Revenue Act Of 1978: New Breaks. New Problems

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The Revenue Act Of 1978: New Breaks, New Problems

By Marjorie A. Daniels and Elizabeth Hebert

On November 6, 1978, President Carter signed the Revenue Act of 1978, a bill which, despite its name, provides net tax reductions of $19 billion dollars. The Act may be interpreted as having three key areas of tax savings:

1. Lower taxes for individuals,
2. Reductions in corporate income taxes and other changes for business, and
3. A large reduction in the effective tax rate on capital gains.

The law also brings new problems for business in three areas:

1. New "at risk" provisions,
2. Advance payment of Earned Income Credit, and
3. Entertainment facilities.

Changes for Individual Taxpayers

The major savings for individuals result from the increase in the zero bracket amount, the widening of tax brackets, and the increase in the personal exemption.

Effective for 1979, the new Act increases the "zero bracket amount" for all taxpayers — the amount of income on which no tax is paid. For 1978, married taxpayers filing jointly paid no tax on their first $3,200 of taxable income; for unmarried and head of household taxpayers, this "zero bracket amount" was $2,200 in 1978, and $1,600 if married but filing separately. Under the new Act, joint returns exempt an additional $200, all others $100.

The rates of tax were not changed; they still range from 14 percent to 70 percent. However, the number of tax brackets has been sharply reduced. For example, joint filers in 1978 fell into one of twenty-five brackets; in 1979, there will be only fifteen brackets of taxable income.

The tax rate schedules for married taxpayers filing jointly and for single taxpayers for 1979 are reproduced on the following page to illustrate the changes effected by the Revenue Act:

The Congress made this change in tax rate schedules in an effort to offset inflation. Before the Revenue Act of 1978, it was commonplace for a "cost of living" pay increase to kick a taxpayer into a higher bracket, thus increasing the percentage of total income going to the government. If the pay increase matched inflation exactly, the percentage change in tax brackets would mean that the taxpayer was actually moving backwards in relation to the cost of living.

To illustrate, assume that an unmarried taxpayer earns taxable income of $20,000. Both this year and last, the taxpayer will be in the 34 percent tax bracket. Assume that this year brings a 7 percent raise to match inflation. Last year only $200 of that raise would be taxed at 34 percent; the balance of $1,200 would be taxed at 36 percent. This year, under the new Act, the entire increase will be taxed at 34 percent. While the $24 savings on the $1,400 increase is not exactly overwhelming, it's a step in the right direction for taxpayers.

However, because the new Act calls for fewer brackets, the brackets are necessarily wider. As a result, a few individuals may find their top dollars of income being taxed this year at a higher marginal rate.

Wider bracketing does not necessarily mean that the total tax liability will increase. Because the spread between taxable income brackets is widened under the Tax Relief Act, more dollars will be taxed at a given rate than previously. For example, under the new tax rate schedules for a married taxpayer filing jointly, the 32 percent marginal rate applies to taxable income from $24,600 to $29,000. This same tax rate in 1978 covers taxable income from $23,200 to $27,200. Anything over $27,200 falls into the 26 percent bracket. Thus, if the taxpayer made $30,000 taxable income in 1978, the excess over $27,200 ($2,800) was taxed at 38 percent. In 1979, the excess over $29,900 is taxed at 37 percent. But the excess is only $100, ($30,000 - $29,900), and the total tax liability is $6,238, compared with $6,668 under the old tax schedules, a savings of $430.

In addition to the increased zero bracket amount, the personal exemption has been increased to $1,000 up from $750. The general credit of $35 per person was eliminated under the Act.

Reduction in Corporate Tax Rates and Other Changes for Business

Effective January 1, 1979, the new law reduces the corporate income tax rate. On the first $100,000 of taxable income, a corporation will save $7,750 in taxes. It will save two cents per dollar thereafter ($20 per $1,000). Corporate income in excess of $100,000 will be taxed at a rate of 46 percent; formerly it was 48 percent. Fiscal year taxpayers will have to pro-rate their tax between the new and old rates.

The business sector in general was also provided with additional tax breaks under the Revenue Act, including investment credit on rehabilitated buildings, a "targeted jobs tax credit" aimed at low income and disadvantaged groups, increased tax relief to holders of stock which proves to be worthless and new relief provisions regarding losses from product liability.

Capital Gains - The Big Ones

The biggest change for both business and individuals brought about by the new Act is the treatment of long-term capital gains. (If the property sold or exchanged is a capital asset, or treated like one, and was held for more than one year, the sale or exchange results in a *long-term capital gain or loss.*)

From now on (retroactive to

MARRIED — FILING JOINTLY

1979

(1) Taxable Income	(2) Tax on Column (1)	(3) Rate (%) On Excess
Under $ 3,400	$ 0	——
3,400	0	14
5,500	294	16
7,600	630	18
11,900	1,404	21
16,000	2,265	24
20,200	3,273	28
24,600	4,505	32
29,900	6,201	37
35,200	8,162	43
45,800	12,720	49
60,000	19,678	54
85,600	33,502	59
109,400	47,544	64
162,400	81,464	68
215,400	117,504	70

UNMARRIED

1979

(1) Taxable Income	(2) Tax on Column (1)	(3) Rate (%) On Excess
Under $ 2,300	$ 0	——
2,300	0	14
3,400	154	16
4,400	314	18
6,500	692	19
8,500	1,072	21
10,800	1,555	24
12,900	2,059	26
15,000	2,605	30
18,200	3,565	34
23,500	5,367	39
28,800	7,434	44
34,100	9,766	49
41,500	13,392	55
55,300	20,982	63
81,800	37,677	68
108,300	55,697	70

November 1, 1978), for individual taxpayers, 60 percent of long-term gain will be exempt from tax (as contrasted with 50 percent before). Starting in 1979, the untaxed portion will no longer be a regular tax preference subject to the 15 percent minimum tax.

However, there is an "alternative mini-tax" for non-corporate taxpayers which works as follows. First the taxpayer computes the regular "add-on" mini-tax, but excludes from the tax base tax preferences for adjusted itemized deductions *and* the capital gains deduction. Then an "alternative mini-tax" is calculated. This alternative mini-tax will apply only if it exceeds the sum of the regular tax liability as increased by the "add-on" mini-tax.

The "alternative mini-tax" is the sum of:

1. 10 percent of "alternative minimum taxable income" above $20,000, up through $60,000,
2. 20 percent of such income above $60,000 through $100,000, and
3. 25 percent of such income over $100,000.

The "alternative minimum taxable income" is essentially gross income less deductions allowed, any accumulation distribution from certain trusts, plus any tax preferences for adjusted itemized deductions and the new capital gains deduction.

There are changes in the corporate area of capital gains as well.

Corporations will continue to be allowed to use an alternative tax on long-term capital gains if the end result produces a tax that is less than the corporation's regular tax. The new Act decreased this alternative tax from 30 percent to 28 percent and a corresponding change is made to the corporate "add-on" minimum tax. Unlike individual taxpayers, however, corporations may not apply the new "alternative mini-tax"; that is, the untaxed portion of corporate capital gains will still be considered a tax preference item for computing the "add-on" minimum tax.

Overall, these changes make capital gain-type fringes for executives even more attractive. The bottom line reveals a more favorable climate for business investments.

Other technical changes as a result of the changes in treatment of capital gains include the following:

1. The excluded portion of the capital gain will no longer reduce the amount eligible for the favorable maximum tax on personal service income, effective retroactive to November 1, 1978.
2. There was no change in the treatment of capital losses. Up to $3,000 of ordinary income to individuals may be offset by long-term capital losses ($2 of long-term loss per $1 of ordinary income). Unused losses may be carried forward. Corporate capital losses continue to be deductible only as an offset to capital gains.
3. Post October 31, 1978 collections on prior installment sales will be taxed at the rates in effect for the year of collection of installments.

New Problems for Business

The problems created for business as a result of the Revenue Act of 1978 are fairly complex and affect many industries. As mentioned earlier, the three key areas adversely affecting business are

1. The new "at risk" provisions,
2. Advance payment of Earned Income Credit, and
3. Entertainment facilities.

New "At Risk" Provisions

The Tax Reform Act of 1976 introduced a new tax concept devised to bring the flourishing "tax shelter" business under control: a taxpayer could claim a loss no greater than the amount of money carried "at risk". An investor is "at risk" to the extent of money or the adjusted basis of other property contributed to the activity, as well as loans on which the investor is personally liable or for which property has been pledged (other than property used in the activity). Originally this rule applied to farming, oil and gas, motion pictures and equipment leasing. It also applied to partnerships regardless of activity - except real estate. Real estate was excepted from the rule entirely. The rule did not apply to corporations (except Subchapter S corporations and personal holding companies).

The law was fairly effective. "Shelter" offerings, other than real estate, were curtailed or forced into areas not covered by the specific rules and not in partnership form. This year the Congress decided to make the most of a good thing and extended the at risk concept to all activities except real estate. The real estate exception has been clarified to include hotels and similar activities.

The new law extends the "at risk" concept to "closely held corporations", defined as corporations in which five or fewer shareholders own directly or indirectly more than 50 percent of the stock. (There is a limited tax exception for equipment leasing corporations.)

What is the amount "at risk"? If an individual or business entity borrows money and is personally liable to repay it, that money is at risk. If, on the other hand, money is borrowed to purchase property as security for the loan, then the money borrowed is not at risk. Operating losses arising from activities where funds are not at risk may not be currently deducted.

When the at risk concept became law, tax practitioners discovered a way to get around the problem (at least temporarily). If in December an enterprise was showing a loss in excess of the amount of capital and debt for which the partners were at risk, the partners would personally borrow funds at the end of the year and contribute them to the capital of the partnership. Since the partners were individually liable, the new money was at risk at the end of the year. The losses would be deductible. However, at the opening of business in January, the partners would withdraw cash from the partnership to repay the loans. Money in one day and out the next and lo! — a possible tax deduction had been created.

The new law sets up a "recapture" provision. Where deductions have been allowed because funds were at risk and those funds are subsequently withdrawn (or recourse debt converted to nonrecourse debt), the deduction must be recaptured as ordinary income.

Note that the at risk provision may provide a planning opportunity where net operating losses are about to expire; withdrawal of amounts at risk may transform an expiring new operating loss carryforward into an "at risk" carryforward of unlimited duration.

The door has also been slammed shut on many of the other resourceful solutions to the at risk limitation such as "private" (one-owner) tax shelters and mineral tax shelters that "elect out" of the partnership provisions.

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Advance Payment of Earned Income Credit

One of the few benefits in the Act aimed at low income taxpayers, the earned income credit, is increased for 1979. The credit is limited to taxpayers with dependent children. Sometimes called a "negative income tax", this refundable credit is calculated as 10 percent of earned income up to $5,000 and is reduced ratably as income increases from $6,000 to $10,000. The maximum credit of $500 is up $100 from 1978; the income ceiling is up $2,000.

This change will require a change in business recordkeeping. Instead of claiming the credit in a lump sum on the tax return, an employee may claim it in advance by filing an Earned Income Eligibility Certificate with her employer. Then the employer, using tables similar to those used for withholding income tax, must pay the credit to the employee on the regular paycheck.

The credit payment will not constitute a pay increase or cost a business additional dollars. The extra dollars going to the employee will be subtracted from the income and Social Security taxes withheld and remitted by the business to the government. The advance payment rule goes into effect January 1, 1979.

In bookkeeping terms, the filing of an Earned Income Eligibility Certificate by an employee means separate accounting for those amounts. It also means that the individual payroll accounts must have another slot to record the advance payment of the credit because this payment is not treated as wages. If the payroll system is a manual one, it may need to be redesigned. The advance payments must be reported on each employee's W-2 Form at the end of the year.

Under some circumstances, the advance payments called for on the tables might exceed the total withholdings for the period. What then? The law provides two methods of resolving the problem: (1) by reducing the advances ratably, or (2) paying them and claiming the overage as a prepayment on future withheld payroll taxes. The second approach might result in a temporary imbalance, but it will cost the employer nothing (except recordkeeping) over the long haul.

It is the responsibility of the employee to file the Earned Income Eligibility Certificate. The employer must be furnished with a new one (or revocation of the old one) within 10 days of a change in status.

If an employee files an Earned Income Eligibility Certificate with an employer, payment of the advance is mandatory. Failure to pay will be treated in the same manner as failure to withhold income taxes.

Entertainment Facilities

The Congress virtually ignored President Carter's attack on the "three martini lunch". However, by the simple expedient of removing half a sentence from the statute, most deductions for "entertainment facilities" were eliminated.

What is an entertainment facility? The statute doesn't say. However, the U. S. Senate says that yachts, hunting lodges, fishing camps, swimming pools, tennis courts, bowling alleys, suites and vacation homes are entertainment facilities. Since some of these items (e.g. autos, planes) are obviously not always entertainment facilities, we must fall back on the statute which refers to items "generally considered to constitute entertainment, amusement, or recreation . . ." Hotel lodging costs for people on overnight business trips (and hospitality suites at business meetings) are still exempt.

The Joint Congressional Conference Committee's report cites this example: A salesperson, for business reasons, takes a customer hunting at a commercial hunting preserve. All the expenses of the hunt would be deductible, assuming the usual substantiation requirements were met. However, if they spent the night at the hunting lodge, the cost of the lodging would not be deductible. On the other hand, meals taken at the lodge would be deductible if properly substantiated. Sounds confusing? Most accountants would agree.

The key to deductibility is whether the "facility" is, in fact, used in connection with entertainment, amusement or recreation. The auto used by a traveling salesperson is obviously outside this category. The apartment rented by the corporation to lodge "visiting firemen" is not an "entertainment facility". The company airplane (usually operated for business reasons but which occasionally takes the company president to a football game) is a stickier matter. The portion applicable to non-business use is nondeductible except to the extent it is deductible compensation.

Country club dues are deductible if the facility is used primarily for business. (Congress is expected to correct this provision to allow deduction of dues to any club which is used primarily for business purposes.)

Tickets to sporting or theatrical events are still deductible if they were deductible under 1978 laws.

The Net Result

The Revenue Act of 1978 is not a revenue raising measure. It is a bill designed to stimulate a troubled economy and to lessen the effect of inflation on tax bills. The law offers many new opportunities to minimize taxes and, despite the new problems and complexities introduced by the Act, the tax savings available will far outweigh any tax increases for the majority of all taxpayers. □