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Tax Forum

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examination. The auditor's review will include a review of the contract terms, a verification of the termination inventories, and a determination that only items allocable to the terminated portion of the contract are included in the claim.

The last area of audit review to be included in this discussion is the post award review. The present defective pricing clause which is being inserted in defense contracts is the result of Public Law 87-653, passed in 1962. This law, commonly known as the "Truth in Negotiations" Law, was enacted to give the government a legal right to adjust a contract price when that price was based on inaccurate, incomplete, or noncurrent cost or pricing data. The objective of the post-award review is to make a factual determination that all information or data available to the contractor at the date of negotiation was either properly or improperly reflected by cost element.

CONCLUSION

The small business enterprise which relies in whole or in part upon government contracts or subcontracts under government procurement for its revenues must accept the responsibilities and conditions of government contracting. However, the prudent businessman will find that the opportunities and rewards which can be achieved in government contracting, as a result of proper management, good cost controls, and sound estimating procedures, make it all worthwhile.

The information in this article has been based on material from *Armed Services Procurement Regulations*, Sections I, II, III, XV, 1969 and Department of Defense, *Armed Services Procurement Regulations Manual for Contract Pricing*, 1969.

THEORY AND PRACTICE

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that if estimates change, the unamortized cost should be allocated over the revised useful life. It also provides that if estimation of value and future benefits indicate that the unamortized cost should be reduced significantly that the deduction should be included as an extraordinary item in the determination of net income.

As to "negative goodwill," the opinion provides that it be used to reduce the value assigned to noncurrent assets acquired (except long-term investments in marketable securities) and that any balance be recorded as a deferred credit and amortized systematically to income over the period estimated to be benefited but not in excess of forty years. A deferred credit should not be recorded unless the noncurrent assets, as defined, are reduced to zero. No part of it should be added to stockholders' equity at date of acquisition.

The opinion also provides that goodwill previously recorded by an acquired company should not be carried forward.

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not be able to use the alternative tax computation on capital gains nor the 50% maximum tax on earned income computation. Taxpayers receiving lump sum distributions from employee benefit plans will not be able to compute the ordinary income portion under Section 72, which would result in double averaging benefits.

Those taxpayers who were married or divorced during the four preceding years which will be used in the base period for the income averaging will need to reconstruct the base period income. Thus, marriage and divorce continue to have more tax implications than romantic implications in our modern world.

Increase in the standard deduction

Accelerating itemized deductions in 1970 may prove to be beneficial to some taxpayers in view of the increase in the standard deduction beginning in 1971. This increase will take place over the next three years as follows:

Year	*Rate*	*Ceiling*
1971	13%	$1500
1972	14%	$2000
1973	15%	$2000

Decrease in rates for single taxpayers

Single taxpayers and heads of households get a break in tax rates starting in 1971; by 1972 single taxpayers will pay tax which will not exceed 120 percent of the tax that would be paid on the same taxable income on a joint return. The head-of-household rates fall halfway between the joint return rates and the new single rates. This group of taxpayers will find it advantageous to defer any noncapital income they can to 1971 and 1972, as they will be benefiting not only from the reduction in rates but also from end of the surcharge which is still with us in 1970. Married couples filing separate returns will no longer look to the single rate schedules to compute their taxes, but now have their own special schedule.

TAX FORUM

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Year-end tax planning under the Tax Reform Act of 1969 can best be described as a mathematics marathon. For those who have income or deductions which can be deferred or accelerated, the possibilities are so numerous that only after performing dozens of calculations and projections can taxpayers satisfy themselves that every potential advantage and disadvantage has been considered. The complexity is partially due to the various transition provisions of the 1969 Act and partially due to the interaction of one provision on another.

The following brief outline points out some of the new provisions which should be considered by the average taxpayer in his annual effort to minimize the final bite. Space does not permit an in-depth analysis of each provision, so proceed with caution and armed with supplemental explanations.

Capital gains and losses

This has been a year of marked fluctuations in the stock market, so many taxpayers are approaching year-end 1970 with an excess of capital losses over capital gains. The 1969 Act amended Sections 1211 and 1212 of the Internal Revenue Code severely restricting the amount of long-term capital losses which can be deducted from ordinary income. First long-term capital losses are applied against capital gains in the same manner they were in prior years. But, when the losses exceed the gains only half of the excess can be used as a deduction against ordinary income. Thus, a $2,000 long-term loss will result in an allowable deduction of $1,000, which is the maximum available in any one year. Married couples can no longer file separate returns and each take advantage of the $1,000 deduction, but will be limited to $500 each. Carryovers are still available, but can be deducted only against capital gains and then against ordinary income in the same manner as current year excess long-term losses. Carryovers from years prior to 1970 will not be subject to the new limitations.

As an example, assume the taxpayer has a $5,000 long-term capital loss and a $1,500 short-term capital gain. First, he can net out his gain of $1,500 which will leave a $3,500 net loss. Of this loss, he can use $2,000 to create a $1,000 deduction against his ordinary net income in 1970. This will leave $1,500 to carry over to the next year. If he has no capital gains or losses the next year, he can use the carryover against ordinary income to the extent of $750. And that is the end of his long-term loss.

In addition to the restrictions on capital loss deductions, the high bracket taxpayer is also going to face higher taxes on his net long-term capital gains. The maximum tax under the alternative tax computation has been increased from 25% to 35% for long-term capital gains in excess of $50,000. Transitional rules included in amended IRC Section 1201 phase this increase in rate over a three-year period, so the 1970 maximum is 29½%, 32½% in 1971, and in 1972 it reaches the 35% maximum. The 25% rate will continue to apply to amounts received prior to 1975 which are long-term gains resulting from transactions entered into prior to October 9, 1969, but such amounts will reduce the $50,000 amount subject to the 25% maximum tax.

For example, assume a taxpayer has net long-term gains of $100,000, of which $30,000 is a payment on a building sold in 1968 which is being reported on the installment basis. The $30,000 is eligible for the maximum 25% rate, but it will reduce the $50,000 which is automatically eligible for the lower rate. So, the maximum gain at the lower rate is still only $50,000. However, if the gain from the installment transaction had been $70,000, then the 25% would apply to the entire $70,000, but no more. After 1975 the 25% will apply to the first $50,000 only, regardless of when the transaction took place. For this reason, taxpayers may want to consider speeding up the realization of income from pre-October 9, 1969, transactions in order to maximize the amount of capital gains on which the 25% rate will apply. This affects only those taxpayers in the over-50% tax brackets.

Tax preference items and the minimum tax

Taxpayers in all tax brackets will feel another pinch on their capital gains income—that is the minimum tax on tax preference items. Fifty percent of net long-term capital gains must be included in the tax preferences to determine if the taxpayer is subject to the 10% minimum tax. New Code Sections 56, 57, and 58 impose a 10% tax on the excess of total preferences over (a) $30,000 plus (b) the taxpayer's income tax liability. In addition to 50 percent of net long-term capital gains, other tax preferences are excess investment interest expense, accelerated depreciation on personal property subject to a net lease, accelerated depreciation on real property, amortization of certified pollution control facilities, amortization of railroad rolling stock, the bargain element in stock options, bad debt deductions of financial institutions, and depletion allowances. Most of the so-called "tax protected" items involve additional deductions against certain types of income, such as rentals from real estate and royalties from oil and gas properties. The taxpayer will therefore have to decide if the extra deductions against ordinary income provide sufficient tax benefits to justify the cost of the minimum tax.

The tax preference items are not only important from the standpoint of the extra 10% tax, but will also have an impact after 1970 on the taxpayer's ability to optimize any benefits he may receive from the 50% maximum tax on earned income.

50% maximum tax on earned income

Although this provision of the Tax Reform Act isn't applicable to 1970 tax returns, it should be considered in 1970 planning in the event that tax savings could be effected by deferring earned income to 1971. This provision, which is new Code Section 1348, is also subject to transitional rules and becomes fully effective in 1972. The maximum tax in 1971 will be 60%.

The formula for computing earned income is not exactly straightforward, and this is where the tax preference items cited above will have some future impact. Earned taxable income is the same ratio to taxable income as earned net income is to adjusted gross income. Earned taxable income must then be reduced by the greater of (a) the current year's tax preference items over $30,000 or (b) the average tax preference items over $30,000 for the current year and four prior years. This is not the *taxable* tax preference items, but the total tax preference items in excess of $30,000. So balancing substantial tax preference items against large income tax liabilities is not going to save the taxpayer seeking relief under this section.

Earned income includes salary, wages or professional fees, etc., received for personal services rendered. But only 30 percent of the profits from a trade or business in which capital is a material income-producing factor can be included. Earned income also includes gains and net earnings derived from inventions, works of art, literature, and other property created by the taxpayer. Capital gains do not qualify as earned income, however. Income from deferred compensation plans does not qualify as earned income except for compensation in the form of restricted stock taxed under new Section 83.

In order to reap the maximum benefits of this provision of the 1969 Act, taxpayers earning abnormally high salaries may want to consider divesting themselves of investments which give rise to tax protected income and thus dilute eligible taxable earned income. However, caution should be exercised as it would be very simple, without numerous long-range projections, to turn a current year's savings into a later year's disaster. It appears that the benefits from the 50% maximum tax provisions are somewhat illusory, so taxpayers who are planning to make use of this device must proceed very carefully.

Liberalized income averaging provisions

Of benefit to both the high and low bracket taxpayers are the new provisions liberalizing the income averaging rules (Sections 1301 to 1305 of the Code). This may prove to be a much more useful tool than the 50% maximum provisions and should be tested as a part of the year-end tax planning routine. Under the prior law taxpayers could average their taxable income (except for long-term capital gains, income from wagering, and income from property received as a gift or inheritance) over a five-year period which included the current year and four preceding years. The excess of the current year's taxable income over 133 percent of average taxable income of the four prior years was taxed at a lower rate.

Under the new provisions, the current year's averageable income must exceed the average of the preceding four years by only 20 percent plus $3,000 instead of the 33⅓ percent plus $3,000 required under the prior law. In addition, long-term capital gains, income from wagering, and income from property received as a gift or inheritance can be included as averageable income.

Taxpayers making use of the income averaging benefits will have to forgo the use of other benefits which minimize the tax rate. Income from distributions from accumulation trusts is not eligible for averaging since it has its own averaging device built in when there are throwback distributions. Taxpayers will

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