Tax: Rx For Economic Recovery: The 1981 Tax Bill

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Rx For Economic Recovery

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As this article is written, President Reagan has yet to sign the Economic Recovery Tax Act of 1981, recently passed by both houses of Congress. While it is clear that the legislation will be signed, it is unclear what the full impact of various last minute amendments will be. This article, the first in a series, will discuss the impact of the law on individual taxpayers.

1981 Changes

Only a few of the vast changes in the tax law will affect individual taxpayers in 1981. These changes include the areas of rate reduction, sales of personal residences, tax straddles, capital gains, adoption expenses and stock options. The rate reduction has been accomplished by providing a credit equal to 1.25% of the 1981 income tax under the old tables. Withholding schedules will be reduced by 5% as of October 1, 1981, to provide wage earners the benefit of this credit. Under a somewhat complicated computation, the law provides that capital gains occurring after June 9, 1981, will be subject to a maximum rate of 20%. No adjustment was made up to the §1202 exclusion, which remains 40%, nor to the holding period, which remains one year. The Act extends the permissible rollover period with respect to sales of principal residences from 18 months to two years, and raises the "over-55" one-time exclusion to $125,000. Both provisions apply to sales made after July 20, 1981, and rollover periods which have not expired by that date.

In the area of stock options, the new law reestablishes preferential treatment for employee stock options, now called incentive stock options. If the options are granted under a plan which meets the new requirements, there is no taxable event (including no tax preference) on the grant or exercise, and the stock need only be held for one year to qualify for capital gain treatment. The combined holding period for the option and the stock must be at least two years. If the stock is disposed of within the two-year period, the transaction will generally be treated in the same manner as the pre-'76 qualified options, i.e., the "spread" at exercise will be treated as ordinary income, and the employer will get a compensation deduction for the same amount. Unlike prior law, if the stock is sold for less than its value on the date of exercise, no capital loss is recognized; the ordinary income (as well as the employer deduction) is limited to the difference between basis and sales price. These rules generally apply to options exercised after January 1, 1981, but may apply earlier in certain circumstances. The law also includes complex rules which change substantially the taxation of commodity-related transactions, including regulated futures contracts, straddles and hedges. These rules generally apply to all "positions" after June 23, 1981.

Finally, the law grants relief for certain expenses involved in the adoption of designated hard-to-place children with special needs.

1982 Changes

The changes for individuals that begin to take effect in 1982 can generally be classified into three groups: changes in tax rates for income and estate taxes, changes affecting savings and retirement planning, and "all other". The best known provision of the Act creates new income tax rate schedules for 1982, 1983 and 1984. The schedules, *in general,* result in cumulative reductions of 10%, 19% and 23%, respectively. For taxpayers with substantial incomes comprised primarily of personal service income, the actual reductions realized will be lower because of the benefits previously enjoyed from the "maxi-tax". In 1982, the top rate of tax will be reduced from 70% to 50%, which will provide savings significantly greater than 10% for taxpayers with income in excess of $100,000. The final adjustment to income tax rates takes the form of a deducation for two-earner married couples, an attempt to mitigate the problems caused by the different rate schedules for single and married persons. In 1982, a couple is permitted to deduct 5% of the lower-earning spouse's net earned income (reflecting reduction for any expenses deducted in arriving at adjusted gross income which are employment related). For 1983 and thereafter, the deduction rises to 10%.

The estate and gift tax changes take several forms. Beginning in 1982, donors can make gifts, free of gift tax, of up to $10,000 per year per donee ($20,000, if spouse consents). In addition, amounts paid for medical expenses or tuition are not treated as taxable gifts. Also, beginning in 1982, the unified credit will be increased annually until 1987 when it will have the impact of exempting from taxation estates of less than $600,000. Simultaneously, there will be a reduction in the tax rate applied to estates in excess of $2,500,000. By 1985, when the rate reduction is fully implemented, the highest estate tax bracket will be 50% and will apply to estates in excess of $2,500,000. The other significant amendments to the estate tax area include eliminating the provision which had taxed gifts made within 3 years of death, except when the gift involves life insurance; and providing for an unlimited marital deduction. The change in the marital deduction, more than any other amendment in this area, requires practitioners involved in estate planning to review and possibly revise existing estate disposition plans.

In the savings and retirement areas, Congress has made a number of changes. The new "all-savers" certificate will provide an exclusion of up to $1,000 ($2,000 on a joint return) of income generated from certain specified certificates of deposit. There are restrictions against borrowing funds to invest in these certificates. This investment may not be as advisable as other forms of investment for taxpayers whose tax bracket is not high enough to compensate for the less-than-market rate of interest being paid. The Act also repeals the $200/$400 exclusion for interest and dividends for 1981. The public utilities also received favorable treatment under the new law for their dividend reinvestment plans. Beginning in 1982, stockholders may elect to defer up to $750 ($1,500 on a joint return) of dividend income where the dividend is received in additional shares. To the extent this election is made, the shares will have a zero tax basis, converting potentially 50% income to 20% income.

In the retirement income category, Congress has responded to the clamoring of taxpayers for liberalized IRA rules. The limitation on deductible contributions was increased for 1982 from $1,500 to $2,000 ($2,250 with a non-working spouse). Of significance to the part-time worker, this contribution may equal up to 100% of earned income. The rules have also been liberalized to permit divorced persons to make deductible IRA contributions from compensation *and* alimony payments of up to $1,125. The provision most likely to generate interest is the repeal of the active participant rule. Beginning in 1982, even though a worker may be considered to be "covered" by an employer-sponsored retirement plan, a deductible contribution of up to $2,000 may be made to an IRA, employer-sponsored plan or combination thereof. The deductible contributions to an employer plan will be treated similarly to IRA amounts when distributed, and will not benefit from special capital gains or 10-year averaging.

In reviewing the limits on contributions to HR-10 plans, Congress was a little more generous. Beginning in 1982, partners and sole proprietors can now contribute up to $15,000 (limited to 15% of earnings). The previous $100,000 limitation on formula compensation can be increased to $200,000 if a contribution of at least 7.5% of compensation is made for all participants. A contribution can also be made to an IRA, in effect, raising the deductible limit to $17,000. There have been revisions to the TRASOP and ESOP rules, some of which became effective in 1982.

Among the miscellaneous provisions is a relaxation of the onerous tax impact upon the receipt of certain restricted property. The law provides that in 1982 and thereafter, where the gain on a sale of stock would be subject to restoration under SEC "insider" rules or where transferability is restricted as a result of "pooling of interest" rules, the income recognition will be delayed until these "restrictions" lapse. One of the much-talked-about provisions, charitable deductions for non-itemizers, will have little benefit until 1985 when 50% of all charitable contributions can be used to reduce gross income. Prior to that year, only 25% of the amount contributed can be deducted, with the deduction limited to $25 in 1982 and 1983 and $75 in 1984. In 1986, 100% of all contributions can be deducted. The provision expires after 1986.

Also beginning in 1982, U.S. citizens working overseas will be granted a substantial exclusion from taxation for certain income earned abroad. The exclusion in 1982 is $75,000 and increases by $5,000 each year until 1986 when a $95,000 exclusion becomes permanent. An excess housing allowance will also be permitted.

The Act also increases the amount of child care credit and creates a tiered structure. For taxpayers with adjusted gross income in excess of $28,000, the credit is limited to $480 for one child and $960 for two or more.

Delayed Provisions

Some provisions of the new law do not become effective for several years, including "indexing." Beginning in 1985, individual tax brackets as well as personal exemptions and the zero bracket amount will be adjusted based on changes in the Consumer Price Index. Also beginning in 1985, a new net interest exclusion will be available. The exclusion will be 15%, but not more than $450 ($900 on a joint return) of the excess of qualified interest income over qualified interest expense. Qualified interest income includes income from regulated thrift institutions and corporate bonds. Qualified interest expense does not include home mortgage interest.

Our next article will address some of the business provisions, in particular, those affecting capital recovery. The impact of the 1982 changes for individuals makes it incumbent upon all practitioners to review the personal tax planning of their clients so that the least possible tax can be paid over the 1981-1982 period. In particular, taxpayers with substantial amounts of passive income should generally take steps to defer the receipt of that income until 1982.

Education

Recent CPA Exams — A Statistical Note

The ABCs And Ds Of Bias

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In recent years, objective questions of a multiple choice type have made up a significant part of the CPA exam. They have been used in all parts of the examination and have constituted from about one-third to one-half of each section as measured by time allowances.

For example (in objective questions) the May 1980 session Practice — Part I showed 135 minutes out of a minimum allowance of 200 minutes; Theory in the same exam represented 90 minutes out of 150 minutes minimum allowance. In the November 1978 exam Practice — Part II contained 100 of 270 minutes on the maximum allowance and Business Law in that exam devoted 105 minutes of 210 minutes on the maximum allowance to multiple choice. Almost without exception all of the questions in every exam have utilized a four answer choice format.

A basic assumption in objective testing is that no bias will exist towards one of the answer choices or against other choices. In elementary statistics there are several demonstrations that can be made to show that unconscious bias exists in most of us. A question can be posed as to whether the objective questions of the CPA exam have exhibited any bias on the part of the examiners. We should stress strongly that we are not implying bias in any sense of dishonesty. The bias we would be examining would be mainly an unconscious one: e.g., a preference for "c" over "d" for any of a variety of reasons, mostly unknown.

Several statistical tests are available that can determine whether such bias has been present. The customary test to use in such circumstances is known as the Chi-