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Planning under the 1981 Economic Recovery Tax Act;

Touche Ross & Co.;

Planning Under The 1981 Economic Recovery Tax Act

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E R R A T A

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...capital gain rate reduction is effective for sales or exchanges occurring after June 9, 1981.

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1. ...a tax deficiency of $10,000 results.

Planning Under The 1981 Economic Recovery Tax Act

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INTRODUCTION

Almost exactly within six months of his inauguration, President Ronald Reagan has succeeded in persuading the Congress to give him two of the most important parts of his overall economic program: government spending reductions, in the recently enacted budget provisions for fiscal 1982; and, at the same time, the Economic Recovery Tax Act of 1981, providing major tax reduction for individuals and businesses.

This booklet concerns itself with the tax package signed by the President August 13. It asks the questions: "What are the decision points you as a manager, or as an investor, must consider in learning to live with the new tax law? What might or should you be doing differently today, under the new law, from what you did yesterday?"

Obviously, there is no way to provide individualized answers to all these questions in this type of booklet. We do, however, attempt to consider some of the more important issues for decision—and, in a generalized way, look at certain options that may be available. Please note, however, that this is *not* intended to be a comprehensive analysis of all parts of the new law; many points within sections of the Act discussed in our booklet—and many complete areas—have been omitted so we could concentrate on what we see as the most important aspects.

The law has been enacted early enough in calendar 1981 for taxpayers to do intelligent planning before the end of the year. With the phasing-in of rate and other changes, planning for 1981 transactions that will affect later year tax returns and tax events becomes particularly complex. Your Touche Ross office is prepared to assist you with specific analysis, planning, and projections.

The 1981 Act and the Individual Taxpayer

PROVISIONS AFFECTING INDIVIDUALS

Points for Consideration:

1. ***Top income tax bracket will drop from 70% to 50% as of January 1, 1982. Most, but not all taxpayers should defer income into 1982 and accelerate deductions into 1981. Deduction acceleration will require its own analysis, however, for high income individuals.***
2. ***A special provision imposes a maximum rate on long term capital gains of 20% effective June 10, 1981. There is, therefore, generally no need to postpone capital transactions into 1982—unless they are short term.***
3. ***Because of the interaction of the various income tax rates (normal tax, maximum tax, alternative and add-on minimum tax) and the varying effective dates of the rate changes, taxpayers should have their 1981 year-end tax planning performed early. Computerized individual tax planning programs can make the analysis easier and more comprehensive.***
4. ***Businesses with overseas operations should find they can now become more competitive using American nationals abroad after 1981, but may also need to consider revising tax equalization agreements.***
5. ***Despite all the publicity, taxpayers will not receive any immediate bonanza from the change allowing charitable contribution deductions for those who do not itemize.***
6. ***Marriage penalty alleviation, new IRA provisions, and a more liberal child care credit will all provide incentives for a second working spouse.***

Rate Reductions

Tax Rates: Individual income tax rates ranged from 14% to 70%, with a maximum rate of 50% on personal service income including retirement income. Effective October 1, 1981, all income tax brackets will be reduced by 5% and withholding tables will be reduced accordingly at that date. The reduction will affect 1981 taxable income by applying a credit of 1¼% to the tax computed on total 1981 income. Additional 10% cuts take effect on

July 1, 1982 and July 1, 1983. After 1984, the individual income tax brackets, zero bracket amount (old standard deduction), and personal exemptions are to be adjusted for inflation based on increases in the Consumer Price Index.

Maximum Tax: The maximum tax rate on investment income is reduced from 70% to 50% as of January 1, 1982, thereby eliminating the distinction between personal service and so-called "unearned" income. This reduction also applies to the tax on undistributed personal holding company income which will be subject to a 50% instead of 70% rate.

Action Steps: In general, taxpayers should postpone income until 1982 provided it is not "constructively received" in 1981. For example, if you postpone receipt of a bonus, that could have the effect of reducing the marginal rate on 1981 investment income taxed above 50%. On the other hand if you do not have investment income, postponement is not necessarily advantageous and, by leaving receipt in the 1981 year, you might obtain a very limited benefit from a quirk in the 1981 tax calculation, depending on how IRS interprets the statute. Since a 5% cut on October 1 is equivalent to a 1.25% cut on January 1, the 1981 tax cut will be implemented by applying a credit of 1.25% to the regular tax for 1981. Thus, the actual earned income maximum tax rate for 1981 is only 49.375% (50% less a credit of 1.25% × 50%) compared to the 50% maximum for prior and later years. This small rate differential is certainly not enough, however, to justify accelerating other earned income into 1981; only in limited circumstances would the tax savings offset the loss of the use of money caused by paying tax for 1981 rather than 1982.

Another deferral technique would be to invest in Treasury bills with maturities in 1982. T-bills are issued at a discount with face amount payable at maturity. There will not be any income recognition on the portion of the discount "earned" in 1981 until it is collected at maturity in 1982. The same result can be achieved using 6-month money market certificates issued by banks and savings and loans. Note that some alternative investment vehicles, including money market mutual funds, will result in 1981 income recognition on the amount "earned" before year-end.

Any taxpayer in a marginal tax bracket higher than 50% for 1981 will be in a "non-recurring high tax bracket" as a result of this Act. Consequently, these individuals can reduce their top tax rate by up to 20 percentage points by accelerating deductions into 1981—such as prepaying local property and income taxes, accelerating medical payments, and making increased charitable contributions. Care should be taken, however, to avoid making substantial enough charitable contributions to incur the alternative minimum tax. If you have earned income, deductions must be apportioned between such income subject to a 50% maximum tax rate, and "unearned" income subject to a 70% maximum tax rate. Consequently, every dollar of deductions accelerated will not reduce income in the 70% bracket. The degree of savings produced by taking deductions sooner, therefore, depends on the facts of each case.

One proven technique for accelerating charitable deductions is a *charitable lead trust.* Such a trust allows you to deduct currently the present value of contributions to be made to charities within the term of the trust. The present value is based on IRS annuity income tables using a 6% interest factor (which is extremely low as compared to current yield opportunities). This can result in 1981 tax savings of up to 70% of the present value amount; where charitable contributions are made after 1981, in the absence of a trust, the maximum tax benefit would be 50% of the contribution. (Please note that this comparison is somewhat oversimplified. Again, if you have earned income, deduction allocation rules may limit the tax benefit on part of the deduction to 50%. Also, when you make such a "deferred" contribution in 1981, the charitable deduction for 1981 as to the trust cannot exceed 20% of adjusted gross income. You can see it is essential to discuss this type of planning with your Touche Ross tax advisor.)

Tax shelters that make economic sense independent of tax savings can be of special value in 1981. The losses can result in tax benefit of up to 70% for 1981 and the ordinary income rollover into 1982 or later will be taxed at a maximum of 50%.

Capital Gains Provisions

One corollary of the cut in top marginal rates on investment income is the reduction of corresponding rates on long term capital gains to a 20% maximum. Because of a concern that taxpayers would defer selling capital assets until 1982, capital gain rate reduction is effective for sales or exchanges occurring after June 19, 1981. Collections after that date on prior installment sales, however, will not be eligible for the 20% maximum this year, but will be starting in 1982.

Capital gains from pass-through entities will be segregated into pre-June 10, and post-June 9 transactions at the entity level. Pass-through entities include mutual funds, REITs, subchapter S corporations, partnerships, estates, trusts, and common trust funds. *Caveat:* The 20% cap only affects brackets above 50%. Anyone in a lower marginal tax bracket will receive no reduction in capital gains rates until January 1, 1982.

AND DON'T FORGET—net *short* term gains are still taxed at top marginal brackets, in full. It may make very good sense to postpone recognizing those gains until 1982, if your top bracket exceeds 50%. Even if you are concerned about a drop in value between now and January, your top bracket could be falling as much as 28.6% next year. And, techniques such as short sales against the box could lock in the amount of your gain now, while postponing recognition until next year.

Alternative Minimum Tax

The alternative minimum tax is imposed on noncorporate taxpayers to the extent it exceeds the regular and "add-on" minimum tax. The maximum rate is 25% on alternative minimum taxable income exceeding $100,000. This rate is reduced to 20% after 1981. The maximum rate also drops to 20% on that portion of the alternative minimum tax attributable to net capital gains realized after June 9, 1981.

Action Step: Because of the interaction of various facets of income tax—such as the regular rates, alternative minimum tax, the maximum rate on capital gains, etc. and the various effective dates, more than the normal care will have to be exercised for 1981 vs. 1982 tax planning. Taxpayers with alternative courses of action could well find it essential to gain access to computerized tax planning programs for the "what if" process of tax planning—an example would be the Touche Ross DELTATAX program.

Principal Residence

The new Act contains two provisions liberalizing the rules concerning gain on the sale of a principal residence. Gain can now be deferred if a replacement residence is purchased within two years before or two years after the sale. Under prior law the replacement period was only 18 months. The new rule applies to sales after July 20, 1981, or to sales prior to July 21, 1981 where the old 18-month replacement period does not expire until on or after that date. Consequently, some taxpayers who have already sold their homes may now have an additional six months within which to find a replacement residence and still defer gain on the sale.

The second relief provision increases the one-time-only exclusion of gain on the sale of a residence by taxpayers aged 55 or over, from $100,000 to $125,000. This provision is also effective for sales after July 20, 1981.

Exclusion for Income Earned Abroad

In 1982 qualified U.S. citizens and residents working abroad will be eligible to exclude $75,000 annually from foreign earned income. This amount will increase $5,000 annually to $95,000 after 1985. In addition, a housing cost exclusion will be allowed for "housing expenses" (including utilities and insurance, but not taxes and interest which are separately deductible), over a base housing amount (currently $6,059, 16% of the present salary of a grade GS-14 government employee). These exclusions will replace the present special deductions from gross income (for cost of living, home leave, education, housing, and hardship deductions for specific hardship areas), which will be repealed. Also liberalized will be the present exclusion from income of lodging furnished by the employer. There will no longer be a requirement that the furnished lodging be in a hardship area or that it be substandard lodging. These changes will be of most benefit to Americans in foreign countries with effective tax rates below those in the U.S.

The test for physical presence is also liberalized to 330 days in any period of 12 consecutive months from the 510 days in any period of 18 consecutive months formerly required.

As a practical matter, these changes will generally benefit employers more than employees. Most companies use tax equalization plans, so the changes will simply cut their costs under these plans. In addition, as the Congressional Budget Office and others have recognized, purchases from American sources for overseas operations should increase if Americans replace foreign nationals in overseas purchasing posts. It is only human nature for foreign nationals to favor foreign products or companies in their purchases.

Note that the exclusion is elective, not mandatory. However, with the repeal of the present special deductions in 1982, failure to make the election will leave the expatriate taxpayer subject to U.S. tax on his worldwide income, with double tax relief available only via the foreign tax credit or treaty provision. Where the effective foreign rate is higher than the comparable U.S. rate, this latter course may well be the better, since no credits or deductions are available with respect to excluded income on the U.S. return. Where, though, foreign rates are low vis-a-vis those in the U.S., the exclusion will presumably be made.

The decision on election is made more complicated due to the fact that, once made, it is irrevocable unless taxpayer wishes to give up any right to its use again for six years.

Given that most expatriate employees are covered by tax equalization agreements, so that any additional tax costs (or benefits) flow to the employer, those agreements may well need to be amended or reviewed to give the employer some rights with respect to determining if an employee should, or should not, make the election.

Planning Thought for Individuals: Accelerating deductions to 1981 can save more tax. Deferring earned income (such as bonuses) to 1982, however, is not likely to effect a tax saving. The new law provides that payment for services will relate back to the year the services are performed. Thus, a bonus for 1981 work, paid in 1982, will be taxed in 1982 but will not be subject to the new exclusion rules.

Planning Suggestion for Businesses: Businesses can now reexamine their decisions on the hiring of foreign nationals vs. sending Americans overseas, as the high cost of tax equalization/tax reimbursement agreements should be greatly reduced.

Marriage Penalty Reduction

Under tax law, a married couple is generally treated as one tax unit and must pay tax on its total taxable income. Tax rate schedules differ for married persons and unmarried persons. If both spouses work, the income of the second spouse pushes their combined earnings into higher incremental tax brackets, and yet at any given income level the tax burden of a married couple with relatively equal incomes will be more than if they were single.

To partially reduce the penalty, a married couple filing a joint return will be able to deduct a percentage of the lower-earning spouse's income (up to $30,000 of income). The deduction will be 5% in 1982 and 10% thereafter.

Married couples will find more economic incentive in having the second spouse work—particularly with a combination of the "marriage penalty" deduction discussed above, the expanded IRA deduction discussed elsewhere, and a newly-liberalized child care credit. A spouse earning $10,000 for example, could deduct a total of $2,800—$2,000 for an IRA contribution and $800 for the "marriage penalty" deduction. (Earnings are reduced by IRA or pension contributions before calculating the "marriage penalty" deduction). In addition, taxes could be further reduced by up to $720 for child care expenses ($1440 for more than one dependent).

Charitable Contributions for Non-Itemizers

Charitable contributions under the old law could only be deducted by individuals itemizing their deductions. In an effort to encourage charitable giving, the law has been changed for a five-year experimental period to allow charitable contribution deductions "above the line"; i.e., for those taxpayers not otherwise itemizing their deductions. For 1982 and 1983 the deduction is limited to 25% of the first $100 given to charity ($25 maximum deduction). This will gradually increase to 100% of contributions in 1986, but the provision is scheduled to expire at the end of 1986—an automatic "sunset" unless Congress chooses to reenact it.

Solution (?) to Over-Withholding for Executives

There may be relief in 1982 for over-withholding attributable to tax shelter deductions.

Withholding tables are relatively explicit as to amounts of tax to be withheld at various income levels. There are provisions whereby employees may adjust their withholding for anticipated itemized deductions, but prior law and regulations did not allow an employee to take into account deductions generated by tax shelters (i.e., deductions to reach adjusted gross income). The new law authorizes Treasury to amend the regulations to allow such deductions to be taken into account. Because the statutory language allows but does not require this change, the degree of liberalization will not be known until regulations are issued.

SAVINGS PROVISIONS

Points for Consideration:

1. ***Will qualified lenders find it beneficial to issue new tax-exempt savings certificates in view of present and expected standards for their use?***
2. ***What investors should purchase these certificates, and in what amount?***
3. ***What will present issuers of tax-exempt securities have to deal with because of this new entrant?***

The new law does three things aimed specifically at general savings:

- Creates a tax-exempt 1-year saving certificate;
- Restores a $100 ($200 for joint filers) dividend exclusion instead of the $200 ($400) dividend-interest exclusion for years beginning after December 31, 1981.
- Provides a new interest exclusion of 15% of "net interest" for years beginning after December 31, 1984.

Of these, the new savings certificate is the only one creating immediate decision opportunities. As a new entrant in the tax-exempt market it appears to have the potential to be a "loose cannon on the deck," depending on its ultimate design and the type of investors it attracts.

Institutions

"Qualified institutions" (banks, savings and loans, credit unions, and other similar insured institutions) must decide whether to issue these new certificates in light of the restrictions the new law imposes on the use of the proceeds. Generally, the law requires that 75 percent of the proceeds of any certificates issued during a calendar quarter must be used for residential financing by the end of the following quarter. (Credit unions are subject to special restrictions.) If the institution falls short, no further certificates can be issued until the shortage is corrected. Once the decision is made to issue the new certificates, an issuer will have to decide on how to meet the 75% requirement. In addition to issuing direct mortgages on various properties, the issuer has the option of investing in the secondary market, including FNMA and GNMA securities backed by residential mortgages.

The new law does not authorize the issuance of these certificates; that is left to banking regulators. In the regulatory process, other conditions or penalties could be added which will affect a decision whether to issue the certificates. These regulatory terms also could affect when interest on the certificates will be deemed paid for tax purposes. The only penalty in the tax law for premature withdrawal is the loss of exempt status, so "original issue discount" rules would cause both institutions and savers to recognize the interest ratably over the 1-year term of a certificate. For example, if a certificate is issued October 1, 1981, $^3/_{12}$ of the interest would be attributable to calendar year 1981 (and excluded by savers) and $^9/_{12}$ to calendar year 1982. Regulatory restrictions similar to those on money market certificates, for instance, could change the tax year to which interest would be attributed. (Even though the interest will be excluded from income by the investor, interest paid should be deductible by the issuer according to its method of tax accounting.)

A major unanswered question is from where the funds for these new certificates will be drawn. Although the Administration hopes the tax cuts will promote new saving and investment, it seems likely that much of the money will flow from existing certificates of deposit. Even this shift would be beneficial to financial institutions, however, since the new interest rate (70% of Treasury Bill yields) will be lower than rates paid on money market certificates, etc.

Investors

Potential investors will need to consider whether the certificates are attractive given their particular circumstances. Interest is to be pegged at 70% of the average yield on 52-week Treasury Bills for the official sale the week prior to an exempt saving certificate's issuance. The certificates must be offered in denominations as low as $500 for the benefit of savers of small amounts, but these same people might be deterred by the necessity of holding the certificates for a full year. Also, these certificates may not necessarily carry government guarantees even though issued by insured institutions. Finally, savers will generally not profit from tax-exempt investments if their marginal tax rate is too low. (The staff of the Joint Committee on Taxation assumes in its revenue loss projections that taxpayers with a marginal tax rate below 30%—e.g., married taxpayers with taxable income of less than $30,000 in 1982—will not find the certificates attractive.)

Under the new law, a taxpayer has a lifetime exclusion of $1,000 dollars of interest ($2,000 for married couples filing jointly) from these certificates. (The $2,000 limit for joint returns applies even if only one spouse carries the investment.) Using recent interest rates, an investor would have to purchase about $9,000 ($18,000 for a married couple) of these certificates during the period they may be offered—October 1, 1981 to December 31, 1982—to gain the maximum tax advantage. Of course, care will need to be taken to avoid exceeding the exclusion limit. *Taxable* interest at a rate of 70% of Treasury Bill yields would not be very attractive.

As with other tax-exempt interest, no deduction will be permitted for interest paid by investors for amounts borrowed specifically to invest in the new certificates.

Tax-Exempt Financing

Major decision points for those involved with traditional tax exempt financing may develop from whatever effects the new exempt savings certificates, perhaps in tandem with other changes made by the new law, have on the cost and availability of financing for traditional issuers of tax-exempt securities. For instance, if the returns on Treasury Bills are similar to the approximately 15.5% seen in early August, 1981, these new certificates would bear interest rates just under 11%. By comparison, some new tax exempts were advertised during the same period at prices and coupon rates yielding 9.5% to 12.25% returns. If these certificates are rated comparably with those yielding lower rates of return, some disruption of the market for tax exempts seems assured.

Many also feel that, even if the institutional investors who buy many of the traditional tax-exempt issues do not shift any funds, competition for the funds of individual investors will still exert significant upward pressure on rates of return. In addition, the general reduction in tax rates, all other factors being equal, should reduce the number of taxpayers in tax brackets high enough to make tax-exempts attractive, putting still more competitive pressure on issuers.

Another factor to be watched is the ability of high visibility streetside marketing to attract investors who would not otherwise be in the tax-exempt market. Also, the statutory rate for these certificates will have to compete with other exempt types of instruments, including municipal bond funds that could provide even better liquidity than the tax-exempt certificate. Thus, there is at least some concern that the new instrument could fail to attract significant investor interest. Either of these situations could reduce or eliminate possible disruption of the market for tax-exempts, but the latter case would deal savings institutions a severe blow.

RETIREMENT SAVINGS PLANS

Points for Consideration:

1. ***Can you, as an individual, use a $2,000 tax shelter? Look again at Individual Retirement Accounts.***
2. ***Employers have the option, with the attendant administrative problems, of allowing voluntary IRA-type contributions to their existing retirement plans.***
3. ***Even where the employer declines the option under 2, above, employees now covered by a qualified plan may still set up their own tax deductible IRA.***
4. ***Self-employeds have a new, higher deduction limit plus the ability to make IRA-type contributions to their Keogh plan or to a regular IRA, but still suffer by comparison to corporate plan beneficiaries and will likely suffer more in the future.***
5. ***Liberalizations in Employee Stock Ownership Plans (ESOPs) may make them worth another look, especially by closely held corporations, as a source of equity.***
6. ***Tax-credit ESOPs will have to be reexamined both by present users and by service-oriented businesses who could gain little benefit from them in the past.***

INDIVIDUALS

Congress has expressed concern that retirement often results in a substantial decrease from preretirement living standards and that there is insufficient incentive for individual savings during the working years. Provision has been made to increase the allowable contributions to Individual Retirement Accounts (IRAs) for those eligible under existing law and to extend the IRA eligibility to individuals participating in employer-sponsored retirement plans.

Tax deductible contributions by those currently eligible for IRAs will be increased from $1,500 to $2,000. Present law further limits such contributions to 15% of compensation; this will now be increased to *100%* of compensation. The limitation on spousal IRAs is increased from $1,750 to $2,250.

Individuals already participating in an employer-sponsored plan will also be able to make tax-deductible contributions to IRAs subject to the same $2,000 ($2,250 for spousal IRAs) and 100% of compensation limitations. If an employer's retirement plan is amended to allow voluntary deductions, an employee may make the same tax-deductible contribution to his or her company plan. IRA-type contributions would be in addition to any voluntary non-deductible employee contributions which may already be a part of the plan.

Although participants in existing employer-sponsored retirement plans cannot take advantage of IRAs until 1982, it is not too early to begin analyzing the various investment vehicles available for IRAs (including their employer's plan if it is amended to accept IRA contributions). They will then be able to fund their IRA and begin tax-free accumulation of earnings as early as possible in 1982. For younger employees, not able to afford the after-tax loss of cash flow from a full $2,000 contribution, it may even be advantageous to borrow, given the shelter of the IRA's earnings.

$2,000 per taxpayer may not appear to be a very substantial inducement for starting an addition to a retirement fund. But the power of tax-sheltered compounding of earnings can be surprising. Assume, for example, a married couple, each age 25, both working. Assume also the IRA earns a return of 12% annually (as we go to press, money market funds are currently returning 16-17%). If each puts aside $2,000 a year until age 65, the retirement fund they will have available at that time will amount to a not-so-casual $3,435,000. And, that is assuming annual compounding only—if semi-annual compounding is used, the increase in the fund, just from the first two years' contributions alone, would be almost $100,000.

Attention Employers! These changes are not effective until tax years beginning after December 31, 1981; i.e., calendar year 1982 for most individuals. Employers, however, should give prompt consideration to the advisability of amending their employee retirement plans to allow the acceptance of tax-deductible payments by employees early in 1982.

Some advantages of such a plan amendment are:

- Employee goodwill;
- Possible economies of scale (but see below);
- The employer will be furthering the underlying objective of the legislation—namely encouraging individual savings. Employers are in a unique position to facilitate employee savings via payroll deduction, etc.

Disadvantages may be:

- Additional accounting, reporting and administrative requirements for the IRA accounts;

- Second-guessing by employees on the investment performance of their IRA accounts;
- Communication problems in advising employees of the differences between their IRA accounts and their other account(s) under the regular company plan; e.g., IRA accounts are subject to penalty if withdrawn before age 59½, and are not eligible for lump sum taxation upon distribution or for favored estate tax treatment;
- Employers with thrift or savings plans may find their plans becoming discriminatory if the lower-paid employees switch their non-deductible contributions to IRA contributions.

IRAs and Keoghs are no longer mutually exclusive: Many directors shelter a portion of their director fees by establishing their own Keogh plan, thereby gaining a deduction for 15% of their fees. In 1982, they will be able to establish an IRA for their director fees and shelter 100% of their fees, subject to a maximum of $2,000 ($2,250 for spousal IRAs). Thus, a person with $10,000 of director's fees could contribute $1,500 to a Keogh and $2,000 to an IRA ($2,250 to a spousal IRA).

Partners, sole proprietors, etc. will now also be able to establish their own IRAs even though they participate in a Keogh plan in their business, or they may make additional tax deductible voluntary contributions to their Keogh plan. These IRA contributions will be allowable even though they contribute the maximum to their Keogh plan. It is thus possible for a self-employed person with $100,000 in earned income to contribute $15,000 to his Keogh plan and $2,000 to an IRA for a combined $17,000 deduction.

Self-Employed

Sole proprietors, partners, and subchapter S corporate shareholder-employees have long been "second class" citizens in terms of the retirement benefits they could provide for themselves through the business, as opposed to the benefits which could be provided if the business were incorporated. Because of this, the formation of professional corporations (and even "executive," "athlete," and "entertainer" corporations) is becoming increasingly commonplace.

Contribution and benefit limits in corporate retirement plans are inflation-adjusted annually, whereas corresponding limits in Keogh plans have not been adjusted since 1974. The contribution limit has now been increased from $7,500 to $15,000 for defined contribution Keogh plans maintained by sole proprietorships and partnerships, for defined contribution plans of subchapter S corporations, and for Simplified Employee

Pension Plans. A similar increase in the level of benefits which can be funded through defined benefit Keogh and subchapter S plans is provided by increasing from $50,000 to $100,000 the annual compensation which can be taken into account in computing future, but not past, limits on benefit accruals.

The bill has also increased from $100,000 to $200,000 the amount of compensation which can be recognized under one of these plans. However, if annual compensation in excess of $100,000 is used, the rate of employer contributions for common-law employee participants cannot be less than the equivalent of 7½% of such employees' compensation. Under a defined benefit plan the rate of benefit accrual for such employees must be at least half of the maximum allowable rate.

Although these revisions are not effective until taxable years beginning after December 31, 1981, the affected plans must be amended to be eligible for the liberalized contributions.

Sole proprietorships and partnerships still considering incorporation will have to reexamine their projected contributions under the various forms of organization. For example, the comparison below shows the maximal, or near maximal tax deductible contributions possible for a professional interested in providing the maximum retirement benefit at age 65 considering his present income and age (for corporations, it is possible to increase deductible amounts by using both a defined benefit and a defined contribution plan):

	Keogh			
	Prior Law	**New Law***	**Corporation**	
			$ 2,000	IRA
			82,600	DB
Age 55, $150,000 earned income			15,00	DC
(emphasis on defined benefit plan)	$8,300	$18,600	$99,600	
			$ 2,000	IRA
Age 35, $150,000 earned income			37,500	DC
(emphasis on defined contribution			5,500	DB
plan)	$7,500	$17,000	$45,000	

DB = Defined Benefit Plan
DC = Defined Contribution Plan

*As discussed above, partners and sole proprietors will now also be able to set up their own IRAs even though making maximum Keogh contributions. Corporate employees may, also. Amounts shown include $2,000 IRA.

And, as dramatic as the above comparison may be, it should be noted that the bias toward corporate plans will become more pronounced in the future unless inflation disappears. Defined benefit and defined contribution limitations in corporate plans have been automatically inflation-adjusted since 1974, and will continue to be. Keogh plans are not: the 1981 changes in limits are the first since 1974, and they will remain constant (regardless of inflation) until Congress is moved to adjust them again.

Employee Stock Ownership Plans (ESOPs)

Under present law there are two types of ESOPs: leveraged (typically used for employee takeovers of ownership) and the tax credit ESOP (essentially a form of profit sharing or defined contribution plan). The new law liberalizes some minor provisions which make leveraged ESOPs more appealing and, perhaps, worth exploring as a means of equity financing. In particular, the requirement that employees be permitted to vote shares of stock allocated to certain types of accounts has been removed. There are more pressing decisions to be made, however, concerning tax-credit ESOPs.

Under present rules, a tax-credit ESOP is funded mainly by an extra 1% or 1½% investment tax credit allowed to an employer establishing a properly qualified plan. For taxable years beginning in 1983 this capital-based credit will be replaced by a credit calculated on aggregate employee compensation. As enacted, this credit is available through 1987, but could be extended.

Employers with tax-credit ESOPs in place will need to decide whether they should be discontinued or switched over to the compensation credit for 1983. However, these employers may wish to accelerate the acquisition of as much investment-credit property as possible into 1982 to take advantage of the extra investment tax credit before it is replaced.

Many employers in service-type businesses will find tax-credit ESOPs worthwhile for the first time in 1983. It is not too early to begin planning toward adoption of a plan for 1983 so that qualification can be assured in time to take maximum advantage of the change in the law.

Touche Ross tax and actuarial benefit consultants can assist you in studying the feasibility and potential benefits of an ESOP, obtaining the necessary qualification rulings from the Internal Revenue Service should you decide to establish a plan, and implementing the plan.

ESTATE AND GIFT CHANGES

Points for Consideration:

1. ***The new level of estate tax credits should exempt most estates from any tax, but planning needs will continue as they are phased in.***
2. ***The increased gift tax exclusion greatly enhances income and estate planning opportunities.***
3. ***The new unlimited estate marital deduction should not be used indiscriminately. Used properly in conjunction with other planning tools, however, it can produce considerable benefits in both tax savings and tax deferral. It can also produce at least one unexpected trap.***
4. ***Deathbed transfers of cash could substantially reduce estate taxes, but deathbed transfers of appreciated property could have adverse income tax consequences.***
5. ***The unlimited gift tax marital deduction is probably of little tax planning importance since the same result can be accomplished by will with added advantage of stepped-up basis at death.***
6. ***Rules for the inclusion of family farms and business property in an estate at a value reflecting the current use of the property are liberalized, in some cases retroactively. Estates and heirs may promptly have to reconsider claiming this special valuation for estates of decedents dying after 1976.***

Credits and Rates

The unified credit for post-1976 lifetime and death transfers is increased from $47,000 (equivalent to an exemption of $175,625) in 1981 to $192,800 (the equivalent of a $600,000 exemption) in 1987. This increase will be phased in as follows:

	CREDIT	EXEMPTION
1982	$ 62,800	$225,000
1983	79,300	275,000
1984	96,300	325,000
1985	121,800	400,000
1986	155,800	500,000
1987 and later	192,800	600,000

For planning purposes, several points should be kept in mind:

- The increased credit (when fully phased in) should eliminate any tax on the vast majority of estates.
- Many fairly large estates can probably be brought into the tax-free range by an effective program of lifetime gifts and other planning techniques.
- Planning for estates which might have tax in excess of the credit will be even more important since the first taxable dollar will fall in a 37% tax bracket (up from 32%).
- At death, a decedent's basis in property is "stepped up" to fair market value without any recognition of gain. The new, higher exemption level makes this fact an even more effective planning tool. (Note, however, a new special rule denies the "step up" for property given to a decedent within one year of death if the property passes by will or intestate succession back to the donor.)
- The credit increase is being phased in over several years, and many people can still benefit from estate and tax planning in the interim.
- Declining term life insurance may be an effective tool to ensure liquidity during this phase-in.
- Unless inflation declines, the reductions discussed above could well disappear during the next decade, in terms of real dollars. Current—and continued—planning can ease the problem and prevent it from becoming acute.

Rate Reduction: The 1981 maximum rate of 70% on taxable transfers will be reduced five percentage points a year starting in 1982, to 50% for taxable transfers exceeding $2.5 million in 1985 and thereafter.

Marital Deduction

The present limits on both lifetime and death transfers to a spouse are eliminated for transfers made after 1981. The unlimited marital deduction will apply to both separate and community property.

Also, property, including community property, in which the surviving spouse has only a lifetime income interest may qualify for the marital deduction for the first time. If the deduction is to be claimed, an election must be filed with the estate tax return, and the survivor's estate must include the full value of the property in which the survivor had the income interest. (Note that it is not the value of the *life estate* which is deducted and later includible, but the value of the *property* to which it relates.)

There is no doubt that existing wills should be reviewed to be sure that formula marital deduction bequests do not leave a spouse more (or less) than intended because of this new unlimited deduction. A transitional rule provides that the unlimited deduction will not apply to transfers due to an unamended formula marital deduction clause in a will or trust executed before September 12, 1981. There is a potential trap here, however: if your state enacts a statute construing existing formula clauses to refer to the new unlimited marital deduction rule, the new rule will apply even if no amendment is made to the will itself. (A similar transition rule applies to powers given to trustees to make excludable annual gifts.)

Other potential pitfalls and points of interest:

- Do not assume that everything should pass to your spouse since it can do so without tax. If there is any chance your spouse will leave an estate on which tax will be paid, you should consider transferring at least enough of your estate to children, etc. to use your full personal lifetime exemption in addition to the marital deduction. In a few cases it still may be desirable to incur an estate tax with respect to the first spouse's estate, to put as much of the combined estates in the lower tax brackets as possible (i.e., tax at 37% in two estates is better than tax at 45% in one, and so on).

Example:

Case 1: X dies in 1987 leaving $1,200,000 to spouse Y. X's estate pays no tax. On Y's death, the estate tax is calculated as follows:

Tax on $1,200,000*		$427,800
Less Credit		192,800
Tax Payable		$235,000
Total tax:	X – $0	Y – $235,000

Case 2: Same except X leaves $600,000 to spouse Y and $600,000 in trust for son Z with limited income interest for Y. X's estate tax return would reflect the following:

X's Gross Estate:	$1,200,000	
Marital Deduction	600,000	
Taxable Estate	$600,000	
Tax on $600,000		$192,800
Credit		192,800
Tax Payable		$ -0-

On Y's death, the estate tax is calculated as follows:

Y's Gross Estate	$600,000*	
Tax on $600,000		$192,800
Credit		192,800
Tax Payable		$ -0-

*Deductions other than the marital deduction are ignored for simplicity.

Comparing these cases, one can see that utilizing both the unified credit and the marital deduction to the optimum degree can transfer up to $1,200,000 to the next generation without estate tax.

- There is probably no special tax advantage in conveying only a terminable life income interest to your spouse as allowed by the new rules. Both the deduction to your estate and the inclusion in your spouse's estate is the fair market value of the property itself. Your spouse, therefore, will have the enjoyment of only the less valuable life income interest, while his or her estate is taxed as if the full property interest was owned. What this new rule does, however, is to allow a decedent to set forth, without the use of trusts, a plan by which children or other objects of his or her bounty will have a right to the property whether or not the surviving spouse remarries, etc. Whether this device is right for you is a matter for careful consideration, but other techniques can accomplish the same tax savings.

- The new law eliminates a presumption that purchased property held jointly by husband and wife is included entirely in the estate of the first to die. Instead, all jointly held property is owned one-half by each joint owner. While this may appear, on its face, to provide a benefit, the following problems do exist:
  (1) Many estate plans took the old presumption into account in one way or another; a review of your plan may be in order to assure that the new 50-50 rule does not upset the plan.
  (2) Although the entire jointly held property would be potentially subject to estate tax using the old rule, the entire basis for determination of gain on a sale would have been "stepped up" to fair market value in the hands of the survivor. Under the new rule, the one-half inclusion likewise yields an increase in only one-half of the basis. Thus, even estates without estate taxes to pay need a plan for overcoming the income tax consequences of joint tenancy. It may be worthwhile to consider retitling the property or transferring it to a trust to improve the overall results of your estate plan.
  (3) Community property states appear to be treated more favorably than separate property states with respect to basis rules on property held jointly between spouses. As noted above, a "stepped up" basis is allowed on only the one-half of jointly-held property included in the decedent spouse's estate. If, however, the jointly-held property is community property, the Code generally provides that the entire community property interest (including the surviving spouse's one-half interest) receives a "stepped-up" basis for income tax purposes.

Annual Gift Exclusion

Two changes in the law concerning gift taxes should greatly enhance income and estate tax planning. Beginning in 1982, the amount that taxpayers may give each year without incurring any gift tax liability will increase from $3,000 per donee to $10,000. Using gift splitting, married couples will be able to transfer a total of $20,000 per donee, annually.

Second, in the case of taxpayers dying after December 31, 1981, gifts that have been made within three years of death will no longer be included in the decedent's estate for estate tax purposes. There are exceptions for transfers of life insurance and property over which the taxpayer retained certain rights or powers. In light of these changes taxpayers should consider the following opportunities:

- High bracket taxpayers can reduce their income tax burden by making annual gifts of income-producing property to lower-bracket family members.
- Income can be further sheltered by gifts of income-producing property to short-term "Clifford" trusts. The fair market value of property transferred to 10-year trusts is discounted, for gift tax purposes, under Treasury tables at a rate of .441605. Consequently, a donor can transfer $22,645 per donee per year to such a trust without any gift tax implications ($22,645 × .441605 = $10,000). The limit increases to over $45,000 if husband and wife split the gift.

  Example: X, who is subject to a 50% marginal tax rate, has four children, each of whom are subject to a 25% marginal tax rate. In 1982, X sets up four trusts for the benefit of his children and transfers property to each with a value of $22,645. Each trust provides that it is to last for ten years and one day from the date of any contributions, and all income is to be distributed currently to the beneficiaries. Assuming the property yields a 16% return, X has effectively shifted $3,600 of income to each trust, or a total of $14,400. This represents a tax savings to X of $7,200 and an increase in tax to each beneficiary of $720. The total annual net savings would be $4,320. In 1983, X could make another transfer to the trusts, effectively doubling his tax savings in that year.

- Payment of medical expenses and school tuition for the benefit of any donee—regardless of the relationship with the donor—will not be treated as a gift. Payment of such expenses on behalf of a donee will not, therefore, reduce the $10,000 excludable amount that can be given to that donee. (Note that only the portion of nursing home expenses which is stated by the institution to be for medical services is not a gift.)

- Deathbed transfers of cash and of other property that has not appreciated can reduce the size of a decedent's taxable estate.

  Example: X, a widow, has an estate worth $800,000 in 1987. X has four married children and eight grandchildren. If X were to die in 1987 her estate tax would be as follows:

Tax on $800,000	$267,800
Less credit	192,800
Tax payable	$ 75,000

  However, if planning permitted, X could make deathbed gifts in 1987 of $10,000 to each of her children, their spouses, and their children for total gifts of $160,000. This would reduce her taxable estate to $640,000 and reduce her estate taxes as follows:

Tax on $640,000	$207,600
Less credit	192,800
Tax payable	$ 14,800

  Total tax savings from making the deathbed gifts would be $60,000.

- Except possibly with respect to $10,000/$20,000 per donee (excludable for gift tax purposes), deathbed transfers of appreciated property should not be made since gifts do not result in a "stepped up" basis to fair market value in the donee's hands. If such property is included in decedent's estate, it will receive a basis in the heirs' hands equal to its fair market value at the date of decedent's death. This can result in substantial income tax savings if the property is subsequently sold.
- On the other hand, on a deathbed or otherwise, an individual might want to gift appreciated property if it otherwise would be taxed in the individual's estate. The donee would take a carryover basis, but gain on sale will generally be subject to no more than the maximum 20% capital gains tax. If taxable in the decedent's estate, however, it would be subject to a minimum 37% estate tax.
- An unlimited deduction is allowed for gifts to spouses. However, this provision is probably of little tax planning importance in light of the unlimited marital deduction for estate tax purposes. Transfers to a spouse at death would result in a "stepped up" basis to fair

market value, whereas lifetime gifts would not. Consequently, income tax advantages can be obtained by postponing such transfers until death. In either case, no tax would be due as a result of the transfer. (From a more practical viewpoint, however, expensive gifts now can be given to a spouse without being concerned with tax due or a technical violation of the law if no gift tax return is filed. Under the new law no return is to be filed if the unlimited marital deduction applies to the full gift.)

- Gifts within 3 years of death will be included in the decedent's estate for purposes of making certain calculations relating to current use valuation, extension of time for payment of estate tax, and redemptions of stock to pay death taxes. For example, such gifts will not be effective in reducing the size of the decedent's estate in order to qualify for the 15-year deferred payment of estate tax attributable to an interest in a closely held business. See below.

Extension of Time for Payment of Estate Tax

The prior law's rules relating to the deferred payment of estate taxes attributable to interests in closely held businesses have been simplified and liberalized. For decedents dying after 1981, an executor can elect to pay over a 15-year period (5-year deferral followed by 10 equal annual installments) the portion of the estate tax attributable to the inclusion in the estate of an interest in a closely held business if the value of the interest exceeds 35% of the adjusted gross estate (AGE).

A special 4% interest rate is charged on approximately the first $300,000 of tax attributable to the closely-held business. Interest at the current rate (prime, effective February 1, 1982) is charged on the balance.

Redemptions of Stock to Pay Death Taxes

Redemptions of stock in closely-held businesses to pay certain estate taxes, funeral expenses, and administration expenses can be utilized by more taxpayers as a result of more liberal rules. Under the old law, stock could qualify for capital gains treatment under this special redemption only if it exceeded 50% or more of the value of the decedent's AGE. If two or more corporations were owned, they could be counted as a single corporation for this 50% test if the decedent owned 75% or more of the outstanding stock of each corporation. The new law adopts the same rules as provided for extended estate tax payments (see above). Consequently, redemption treatment will be available if the value of stock in a closely-held corporation exceeds 35% of the decedent's AGE. Interests in two or more corporations can be aggregated for this purpose if the decedent owned 20% or more of the outstanding stock of each corporation. This should provide for increased flexibility in guaranteeing sufficient liquidity in the estates of those holding interests in closely-held corporations. However, there will be a lesser need to redeem such stock as federal estate taxes are reduced.

Other Provisions

- The exemption from the generation-skipping transfer tax for transfers from a revocable trust or will in existence on April 30, 1976 will continue provided the grantor dies before January 1, 1983, rather than January, 1982, and the trust or will was not revised after April 30, 1976.
- A disclaimer will be effective for Federal estate and gift tax even if it does not satisfy local law. However, the refusal must satisfy the Federal requirements and the disclaimant is to make a timely transfer of the property interest to the person who would have received the property had the refusal been an effective disclaimer under local law.
- Quarterly gift tax returns will no longer be required for gifts made after 1981. Instead an annual return will be due by April 15 for the prior calendar year gifts.

Current Use Valuation

The old law contains provisions which allow real property used in farming or in a closely-held business to be included in a decedent's estate at its value in its current use, rather than its full fair market value. This "current use valuation" could not reduce the fair market value, however, by more than $500,000. The new law raises this maximum reduction to $600,000 for estates of decedents dying in 1981, $700,000 in 1982, and $750,000 in 1983 and later, and makes a variety of changes in the technical requirements which must be met to qualify for the special valuation.

Most of the technical changes are effective for estates of decedents dying after December 31, 1981, but there are a number of changes which are retroactive to 1976. These retroactive changes will allow some estates to elect current use valuation which previously could not, and to claim a refund, but these taxpayers must act quickly. See below on timing of elections.

The following adjustments to the law are made retroactive:

- Under interpretations of the old law, current use valuation may have been denied if the decedent was not directly involved in the business at the time of death. The new law makes it clear that use by the decedent or a family member is sufficient. For instance, a farm could be leased to a son by a retired farmer (with or without rent) and still qualify for special treatment in the retiree's estate.
- A "qualified heir" (i.e., a family member acquiring the property from the decedent) generally must continue the "qualified use" of the property and "materially participate" in the farming or business operations for a certain amount of time. There are two liberalizations of these requirements in the new law:
  (1) The qualified heir has two years after the decedent's death to begin the qualified use.
  (2) A spouse, minor, disabled person, or student can meet the "material participation" standard without having to make the "daily operating decisions."
- Trust interests will qualify as present interests held by qualified heirs when all beneficiaries are qualified heirs. Thus, transfers of property from a decedent to certain trusts will not necessarily bar the use of a special valuation.
- The new law expands the category of qualifying acquisitions from a decedent to include purchases from the estate by a qualified heir, whether under an option from the decedent, directions in the will, or at the discretion of the executor.

Fiduciaries of estates of decedents who died after December 31, 1976 who chose not to use or were denied current use valuation because of one of the factors just discussed should consider a claim for refund. Quick consideration is necessary, however, since the election may have to be filed within a matter of months—the period for filing cannot expire before February 13, 1982, but the statute is not clear on how much time may be allowed thereafter. (In some cases, retroactive claims will not be allowed unless the estate tax return was timely filed.)

Life Insurance

Several of the provisions discussed above, while in no way affecting the taxation of life insurance, significantly alter the need for it, in estate and financial planning. The reduction or elimination of tax, increased annual gift exclusions, liberalized extension of time to pay tax, and current use valuations of family farms, etc., all tend to reduce the need for insurance.

With less of the estate going to taxes, more will be available to support survivors without the need for extra insurance to supply the funds. All of these provisions decrease the need for liquidity (and, therefore, insurance to provide it) either by reducing the need for cash or the speed with which it must be supplied. Similarly, buy-sell agreements used in closely-held businesses may be able to rely more on payment techniques other than insurance because the decedent's heirs will not necessarily need as much cash immediately.

You should not, however, drop any insurance without a careful review. As noted above, many of the changes in the law are phased in over a number of years, so the needs which the insurance is intended to meet will not disappear immediately. Also, insurance will continue to play a vital role in some estates where taxes will still be paid or where the need for cash does not hinge on the payment of estate taxes.

In short, while for all estates the amount of insurance needed may decrease, a role for some insurance is very likely to remain. One area for consideration could well be "survivor insurance"—insurance payable on the life of the last of two persons to die.

TAX STRADDLES

Points for Consideration:

1. ***Tax shelter investors will find other techniques much more fruitful because of this act.***
2. ***Hedgers should take care to comply with standards for exemption from the new rules imposed by this law.***
3. ***Treasury Bills may no longer be used to produce ordinary losses.***
4. ***Commodity gains will still be taxable at lower rates (32% maximum) than short term capital gains (50% maximum).***
5. ***The deemed closing of all market positions in futures contracts affects not only commodity planning but all year-end capital transaction planning.***

The new law seeks to prohibit a variety of transactions in commodities and government securities which have been perceived as abusive tax avoidance techniques. In general, these new rules leave true hedgers unaffected, cause traders to reassess their operations, and drastically curtail casual investors seeking to shelter income or convert ordinary income to capital gain (or capital losses to ordinary losses).

The tax avoidance possibilities of commodities and commodity futures contracts grow out of a taxpayer's ability to take market "positions" with offsetting economic effects. Thus, while an unrealized profit might develop on one contract, the offsetting contract would show an equivalent loss. By manipulating the time of sale for each contract, a profit or loss could be timed to the taxpayer's best advantage. The new law, therefore, imposes two restrictions. (1) It restricts the reporting of losses in excess of unrealized gains as to offsetting interests in actively traded personal property. Thus, losses in excess of gains can no longer be created to offset other income for the year. (2) It closes all "regulated futures contracts" at year end, recognizing all gains or losses based on the then market prices (i.e., "marked to market").

Hedging transactions are exempted from both personal property loss restrictions and the "marked to market" concept. There are prescribed standards for a "hedging transaction," including a requirement that the taxpayer identify a hedge as such on the same day it is entered into; and care must be taken to comply with these standards to avoid losing some of the hedging benefits as taxes. The new rules will cover traditional hedgers such as food processors, assuring a supply of produce at favorable prices, as well as financiers seeking to reduce the impact of interest rate fluctuations on their commitments to borrow or lend.

Other provisions will affect the taxability of commodity-related transactions. First, no ordinary deduction may be taken for carrying charges incurred with regard to the ownership of a commodity where an offsetting futures contract also is held. Instead, the carrying charges must be capitalized.

Second, U.S. Treasury Bills are defined to be capital assets, in order to prevent claims of ordinary loss on Treasury Bill transactions. Prior to this rule, Treasury Bills were ordinary income property but futures contracts for Treasury Bills were held by IRS to be capital assets. Thus, taxpayers were able to use straddles in Treasury Bill futures to produce *ordinary* loss (by taking delivery of the Treasury Bills to close a loss position) and *capital* gain (by selling the futures contract to close the straddle on a gain position).

The new law also contains provisions designed to ease the impact of its passage:

- Transactions entered before June 24, 1981 can be taxed using the new rules. There is much planning which can be done in comparing the predictable results of the new law with the potential benefits and risks of maintaining a tax posture under the old law.
- Taxes on income triggered by this law from positions entered before 1981 can be paid over five years, *with interest*.

Other points of importance in tax planning are:

- Attribution rules should be reviewed to be sure that positions taken by related parties do not become subject to these restrictions.
- Although enacted in the context of restricting *commodity* straddles, the law applies to any "interest" in "personal property," with the latter term meaning "any personal property (other than stock) of a type which is actively traded." Depending on the IRS's interpretation of the law, we might be surprised to see what else besides pork bellies, silver, etc. would be seen as "actively traded" and, therefore, subject to these rules.
- Any gain on a regulated futures contract (whether realized or only "marked to market") will be taxed at no more than a 32% effective rate after 1981 and a 40% rate in 1981. This compares to a maximum rate on short-term capital gains of 70% in 1981 and 50% thereafter.

The 1981 Act and the Business Taxpayer

PLANNING FOR BUSINESS CAPITAL INVESTMENT: THE ACCELERATED COST RECOVERY SYSTEM

Points for Consideration:

1. ***New depreciation rules may require amending tax returns already filed.***
2. ***For capital intensive industries, more careful long range planning may be required.***
3. ***More "tax-free" incorporations and distributions will have part of their gain recognized than prior to 1981.***
4. ***For real estate owners or investors, straight line depreciation may become much more attractive for nonresidential property.***
5. ***As to personal property, straight line depreciation, for certain years' additions, may become an important part of the planning process.***
6. ***Rules permitting limited expensing of personal property may not be as clear a "winner" as expected and, for some, may be a loser.***
7. ***It may become more advantageous not to own your depreciable personal property.***
8. ***Depending on the nature of the property, the ACRS rules may or may not make equipment leasing more attractive as a tax shelter.***
9. ***Real estate shelters, on the other hand, will become more attractive as to returns—and shelters for rehabilitated structures may be the best of all.***
10. ***Extension of "at risk" rules to investment tax credit may require changes in methods of financing acquisitions.***
11. ***Amount "at risk" with respect to some 1981 acquisitions may need to be increased by year end.***

The Accelerated Cost Recovery System (ACRS) is a modification of the so-called "10-5-3" system of depreciation which has been under discussion for the past few years. Two extremely important aspects of the system are, first, ACRS is mandatory and not elective, and, second, *it has* *been in place since January 1.* Thus, any acquisitions of depreciable real or personal property in calendar 1981 are already subject to ACRS rules, which replace virtually all other depreciation systems.

Did your fiscal year end early in 1981? Have you filed your tax return for the fiscal year, and are there additions (after December 31, 1980) to depreciable property accounts? You will have to start thinking of an amended return, at least for federal purposes.

Recovery Periods and Rates

Taxpayers should find disputes with the Internal Revenue Service substantially reduced with respect to the depreciation life used for assets. For personal property, there are two major lives: 3 and 5 years. 3-year property includes only autos, light duty trucks, and personal property used in connection with research and development activities. Virtually all other personal property is in the 5-year class (public utility property has its own rules and is not further treated in this booklet). Most real property is placed into a 15-year class.

Separate tables are provided in the law with respect to personal property placed in service before 1985, in 1985, or after 1985. The tables are constructed to permit ½ year depreciation in the year of acquisition (regardless of when the property is acquired during the year). For 1981 to 1984, depreciation is computed using the 150% declining balance method, switching to straight line at the most advantageous time; for 1985 the method is 175% declining balance with a switch to sum-of-the-year's-digits at the most beneficial time, and after 1985 the computation is made using the double declining balance method, switching to sum of the years'-digits at the most beneficial point.

The pre-1985 and post-1985 tables are reproduced below (the 10-year life column applies only to certain public utility property, railroad tank cars, and very limited kinds of real property).

For property placed in service before 1985:

If the recovery year is:	The applicable percentage for the class of property is: 3-year	5-year	10-year
1	25	15	8
2	38	22	14
3	37	21	12
4		21	10
5		21	10
6			10
7			9
8			9
9			9
10			9

For property placed in service after 1985:

If the recovery year is:	The applicable percentage for the class of property is: 3-year	5-year	10-year
1	33	20	10
2	45	32	18
3	22	24	16
4		16	14
5		8	12
6			10
7			8
8			6
9			4
10			2

The investment tax credit has also been liberalized for personal property. The comparison of past and present rates is as follows:

Depreciable Life	Pre-1981	Post-1980
3 years	$3\frac{1}{3}$%	6%
5 years	$6\frac{2}{3}$%	10%

For real property the Treasury Department will publish tables for depreciation based on use of the 175% declining balance method switching to straight line at the most advantageous time. Depreciation of subsidized low-income housing will be based on the 200% declining balance method with a switch to straight line. Unlike personal property, depreciation on real property is allowed for all months during the year that the property is actually in service. The following table, for example, is an approximation of how the rules would apply to real estate placed in service on the first day of the taxable year.

If the recovery year is:	The applicable percentage for the class of real property is:	
	Low-income housing	All other 15-year real property
1	13	12
2	12	10
3	10	9
4	9	8
5	7	7
6	7	6
7	6	6
8	5	6
9	5	6
10	5	5
11	5	5
12	4	5
13	4	5
14	4	5
15	4	5

Different rules are applicable to real and personal property located or used outside the United States and will not be discussed in this booklet.

Comparisons With Prior Law

Factors other than tax policy will continue to affect investment decisions—inflation, interest rates, and the strength of the economy—but the new depreciation rules will certainly influence such decisions. In most cases, the new rules permit business to deduct the cost of investments over a much shorter period of time, thus increasing the size of annual deductions and the after-tax return compared with what they would have been under the old rules. The increased investment tax credit rates for investments in personal property and rehabilitation of older real property will serve to further increase after-tax returns on investments. There may be some instances, however, where the recovery period under ACRS will be longer than useful lives presently used for computing depreciation. In such cases lower after-tax returns result, but this result may be mitigated by lower recapture on disposition and, in some situations, greater investment credit than under prior law.

The utility of the new accelerated depreciation deductions and investment credit rules, as compared to pre-1981 tax law, depends upon the depreciable life of an asset before 1981, along with the method of depreciation being used. Assume, for example, a $100,000 investment in personal property with a 14-year depreciable life (pre-1981), depreciated using the sum-of-the-years'-digits method. At a marginal rate of 46%, and using a 16% return as an opportunity cost, the present value of tax benefits from that investment, pre-1981, is $31,983. A similar investment under ACRS, using the pre-1985, 5-year recovery tables, produces a tax benefit present value of $38,213, an increase of 19.5%. Using the post-1985 tables, the tax benefit present value increases to $40,381, an increase over pre-1981 of 26.3%. See Table I.

Much more favorable results are attained for investments in real property. Assume a $1,000,000 investment at the start of the year in new residential property that would have been depreciable over 33⅓% years under the double declining balance method prior to enactment of ACRS. This investment would have yielded a first year depreciation deduction of $60,000, resulting in tax savings of $25,500 to a taxpayer who is subject to a 50% marginal rate and the 15% tax on preference income. The same investment in 1981 would yield a first year depreciation deduction of $116,667 and a tax benefit of $50,833. Note that the savings is almost twice that under prior law despite a lower depreciation rate (175% vs. 200%) and much higher preference income. The present value tax benefit of the deductions over the depreciable life of the asset would be $123,185 for the pre-1981 investment and $205,532 for the same investment under ACRS, an increase of 66.9%. See Table II, pp. 42-3.

Since taxpayers' (and practitioners') minds are infinitely fertile and creative, a good many pages of the new statute are designed to avoid abuses of Congressional and Administration largesse. There are a number of "anti-churning" rules to prevent property in use before 1981 from being sold to a related party (very broadly defined) after 1980 to take advantage of the faster write-offs. It won't work for you to sell depreciable property this year to your spouse, even if you file separate returns (or to your

Table 1

	Old Law—14 Year Life			New Law—5 Yr. Pre-85 Table			New Law—5 Yr. Post-85 Table		
	Depreciation On 100000	Tax Benefit @ 46% Plus 10% Inv. Cred.	Present Value @ 16%	Depreciation on 100000	Tax Benefit @ 46% Plus 10% Inv. Cred.	Present Value @ 16%	Depreciation on 100000	Tax benefit @ 46% Plus 10% Inv. Cred.	Present Value @ 16%
Year 1	13333	16133	13908	15000	16900	14569	20000	19200	16552
Year 2	12381	5695	4232	22000	10120	7521	32000	14720	10939
Year 3	11429	5257	3368	21000	9660	6189	24000	11040	7073
Year 4	10476	4819	2662	21000	9660	5335	16000	7360	4065
Year 5	9524	4381	2086	21000	9660	4599	8000	3680	1752
Year 6	8571	3943	1618						
Year 7	7619	3505	1240						
Year 8	6667	3067	935						
Year 9	5714	2629	691						
Year 10	4762	2190	497						
Year 11	3810	1752	342						
Year 12	2857	1314	221						
Year 13	1905	876	127						
Year 14	952	438	55						
Present Value of Tax Benefit			31983			38213			40381
Advantage of New Law						6230			8397

corporation, trust, etc.)—and expect to obtain the faster write-offs of ACRS. Except when these rules apply, however, any sale of property will require ACRS to apply anew for the new owner.

Tax Traps and Drawbacks—It's not all one-sided

While businesses and investors may well revel in the increased deductions from the new Accelerated Cost Recovery System, there are some potential drawbacks of which taxpayers should be aware.

- The "add on" minimum tax preference rules still remain in the Code. Thus, the excess of accelerated depreciation over straight line on all real property and leased personal property continues to constitute an item of tax preference. The acceleration of depreciable lives could result in artificially large preferences being generated, so special lives apply with respect to computations of the preference. For 3-year property, the tax preference computation period is five years, for 5-year property it is eight years, and for 15-year real property it remains at fifteen years. In computing straight line depreciation under the special computation period, the one-half year convention must be used for personal property though not for realty.

  The results of the artificial extended lives for preference purposes may be mixed. Assume a $10,000 ownership interest in leased computers placed in service on January 1. Using double declining balance depreciation and a seven-year life, the first-year tax preference under pre-1981 law would be $1,428. Under ACRS rules, the first year preference would be only $875. However, in the second year, the preference under prior law would be $613, while under ACRS it would increase to $950. With respect to longer lived assets, the comparison is less attractive as illustrated by the real property example in Table II.

  Depending on the nature of the asset, the ACRS rules will create changes in internal rates of return and investors should be prepared to put pencil to paper (or have their tax consultants do it for them) to fully understand the nuances.

- Businesses will need to take greater care in planning so-called "tax-free" transfers of property to keep them truly free of tax. For property which is subject to a mortgage or other liability, ACRS depreciation will bring adjusted basis below the outstanding liability

Table II
OLD LAW
200% DB over 33⅓ Years

Year	Depreciation (original cost $1,000,000)	Preference	Tax Benefit @ 50% less 15% Min. Tax	Present Value @ 16%
1	$60000	$30000	$25500	$21983
2	56400	26400	24240	18014
3	53016	23016	23056	14771
4	49835	19835	21942	12119
5	46845	16845	20896	9949
6	44034	14034	19912	8173
7	41392	11392	18987	6718
8	38909	8909	18118	5526
9	36574	6574	17301	4549
10	34380	4380	16533	3748
11	32317	2317	15811	3090
12	30378	378	15132	2549
13	28555	0	14278	2073
14	26842		13421	1680
15	25231		12616	1362
16	23718		11859	1103
17	22294		11147	894
18	21384		10692	739
19	21384		10692	637
20	21384		10692	549
21	21384		10692	474
22	21384		10692	408
23	21384		10692	352
24	21384		10692	303
25	21384		10692	262
26	21384		10692	226
27	21384		10692	194
28	21384		10692	168
29	21384		10692	144
30	21384		10692	125
31	21384		10692	107
32	21384		10692	93
33	21384		10692	80
34	7136		3568	23
			Present value of tax benefit	$123185

Table II

NEW LAW
175% DB over 15 Years

Year	Depreciation (original cost $1,000,000)	Preference	Tax Benefit @ 50% less 15% Min. Tax	Present Value @ 16%
1	$116667	$50000	$50833	$43822
2	103056	36389	46069	34237
3	91032	24365	41861	26819
4	80412	13745	38144	21067
5	71031	4364	34861	16598
6	62744	0	31372	12876
7	55424		27712	9805
8	52424		26227	8000
9	52424		26227	6896
10	52424		26227	5945
11	52424		26227	5125
12	52424		26227	4418
13	52424		26227	3809
14	52424		26227	3283
15	52424		26227	2831
			Present value of tax benefit	$205,532

(The above ACRS calculations were made on the basis of actual 175% declining balance rates rather than on the rounded percentages anticipated to appear in the published tables and exemplified on p. 38.)

more rapidly and more often. In incorporations of and transfers to *controlled* corporations, distributions of appreciated depreciable property in redemptions, and similar "nonrecognition transactions," gain will be recognized to the transferor to the extent that the adjusted basis of the assets transferred is less than the amount of liabilities to which assets are subject plus other liabilities assumed in the transfer. Planning thought: Use tax savings from ACRS to reduce liability, thus reducing exposure to the problem.

- The more rapid reduction of adjusted basis will also affect tax liability upon taxable sales or exchanges of property, including corporate liquidations treated as sales or exchanges. The amount of depreciation or, possibly, investment tax credit which must be taken back into income can be significantly greater than before. This can be especially true for sales of nonresidential real property on which accelerated depreciation is selected. See discussion under "Special Considerations" on page 52.
- One aspect of the new provisions which will often come up in an investment context, relates to so-called "hobby losses". Provisions

of the Code (which have not changed) provide that losses from activities the IRS has tended to regard as hobbies are non-deductible against other income. So long as the taxpayer can show a profit (using tax accounting rules) in two out of any five consecutive years, however, the activity is considered as entered into for purposes of producing income or making a profit. Failure to meet this safe harbor does not automatically disallow any loss from the activity; rather, the taxpayer must prove to the IRS the highly subjective proposition that a profit motivation for the activity existed.

In many businesses with depreciable property, ACRS may increase tax deductions so dramatically that it may be almost impossible to meet the hobby loss safe harbor. Affected parties have two choices:

1. Elect one of the extended recovery periods described below, along with the required straight line computation, if that will result in taxable income for the requisite two years.
2. Be prepared to substantiate a profit motivation to the satisfaction of an examining revenue agent (not always the easiest job).

- Some corporations have found the 5% limit on charitable contribution deductions too constraining, and have resorted to Clifford trusts or even offshore corporations to solve their problems. The good news is that the limit has been doubled to 10% of taxable income. The bad news is that the benefits of ACRS may reduce taxable income so dramatically that the 10% limit may be meaningless.

  The limit on individual charitable contributions is unchanged (generally 50%, 30%, or 20% of adjusted gross income depending on the type of charitable donee), so the net effect of ACRS may be smaller contributions than in the past—or larger contribution carryovers.

  The above tax constraints on charitable contributions along with the budget cutbacks affecting many charitable organizations will force fundraisers for such organizations to develop new techniques to encourage contributions. See p. 68 of the booklet.
- The recordkeeping burden under ACRS could create a certain amount of frustration. For financial accounting purposes, economic useful life records and depreciation schedules will be required. For federal tax purposes, ACRS records must be maintained. Many states do not follow federal taxable income—and others may change

their depreciation rules to avoid the major revenue losses ACRS could cost—and a third set of records may be necessitated for state tax depreciation. And, even businesses that elect the limited expensing option for fixed assets (discussed later in this section), thus avoiding all recordkeeping except for financial reporting, will still have to keep track of those expensed assets for property tax and insurance purposes. Also, property used outside the U.S. is subject to its own special lives, and will require its own special records.

- Finally—but not unimportantly—corporations whose taxable income is eliminated or greatly reduced via ACRS will have to pay particular attention to a special set of rules for calculating hypothetical depreciation with respect to computing earnings available for dividend payment. Otherwise, dividends would be largely return of capital or capital gain, and provisions are included to minimize that likelihood.

Flexibility

There are several basic questions that must be considered by any business as a result of ACRS. The problems get particularly critical for new and for capital intensive businesses. The tremendous potential acceleration of depreciation deductions, combined with the increase in investment tax credit for many assets, raises at least the possibility that many businesses will incur a zero effective tax rate on business operations for some period of time. Further, it is highly possible that for some businesses the increased deductions and credits will generate loss carryovers and credit carryovers that could not have been utilized within the carryback and carryover framework of the tax law prior to the 1981 Act.

The new law provides several opportunities to plan for avoidance of this unfortunate result. First, the carryover (but not carryback) period for unused net operating losses and investment credits is extended, generally, to 15 years from the present 7. To provide some flexibility, the extended loss carryover period can be utilized for any net operating losses originally generated in years ending after December 31, 1975, and to unused investment credits carried from years ending after December 31, 1973. Thus, utilization of earlier year losses and credits will be permitted before "excess" losses or credits arising in years subject to the ACRS. The new leasing provisions, discussed below, also provide some flexibility to those companies which are unable to take advantage of the accelerated deductions and expanded credits.

While ACRS has been popularly described as a "15-10-5-3" depreciation system, there is flexibility built into the system. Two elections are available to mitigate the impact of high deprecation deductions which may not be utilized:

1. Straight line depreciation, rather than the accelerated tables, is authorized.
2. Longer recovery periods may be used than those in the ACRS tables.

As mentioned below, where one of the longer lives is elected, straight line *must* be used. However, straight line may also be elected for the regular ACRS life; that is, most persónal property may be depreciated over five years and most real property may be depreciated over 15 years, using the straight line method in order to decelerate the flow of deductions. If the straight line method is elected (for the recovery period or for an extended recovery period) the half-year convention must still be observed for personal property.

The extended recovery periods permitted for various ACRS classes are as follows:

3-year class:	5 years, 12 years
5-year class:	12 years, 25 years
10-year class:	25 years, 35 years
15-year class:	35 years, 45 years

There are certain ground rules. If an extended period is selected, it must be used for all property (other than real property) of the particular class (that is, all 3-year property, all 5-year property, etc) placed in service in that taxable year. Elections relating to real property, however, can be made property by property. Of course, the same class of property placed in service in a subsequent year would again be eligible for the regular recovery period or a different extended period.

If an extended period is elected, only straight line depreciation may be used—there are no tables of accelerated rates for extended recovery periods. Even though the extended period may coincide with the same regular life—for different class property—for which an accelerated table is provided, that table may not be used. Finally, electing a 5-year extended recovery period for 3-year class property does not increase the available investment credit from 6% to 10% on that property—nice try.

ACRS is not elective; it is mandatory. Elections made under ACRS are made on the return for the year in which property is placed in service and may be revoked only with IRS consent. Use of the accelerated tables in the statute (or the tables to be developed by the Treasury for 15-year real property) is not the making of an election and, therefore, appears to be an irrevocable choice. Use of the straight line method or an extended recovery period, however, is elective, and there may be certain instances where the IRS will consent to a change in these depreciation methods or periods at a subsequent date.

Under prior law, the IRS has issued various revenue procedures granting "automatic" permission to change from one depreciation method to another, so that the request for permission is a mere formality. It is not known what their outlook will be with respect to permitted changes under ACRS.

Special Considerations

1. *Expensing*

One incentive, specifically included in the 1981 Act as a "small business" issue, will require attention by both small and large businesses, as an indication of what the future might hold. We refer here to the expensing of a limited amount of personal property capital additions. The amount subject to expensing is relatively small (up to $5,000 in 1982-3, $7,500 in 1984-5, and $10,000 annually thereafter), but those provisions will permit a large percentage of businesses to effectively write off personal property capital additions in the year acquired. The House Ways and Means Committee actually passed a bill that would have phased in complete expensing of personal property capital additions by 1990—but that bill was not adopted by the full House. Nonetheless, failure of adoption may be laid at least as much to political issues as to questions of whether expensing represented sounder tax policy than the modified 10-5-3 approach. And, on the Senate side, as powerful a senator as Russell Long of Louisiana (ranking Democrat and former chairman of the Finance Committee) has stated his strong support for the expensing of fixed assets, and claimed it to be "the wave of the future."

The limited expensing provisions replace the old, so-called "bonus" depreciation rules under which taxpayers could obtain up to $2,000 ($4,000 on a joint return) depreciation in the year of acquisition, before the computation of "regular" depreciation. For property placed in service after December 31, 1980, bonus depreciation is no longer available—but note that the expensing election will not be available until taxable years *beginning* in 1982. For fiscal years beginning in 1980 and 1981, neither bonus depreciation nor expensing will be allowed, except for qualifying assets placed in service by December 31, 1980.

Not surprisingly, to preclude obtaining more than a 100% write-off in the year of acquisition, property subject to the expense election will not qualify for investment tax credit. Therefore, it may be of interest to note the comparable tax benefits of an investment in 3-year and 5-year class property with 6% and 10% investment credit, respectively, versus expensing that same investment and forgoing the investment credit. Using a 46% marginal tax rate and a 16% opportunity cost, the present value of tax benefits on 3-year property is $359.81 per $1,000 investment using the pre-1985 tables. See Table III. For 5-year property, the tax benefit present value per $1,000 invested is $382.13 pre-1985 and $403.81 post-1985. All of these contrast with a present value of $396.55 where an item is immediately expensed. (We have assumed in all these examples that the tax benefit is incurred in the year after investment. If the benefit were reflected immediately, current expensing would, of course, produce a present value benefit of $460.)

The interesting point of these comparisons is that, at top corporate rates, there is little basis for choice between expensing and ACRS with investment credit. To the extent the limit on expensing remains at $10,000 in the future, smaller businesses will presumably elect expensing to ease tax accounting and recordkeeping. Similarly, larger companies may well forgo the election simply to avoid dual recordkeeping. Tax savings probably will not be a consideration.

Even if the amount of permissible expense increases, it is not clear that expensing would be automatically elected at top marginal rates. For example, using the above approach, with $100,000 of investment, the tax benefit present value for 5-year property is $39,665 if expensed, but $40,381 if depreciated. The 10% investment credit in the first year offsets the attraction of immediate write-off, but perhaps not enough to justify the added record keeping complexity.

However, note what happens using the lower effective tax rates paid by the smaller, private companies at whom the expensing provisions are aimed. Because the investment credit is a fixed percentage of cost, having nothing to do with marginal or average tax rates, the same asset will produce an identical credit against tax for a business in the 46% or 20% bracket. Or, put another way, the investment credit provides substantially more tax (and therefore investment) leverage for the lower-bracket taxpayer.

Using Table III information, but with a 20% tax rate rather than 46%, the tax benefit present value per $1,000 invested in 3-year property is $172.41 if expensed, but $203.69 for post-1985 depreciation claiming a 6%

Table III

	Immediate Write-Off			3-Year Life—Pre-85 Table			3-Year Life—Post-85 Table		
	Expense	Tax Benefit @ 46% Plus No Inv. Cred.	Present Value @ 16%	Depreciation on 100000	Tax Benefit @ 46% Plus 6% Inv. Cred.	Present Value @ 16%	Depreciation on 100000	Tax Benefit @ 46% Plus 6% Inv. Cred.	Present Value @ 16%
Cost	100000	46000	39655	25000	17500	15086	33000	21180	18259
				38000	17480	12990	45000	20700	15383
				37000	17020	10904	22000	10120	6483
PV of Tax Benefit			39655			38981			40126
Advantage of Expensing						−674			470

	Immediate Write-Off			5-Year Life—Pre-85 Table			5-Year Life—Post-85 Table		
	Expense	Tax Benefit @ 46% Plus No Inv. Cred.	Present Value @ 16%	Depreciation on 100000	Tax Benefit @ 46% Plus 10% Inv. Cred.	Present Value @ 16%	Depreciation on 100000	Tax Benefit @ 46% Plus 10% Inv. Cred.	Present Value @ 16%
	100000	46000	39655	15000	16900	14569	20000	19200	16552
				22000	10120	7521	32000	14720	10939
				21000	9660	6189	24000	11040	7073
				21000	9660	5335	16000	7360	4065
				21000	9660	4599	8000	3680	1752
PV of Tax Benefit			39655			38213			40381
Advantage of Expensing						−1442			726

ITC. For 5-year property, with 10% ITC, the comparable benefits are $172.41 for expensing and $234.29 for depreciating—a 35.9% better result from forgoing the expense election.

As is so often the case in tax matters, a relatively simple concept can be complicated by anti-abuse measures surrounding it. For example, to the extent of any expense election made, gain on disposition of such property cannot qualify for installment sale treatment. Also, to avoid the flow-through of the expense to passive investors, as opposed to leasing companies, the election is not available to noncorporate lessors (including subchapter S corporations) unless they would otherwise qualify for obtaining investment credit using the special rules applicable to those classes of lessors. A final caveat on expensing: the election is available only for property used in a business, not for investment property.

2. *Leasing*

A critical decision point for a number of businesses is whether they should even own their personal property fixed assets after 1980 or, instead, lease such property. For example, the Senate committee report is vocal and explicit as to the point that Congress wishes to encourage the leasing of depreciable property where there is concern that ownership might result in in loss of credits or deductions or where the operating business wishes more certainty in the planning of its cash flows regarding capital investment.

Leasing, as opposed to buying, is hardly a new technique. It is readily apparent that if leasing companies themselves utilize depreciation deductions and investment credits, they can "pass through" those tax benefits to lessees via reduced rental charges. However, because of the tax shelter potential inherent in leasing activities, the Internal Revenue Service has found it necessary to articulate certain standards which must be met before the Service will issue an advance ruling that a proposed transaction will be treated as a lease for tax purposes rather than as a conditional sale or financing arrangement.

With a number of other provisions now added to avoid tax shelter abuse, the 1981 Act substantially liberalizes the IRS guidelines so that it will be much easier to meet the safe harbor tests guaranteeing treatment as a lease. Unfortunately, the new standards do *not* apply to property leased before August 13, the date of enactment of the 1981 law.

Here is a comparison of the IRS guidelines and the new safe harbor rules established by Congress:

Leasing Guidelines

IRS	*ACRS*
1. Lessor must have at risk at least 20% of asset cost during lease period.	1. Only 10% of asset need be at risk.
2. Lessor must be able to demonstrate profit motivation from lease transaction, without regard to tax benefits.	2. Tax benefits may be included as lessor evaluates profitability.
3. Any purchase option for a lessee to acquire leased property must be for fair market value at time of purchase.	3. No such requirement.
4. Lessor may not have contractual right to "put" the property to lessee.	4. No such requirement.
5. Lessee, or related party, may not have provided or guaranteed financing for lessor's acquisition of the property.	5. No such rule, other than requirement that 10% of cost be at risk by lessor.
6. Property may not be "special use"; that is, at termination of lease, there must be additional commercially feasible use of property to the lessor.	6. No such requirement.

The safe harbor lease rules can only be used with respect to property eligible for investment credit, thus effectively denying them for real property (which, because of its longer depreciable life, is considered less likely to cause permanent loss of deductions). All beneficial ownership interests in the leased property must be in corporations (other than subchapter S corporations)—again, to discourage passing through accelerated deductions and credits to individuals as a shelter.

While each case must be considered separately, there may well be some benefit for a lower tax bracket business to lease most of its personal property from a high bracket leasing company, but to have the investment credit passed through to the lessee. If the leasing company gets a 46% tax benefit from depreciating the property, and the lessee could have received only, say, a 25% benefit, it would seem that a lease could be negotiated resulting in lower after-tax costs to the business. And, as discussed above, leverage from the investment credit increases at lower tax brackets.

3. *Straight Line Depreciation of Nonresidential Real Property*

Present law contains provisions requiring that upon the sale of property, a certain portion of the depreciation deductions taken in the past must be reported as ordinary income to the extent any gain is realized (i.e., "recaptured"). Generally, when personal property is sold, all depreciation deductions taken must be "recaptured" as ordinary income. When real property is sold, gain is treated as ordinary income only to the extent that accelerated depreciation exceeds straight line depreciation. (A special rule applicable to low-income housing phases out the potential recapture by 1% per month after the property has been held for 100 months.) Consequently, there is no ordinary income recapture in the case of dispositions of real estate for which straight line depreciation has been elected, and any gain is capital gain.

As a general rule, owners and investors in real property have found that the present value of the increased depreciation deductions obtained by using an accelerated method is greater than the present value of the potential tax liability on recaptured ordinary income. With one major exception, this finding should hold true under ACRS.

The exception is nonresidential real property. No longer will recapture income on sale of such property be limited to the excess of accelerated over straight line depreciation. Instead, under the 1981 Act, if the accelerated computation table is used, *all* of the depreciation deductions taken in the past will constitute ordinary income upon sale. On the other hand, if straight line depreciation is elected, the law still provides that there will be no recapture and all gain on the sale will be capital gain.

In light of this change in the law regarding recapture income on sales of nonresidential property, owners and investors in such property should seriously consider electing straight line depreciation over 15 years. Except in those cases where net operating losses cannot be fully utilized in the foreseeable future, the 35- and 45-year options are probably of little planning importance. If, however, capital gains is not an important consideration, or the property is expected to be held for a long time (e.g., 20 years), the present value of the increased depreciation deductions in the early years after real property acquisitions will continue to call for use of accelerated depreciation and, therefore, application of the ACRS tables.

Table IV illustrates the above concept. The following assumptions have been utilized for the purpose of comparison between use of accelerated and straight line depreciation:

1. The taxpayer is subject to a 50% marginal tax rate and the 15% minimum tax on preference income.
2. A nonresidential building with a depreciable basis of $1,000,000 is placed in service on the first day of the taxable year.
3. One day after the close of each year, the building is sold at its original cost of $1,000,000.

If the taxpayer uses accelerated depreciation, the present value of the tax benefits realized over the 15-year depreciable life, is based on this table, $205,532. If straight line depreciation is elected, the present value of such tax benefits is only $185,849. However, the present value of tax on the gain ordinary at income rates (50%) is much greater than the present value of the tax on gain at capital gains rate (20%), so that straight line depreciation would be preferable if the property is to be sold at any time within the first 18 years after being placed in service. See pp. 54-5.

4. *ACRS and Tax Shelter Considerations*

There are a number of provisions which can best be described as anti-tax shelter (see, for example, the discussion below involving the extension of the at-risk rules to investment tax credit). Investors looking for a bonanza in tax shelter activity, because of the accelerated deductions and increased credits, will likely be disappointed, except with respect to real estate.

As discussed above, the new leasing safe harbor rules may be used only where the ultimate owners of the leased property are corporations (other than subchapter S corporations). Non-corporate lessors will not be able to obtain the investment credit on property they own unless they continue to meet prior tax rules, including the provision that the lease may not extend beyond one-half the useful life of the leased property. (Because of the artificial reduction in useful lives of most personal property, special lives are prescribed for this particular test. For example, it might be a little difficult to arrange a trust lease of a new airplane if the term of the lease could not extend beyond two and one-half years. Accordingly, non-corporate lessors will still be eligible for the investment credit if the term of the lease is no more than one-half the pre-1981 life designated by the ADR mid-point life, or twelve years if the asset was not assigned an ADR class life.)

Table IV

			New Law—15-Year Life @ 175% DB				
			Tax Benefit		Tax on Recapture		Net
Year	Depreciation on 1,000,000	Subject to Recapture	@ 50% Less 15% Min. Tax	Present Value @ 16%	@ 50%	Present Value @ 16%	Net Present Value If Sold After Year End
1	116667	116667	50833	43822	−58333	−50287	−6466
2	103056	219722	46069	34237	−109861	−81645	−3586
3	91032	310755	41861	26819	−155377	−99544	5334
4	80412	391167	38144	21067	−195583	−108019	17926
5	71031	462197	34861	16598	−231099	−110029	32513
6	62744	524941	31372	12876	−262470	−107729	47689
7	55424	580364	27712	9805	−290182	−102675	62549
8	52454	632818	26227	8000	−316409	−96513	76711
9	52454	685272	26227	6896	−342636	−90097	90023
10	52454	737726	26227	5945	−368863	−83615	102450
11	52454	790180	26227	5125	−395090	−77207	113983
12	52454	842634	26227	4418	−421317	−70976	124632
13	52454	895088	26227	3809	−447544	−64995	134422
14	52454	947542	26227	3283	−473771	−59314	143387
15	52454	999996	26227	2831	−499998	−53963	151568
16	0	999996	0	0	−499998	−46520	159012
17	0	999996	0	0	−499998	−40104	165428
18	0	999996	0	0	−499998	−34572	170960
19	0	999996	0	0	−499998	−29803	175728
20	0	999996	0	0	−499998	−25693	179839
21	0	999996	0	0	−499998	−22149	183383
22	0	999996	0	0	−499998	−19094	186438

Present Value of Tax Benefit 205,532

Those investors who believe that real estate has been the best tax shelter available will likely have that belief strongly reinforced as a result of the changes in depreciation produced by ACRS and the increased credits for rehabilitation of older buildings and certified historic structures.

Taxpayers are presently allowed a 10% investment tax credit on expenditures to rehabilitate buildings that are at least 20 years old. In lieu of the credit, a taxpayer rehabilitating a certified historic structure, can elect to amortize the expenditures over 60 months.

For rehabilitation expenditures incurred after 1981:

- The credit is increased to the following percentages for three categories of buildings which are *substantially* rehabilitated:

  30-39 years old — 15%
  40 years old or more — 20%
  certified historic structures — 25%

Table IV *(continued)*

New Law—15-Year Life @ Straight Line

		Tax Benefit		Tax On Sale			
Depreciation on 1,000,000	Subject to Recapture	@ 50%; No Min. ax	Present Value @ 16%	CG rate: 20%	Present Value @ 16%	Net Present Value If Sold After Year End	Difference
66667	0	33333	28736	− 13333	−11494	17241	−23707
66667	0	33333	24772	− 26667	−19818	33690	−37276
66667	0	33333	21355	− 40000	−25626	49237	−43903
66667	0	33333	18410	− 53333	−29456	63817	−45892
66667	0	33333	15870	− 66667	−31741	77402	−44889
66667	0	33333	13681	− 80000	−32835	89989	−42300
66667	0	33333	11794	− 93333	−33024	101595	−39046
66667	0	33333	10168	−106667	−32536	112250	−35540
66667	0	33333	8765	−120000	−31554	121997	−31974
66667	0	33333	7556	−133333	−30224	130883	−28433
66667	0	33333	6514	−146667	−28661	138960	−24977
66667	0	33333	5615	−160000	−26954	146283	−21650
66667	0	33333	4841	−173333	−25173	152905	−18483
66667	0	33333	4173	−186667	−23370	158881	−15494
66667	0	33333	3598	−200000	−21585	164263	−12695
0	0	0	0	−200000	−18608	167240	−8229
0	0	0	0	−200000	−16041	169807	−4379
0	0	0	0	−200000	−13829	172020	−1060
0	0	0	0	−200000	−11921	173927	1801
0	0	0	0	−200000	−10277	175571	4268
0	0	0	0	−200000	−8860	176989	6394
0	0	0	0	−200000	−7638	178211	8227

Present Value of Tax Benefit 185,849

- The credit is eliminated for buildings under 30 years old except that the old 10% credit will apply to buildings which would have qualified for the old credit if physical work begins before January 1, 1982.
- The 60-month rapid amortization of rehabilitation expenditures of historic buildings is repealed for most purposes (new ACRS recovery rules will still provide fairly rapid cost recovery).

There are special limits on some categories of the credit. For buildings other than certified historic structures, the basis for sale or depreciation is reduced by the amount of the credit. The 20% and 25% credits are allowed only if the taxpayer elects straight line depreciation for the rehabilitation expenditures. (As pointed out above, many taxpayers would be better off with straight-line depreciation anyway.) In all credit categories, a building will be considered substantially rehabilitated only if the expenditures during the two years ending on the last day of the taxable year exceed the greater of $5,000 or the adjusted basis of the property without regard to the rehabilitation expenditures.

The interaction of ACRS and the rehabilitation credit is illustrated by the following example:

> In 1981 taxpayer purchases a nonresidential building that is 50 years old for $1,000,000, on which he elects 15-year straight line depreciation. Beginning January 1, 1982, taxpayer begins restoration, expends $2,000,000, and places the improvements in service in January, 1983. Assuming 75% or more of the existing external walls are retained in place, taxpayer will be entitled to a credit in 1983 of $400,000 ($2,000,000 × 20%).
>
> The $400,000 credit would reduce the $2,000,000 basis of the rehabilitation improvement. When such improvement is placed in service, taxpayer would begin straight line depreciation of the remaining $1.6 million over 15 years.

Rehabilitation of older buildings is likely to become a flourishing tax shelter in the future. A huge front-end credit of as much as 25% of rehabilitation costs, coupled with a 15-year depreciable life on both the building and the rehabilitation expenditures, will generate substantial savings in the early years of a shelter. In the example above, the depreciation deduction on the building would be $66,667 in each year beginning in 1981. The depreciation deduction in 1983 on the rehabilitation expenditures (reduced by the $400,000 credit) would be $106,667 for a total depreciation deduction in that year of $173,334. The tax savings of a taxpayer subject to a 50% marginal tax rate would thus be $33,333 in 1981 and 1982, and $486,667 in 1983. Under present law, assuming a 40-year life, depreciation at 150% declining balance, and application of the 15% minimum tax on preference income, the tax savings would only be $18,750 in 1981, $18,046 in 1982, and $254,870 in 1983. Over three years the tax savings over and above that realized under present law is more than $260,000.

The changes produced by ACRS are so substantial that even experienced investors in real estate will need to consider carefully any new investments or they may find themselves over-sheltered. Since the changes apply to real property placed in service after December 31, 1980, some taxpayers may find the new rules applicable to investments that have already been made. In such cases new income tax forecasts should be made. Special attention should be paid to two types of taxes that will take on added significance in the future—the 15% "add-on" minimum tax on preference income and, in the case of non-corporate taxpayers, the alternative minimum tax.

If the increased depreciation deductions and credits generated by ACRS produce too much shelter, taxpayers should prepare themselves for advice that may seem incongruous with the fact that tax rates will be dropping in the future—accelerate income and postpone deductions.

Extension of "At Risk" Rules to Investment Tax Credit

Under existing law, certain taxpayers—individuals, trusts, estates, subchapter S corporations, and some closely-held corporations—are limited in the deduction of losses incurred in most activities (other than real estate) to the amount they have "at risk" in the activity. Generally, a taxpayer is "at risk" for borrowed amounts unless:

1. The taxpayer is not personally liable for repayments (non-recourse financing),
2. The lender has an interest in the activity other than as a creditor, or
3. The lender is related to the borrower.

To combat the increased use of tax shelters promoting front-end tax credits, Congress has extended the applicability of these rules. For property placed in service after February 18, 1981, the investment tax credit will be allowed only to the extent the taxpayer is "at risk" in the basis of the property at the end of the taxable year.

Assume, for example, that taxpayer purchases a $10,000 computer for use in his oil and gas exploration business and borrows $5,000 from his father to help pay for the machine. Since amounts borrowed from related parties are not considered "at risk", the taxpayer would only be entitled to investment credit on his $5,000 equity investment. Taxpayers who use non-recourse financing to acquire property eligible for the investment tax credit are also subject to the limitation on allowance of the credit. An exception exists, however, for amounts borrowed from "qualified lenders," including federal, state, and local governments, banks and other lending institutions, and unrelated persons engaged in the business of lending money. In order for this exception to apply, the taxpayer must have a minimum "at risk" investment of 20% of the basis of the property. If the taxpayer meets this requirement at all times during the taxable year, then all debt with respect to the property from qualified lenders will be considered as "at risk" even though the taxpayer has no personal liability for the amounts borrowed.

Assume taxpayer purchases equipment for $100,000 of which $70,000 is non-recourse financing from a bank, $10,000 is borrowed from the taxpayer's father, and $20,000 is cash paid by the taxpayer. Since the taxpayer is "at risk" to the extent of 20% of the $100,000 basis ($20,000 cash), he will also be considered as at risk for any amount borrowed from qualified lenders with respect to the property—i.e., the $70,000 borrowed from the bank. Consequently, the taxpayer would be entitled to ITC on $90,000 (the money borrowed from the taxpayer's father is still not at risk).

If you are engaged in activities to which the "at risk" rules apply, you should examine any acquisitions of property eligible for ITC that have been made since February 18, 1981. It is too late to meet the qualified lender exception for 1981, if you find that you are "at risk" for an amount that is less than 20% of the basis of the property, because the 20% requirement with respect to the property must have been maintained at *all* times during the year. You still have until the end of the year, however, to increase your amount "at risk" for purposes of the general rule. If you have non-recourse financing from qualified lenders, you should consider personal guarantees of the loan proceeds. Recourse or non-recourse loans from related parties should, if possible, be replaced with recourse loans from qualified lenders. If you meet the 20% "at risk" amount but have a non-recourse note from a related party, a simple switch to an unrelated lender by year end will bring the entire amount "at risk."

If your taxable year has already closed, or you are unable or unwilling to adjust your financing this year, don't be too disheartened. As the amount at risk with respect to the property increases in future years, you will be treated as having made additional qualified investments on which ITC can be claimed. Your "at risk" amount will increase, for example, as you pay down the principal on a loan from a related party or on a non-recourse loan to which the exception does not apply. Once the amount at risk equals 20% of the basis, then the qualified lender exception would become applicable in the succeeding taxable year.

Caution—just as increases in amounts "at risk" result in ITC, decreases in amounts "at risk" are treated as dispositions on which ITC may be recaptured.

PROVISIONS FOR PRIVATE COMPANIES AND THE SMALLER BUSINESS

Points for Consideration:

1. ***Some advantage might be gained from shifting income and deductions to take advantage of lower corporate rates in 1982 and 1983.***
2. ***Accumulated earnings tax avoidance may be eased for many, except professionals practicing through professional corporations.***
3. ***New rules for subchapter S corporations, electing to "pass through" earnings to shareholders, may make this corporate form appropriate for your business, especially given changes in individual tax rates. But, it is no panacea.***
4. ***New, simpler rules for LIFO inventory costing require scrutiny over the coming months.***

There are a number of decision points described throughout this booklet which apply to small businesses and those who own them. Important subject areas you should review in detail are:

- General rate reductions for individuals
- "Marriage penalty" relief and retirement savings liberalization—particularly as they relate to the involvement of a spouse in the business
- ACRS rules, particularly
  - — application of rules to purchases after December 31, 1980, no matter what the tax year
  - — adverse effect on the safe harbor in the so-called "hobby loss" provision (a problem if the small business is not the taxpayer's only work)
  - — expensing immediately a small amount of investment in equipment ($10,000 per year when fully effective)
- Estate and gift tax changes—easing the splitting of income among family members or the transfer of a family business to younger generations
- Interest rate adjustments—more frequent adjustments of interest rates to 100 percent of prime may make underpayment of estimated taxes less desirable

In addition, there are a few areas of the new law specifically described as "small business" provisions which may require some decision making.

Corporate Rate Reductions

Over the next two years the tax rates for the $25,000-and-under and $25,000-to-$50,000 corporation tax brackets will drop one percentage point per year. Thus, for businesses with total taxable income below $50,000 there will be some advantage to accelerating deductions and deferring income wherever possible for 1981 and 1982 tax years. (Note, in contrast to individual taxpayers, corporations have no separate cut in the tax rate for capital gains, and their maximum capital gain tax remains at 28 percent though the individual rate is now no more than 20 percent.)

The structure of the corporate tax brackets presents a real danger, however, that such a deferral-acceleration strategy will backfire. If income is deferred to a later year when other earnings exceed $50,000, the tax paid on the deferred income will be much higher. Thus, this strategy probably is worth the risk only if taxable income is well below $50,000. In most cases, corporations will simply have up to $500 more in 1982 and $1,000 more in 1983 to spend in other ways.

Accumulated Earnings Tax

The amount of earnings which can be accumulated in a corporation without demonstrating that they are "for the reasonable needs of the business" has been increased for most taxpayers from $150,000 to $250,000. No action is necessary to get the extra "breathing room" this change provides before a plan to avoid this tax must be implemented.

Professionals providing services through a professional corporation, however, generally do not share in this inflation adjustment. The new law specifically leaves most professional corporations with the existing $150,000 limit at a time when inflation demands increased working capital.

Subchapter S Election

The 1981 Act introduces increased flexibility into the provisions for "passing through" corporate earnings to shareholders, using what is referred to as the "subchapter S election." Any business which has not used the corporate form or has not elected subchapter S status because of the number or type of owners should re-examine that decision. The maximum number of shareholders for an electing corporation is raised from 15 to 25 and simple, single-beneficiary trusts are made eligible to be shareholders.

The changes make the subchapter S corporation much more useful for personal financial and estate planning and could allow the administrative consolidation of various subchapter S corporation investments. The increase in the maximum number of shareholders, for instance, would allow lifetime gifts of stock to children and grandchildren in all but the largest families. If maintenance of control or a relative's incapacity is a concern, distributions of stock can now be made to simple trusts rather than to the beneficiaries directly.

In the months ahead you may hear that these changes will make subchapter S corporations the preferred form for business operations in the future. We would caution you that while the changes indeed should lead to wider use of the subchapter S election, the choice is not automatic. For instance, compare the corporation tax rates on business income with the individual tax rates applicable to unincorporated or subchapter S businesses. At first glance, the top corporate rate on an additional dollar of income of 46 percent would seem preferable to the top individual rate of 50 percent. Most will be willing to pay the extra four percentage points, however, to avoid "double taxation" (once on corporate income and again on shareholders' dividend income).

However, the analysis does not necessarily involve comparing only the top rates. Consider the following example:

> Assume a business expects to show taxable income for 1984 of $100,000 of which the owner-president will draw out $50,000 (which is reasonable compensation for his services). The $50,000 balance will be retained in the business as additional operating capital. Taxes would be payable as follows:

Business in Corporate Form	**Income**	**Tax**
Corporate taxable income ($100,000 less $50,000 deductible salary)	$50,000	$ 8,250
President's taxable income* ..	50,000	11,368
Total Taxes		$19,618

Business in Proprietorship or Subchapter S Form	**Income**	**Tax**
Corporate taxable income ...	—0—	
President-shareholder's taxable income*	$100,000	$32,400

*Married filing jointly, ignoring other income and personal deductions for simplicity.

As you can see in this oversimplified example, the overall tax rate in the pure corporate business is about 20 percent compared to about 32 percent where all income passes through to the owner. (The aftertax corporate retained income could also be subject to a capital gain tax if the corporation is liquidated prior to the owner's death, and the present value of that potential tax may make the comparison narrower.) Considering this example, statutory rules restricting the use of the subchapter S election for short-term advantage, and the fact that subchapter S retirement benefits are more restricted than those payable by regular corporations, you can appreciate the need to consider all of the facts and circumstances before electing or rejecting subchapter S status. And, if subchapter S is finally elected, remember that eternal vigilance is the price of success. There are a large number of tax traps awaiting the unwary in this area.

LIFO Inventory

In the current inflationary economy, the "Last-In-First-Out" (LIFO) method of costing inventory can save taxpayers significant amounts of tax. The new law has three provisions designed to make this complex method easier to deal with for small concerns. Depending on how they are implemented by the IRS, these could make the changeover to LIFO worthwhile for many more businesses.

The impact of a change to LIFO is softened by providing that any additions to income arising from converting inventories to full cost valuation may be spread over three years. Potential tax benefits would be increased by allowing a single inventory "pool" for each trade or business of a taxpayer whose average annual gross receipts are $2 million or less. The cost of calculating LIFO is reduced by requiring the IRS to allow published indexes to be used.

This last point simply gives Congressional impetus to regulations currently being written by the IRS. As Touche Ross noted in comments submitted to the IRS earlier this year, the present proposed regulations may not give some small businesses a realistic opportunity to use a published index. Without the index, the other changes are of little use. Consequently, a final decision as to whether a change to LIFO inventory accounting is warranted by the liberalizations set forth in the new law will depend, for some taxpayers, on further developments.

INCENTIVE STOCK OPTIONS

Points for Consideration:

1. ***Employers will have to decide whether they can, or should, amend present option plans—or individual, unexercised options—to convert them to the new incentive option format.***
2. ***For high bracket individuals, incentive options can produce substantially better tax results than nonqualified options alone.***
3. ***Limit of $100,000 value of stock which can be granted annually to an employee will diminish option incentive for some in top management. Alternatives still exist for these individuals, such as nonqualified options with stock appreciation rights.***
4. ***Some employees who exercised old "qualified" options in 1981, before they expired May 21, might—without detriment to their employers—avoid tax preference problems on those shares and be eligible for the shorter holding period of incentive options. Some 1981 exercisers of nonqualified options (before August 13) may be able to avoid ordinary income treatment from their exercise.***

The 1981 Act reinstates the favorable tax treatment accorded "qualified" options in a new, more liberal form. Many have seen these as an important incentive device for corporations to attract new management and retain the service of key executives by giving them the opportunity to share in the success of a business.

Incentive stock options will be taxed similarly to the old restricted and qualified stock options. There will be no tax to the employee when such an option is granted or exercised. If holding period requirements are met (the stock cannot be sold within two years of the grant of the option and the stock itself must be held for at least one year), the gain will be taxed as long-term capital gain. The employer gets no deduction. If holding period rules are *not* met, but other requirements are met, the gain upon sale will be taxed as ordinary income rather than capital gain with an offsetting deduction to the employer at that time. The bargain element in an incentive stock option on the date of exercise is *not* a preference item subject to the add-on 15% minimum tax.

To qualify for incentive option treatment, certain conditions must be satisfied. Generally, they are similar to those for the old qualified or restricted options, with differences highlighted below.

- The option must be exercised within 10 years from the date of grant (5 years for a 10% shareholder).
- The option price must equal or exceed the fair market value of the stock at the time of its grant (110% for a 10% shareholder).
- Stock covered by options granted after December 31, 1980 cannot exceed $100,000 (fair market value at date of grant) for any calendar year per employee.

Options granted after 1975 and outstanding on August 13, 1981 (or plans granting such options) may be changed by August 13, 1982 to conform to the new incentive stock option rules. The modification will not be considered as issuing a new option, so that the price will not have to equal the fair market value at the date of the modification but only the value at date of original grant. Also, for each employee no more than $50,000 in value of stock covered by modified options granted in each prior calendar year may become incentive options, with a limit of $200,000 for all prior years.

These transition rules present some interesting planning possibilities. The favorable rules allowing amendment of plans without adverse tax consequences apply only to options not *exercised* by August 13, 1981. But, what about those which were exercised in 1981 before that date?

Under the old qualified option rules, May 20, 1981 was the last exercise date for obtaining preferred tax treatment. However, a corporation could elect, before the end of 1981, to have incentive option rules apply to those exercised qualified options, *if* the qualified plan met the same tests as for the new incentive option (see highlights of differences, above). For those plans which meet the tests, making the election costs the employer nothing—it gets no tax deduction under either type of plan—but it would permit the employee to avoid reporting tax preference income for 1981 on the exercise (which has both minimum tax and maximum tax connotations), and would allow a shorter holding period before sale.

If the qualified plan does not, on its face, meet the incentive plan rules—and that may well be the case for many or most—the discussion, following, as to nonqualified plans would be applicable.

Nonqualified plans or options may also be amended to acquire incentive option status. However, except by rarest coincidence, their terms will likely not meet incentive option standards without formal amendment.

Under such circumstances, with respect to options exercised between January 1 and August 13, 1981, amendment of the plan will be treated as the granting of a new option at the date of amendment.

The significance of this point is that the original grant price, at which the option is exercised earlier in 1981, must now be tested against the fair market value of the stock at the date of amendment. If the amendment date value is higher, then the exercised option cannot be taxed as an incentive option (even though the plan is amended), but will remain subject to the nonqualified option rules. If, however, the value at date of amendment is the same or lower than the original grant date value, there is at least an argument to be made that the incentive option rules should apply, and no ordinary income be reported for 1981. The corporation, on the other hand, will give up its deduction.

One non-tax question that permeates the issue of exercised options relates to the corporation's later amendment of a plan applying to shares already purchased. An option grant is an executory contract whose thrust goes to the terms under which stock may be acquired by an employee. Certainly, it is contemplated that those terms may be changed on a prospective basis before exercise. However, once the stock has actually been purchased, may a later change in the plan (dealing with further prospective purchases) have a retroactive effect on prior exercises? The IRS may wish to be heard from on this subject at some point in the future, but since the effective date language of this part of the Act makes the incentive option rules available for options "exercised on or after January 1, 1981, or outstanding on such date," potentially affected employers and employees may wish to consider carefully amending their plans.

The new options have several comparative advantages and disadvantages:

- The taxation of gain on incentive stock as capital gain produces a significant tax saving to the employee compared with a nonqualified option.

Example: Assume an executive earns $100,000 in salary:

	Stock Value
1981 grant of option	$30,000
1982 exercise	60,000
1983 sale	70,000

Net proceeds to the executive can be calculated as follows:

	Nonqualified Option	Incentive Option
Income at grant	-0-	-0-
Income at exercise	$30,000	-0-
Tax (50% maximum)	15,000	
Net	$15,000	
Proceeds on sale	$70,000	$70,000
Less basis	60,000	30,000
	$10,000	$40,000
Tax (20% effective rate)	2,000	8,000
After-tax gain	$ 8,000	$32,000
Net cash to employee	$23,000	$32,000

- The optionee's employer receives no deduction for the incentive stock option. For a corporation in the 46% maximum bracket, for instance, this results in additional tax of $13,800 in the example just above.
- Incentive stock can be sold as early as two years from the date an option is granted, but this is two years longer than shares received under a nonqualified option need be held. Also, incentive options must be exercised in order of grant.
- Because options for no more than $100,000 of stock ($50,000 for certain existing grants) may be granted in any one year, incentive options may not be very useful for some top corporate executives.
- However, other alternatives exist and should be considered carefully with respect to any compensation planning. While the example shown above compares an employee's position between nonqualified and incentive options, had the nonqualified option been granted in tandem with a stock appreciation right (SAR), the net cash to the employee on ultimate sale of the stock would have been $38,000, an 18.8% better result than using an incentive option.

The trade-off to the corporation could have been minor: It would receive net cash of $27,600 under the SAR plan, and $30,000 under the incentive option plan, if it were in the top corporate tax bracket. At lower brackets, the corporation may well prefer the incentive option route. Further, the SAR-nonqualified option carries a charge to reported earnings that may well not be the case for the incentive option.

- Incentive options provide more flexibility than the old qualified options, but they still can not provide the flexibility in option price, option period, or freedom to exercise or to sell, which nonqualified options provide.
- The new incentive options may be exercised in exchange for existing stock of the corporation. This stock may have been received by purchase, under a prior incentive option, or (we believe) from exercise of a nonqualified option.

CHARITABLE FUNDRAISING PROBLEMS

Points for Consideration:

1. ***While none of the sections of the 1981 Act has a major, specific effect on charitable giving, a combination of changes will require fundraisers to rethink intermediate and long-term strategies.***
2. ***The unlimited estate tax marital deduction for the first spouse to die may place more emphasis on seeking charitable bequests from surviving spouses.***
3. ***For most high-bracket individual taxpayers, the cut in top income tax rates to 50% should not have as dampening an effect on contributions as might intuitively be thought.***

Executives concerned with fund-raising activities of charitable organizations will have to consider the impact of several sections of the Act.

Changes promoting charitable giving are:

- A new deduction for charitable contributions by individuals whether or not they itemize deductions.
- An increase in the corporate limit for charitable contribution deductions to 10% of taxable income from 5%.

As discussed elsewhere, the "above-the-line" treatment for charitable contributions by individuals is gradually phased in beginning January 1, 1982, with a maximum deduction in 1982 and 1983 of only $25. The corporate change is effective for tax years beginning after December 31, 1981. Thus, neither provision will have any effect before 1982.

Changes potentially dampening charitable giving are:

- The top individual income tax bracket reduction from 70% to 50%.
- The top estate and gift tax bracket reduction of from 70% to 50%, phased in over several years.
- A gradual increase in estate and gift tax credits to eventually give an exemption equivalent of $600,000.
- An unlimited gift and estate tax deduction for transfers to a spouse.
- A reduction in corporate taxable income from the Accelerated Cost

Recovery System, which in turn may reduce the allowable amount of charitable contributions.

The unlimited marital deduction will have the effect only of delaying the usefulness of charitable remainder trusts or outright gifts from a person's estate. The first spouse to die has no tax incentive to make an estate-reducing gift, but the survivor usually will face taxation on the entire combined estates of the spouses. Thus, the focus of estate-oriented giving may have to shift to surviving spouses. In fact, charitable organizations might wish to become more involved as trustees for some of the new types of marital trusts permitted by the 1981 Act, in which the surviving spouse is income beneficiary, and the charity is remainderman.

The reduction in income tax rates also is not as drastic a disincentive as it might at first seem. High-bracket taxpayers who receive the bulk of their income as salary or other compensation already receive only a 50% tax benefit on most of their charitable contributions. Under the maximum tax rules for earned incomes, itemized deductions must be allocated between earned and unearned income, so the charitable deduction from unearned income in the 70% bracket is the percentage of the contribution that unearned income bears to total income. If unearned income has been largely sheltered, little (if any) of the charitable deduction has been at more than a 50% rate in the past—and this should continue in the future.

For those, however, with high proportions of unearned income for 1981, taxed at over 50%, see discussion on page 7 for the beneficial use of a charitable lead trust set up before the end of 1981.

Charities must also focus on the fact that most of the changes mentioned do not occur immediately and with full effect. The reduction of the maximum individual rate to 50%, for instance, does not occur until January 1, 1982, and even then will not relieve the largest donors from tax. Fund-raising drives during the remainder of 1981 will certainly want to emphasize the "last chance" opportunity to obtain a deduction at 70 cents on the dollar.

In general, it is obvious that those responsible for planning solicitation campaigns must take the new law into account. A major part of their strategy, however, may best be aimed at dispelling vague notions that charitable giving no longer pays off in tax savings. There is an indirect point, too, that the major reductions in income and estate tax should result in increased net worth, some of which could well be considered for transfer to educational and charitable organizations, even at higher after-tax costs.

RESEARCH AND EXPERIMENTATION

Points for Consideration:

1. ***Does your business generate new U.S.-based research? The costs may qualify for a new tax credit.***
2. ***The new R & E credit rules contain "anti-shelter" provisions that may require restructuring of offerings if the credit is to be obtained.***
3. ***A temporary, 2-year rule can increase allocation of R & E deductions to U.S. source income, boosting utilization of foreign tax credits for those with overseas operations.***

Congress has been concerned about the decline in research and development activities, and the accompanying adverse effect on economic growth, productivity, and our competitiveness in world markets. In an effort to stimulate research and experimentation, a 25% nonrefundable credit is provided on incremental research expenditures above the average in a base period (generally, the preceding three years).

The definition of "qualifying research expenditures" is similar to that used in the past for current expensing or 60-month amortization, but remains somewhat narrower. Qualifying expenditures will include certain in-house costs plus 65% of contract research (performed by a university or a research firm), and 65% of corporate grants for basic research to be performed by universities and certain scientific research organizations. For all types of research, the new rules are designed to exclude "overhead" expenditures from the base for computing the credit. Qualifying research expenditures also do not include (1) research conducted outside the U.S., (2) research in the social sciences or humanities, and (3) research funded by any grant or contract with another person or any governmental entity.

The credit is available on qualifying research paid or incurred after June 30, 1981 and before January 1, 1986.

Although tax benefits would be only one factor among many in deciding on in-house versus contract research, the 65% allowance for contracts could have a bearing on the decision. For instance, if in-house qualifying costs would be below 65% of the proposed research expenditures, a larger credit would be generated using a contract arrangement.

The new law is designed to deny the credit to many of the R & D limited partnerships which have been formed in the past few years. As a further deterrent to R & D shelters, the credit can only be used by partners, subchapter S shareholders, etc. as an offset against tax on income only from the particular entity generating the credit. Even though the credit can be carried forward, it can not be used *until* and *unless* the R & D resulted in income generating sufficient tax to offset the credit.

Foreign Tax Credit Utilization Temporarily Eased to Aid U.S.-Based Research

Current Treasury regulations generally require an allocation or apportionment of research and development expenditures to worldwide income, thereby reducing foreign-source income and the allowable foreign tax credit. As a further inducement to increase research and experimentation, for the two tax years beginning after August 13, 1981, all research and experimental expenditures (as defined in the old law) *conducted in the U.S.* shall be allocated or apportioned to income from sources within the U.S. Companies with substantial U.S. research and experimental expenditures will find the utilization of foreign tax credits much easier for the next two years. Further, those performing research abroad may find this provision an incentive to shift that work to the U.S.

TARGETED JOBS TAX CREDIT

Points for Consideration:

1. ***Retroactive certification only allowed for employees hired between June 29, 1981 and September 26, 1981.***
2. ***Beginning September 26, 1981, employees must be certified or certification must be requested by the date they begin work, or no credit is allowed. Thus, job credit eligibility is no longer an issue for consideration on the first day of work; it must be dealt with as part of the hiring process.***

The Targeted Jobs Tax Credit, which can be worth up to $4,500 per certified employee, was enacted in 1978 to encourage employers to hire certain economically disadvantaged job seekers. To accomplish this objective, employers hiring eligible employees are allowed a credit based on wages paid to them during the first two years of employment. The credit, which was set to expire at the end of 1981, has been extended an additional year so that it will be available on wages paid to targeted employees who begin work before Janury 1, 1983. Additionally, the targeted group has been expanded (certain WIN and CETA employees are now eligible) and several technical changes have been made to simplify the structure and administration of the credit program.

To correct a perceived abuse in the administration of the program, Congress has acted to deny the opportunity to employers to certify employees retroactively as eligible for the credit. To ensure that the credit is allowed only to those employers who hire members of the targeted group in order to receive the credit (and not to employers who discover the existence of the credit only after such employees have been hired) the law now provides time limits for certification which must be satisfied if the credit is to be allowed. In general, employers cannot claim the credit on wages paid to a member of the targeted group unless the employee was certified before he began work or a written request for certification had been made to the appropriate agency before that date.

There are two exceptions to the above rule denying retroactive certification. Generally, for eligible employees who began work before June 29, 1981, the employer may claim the credit if certification was obtained or requested by July 23, 1981. (As a practical matter, this rule effectively precludes employers from claiming the credit on wages paid to most employees who began work before enactment of the new law—perhaps an inequitable result.) The second exception applies to those employees who began work between June 28 and September 26, 1981. As long as certification is obtained or requested by September 26, 1981, the employer will be entitled to the credit.

Note: Some employees whom you don't expect to be may be certifiable. Newly employed college graduates, for instance, may be eligible if they have subsisted mainly on loans and not received more than 50% of their support from their families.

ENERGY PROVISIONS

Points for Consideration:

1. ***Carve out royalty interest before a property is "proven" to preserve Windfall Profit Tax credit and exemption.***
2. ***Before assuming that stripper properties are exempt from the Windfall Profit Tax, always review title records back to July 21, 1981.***

Windfall Profit Tax on Newly Discovered Oil Reduced

The Windfall Profit Tax (WPT) rate applicable to newly discovered oil will be reduced as follows:

1982	27½%
1983	25%
1984	22½%
1985	20%
1986 and thereafter	15%

Stripper Oil Exempt after 1982

Independent producers' qualified stripper oil will not be subject to the Windfall Profit Tax after December 31, 1982. Nor need a producer reduce his 1,000 barrels a day qualifying for lower independent-producer Windfall Profit Tax rates by the amount of stripper oil subject to the exemption.

Importantly, however, if at any time after July 21, 1981, a property is owned by a person other than an independent producer, oil produced from the property will never qualify for the stripper exemption, even if subsequently transferred to an independent producer. For those investors or producers seeking the exemption before "sunset" of the WPT, title search may be almost as important as when buying a new home.

Royalty Owners

The limited tax credit that was made available to qualified royalty owners subject to the Windfall Profit Tax for 1980 has been increased from

$1,000 to $2,500 for 1981. In 1982, 1983, and 1984 there will be no Windfall Profit Tax levied on royalties from the first two barrels of qualified daily production. In 1985 and thereafter, the exemption will be extended to royalties from three barrels of qualified daily production.

Withholding rules have been changed to allow the royalty owner benefit of the credit as the oil is removed. The credit may also be taken into account in determining estimated tax payments required of qualified royalty owners.

Note: the royalty exemption does not apply to working interests. And, to avoid carving out additional royalty interests for purposes of obtaining the exemption, no royalty interest will qualify for the increased credit if it is created after June 9, 1981, out of a proven operating interest. However, a royalty or similar interest created after June 9, 1981, from unproven property or pursuant to a binding contract entered into prior to June 10, 1981, will qualify. Any transfer after June 9, 1981, of a qualified royalty interest in a proven property that would result in that property's being ineligible for percentage depletion will also disqualify the royalty interest from the Windfall Profit Tax credit or exemption.

The 1981 Act: Administrative Aspects

ADMINISTRATIVE PROVISIONS

Points for Consideration:

1. ***Acceleration of estimated tax payments by large corporations requires more sophisticated planning of quarterly estimates.***
2. ***New rules for determining interest on deficiencies and refunds will make taxpayers more wary of "borrowing" from Uncle Sam, and will give much stronger impetus to the proper planning of estimated tax payments.***
3. ***New penalty raises the stakes in "aggressively" valuing property to yield higher income tax deductions or lower capital gains. Competent valuation analyses become even more important.***
4. ***Increase in negligence penalty places premium on reliance on advice of a qualified professional tax adviser.***

Estimated Tax Payments by Large Corporations

An obscure section of the new law aptly entitled "Cash Management" seeks to improve the government's cash flow at the expense of large corporations (those whose taxable income exceeded $1,000,000 in any of the prior three years).

Corporations must make quarterly estimated tax payments totalling at least 80% of the tax due for the year, or face penalties for underpayment. No penalty is imposed, however if the amount paid is equal to or greater than:

(1) The prior year's tax;
(2) A tax at current rates based on facts shown on the prior year's return; or
(3) The tax payable on the amount determined by "annualizing" the year's taxable income up to the payment date.

Last December, however, Congress provided that exceptions (1) and (2) above could only be used so long as they resulted in payment of 60% or more of the actual tax for the current year.

To illustrate, assume a large corporation had a tax of $500,000 in 1980 and $900,000 in 1981. Under the general rule, $720,000 of estimated taxes should be paid during 1981. Before the December, 1980 amendment, however, a penalty could have been avoided under exception (1) above, by paying the prior year's tax of $500,000. After December, 1980 this exception could not be used because it would not yield 60% of 1981 tax; i.e., $540,000.

As if last December's changes were not enough, the 1981 Act progressively pushes the 60% limitation upward toward complete elimination of exceptions (1) and (2) beginning in 1984. And, a separate provision of the new law (discussed in the next section) provides for adjustment of nondeductible underpayment penalties annually to 100% of prime. Thus, the cost of underpayment could increase dramatically based on current prime rates. These points, taken together, put a premium on estimated tax planning for large corporations.

There are still many approaches worth considering which can minimize estimated payments. For instance, large corporations in seasonal or cyclical industries may find exception (3) very useful if most income is received late in the year. If a large corporation normally has peak income early in the year, part of the advantage from exception (3) might be gained by changing the corporation's tax year—at least, it's worth looking into.

Interest on Tax Deficiencies and Refunds

After relying on underpayment of taxes as a form of financing for years, taxpayers will now find borrowing from Uncle Sam much more costly. Under the old formula, the interest rate on tax deficiencies and refunds was set at 90% of prime and adjusted only every two years. More often than not this formula yielded rates well below those in the commercial market. Under the new law, the rate will be adjusted each January 1 to 100% of the prime posted during the previous September. (For 1982 only, the adjustment will be effective February 1.)

Based on this formula, next year's interest rate on deficiencies—and refunds—could well go to 20% or so from its current 12% level. In addition, if interest rates fall in late 1981 or early 1982 as predicted by the Administration, the interest rate for deficiencies and refunds could significantly exceed commercial rates.

Because the interest rate on tax deficiencies and overpayments is also the penalty rate for underpayment of estimated tax, the expected increase in the rate will make failure to pay quarterly estimates of income tax much more costly—both for individuals and corporations (for a 50% taxpayer, a 20% underpayment penalty is the equivalent of a 40% annual interest cost).

At the same time, two of the exceptions to the penalty are virtually eliminated for large corporations by another provision of the new law. See the preceding section.

How Much Did You Say That Property is Worth?

Expressing its concern over 500,000 pending tax disputes ($2.5 billion in tax) involving questions of property valuation, Congress has provided a new penalty for valuation overstatements. (There is at least some legislative recognition here that the tendency to overvalue is partly attributable to the settlement technique of "splitting the difference" between the valuation claimed by the taxpayer and by a revenue agent.)

A 10% penalty will be assessed on *income* tax deficiencies (not estate or gift tax) of $1,000 or more to the extent the deficiency is attributable to a valuation overstatement in which the valuation or adjusted basis claimed on a return is 150% or more of the correct amount. The arithmetic, if misleading, is important. While the overvaluation must be 50% in excess of "true" value, this is the same as reducing a claimed valuation by only 33% before the penalty can apply.

If the overvaluation is more than 200% (50% reduction in claimed value), the penalty is 20%; if more than 250% (60% reduction), the penalty is 30%.

The penalty will only be applied if the taxpayer incurring the deficiency is an individual, a closely-held corporation, or a personal service corporation. Valuation overstatements will not result in penalty if the underlying property has been held for more than five years.

The penalty may be imposed on tax returns filed after December 31, 1981; e.g., deductions claimed on a 1981 calendar year return filed in 1982 will be subject to the penalty.

The penalty is obviously aimed at those tax shelters resulting in investment credit, depreciation, or other deductions on inflated property values; e.g., bibles, lithographs, etc. There are, however, other forms of tax planning apparently subject to the overvaluation penalty:

1. An individual donates an art object, acquired within the past five years, to a museum and claims a charitable contribution of $50,000. A contribution of $30,000 is ultimately allowed and a tax deficiency of $20,000 results. The amount claimed is 167% of the amount allowed so a 10% penalty of $1,000 would be assessed.
2. Depreciable property is acquired from a decedent by a surviving spouse, and an estate tax valuation of $200,000 is used. No estate

tax is due because of the new unlimited marital deduction (see discussion elsewhere), so there is no pressure on the estate to report a low value. A five-year life is used under new ACRS rules. On examination, IRS claims the property value is overstated and ultimately the settlement is $125,000. If the depreciation adjustment resulted in a tax deficiency of $1,000 or more, a 10% penalty would result. Query—if the couple has owned the property in joint tenancy or as community property for more than five years, could the surviving spouse avoid the penalty by claiming to have owned the property for more than five years even though benefitting from the step-up in basis at death?

Obviously, taxpayers will have to consider more carefully how well a valuation claim can be substantiated. It is increasingly important to have a competent valuation analysis performed concurrently with any transaction which will ultimately give rise to tax deductions or credits.

Upon examination by the IRS, taxpayers should consider any proposed compromise with the overvaluation penalty in mind. Yielding only a few extra dollars in a revenue agent's favor could bring much higher penalties. Query—will revenue agents now be tempted to assert even lower valuation in an attempt to ensure that the ultimate settlement will be low enough to trigger this extra penalty?

There is one interesting historical footnote to these provisions. They were included in the House Ways and Means Committee bill because that bill did not adopt the ACRS provisions extending the at risk rules to the investment credit (which accomplish somewhat the same end by providing a substantial disincentive to shelters where the investment credit is taken on what may be perceived as inflated values). However, in a true spirit of compromise, the final Act contains both anti-abuse approaches.

Negligence Penalty Stiffened

Congress and the Internal Revenue Service have expressed concern about taxpayers taking questionable positions on returns in the hope that the "audit lottery" will result in the position not being challenged by the IRS.

There is an existing penalty of 5% of the entire underpayment on a return if any part of the underpayment is due to negligent or intentional disregard of rules or regulations. The 1981 Act augments this penalty by imposing an additional penalty equal to 50% of the interest on that portion of any underpayment which is attributable to negligent or intentional disregard of rules or regulations. And, the dollars can be significant: if interest on deficiencies goes to a 20% annual rate in 1982 (see discussion above)—the nondeductible penalty on the "negligent" part of the deficiency would be 10%.

It should be noted that courts have tended not to find negligence on the part of taxpayers who have consulted competent tax advisers. The desirability of obtaining opinions on tax aspects of transactions is, therefore, considerably enhanced.

Information Return Penalties

Those required to file information returns (Forms 1099 and W-2 in most cases) will now have a much greater incentive to do so. For instance, payers of dividends or interest are required to file a Form 1099 to report any payments totalling $10 or more during the year for any reason. Penalties for failure to file these and other information returns are increased from $1 to $10 per return, to a maximum of $25,000, so the penalties could now almost equal the payments in many cases.

Paperwork Simplification and Estimated Tax Payments

Prior law required individuals to pay estimated taxes if their tax liability was expected to exceed withholding tax by $100. Starting in 1982, this threshold amount will be increased $100 per year until it reaches $500 in 1985. This change will reduce the filing burden (or penalty exposure) for many who have made gifts of income-earning property to their children or for others with modest unearned income.

Appendix

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