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Nancy Lazar

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RECENT LEGISLATIVE ACTIVITY

by Nancy Lazar

Winners and Losers of the Taxpayer Relief Act of 1997

On August 5, 1997, President Clinton signed the Taxpayer Relief Act of 1997 ("the Act") into law. With over 800 changes to the Internal Revenue Code — more changes than any tax measure since the 1986 Tax Reform Act — the new tax act gives taxpayers a \$95 billion tax cut. The critical question, however, is who will receive tax "relief" as a result of this new federal law.

Parents

The Act provides the most generous "relief" to parents. It not only gives parents a tax credit for their children, but also gives parents several ways to save for their children's education. Beginning in 1998, married couples filing jointly who report an adjusted gross income ("AGI") of \$110,000 or less (\$75,000 for a single parent) will receive a \$400 tax credit for each child sixteen years old and younger. This tax credit will increase to \$500 per child in 1999. This credit, however, will phase out and ultimately vanish when a family earns an AGI of \$120,000 (\$85,000 for singles).

The Act also provides taxpayers with tools to minimize education costs and to plan early and wisely for their children's future. For example, parents who want to save for their children's college expenses have several options under the Act. They may establish an Education Savings Account ("ESA"). With an ESA, married couples filing jointly who report an AGI of \$150,000 or less (\$95,000 for single parents) can save up to \$500 a year in an ESA for each dependent child under eighteen years

old. Any growth in the ESA is tax-free and withdrawals from the ESA will not be taxed as long as the withdrawals are used only for "qualified higher education expenses." The Act broadly defines these expenses as tuition, fees, books, supplies, and equipment and may also include room and board if the child is a full-time student.

Despite the tax benefits of an ESA, it is not a lifelong savings account. Money in an ESA must be used for qualified educational expenses by the time the student reaches 30 years old. If the student turns 30 and has not used all of his or her ESA funds, any unused money will be subject to an income tax and a 10% withdrawal penalty.

As an alternative to an ESA, parents may contribute to a prepaid tuition plan if the state where they reside establishes such a program. Although the details of prepaid tuition plans vary state-by-state, generally, these state plans permit parents to annually contribute a set amount to a plan based on their children's ages. The state invests the contribution and

guarantees that it will pay tuition costs at any four-year public institution in the state, even if tuition increases by the time the child enrolls. Whether parents will be taxed on the growth of the funds in these accounts is determined according to the specifics of each state's program.

Most state prepaid tuition plans, however, include several restrictions. For instance, all contributions to, and earnings from, most state plans can be applied only to the college tuition itself, not to room, board, books, or other college expenses. Moreover, if a taxpayer makes a withdrawal from most state programs, the withdrawal will be taxed unless the withdrawal is used solely for the child's college tuition. Finally, a parent may not contribute to both a prepaid tuition program and an ESA for the same child in the same year.

Despite their various limitations, most state tuition plans are not restricted to in-state public institutions. If the child decides to attend a private or an out-of-state public institution, most state prepaid tuition plans permit the fund's principal and earnings to pay for the tuition at such institutions. Many states provide refunds if the child decides not to attend college or the parent or child dies before the child attends college. Moreover, many programs allow the transfer of funds to pay for the education of another child within the same family.

With the rising costs of higher education, the Act will appease many parents' struggle in planning for their child's education. The education provisions of the Act provide parents with several educational savings options and therefore encourage parents to begin saving early. The Act's benefit to parents, however, is not limited to savings for their children's higher education. As discussed below, the new tax law also offers parents two tax credits on their children's post-secondary education.

Students of Higher Education

Beginning in January 1998, parents of students or students themselves in the first two years of post-secondary education may claim an annual Hope Scholarship Tax Credit ("Hope Credit") of up to \$1,500. The tax credit applies against 100 percent of the first \$1,000 spent on tuition and fees and against 50 percent of the next \$1,000, for a maximum annual tax credit of \$1,500. The amount of this credit phases out for joint filers earning an AGI of over \$80,000 or individuals earning an AGI of over \$40,000 and ultimately disappears when joint filers earn an AGI of \$100,000 and individuals earn an AGI of \$50,000.

To qualify for the Hope Credit, a student must carry a minimum of one-half a full time student's average academic load for at least one academic period during the year. Not limited to a child's higher education, the Hope Credit applies to the first two years of the taxpayer's, taxpayer's spouse's, or taxpayer's dependents' post-secondary education. A student may claim the Hope Credit only in lieu of a withdrawal from an education savings account or a state prepaid tuition program, and the credit may be claimed separately by each qualified student in a taxpayer's family.

Alternatively, a taxpayer may claim the Lifetime Learning Credit, a single tax credit for the post-secondary education costs for all eligible students in the taxpayer's family. This credit allows taxpayers to claim 20% of qualified education expenses up to \$5,000 (resulting in a maximum credit of \$1,000) of all expenses paid after June 30, 1998. The credit will increase to a maximum of \$2,000 in the year 2003. In contrast to the Hope Credit's availability to each eligible student in a taxpayer's family, the Lifetime Learning Credit applies only to each taxpayer regardless of the number of eligible students in the family. The Lifetime Learning Credit phases out for married couples filing jointly reporting an AGI between \$80,000 and \$100,000 and for singles reporting between \$40,000 and \$50,000.

Like the Hope Credit, the Lifetime Learning Credit applies to the post-secondary education of the taxpayer, the taxpayer's spouse, or any dependent child. In addition, the Lifetime Learning Credit may apply to any year of the taxpayer's post-secondary education. The taxpayer need not be enrolled in school on a half-time basis to qualify for this credit. Rather, the Credit covers a taxpayer's tuition for classes intended to enable the taxpayer to "acquire or improve job skills." Tuition paid for certain vocational training programs, trade schools, and job-improvement classes may enable a taxpayer to qualify for the tax credit. A taxpayer may not, however, claim both a Hope Credit and a Lifetime Learning Credit for the same child in the same year.

In addition to the Hope Credit and Lifetime Learning Credit, the new tax law gives students a tax deduction for the first \$2,500 of interest paid each year for federal student loans.

These educational tax benefits, however, may ultimately be detrimental to taxpayers. Although the Act appears to "relieve" students of some of the burden associated with the costs of continuing education, critics question whether the new law's \$30 billion in federal education incentives will reduce the amount of financial aid awarded to students and ultimately increase tuition costs. Edwin Below, Director of Financial Aid at Wesleyan University in Connecticut, estimates that a student's award of financial aid may be reduced by 20 to 40 percent of the value of the tax credit if a student claims a Hope Credit because colleges will incorporate the additional disposable income that the credit frees up into a student's financial aid determination. See David Brindley, *How To Pay For College; 1998 Annual Guide*, U.S. NEWS & WORLD REPORT, Sept. 8, 1997, 78. Furthermore, the Congressional Research Service predicts that tuition costs will eventually rise, partially due to the possibility that states may reduce their university funding because of the federal tax credit. See *id.* Therefore, the education incentives of

the Act may not provide true "relief" from the increasing costs of higher education.

Investors

The Act makes several changes to the capital gains tax structure. For example, it requires taxpayers to hold capital assets longer before realizing a gain in order for a gain to be classified as a "long-term" capital gain. Formerly, for gain to constitute "long-term" capital gain, a taxpayer had to hold a capital asset for more than twelve months. The Act now requires a taxpayer to hold a capital asset for more than eighteen months for it to be considered "long-term."

Even though the Act extends the required holding period, it sharply reduces the tax rate on "long-term" capital gains. The new tax law reduces the maximum tax rate on long-term capital gains by approximately one-third, from 28% to 20%. This maximum tax rate will be further reduced to 18% for sales of capital assets acquired on or after January 1, 2001, and held for at least five years. Taxpayers in the lowest tax bracket also will see a reduction in their tax rate.

Taxpayers in the 15% income tax bracket will be taxed at a rate of 10% on their long-term capital gains, down from 15% under the former law. This rate will fall even further to 8% for sales of capital assets acquired on or after January 1, 2001, and held for a minimum of five years.

Homeowners

Under the Act, many taxpayers who sell their homes may reduce federal capital gains taxes on the profits from their home sales. Once every two years, married taxpayers filing jointly may exclude up to \$500,000 of profit from the sale of their home, while a single taxpayer may exclude up to \$250,000 of profit if the taxpayer has owned and occupied his home as his principal residence for at least two of the five years prior to the sale.

The Act is generally favorable to homeowners. Primarily due to the abolition of age limitations and the increase in the amount that may be excluded, the Act allows more taxpayers to exclude a greater amount of gain from the sale of their homes.

Beneficiaries of IRAs

The Act provides taxpayers with two incentives for maintaining individual retirement accounts ("IRAs"). First, the new law permits more taxpayers to qualify for a "Deductible IRA." Under the old tax law, a taxpayer with an employer-provided retirement plan was able to fully deduct IRA contributions of \$2,000 a year only if the taxpayer's AGI was \$40,000 or less for married couples, or \$25,000 or less for individual taxpayers. Beginning in 1998, however, married couples filing jointly and reporting an AGI of \$50,000 or less and individuals with an AGI of \$30,000 or less also may qualify for a Deductible IRA. Nevertheless, a taxpayer's contributions to a Deductible IRA and their earnings are still taxed upon withdrawal.

Second, the Act provides taxpayers with an opportunity to use a new savings tool, the Roth IRA, named after Senator William Roth (R-Del.), Chairman of the Senate Finance Committee. Beginning in 1998, a wife and husband with an AGI of \$150,000 or less (and individuals up to \$95,000) may each make annual contributions of up to \$2,000 to the Roth IRA. Contributions to a Roth IRA are not tax-deductible, but earnings grow tax-free. Additionally, a taxpayer may withdraw profits from a Roth IRA tax-free after five years, if the taxpayer is at least 59 1/2 years old at the time of withdrawal, or the taxpayer is using the savings for a first-time home purchase.

Taxpayers "Conducting" Business at Home

The Act also provides relief to taxpayers who wish to set up a business office at home. Beginning in 1999, taxpayers who operate businesses from their homes, yet execute most of their business duties outside of the home, may deduct some costs of their home-office space as a business expense. A taxpayer may qualify for the "home office" deduction if the office is used for the administrative or management operations of a business and no other established location is available for the taxpayer to perform these duties. To qualify for the deduction, however, the office area must be used regularly and exclusively to conduct business. Ownership of the business is not required to qualify for the deduction. However, an employee who sets up an office at home may qualify for the deduction only if his or her employer does not provide work space.

Conclusion

Since Congress enacted the Tax Relief Act of 1997 recently, and taxpayers have not yet filed tax returns under the new tax act, the real winners and losers are yet to be determined. However, the Act does include incentives for parents, students, investors, homeowners, and IRA beneficiaries.

Editor's Note

This section on the Taxpayer Relief Act of 1997 is only an overview of certain provisions the new law. Therefore, it should not be relied on for tax planning purposes. Instead, taxpayers should consult a tax advisor to plan wisely and effectively for the upcoming tax year.