NORTHERN ILLINOIS UNIVERSITY

New for 1998:

How Changes in the Tax Law Affect the Filing of Individual Income Tax Returns

A Thesis Submitted to the

University Honors Program

In Partial Fulfillment of the

Requirements of the Baccalaureate Degree

With University Honors

Department of Accountancy

by

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May 9, 1998

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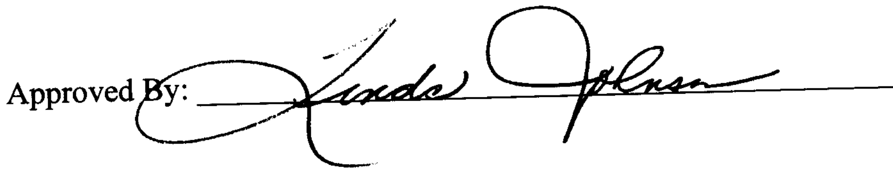

Department of : Accountancy

Date: May 9, 1998

Honors Thesis Abstract
Thesis Submission Form

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Thesis Title: "New for 1998: How Changes in the Tax Law Affect the Filing of Individual Income Tax Returns"

Advisor: Dr. Linda Johnson　　Advisor's Dept: Accountancy

Discipline: Individual Income Tax　　Year: 1998

Page Length: 26　　Bibliography: yes　　Illustrated: no

Published(yes of no): no　　List Publication: not applicable

Copies Available(Hard Copy, Microfilm, Diskette): Hard Copy and Diskette

Abstract(100-200 words):

The Taxpayer Relief Act of 1997 greatly affected the way individuals file their income tax returns. The purpose of this Act is to provide relief for individual taxpayers in the form of tax credits and deductions. By the end of the 1998 tax year, most of the provisions of this Act will be in effect. The focus of my research was to analyze and provide examples of the major provisions affecting individuals. Many of the sections studied dealt with children and education, including the Child Tax Credit, Hope Scholarship Credit, Lifelong Learning Credit, and the standard deduction for dependents. The rest of the sections focused on savings and investment incentives, such as Roth IRAs, changes to conventional IRAs, savings from the sale of a principal residence, and changes in the rules for capital gains. The overall effect of the Taxpayer Relief Act will not be clear until well after the 1998 Individual Income Tax Returns are filed in 1999. It is expected, however, that many individuals will take advantage of the new tax credits and deductions. In order to use each provision effectively, taxpayers should consult a tax planner for advice.

Introduction

Tax laws change frequently. New laws arise or old laws are revised, changing the way taxpayers file their Federal income tax returns. It has been 13 years since the last major tax cut. This cut in taxes occurred in 1986 under then President Ronald Reagan. Those tax cuts had a very different purpose than the latest tax cuts. The most recent tax cut came about in The Taxpayer Relief Act of 1997. The major provisions of this Act are targeted towards taxpayers with children, education, savings, and investments. This differs from 1986 tax cut which was much broader in nature. The Act is also 15 times smaller than the 1986 Act, but more complicated. While the Taxpayer Relief Act of 1997 does involve relief from estate and gift taxes, the main changes include a new child tax credit, new education incentives, changes to the standard deduction for dependents, a new "Roth" IRA, changes in conventional IRAs, and changes to the capital gains tax. This Act was signed into law on August 5, 1997 by President Bill Clinton. The focus of this study was to research all the information regarding this new Act for the previously stated provisions.

Standard Deduction for Dependents

The Taxpayer Relief Act increased the basic standard deduction for employed dependents. Before the Act was passed, the 1997 deduction was limited to the greater of $650, or the dependent's earned income. This amount could also not exceed the regular standard deduction amount of $4150.[1]

Under the new law, for 1998 the deduction is the greater of $700, or $250 plus earned income, limited to a maximum of $4250.[2] This standard deduction will be

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[1]Code Sec. 63(c)(4) and (5).
[2]Code Sec. 63(c)(4) and (5).

indexed for inflation. The new deduction will be available for tax years beginning after December 31, 1997.

Example
Angie has earned income in the amount of $2,500 for 1998. She is claimed on her parents' tax return as a dependent. Under the new law, Angie's standard deduction is $2,750($250 + $2,500).

Child Tax Credit

Taxpayers with children may receive some relief in their taxes under the 1997 Taxpayer Relief Act. Beginning in 1998, parents who meet the adjusted gross income requirements with a qualifying child receive with a $400 per child credit. After 1998, this credit increases to $500.[3] A qualifying child is a child, stepchild, grandchild, or foster child of the taxpayer, who is under 17 years old, a U.S. citizen, and a dependent of the taxpayer.[4]

The Child Tax Credit directly reduces the tax liability. This credit is a nonrefundable credit, except for families with three or more children who may qualify for a supplemental credit. This will allow a portion of the credit to be refunded. The taxpayer must have a tax liability in order to qualify for the credit.

The Child Tax Credit is phased-out for certain income levels. The threshold amounts are:

Filing Status	Amount
Single/Head of Household	$75,000
Married Filing Jointly	$110,000
Married Filing Separately	$55,000

When the taxpayer's modified adjusted gross income(AGI) exceeds these amounts, the credit is reduced by $50 for every $1,000 over the threshold. For married filing jointly,

[3]Code Sec. 24 (a).
[4] Engelbrecht, Ted. "The Taxpayer Relief Act of 1997". The CPA Journal. October, 1997. Act Sec. 101(a),(b),(d), and (e). Conference Comm. Rpt. ¶10,115.

when the income reaches $119,000 the credit is lost. Modified AGI is AGI without foreign earned income and foreign housing costs.[5]

Example

Cindy and John file jointly and have a 5-year-old daughter. In 2000, Cindy and John's modified AGI is $111,000. They qualify for the child tax credit, but may not take a credit for the full $500. The maximum amount of credit they may take is $450($500-$50). The amount of the credit is reduced by $50 because the modified AGI is $1,000 over the threshold.

Example

Alan and Jackie Miller file a joint return, and have three children. All three children are under 10 years of age. The Miller's modified AGI for 1999 is $120,000. Since the amount of AGI exceeds the threshold ($119,000) for the year, they will not be allowed to use the child tax credit to reduce their tax liability.

The supplemental credit is available only for taxpayers with three or more children. The credit equals the lesser of the amount of the Child Tax Credit or the taxpayers' tax liability, divided by the tentative minimum tax. The tentative minimum tax is the income tax figure before the alternative minimum tax foreign tax credit is accounted for. In addition, it can not exceed the tax liability plus the employee share of FICA, minus the amount of the earned income credit.[6]

Example

Chelsea and John have three children under the age of 10. Their tax liability for 1999 was $250,000 and their tentative minimum tax was $2,000. The amount of the supplemental credit available to Chelsea and John is $125, which is the lesser of $1,200 or $125[$250,000/$2000].

When the new tax law was passed, the issue of a program named KidSave resurfaced after being unsuccessful in October of 1997. This program gives parents the

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[5]Code Sec. 24 (b)(2).
House Comm. Rpt. ¶10,115.
[6]Code Sec. 32 (m) and (n).

opportunity to place the amount of the new child tax credit into an Individual Retirement Account (IRA) in the child's name. This allows the money to be put into an education IRA with the same rules as a conventional IRA. The child is allowed to withdraw the money in a 10 year loan at any time without penalty. This enables the taxpayer to set aside money for the child's higher education costs. The first proposal of this plan made depositing the credit into an IRA mandatory. The idea of making it an option is being proposed.[7]

Education Credits

HOPE Scholarship Credit

The Taxpayer Relief Act of 1997 includes two provisions for education incentives. The first of these two incentives is the HOPE Scholarship Credit, which is a nonrefundable credit for qualified tuition and related expenses. Room and board payments do not qualify as related expenses. The credit applies for post-secondary education expenses paid after December 31, 1997.

In order for a taxpayer to claim this credit, the expenses must be paid on behalf of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer. The student must be enrolled in at least one-half the full course load for a particular semester. This credit only applies to the first two tax years the student is enrolled in a program which leads to the receipt of a certificate or degree. Consequently, this credit is not available for graduate-level and most upper division coursework.

[7] Butler, Stuart M. "Why Combining "Kidsave" with a Child Tax Credit Makes Good Sense". The Heritage Foundation. Executive Memorandum No.444. February 6, 1996.

If all these qualifications are met, the maximum credit allowed is $1,500. This is comprised of 100% of the first $1,000 paid, and 50% of the next $1,000 paid for qualified tuition expenses. Generally, the tuition expenses must be out-of -pocket expenses.[8] Students who receive aid from a Pell Grant, other tax-free scholarship money, a tax-free distribution from an education IRA, or tax-free employer-provided educational assistance, do not consider these amounts when calculating the amount of the credit.[9]

Example
Adam, a full-time student, incurred $15,000 of expenses relating to his education in 1998, his first year of college. The expenses were for tuition and books. Assuming Adam meets the AGI thresholds, he may use the full $1,500 credit for 1998 because the payments were for qualified education expenses. Adam will be able to take the full credit again in 1999, but not for the year 2000 or any subsequent year.

The HOPE Scholarship Credit is reduced when the taxpayer's modified AGI exceeds a certain threshold. Modified AGI for purposes of the HOPE Scholarship Credit is computed as Adjusted Gross Income increased by foreign income excluded from gross income and, certain income from U.S. possessions, and Puerto Rican income. The thresholds amounts (subject to inflation after the year 2000) for modified AGI are:

Filing Status	Amount
Single/Head of Household	$40,000
Married Filing Jointly	$80,000

The HOPE Scholarship Credit is not available for a married individual who files separately. The credit is gradually phased-out when AGI falls in the given range. The formula used to figure the amount of the reduction is:

$$\text{Sum of HOPE Credit} \times \frac{\text{Modified AGI} - \$40{,}000}{\$10{,}000}$$

(for married filing jointly, the $40,000 is replaced with $80,000

[8] Code Sec. 25(b)(1)(a) and (b). Conference Comm. Rpt. ¶10,135.
[9] IRS Notice 97-60.

and the $10,000 is replaced with $20,000)[10]

Example
Sally, a single taxpayer, has a modified AGI of $45,000 for 1998. Sally is a full-time student and has expenses relating to education of $5,000 per year. Since Sally's AGI is above the $40,000 threshold, her credit must be reduced. The $1,500 maximum amount of the credit must be reduced by $750 [$1,500 x ($45,000-$40,000) / $10,000)]. Therefore, Sally's total credit is $750($1,500-$750).

The amount of the credit is valued on the basis of the number of students, not the total expenses for the taxpayer. Therefore, if the taxpayer is using the credit for two students, the maximum amount available is $3,000. If the parent is claiming the child and adds the credit amount to his tax return, the child may not add the credit to his or her return also. It must be claimed by one or the other.

The HOPE Scholarship Credit can only be claimed for expenses paid in the year in which they are incurred. The only exception to this rule is expenses paid in one year, relating to an academic period beginning in the first three months of the next year. Any other prepayment of expenses will not qualify for this credit.

The AGI threshold applies to the taxpayer claiming the credit, and can only be claimed by the individual who pays the expenses. For example, if a student's parents pay college expenses for the first two years, only they can claim the HOPE Scholarship Credit on their income tax return. The threshold amount used will be based on their AGI amount, and not that of the student.

The 1998 tax forms will have complete instructions on how to claim the HOPE Scholarship Credit. The credit will be part of the Credits section on page two of Form 1040, Individual Income Tax Return. The first time this credit may be claimed is on the

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[10]Code Sec. 25(d)(2).

1998 forms which are filed in 1999. Since the taxpayer may only claim this credit for the first two years of the student's higher education, the taxpayer may want to explore the new Lifetime Learning Credit for subsequent years. Also, advanced planning is possible for individuals wishing to use this credit.

Lifetime Learning Credit

The second education incentive included in The Taxpayer Relief Act of 1997 is the Lifetime Learning Credit. This credit is available beginning on July 1, 1998. Like the HOPE Scholarship Credit, the credit can be claimed for qualified tuition and related expenses for students in the taxpayer's family who are enrolled in qualified institutions. Unlike the HOPE Credit, however, the Lifetime Learning Credit applies per taxpayer, not per student.

Until 2002, the amount of the credit is equal to 20% of the first $5,000 of out-of-pocket costs. After 2001, the amount equals 20% of the first $10,000 paid. The amount is gradually phased-out using the same formula as was used for the HOPE credit. After a taxpayer's modified AGI exceeds the appropriate threshold, the Lifetime Learning Credit is no longer allowed.[11]

The eligibility requirements for the Lifetime Learning Credit are more lenient than the requirements for the HOPE credit. For example, the Lifetime Learning Credit does not require that students be enrolled at least half-time as is required for the HOPE credit. Thus, if the student is only enrolled in one course, the taxpayer may still claim the Lifetime Learning Credit. The courses the student takes, however, must be taken to

[11] "President Signs Balance Budget Legislation". http://www.irs.ustreas.gov/prod/hot/tax-law.html. The Taxpayer Relief Act of 1997. CCH Incorporated, 1997. ¶139.
Code Sec. 25(c)(1). Conference Comm. Rpt. ¶10,135.

improve job skills or qualify as Continuing Professional Education for the individual. Another difference between the two credits is that the Lifetime Learning Credit can be claimed for an unlimited number of years, and unlike the HOPE Scholarship, this credit can be claimed for graduate school expenses, and can be used for more than the first two years of education. As stated above, the credit is based on the total expenses of the taxpayer. Therefore, the maximum credit is $1,000 regardless of the number of students involved. The qualifications for the institution are the same for both credits, as well as the ability of a parent to claim the credit for expenses paid for family members.

Example
The Johnsons have three dependent children in college. Their modified AGI for 2002 is $90,000. Only one credit can be taken by the Johnsons even though they have three children in college. The maximum amount available to them is $2,000 (20% x $10,000), but this amount must be reduced due to the amount of their modified AGI. The total credit the Johnsons may take is $1,000 [$2,000 - ($2,000 x ($90,000-$80,000) / $20,000)].

A taxpayer cannot claim both the HOPE credit and the Lifetime Learning Credit for the same person. Usually, the HOPE credit would be claimed for two years, then the Lifetime Learning Credit used for each subsequent year the student is in school. The credit must be claimed for expenses which cover an academic period. This means that prepaid payments are generally not included. One exception is for payments made in the prior year for a semester beginning in January, February, or March of the next year.[12]

Example
Tom paid tuition to the University on December 15, 1998 for the summer session starting in June of 1999. Tom would not be able to take the Lifetime Learning Credit for these expenses because he made the payment in the previous year. If the payment had been for the Spring semester starting in January, he could have used the Lifetime Learning Credit.

[12] IRS Notice 97-60.

The same rules apply here for qualified tuition and related expenses as are applied for the HOPE credit. The credit will also be part of the Credits section on the 1998 Form 1040, Individual Income Tax Return.

Filing Instructions

Each taxpayer has the option of making the election to claim either of the two education credits. To receive the credit, the name and social security number of the student must be included on the tax form. If this information is not provided, the credit will be disallowed.

If the total amount of money owed for tuition and expenses is paid by the employer, then neither of these credits may be claimed. The amount used to figure the credit must be out-of-pocket expenses of the taxpayer. The only exception is students using a Qualified State Tuition Program to pay for their higher education. They will still be able to claim the credits.

Similarities and Differences

The HOPE Scholarship Credit and the Lifetime Learning Credit have many similarities. One similarity between the two is the requirements for the institution and the definition of the qualified tuition and related expenses. Another similarity is the formula to calculate the credit. Since both credits use the same formula, this leads to another common aspect, the threshold amounts. The same modified AGI thresholds are used to calculate the reduction in both credits.

Although these credits have their similarities, they also have some differences. First, the HOPE credit is more financially appealing. This credit has a maximum amount of $1,500 per student. The maximum amount for the Lifetime Learning Credit is only

institution. For this, the institution must be a post-secondary school, certain vocational schools, or institutions conducting an internship or residency leading to a degree.

Not all taxpayers with qualified education loans are eligible for this deduction. If a homeowner deducts the interest paid on a mortgage loan which is taken to pay for educational expenses, this interest cannot be deducted again. This is also true of any other loan used for educational expenses. Debt to a related party also does not qualify for this deduction. For example, if a family member loans you money to pay for college, the interest you pay to that family member may not be deducted. Like all other deductions, if the person is claimed as a dependent on another taxpayer's return, they cannot also deduct the interest.[14]

The deduction is phased out for certain income levels. The phase-out is based on the modified AGI of the taxpayer. The modified AGI is AGI determined without regard to this deduction for interest. The phase-out begins with modified AGI over $40,000($60,000 MFJ), and is completely phased out at $50,000($75,000 MFJ). The first amount is for taxpayer's filing single or head of household. The deduction can never be reduced below zero. The formula for computing the phase-out is:[15]

$$\text{deductible amount} \times \frac{\text{modified AGI} - \$40{,}000}{\$15{,}000}$$

In order for married couples to claim the deduction, a joint return must be filed.

Example
Jerry, a single taxpayer, has modified AGI of $43,500 in 2002. Also in that year, Jerry had a qualified student loan and makes an interest payment of $3,000. Jerry is not be able to deduct the full amount of the interest because his modified AGI exceeds the threshold. The amount he

[14]Code Sec. 221.
[15]Code Sec. 221(e)(1).

is able to deduct is $1,917 [$2,500 - ($2,500 x ($43,500 - $40,000)/$15,000)].

Example
Don and Kristen have combined AGI of $63,200 in 1998. Their son, whom they claim as a dependent, has a student loan. The amount of interest they paid in 1998 was $1,000. They will not be able to deduct the full amount of this due to the level of their AGI. Therefore, Don and Kristen's deduction is $787[$1,000-($1,000 x ($63,200-60,000)/$15,000)].

This deduction is effective for loans made on, before, or after August 5, 1997, but only for interest due and paid after December 31, 1997. When reporting, lenders should separately report to the borrower the amount of deductible interest. Also, borrowers must be able to prove that the proceeds of the debt are being used to pay for educational expenses.

Sale of a Principal Residence

Rules for how an individual reports gain from the sale of a principal residence have been amended by the 1997 Taxpayer Relief Act. Before this new law was passed, the gain from a sale or exchange was rolled over to the new residence if the new residence is purchased within 2 years of the sale. Also, if the individual was 55 years of age or older, and occupied the residence for at least 3 of the last 5 years before the sale, an exclusion of $125,000 of the realized gain was available.[16] Congress felt that changing this law would benefit most taxpayers. Under the old law, the taxpayer would have to keep detailed records documenting any improvements which increased the basis of the residence. Also, many people would not sell their house because they could not

[16]Code Sec. 121.

exclude the gain. This would make them stay in a place that was not meeting their needs anymore. The new law has created new opportunities for these taxpayers.

For sales or exchanges of a principal residence after May 6, 1997, a $250,000 exclusion of realized gain applies.[17] To be eligible for this exclusion, the taxpayer must have owned or occupied the residence for two of the five years before the sale. A $500,000 exclusion of realized gain is available for those married taxpayers filing jointly if they meet certain criteria: 1) either meet the ownership test, 2) both meet the use test, and 3) neither is ineligible for the exclusion due to prior sale within two years.

If these requirements are not met by both spouses, the total exclusion available is $250,000. Also, if the situation arises where joint filers do not occupy the same house, the amount of the exclusion is $250,000. If a taxpayer is holding property given to him or her due to a divorce, the time period includes the time it was held by the transferor. The person holding the property, however, must still meet the use requirement. The amount of the exclusion may be prorated if the requirements are not met. The proration of the amount is $250,000 ($500,000 for MFJ) x the shorter of: 1) aggregate periods during which the ownership and use requirements were met during the five year period ending on the date of sale, or 2) the period after the date of the most recent sale or exchange to which the exclusion applied bears to two years.[18] Another adjustment which may need to made is for depreciation. If depreciation was taken with respect to rental or business use after May 6, 1997, gain must be recognized to the extent of depreciation taken.

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[17]Code Sec. 121(b)(1). Conference Comm. Rpt. ¶10,315.
[18]Code Sec. 121(c)(1)(B)(ii).

For sales after May 6, 1997, but before August 5, 1997, the taxpayer may elect to use the old laws. This means that the individual may rollover the gains from one residence to another. Also, if the taxpayer is 55 year old or older, they would be able to use a $125,000 exclusion. Under certain circumstances, the taxpayer may elect to use the old law.

Changes to the Conventional IRA

Many changes to conventional IRAs are included in the new tax law. These changes make it easier for individuals to contribute to and make early distributions from an IRA. The three provisions are: (i) increases in AGI limits, (ii) changes in the active participation rules, and (iii) a repeal of the penalty for early withdrawals.

Increase in AGI limits

The Taxpayer Relief Act of 1997 made it easier for individuals to make deductible contributions to an IRA. Whether an IRA contribution is deductible depends on the taxpayer's AGI. For contributions made in 1997, the AGI threshold for unmarried taxpayers was $25,000 ($40,000 for joint filers). This rule only applies to active participants in an employer sponsored retirement plan. The maximum deduction was phased-out once the AGI reached $35,000 for unmarried taxpayers, and $50,000 for joint filers.[19]

Beginning in 1998, the AGI limits for active participants increased. In 1998, active participants can make deductible payments as long as their AGI is below $30,000 for unmarried individuals ($50,000 for MFJ). Once the taxpayer's AGI reaches this level, the amount of the deduction is phased-out. The deduction is completely phased-out when

[19]Code Sec. 219(g).

AGI exceeds $40,000 and $60,000 for single and joint returns respectively. Any contributions made after this are nondeductible. The AGI thresholds will eventually increase to $60,000 for single taxpayers, and $100,000 for MFJ in the years 2005 and 2007, respectively.[20] For contributions made before the year 2007, the equation to calculate the amount of deductible contributions is:

$$\frac{\$2{,}000 \times (\text{AGI - applicable dollar amount})}{\$10{,}000}$$ [21]

The formula for contributions made by taxpayers filing jointly after the year 2007 is a little different. This is because the phase-out range increases to $20,000 in that year. The formula is the same, except the denominator must be changed to $20,000, instead of $10,000.

Example

Josh, a single taxpayer, has AGI of $35,000 for the tax year ending December 31, 2001. Josh will not be allowed to make the full $2,000 deductible contribution since his AGI exceeds $33,000. Therefore, his contribution will be appropriately phased-out.

The phase-out limits are increased as follows:

Tax years beginning in:	Single Taxpayers	MFJ Taypayers
1998	$30,000-$40,000	$50,000-$60,000
1999	$31,000-$41,000	$51,000-$61,000
2000	$32,000-$42,000	$52,000-$62,000
2001	$33,000-$43,000	$53,000-$63,000
2002	$34,000-$44,000	$54,000-$64,000
2003	$40,000-$50,000	$60,000-$70,000
2004	$45,000-$55,000	$65,000-$75,000
2005	$50,000-$60,000	$70,000-$80,000
2006	$50,000-$60,000	$75,000-$85,000
2007 and thereafter	$50,000-$60,000	$80,000-$100,000[22]

[20]Code Sec. 219(g)(1).
[21]Code Sec. 219(g).
[22]Code Sec. 219(g)(1). Conference Comm. Rpt. ¶10,255.

Example
Bill and Laurie have a combined AGI of $49,000 for 1998. Since their AGI does not exceed the $50,000 threshold, they may make a fully deductible contribution to an IRA.

Example
Assume the same facts as above, but Bill and Laurie's is $58,500. Since their AGI exceeds the threshold for 1998 maximum amount of the deduction allowed will be reduced to $300 [$2,000 - ($2,000 x ($58,500-$50,000)/$10,000)].

Changes in the Active Participation Rules

Prior to the 1997 Taxpayer Relief Act, individuals were able to contribute to an IRA if they were not active participants in an employer sponsored retirement plan. Married couples were able to contribute if neither spouse were an active participant. If an individual or a spouse was an active participant, the amount of the IRA deduction was phased-out when AGI reached a certain level. The new legislation for IRAs provides further assistance to taxpayers who are active participants in an employer-sponsored retirement plan. This new provision states that a person is not automatically an active participant because his or her spouse is. This allows the maximum amount of the deduction to be taken regardless of the level of participation providing the AGI does not exceed certain thresholds.

Similar to what was discussed above, the amount of the contribution is phased-out for AGI exceeding the appropriate threshold. The previously discussed AGI thresholds apply to the spouse who is an active participant. The amount of the phase-out is figured differently when the situation has both an actively participating spouse and a non-active spouse. The amount of the deduction for a non-active spouse is phased-out when AGI reaches $150,000, and is completely phased-out when AGI is $160,000. The phase-out

will be calculated as it was in the preceding section with the new AGI limits. The combined AGI of the couple is used to compute the phase-out amount.

Example
John and Mary have a combined AGI of $135,000. John is an active participant in an employer-sponsored retirement plan, but Mary is not. Mary will be allowed to make a $2,000 deductible contribution to an IRA because their combined AGI is less than $150,000. John, however, will not be able to make any deductible contributions because AGI exceeds the AGI limit for joint filers.

Additional Exceptions to the Penalty on Early Withdrawal

The last change in tax law for traditional IRAs, is an exception for the penalty imposed on early withdrawals from an IRA. Any withdrawal made before December 31, 1997 will incur a 10 percent penalty if the taxpayer has not reached 59 1/2. A few exceptions to this rule were withdrawals for death, disability, and medical costs of certain unemployment persons. The new law provides and exception from this penalty withdrawals after 1997 used to cover qualified higher education expenses or towards certain first-time home purchases.

Expenses paid for higher education are costs for post-secondary education for a taxpayer and spouse, a child, or grandchild of the taxpayer. If the money withdrawn from the IRA goes towards these expenses, the taxpayer will not be penalized for an early withdraw. Qualified educational expenses are those for tuition, room and board, and other related education costs. The amount of these expenses is further reduced by any scholarship received, or any financial assistance excluded from gross income.

In order to qualify for this favorable tax treatment, the academic period must have started after December 31, 1997, and the expenses must also have been paid after this date. Therefore, it would be beneficial for the taxpayer to hold off paying any tuition

bills for the 1998 Spring semester until after December 31, 1997. If the bill was paid before this date using money withdrawn from an IRA, the 10 percent penalty will apply.

> **Example**
> Jennifer, 23, makes a withdraw from her IRA. The purpose of this withdrawal was to pay for expenses relating to her education. The expenses were paid on December 20, 1997 for the Spring semester. Jennifer will have to pay a 10% penalty on her withdrawal. This is because the amount was paid before January 1, 1998. If she waited until after December 31, 1997, there would have been no penalty for this transaction.

The second exception to the penalty is withdrawals up to $10,000 to pay expenses of a purchase of a principal residence for a first-time home buyers. Expenses of this type include those for financing, closing costs, and any expense for building or reconstructing a principal residence. For purposes of this provision, a first-time homebuyer is any buyer who has not owned another residence for the previous two years ending on the date of acquisition. The taxpayer's spouse must also meet this ownership requirement to qualify. This definition allows more taxpayers to take advantage of this provision of the new law, even if this is not the first home the taxpayer has owned a home. The withdrawal from an IRA can be used for the taxpayer, the taxpayer's spouse, descendent, or ancestor of the taxpayer or taxpayer's spouse.

The exception only applies to the first $10,000 withdrawn, which is a lifetime limit. After this amount, any other withdrawn also will be subject to the 10 percent penalty. Also, the money taken from an IRA to pay these expenses must be used within 120 days of the withdrawal. If, for some reason, the money is not used, the remaining money may be rolled back into the IRA before the end of the 120 days. It has not been clearly stated yet, but at this time it is assumed that both a husband and wife will be able

to withdraw up to $10,000 from an IRA without penalty.[23] Also, previously untaxed amounts withdrawn will be taxed and may not be recontributed back to the IRA.

Example
Jeff and Carol have just purchased their first home. The amount of the costs relating to the purchase was $45,000. Jeff withdraws $35,000 from his IRA to pay for part of these expenses. Carol then withdraws $10,000 from her IRA to pay for the rest. Carol will not incur a penalty for her withdrawal because the first $10,000 is exempt. Jeff, however, will have a penalty of $2,500 ($25,000 x 10%), for the amount withdrawn over $10,000.

Roth IRA

Besides the provisions of the Taxpayer Relief Act for conventional IRAs, there is also a provision for the new Roth IRA, effective for tax years after 1997. This is a nondeductible individual retirement account named after its sponsor, Senator Roth. The Roth IRA is also known as the "backloaded" IRA because of its nondeductible feature and the nature of the benefits received. The contributions of a regular IRA may be deductible when contributed. Therefore, the tax benefits come first. The benefits of the Roth IRA come later when the money is withdrawn from the account. Withdrawals, which will be discussed later, can be tax-free. The terms of this new IRA are very different from the terms of conventional IRAs.

In order for an IRA to be considered a Roth IRA, it must be designated as such when established. This type of IRA can be used even if the taxpayer is an active member of a qualified pension, profit sharing, or other retirement plan. Investors with long-term goals are more likely to benefit from the Roth IRA.

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[23]Code Sec. 72(t).
Senate Comm. Rpt. at CCH ¶10,265.

Contributions to an IRA can be made from January 1 of one tax year, until April 15 of the following year with both conventional IRAs and the Roth IRA. This is true regardless of any extensions filed. For example, a contribution intended for the year of 1999 must be made before April 15, 2000. If the contribution is made after this date, it will be included with the contributions for the year 2000.

Contributions to the Roth IRA have a few other unique characteristics. As stated above, all contributions are nondeductible. This is why the tax benefit comes later in the case of the Roth IRA. The interest and capital gains attributed to these contributions will be tax-free depending on the terms of withdrawals. Like conventional IRAs, the maximum contribution to a Roth IRA is $2,000 of earned income. This includes any contributions made to any other IRA account. If a married couple both contribute to the account, the maximum contribution is $4,000 of the couple's earned income. Excess contributions are subject to a six percent tax.[24] The taxpayer is also eligible to make contributions after the age of 70 1/2, which is also different from conventional IRAs.[25]

As with many of the provisions of the Taxpayer Relief Act, there are adjusted gross income limitations. The maximum contribution amount of $2,000 is gradually phased out when the taxpayer's AGI reaches $150,000 for married filing jointly ($95,000 for single taxpayers). The amount is completely phased out when AGI exceeds $160,000 for married filing jointly ($110,000 for single taxpayers). The amount of the reduction is reduced by the ratio of the excess AGI over $10,000 for joint returns and $15,000 for single filers.[26]

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[24] Code Sec. 4973
[25] " Most Frequently Asked Roth IRA Questions and Answers". http://www.nbfunds.com/retirement/rothfaq.html
[26] Code Sec. 408A(c)(3)(A).

Example
Mary and George are married taxpayers who file a joint return. Their AGI for 1998 was $159,000. The maximum amount they can each contribute to a Roth IRA is $200 [$2,000-(2,000 x 9,000/10,000)].

Example
Joan, a single taxpayer, has decided to start a Roth IRA. Her AGI for 1999 is $106,500. Joan is not able to make the full deductible contribution of $2,000, because her AGI exceed the threshold of $95,000. Instead, she can make a contribution of $467[$2,000-($2,000 x 11,500/15,000)].

Withdrawals from the Roth IRA are generally tax-free. In order to qualify as tax-free, the withdrawal must meet two requirements. First, the account has to have been open for at least five years after the beginning of the year in which the first contribution is made. Second, the withdrawal must be made after the taxpayer reaches the age of 59 1/2. The exceptions to this requirement are:

- any premature withdrawal for the beneficiary after the taxpayer has died,
- early withdrawals made for a taxpayer who is disabled,
- first time home buyers of a principal residence.

If a taxpayer falls into any of these categories, their early withdrawals from the account will not be taxed. Also, if either of the two requirements is not met, the withdrawal is subject to the ordinary income tax and a ten percent penalty.

It is possible to rollover funds from a conventional IRA to a Roth IRA. This is available for taxpayers whose AGI for the year does not exceed $100,000.[27] This rollover is not allowed for married taxpayers who file separately. The 10 percent early withdrawals penalty does not apply to these rollovers.

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[27]Code Sec. 408A.