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America's New Tax Law

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AMERICA'S NEW TAX LAW

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Mr. Monroe, of Uebel, Monroe & Faber, Certified Public Accountants, Cleveland, Ohio, presented the following talk at a dinner meeting of the Cleveland Chapter of ASWA, October 21, 1954.

August 16, 1954 is the date of enactment of the new Internal Revenue Code. The 1954 Code is the first comprehensive revision of the Internal Revenue laws. This revision includes a rearrangement of the provisions to place them in a more logical sequence, the deletion of obsolete material, and an attempt to express the Internal Revenue laws in a more understandable manner. Also, the 1954 Code contains many substantive changes and has codified rules which used to lie outside the statute. Quoting from the House Ways and Means Committee, it is "a bill to remove inequities, and harassment of the taxpayer and to reduce tax barriers to future expansion of production and employment."

Except as specifically provided, the income tax provisions of the new law are effective for the calendar year 1954 and later years. The estate tax provisions are effective with respect to estates of those individuals dying after date of enactment. The gift tax provisions relate to gifts made after December 31, 1954.

There are far too many changes for me to mention them all. This discussion is limited to a few which I think will be of special interest to you.

Filing date—The final return of individuals must be filed on or before April 15 or 15th day of fourth month after taxable year. The date for filing an income tax return in lieu of a final estimated tax return has been extended from January 15 to January 31. Thus, if an income tax return is not filed before February 1, the last day for filing an estimated or an amended tax return is January 15. There has been no change with respect to the due date for filing corporation returns.

INCOME TAX

INDIVIDUAL RETURNS

Pension credit—A credit is provided for retirement income from pensions, annuities, etc., where taxpayer is 65 or over and has received income in excess of $600 in each of any 10 calendar years before taxable year. Credit is equal to 20% of such income up to $1,200. Credit is reduced by retirement income already excluded from gross income and by income in excess of $900 earned by taxpayer under 75. Income received by persons under 65 from public retirement systems is entitled to a credit.

Prizes, awards — Amounts received on "give-away programs" or as awards are taxable to the recipient. An exception is made for awards given in recognition of religious, scientific, literary, etc., achievements where the recipient is selected without any action on his part and where he is not required to render substantial future services as a condition to receiving the prize or award.

Employee meals and lodgings—Meals and lodgings furnished an employee for the convenience of the employer at the place of employment and required to be accepted by the employee are not taxable.

Dividend credit—A 4% dividend received credit is allowed for dividends received after July 31, 1954. Credit is limited to 2% of taxable income in 1954 and 4% thereafter. First $50 is completely excluded. Credit not allowable on dividends of tax exempt corporations.

Accident and health plan benefits—Benefits received from certain employer accident and health plans are excluded from gross income without regard to whether plan is insured. Benefits representing reimbursement for actual medical expenses are wholly excluded. Benefits representing compensation for loss of wages are excluded up to $100 a week, except for first seven (7) days, unless hospitalization is required. Plan need not be qualified.

Premiums paid by employer for group health and accident insurance are exempt.

Employer payments to beneficiaries—The exclusion of $5,000 of payments made by employer to beneficiaries of deceased employee is extended to include payments not made under a contract, and to payments to which employee had (under a qualified stock-bonus, pension or profit-sharing plan) a non-forfeitable right prior to his death.

Annuities—If cost of an annuity to taxpayer will be returned within three (3) years, all receipts are excluded from taxable income until full cost is recovered; thereafter receipts are fully taxable. If cost will not be recovered in three (3) years, receipts are taxed under life expectancy method.

Life expectancy exclusions of present annuitants will be computed by reducing cost of annuity by amounts previously recovered tax-free under the 3% rule.

Dependents—Dependency exemption is a deduction from adjusted gross income.

Exemption may be taken for dependent child under the age of 19 or a full-time student, irrespective of earnings of child if taxpayer contributes more than one-half to support of child.

Where group of taxpayers contribute more than one-half support of dependent, dependency exemption may be assigned to any member of the group who contributes more than 10% of the support.

DEDUCTIONS

Medical—A deduction is allowed for medical expenses in excess of 3% of adjusted gross income. The maximum is increased from $1,250 to $2,500 for each exemption with a total limit of $5,000 for a single return and $10,000 for a joint return, or one filed by the head of a family.

Charitable—An individual may make charitable and other contributions up to 30% of adjusted gross income but the additional 10% is allowable only with respect to contributions to churches, hospitals and educational institutions. This latter limitation does not apply with respect to the first 20%.

Child care—The new law allows to a widow, widower, or a mother whose husband is incapable of self-support because of a mental or physical defect, the amounts actually expended for child care expenses not in excess of $600. The child must be under the age of 12 or be mentally or physically defective. The term "widow" or "widower" includes a divorced person or one who is legally separated.

The law specifically provides that amounts paid to a person who is a dependent of a taxpayer may not be deducted.

A deduction is also allowed in the case of a working couple, but the deduction is reduced by their combined income in excess of $4,500.

Residence sale expenses—Previously, sale of a residence at a gain did not result in taxable income to the extent that the proceeds were used for the purchase or erection of a new residence. The definition of proceeds did not allow for a deduction of selling expenses. The new law allows such expenses and, in addition, allows as additional cost the property expenses incurred within 90 days prior to sale where such expenses are related thereto, such as decorating, repairs and the like.

Interest—Interest paid for a loan used to purchase a single premium life insurance or endowment contract or a single premium annuity contract is not deductible.

Employee expenses—An employee cannot, generally speaking, deduct unreimbursed expenses, other than the cost of travel, meals and lodging while away from home, from gross income in arriving at adjusted gross income. The new Code allows him to deduct, also, business transportation expenses other than the cost of commuting to and from work.

Business transportation expenses include only the cost of actually transporting an employee while he is not traveling away from home. They do not include meals and lodging. They do include transportation costs whether the transportation is furnished by the employee or by others.

Outside salesmen are permitted all such deductions as travel, lodging, entertainment and other expenses in arriving at adjusted gross income. The advantage being use of standard deduction.

Depreciation—New depreciable assets acquired after December 31, 1953 and having useful life of 3 or more years may be depreciated by the double declining balance method or the sum-of-the digits method.

These new provisions for depreciation, together with other provisions which allow certain research and development costs to be taken as current deductions, should provide a considerable stimulus for modernization and expansion of American business.

CORPORATION RETURNS

An unincorporated association with 50 or less members, and where either capital is a material income producing factor or 50% of gross income is derived from trading, may elect to be taxed as a corporation.

Carry-back—Business losses can be carried back two years instead of one, as well as being carried forward five years.

Organization expenses—A corporation may elect to amortize organizational expenses over a period of not less than 60 months.

Contributions—Contributions made to a

corporation by non-stockholders will not be included in the gross income of the corporation. Basis for such contributions is zero.

Stock Sales—Under the new law, no gain or loss will be recognized to a corporation from the sale of its stock, including treasury stock.

Charitable contributions—Allowable charitable contributions by corporations have been extended to include (1) organizations for the prevention of cruelty to animals, (2) political subdivisions of U. S. possessions and (3) certain cemetery companies. In determining taxable income, for the purpose of the 5% limitation on the contribution deduction, the new deduction on organizational expenses, if elected, shall be taken into consideration. Further, such income is not reduced by a net operating loss carryback and a carryover to the succeeding two years of the excess qualified contributions over the 5% limitation is available.

Unreasonable accumulations — Corporations which were considering expansion often were handicapped by Section 102 of the old law. Under this section, there was always the threat that profits retained in the business might be judged as unreasonable accumulation and subject to a special penalty tax. The burden of proof that the accumulation was not unreasonable was on the corporation. Now, under certain circumstances, the burden of proof is on the Government and, in any case, the penalty tax will not be imposed on any corporation whose accumulated earnings are less than $60,000.

PARTNERSHIP RETURNS

Taxable year—A partnership may adopt or change to any fiscal year if both the principal partners and partnership change to or adopt the same year. Otherwise, a change or adoption of a fiscal year other than calendar year requires approval of the Commissioner.

The taxable year of a partnership does not close as a result of death of a partner, the admission of a new partner or the liquidation, sale or exchange of a partnership interest in the absence of a partnership agreement calling for such termination.

Partnership-partner transactions — Capital gains on transactions between partnership and partner will be recognized as such unless partner has an 80% or more interest. The 50% rule applicable to corporations is made applicable to losses.

Basis-partnership assets—An alternative method is provided for determining basis of property contributed to partnership. Partners may agree to divide basis of contributed property in a manner which attributes precontribution appreciation in value to the contributor.

An adjustment of basis of partnership assets to reflect changes in basis of transferred partnership interest is an irrevocable election. However, it may be changed with approval. Adjustment is available only for the transferee partner.

Distributions of partnership assets—Distributions made to retiring partner or successor of deceased partner are allocated between purchase of capital interest and other payments. Payments for other than purchase of capital interest are deductible by remaining partners. Amounts paid for receivables and goodwill are, unless agreement is to the contrary, treated as a distributive share of income.

ESTATE TAX

Life insurance proceeds—One of the changes provided for in the new law relating to Federal estate tax excludes from taxation proceeds of life insurance received on the death of the insured where the decedent possesses no incidents of ownership but he pays the premiums on the policy.

This differs from prior laws wherein the proceeds were excludable only if the decedent neither paid the premiums nor possessed any incidents of ownership at his death. Undoubtedly, this will boost the purchase of life insurance, since, by the simple procedure of irrevocable assignment, life insurance proceeds may be excluded from a decedent's estate even though he has paid all the premiums.

Marital deduction—Another change provides that a marital deduction will be allowed where the surviving spouse receives a life estate in property coupled with a general power of appointment, similar to the former provisions which qualify a trust for the marital deduction.

Tax Rates—No change in rates but basic and additional estate taxes are combined into a single tax schedule.

GIFT TAX

Under prior law, there was doubt as to whether gifts to minors in trust could be made in such a way as to qualify for the $3,000 annual gift tax exclusion.

Under the new law, gifts made in trust after December 31, 1954 will qualify for the annual exclusion, even though made for

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the benefit of a minor child, under the following conditions:

(1) Where all the income and property will be expended for the benefit of the donee before his attaining the age of twenty-one years;

(2) To the extent not so expended, it will pass to him at the age of twenty-one or, in the event of his death, the property will become part of his estate.

I could go on telling you about many more of the provisions of the new law but I think I have mentioned enough to make it clear that we are operating under a new Internal Revenue Code.

This new tax law has many provisions which will help to eliminate difficulties that have hampered tax administration in the past. Bringing tax rules closer in line with generally accepted accounting principles will be a great help in many ways. Much has already been done for better administration by the present Commissioner of Internal Revenue, T. Coleman Andrews. Members of our profession are naturally proud of him as the first certified public accountant to serve in that office.

The new tax law is not perfect of course. Such a law never can be. We will always have additional recommendations for improvement. It is, however, a major achievement. It represents many years of work by many persons. Certified Public Accountants, through their state and national organizations, have helped to bring about this revision of the tax law. Business men, lawyers, labor unions, tax organizations and, of course, Treasury officials, Congressional committees and their staffs have all contributed ideas to the new law.

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use and the action of time and the elements, which are not replaced by current repairs; also, losses in capacity for use through obsolescence, discoveries, change in popular demand, or the requirements of public authority.

It is the practice of some international carriers to write off aircraft over a period of five years with the assumption that the aircraft will have a residual value of at least 10% of cost. When you realize that one DC or Constellation costs in the neighborhood of $1,500,000, you can understand the impact a five-year depreciation policy has on the income statements. In addition to this policy, airlines today are faced with obsolescence problems presented by the development of jet, atomic and other new forms of propulsion.

Another large depreciation expense item found on an airline's income statement is derived from depreciation of various technical equipment—passenger loading stands used for boarding aircraft, spare parts, buildings, hangars, workshops, office furniture, vehicles, jeeps.

Airline Tickets

Airline tickets have no intrinsic value of themselves, but as a result of various completion and validation procedures they acquire the character of a promise by the airline to carry the passenger over a certain route on a date which may or may not be specified. Once a ticket has been completed, the holder may claim a refund with a consequent financial loss to the company. For this reason, a very strict procedure is set up regarding inventory of tickets.

A record is kept of every ticket sold, indicating the amount of the fare. This does not mean that the fare received is considered actual income. The passenger can still cancel or travel over another airline. This income is considered as Unearned Transportation Revenue and appears on the balance sheet as a liability, representing an obligation towards people who have purchased tickets but have not yet made or completed their flight.

As soon as a passenger checks in at an airport, the flight coupon for the stretch to be flown is sent to the traffic accounts or passenger revenue section of the accounting office. The individual record of that ticket is then changed and the appropriate entries made to record earned transportation revenue and to reduce the balance sheet liability account.

As each section of the flight is completed, the same procedure is followed except when a section of the flight is performed by another airline. In that case, the reduction of the unearned transportation revenue account is offset by an increase in accounts payable to other airlines.

Agents

Very often the bulk of airline revenues originates with agents. These agents, due to competition and practical business practices, generally operate on unsecured credit. Adequate control of credit is a constant problem. It involves a continuous check of the agent's accounts, for, should the agent fail, his assets usually consist of a counter, some printed matter, a typewriter, and . . .