By *David J. Silverman*

Happy Tax Year

Thought things couldn't get any more complicated? Guess again.

Most of my clients are amazed at how filing their return becomes a more nightmarish experience every year. I hope they're bracing themselves: In 1997 it's going to get even worse. The reason? In 1996, instead of yanking the tax code out by its roots, as Steve Forbes proposed, Congress added a richer layer of fertilizer. And while no single new provision affects the number of people that, say, a family child credit would, there are many changes that affect smaller groups.

The most fiendish part of all is when these provisions take effect. Some kick in on the day of enactment, some on the day after, some seven days after. Others are retroactive to 1995 or to 1996, and some don't take effect until 1997. I'll concentrate on the last provisions here.

Individual Retirement Accounts. Formerly, in a household with only one breadwinner, a couple was limited to an annual $2,250 deduction on their IRA contributions. Now they're allowed to deduct up to $2,000 each. But if you're already covered by a retirement plan and your income is over $50,000, neither you nor your spouse can take any IRA deduction. You can, however, take a partial deduction if your income is between $40,000 and $50,000.

Need to make an IRA withdrawal to pay medical expenses? There's more good news. The 10 percent penalty for an early withdrawal before age 59½ will no longer apply, as long as the expenses are in excess of 7.5 percent of your income. (This is the same rule that has always applied to company pension plans.) Of course, you're still liable for taxes on the amount withdrawn. What if you're out of work? If you've been receiving unemployment compensation for 12 consecutive weeks, you can now make withdrawals to pay health insurance premiums without facing the 10 percent penalty—until you've been re-employed for 60 days. Self-employed taxpayers can also avoid the penalty if they have no income for 12 weeks.

Pensions. Let's say you've chosen not to retire, even though you've passed what the IRS considers "normal" retirement age. You're no longer locked into having to withdraw money from your pension by April 1 of the year after you turn 70½, but can now postpone making withdrawals until April 1 of the year after you stop working. Fair warning: This option doesn't apply to IRAs or to people who own at least 5 percent of their business.

The rules for retirement-plan withdrawals are also changing. If you took out more than $155,000 in 1996 from such a plan, or if you elected to take all the cash in the form of a lump sum that exceeded $775,000, the excess was subject to a 15 percent penalty. In 1997 these limits will be adjusted for inflation to $160,000 and $800,000, respectively, and the penalty will be suspended altogether for 1997, 1998 and 1999. If you're taking a big deduction because of, say, an investment that tanked, consider offsetting it with a pension withdrawal—while you've got a chance to escape the penalty.

Health Insurance. Self-employed taxpayers get an additional break this year. They can deduct 40 percent of their health insurance premiums, including coverage for their spouses and their dependents, up from 30 percent in 1996. For 1998 through

2002, the deduction will be 45 percent, gradually increasing to 80 percent in 2006.

Benefits received from a long-term-care policy are now tax-free, provided you are chronically ill (see definition below) and are reimbursed only for the actual long-term-care expenses. Additionally, a limited portion of the premium qualifies as a medical deduction. The policy must be issued on or after Jan. 1, 1997, though policies issued before that date qualify if they meet your state's long-term-care insurance requirements.

Are you self-employed, or do you work for a firm no larger than 50 people? If you feel like being a guinea pig for the IRS, you can sign up for something called the Medical Savings Account pilot program. (Between 1997 and 2000, 750,000 people—first come, first served—will be eligible to participate.) Designed to pay for routine medical expenses not covered by regular insurance, but not for health insurance premiums, these accounts are similar to IRAs in that what you put into them is tax-deductible. Additionally, the money you withdraw to pay your medical bills is tax-free, as are the earnings. The catch? The rules are unbelievably complex; the most that can be deducted for family coverage is $3,375 or, if you're single, $1,463; and you have to buy your health insurance from the insurance company that manages your account.

Life Insurance. The IRS has always kept its paws off death benefits paid on a life insurance policy. Now it's taking it further: An accelerated benefit paid *before* death to someone who is terminally or chronically ill will also be exempt from taxes. The sale of a life insurance policy by someone in this condition also qualifies for the exemption. If you are chronically, but not terminally, ill, the exclusion applies only to amounts that reimburse you for your actual long-term-care expenses. The maximum exclusion is limited to $175 per day ($63,875 annually), but this applies only to per diem policies. Amounts above $175 are excludable if used to pay for long-term care. If you're terminally ill, all benefits are exempt from taxes. A terminally ill person is someone who is certified by a doctor as having a life expectancy of 24 months or less. Someone is chronically ill if he can't perform at least two of his normal daily functions, such as eating, bathing or dressing. (Only the IRS could make such a distinction.)

Personal Injury. Damages received because of a personal physical injury or sickness aren't taxable. But when some courts ruled that this exception also applied to awards for employment discrimination and injury to a person's reputation, the IRS got mad, as it regarded these as taxable payments for lost wages or profits. Now, only damages related to injury or sickness are exempt.

Here's how the new law works. Say you're in an auto accident and end up in the hospital. Damages for injuries, medical costs, emotional distress and even the loss of what the law calls "consortium with your spouse" aren't subject to taxes. On the other hand, if you are wrongfully discharged and end up on a shrink's couch, be prepared to pay. Under the new law, damages for emotional distress not related to a physical injury or sickness are taxable. And punitive damages are taxable in every case—unless the law in your state allows only for punitive damages in a wrongful-death suit and was in effect before Sept. 13, 1995.

All these provisions apply to awards received after Aug. 20, 1996, unless you won or settled your claim before Sept. 13, 1995. Then none of the above applies.

Adoption Expenses. The new law provides for a $5,000-per-child tax credit for the payment of adoption expenses, or $6,000 if the child has special needs. (Sorry, surrogate-parenting arrangements or the adoption of a spouse's child aren't eligible.) With the exception of a special-needs adoption, this credit expires on Dec. 31, 2001, and until then, there's an income limitation. If you earn between $75,000 and $115,000, the credit is gradually phased out. At $115,000, it's gone.

Foreign Gifts. You think the IRS doesn't care if you receive a windfall from your aunt in Antwerp? Think again. Since this past August, foreign gifts and bequests totaling more than $10,000 over the course of a year have to be reported to the IRS, even though they're not taxable to the recipient. If you fail to report the gift, the penalty is up to 25 percent of the amount received.

Simple Retirement Plans. A lot of small companies have zapped their retirement plans—or never set one up to begin with—because of the high cost of following extremely complex rules. Congress responded by establishing the Simple retirement plan, which combines the benefits of an IRA and a 401(k). An employee can contribute up to $6,000 pretax, with the boss matching a portion of the employee's salary. Both contributions are tax-deductible. If you own a business, the appealing feature about these new plans is that the rules that prevent owners and top-level employees from cutting a better deal for themselves than for the rank and file don't apply. This means a plan will be approved even if the owner is the sole participant. Only companies with 100 or fewer employees—and the self-employed—are eligible.

There are drawbacks, however. Even in tough times, employers have to keep making contributions. If you are under 59½ and withdraw money from a regular retirement plan, there's a 10 percent penalty. If you withdraw money from a Simple plan during the first two years of your participation, the penalty is 25 percent; afterward, it drops back to 10 percent.

With the IRS, nothing is truly simple. SM

David J. Silverman, an enrolled agent and author in New York, has a Web page at *www.naea.org/ea/002677.htm*.