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Recommended Citation
Tempo, Vol. 18, no. 1 (1971/72, winter), p. 30-34, 43-47

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REVENUE ACT of 1971 . . .

Tax Reductions, Incentives and Other Changes

by Herbert Sirowitz and Sol Coffino

INTRODUCTION:

The new Act is a vital piece of tax legislation. It is aimed principally at reducing the taxpayers' burden and providing incentives for business, but it also embraces various technical changes which could materially affect certain taxpayers. Some of the highlights of the new Act are concisely set forth in this article. *Caveat:* The law itself contains numerous special provisions plus detailed exceptions and conditions.

The President, on December 10, 1971, signed into law the Revenue Act of 1971. The major provisions of the Act—those which will have the most impact on the economy—include the restoration of the investment credit, a codification of liberalized depreciation rules recently adopted by the Treasury Department, an acceleration of individual income tax reductions, the repeal of the federal excise tax on automobiles and light-duty trucks, and the enactment of tax incentives to encourage exports.

The new Act, which is intended to stimulate economic recovery, also contains many other provisions in the nature of structural changes in the tax laws. While these changes may not have a significant effect on the economy as a whole, they could have an important bearing on the tax liability of affected persons.

1. INVESTMENT CREDIT

The Revenue Act of 1971 provides for a 7 percent "Job Development Investment Credit" which restores to our tax laws an investment credit substantially similar to the credit repealed by the Tax Reform Act of 1969. The credit, which is intended to stimulate the economy by reducing the cost of capital investment, is generally available for property ordered after March 31, 1971, or property delivered after August 15, 1971 (regardless of when ordered).

Qualified Investment

The 7 percent investment credit is generally available with respect to the cost of depreciable tangible personal property. The portion of the investment in eligible property which qualifies for the credit is determined by the useful life of the property. The useful-life brackets which had been in effect under prior law have been shortened by one year. Thus, the full cost of property with a useful life of 7 years or more qualifies for the credit. Property with a useful life of 5 to 7 years will qualify to the extent of two-thirds of its cost, and property with a useful life of 3 to 5 years will qualify to the extent of one-third of its cost. No credit is available for shorter-lived property.

Importantly, a taxpayer must use the same useful life for an asset in determining both the allowable investment credit and in computing depreciation or amortization. This rule can have a negative effect; while a longer life may produce a larger investment credit, current depreciation deductions will be lower. Special rules are provided for cases where the taxpayer uses a method of depreciation which does not directly relate to the useful life of the property (e.g., units-of-production).

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Amount of Credit

The allowable investment credit is applied dollar-for-dollar against the tax liability, subject to certain limitations. The amount of credit taken in any one year cannot exceed the first $25,000 of tax liability plus 50 percent of the tax liability in excess of $25,000. Where used property is placed in service, the amount of such used property which can be taken into account in determining the credit is limited to $50,000 each year (generally $25,000 for husband and wife filing separate returns). The used-property limitations must be allocated among the component members of a controlled group of corporations, and the limitation applies at both the partnership and partner levels, and at the subchapter S and shareholder levels.

Carryovers and Carrybacks

If an otherwise allowable investment credit cannot be used in a particular year because of the 50 percent of tax liability limitation, the credit can be carried back 3 years, and then forward 7 years. Congress was concerned that in many cases new credits would fully absorb the 50 percent limitation and that carryover of old credits would therefore be wasted, thus discouraging new investment. Consequently, it is provided that the 50 percent limitation for 1971 and later years is to be first absorbed by carryovers from pre-1971 years; unexpired carryovers from 1970 and earlier years are allowed a special 10-year carryforward. This will both preserve unexpired credits and encourage investment.

When the credit was terminated by the 1969 Act, a provision generally limited the amount of carrybacks and carryovers of prior unused credits to an amount not in excess of 20 percent of the aggregate amount of carryovers to 1969. This limitation is now removed, in effect beginning with the portion of taxable years ending in 1971 after August 15, 1971.

Buy America

In line with the President's overall economic program, the credit is generally denied for property manufactured abroad for the period within which the 10 percent import surcharge remained effective.

Since the import surcharge was removed on December 20, 1971, foreign property will qualify for the credit if acquired on or after December 20, 1971, provided the property was not ordered during the surcharge period (August 16 through December 19, 1971, inclusive).

The President has the discretionary authority to extend the "Buy America" provision, even after the removal of the import surcharge, under certain conditions. Also, if he finds it to be in the public interest, the President may allow the credit for certain foreign-produced articles; this exemption can be made retroactive to any date after August 15, 1971.

Eligible Property

The investment credit generally applies to depreciable tangible personal property, tangible property which is an integral part of manufacturing, production, etc. (not including buildings and structural components) and elevators and escalators. The definition of eligible property in effect under prior law has been expanded and clarified. The credit is now extended to cover livestock (except horses); a special rule applies to replacements. Certain storage facilities, coin-operated washing machines and dryers located in apartment buildings, certain communication satellites, railroad replacement track material, undersea cables, and rigs are all defined as eligible property.

Property for which the taxpayer elects special 5-year rapid amortization (e.g., for pollution-control facilities, railroad rolling stock, expenditures for rehabilitating low income housing, etc.) is not eligible for the investment credit. In these instances, the advantages of the rapid write-off should be weighed against the investment credit.

Lessors

The re-enactment of the investment credit does not necessarily signal a return to equipment-leasing tax shelters. Under prior law individuals (either alone or in conjunction with others) would purchase equipment and enter into leasing transactions; resulting depreciation and interest deductions and the investment credit would offset a substantial part of income from other sources.

In order to prevent abuse in this area, Congress provided that the credit is generally to be available to noncorporate lessors only in limited cases where the leasing activity constitutes a business activity of the taxpayers; special rules are provided for short-term leases.

Recapture

As under prior law, the investment credit will be recaptured to the extent property is disposed of before the end of the useful period used in determining the amount of credit originally allowed. Certain exceptions and transitional rules are eliminated, including the replacement exceptions for property destroyed by casualty or theft (casualties occurring after August 15, 1971). In the case of a premature disposition of property with

respect to which the full credit was originally allowed (i.e., because it had a useful life of 8 years or more), there is to be no recapture if the disposition occurs after 7 years of use by the taxpayer.

Accounting Treatment

Generally, the new law provides that a taxpayer is not required to use any particular method of accounting for purposes of accounting for the investment credit in financial reports subject to federal jurisdiction; however, the method chosen for such reports is subject to disclosure requirements. Also, the method used in the first year is required to be followed in succeeding years, unless consent to change is secured.

Effective Date

The investment credit is to be available with respect to property acquired after August 15, 1971. The credit is also available if property is acquired after March 31, 1971 and before August 16, 1971, if acquired pursuant to orders placed after March 31, 1971.

Where the taxpayer constructs, reconstructs or erects property and construction is completed after August 15, 1971, an allocable portion of the basis attributable to construction after August 15, 1971 will qualify. The entire credit applies if construction began after March 31, 1971.

Contracts and orders should be reviewed in order to maximize the credit. In appropriate situations confirmations from vendors should be secured in order to avoid future conflict with the Revenue Service.

2. LIBERALIZED DEPRECIATION

Background

During 1971 the Treasury Department administratively put into effect a liberalized depreciation system referred to as the Asset Depreciation Range (ADR) System. The system was elective and effective January 1, 1971. Certain groups challenged the legality of ADR, claiming that the Treasury exceeded its administrative authority by promulgating the system.

In the Revenue Act of 1971 Congress has, in effect, codified most of the ADR system. This action negates potential litigation by those challenging ADR. The legislation amends the depreciation section of the Internal Revenue Code and furnishes a new definition for the term "reasonable allowance for depreciation." Congress has termed this new system the "class life depreciation system."

The class life depreciation system replaces both ADR and the optional guideline life system adopted by the Treasury Department in 1962. Under the 1962 guidelines assets were divided into broad classes which were given specified lives. In order to assure that assets were not depreciated over a period substantially shorter than actual use, a "reserve ratio test" was used. Briefly, the reserve ratio test measured the relationship between the tax lives being used and the taxpayer's asset replacement practice. Where the test was not met, the Revenue Service had a basis for proposing an adjustment which would limit depreciation deductions. The ADR system was to eliminate the reserve ratio test for 1971 and future years. The class life depreciation system not only eliminates the reserve ratio test, but replaces guideline lives and ADR for property *placed in service after 1970.*

Although ADR is replaced with the class life system, in the committee reports Congress has indicated that most ADR provisions (e.g., salvage value, retirements, etc.) are to be incorporated into the new system. Hence, in the discussion below the presumption has been made that Treasury, in exercising its authority under the new legislation, will adopt rules similar to the ADR regulations.

The Election

The class life depreciation system is elective for each taxable year. Taxpayers wishing to enjoy the benefits of the system must adhere to conditions prescribed by the Treasury Department. The election must be made by the time the tax return is required to be filed. If no election is made, the class life system cannot be used; thus, in an IRS examination the taxpayer would have to demonstrate the actual anticipated useful life of assets (this is the "facts and circumstances of each case" test). The election to use the class life system is irrevocable for that year.

If the election is made, the taxpayer generally must use the system for *all assets* placed in service which fall within any class for which Treasury has prescribed a class life.

Class Lives

Under the new system the Treasury Department is given anthority to prescribe class lives, and the Revenue Service may permit depreciation deductions based on a range from 20 percent above to 20 percent below the class lives. Thus, electing taxpayers may speed up or defer deductions depending upon their needs each year.

Although the class lives initially are to be the same as those prescribed by the 1962 guidelines, Treasury

is to collect and analyze data and periodically adjust class lives in order to reflect accurate anticipated useful lives. Electing lessors may depreciate property according to class lives and without regard to the term of leases.

Vintage Accounts

Taxpayers electing the class life system must account for assets by placing such assets in so-called "vintage accounts" which are to include all eligible assets placed in service during the year. A detailed schedule must be included in the income tax return for the year; the schedule must indicate acquisitions, retirements, type and age of equipment, etc.

First-Year Convention

The ADR system, as administratively established, provided for a first-year depreciation convention (rule) which would, in effect, have permitted three-fourths of a full year's depreciation for the year in which an asset is placed in service. The class life system rejects this liberal convention. No convention is permitted which would provide for a greater first-year depreciation deduction than would be allowed if all assets had been placed in service ratably throughout the year and if depreciation allowances were computed without regard to any convention. As a general rule only one-half year's depreciation is allowable under the permitted convention.

Salvage Value

Under the class life system it is contemplated that salvage value will not affect the rate of depreciation. However, salvage value does limit the total amount of depreciation which may be claimed. A taxpayer's estimate of salvage is not to be challenged by the IRS if the proposed adjustment is not more than 10 percent of the cost of the property.

Retirements

As a general rule no gain or loss is recognized upon the ordinary retirement of assets. Special rules are the keynote in this area, including complicated provisions for extraordinary retirements.

Repairs

The new legislation also adopts the ADR treatment for repairs. Briefly, the Treasury Department may prescribe repair allowances for classes of depreciable property. The initial allowances are to be the ones provided for under ADR; Treasury is to develop and periodically modify these figures.

The allowance is determined by applying the applicable repair percentage prescribed for a particular class of assets to the cost of the assets in the class.

The repair allowance is the amount of repair expenses and specified repair or improvement expenditures (which might otherwise be treated as a capital expenditure) that may be deducted currently. If incurred expense exceeds the repair allowance, the excess must be capitalized. Expenses which are clearly capital in nature, e.g., expenditures which increase productivity or capacity, are not to be taken into account.

Transition Rules

Special transitional rules apply to *real property* and to so-called *subsidiary assets* (jigs, dies, returnable containers, etc.). Although not included in the ADR system, real property is part of the class life depreciation system. The transitional rules are to apply while Treasury studies the matter of appropriate lives for real property. Similarly, since no separate class was provided for subsidiary assets under ADR, a transitional rule applies while Treasury studies this matter. Under both of these transitional rules, taxpayers electing the class life system can, in effect, exclude real property and/or subsidiary assets from the class life system in certain cases.

Effective Date

The class life system of depreciation applies with respect to property placed in service after December 31, 1970. Even if a return for a fiscal year including January 1, 1971 has been filed prior to, or shortly after, the date of enactment of the legislation (December 10, 1971), the taxpayer may within a reasonable time (no date set at this writing) elect the class life system; such election may be made whether or not ADR had been elected. Furthermore, Treasury is authorized to provide for an elective guideline life system for assets placed in service prior to 1971. Finally, the repair allowance provision is to apply to taxable years ending after December 31, 1970.

3. GENERAL INCOME TAX REDUCTIONS FOR INDIVIDUALS

The new law speeds up the effective dates and expands the relief measures introduced by the 1969 tax reform legislation. For calendar year 1971, each personal exemption becomes $675 rather than the previously scheduled $650. Also, a full low-income allow-

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ance (or minimum standard deduction) of $1,050 is available to lower-bracket taxpayers.

For 1972 and subsequent years, each exemption will be worth $750, the low-income allowance would increase to $1,300, and the percentage standard deduction will rise to 15% or a maximum of $2,000 from its 1971 level of 13% or a maximum of $1,500. Thus, with the increase in the low-income allowance and in the personal exemption, the tax-free income level for 1972 would rise to $2,050 for a single person and $2,800 for married persons with no dependents. If both married persons are age 65 or over, the tax-free income level is further increased to $4,300.

4. WITHHOLDING TAXES

The withholding tax structure is revised for 1972 and later years in order to reflect the increases in the standard deduction and personal exemptions and to minimize underwithholding. The changes were scheduled to take effect with respect to wages paid after January 15, 1972.

To restrict underwithholding, there will be an increase in the amount of withholding required if both husband and wife are employed or if a person works for more than one employer at the same time. Also, increased rates will apply to higher-income taxpayers so that a closer approximation of actual tax liability can be achieved. At the same time it should be noted that under separate existing legislation increases in Social Security taxes are scheduled to go into effect in 1972.

For the taxpayer with large itemized deductions, the problem of overwithholding still can be reduced by claiming additional withholding allowances on an exemption certificate filed with his employer. In fact, this provision has been simplified somewhat. A taxpayer who has not filed his return for the preceding year must base his estimated itemized deductions on the amount claimed for the second preceding year. However, he will no longer be required to file a new exemption certificate after his tax return is filed even if the preceding year's itemized deductions turn out to be less than those of the second preceding year. In addition, the exemption certificate continues in effect until the employee files a new exemption certificate because of a change in his circumstances.

5. ESTIMATED TAX OF INDIVIDUALS

For 1971, many individuals who otherwise might be subject to a 6 percent penalty for underpayment of estimated tax will be excused.

Generally, those individuals for whom the penalty is waived for 1971 are single persons (or married persons not entitled to file a joint return) whose gross income does not exceed $10,000, married individuals entitled to file jointly if their combined income does not exceed $20,000, and heads of households and surviving spouses if their gross income does not exceed $20,000. However, as under prior law, the waiver will not apply if the taxpayer had more than $200 ($400 in the case of married taxpayers) in income from sources other than wages.

Additionally, for 1972 and later taxable years, the requirements for paying estimated tax will be eased. Under the new law, the income level at which a declaration of estimated tax is to be filed is increased to $20,000, for a single person, a head of household and a surviving spouse, and a married individual whose spouse does not receive wages. The income level remains at the former $10,000 figure in the case of a married couple where both spouses receive wages. Also, a declaration would be required if gross income is expected to include more than $500 of non-wage income. No declaration is necessary however, if the estimated tax for the year is expected to total less than $100.

Notwithstanding the requirements for payment of estimated tax, a penalty for underpayment still may be avoided as long as any one of several exceptions applies. The most frequently used exception involves the payment of estimated tax based on the tax shown on the prior year's income tax return, assuming a return showing a tax liability was filed for a 12-month period. The exceptions to imposition of the underpayment penalty are not affected by the new law.

6. CHILD CARE & HOUSEHOLD EXPENSES

Effective for taxable years beginning after 1971, households with one employable adult or with working parents become eligible for an expanded deduction for the costs of household and dependent care services incurred to permit the taxpayer to be gainfully employed on a full-time basis.

Prior Law

Under prior law a deduction generally was allowed for amounts expended for the care of a dependent child (under age 13) or an incapacitated dependent in order to enable the taxpayer to be gainfully employed. The annual deduction was available only to certain categories of taxpayers and was limited to $600 for one dependent and $900 for two or more dependents. Further, in the case of married couples the deductible amount would phase out on a dollar-for-dollar basis for income above $6,000.

Amount Deductible

The new law makes available a deduction both for household service expenses and also for dependent care expenses. For in-home help, a deduction of up to $400 a month would be permissible. For dependent care expenses outside the home (e.g., a child care center), the allowable deduction could be as much as $200 a month for one child, $300 for two children, and $400 for three or more children.

One of the critical limitations on the amount deductible relates to the taxpayer's income. Generally, a deduction is fully available where income is not above $18, 000. However, the deduction is reduced by 50 cents for each dollar of income above $18,000. Thus, taxpayers with income of $27,600 or more would obtain no benefit.

Qualifying Individuals

This deduction under the new law will arise in cases where the taxpayer's household includes a child under age 15, a disabled dependent (regardless of age), or a disabled spouse. For the deduction to be allowable, payments for household service or dependent care cannot be made to a person who is related to the taxpayer. Also, household service expenses will not include amounts paid to a gardener, bartender or chauffeur.

7. UNEARNED INCOME OF DEPENDENTS

While the new law accelerates an increase in the standard deduction, it also provides rules to discourage the use of this benefit within a family unit. In fact, under one of the less publicized provisions, the familiar techniques for diverting family income from high-tax-bracket individuals to minors or other dependents with little or no income has been dealt a severe blow.

The techniques for income splitting among family members usually fall into two categories. Income-producing property is either transferred outright to a dependent, e.g., under the Uniform Gifts to Minors Act, or is transferred to a trust for the benefit of the dependent, e.g., a 10-year reversionary trust. In both cases the general idea is to have the income generated by the property taxed to an individual in a lower bracket. In addition, the allowance of two standard deductions and two exemptions (that allowed to a child and that allowed to his parent) made such planning very attractive. For example, for 1970 a child could have received up to $1,725 and still have had no income tax liability.

Effective for taxable years beginning after 1971, any individual who is a dependent of another (e.g., a child) will not be able to use the standard deduction or low-income allowance to shelter unearned income. The new law provides that the low-income allowance (which will be $1,300 in 1972) is limited to earned income and the percentage standard deduction (15% or $2,000 next year, whichever is smaller) can be computed only on the basis of earned income. For example, if a child has earned income of $600 and unearned income of $1,400 in 1972, his father could still claim a dependency deduction for the child of $750 in 1972. However, on the child's tax return, the standard deduction would be limited to $600. Thus, the child would have taxable income of $650, his $2,000 in gross income less a $750 exemption and a standard deduction of $600.

As the example indicates, the double personal exemption is not affected by the new law. Hence, to that extent unearned income can be received tax-free. Also, there still are benefits to be derived from the tax rate differential by shifting income from a high bracket parent to a low-bracket child.

8. ACQUISITION CARRYOVERS

One of the purposes of some corporate acquisitions is to gain the tax advantage of certain carryovers (e.g., losses, credits) of the acquired corporation. Whereas the tax laws generally provide for limitations on the use of net operating loss carryovers through a corporate purchase or reorganization, no similar limitations applied to carryovers of (1) unused investment credits, (2) excess foreign tax credits, or (3) capital losses.

The 1971 Act provides that the same limitations which apply to net operating loss carryovers shall apply to the carryovers enumerated above. Thus, for corporate reorganizations and other changes of ownership pursuant to contracts entered into on or after September 29, 1971, the tax benefits of these carryovers will be limited. This provision also applies to unused work incentive program credits (a new provision).

9. FAST WRITE-OFFS FOR JOB TRAINING & CHILD CARE FACILITIES

Instead of depreciation over the useful life of the asset, the cost of acquiring, constructing, reconstructing or rehabilitating on-the-job training or child care facilities can be amortized over a 60-month period, at the taxpayer's election. The new law generally defines eligible property as depreciable tangible property for use in training employees (present or prospective) of the taxpayer or in caring for children of the employees; eligible property does not include property located outside the

U.S. In addition, the rapid amortization deduction is available only for expenditures made after 1971 and before 1977.

Any gain realized on the sale of property within this provision will be subject to the recapture rules to the extent of the amortization deductions taken. Also, the minimum tax on preferences will apply to the excess of amortization over allowable accelerated depreciation. Finally, if the 60-month election is made, the property involved is not eligible for the investment credit.

10. EXCESS INVESTMENT INTEREST

The determination of whether property is subject to a "net lease" has a bearing on the minimum tax on preferences and, starting in 1972, will affect the limitation on deductibility of excess investment interest (only one-half of such interest over $25,000 will be deductible currently by individuals). For these purposes, property subject to a net lease is treated as passive investment property, thereby raising the possibility of a minimum tax and a limited interest deduction.

Under the statutory test a lease is considered to be a net lease if business deductions related to the property are less than 15 percent of rental income. The new law makes it more difficult to escape the net lease classification. Business deductions, for purposes of the amended 15 percent test, may not include ground rents paid by the lessor of the property and any expenses for which the lessor is reimbursed by the lessee.

The new law also incorporated two liberalizing changes in the definition of a net lease. First, taxpayers can elect to aggregate all leases on a single parcel of real property (a shopping center or office building) into a single lease under the 15 percent test, thus making it unnecessary to evaluate each lease separately. Second, a taxpayer can elect to exclude from the 15 percent test all real property which is more than five years old.

In addition, amendments provide that the amount of excess investment interest is to be reduced by out-of-pocket expenses with respect to the leased property. These expenses could include expenses for business and investment, interest and property taxes.

The new amendments relating to the minimum tax are retroactive to years beginning after 1969, and in the case of the limitation on interest deductions they will apply to years beginning after 1971.

11. FARM LOSSES OF SUBCHAPTER S CORPORATIONS

The 1969 Act introduced restrictions affecting farm losses specifically directed at high-bracket taxpayers whose primary activity is other than farming. As a consequence, farm losses which are used by a taxpayer to offset his nonfarm income become subject to recapture as ordinary income when certain farm assets, which would otherwise produce capital gain, are subsequently sold. The vehicle for achieving this conversion of future capital gain into ordinary income is the excess deductions account or EDA; each year's loss must be recorded in this account. However, farm losses need only be recorded in a year in which an individual's nonfarm income exceeds $50,000 and then only to the extent the farm loss exceeds $25,000.

While no such dollar limits apply to regular corporations, the $50,000 and $25,000 tests were available to shelter the subchapter S corporation from EDA (since its income generally is taxed to the shareholder rather than to the corporation).

The lone exception under the 1969 Act was that the dollar limits did not apply to the subchapter S corporation in any year in which one of its shareholders incurred a separate farm loss.

A literal interpretation of these rules would allow a subchapter S corporation to avoid the EDA requirement entirely if its nonfarm income did not exceed $50,000 and none of its shareholders incurred a farm loss during the year. Thus, a subchapter S corporation could be availed of by an individual solely for his farming operation, permitting him to do what he could not do in his individual capacity. A second possibility for avoiding the EDA requirement involved the use of multiple subchapter S corporations. Under this arrangement each entity could exclude the first $25,000 of its farm loss from EDA.

To prevent possible escape from the farm loss rules by these means, the new law adds two restrictions affecting subchapter S corporations:

1. The nonfarm income of that shareholder with the largest amount of such income for the year is treated as nonfarm income of the subchapter S corporation in determining whether it has more than $50,000 of nonfarm income;
2. The $25,000 exclusion is denied to a subchapter S corporation if any shareholder is also a shareholder of another subchapter S corporation that has a farm loss during the year.

The new restrictions are effective for taxable years ending after the date of enactment, December 10, 1971, but no inference is to be drawn from this effective date as to the allowable treatment for prior years.

12. CAPITAL GAIN THROWBACK

Application of the capital gain throwback rule (generally taxing a trust distribution of accumulated capital gains from prior years as if distributed in the prior years) is to be postponed for one additional year until 1973. The postponement applies to the beneficiary of one accumulation trust in existence on December 31, 1969 or to two trusts where one is for the lifetime benefit of a surviving spouse.

Also, the new law amends the definition of the term "capital gain distribution." Such a distribution in a given year will include the total undistributed capital gains for all years of the trust beginning after 1968, and ending before the year of distribution. Under the prior wording the tax on distributions of capital gains accumulated in prior years might have been avoided if distributions were made in a year when the trust had no undistributed capital gains. Since the amendment is clarifying in nature, it is made effective with respect to taxable years beginning after 1968.

13. FOREIGN SOURCE CAPITAL GAINS & STOCK OPTIONS

The Tax Reform Act of 1969 introduced a minimum tax on tax preferences equal to 10 percent of the amount by which the sum of the tax preferences exceeds $30,000 plus the income taxes otherwise payable for the taxable year. In the case of individuals, tax preferences include one-half of excess long-term capital gains and the bargain element upon the exercise of a qualified stock option. However, a special rule applies if the stock option or capital gain is derived from sources outside the United States; there is no minimum tax on preferences in this case if the foreign country in which the transaction occurs does not give preferential treatment to such income.

By reason of this special rule it could be interpreted that no preferential treatment exists where, for example, a capital gain is realized in the Bahamas. Because income is not subject to tax there, capital gains could be considered as not preferentially treated. But it apparently was not the intent of Congress to exclude capital gain or stock option income in situations of this type.

Thus, the new Act makes it clear that preferential treatment is being received if the foreign country imposes no significant amount of tax with respect to the transaction. This clarification to make income subject to the minimum tax applies to taxable years beginning after 1969.

14. BRIBES, KICKBACKS AND OTHER ILLEGAL PAYMENTS

Denial of deductions for bribes, kickbacks and other illegal payments will be expanded beyond the limits previously established. The Tax Reform Act of 1969 provided that such deductions for illegal payments are denied only if the payment is to a government official or if the payor is successfully prosecuted.

Under the new Act no deducion is to be allowed for an illegal payment (including referral fees) made in violation of any federal law, or state law which is generally enforced, if the law makes the payor liable for criminal penalties or loss of his license to engage in business. This stricter provision is made effective with respect to payments made after December 30, 1969—the date of enactment of the 1969 Act.

15. HOBBY LOSSES

The 1969 Reform Act amended the so-called hobby-loss provision of the tax laws to provide for a rebuttable presumption that an activity is engaged in for profit (and hence losses are deductible) if there is a profit in the particular activity in 2 out of the 5 taxable years ending with the year in question (7 years for horses). There was a question as to the application of this provision to new activities.

Effective for years beginning after December 31, 1969, the taxpayer may elect to suspend the application of this presumption for a limited period in the case of a new activity. Furthermore, the taxpayer shall not be treated as having engaged in an activity during any taxable year beginning before 1970.

16. CONFIDENTIALITY OF TAX RETURNS

A person engaged in the business of preparing tax returns or providing services in connection with the preparation of returns will be subject to criminal penalties if he discloses the client's tax information for any purpose other than in preparing the return. This penalty provision will become effective as of January 1, 1972.

17. EXCISE TAX REPEAL

The 7 percent excise tax on passenger automobiles and the 10 percent excise tax on light trucks and buses (10,000 pounds or less) have been repealed. The effective dates for repeal are August 16, 1971 for automobiles and September 23, 1971 for light-duty trucks and buses. Procedures will be set up for refunds of such excise taxes paid by consumers purchasing vehicles on or after the effective dates. Also repealed are the excise taxes

on some other types of vehicles and related items, e.g., certain buses, light trailers and semitrailers, etc. In addition, dealers will be eligible for floor-stock refunds or credits.

18. DISC EXPORT INCENTIVE

The tax laws have played a significant role in inducing U.S. firms that sell products abroad to form foreign subsidiaries to handle manufacturing and foreign sales. Generally, this permits the subsidiary's foreign profits to be sheltered from U.S. tax so long as they are kept abroad. In contrast, U.S. corporations engaged in export activities were taxed currently on their foreign profits regardless of whether the profits were kept abroad or repatriated. Thus, to provide inducement for increasing exports and as a means of removing discrimination against those who export through U.S. corporations, the new Act establishes a system of tax deferral for a U.S. corporation known as a Domestic International Sales Corporation, or DISC, and its shareholders.

Taxation of DISC

Under this new system, a DISC itself generally will not be subject to U.S. income tax; its shareholders will be directly taxed on one-half of DISC income each year. The remaining half of DISC income will be deferred from tax until actually distributed to the shareholders or deemed to be distributed to them. The tax exemption granted to the DISC includes not only the regular corporate tax, but also the minimum tax on preferences and the accumulated earnings tax. Furthermore, the arm's-length requirements on sales between related parties are eased in the case of a DISC. Liberalized pricing rules will permit the DISC to earn a larger relative amount of the profits arising from sales it makes of its parent company's export products.

Taxation of Shareholders

Shareholders generally are to be taxed on the income of a DISC when it is actually distributed. In addition, there are several occasions when DISC shareholders will be taxed on income even though it is not actually distributed to them.

Each year the shareholders of a DISC are deemed to receive one-half of the DISC's taxable income less other amounts deemed distributed, such as income not arising from export activities or otherwise not qualifying for deferral.

When a DISC becomes disqualified or there is a sale or liquidation of the company, the shareholder will be subject to tax. That tax will include an accounting for the one-half of accumulated DISC income which had been deferred in prior years.

Qualifying Corporation

To qualify as a DISC the corporation's activities will have to be limited almost exclusively to export selling and related activities. A corporation is required to derive at least 95 percent of its gross receipts from export activities and use at least 95 percent of its assets in the export business. Included in export assets are "producer's loans," which are loans made to the U.S. parent producer or any other U.S. exporter to the extent of the producer's assets used for export business. These loans by a DISC do not give rise to taxation of the DISC or the parent on the amounts lent.

Application

A corporation can qualify as a DISC for its first taxable year beginning after 1971, provided it makes an election to be treated as a DISC. Thus, for those businesses which are affected, prompt action should be considered in order to secure immediate benefits. Most requirements can be readily satisfied by establishing a separate corporation as an export subsidiary to obtain the advantages of a DISC.

19. WORK INCENTIVE TAX CREDIT

A new income tax credit was enacted in order to develop job opportunities for welfare recipients participating in the Labor Department's Work Incentive Program. The credit can amount to 20 percent of the wages and salaries paid in cash to these individuals during their first 12 months of employment. If the employer terminates employment without cause before the end of the second 12-month period of employment, credit recapture provisions apply.

Only wages and salaries paid in the course of a trade or business (not amounts paid to domestic employees) qualify for the credit. Limitations on the amount of the credit and carryback and carryover provisions are similar to those respecting the investment credit. The provision is effective for taxable years beginning after 1971.

20. POLITICAL CONTRIBUTIONS.

Beginning in 1972, individuals will be able to enjoy some tax benefit from making contributions to political parties. The taxpayer may either (1) elect to credit against tax liability one-half of his contributions, with a maximum credit of $12.50 ($25 for joint returns), or (2) elect to deduct an amount not to exceed $50 ($100 on a joint return).