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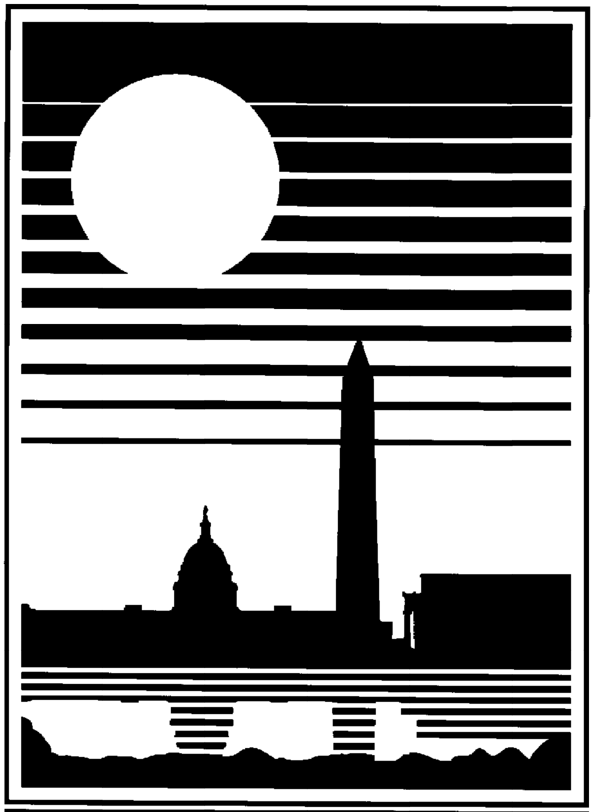
Highlights of 1996 Tax Changes



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See *How To Get More Information* in this publication.

Contents

Introduction

Many changes to the tax law were enacted in 1996. Some of our publications and tax forms instructions refer to this publication for more information on the changes.

In each chapter, topics are organized under the headings ''1996 Tax Changes '' and ''1997 Tax Changes''. Please note that some topics within ''1996 Tax Changes'' also apply to earlier years.

Before You File...

Each year the IRS tries to make it easier for you at tax time. Some of the new ways to help you prepare your return are listed below.

- You can get tax forms and publications from many sources. Alternate sources for forms and publications are the IRS TaxFax, Internet, FedWorld, and CD-ROM. (See chapter 8.)
- You can choose to have your refund directly deposited into your bank account without filling out any other paperwork. To take advantage of this safe, quick, and easy way to get your refund, see the instructions in your forms package.
- You can make payments electronically through the Electronic Federal Tax Payment System. (See *Electronic Payment of Taxes* in chapter 1.)

1.

Tax Changes for Individuals

1996 Tax Changes

Social Security Numbers for Dependents

You must list the social security number (SSN) of any person you claim as a dependent (except a child born during December of 1996) in column (2) of line 6c of your Form 1040 or Form 1040A. If your dependent was born in December of 1996 and does not have an SSN, enter ''12/96'' in column (2).

You do not need an SSN for a child who was born in 1996 and died in 1996. Write ''Died'' in column (2) of line 6c of your Form 1040 or Form 1040A.

If you do not list the dependent's SSN when required or if you list an incorrect SSN, the exemption may be disallowed.

Note. If your dependent does not have and is not eligible to get an SSN, you must list the dependent's individual taxpayer identification number (ITIN) instead of an SSN. See *Identification Numbers* under *Foreign Issues.*

Employer-Provided Education

The exclusion from income of up to $5,250 of employer-provided educational assistance benefits, which expired for tax years beginning after December 31, 1994, has been extended retroactively. It will now expire for tax years beginning after May 31, 1997. However, the exclusion does not apply to graduate level courses that begin after June 30, 1996.

For the tax year beginning in 1997, you can exclude only the benefits for courses that begin before July 1, 1997.

Educational assistance defined. Educational assistance includes payments by your employer for tuition, fees and similar payments, books, supplies, and equipment. It does not include payments for meals, lodging, transportation, or tools or supplies (other than textbooks) that you can keep after completing the course of instruction. It does not include payments for education involving sports, games, or hobbies unless the education:

1) Has a reasonable relationship to the business of your employer, or
2) Is required as part of a degree program.

Graduate level course. The term ''educational assistance'' does not include any payment for, or the provision of, any benefits for any graduate level course that is normally taken by an individual pursuing a program leading to a law, business, medical, or other advanced academic or professional degree.

Refund for employees. Because the exclusion has been extended retroactively, you may be entitled to refunds for federal income, social security, and Medicare taxes paid on excludable educational assistance benefits provided in 1995, and for social security and Medicare taxes paid on excludable benefits provided in 1996. Get Publication 508, *Educational Expenses,* for more information about how to get a refund.

If your employer continued to exclude these benefits from your income after 1994, you have not overpaid taxes on educational benefits and are not entitled to a refund.

Exclusion for Lodging at Academic Health Centers

Beginning in 1996, the exclusion from gross income for the value of qualified campus lodging is extended to lodging provided on or near academic health centers. These are certain medical research institutions that engage in and teach basic and clinical medical science and research. For more information on this exclusion, see *Meals and Lodging* under *Fringe Benefits* in Publication 525, *Taxable and Nontaxable Income.*

Education Savings Bond Program

If you pay qualified higher educational expenses and redeem qualified U.S. Savings Bonds during the same year, you may be able to exclude from income part or all of the interest you receive from those bonds. The exclusion is phased out if your modified adjusted gross income (modified AGI) is more than the limit for your filing status. The amount of modified AGI you can have and still exclude this interest increased in 1996 and increased retroactively for 1993, 1994, and 1995. If the old modified AGI limit reduced or eliminated your exclusion in 1993, 1994, or 1995, you may be entitled to a refund.

For 1996, the modified AGI above which the phaseout begins and at which it is complete are, respectively, as follows:

- $49,450 and $64,450 for taxpayers filing as single or head of household, and
- $74,200 and $104,200 for married taxpayers filing jointly and for taxpayers filing as qualifying widow(er) with dependent child.

For 1995, the new modified AGI limits are:

- $48,100 and $63,100 for taxpayers who filed as single or head of household, and
- $72,150 and $102,150 for married taxpayers who filed jointly and for taxpayers filing as qualifying widow(er) with dependent child.

For 1994, the new modified AGI limits are:

- $46,900 and $61,900 for taxpayers who filed as single or head of household, and
- $70,350 and $100,350 for married taxpayers who filed jointly and for taxpayers filing as qualifying widow(er) with dependent child.

For 1993, the new modified AGI limits are:

- $45,500 and $60,500 for taxpayers who filed as single or head of household, and
- $68,250 and $98,250 for married taxpayers who filed jointly and for taxpayers filing as qualifying widow(er) with dependent child.

If you are entitled to a refund for 1993, 1994 or 1995, complete and file a separate Form 1040X, *Amended U.S. Individual Income Tax Return,* for each tax year affected. (Generally, an amended return for 1993 must be filed by April 15, 1997.)

For more information on the exclusion of interest from Series EE U.S. Savings Bonds, see *Education Savings Bond Program* in Publication 550, *Investment Income and Expenses,* and Form 8815.

Qualified State Tuition Programs

Effective for tax years ending after August 20, 1996, distributions from a qualified state tuition program are taxable only to the extent they are more than the amount contributed to the program. Previously, the tax treatment of these programs was not clearly defined.

A qualified state tuition program is one that is established and maintained by a state or agency and that:

1) Allows a person to:
   a) Buy tuition credits or certificates for a designated beneficiary who is then entitled to a waiver or payment of qualified higher educational expenses, or
   b) Make contributions to an account that is set up to meet the qualified higher educational expenses of a designated beneficiary of the account,
2) Requires all purchases or contributions to be made only in cash,
3) Prohibits the contributor and the beneficiary from directing the amount invested, and
4) Allows a change of beneficiary to be made only between members of the same family.

For more information on a specific program, contact the state or agency that established and maintains it.

Damages for Nonphysical Injuries or Sickness and Punitive Damages

Generally, amounts received after August 20, 1996, as damages for nonphysical injuries or sickness or as punitive damages are taxable.

Damages received for nonphysical injuries or sickness. Damages for nonphysical injuries or sickness, such as employment discrimination, defamation, or emotional distress, are generally taxable. However, damages for emotional distress due to nonphysical injuries or sickness are excludable up to the amount paid for medical care for the emotional distress.

Only damages received for physical injuries or physical sickness can be excluded from income. If emotional distress is due to physical injuries or physical sickness, the damages you receive for that emotional distress are not taxable.

Emotional distress defined. Emotional distress includes physical symptoms that result from emotional distress, such as headaches, insomnia, and stomach disorders.

Punitive damages. Punitive damages generally are taxable. It does not matter if they relate to a physical injury or physical sickness. This rule does not create any inference about punitive damages under prior law.

Pre-existing agreement. If you receive damages under a written binding agreement, court decree, or mediation award that was in effect (or issued on or before) September 13, 1995, these rules do not apply to you.

Repeal of $5,000 Death Benefit Exclusion

The new law repeals the $5,000 exclusion for employer-provided death benefits. If an employee dies ***after August 20, 1996,*** his or her beneficiary can no longer exclude from income any otherwise taxable benefits paid by or on behalf of an employer because of the employee's death.

Parents' Election To Report Child's Interest and Dividends on Parents' Return

If you are a parent of a child under age 14 who has interest and dividend income of less than $6,500, you may be able to include your child's income on your return. If you make this choice, your child will not have to file a return and $650 of the child's income will not be taxed.

Beginning in 1996, the amounts involved in this choice are adjusted for inflation. The previous income limit was $5,000 and the untaxed amount was $500.

For more information on the election to report a child's interest and dividends, see Publication 929, *Tax Rules for Children and Dependents,* and Form 8814.

Tax Relief for Service in a Qualified Hazardous Duty Area

Members of the U.S. Armed Forces serving in a ''qualified hazardous duty area '' receive the same tax relief as members serving in a combat zone. This means that certain military pay is excluded from their income, and the deadline for filing tax returns and paying taxes is extended. The qualified hazardous duty area includes Bosnia and Herzegovina, Croatia, and Macedonia.

For officers serving in a combat zone or qualified hazardous duty area, the amount of pay excluded from tax is increased from $500 per month to the highest rate of enlisted pay per month ($4,104.90 for 1996), plus the amount of imminent danger pay received.

Even if not serving in the qualified hazardous duty area, members deployed overseas away from their permanent duty station in support of Operation Joint Endeavor are given an extension of time to file tax returns and take care of other tax matters. These personnel, however, are not entitled to other combat zone tax benefits.

These changes are effective retroactively to November 21, 1995.

For more information on combat zone tax benefits, get Publication 3, *Armed Forces' Tax Guide.*

Exemption Amount Increased

The amount you can deduct as an exemption has increased from $2,500 in 1995 to $2,550 in 1996.

You will lose all or part of the benefit of your exemptions if your adjusted gross income goes above a certain level. In 1996, the income level ranges from $88,475 (for married filing separately) to $176,950 (for married filing jointly) depending upon your filing status. There is a *Deduction for Exemptions Worksheet* in the form 1040 instructions.

Standard Deduction Amount Increased

The standard deduction for taxpayers who do not itemize deductions on Schedule A of Form 1040 is higher in 1996 than it was in 1995. The amount depends upon your filing status. The *1996 Standard Deduction Tables* are shown in Publication 501, *Exemptions, Standard Deduction, and Filing Information.*

Limit on Itemized Deductions

You will lose all or part of the benefit for itemized deductions if your adjusted gross income goes above a certain amount. In 1996, this amount has risen to $117,950 ($58,975 if you are married filing separately). See Publication 501, *Exemptions, Standard Deduction, and Filing Information,* for more information.

Donations of Appreciated Stock

The special rule allowing a deduction for the full fair market value of qualified appreciated stock given to certain private foundations is reinstated, but only for contributions made after June 30, 1996, and before June 1, 1997.

For more information, get Publication 526, *Charitable Contributions.*

Car Expenses

The information on how to figure deductible expenses for the business use of a car is now included in Publication 463, *Travel, Entertainment, Gift, and Car Expenses.* To eliminate duplication and to provide one comprehensive discussion, the contents of former Publication 917, *Business Use of a Car,* have been merged into Publication 463.

Standard mileage rate. The standard mileage rate for the cost of operating your car in 1996 is 31 cents a mile for all business miles. The special rate for rural mail carriers is 46 $1/2$ cents a mile. Use of the standard mileage rate is explained in chapter 4 of Publication 463, *Travel, Entertainment, Gift, and Car Expenses.*

The standard mileage rate for medical and moving expenses is 10 cents a mile, and the standard mileage rate for charitable contributions remains at 12 cents a mile.

Self-Employment Tax for Newspaper Carriers and Distributors

For services you perform after 1995, you are a direct seller and are subject to self-employment tax if:

1) You are in the business of delivering or distributing newspapers or shopping news (including directly related services such as soliciting customers and collecting receipts),
2) Substantially all the pay you receive for the services in (1) relates to the number of your sales or deliveries rather than to the number of hours you work, and
3) You perform the services under a written contract that states you will not be treated as an employee for federal tax purposes.

You are a direct seller whether or not you hire others to help you make deliveries and whether you work under a buy-sell or agency distribution system. You are not a direct seller if you deliver or distribute newspapers and are under the age of 18. For more information, get Publication 533, *Self-Employment Tax.*

Self-Employment Tax for Retired Ministers

For any year (including a prior year), the retirement benefits you receive from a church plan and the rental value of any parsonage or any parsonage allowance provided to you after you retire are not subject to self-employment tax. This is true even if the rental value of the parsonage or parsonage allowance is not excludable from income.

In general, a ''church plan'' means a plan established and maintained for its employees by a church or convention or association of churches that is tax-exempt.

Certain Fishermen Considered Self-Employed

If you work on a fishing boat that normally has an operating crew of fewer than 10 people, you may be considered self-employed.

The following two law changes have made it easier for you to be considered self-employed.

1) An operating crew is considered to be normally made up of fewer than 10 people if the average number of crew members on trips made during the last 4 calendar quarters was less than 10.
2) You may be considered self-employed even if you receive cash pay that is not from your share of the proceeds from the sale of the catch. The additional cash pay must be:
   a) Not more than $100 per trip,
   b) Paid only if there is some minimum catch, and
   c) Paid solely for additional duties (such as mate, engineer, or cook) for which additional cash pay is traditional in the fishing industry.

These changes generally apply to payments you received after 1984. However, they do not apply to payments you received before 1995, from an employer who treated these payments as subject to social security and Medicare taxes.

For more information, get Publication 595, *Tax Highlights for Commercial Fishermen.*

Earned Income Credit

The maximum amount of the earned income credit for 1996 is more than it was in 1995. The most you can receive in 1996 is:

- $2,152 with one qualifying child,
- $3,556 with more than one qualifying child, or
- $323 without a qualifying child.

Earned income is more. The amount you can earn in 1996 and still get the earned income credit is more than it was in 1995. The amount you can earn in 1996 must be less than:

- $25,078 with one qualifying child,
- $28,495 with more than one qualifying child, or
- $9,500 without a qualifying child.

Social security numbers. You must provide a correct and valid social security number (SSN) for each person listed on your tax return who was born ***before December 1, 1996.*** For purposes of the earned income credit, this includes yourself, your spouse, and any qualifying children. If an SSN is missing or incorrect, you may not get the credit.

The SSN must be issued by the Social Security Administration to a person who is a U.S. citizen or who has permission from the Immigration and Naturalization Service to work in the United States.

Investment income. If your investment income is more than $2,200, you generally cannot claim the earned income credit. See Publication 596, *Earned Income Credit,* for more information.

Self-employed persons. If you are self-employed and your net earnings are $400 or more, be sure to correctly fill out Schedule SE (Form 1040), *Self-Employment Tax,* and pay the proper amount of self-employment tax. If you do not, you may not get all the earned income credit to which you are entitled.

Diesel-Powered Vehicle Credit Repealed

The credit or refund for buyers of diesel-powered highway vehicles has been repealed for vehicles bought after August 20, 1996. More information is in Publication 378, *Fuel Tax Credits and Refunds.*

Electronic Payment of Taxes

Instead of mailing a check to pay taxes, you can now pay taxes electronically using the Electronic Federal Tax Payment System (EFTPS). You can use EFTPS to pay a balance due on your tax return or to make an estimated tax payment. EFTPS is a safe, fast, and convenient way to make your payments. You can even call in your tax payment up to 105 days before the due date and the money will be transferred on the day you specify.

You must apply to use EFTPS. The application process normally takes several weeks. For additional information on EFTPS, call 1–800–555–4477 or 1–800–945–8400.

Estimated Tax Penalty Waived If Due to New Law

You will not have to pay a penalty for underpaying either of the first two installments of 1996 estimated tax if you underpaid because of provisions in the Small Business Job Protection Act of 1996. Provisions in that Act that could have caused your underpayment are:

1) Repeal of the $5,000 death benefit exclusion for beneficiaries of employees who died after August 20, 1996,

2) Changes in the taxation of certain punitive damages and damages that are not for physical injuries or sickness,
3) A change in the taxation of annuities that started after November 18, 1996,
4) Denial of an exemption and the child and dependent care credit for any individual (except a child born in December 1996) whose taxpayer identification number is not included on your return,
5) Repeal of the diesel-powered highway vehicle credit for vehicles bought after August 20, 1996,
6) A rule that lets a parent choose to report a child's 1996 interest and dividend income on the parent's 1996 return only if that income was less than $6,500 (increased from $5,000 in 1995),
7) Clarification that distributions from a qualified state tuition program generally are taxable to the extent they are more than the amount contributed to the program,
8) Clarification that newspaper distributors and certain fishing crew members are not employees and so must pay self-employment tax,
9) A new rule for S corporation stock inherited from an individual who died after August 20, 1996,
10) Changes to the income forecast method of depreciation, generally for property placed in service after September 13, 1995, and
11) Changes in rules for certain foreign trusts.

For more information about these provisions, see the discussions of them in this publication. For more information on the estimated tax penalty, see chapter 4 of Publication 505, *Tax Withholding and Estimated Tax.*

1997 Tax Changes

Life Insurance Paid Before Death

Beginning in 1997, certain payments received under a life insurance contract on the life of a terminally or chronically ill individual before the individual's death (an accelerated death benefit) can be excluded from income. See the exception later. For a chronically ill individual, the payments must be for costs incurred for qualified long-term care services or made on a periodic basis without regard to the costs. The exclusion for payments made on a periodic basis is limited.

In addition, if any portion of a death benefit under a life insurance contract on the life of a terminally or chronically ill individual is sold or assigned to a viatical settlement provider, the amount received is also excluded from income. Generally, a viatical settlement provider is one who regularly engages in the business of buying or taking assignment of life insurance contracts on the lives of insured individuals who are terminally or chronically ill and who meets certain other requirements.

Terminally or chronically ill defined. A terminally ill person is one who has been certified by a physician as having an illness or physical condition that can reasonably be expected to result in death within 24 months from the date of the certification. A chronically ill person is one who is not terminally ill but has been certified by a licensed health care practitioner as meeting one of the following conditions:

1) Is unable to perform (without substantial help) at least two activities of daily living for a period of 90 days or more because of a loss of functional capacity,
2) Has a level of disability similar to the disability in (1) above, or
3) Requires substantial supervision to protect himself or herself from threats to health and safety due to severe cognitive impairment.

Exception. The exclusion does not apply to any amount paid to a person other than the insured if that other person has an insurable interest in the life of the insured:

- Because the insured is a director, officer, or employee of the other person, or
- Because the insured has a financial interest in the business of the other person.

Long-Term Care Insurance

Beginning January 1, 1997, qualified long-term care insurance contracts are generally treated as accident and health insurance contracts. Amounts you receive from them (other than policyholder dividends or premium refunds) generally are excludable from income as amounts received for personal injury or sickness. Insurance premiums are deductible as a medical expense up to certain limits.

A long-term care insurance contract is any insurance contract that only provides coverage of qualified long-term care services. The contract:

1) Must be guaranteed renewable.
2) Must not provide for a cash surrender value or other money that can be paid, assigned, pledged, or borrowed.
3) Must provide that refunds, other than refunds on the death of the insured or complete surrender or cancellation of the contract, and dividends under the contract may be used only to reduce future premiums or increase future benefits.
4) Generally must not pay or reimburse expenses incurred for services or items that would be reimbursed under Medicare, except where Medicare is a secondary payer or the contract makes per diem or

other periodic payments without regard to expenses.

Qualified long-term care services. Qualified long-term care services are:

1) Necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services, and
2) Maintenance or personal care services required by a chronically ill individual as prescribed by a licensed health care practitioner.

Chronically ill individual. A chronically ill individual is one who has been certified as one of the following:

1) An individual who, for at least 90 days, is unable to perform at least two activities of daily living without substantial assistance due to loss of functional capacity. Activities of daily living are eating, toileting, transferring, bathing, dressing, and continence.
2) An individual who requires substantial supervision to be protected from threats to health and safety due to severe cognitive impairment. The certification must have been made by a licensed health care practitioner within the previous 12 months.

Income not taxed. You can generally exclude from gross income benefits you receive under a per diem type long-term care contract, subject to a limit of $175 a day ($63,875 a year) for 1997. The $175 is indexed for inflation after 1997.

Itemized deductions. If you itemize deductions, you can include the following as medical expenses on Schedule A (Form 1040).

1) Unreimbursed expenses for qualified long-term care services.
2) Qualified long-term care premiums up to the amounts shown below.
   - Age 40 or less—$200
   - Age 41 to 50—$375
   - Age 51 to 60—$750
   - Age 61 to 70—$2,000
   - Age 71 and above—$2,500.

Medical Savings Account

Beginning in 1997, a test program of up to 4 years will be open to self-employed individuals and employees of certain small businesses with 50 or fewer employees. If you are eligible, you may be able to make tax deductible contributions to a Medical Savings Account (MSA). You can use the money in this account tax free to pay medical expenses for which your health insurance does not provide coverage or reimbursement.

Eligibility. To be eligible for this new program, you must have health insurance with an annual deductible amount between $3,000 and $4,500 for families (between $1,500 and $2,250 for self-only health insurance). The health insurance must have an annual cap on out-of-pocket expenses of $5,500 or less for families ($3,000 or less for self-only insurance). You or your spouse cannot belong to any other health insurance plan unless the plan provides only limited coverage such as for supplemental Medicare insurance, tort liability, property liability, specific diseases or illnesses, or a fixed-amount-per-day hospitalization plan.

Contributions. You can make fully deductible contributions to your MSA (even if you do not itemize deductions) up to certain limits. You can contribute up to 75 percent (65 percent for self-only health insurance) of the amount of the annual deductible of your health insurance. If you did not have the insurance all year, you can only contribute part of the annual deductible amount.

Example. You have health insurance for your family with an annual deductible of $4,000. You carry the insurance all year. You can contribute and deduct $3,000 ($4,000 × 75%) from your gross income on your tax return.

Employer payments. Your employer can also choose to make contributions for you. The limits remain the same, but instead of you deducting an amount on your tax return, you will exclude the amount from your taxable wages. You will report less income on your tax return but your benefit is the same. You cannot make any deductible contributions to your MSA for any year that the employer contributes to your MSA.

Distributions. You can get money from your MSA tax free as long as you use the money to pay for qualified medical expenses. Generally, qualified medical expenses are those you can include on Schedule A (Form 1040) *Itemized Deductions.* You must have paid these expenses yourself. For more information about qualified medical expenses, see Publication 502, *Medical and Dental Expenses.* You cannot buy health insurance with distributions from your MSA unless you are receiving unemployment benefits, buying continuation coverage required by federal law, or buying long-term care insurance.

Taxable distributions and penalty. If you use the money from your MSA for any purpose besides qualified medical expenses, it will be taxable income that you must report on your tax return. In addition to the tax, you will be charged a 15% penalty tax for an early distribution. The penalty will not be charged if you are disabled or at least age 65.

Adoption Expenses

Beginning in 1997, you may be able to take a new tax credit for qualifying expenses paid to adopt an eligible child. The adoption credit is a nonrefundable credit that you subtract from your tax liability.

Also, beginning in 1997, through 2001, money or other benefits received from your employer for qualifying adoption expenses under an adoption assistance program, may be excludable from your gross income.

When to take the adoption credit. If you adopt a child who is a U.S. citizen or resident, you take the adoption credit for the tax year following the tax year in which the qualifying adoption expenses were paid. Or, for the expenses paid in the year the adoption becomes final, you can take the credit for that year.

Foreign child. If you adopt a child who is not a U.S. citizen or resident, you cannot take the adoption credit or exclude employer provided adoption assistance unless the adoption becomes final. You can take the credit only for the year the adoption becomes final. Adoption expenses paid earlier are treated as paid during the year the adoption becomes final.

Adoption assistance program. An adoption assistance program is a separate written plan set up by an employer to provide adoption assistance to its employees. Examples are the programs that reimburse members of the Armed Forces and Coast Guard for adoption expenses. See *Adoption Assistance Programs* under *Tax Changes for Businesses,* later, for more information.

Qualifying expenses. Qualifying adoption expenses are reasonable and necessary adoption fees, court costs, attorney fees, and other expenses directly related to, and whose principal purpose is for, the legal adoption of an eligible child

Nonqualifying expenses. Qualifying adoption expenses do not include expenses:

- That violate state or federal law,
- For carrying out any surrogate parenting arrangement,
- For the adoption of your spouse's child,
- Paid using funds received from any federal, state, or local program,
- Allowed as a credit or deduction under any other federal income tax rule, or
- Paid before January 1, 1997.

Adoption expenses paid or reimbursed under your employer's assistance program are not qualifying expenses for the adoption credit.

Eligible child. An eligible child must be:

1) Under 18 years old, or
2) Physically or mentally incapable of caring for himself or herself.

After 2001, the adoption credit applies only to qualified expenses for adopting an eligible child with special needs.

Special needs child. An eligible child is a special needs child if he or she is a U.S. citizen or resident and a state determines that the child cannot or should not be returned to his or her parent's home and probably will not be adopted unless adoption assistance is provided to the adoptive parents. A foreign child cannot be treated as an eligible special needs child. Factors used to determine if a child is an eligible special needs child could include:

- The child's ethnic background,
- The child's age,
- Whether the child is a member of a minority or sibling group, or
- Whether the child has a medical condition or physical, mental, or emotional handicap.

Limit and phaseout. The amount of expenses that you can claim as a credit or the amount of employer-provided adoption assistance that you can exclude from your income is limited to $5,000 for each eligible child or $6,000 for each eligible special needs child. The amount of expenses or assistance is reduced ratably if your modified adjusted gross income is more than $75,000 and is eliminated if your modified adjusted gross income is $115,000 or more.

The limit and phaseout apply separately to the credit and the exclusion. For example, if you use your own funds to pay $5,000 of the $10,000 qualifying expenses to adopt an eligible child, you may be able to take a $5,000 credit. In addition, if you receive $5,000 in benefits from your employer as part of an adoption assistance program you may be able to exclude these benefits from your income. This may give you a total tax benefit of $10,000.

Modified adjusted gross income. Modified adjusted gross income, for purposes of the credit and exclusion, is adjusted gross income figured by adding back any:

- Foreign earned income exclusion,
- Foreign housing exclusion or deduction, or
- Exclusion for income from Guam, American Samoa, Northern Mariana Islands, or Puerto Rico.

Your modified adjusted gross income for purposes of the exclusion also includes the benefits from your employer's adoption assistance program.

Unused credit carryforward. The amount of your allowable adoption credit for a year cannot be more than your regular tax liability for that year, minus the following:

1) Any credit for child and dependent care expenses (Form 2441),
2) Any credit for the elderly or the disabled (Form 1040, Schedule R), and
3) Your tentative minimum tax (Form 6251).

If your credit is more than this limit, you can carry the unused credit to your next 5 tax years, or until used, whichever comes first.

Joint return required. Married couples must file a joint return to take the adoption credit or qualify for the income exclusion. However, if you are legally separated or living apart from your spouse for the last six months of the tax year, you may be able to file a separate return and still take the credit or qualify for the exclusion.

Information required. You must identify, on the tax return for the year you claim the credit or exclusion, all eligible children for whom you paid expenses to adopt. To identify the eligible child, you must give (if known) the child's:

- Name,
- Age, and
- Taxpayer identification number.

If you do not know the above information, you may be required to give other information to identify the child including identifying an agent who assisted with the adoption.

Basis adjustment. If a qualifying adoption expense causes an increase in the basis of any property (for example, the cost of a structural improvement to your home to accommodate a child with special needs), subtract the amount of adoption credit or income exclusion allowed for that expense from the increase in the basis of the property.

Self-Employed Health Insurance Deduction

If you are self-employed, your deduction for health insurance expenses for you, your spouse, and your dependents will increase to 40% in 1997. The deduction will increase in later years as shown in the schedule below.

Year	Percentage
1997	40 percent
1998 through 2002	45 percent
2003	50 percent
2004	60 percent
2005	70 percent
2006 and thereafter	80 percent

Withholding from Social Security and Other Government Payments

Beginning in 1997, you can choose to have income tax withheld from certain government payments you receive. These payments are:

1) Social security benefits,
2) Tier 1 railroad retirement benefits,
3) Commodity credit loans,
4) Crop disaster payments under the Agricultural Act of 1949, or title II of the Disaster Assistance Act of 1988, as amended, that are treated as insurance proceeds, and
5) Unemployment compensation.

To make this choice, you will have to fill out **Form W–4V,** *Voluntary Withholding Request* (or a similar form provided by the payer), and give it to the payer. You can choose to have 7%, 15%, 28%, or 31% of each payment withheld, except that 15% will be withheld from unemployment compensation.

If you do not choose to have income tax withheld, you may have to make estimated tax payments. See chapter 2 of Publication 505, *Tax Withholding and Estimated Tax,* for information about estimated taxes. If you do not pay enough tax either through withholding or estimated tax, you may have to pay a penalty. Chapter 4 of Publication 505 has information about this penalty.

For more information about the tax treatment of social security and railroad retirement benefits, get Publication 915, *Social Security and Equivalent Railroad Retirement Benefits.* Get Publication 225, *Farmer's Tax Guide,* for information about the tax treatment of commodity credit loans or crop disaster payments. Unemployment compensation is discussed in Publication 525, *Taxable and Nontaxable Income.*

Social Security and Medicare Taxes

For 1997, the employer and employee will continue to pay:

1) 6.2% each for social security tax (old-age, survivors, and disability insurance), and
2) 1.45% each for Medicare tax (hospital insurance).

Wage limits. The maximum amount of 1997 wages subject to the social security tax (6.2%) is $65,400. There is no wage base limit for the amount subject to Medicare tax (1.45%). All covered wages are subject to the tax.

Joint Return After Separate Returns

If certain requirements are met, married persons who filed separate returns can file an amended return as married filing jointly. For tax years beginning after July 30, 1996, the requirement that you pay the full tax liability as a condition to change a separate return to a joint return is repealed.

2.

Tax Changes for Businesses

1996 Tax Changes

Replacement Property for Losses in a Federal Disaster Area

If your property is destroyed because of a casualty and you receive an insurance or other reimbursement, you can choose to postpone reporting the gain if, within a specified period of time, you acquire qualified ***replacement property***. The replacement property must be similar or related in service or use to the destroyed property.

A new rule applies to destroyed business or income-producing property located in areas that were declared federal disaster areas after December 31, 1994, in tax years ending after that date. Under this rule, ***any*** tangible replacement property you acquire for use in a business is treated as similar or related in service or use to the destroyed property. For more information about losses of property in federal disaster areas, see *Disaster Area Losses* in Publication 547, *Casualties, Disasters, and Thefts (Business and Nonbusiness).*

Postponement of Gain on Involuntary Conversions

If your property was involuntarily converted after August 20, 1996, and you postpone gain by acquiring a controlling interest in a corporation owning similar or related property, the basis of the corporation's property must be reduced by your postponed gain, if any. You are not required to reduce the adjusted bases of the corporation's properties below your adjusted basis in the corporation's stock (determined after reduction by the amount of your postponed gain).

Allocate this reduction to the following classes of property in the order shown below.

1) Property that is similar or related in service or use to the converted property.
2) Depreciable property not reduced in (1) above.
3) All other property.

If two or more properties fall in class (1), (2), or (3), allocate the reduction to each property in proportion to the adjusted bases of all the properties in that class. The reduced basis of any single property cannot be less than zero.

For information about involuntary conversions due to condemnations, see chapter 1 in Publication 544, *Sales and Other Dispositions of Assets.* For information about involuntary conversions due to casualties or thefts, see Publication 547, *Casualties, Disasters, and Thefts (Business and Nonbusiness).*

Educational Assistance Programs

You can exclude from an employee's wages each year up to $5,250 you pay or incur under an educational assistance program. This exclusion, which expired for tax years beginning after 1994, has been extended retroactively. It will now expire for tax years beginning after May 31, 1997. See *Employer-Provided Education,* under *Tax Changes for Individuals.*

Refund of taxes. If you paid social security, Medicare, or unemployment (FUTA) taxes on amounts that are now excludable because they were paid or incurred during 1995 or 1996, you may file a claim for refund. See Publication 15, *Circular E, Employer's Tax Guide,* for instructions on filing this claim.

More information. For more information on educational assistance programs, see chapter 5 in Publication 535, *Business Expenses.*

Home Office Deduction Includes Storage of Product Samples

Beginning in 1996, you can deduct expenses that relate to the use of part of your home for the storage of product samples. You must, however, meet all the following tests.

1) The product samples are for use in your trade or business.
2) Your trade or business is the wholesale or retail selling of products.
3) Your home is the only fixed location of your trade or business.
4) The storage space is used on a regular basis.
5) The space is a separately identifiable space suitable for storage.

For more information on the rules on taking a deduction for the business use of your home, get Publication 587, *Business Use of Your Home (Including Use by Day-Care Providers).*

Interest on Company-Owned Life Insurance Debt

You generally cannot deduct interest paid or accrued after October 13, 1995, on debt incurred on any life insurance policy or annuity or endowment contract you own that covers an employee, officer, or someone financially interested in your business unless that person is a ***key***

person. If the policy or contract covers a key person, you can deduct the interest to the extent:

1) The aggregate debt is not more than $50,000 for that key person, and
2) The interest paid or accrued for any month after 1995 is not more than the Moody's Corporate Bond Yield Average-Monthly Average Corporates (Moody's rate) for that month.

Key person. A key person is an officer or 20% owner. However, the number of individuals you can treat as key persons is limited to the greater of :

1) Five individuals, or
2) The lesser of 5% of the total officers and employees of the company or 20 individuals.

Existing debt. There are special rules for interest paid or accrued after October 13, 1995, and before 1999, on certain debt incurred before 1997, and the income included upon surrender of certain contracts during 1996 through 1998.

The deduction for interest paid or accrued after 1995 on debt for contracts purchased on or before June 20, 1986, is limited.

For more information, see section 264 of the Internal Revenue Code.

Property No Longer Qualifying as Section 179 Property

The following kinds of property placed in service after 1990 can no longer be treated as section 179 property:

- Air conditioning or heating units,
- Certain property used predominantly outside the United States,
- Property used predominantly to furnish lodging or in connection with the furnishing of lodging,
- Property used by certain tax-exempt organizations,
- Property used by governmental units,
- Property used by foreign persons or entities.

Exception for certain property used for lodging. The following types of property used predominantly for lodging can qualify as section 179 property:

- Property that is a nonlodging commercial facility and that is available to those who are not using the lodging facility on the same basis as it is to those using the lodging facility.
- Property used by a hotel or motel in connection with the trade or business of furnishing lodging where most of the accommodations are used by transients.
- Any energy property.

Energy property. This is equipment that:

- Uses solar energy to generate electricity, to heat or cool (or provide hot water for use in) a structure, or to provide solar process heat, or
- Is used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to (but not including) the electrical transmission stage.

If you did not construct, reconstruct, or erect the equipment, the original use of the property must begin with you. The property must meet any performance and quality standards prescribed by Income Tax Regulations that are in effect at the time you get the property.

Energy property does not include any property that is public utility property as defined by section 46(f)(5) of the Internal Revenue Code (as in effect on November 4, 1990).

More information. For more information on the section 179 deduction, see chapter 2 in Publication 946, *How To Depreciate Property.*

Depreciation Under the Income Forecast Method

There are new rules for the income forecast method of figuring depreciation deductions on property you placed in service after September 13, 1995 (other than property you produced or acquired under a written contract that was binding on that date and until you produced or acquired the property). Also, you may have to pay (or you may receive) interest based on the recomputation of depreciation under a "look-back" method.

Estimated income under the income forecast method. When estimating the income to be derived from the property during its useful life, include the income earned in connection with the property before the close of the tenth tax year following the year the property was placed in service.

Adjusted basis of the property. When figuring depreciation under the income forecast method, include in the adjusted basis of the property only amounts that satisfy the economic performance standard of section 461(h) of the Internal Revenue Code.

Deduction in final year. The depreciation deduction for the tenth tax year following the year the property is placed in service is the adjusted basis of the property at the beginning of that tenth tax year.

More information. For more information, see Internal Revenue Code section 167(g).

Depreciation of Water Utility Property

You can depreciate water utility property placed in service after June 12, 1996 (unless placed in service under a binding contract in effect before June 10, 1996, and at all times until the property is placed in service), using the straight line method over a 25–year recovery period.

Water utility property is:

1) Property that is an integral part of gathering, treating, or commercially distributing water and that, without regard to this provision, would have a 20–year recovery period, and
2) Any municipal sewer.

For more information on depreciation, see Publication 946, *How To Depreciate Property.*

Depreciation of Gas Station Convenience Stores

You can now treat real property that is a ***retail motor fuels outlet*** as 15–year property, whether or not it sells food or other convenience items. This property must have been placed in service after August 19, 1996.

Retail motor fuels outlet. Real property is a retail motor fuels outlet if it meets any one of the following three tests.

1) It is a building of no more than 1,400 square feet used to a substantial extent in the retail marketing of petroleum products.
2) 50% or more of the gross revenues that are generated from the property are from petroleum sales.
3) 50% or more of the floor space in the property is for petroleum marketing sales.

However, a retail motor fuels outlet does not include any facility related to petroleum and natural gas trunk pipelines. It also does not include any real property that is not used to a substantial extent in the retail marketing of petroleum or petroleum products.

For more information on depreciation, see Publication 946.

General Business Credit

The following paragraphs explain the changes to the general business credit.

Credit for taxes paid on certain employee tips. The credit is generally equal to your (employer's) part of social security and Medicare taxes paid on tips received by employees of your food and beverage establishment where tipping is customary. However, you cannot get credit for your part of social security and Medicare taxes on those tips that are used to meet the federal minimum wage rate applicable to the employee under the Fair Labor Standards Act. The changes to this credit are as follows:

1) The credit is effective for your part of social security and Medicare taxes paid ***after 1993,*** regardless of:
   a) Whether your employees reported the tips to you, or
   b) When your employees performed the services.
2) Effective for services performed ***after 1996,*** the credit applies to these taxes on tips your employees receive from customers in connection with providing, delivering, or serving food or beverages, regardless of whether the customers consume the food or beverages on your business premises.

For more information about this credit, see Form 8846.

Orphan drug credit. The orphan drug credit is now part of the general business credit. It applies to qualified expenses incurred in testing certain drugs (orphan drugs) that treat rare diseases and conditions. This credit expired after December 31, 1994, but has been extended to apply to qualified expenses paid or incurred after June 30, 1996, and before June 1, 1997, in tax years ending after June 30, 1996. You can carry back any unused credit to 3 years before the year the credit was earned, but not to a tax year ending before July 1, 1996. For any credit you do not carry back, you can carry that credit forward 15 years after the year the credit is earned. For more information, get Form 8820.

Research credit. The research credit is designed to encourage businesses to increase the amounts they spend on research and experimental activities. The credit is generally 20% of the amount by which your research expenses for the year are more than your base amount. This credit expired after June 30, 1995, but has been reinstated for expenses paid or incurred after June 30, 1996, and before June 1, 1997, in tax years ending after June 30, 1996. (There is a special rule for the new alternative incremental credit and expenses paid to a qualified research consortium, explained later.)

The changes to the research credit are as follows:

1) A ***start-up company*** now includes any company whose first tax year that included both gross receipts and qualified research expenses began after 1983.
2) You can elect the ***alternative incremental credit.*** This credit features a reduced credit rate and a three-tiered fixed-base percentage that is lower than the regular fixed-base percentage. You can elect this credit only for your first tax year beginning after June 30, 1996, and before July 1, 1997. This election will apply to that tax year and all later years unless you have permission from the IRS to revoke it. If you make this election, all qualified research expenses paid or incurred during the first 11 months of that first tax year are treated as qualified research expenses for purposes of computing the alternative incremental credit.
3) You will get a larger credit for contract research expenses paid to a ***qualified research consortium*** in tax years beginning after June 30, 1996. Of these

expenses, 75% will be eligible for the research credit. The consortium must conduct research for you and at least one other unrelated person. A qualified research consortium is any organization that is :

   a) A tax-exempt organization described in Internal Revenue Code section 501(c)(3) or 501(c)(6),
   b) Organized and operated primarily to conduct scientific research, and
   c) Not a private foundation.

4) You cannot take the research credit into account when figuring estimated tax payments required to be paid for a tax year beginning in 1997.

For more information about the research credit, get Form 6765.

Work opportunity credit. The work opportunity credit replaces the jobs credit, which expired on December 31, 1994. This credit provides an incentive to hire individuals from targeted groups that have a particularly high unemployment rate or other special employment needs. The credit is based on qualified first-year wages you pay to individuals who begin work for you after September 30, 1996, and before October 1, 1997. The work opportunity credit is similar to the jobs credit, except for the following changes.

1) The credit is 35% of qualified first-year wages.
2) The targeted groups have changed. An individual must be one of the following:
   a) A qualified IV-A recipient,
   b) A qualified veteran,
   c) A qualified ex-felon,
   d) A high-risk youth,
   e) A vocational rehabilitation referral,
   f) A qualified summer youth employee, or
   g) A qualified food stamp recipient.
3) An individual will not be treated as a member of a targeted group unless:
   a) On or before the day on which the individual begins work for you, you have received a certification from your state employment security agency that the individual is a member of a targeted group, or
   b) On or before the day you offer employment to an individual, you complete Form 8850, *Work Opportunity Credit Pre-Screening Notice and Certification Request,* and send it to your state employment security agency no later than the 21st day after the individual begins work.
4) An individual must work for you for at least:
   a) 180 days (20 days in the case of a qualified summer youth employee), or
   b) 400 hours (120 hours in the case of a qualified summer youth employee).

For more information about the work opportunity credit, see Form 5884.

Electric Vehicle Basis Adjustment

If you elect to claim a tax credit for a qualified electric vehicle you place in service during the year, you must reduce your basis in that vehicle. For vehicles placed in service on or after August 20, 1996, you must reduce your basis by the lesser of $4,000 or 10%of the cost of the vehicle, even if the credit allowed is less than that amount.

Diesel-Powered Vehicle Credit Repealed

The credit or refund for buyers of diesel-powered highway vehicles has been repealed for vehicles bought after August 20, 1996. More information is in Publication 378, *Fuel Tax Credits and Refunds.*

Puerto Rico and Possession Tax Credit Repealed

The Puerto Rico and possession tax credit provided by section 936 of the Internal Revenue Code has been repealed for tax years beginning after 1995. Some existing credit claimants can continue to claim the credit during a transition period, subject to certain conditions and special rules.

For more information, see sections 30A and 936(j) of the Internal Revenue Code.

Information for Form 1099–S Filers

A change in the law affects persons who are responsible for closing real estate sales and reporting the sales to the IRS on Form 1099–S, *Proceeds From Real Estate Transactions.* This law change clarifies that Form 1099–S filers, who may not charge customers a separate fee for filing the form, may take into account the cost of filing the form in setting the fees they charge customers for services. This change takes effect as of November 10, 1988, when the law prohibiting a separate charge took effect.

Estimated Tax Penalty Waived If Due to New Law

You will not have to pay a penalty for underpaying either of the first two installments of 1996 estimated tax if you underpaid because of provisions in the Small Business Job Protection Act of 1996. Provisions in that Act that could have caused your underpayment are:

1) Repeal of the diesel-powered highway vehicle credit for vehicles bought after August 20, 1996,
2) A new rule for S corporation stock inherited from an individual who died after August 20, 1996,

3) Changes to the income forecast method of depreciation, generally for property placed in service after September 13, 1995,

4) Changes in rules for certain foreign trusts,

5) A requirement that a corporation whose stock is acquired in certain involuntary conversions after August 20, 1996, reduce its basis in certain assets, and

6) Termination of the Puerto Rico and possession tax credit.

For more information about these provisions, see the discussions of them in this publication.

Penalty for Not Depositing Payroll Taxes May Be Waived

Beginning with deposits required to be made after July 30, 1996, the penalty for not making required deposits of payroll taxes may be waived if:

- Your missed deposit occurs during the first quarter that you were required to deposit any employment tax, and
- You filed your employment tax return by its due date.

However, even if you meet these conditions, the penalty cannot be waived if the net worth of your business is more than $7 million ($2 million for an individual).

Deposit sent to IRS. The penalty may also be waived if you are a first time depositor and you inadvertently sent your deposit to the IRS instead of to the required government depository.

Penalty for Not Including Telephone Number on Certain Information Returns Waived

New law requires payers to provide a telephone number of a person to contact on Copy B of certain Forms 1099, 1098, and W–2G, starting with 1996 statements due to recipients by January 31, 1997. The number must provide direct access to a person who can answer questions about the statement. Because the law was enacted after the 1996 statements were printed, there is no space designated for the number on the statements. Payers are encouraged to enter the number on the 1996 statement wherever they choose. However, the penalty for not providing the number on 1996 statements will be waived if the payer includes the number on the 1997 statement (due to recipients by February 2, 1998). See the 1997 *Instructions for Forms 1099, 1098, 5498, and W–2 G* for the statements on which payers are required to include the number.

1997 Tax Changes

Energy Conservation Subsidies for Nonresidential Property

For amounts received after 1996, the partial exclusion from gross income of any subsidy provided by a public utility to a customer for the purchase or installation of an energy conservation measure on nonresidential property is repealed. Beginning in 1997, the exclusion is available only for dwelling units.

However, the partial exclusion for nonresidential property is still available if the amounts received after 1996 are made under a written binding contract that was in effect on September 13, 1995, and at all times thereafter.

Fringe Benefit Nondiscrimination Rules

Nondiscrimination rules apply to the exclusion of certain fringe benefits from the income of a highly compensated employee. For tax years beginning after 1996, the definition of ‘‘highly compensated employee ’’ has changed.

The new definition of a highly compensated employee is an employee who:

1) Was a 5% owner at any time during the year or the preceding year, or

2) Received more than $80,000 in pay from the employer for the preceding year.

When you apply requirement (2), you may choose to include only employees who were also in the top 20% of employees when ranked by pay for the preceding year.

For more information on fringe benefit nondiscrimination rules, see chapter 4 in Publication 535, *Business Expenses.*

Adoption Assistance Programs

You can deduct the cost of an adoption assistance program you provide for your employees on the ‘‘Employee benefit programs’’line of your business income tax return.

For tax years beginning after 1996, amounts you pay or incur under your adoption assistance program for an employee’s qualified adoption expenses are not subject to income tax withholding. However, these amounts are subject to social security, Medicare, and federal unemployment (FUTA) taxes. Up to $5,000 ($6,000 for a special needs child) of these amounts may be excluded from the employee’s gross income. The employee will figure the amount (if any) subject to income tax when he or she files a federal income tax return. For information on this exclusion, including the definitions of the terms ‘‘special needs child, ’’ and ‘‘qualified adoption expenses,’’ see *Adoption Expenses* under *Tax Changes for Individuals,* earlier.

Form W–2. You must report all qualified adoption expenses you paid or incurred under your adoption assistance program for each employee for the year in box 13 of the employee's Form W–2. Use Code ''T''to identify this amount. Also include this amount in the totals for social security wages in box 3 and Medicare wages in box 5. However, do not include this amount with the employee's wages in box 1.

Adoption assistance program. An adoption assistance program must meet all of the following tests.

1) It is a separate written plan that only provides adoption assistance to your employees.
2) It benefits employees who qualify under rules set up by you, which do not favor highly compensated employees or their dependents. To determine whether your plan meets this test, do not consider employees excluded from your plan who are covered by a collective bargaining agreement, if there is evidence that adoption assistance was a subject of good-faith bargaining. The term ''highly compensated employee '' is defined under *Fringe Benefit Nondiscrimination Rules,* earlier.
3) It does not pay more than 5% of its benefits during the year for shareholders or owners (or their spouses or dependents). A shareholder or owner is someone who owns (on any day of the year) more than 5% of the stock or of the capital or profits interest of your business.
4) You give reasonable notice of the plan to eligible employees.

Medical Savings Accounts

For tax years beginning after 1996, a new program for a tax-exempt medical savings account (MSA) will be available (for up to 4 years) to self-employed persons and employees of a small business. You can contribute (within limits) to an MSA for each employee you cover under a high-deductible health plan. Deduct these contributions on the ''Employee benefit programs'' line of your business income tax return for the tax year in which you make them.

Also, exclude from an employee's income amounts you contribute to his or her MSA.

Small business. You have a small business for a calendar year if you employed on average 50 or fewer employees on business days during the 2 preceding calendar years. If you were not in business throughout the preceding calendar year, you have a small business if you can reasonably be expected to employ an average of 50 or fewer employees on business days in the current calendar year. However, special rules apply in calendar years after 1997 for growing businesses.

Medical savings account (MSA). An MSA is a trust or custodial account (similar to an individual retirement arrangement (IRA)) that offers individuals who are covered by a small business high-deductible health plan tax advantages to set aside money for qualified medical expenses that are not reimbursable by the plan. You can set up an MSA with a trustee, such as a bank or insurance company. For information about MSA rules that apply to individuals, see *Medical Savings Accounts* under *Tax Changes for Individuals* in this publication.

High-deductible health plan. A high-deductible health plan is a plan that provides:

1) An annual deductible that is:
   a) Not less than $1,500 and not more than $2,250 for self-only coverage, and
   b) Not less than $3,000 and not more than $4,500 for family coverage, and
2) An annual out-of-pocket expense limit of not more than:
   a) $3,000 for self-only coverage, and
   b) $5,500 for family coverage.

A plan is not a high-deductible health plan if substantially all of its coverage is for:

1) Accidents,
2) Disability,
3) Dental care,
4) Vision care,
5) Long-term care,
6) A benefit provided by Medicare supplemental insurance, or
7) A benefit provided by insurance:
   a) Related to workers' compensation laws, tort liabilities, or ownership or use of property,
   b) For a specific disease or illness, or
   c) That pays a fixed amount per day (or other period) of hospitalization.

Qualified medical expenses. Qualified medical expenses include medical expenses for the employee, his or her spouse, and any dependents. These expenses are generally the types of expenses the employee could include as medical expenses on Schedule A (Form 1040), if he or she itemizes deductions. For more information on medical expenses, see Publication 502.

Failure to make comparable contributions. Generally, employers will be subject to an excise tax if they make a contribution during any calendar year to an employee's MSA and do not make comparable contributions for all comparable participating employees for each coverage period during that year.

Comparable contributions. Comparable contributions are contributions that are either:

1) The same amount, or
2) The same percentage of the annual deductible limit under the high-deductible health plan covering the employees.

Comparable participating employees. Comparable participating employees are all employees who:

1) Are covered by your high-deductible health plan and eligible to establish an MSA,
2) Have the same category of coverage (either self-only or family coverage), and
3) Have the same category of employment (either part-time or full-time).

Part-time employees are those who usually work fewer than 30 hours a week.

Excise tax. The excise tax for not making comparable contributions is 35% of the total amount the employer contributes to MSAs during the calendar year. If you are subject to this tax, but your case was due to reasonable cause and not willful neglect, the IRS may waive the part of the excise tax that would be excessive relative to the degree of noncompliance involved.

Employment taxes. Amounts you contribute to an employee's MSA are generally not subject to employment taxes. However, you must report your contributions on the Form W–2 you file for the employee for the calendar year.

Group Health Plan Accessibility, Portability, and Renewability Requirements

Generally effective for plan years beginning after June 30, 1997, you (or the plan, if a multi-employer plan) will be subject to an excise tax if your plan does not meet the new accessibility, portability, and renewability requirements. These requirements generally:

- Limit the circumstances under which plans can deny coverage for preexisting conditions,
- Bar group health plans from using an individual's health status to exclude him or her from coverage, and
- Guarantee continued health coverage to an employer under a multi-employer plan.

Collective bargaining agreement. If your plan stems from a collective bargaining agreement ratified before August 21, 1996, these new rules will first apply to your plan for plan years that begin after the collective bargaining agreement expires if that is later than June 30, 1997.

Excise tax. The excise tax generally is $100 per day during the ***noncompliance period*** for each beneficiary.

The **noncompliance period** begins on the first day your plan does not meet these requirements and ends on the first day your plan meets these requirements and the past failures have been corrected.

Exceptions. The tax does not apply:

1) For any period during which:
   a) You did not know that your plan failed to meet these requirements, and
   b) By exercising reasonable diligence you would not have known that your plan failed to meet these requirements, or
2) Your plan failed to meet these requirements due to reasonable cause, not willful neglect, and the plan's failure is corrected within a 30-day period beginning when you knew, or would have known if reasonable diligence were used, that these requirements were not met. If your plan is a church plan, the 30-day period is replaced by a special period described in section 414(e)(4)(C) of the Internal Revenue Code.

However, even if you meet one of these exceptions, you may have to pay a minimum amount of tax, discussed next.

Minimum tax. Even if you meet one of the preceding exceptions to the excise tax, you may still owe a minimum amount of tax unless your plan is a church plan. To avoid all tax, you must correct the failure to meet the accessibility, portability, and renewability requirements ***before*** the IRS sends you a notice of an income tax examination for a period during which your plan failed to meet these requirements. For more information on this excise tax, see section 4980D of the Internal Revenue Code.

Plans exempt from the excise tax. The excise tax for failing to meet these requirements does not apply to any plan maintained by a small employer whose coverage is from a contract with an insurance company. In addition, certain plans such as a governmental plan or a plan that on the first day of the plan year had fewer than 2 participants who are current employees are not subject to these requirements and the excise tax does not apply to them.

Small employer. You are a small employer if you employed an average of at least 2 but not more than 50 employees on business days during the preceding calendar year. If you were not in business throughout the preceding calendar year, you are a small employer if you can reasonably be expected to employ an average of at least 2 but not more than 50 employees on business days in the current year.

Benefits exempt from these requirements. These requirements do not apply to certain benefits that are provided under a separate policy, certificate, or contract of insurance or that are not otherwise an integral part of the plan.

Accessibility

For plan years beginning after June 30, 1997 (see *Collective bargaining agreement,* earlier for a special rule), your plan must not base eligibility rules for employees or their dependents on:

1) Health status,
2) Medical condition (whether physical or mental),
3) Claims experience,
4) Receipt of health care,
5) Medical history,
6) Genetic information,
7) Evidence of insurability, or
8) Disability.

Also, your plan cannot use these factors to charge a higher premium for certain individuals.

Portability

For plan years beginning after June 30, 1997 (see *Collective bargaining agreement,* earlier for a special rule), your plan must limit exclusions based on preexisting conditions and give credit for certain periods of previous coverage.

Preexisting conditions. Your plan can exclude an individual for a preexisting condition only if:

1) The exclusion relates to a condition (whether physical or mental), regardless of the cause, for which medical advice, diagnosis, care, or treatment was recommended or received within the 6-month period ending on the enrollment date,
2) The exclusion extends for a period of not more than 12 months (18 months for a late enrollee) after the enrollment date, and
3) The length of the preexisting condition exclusion period is reduced by any creditable coverage the individual has on the enrollment date.

Your plan cannot exclude certain newborns and adopted children. Also, pregnancy cannot be treated as a preexisting condition. For more information on preexisting conditions, see section 9801 of the Internal Revenue Code.

Creditable coverage. Creditable coverage is coverage that your employee had before he or she enrolled in your plan. Coverage is not counted if an individual had it before any 63-day or longer period during which the individual was not covered under any creditable coverage.

Creditable coverage is coverage under any of the following:

1) A group health plan,
2) Health insurance, or
3) Certain other health plans.

For more information on creditable coverage, see section 9801 of the Internal Revenue Code.

Renewability

For plan years beginning after June 30, 1997 (see *Collective bargaining agreement,* earlier for a special rule), a multi-employer plan or a multiple employer welfare arrangement cannot deny an employer continued access to the same or different coverage under the plan other than:

1) For nonpayment of contributions,
2) For fraud or other intentional misrepresentation of material fact,
3) For noncompliance with material plan provisions,
4) Because the plan is ceasing to offer any coverage in the employer's geographic area, or
5) For certain actions related to:
   a) Network plans, or
   b) Collective bargaining agreements.

Increases to the Section 179 Deduction

The total cost of section 179 property that you can deduct increases as shown below:

Tax Year	Maximum Amount Deductible
1997	$18,000
1998	18,500
1999	19,000
2000	20,000
2001 — 2002	24,000
After 2002	25,000

For more information on the section 179 deduction, get Publication 946, *How To Depreciate Property.*

Electronic Deposits of Taxes

If your total deposits of social security, Medicare, and withheld income taxes were more than $50,000 in 1995, you must make electronic deposits for ***all*** depository tax liabilities that occur after June 30, 1997. If you were required to deposit by electronic funds transfer in prior years, continue to do so in 1997. You must use the Electronic Federal Tax Payment System (EFTPS) to make electronic deposits. If you are required to make deposits by EFTPS and do not do so, you may be subject to a 10% penalty. Even if you do not have to make deposits by EFTPS, you can voluntarily participate in the system. For information ***only*** on EFTPS, call 1–800–945–8400 or 1–800–555–4477.

Social Security and Medicare Taxes

For 1997, the employer and employee will continue to pay:

1) 6.2% each for social security tax (old-age, survivors, and disability insurance), and
2) 1.45% each for Medicare tax (hospital insurance).

Wage limits. The maximum amount of 1997 wages subject to the social security tax (6.2%) is $65,400. There is no wage base limit for the amount subject to Medicare tax (1.45%). All covered wages are subject to the tax.

Federal Unemployment Tax (FUTA)

For 1997, the gross FUTA tax rate remains 6.2% and the federal wage base remains $7,000.

Alien farm workers. Wages paid to an alien who is admitted to the United States, performs contract farm labor for you, and then returns to his or her own country when the contract is completed, are exempt from the FUTA tax. This exemption, which expired December 31, 1994, has been made permanent as of January 1, 1995. If you paid FUTA tax on these alien workers in 1995, you can file an amended Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return,* for a refund. You must use the 1995 form. Amounts paid in 1996 will reduce your tax liability on the 1996 Form 940. See the form instructions for more information.

S Corporations

Permitted number of shareholders increased. For tax years beginning after 1996, an S corporation can have up to 75 shareholders.

Electing small business trusts and certain financial institutions permitted to be shareholders. For tax years beginning after 1996, a new type of trust, an ''electing small business trust,'' and a financial institution that does not use the reserve method of accounting for bad debts under section 585 are permitted to be shareholders. An electing small business trust is one that has made an election to be treated as such and that does not have as a beneficiary any person other than an individual, an estate, or a charity that holds a contingent remainder interest.

Post-death qualification period increased for certain trusts. For tax years beginning after 1996, the period during which a testamentary trust can remain a shareholder following the death of the deemed owner is extended to 2 years.

S corporations permitted to own subsidiaries. For tax years beginning after 1996, there is no longer any restriction on the percentage of another corporation's stock that an S corporation may hold. In addition, an S corporation can make an election to treat the assets, liabilities, income, deductions, and credits of a wholly-owned subsidiary as those of the parent S corporation.

Invalid and late elections. The IRS has been given the authority to allow an S corporation that has inadvertently made an invalid election to be treated as an S corporation for a specified period if the corporation takes the steps needed to perfect the election. The IRS can also treat certain late elections as timely made if the corporation demonstrates reasonable cause for being late.

Election to terminate tax year made only by affected shareholders. For tax years beginning after 1996, the election to close the corporation's books when a shareholder terminates his or her interest in the S corporation is made only by the affected shareholders, rather than all shareholders.

Carryover of disallowed losses and deductions to post-termination transition period. For tax years beginning after 1996, the rules allowing the carryover of certain losses and deductions to the post-termination transition period are expanded to allow the carryover of amounts disallowed due to the at-risk limitations.

Consolidated audit procedures repealed. For tax years beginning after 1996, the consolidated audit procedures at the corporate level that applied to certain corporations, including those with more than 5 shareholders, have been repealed. Instead, S corporation items will be determined in separate proceedings with the individual shareholders. However, shareholders still must either treat a subchapter S item in a manner consistent with the treatment of that item on the corporate return or notify the IRS of any inconsistent treatment.

Distributions made during loss years. For tax years beginning after 1996, adjustments to basis for distributions made by an S corporation are taken into account before applying the loss limitation for the year. Therefore, distributions reduce adjusted basis when figuring the allowable loss, but the loss does not reduce adjusted basis when figuring the taxability of distributions. Also, net negative adjustments are disregarded when figuring the accumulated adjustments account for the purpose of determining the taxability of distributions.

Elimination of certain accumulated earnings and profits. For its first tax year beginning after 1996, an S corporation's accumulated earnings and profits (E&P) is reduced (as of the first day of that year) by the E&P accumulated from any tax year beginning before 1983 when the corporation was a subchapter S corporation. Thus, an S corporation's E&P after 1996 is solely attributable to tax years when the corporation did not have an S election in effect.

Real property subdivided for sale. For tax years beginning after 1996, an S corporation is eligible for the rules under Internal Revenue Code section 1237 that apply to real property subdivided for sale by noncorporate taxpayers.

Re-election after a prior termination. For purposes of the 5-year waiting period that generally applies to an election to be an S corporation after a prior termination, any termination in a tax year beginning before 1997 is not taken into account.

Reduced basis of inherited S corporation stock. The basis of inherited S corporation stock must be reduced by the portion of its value attributable to income in respect of a decedent. This provision is effective for stock inherited from decedents dying after August 20, 1996.

3.

IRAs and Other Retirement Plans

1996 Tax Changes

Annuity Payments From Qualified Plans

If your annuity starting date is ***after November 18, 1996,*** you generally must use the Simplified General Rule to figure your taxable pension from a qualified plan. The recovery factors (the number of anticipated monthly payments) used to figure the tax-free portion of your annuity from a qualified plan have changed. For more information, see Publication 575, *Pension and Annuity Income.*

Tax-Sheltered Annuity Plans — Employees Can Enter Into More Than One Salary Reduction Agreement

For years beginning after 1995, employees can enter into more than one salary reduction agreement under tax-sheltered annuity plans (403(b) plans) during a year.

For more information on tax-sheltered annuities (403(b) plans), get Publication 571, *Tax-Sheltered Annuity Programs for Employees of Public Schools and Certain Tax-Exempt Organizations.*

Tax-Sheltered Annuity Contracts Purchased by Indian Tribal Governments

Any tax-sheltered annuity (TSA) contract purchased by an Indian tribal government for its employees in a plan year beginning before January 1, 1995, is treated as having been purchased by a tax exempt organization that is qualified to provide TSAs for its employees. An Indian tribal government includes any political subdivisions, agencies, and instrumentalities of it, as well as any corporations that are chartered under federal, state, or tribal law and owned by it.

For more information on tax-sheltered annuities (403(b) plans), get Publication 571, *Tax-Sheltered Annuity Programs for Employees of Public Schools and Certain Tax-Exempt Organizations.*

Increase in Tax on Prohibited Transactions

The excise tax on prohibited transactions occurring ***after August 20, 1996,*** increases from 5% to 10%. For more information, see *Prohibited Transactions* in Publication 560.

1997 Tax Changes

Contributions to Spousal Individual Retirement Arrangements (IRAs)

Beginning in 1997, a married couple filing a joint return can contribute up to $2,000 to each spouse's IRA, even if one spouse has little or no compensation. This means that the total combined contributions that can be made to both IRAs can be as much as $4,000 for the year. Previously, if one spouse had no compensation or elected to be treated as having no compensation, the total combined contributions to both IRAs could not be more than $2,250.

Deduction for contributions. Also beginning in 1997, the limit on the deductible contributions to the IRA of the spouse with less compensation is the smaller of:

1) $2,000, or
2) The total compensation of both spouses, reduced by any deduction allowed for contributions to IRAs of the spouse with more compensation.

The deduction for contributions to both spouses' IRAs may be further limited if either spouse is covered by an employer retirement plan.

For more information on individual retirement arrangements (IRAs), get Publication 590, *Individual Retirement Arrangements (IRAs).*

Early IRA Withdrawals for Certain Medical Expenses

Beginning in 1997, the 10% additional tax on premature distributions (early withdrawals) from an IRA will not apply to distributions up to the amount you pay for unreimbursed medical expenses that are more than 7 ½% of your adjusted gross income.

Also beginning in 1997, the 10% tax may not apply to distributions up to the amount you paid for medical insurance for yourself, your spouse, and your dependents. The tax will not apply if all four of the following conditions apply.

1) You lost your job.
2) You received unemployment compensation under any federal or state law for 12 consecutive weeks.
3) The distributions are made during either the year you received the unemployment compensation or the following year.
4) The distributions are made no later than 60 days after you have been reemployed.

For more information on IRAs, get Publication 590, *Individual Retirement Arrangements (IRAs).*

Temporary Suspension of Tax on Excess Distributions

For distributions from IRAs and qualified employer plans made after 1996 and before the year 2000, the 15% tax on excess distributions has been suspended.

For more information on IRAs, get Publication 590, *Individual Retirement Arrangements (IRAs).* For more information on distributions from qualified employer plans, get Publication 575, *Pension and Annuity Income (Including Simplified General Rule).*

Minimum Required Distribution Rule Modified

Beginning in 1997, new law modifies the definition of the required beginning date that is used to figure the minimum required distribution from qualified retirement plans. Under the new law, the required beginning date of a participant who is still employed after age 70 ½ is April 1 of the calendar year that follows the calendar year in which he or she ***retires.*** The new law does not extend this provision to IRAs. For years prior to 1997, all participants in qualified plans and IRAs must start distributions by April 1 of the year following the calendar year in which they reach age 70 ½. For more information, get Publication 575.

Waiver of Survivor Benefit

For plan years beginning after December 31, 1996, a plan participant can elect to waive (with spousal consent) the 30–day election period if the distribution begins more than 7 days after a written explanation of the qualified joint and survivor annuity is provided. For more information, see *Survivor benefits,* in Publication 560.

Savings Incentive Match Plan for Employees (SIMPLE)

Beginning in 1997, you may be able to set up a SIMPLE retirement plan. The SIMPLE plan allows an employer to contribute to a SIMPLE retirement account on behalf of each employee. The SIMPLE plan:

1) Can be used only by an employer with 100 or fewer employees, who received at least $5,000 of compensation from the employer for the preceding year,
2) Can be established as an IRA or as part of a 401(k) plan,
3) Allows each employee to elect to contribute a percentage of his or her compensation to the SIMPLE plan under a salary reduction arrangement. (This amount cannot exceed $6,000 for 1997.),
4) Requires the employer to match employee's contributions on a dollar-for-dollar basis, up to 3% of compensation, OR allows the employer to elect to make a 2% nonelective contribution on behalf of all eligible employees, and
5) Must be the only retirement plan of the employer.

For more information on the SIMPLE plan, get Form 5305–SIMPLE and Publication 560.

Repeal of Salary Reduction Arrangement Under a SEP (SARSEP)

For tax years beginning after December 31, 1996, an employer will no longer be permitted to establish a Salary Reduction Simplified Employee Pension (SARSEP) plan. However, participants (including new participants) in a SARSEP that was established before 1997 can continue to elect to have their employer contribute part of their pay to the plan. See *Salary Reduction Arrangement* under *Simplified Employee Pension (SEP)* in Publication 560.

Tax-Exempt Organizations Can Offer Cash or Deferred Arrangements

For plan years beginning after 1996, tax-exempt organizations (other than state or local governments) can provide cash or deferred arrangements for their employees. The state or local government exception applies to political subdivisions, agencies, and instrumentalities of these governments. It does not include rural cooperatives or Indian tribal governments. The term Indian tribal governments includes political subdivisions, agencies, and instrumentalities of tribal governments as well as corporations chartered under federal, state, or tribal law that are owned by them.

For more information on tax-exempt organizations, get Publication 557, *Tax-Exempt Status for Your Organization.*

Self-Employed Ministers and Chaplains

The following paragraphs discussing changes affecting certain ministers and chaplains are effective for tax years beginning after 1996.

A duly ordained or licensed minister of a church who is working as a minister or chaplain but is self-employed or is working for an employer that is not a qualified tax-exempt organization, is treated as employed by a qualified tax-exempt organization for purposes of participating in a tax-sheltered annuity plan.

For more information on tax-sheltered annuities (403(b) plans), get Publication 571, *Tax-Sheltered Annuity Programs for Employees of Public Schools and Certain Tax-Exempt Organizations.*

Contributions. Contributions made by a self-employed minister or chaplain who is treated as employed by a qualified tax-exempt organization to a retirement income account that is treated as a tax-sheltered annuity are deductible up to the limits for elective contributions to tax-sheltered annuities. For this purpose, all plans in which the minister participates are treated as one plan.

Includible compensation. Compensation of a self-employed minister who is treated as employed by a tax-exempt organization is the minister's net earnings from self-employment reduced by contributions to retirement plans and the deduction for one-half of the self-employment tax.

Years of service. Years of service, for purposes of section 403(b), includes full years (and fractional years) in which a self-employed minister is treated as employed by a qualified tax-exempt organization.

Family Aggregation Rules Repealed

For years beginning after 1996, the special aggregation rules that only apply to self-employed individuals are eliminated. See *Additional Rules for Plans Covering Owner–Employees,* near the end of Publication 560.

New Definition of Highly Compensated Employee

For years beginning after 1996, a ***highly compensated employee*** is an employee who:

1) Was a 5% owner of the employer at any time during the year or the preceding year, or

2) Received more than $80,000 in compensation (indexed for inflation) from the employer during the preceding year and was in the top-paid group of employees for that year.

For more information regarding the definition that applies to 1996, see *Definitions* under *Simplified Employee Pension (SEP)* in Publication 560.

New Definition of Leased Employee

For tax years beginning after 1996, the requirement that a leased employee (for purposes of a simplified employee pension (SEP)) be an individual whose services are of a type historically performed by employees in the recipient employer's field of business is replaced by the requirement that the individual perform services under the primary direction or control of the recipient employer.

For more information on leased employees, get Publication 560, *Retirement Plans for the Self-Employed.*

4. ExciseTaxes

1996 Tax Changes

This chapter explains changes to the rules for certain excise taxes. Some of the changes that became effective in 1996 were not included in Publication 510, *Excise Taxes For 1996.* However, Publication 510, *Excise Taxes For 1997,* now available, explains these changes and other changes effective in 1997.

Luxury Tax on Automobiles

For sales after August 27, 1996, the luxury tax on automobiles is decreased from 10% to 9% of the amount by which the sales price exceeds the base amount. The base amount for 1996 is $34,000.

For 1997, the tax rate decreases to 8% and the base amount increases to $36,000. After 1997, the tax rate decreases by one percentage point each year until the tax ends at the end of 2002.

Gasohol Blending

The credit or refund for the excise tax on gasoline used to produce gasohol expired for gasohol sold or used after September 30, 1995. This refund or credit has been reinstated for the period beginning October 1, 1995, and ending September 30, 1999. See Publication 378, *Fuel Tax Credits and Refunds,* for more information.

Diesel Fuel Used in Boats

The excise tax on diesel fuel used or sold for use in boats is suspended for the period August 27, 1996, through December 31, 1997. You can claim a credit or refund for the excise tax paid on undyed diesel fuel used in any boat during that period.

Ozone-Depleting Chemicals

Effective August 27, 1996, chemicals that are used as propellants in metered-dose inhalers are exempt from the excise tax on ozone-depleting chemicals.

Effective January 1, 1997, recycled halons imported from countries that have signed the Montreal Protocol on Substances that Deplete the Ozone Layer are exempt from the tax on ozone-depleting chemicals. However, this exemption does not apply to Halon–1211 until January 1, 1998.

Air Transportation Taxes

The following taxes were reinstated for amounts paid after August 26, 1996, for transportation starting after August 26, 1996, and before January 1, 1997:

1) The 10% tax on transportation of persons by air,
2) The 6¼% tax on transportation of property by air, and
3) The $6 tax for use of international air travel facilities.

The following exemptions were also changed.

1) The exemption for emergency medical transportation was changed to permit takeoffs and landings at any airport and was extended to include certain fixed-wing aircraft.
2) The exemption relating to affiliated corporations was changed to apply on a flight-by-flight basis.
3) The exemption relating to helicopters used in certain exploration or development activities was changed to apply to each flight segment.

Aviation Fuel

Gasoline. For the period starting August 27, 1996 and ending December 31, 1996, a tax of 19.3 cents per gallon applies to aviation gasoline when it is removed at the terminal rack. On January 1, 1997, the tax on aviation gasoline decreases to 4.3 cents per gallon.

Fuel other than gasoline. The tax on aviation fuel other than gasoline is increased to 21.8 cents per gallon for the period starting August 27, 1996 and ending December 31, 1996. On January 1, 1997, the tax decreases to 4.3 cents per gallon.

Floor stocks tax. A floor stocks tax of 17.5 cents per gallon applies to any person who held previously-taxed aviation fuel other than gasoline on the first moment of August 27, 1996. This tax is due by March 1, 1997.

The floor stocks tax does not apply to fuel held for exempt uses such as use in foreign trade or in military aircraft. It also does not apply if the amount of the fuel held by a person or a group of related persons on August 27, 1996, was not more than 2,000 gallons. Do not count fuel held for an exempt use in figuring the 2,000 gallons.

5.
Exempt Organizations

1996 Tax Changes

The following paragraphs explain changes to the rules for tax-exempt organizations. These changes are not covered in the January 1995 revision of Publication 557, *Tax-Exempt Status for Your Organization.* However, you may want to get Publication 557 if you need detailed information about the rules for tax-exempt organizations.

Lobbying and Political Expenditures

Under the reporting and notification requirements for lobbying activities, certain tax-exempt organizations must report on their total lobbying and political expenses and notify their members of the dues that are allocated to those expenses. New law clarifies that political expenditures paid or incurred after 1993 on which tax was paid under IRC section 527(f) are disregarded for purposes of these requirements.

Certain Charitable Risk Pools are Tax-Exempt

For years beginning after August 20, 1996, if an organization meets the requirements of a ‘‘qualified charitable risk pool’’ it will not be denied tax-exempt status for pooling insurable risks of a group of tax-exempt organizations described in section 501(c)(3).

A qualified charitable risk pool is an organization that meets the following requirements.

1) It is organized and operated solely to pool insurable risks of its members and to provide information to members with respect to loss control and risk management.
2) It does not pool insurable risks of its members related to medical malpractice.
3) Other than providing the information in (1) and providing members with insurance coverage below the cost of comparable commercial coverage, no profit

or other benefit is given to any member of the organization.

4) Only charitable tax-exempt organizations described in section 501(c)(3) are members of the pool.
5) It is organized under state law that allows risk pooling for charitable organizations.
6) It is exempt from state income tax.
7) It has obtained at least $1,000,000 of startup capital from nonmember charitable organizations.
8) It is controlled by a board of directors elected by its members.
9) It provides in its organizational documents that:
    a) Members must be tax-exempt charitable organizations at all times.
    b) If a member loses tax-exempt status, it must immediately notify the organization.
    c) No insurance coverage applies to a member after the date of any final determination that the member no longer qualifies as a tax-exempt charitable organization.
10) To be entitled to tax-exempt status under section 501(c)(3), it satisfies the other requirements for organizations exempt from tax under section 501(c)(3).

Civic Leagues and Social Welfare Organizations

Under section 501(c)(4) of the Internal Revenue Code, civic leagues and social welfare organizations meeting certain requirements are exempt from tax. New law requires that no part of the entity's net earnings benefit any private shareholder or individual. The new requirement is effective beginning September 14, 1995. However, it will not apply to any benefit received before January 1, 1997, under a written contract that was binding on September 13, 1995, and at all times up to the date the benefit was received.

Special rule for cooperatives. A cooperative that allocates or returns net margins or capital to its members under its incorporating statute and bylaws does not, for that reason, lose its eligibility to be a section 501(c)(4) organization if:

1) The statute and bylaws are substantially the same as the ones in existence on July 30, 1996, and
2) The cooperative was determined, before July 30, 1996, to be an organization described in section 501(c)(4).

Excise Tax Imposed on Excess Benefits

A person who receives an excess benefit from a tax-exempt organization may now have to pay an excise tax. A manager of the tax-exempt organization may also have to pay an excise tax.

The excise taxes are imposed if all the following are true.

1) A tax-exempt organization provides an excess benefit (defined later) directly or indirectly to or for the use of a disqualified person (also defined later).
2) The excess benefit is the result of a transaction occurring after September 13, 1995 (other than a transaction under a written contract that was binding on September 13, 1995, and at all times up to the date the transaction took place).
3) The organization is not a private foundation.
4) The organization either:
    a) Is a tax-exempt organization that (without regard to any excess benefit) would be described in section 501(c)(3) or 501(c)(4), or
    b) Was an organization described in (a) at any time during the 5–year period ending on the date of the excess benefit transaction.

A manager of a tax-exempt organization must pay the tax only if he or she participated in the excess benefit transaction and knew that it was that type of transaction. The manager does not have to pay the tax if his or her participation was not willful and was due to reasonable cause.

Excess benefit. An excess benefit is an economic benefit that has more value than the value of the consideration, including services, received by the organization providing the benefit. An economic benefit is not treated as consideration for services unless the organization clearly showed its intent to treat the benefit in that way.

Disqualified person. A disqualified person is any of the following:

1) A person who was in a position to exercise substantial influence over the affairs of the organization at any time during the 5–year period ending on the date of the excess benefit transaction,
2) A member of the family of an individual described in (1), or
3) Certain entities controlled by persons described in (1) or (2).

Amount of tax. The tax that a disqualified person must pay is 25% of the excess benefit. If the excess benefit is not corrected within a specified period of time, the disqualified person must pay an additional tax of 200% of the excess benefit.

The tax that an organization manager must pay is 10% of the excess benefit up to a maximum of $10,000.

If you are liable for the excise tax on excess benefits, you are required to file an annual return on Form 4720.

More information. For more information, see Internal Revenue Code section 4958. Also see Notice 96–46 in *Internal Revenue Bulletin* 1996–39.

Penalty Exemption for Volunteer Board Members

Beginning July 30, 1996, unless there is no other person liable for the penalty, the penalty for failure to collect or pay over tax does not apply to an unpaid, volunteer board member of a tax-exempt organization if the member meets the following requirements.

1) He or she is solely serving in an honorary capacity.
2) He or she does not participate in the day-to-day or financial operations of the organization.
3) He or she does not have actual knowledge of the failure on which the penalty is imposed.

Penalty Increased for Not Filing Annual Return

The penalty has increased from $10 to $20 a day for:

1) Not filing a required annual return on time,
2) Not including any required information on the return, or
3) Not including the correct information on the return.

The maximum penalty is now the smaller of:

1) $10,000 (previously $5,000), or
2) 5% of the organization's gross receipts for the year.

For an organization that has gross receipts of over $1 million for the year, the penalty has increased to $100 a day up to a maximum of $50,000.

These increased penalties apply to returns for tax years ending on or after July 30, 1996.

Dues Paid to Agricultural or Horticultural Organizations

For years beginning after 1986, required annual membership dues of $100 or less paid to tax-exempt agricultural or horticultural organizations are not subject to the tax on unrelated business income. For years beginning after 1995, the $100 limit will be indexed for inflation and dues for memberships of more than 12 months will be prorated for purposes of the limit.

For more information on the tax on unrelated business income, get Publication 598, *Tax on Unrelated Business Income of Exempt Organizations.*

6. Foreign Issues

1996 Tax Changes

Identification Number

A taxpayer identification number must be furnished on returns, statements, and other tax-related documents. For an individual, this is a social security number (SSN). If you do not have and are not eligible to get an SSN, the IRS will issue you an individual taxpayer identification number (ITIN). An employer identification number (EIN) is required if you are an employer or are engaged in a trade or business as a sole proprietor.

You must furnish a taxpayer identification number if you are:

1) An alien who has income effectively connected with the conduct of a U.S. trade or business at any time during the year,
2) An alien who has a U.S. office or place of business at any time during the year,
3) A nonresident alien spouse electing to file a joint U.S. tax return with a spouse who is a U.S. citizen or resident, or
4) Any other alien who files a tax return, an amended return, or a refund claim (but not an information return).

Social security number. Generally, you can get an SSN if you have been lawfully admitted to the United States for permanent residence or under other immigration categories that authorize U.S. employment.

To apply for this number, get Form SS–5 from your local Social Security Administration office or call the SSA at 1–800–772–1213. The completed form should be returned to the SSA. It usually takes about 2 weeks to get an SSN.

Individual taxpayer identification number. If you are not eligible to obtain an SSN, you must get an ITIN. Enter your ITIN wherever an SSN is required on your tax return.

CAUTION *You cannot claim the earned income credit using an ITIN. You, your spouse if married, and any qualifying child must have SSNs.*

ITINs are for tax use only. They do not affect your immigration status or your right to be legally employed in the United States.

To apply for an ITIN, file Form W-7, *Application for IRS Individual Taxpayer Identification Number,* with the IRS. It usually takes about 30 days to get an ITIN.

In addition to those aliens who are required to furnish a taxpayer identification number and are not eligible for an SSN, a Form W-7 should be filed for:

- Alien individuals who are claimed as dependents and are not eligible for an SSN.
- Alien individual spouses who are claimed as exemptions and are not eligible for an SSN.

Transactions with Foreign Trusts and Gifts from Foreign Persons

Form 3520, *Annual Return To Report Transactions With Foreign Trusts and Receipt of Foreign Gifts,* will be revised for 1996 to incorporate the changes made in the foreign trust area. Form 3520 will be used to report:

- Transfers to or creations of foreign trusts. Form 3520 will still be used to report the creation of a foreign trust or a direct or indirect transfer to a foreign trust by a U.S. person, including the executor of an estate.
- Distributions from a foreign trust received after August 20, 1996.
- Gifts received after August 20, 1996, that total more than $10,000 from any foreign person.
- The annual information return for the owner of the trust. This information was previously reported on Form 3520–A, *Annual Return of Foreign Trust With U.S. Beneficiaries.* This form will be obsolete upon publication of the revised Form 3520. The decision to obsolete Form 3520-A was made after the major tax forms and publications were printed.

When to file. File Form 3520 by the 15th day of the 4th month following the U.S. person's tax year to report any of the events listed above. Persons required to file Form 3520 may also have to file **Form 926,** *Return by a U.S. Transferor of Property to a Foreign Corporation, Foreign Estate or Trust, or Foreign Partnership,* and **Form TD F 90-22.1,** *Report of Foreign Bank and Financial Accounts.*

Penalties for failure to file reports. Penalties will be assessed for failure to make the required report of foreign financial transactions unless reasonable cause for the failure can be shown.

Grantor trusts. Failure of a foreign trust to provide an annual report of the trust activities will result in a penalty of 5 percent of the gross value of the portion of the foreign trust's assets treated as owned by the U.S. person at the close of the tax year. This penalty is assessed on the U.S. person and applies to tax years beginning after December 31, 1995.

Creation of and transfers to a foreign trust. Before August 21, 1996, a penalty of 5 percent of the amount transferred to a foreign trust (but not more than $1,000) is imposed for failure to file on time, or failure to report the required information. After August 20, 1996, the penalties are the same as those described under *Distributions from a foreign trust,* discussed next.

Distributions from a foreign trust. After August 20, 1996, if the required foreign trust information is not filed on a timely basis, or if it is incomplete or incorrect, a penalty of 35 percent is imposed on the gross reportable amount. The gross reportable amount for failure to report the creation of a foreign trust or the transfer of money or property to a foreign trust is the gross value of the property; the gross reportable amount for failure to report receipt of a foreign trust distribution is the gross amount of the distribution. If the failure continues for more than 90 days after the IRS notice of failure is mailed, an additional $10,000 penalty for each 30-day period (or portion thereof) is imposed.

Gifts. Failure to file the required information to report gifts totaling more than $10,000 received during the tax year from foreign persons, will result in a penalty of 5 percent of the amount of the gift for each month the failure continues (not to exceed 25 percent of the total amount of the gift).

Transfers to foreign entities. Failure to file Form 926 will result in a penalty equal to 35 percent of the gross value of the property transferred after August 20, 1996. This penalty will not apply if it can be shown that the failure to file was due to reasonable cause. See Notice 96-60 in *Internal Revenue Bulletin* 1996-49.

Former U.S. Citizens or Residents —Expatriation Tax

The expatriation tax provisions apply to U.S. citizens who have renounced their citizenship and long-term residents who have ended their residency, if one of the principal purposes of the action is the avoidance of U.S. taxes.

For 1996, you are presumed to have tax avoidance as a principal purpose if:

1) Your average annual net income tax for the last five tax years ending before the date of the action is more than $100,000, or
2) Your net worth on the date of the action is $500,000 or more.

Long-term residents. You are a long-term resident if you were a lawful permanent resident of the United States in at least 8 of the last 15 tax years ending with the year your residency ends. In determining if you meet the 8–year requirement, do not count any year that you are treated as a resident of a foreign country under a tax treaty and do not waive treaty benefits.

Your U.S. residency is considered to have ended when you cease to be a lawful permanent resident or you commence to be treated as a resident of another country under a tax treaty and do not waive treaty benefits.

Tax. Individuals covered by these rules are subject to tax on U.S. source income and gains at the graduated rates applicable to U.S. citizens (if it is more than the tax computed under the rules for nonresident aliens). This applies to the 10–year period following the date of the action.

Other information. Generally, the provisions relating to long-term residents and the presumption of tax avoidance apply to actions that occur after February 5, 1995. For more information on the expatriation tax provisions, including exceptions to the tax and special U.S. source rules, see section 877 of the Internal Revenue Code.

Reporting Requirements

If you lost your U.S. citizenship after February 5, 1995, you are required to provide an information statement to the Department of State, a consular office, or a federal court. If you end your long-term residency after February 5, 1995, you are required to provide an information statement to the Internal Revenue Service with your tax return for the year your residency ends. The Internal Revenue Service intends to issue public guidance by the end of 1996 that will provide specific details about the information that must be included in these statements. You will not be required to submit these information statements any earlier than the 60th day after such guidance is published. See Notice 96–60 in *Internal Revenue Bulletin* 1996–49. No penalties will be imposed during this period for failing to file these information statements. U.S. citizens losing citizenship before guidance is issued, however, may file an information statement with the appropriate government entity at the time of loss of citizenship. These statements must include the following information:

1) Your name,
2) Your taxpayer identification number,
3) Mailing address of your principal foreign residence,
4) Foreign country in which you are a resident,
5) Foreign country of which you are a citizen, and
6) A balance sheet if you have net worth of $500,000 or more.

7.
Taxpayer Bill of Rights

The Taxpayer Bill of Rights 2 was enacted on July 30, 1996. It provides for increased protection of taxpayer rights in complying with the tax laws and in dealing with the Internal Revenue Service. This chapter discusses some of the provisions of that law.

Taxpayer Advocate

On July 30, 1996, the Office of Taxpayer Advocate was established. It replaces the Office of Taxpayer Ombudsman. The Taxpayer Advocate has broader authority to take any action permitted by law to assist taxpayers who would otherwise suffer a significant hardship due to how the IRS is administering the tax laws.

The functions of the Taxpayer Advocate are to:

- Assist taxpayers in resolving problems with the IRS,
- Identify areas in which taxpayers have problems in dealing with the IRS,
- Propose changes in administrative practices to mitigate those problem areas, and
- Identify legislative changes that may mitigate those problems.

Abatement of Interest

The IRS's authority to abate (lower) interest has been expanded to cover interest due to an unreasonable error or delay by an IRS official performing a managerial act. This applies to extensive delays caused by the IRS losing records, or IRS personnel transferring, being on extended training, or being on extended leave (due to illness or otherwise). This provision applies to interest on taxes you owe for tax years beginning after July 30, 1996.

Extension of Interest-Free Period

The interest-free period for paying the amount shown on a notice and demand given after 1996 is extended from 10 calendar days to:

- 21 calendar days after the date of notice and demand if the amount you owe is less than $100,000.
- 10 business days after the date of notice and demand if the amount you owe is $100,000 or more.

Payee Statements Must Have Phone Numbers

New law requires payers to provide on certain payee statements the telephone number of a person to contact. Generally, the statement is Copy B of information returns such as Forms 1099, 1098, and W-2G. This should make it easier for you to resolve questions about the accuracy of the information provided to the IRS on these forms.

This new requirement applies to the statements you receive for 1996. However, because the law requiring this was enacted after the 1996 forms were printed, the statements you get for 1996 may not include a phone number.

Use of Private Delivery Services

In addition to the United States Postal Service, private delivery services (designated by the IRS) can be used to meet the timely mailing as timely filing and paying rule. At the time this publication was being prepared for print, no private delivery services had been designated.

Installment Agreements

Under certain circumstances, an installment agreement to pay tax can be altered, modified, or terminated by the IRS. Beginning January 30, 1997, the IRS must notify taxpayers 30 days before taking any such action and must include an explanation as to why it intends to take that action. This does not apply if the collection of the tax is in jeopardy.

Collection Activities

Effective July 30, 1996, the IRS may withdraw a public notice of tax lien before it is paid in full if the IRS determines that:

1) The filing of the notice was premature or not in accordance with administrative procedures,
2) The taxpayer has agreed to make installment payments to satisfy the liability,
3) The withdrawal will facilitate the collection of the tax liability, or
4) The withdrawal would be in the best interest of the taxpayer (as determined by the Taxpayer Advocate) and the government.

A similar provision allows the IRS to return property that has been levied upon.

Disclosure of collection activities. If you are divorced or separated from a spouse with whom you had filed a joint return on which a tax deficiency has been assessed, you can submit a written request for information on the collection activities. For requests made after July 30, 1996, the IRS must give you a written response as to whether it has attempted to collect the deficiency from the other person, the general nature of the collection activities, and the amount collected.

Information on Rights

You can get free publications from the IRS that provide information on your rights as a taxpayer. These publications include:

- **1,** *Your Rights as a Taxpayer*
- **556,** *Examination of Returns, Appeal Rights, and Claims for Refund*
- **594,** *Understanding The Collection Process*
- **1546,** *How To Use the Problem Resolution Program of the IRS*
- **1660,** *Collection Appeal Rights (for Liens, Levies and Seizures)*

See chapter 8 for information on how you can get these publications.

8. How To Get More Information

You can get help from the IRS in several ways.

Free publications and forms. To order free publications and forms, call 1–800–TAX-FORM (1–800–829–3676). You can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address. Your local library or post office also may have the items you need.

For a list of free tax publications, order Publication 910, *Guide to Free Tax Services.* It also contains an index of tax topics and related publications and describes other free tax information services available from IRS, including tax education and assistance programs.

If you have access to a personal computer and modem, you also can get many forms and publications electronically. See *Quick and Easy Access to Tax Help and Forms* in your income tax package for details. If space permitted, this information is at the end of this publication.

Tax questions. You can call the IRS with your tax questions. Check your income tax package or telephone book for the local number, or you can call 1–800–829–1040.

TTY/TDD equipment. If you have access to TTY/TDD equipment, you can call 1–800–829–4059 to ask tax questions or to order forms and publications. See your income tax package for the hours of operation.