment of Nonqualified Preferred Stock in Corporate Transactions

The 1998 Reform Act clarifies the treatment that will be afforded to a taxpayer that contributes loss property to a controlled corporation solely in exchange for "nonqualified preferred stock." Under these circumstances, the nonrecognition rules that, under prior law, might have applied to preclude the taxpayer from recognizing a loss with respect to the contribution will not apply. Instead, the taxpayer will be permitted to recognize a loss in connection with the contribution.

For this purpose, "nonqualified preferred stock" generally includes preferred stock if: (1) the holder has the right to require the issuer or a related person to purchase the stock; (2) the issuer or a related person is required to purchase the stock; (3) the issuer or a related person has the right to purchase the stock and, as of the issue date, it is more likely than not that this right will be exercised; or (4) the dividend rate on the stock varies with reference to interest rates, commodity prices, or other similar indices.

Charitable Contributions of Qualified Appreciated Stock

The 1998 Tax Extension Act resurrects and permanently extends the fair-market-value deduction previously available for donations of "qualified appreciated stock" to private foundations. For this purpose, "qualified appreciated stock" generally is any publicly traded stock that is capital gain property. The above deduction previously had expired on June 30, 1998.

Extraordinary Dividends Within Consolidated Groups

The 1998 Reform Act authorizes the Internal Revenue Service to issue regulations dealing with certain inconsistencies between the current "extraordinary dividend" rules and the current consolidated return rules. An "extraordinary dividend" generally is a dividend that exceeds a certain percentage of the recipient's basis in the dividend-paying stock or a dividend resulting from a non-pro rata redemption or partial liquidation. Under the current extraordinary dividend rules, a corporation that receives an extraordinary dividend may, under certain circumstances, be required to recognize a gain with respect to the stock on which the dividend was paid. Yet, under the current consolidated return rules, such a gain would likely be deferred until the occurrence of certain specified events.

The 1998 Reform Act provides that, until the Internal Revenue Service issues new regulations addressing the above inconsistency, when a corporation receives an extraordinary dividend that would not be currently taxable under the consolidated return rules, the corporation will not be required to recognize gain under the extraordinary dividend rules. This provision generally is effective for distributions made after May 3, 1995.

Gain Recognition on Certain Distributions of Controlled Corporation Stock

The 1997 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, the 1997 Act, in what is referred to as the repeal of the Morris Trust rule, requires a distributing corporation to recognize gain on the distribution of stock of a controlled corporation when, pursuant to a plan or arrangement, 50% or more of the stock of either the controlled corporation or the distributing corporation is acquired. The 1997 Act, however, does provide exceptions for certain stock acquisitions, which are not to be taken into account as part of such a plan.

The 1998 Reform Act clarifies these exceptions and, in particular, specifies that an acquisition of stock of either the distributing or controlled corporation will be disregarded only to the extent that the percentage of stock owned by any shareholder immediately prior to the acquisition does not decrease. Prior to this clarification, the relevant statutory language had suggested that if the stock of the distributing or controlled corporation were acquired from one current shareholder by another current shareholder (and not by an outside party), then the acquisition could be disregarded.

Research Tax Credit Extended

The 1998 Tax Extension Act resurrects and extends to June 30, 1999 the research tax credit, which had expired on June 30, 1998. The research tax credit generally is allowed for qualified research expenditures that exceed a base amount.

Phase-In of Self-Employed Health Insurance Deduction Accelerated

The 1998 Tax Extension Act accelerates the phase-in schedule for the deduction of health insurance expenses by self-employed individuals. Under prior law, such expenses were scheduled to be fully deductible starting in 2007. Under the 1998 Tax Extension Act, those expenses now will be fully deductible starting in 2003.

Extension of Confidentiality Privilege to Accountant-Client Communications

Effective July 22, 1998, the 1998 Reform Act extends to accountant-client communications a limited version of the confidentiality privilege that previously had been reserved exclusively for attorney-client communications. In particular, with respect to tax advice, the same common law protections of confidentiality that apply to attorney-client communications now apply, with certain important exceptions, to communications between taxpayers and accountants. Unlike the attorney-client privilege, however, the new accountant-client privilege may be asserted only in noncriminal federal tax matters before the Internal Revenue Service and in noncriminal tax proceedings in federal court brought by or against the United States. Moreover, the accountant-client privilege does not apply to written communications between accountants and certain corporate representatives in connection with promoting a corporation's participation in a tax shelter.

Burden of Proof Shifted to the Internal Revenue Service

Under the 1998 Reform Act, if a taxpayer introduces credible evidence on a factual issue relevant to the taxpayer's tax liability, then, in certain court proceedings, the burden of proof may shift to the Internal Revenue Service, provided that the taxpayer satisfies various additional requirements, including compliance with substantiation and record-keeping requirements, cooperation with reasonable requests of the Internal Revenue Service, and, if the taxpayer is a partnership, corporation, or trust, a requirement that the taxpayer have a net worth of $7 million or less. There is no net-worth limitation for individuals. This provision generally applies to court proceedings arising in connection with examinations commencing after July 22, 1998.

Rules for Innocent Spouse Relief Relaxed

When spouses file a joint tax return, they generally are jointly and severally liable for any tax due on their aggregate income for that tax year. Nevertheless, when the tax due on that income has been understated due to the actions or inactions of only one spouse, the "innocent spouse" may be able to obtain relief from the additional tax, penalties, and interest due as a result of such actions or inactions.

The 1998 Reform Act has made the rules for obtaining innocent spouse relief less stringent than under prior law. In addition, where a joint return has been filed by taxpayers who are no longer married, who are married but legally separated, or who have been living apart for at least 12 months, the 1998 Reform Act permits such taxpayers in certain circumstances to elect separate tax liability. Under the 1998 Tax Extension Act, however, such an election cannot be used to create a tax credit or refund.

If a taxpayer is denied an election for innocent spouse relief or separate tax liability, the taxpayer now may petition the Tax Court for review of that denial. The 1998 Reform Act also authorizes the Internal Revenue Service to provide equitable relief in situations where relief is not otherwise available and when, taking into account all the facts and circumstances, it would be inequitable to hold an innocent spouse liable for an unpaid tax or deficiency.

Additional Safeguards Imposed on Lien, Levy, and Collection Procedures

Under the 1998 Reform Act, most taxpayers now have a right to a hearing before the Internal Revenue Service and to have the result of that hearing reviewed by the Tax Court before any lien or levy can be imposed by the Internal Revenue Service. The 1998 Reform Act also imposes additional limitations on the ability of the Internal Revenue Service to seize a taxpayer's business. In general, except when the collection of a tax is deemed to be in jeopardy, the Internal Revenue Service must now exhaust all other payment options before seizing property used in a taxpayer's trade or business.

The 1998 Reform Act further requires the Internal Revenue Service to give taxpayers additional notice regarding internal appeals, examination procedures, and rights to hearings. It also requires the Internal Revenue Service to comply with certain fair debt collection practices, to keep better records on the sale of seized property, and to complete more thorough investigations prior to any seizures of property.

Provisions Affecting International Transactions

The Senate version of the 1998 Reform Act contained a provision that would have prohibited the Internal Revenue Service from finalizing its previously proposed regulations relating to the taxation of arrangements involving foreign hybrid entities. The Internal Revenue Service, however, withdrew its proposed regulations, thereby obviating the need for a legislative prohibition. Nevertheless, in withdrawing its proposed regulations, the Internal Revenue Service announced that it intends to issue new proposed regulations covering hybrid transactions. It also announced that, although these new regulations will not be finalized before January 1, 2000, they will apply to arrangements entered into on or after June 19, 1998. Accordingly, absent further Congressional action, hybrid arrangements designed to reduce foreign taxes and avoid Subpart F income should be approached cautiously.

Moratorium on State Taxes on Internet Access and Electronic Commerce

Under the Internet Act, states now are generally prohibited from imposing (1) any new taxes on Internet access, or (2) any multiple or discriminatory taxes on electronic commerce - at least until October 22, 2001. For this purpose, multiple or discriminatory taxes generally would include, among other taxes, any taxes that could not otherwise be imposed on a business if it were a mail-order company. This moratorium, which runs from October 1, 1998 until October 21, 2001, generally does not apply to protect persons or entities who knowingly make a commercial communication via the World Wide Web if the communication includes material that is harmful to minors, unless access to such material is restricted. In addition, the moratorium does not apply to protect Internet access providers unless they offer software that can screen out material harmful to minors.

Other Proposals

Of course, while all of the above provisions - together with numerous others not described in this Bulletin - were enacted into law in 1998, several important legislative proposals were not ultimately enacted in 1998. Included among these were proposals for marriage-penalty relief, alternative minimum tax reform, and a relaxation of the qualified small business stock rules. Accordingly, taxpayers can expect further legislative developments in 1999.

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