July 2015

Economic Recovery Tax Act of 1981

Merlin G. Briner

ECONOMIC RECOVERY TAX ACT OF 1981

MERLIN G. BRINER*

INTRODUCTION

THE 1981 ACT represents a dramatic approach to the revision of the federal tax law. For the first time in recent history Congress has drastically reduced income, gift and estate taxes. The goals of the Act as set forth in the report of the United States Senate Finance Committee are: to insure economic growth in the future; to upgrade the country's industrial base; to stimulate productivity and innovation; to lower personal income taxes; to control the growth of the federal government; to restore certainty to economic decision making; and to provide a sound basis for economic recovery. The objective of the $750 billion tax cut to be phased in by 1987 is to restore and create incentives for both individuals and businesses to "*work, produce, save* and *invest*."

In essence this Act and the results it either produces or fails to produce will be a test of our free enterprise system. The Act, coupled with the administration's policy of deregulation and relaxing government controls of business, provides the opportunity business leaders have been looking for.

A key to future economic health is the reduction of federal expenditures. If these cannot be curtailed, the combined effect of expenditures and reduced tax revenues on inflation will be disasterous. If expenditures cannot be controlled, then taxes will have to be increased substantially in the not too distant future.

As this article goes to press, measures the administration is proposing include: requiring corporations and contractors to pay taxes earlier; eliminating tax credits for insulation and solar heating; restricting the issuance of tax exempt industrial development bonds; and increasing the income tax on unemployment pay. Democrats and some Republicans are also urging that excise taxes on gasoline, telephone calls, cigarettes and liquor be increased; that cost of living increases for retirees be deferred and that oil tax breaks be restricted.

Compiling this article required a concentrated effort to meet the publication deadlines for the fall issue of the Law Review. This article, in addition to the annual Tax Developments article, proved the dedication of the contributing authors and the Law Review staff. Appreciation is hereby expressed to the following students who made substantial contributions in the researching and writing of this article:

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Special appreciation is extended to William Meyer and Amie Bruggeman for their dedicated efforts in editing.

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1.01 Individual Income Tax Rate Changes

I.R.C. §§ 1, 1348 - Act § 101. Effective for rate changes 10-1-81 and for repeal 12-31-81.

After October 1, 1981, tax rates for individuals will be reduced the equivalent of 5% for the remainder of 1981. The reduction will be accomplished by means of a 1.25% credit against tax liability. For example, a taxpayer who owes $3,398 in taxes will receive a $42.48 credit against this amount. For 1982 and 1983, the rates will be decreased 10% each year. In 1984, the remaining 5% of the cut will go into effect. The overall result of these reductions will be a 23% cut in rates from the present structure.

A married taxpayer filing jointly who earns $27,500 in 1981 will pay $5,433 in taxes. In 1984, the tax on the same salary will be $4,190, a savings of $1,243. The present marginal rates range from 14% to 70% while the new rates, when the cuts are finally phased in, will range from 11% to 50%. Because the highest marginal tax rate has now been dropped to 50%, the section 1348 provision for the maximum tax on earned personal service income is no longer necessary, and it has therefore been repealed. Where possible, it is advantageous to most taxpayers to shift deductions into the 1981 tax year and to defer income until 1982. If the taxpayer knows that certain deductible items will be owing in 1982, he may wish to consider prepayment in order to take maximum advantage of the benefits of the new law.

1.02 Maximum Capital Gains Rate - Personal Holding Company Rate
Act §§ 101, 102. Effective as to exchanges after 6-9-81.
I.R.C. § 541 - Act § 101. Effective after 12-31-81.

With the maximum tax rate now scheduled to be 50%, the tax on capital gains has effectively dropped from 28% (70% rate x .40) to 20% (50% x .40). This provision affects all sales or exchanges made after June 9, 1981, and will therefore result in an increased flow of capital before the end of the year.

A taxpayer who has net capital gain in 1981 must make two separate computations and pay tax on the lesser amount. First the tax is computed on all of the taxable income including 40% of qualified net capital gain. The tax is then computed on all income other than 40% of qualified net capital gain plus 20% tax on qualified net capital gain.

The change in the maximum tax rate will also affect the rate on undistributed personal holding company income. This rate will drop from 70% to the new maximum 50%.

1.03 Alternative Minimum Tax
I.R.C. § 55(a) - Act § 102. Effective as to transfers after 6-9-81.

The new Act lowers the alternative minimum tax on items of tax preference. The rate for tax year 1982 will be 10% on amounts from $20,000 to $60,000 and 20% on the excess above $60,000. For the remainder of 1981, a special rule will apply. The tax will be the lesser of the tax computed according to the usual method or the tax an alternative minimum taxable income other than qualified net capital gain plus a 20% tax on qualified net capital gain.

1.04 Marriage Tax Lessened
I.R.C. § 221 - Act § 103. Effective after 12-31-81.

In providing for the joint filing of income tax returns in 1948, Congress intended to promote the marital relationship by giving it a certain tax preference. Joint filing served this aim because most women were not employed outside the home and there was only one income to be considered. As more women began to work outside the home, an unforseen complication arose. When the woman's salary was added to that of her husband, the couple was pushed into a higher tax bracket and was forced to pay more than if each had filed separate returns. Some couples attempted year-end divorces to counter this effect, while others saw this tax result as a reason to delay or avoid marriage.

The Economic Recovery Tax Act attempts to alleviate this problem by giving a deduction of 5% in 1982, and 10% thereafter, for either $30,000 or the earned income of the lower paid spouse, whichever is less. In other words, a maximum deduction of $1,500 is allowed in 1982 and

$3,000 thereafter. The deduction is to be taken from gross income, so that in order to use it, a couple need not itemize. Certain deductible items, including trade or business expenses, certain employee business expenses, contributions to either Keoghs, IRAs or Subchapter S pension plans, or required repayments of supplemental unemployment benefits, must be deducted in computing qualified earned income.

The marriage penalty has been most severe for those couples whose incomes are relatively equal. Consider the effect on a husband and wife each earning $22,000 per year, for a combined total of $44,000. In 1982, they can deduct $1,100 from their gross income (5% of the lesser income up to $1,500) leaving a total of $42,900 for a tax bill of $10,326, assuming no deductions. If, however, each had filed separately, the tax for each would be $4,372 for a combined total of $8,744. The marriage tax here is still $1,582.

If the taxpayer uses the exemption and zero bracket amounts as he should, the difference becomes even greater because the zero bracket amount for an unmarried person is $2,300 and only $3,400 for a married couple, not $4,600. It is in this area that future legislation will be necessary. One possible solution would be to allow married persons to elect to file as single if it is to their advantage. This would achieve the desired result without the present complications.

1.05 Exclusion for Dependent Care

I.R.C. § 129 - Act § 124(e)(1). Effective after 12-31-81.

If an employer provides dependent care program assistance, either by payment or by provision of services which would be employment-related expenses for an individual, the amount so provided is not considered income to the employee. However, the maximum expense limitations of $2,400/$4,800 applicable to persons still apply just as they do under the child care credit provisions. Any amounts in excess of these figures cannot be excluded from the employee's income. The exclusion is allowed for payments to either an employee's child under age 19 or an individual related to the employee, if they are claimed as dependency exemptions.

In order to qualify, the program must be in writing and for exclusive benefit of employees. It must not discriminate in favor of officers, owners or highly compensated individuals. If a union and employer engage in good faith bargaining which results in exclusion of union employees, however, this discrimination will not disqualify the program. No more than 25% of the assistance may be provided to shareholders or owners of more than 5% of the stock, capital or profit interest. The program need not be funded. Eligible employees must be given reasonable notice of the availability and terms of the program. A yearly written statement must be given each employee indicating the amounts paid or the expenses incurred by the employer in providing the care during the preceding year.

If an amount is excluded under this provision, the same amount cannot also be deducted or used as a credit elsewhere on the tax return. None of the amounts excluded by the employee are subject to withholding, social security or unemployment tax.

This is an excellent fringe benefit which should prove to be extremely valuable to both the employer and the employee because of the increased number of women who are now employed.

1.06 Savings Interest Exclusion
I.R.C. § 128 - Act § 301. Effective after 9-30-81.

Because of extensive lobbying by the savings industry, as well as a congressional desire to encourage savings, the Economic Recovery Tax Act grants a $1,000 individual lifetime exclusion for tax exempt savings certificates. Married persons filing joint returns may exclude a total of $2,000.

There are very strict rules which must be followed in order for the certificate to qualify. The certificate must: (1) be issued after September 30, 1981, and before January 1, 1983; (2) be issued by a qualified savings institution (defined in section 128); (3) be available in denominations of $500; (4) have a maturity of one year; and (5) yield 70% of the average investment yield for the most recent auction of 52-week Treasury Bills.

If a person pledges this certificate as collateral, it shall be treated as redeemed and the exclusion will be lost. Also, the penalty for early withdrawal of funds in this certificate is a loss of the interest exclusion on that particular certificate.

For an institution other than a credit union to qualify to issue the certificates, the institution must provide qualified residential financing during the succeeding calendar quarter that is not less than the lesser of 75% of the face amount of certificates issued during the calendar year or 75% of the qualified net savings for the calendar quarter. In other words, each institution is obligated to lend 75% of the money it is receiving from these certificates or 75% of its net savings. This provision constitutes an effort to stimulate the housing industry by providing more funds for loans. However, the wording is such that the industry believes it can comply with this requirement without actually directly making new loans with these new deposits.

1.07 Child and Dependent Care Credit
I.R.C. § 44A - Act § 124. Effective after 12-31-81.

The Tax Reform Act of 1976 changed child care expenses resulting from parental employment from a deduction to a credit. The maximum expense allowed in calculating the credit was $2,000 for 1 child, and $4,000 for 2 or more children. The credit was 20% of the expenses or a maximum of $400 and $800, respectively.

Under the Economic Recovery Tax Act, the percentage of allowable credit is increased to 30% of the employment related expenses for a person with an adjusted gross income of $10,000 or less. The ceiling on expenses is increased to $2,400 for one child and $4,800 for two or more. The 30% credit is reduced 1% for each additional $2,000 of earned income up to $28,000. The credit is 20% for earned income over $28,000. Congress increased the credit as a work incentive, especially for persons in low and middle income brackets. The definition of employment related expenses for outside services has been broadened to cover not only a dependent under 15, but also an individual who regularly spends at least 8 hours each working day in the taxpayer's household.

In order to receive a credit for the expenses of a dependent child care center, the center must comply with state and local laws and provide care for more than 6 children. This will probably eliminate many small home care centers that may or may not be providing quality care.

Employment related expenses cannot exceed the individuals' earned income if they are not married. If married, the expenses may not exceed the lesser of the earned income of the taxpayer or the spouse. Income is imputed to a dependent spouse who is either a student or incapacitated. As a result of the increase in allowable expense for the care of a student or an incapacitated spouse, it is necessary to increase the amount of income imputed to such a spouse. Thus, imputed income is increased from $166 to $200 per month for families with one qualifying dependent and from $333 to $400 per month if there are two or more qualifying dependents.

1.08 Indexing

I.R.C. § 1(f), 151(f) - Act § 104. Effective after 12-31-84.

As a result of inflation, many individuals have received an increase in wages. However, their actual purchasing power has remained the same or decreased because they have been forced into higher marginal tax brackets. This "bracket creep" is the result of considering an increase in income as a taxable gain rather than a nontaxable event which restores the status quo. As more and more individuals are taxed at higher marginal tax brackets without a corresponding increase in their lifestyle, the net result is a greater tax liability.

The Economic Recovery Tax Act of 1981 will reduce this "bracket creep." Beginning with taxes in 1985, the amounts of personal exemptions, zero bracket amounts and tax bracket amounts will be tied to the Consumer Price Index. On September 30 of each year the amount of change in the Consumer Price Index from the preceding year will be determined in order to prepare new tax tables. The base year for the Consumer Price index will be 1983. If the 1984 price index is higher than that of the base year, that percentage of change will be used to adjust these various factors upward.

There has been some fear expressed that by indexing in this manner, inflation will become institutionalized, and the incentive of the taxpayer to control it will be dissipated. However, it will take some years of experience before the effectiveness of indexing can be determined. Hopefully, by 1985 when this procedure is begun, inflation will be controlled.

1.09 Residential Exclusion Amount for over 55's Increased
I.R.C. § 121(b) - Act § 123. Effective after 7-20-81.

Recognizing the effect which inflation has had on the selling prices of homes, the Economic Recovery Tax Act increases the amount of the one-time exclusion of gain realized on the sale of a principal residence by a person 55 years or older. The residence must have been owned as such for 3 of the last 5 years. A married taxpayer filing a joint return may now exclude up to $125,000 of the gain on a sale rather than the $100,000 allowed under the 1976 Act. A single person is limited to an exclusion of $62,500.

For example, a 59-year-old taxpayer sells his principal home for $110,000 which he has owned for 15 years. The basis in the property is $35,000 and there are selling and pre-sale fixup expenses of $16,500. The realized gain is $58,500. If the taxpayer elects to use the exclusion now, the entire gain is excluded from income. This is a one-time opportunity for taxpayers and there is no carry forward as to any unused portion of the total exclusion.

1.10 Sale of Residence Roll-Over Period Increased
I.R.C. § 1034 - Act § 122. Effective after 7-20-81 for sales and exchanges.

A taxpayer now has two years in which to invest the proceeds from the sale of a principal residence into an equally or more expensive residence without recognizing gain. Previously the two-year period had been available only if the taxpayer was building a home, while for the purchase of an existing residence the period was 18 months.

Perhaps the most helpful aspect of this section is that it applies to sales or exchanges whose 18 month roll-over period had not expired as of July 20, 1981. Because of the sluggish character of the home sale market, many people have been unwilling to commit to a high interest mortgage even to avoid recognizing gain. There is now a longer period available to determine what action they will take.

1.11 Dividend Interest Exclusion

I.R.C. § 116 - Act § 302. Effective after 12-31-81.

Under prior law, the exclusion available for interest and dividend income was increased to $200 for an individual return and $400 for a joint return. This has been effective for only one tax year, 1981, because the Economic Recovery Tax Act reenacts the exclusion for dividends to $100 for individuals and $200 for taxpayers filing joint returns. In recommending this action, the Committee stated that it did not believe that the previous excluded amounts had been sufficient to stimulate savings. Other provisions in the Act, particularly the exemption for all savers certificates, provide new and better incentives.

Starting with the 1985 tax year, a taxpayer will be allowed to exclude from gross income earned interest up to a maximum of $450 for a single return, $900 for married, filing jointly. This amount will be computed by taking 15% of the lesser of $3000 on a single return or $6000 for a joint return or the net difference between the amount of interest paid and interest earned. To arrive at this figure it will not be necessary to include any interest payments on either home mortgages or trade or business related loans. These particular amounts will continue to be fully deductible by the taxpayer. This action is yet another manifestation of the desire of Congress to encourage Americans to save.

2:00 Corporate Business Tax Changes

2.01 Corporate Charitable Deduction Raised

I.R.C. § 170(b)(2) - Act § 263. Effective in tax years beginning after December 31, 1981.

Previously corporations could deduct their contributions to charity up to a maximum of 5% of their taxable income. The Act raises this limit to 10% of taxable income. This is apparently a concession to charitable institutions affected by previous budget cuts.

2.02 Gifts and Awards to Employees

I.R.C. § 274(b) - Act § 265. Effective in tax years ending on or after date of enactment.

Gifts of tangible personal property to an employee costing $100 or less have been deductible for an employer where the gift was given for the employee's service or safety record. The limit on deductibility has now been increased to $400. In addition, a new category of awards, the qualified plan award, has been created. Awards given for productivity also qualify under the Act.

A qualified plan award is an award given pursuant to a permanent written plan which does not discriminate in favor of officers, shareholders, or highly compensated employees with regard to eligibility or benefits. Although the average cost of all items awarded cannot exceed $400, individual awards can cost up to $1,600 and still be eligible for the qualified plan award.

It should be noted that the Act did not increase the $25 limitation of section 274(b)(1) for gifts to other individuals, such as customers or clients.

2.03 Corporate Tax Rates Lowered

I.R.C. § 11(b) - Act § 231(a). Effective in years beginning after 1981.

Effective in years starting after December 31, 1981, the corporate income tax rate drops to 16% from 17% for any income not greater than $25,000. For income over $25,000 but not over $50,000, the rate drops from 20% to 19%. Another reduction occurs for years beginning after December 31, 1982. The rate becomes 15% for the $0 to $25,000 bracket and 18% for the $25,000 to $50,000 bracket. The statutory procedure for proration may be found in section 21.

Assuming a calendar year as the tax year, a corporation with $25,000 of income per year will pay $250 less tax in 1982, and $500 less tax in 1983 and beyond. A corporation making $50,000 per year will pay $500 less tax in 1982, and $1,000 less tax in 1983 and beyond. This reduction coupled with the increase in the accumulated earnings credit from $150,000 to $250,000 provides an incentive for small corporations to retain funds in the corporation.

2.04 Tax Credit and Extension of Loss Carryovers

I.R.C. §§ 44E (e), 46(b), 50A(b), 53(b), 172(b) & (g), 812(b), 825(d) - Act § 207. Effective date varies.

Carryovers of net operating losses are extended from 7 to 15 years for tax years ending after 1975. Also covered under the 15-year rule are regulated transportation companies and certain insurance companies which previously had 9 and 8 year carryovers respectively.

Similarly, the carryover period for unused investment tax credits and work incentive program credits is lengthened from 7 years to 15 years for years ending after 1973. Furthermore, the carryover period for the new employee credit is expanded to 15 years from 7 years for years beginning after 1976. The Act also extends the alcohol fuels credit carryover period for years ending after September 30, 1980 from 7 to 15 years.

2.05 Subchapter S Corporations

I.R.C. § 1371(e) & (g) - Act § 234. Effective for tax years beginning after December 31, 1981.

Previously, the maximum number of shareholders a corporation could have and still qualify under Subchapter S was 15. This is increased to 25 by the Economic Recovery Tax Act.

2.06 Accumulated Earnings Tax Credit Increased

I.R.C. §§ 243(b)(3)(c)(i), 535(c)(2) & (3), 1561(a)(2) - Act § 232. Effective in tax years beginning after December 31, 1981.

To allow for the ravages of inflation, the minimum credit to offset accumulated earnings for the accumulated earnings tax on corporations is increased from $150,000 to $250,000. However, personal service corporations whose principal business is providing services in health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting, retain only a $150,000 minimum credit. This reflects the belief that most personal service corporations do not require a substantial working capital.

3.00 Business Incentive Provisions

3.01 Election to Expense Certain Assets

I.R.C. §§ 179, 453(i), 1245(a) - Act § 202. Effective when the property is placed in service after December 31, 1980.

Prior law allowed an additional first-year depreciation allowance, or "bonus" depreciation, of up to 20% of the cost of qualified personal property. This was limited to a maximum deduction of $2,000 for corporations, partnerships and single individuals or $4,000 for married individuals filing joint returns. The new law repeals this additional first-year deduction for property placed in service after December 30, 1980, and substitutes an election to treat the cost of certain assets as an expense. The new election is available for property placed in service after December 31, 1981, therefore allowing neither "bonus" depreciation nor a deduction for property placed in service during 1981. This oversight may be corrected by the technical corrections act which always follows a major tax bill.

The maximum amount that may be expensed is $5,000 per year for property placed in service during 1982 and 1983. The limit increases to $7,500 in 1984 and 1985. For 1986 and later, the limitation is $10,000. These dollar limitations are reduced by 50% for married individuals filing separate returns. The amount expensed does not qualify for the investment credit.

The election is available for personal property eligible to be treated as recovery property, if it is acquired by purchase for use in a trade or business and is eligible for the investment credit. The "use" requirement means that property held merely for the production of income does not qualify. The "purchase" requirement means that property will not be eligible if acquired from a related person or from a controlled group of which taxpayer is a member, or if the basis of the property is in whole or in part a carryover basis.

A "controlled group" of corporations (as determined under Code section 1563 using a 50% test), is treated as one taxpayer, and must therefore allocate the dollar limitation among members of the group. Also, the dollar limitation applies both to partnerships and to each partner. The new law further provides that any portion of the basis of the property which is determined by reference to the basis of property traded in is not eligible for the election. The election must be made on an original return, and the taxpayer must specify the items of property to which the election applies and the amount thereof.

A disposition of the property triggers recapture under section 1245 of the amount expensed as ordinary income. If expensed property has been disposed of in an installment sale, the taxpayer must immediately recognize any gain to the full amount expensed. The amount of this recognized gain is then added to the adjusted basis of the property to determine the profit ratio of the installment payments to be received later. But, because the installment payments are deemed to be received immediately, the taxpayer's tax liability arising from the transaction could conceivably exceed the payments actually received during that tax year. The best way to avoid this situation is not to sell expensed property for installment notes. If the taxpayer must sell in installments, he should make certain that the payments he receives in the year of the sale are at least equal to his tax liability arising from the sale. Because the investment credit is not allowed for expensed property, the tax benefits from using the shorter accelerated ACRS method may in some instances exceed the tax benefits of expensing the property. Taxpayers in lower brackets may find this to be the case because the credit to them will provide a greater tax benefit than a deduction.

3.02 Anti-Churning Rules

I.R.C. § 168(e)(4) - Act § 201. Effective as to property acquired after December 31, 1980, and before January 1, 1986.

To prevent a taxpayer from attempting to bring his pre-Accelerated Cost Recovery System (ACRS) property, which was placed in service before January 1, 1981, under ACRS through questionable transactions, special anti-churning rules were included in the new law. To qualify for ACRS treatment, depreciable personal property acquired by the taxpayer after December 31, 1980, must not have been (1) owned or used by the taxpayer or a related person at any time during 1980; (2) acquired from a person who owned the property at any time during 1980, and the user of the property has not changed; (3) leased to a person (or a person related to such person) who owned or used the property at any time during 1980); or (4) acquired in a transaction in which the user does not change and the property did not qualify as ACRS property in the hands of the person from whom the property is acquired by reason of (2) or (3) above. The requirement of user change prevents sale and leaseback transactions from qualifying. These new rules do not apply to property "owned" in 1980 but not used until after 1980. Property is not owned for purposes of this section until it is in service.

Depreciable real property will not qualify for ACRS treatment if the property was acquired after December 31, 1980, and if the property had been (1) owned by the taxpayer or a related person at any time during 1980; (2) leased to a person (or a person related to such person) who owned such property at any time during 1980; or (3) acquired certain like kind exchanges, "rollovers" of low-income housing, involuntary conversions, or repossessions, for property owned by the taxpayer or a related person during 1980. This last requirement applies only to the extent of the substituted basis in the property, so any remaining basis attributable to boot is eligible for ACRS treatment.

A related person is defined under section 267(b) or section 707(b)(1) using the 10% test for control rather than the 50% test, or persons engaged in trades or businesses under common control using the control tests of sections 52(a) and (b). An exception to the related person test is a corporation which purchases stock to get assets in a section 334(b)(2) corporate liquidation.

The Secretary is given broad powers to enforce the anti-churning rules, and any property which is acquired in a transaction for the purpose of avoiding the anti-churning rules will be denied ACRS treatment. In addition, similar anti-churning rules are to be issued by the IRS to prevent taxpayers from attempting to qualify property placed in service before 1985 or 1986 for the more accelerated methods of cost recovery which go into effect after 1984.

3.03 Minimum Tax on Accelerated Cost Recovery System

I.R.C. § 57 - Act § 2.05. Effective as to property placed in service December 31, 1980.

Under prior law, accelerated depreciation of real property or leased personal property was an item of tax preference subject to the 15% minimum tax imposed by section 56. The same rules hold true for Accelerated Cost Recovery System (ACRS) property. The amount subject to the minimum tax for real property is the excess of the ACRS deduction for the tax year over the allowable straight line deduction using a 15 year recovery period with no salvage value. For leased personal property, it is the excess of the ACRS deduction for the year over the allowable straight line deduction using extended recovery periods with no salvage value. The half-year convention is also required. The extended recovery periods are five years for 3-year property, eight years for 5-year property, 15 years for 10-year property, and 22 years for 15-year property. The effect of the extended recovery periods is to increase the amount subject to the preference tax by lowering the allowable straight line deduction. These rules are not applicable to corporations other than Subchapter S or personal holding companies.

3.04 Accelerated Cost Recovery System for Personal Property
I.R.C. §§ 168, 263, 1245 - Act §§ 201, 204. Effective as to property placed in service after December 31, 1980.

Under prior law, depreciation deductions were designed to reflect the recovery of cost over the useful life of an asset. The midpoint lives in the Asset Depreciation Range (ADR) were based upon actual industry experience, and the taxpayer could elect to depreciate an asset over any period between 80% and 120% of the ADR midpoint life of the asset. The taxpayer could also elect not to use ADR, but the useful lives chosen would have to be determined according to the facts and circumstances pertaining to each asset. Another choice available to the taxpayer was the election to use the straight line method of depreciation or certain accelerated methods.

The Accelerated Cost Recovery System (ACRS) replaces ADR with recovery periods that are generally shorter than the useful lives of the assets and tables that are based on accelerated methods of depreciation. There are also several elections available to the taxpayer to provide flexibility. One election is to exclude property from ACRS and depreciate it under any method of depreciation not expressed in a term of years, such as the unit-of-production method.

The recovery periods under ACRS are 3, 5, 10 or 15 years, depending upon the type of asset to be depreciated. Personal property placed in the 3-year class includes automobiles, light duty trucks, equipment used for research and development, machinery or equipment with an ADR midpoint life of four years or less, race horses which are more than two years old when placed in service, or any horse that is more than 12 years old when placed in service. The 5-year class contains all depreciable personal property not included in other classes, single-purpose agricultural structures, facilities for the storage of petroleum and its primary products, and public utility property with an ADR midpoint life of 18 years or less. The 10-year class contains public utility property with an ADR midpoint life of at least 18.5 years but no more than 25 years, railroad tank cars, section 1250 property with an ADR midpoint life of 12.5 years or less, and qualified coal utilization property not included in the 5-year or 15-year classes. The 15-year class of personal property contains only public utility property with an ADR midpoint life of more than 25 years.

The cost recovered for each year is computed by multiplying the unadjusted basis of the property by the applicable percentage for the property. The unadjusted basis of an asset is the excess of its basis for purposes of determining gain over the sum of that portion of the basis that is to be amortized plus that portion that the taxpayer elects to treat as an expense.

The applicable percentage comes from tables now contained in the Code itself. For property placed in service from 1981-1984, the tables are based upon the 150% declining balance method in the earlier years and the straight line method in the later years. For property placed in service in 1985, the tables are based on the 175% declining balance method in the earlier years and the sum-of-the-years-digits method in the later years. For property placed in service after December 31, 1985, the tables are based upon the 200% declining balance method for the earlier years and the sum-of-the-years-digits method for the later years. The tables do not take salvage value into consideration. Therefore, the entire cost of every asset is eventually recovered.

It is interesting to note that while the ACRS has been hailed as a great tax savings, the depreciation deduction using double declining balance on a $12,000 car purchased in early January using pre-1981 depreciation would be:

Year	Pre-1981	ACRS-1981	Difference
1	$ 8,000	$ 3,000	$ 5,000
2	$ 2,667	$ 4,560	($ 1,893)
3	$ 889	$ 4,440	($ 3,551)
Total	$11,556	$12,000	$ 444

The Code section 168 tables also incorporate the half-year convention, which assumes that every asset was placed in service in the middle of the year. The half-year convention is advantageous for the taxpayer if the depreciable asset is placed into service towards the end of the year, but is disadvantageous if the depreciable asset is placed into service at the beginning of the year. The half-year convention is *mandatory*.

Several elections designed to provide flexibility are available to the taxpayer. If the taxpayer does not desire to use the accelerated method of cost recovery in the tables, an election may be made to recover the cost over the applicable ACRS period using the straight line method. Also, once the taxpayer elects to use the straight line method, he may also elect to extend the period of recovery to the longer recovery periods used to calculate earnings and profits for the asset or for property in the next higher class. Thus, the optional periods for 3-year property are 3, 5, or 12 years; for 5-year property, 5, 12, or 25 years; for 10-year property, 10, 25, or 35 years; and for 15-year property, 15, 35, or 45 years. In all cases, the half-year convention must be used. Furthermore, the same percentage must be used for all personal property of the same class (e.g., ACRS 3-year property) which is put into service in the same year.

Upon disposition of depreciable personal property, gain or loss is generally recognized unless some provision of the Code provides for nonrecognition. Cost that has been recovered under ACRS is still recaptured under section 1245. Therefore, because the cost recovery deduction in the year of disposal would be recaptured as ordinary income in any case, no deduction is allowed for ACRS personal property in that year. A special rule concerning the disposition of assets from mass asset accounts allows gain to be recognized to the extent of proceeds and leaves the unadjusted basis of the property in the account until fully recovered in future years. The purpose of this special rule is to avoid calculation of gain on the disposition of these assets. Amounts that had been expensed in the year of acquisition must also be recaptured as ordinary income, and dispositions may cause some recapture of the investment credits.

3.05 Accelerated Cost Recovery System Writeoffs for Real Property I.R.C. §§ 167, 168, 1250 - Act §§ 201, 203, 204. Effective as to property placed in service after December 31, 1980.

Under prior law, real property was depreciated over its useful life, usually from 30 to 60 years. Under the new law, the cost of most real estate can be recovered over a period of only 15 years and the cost of real property, which had a previous Asset Depreciation Range (ADR) midpoint life of 12.5 years or less, can be recovered over a period of only 10 years. This category includes theme park structures and manufactured homes. The rules and cost recovery tables pertaining to Accelerated Cost Recovery System (ACRS) 10-year property apply to them. However, the class consisting of 15-year real property has its own rules and cost recovery tables.

The cost recovery deduction is computed by multiplying the unadjusted basis of the property by the applicable percentage from tax tables issued by the IRS. The table for most of the 15-year class of real property is based upon the 175% declining balance method of recovery for the earlier years and the straight line method of recovery for the later years. The table for low-income housing is based upon the 200% declining balance method in the earlier years and the straight line method in the later years. No salvage value is considered in the deduction, and, unlike the tables for depreciable personal property, the tables do not use the half-year convention. Instead, they consider the number of months the property has been in service. The taxpayer is also entitled to a deduction for the number of months the property is in service during the year of disposition. Thus, there is no advantage or disadvantage concerning purchases or dispositions of real property which occur in the early or later parts of the tax year.

Elections available to the taxpayer concerning real property are similar to those available for personal property. The taxpayer may elect to use the straight line method of cost recovery rather than the accelerated methods of the tables. Also, once an election to use the straight line method, has been made, the taxpayer can recover his costs over the normal period of

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15 years or over either of the extended recovery periods of 35 or 45 years. Furthermore, these elections can be made on a property-by-property basis.

The 1981 Act also eliminates composite depreciation. Under prior law, a taxpayer could allocate the cost of a building to its component parts, such as wiring and plumbing, and depreciate these components separately using shorter life spans than that of the structure itself. Now the entire building must be depreciated as a whole, with the result that the cost of all components must be recovered using the same methods and percentages as those used for the building itself. An exception to the composite depreciation requirement exists for substantial improvements which may be treated as separate structures. Because of this exception, a substantial improvement can have different recovery methods or periods from those of the original building. This rule will also allow a substantial improvement to qualify for ACRS treatment if made after December 31, 1980, even though the original building must still be depreciated under the ADR rules.

The new rules concerning treatment of gain or loss upon disposition of depreciable real property will be extremely important to the tax planner. The treatment for gain on the sale of residential real property remains the same as before. That part of the gain which reflects the excess of the deductions taken using an accelerated method of cost recovery over the deductions which would have been taken if the straight line method had been used over 15 years is treated as ordinary income. However, if the real property is non-residential and an accelerated method of cost recovery has been used, all gain up to the total amount of deductions taken is treated as ordinary income. But if the taxpayer elects to use the straight line method, all gain will be capital gain.

Therefore, taxpayer should compute the present values of the excess of the tax benefits of the accelerated deductions over the tax benefits of straight line deductions. The present value of the excess of the tax liability accruing from recapture of ordinary income over the liability accruing from capital gains should also be computed. These computations should then reveal whether there is any benefit to the taxpayer in using the accelerated method of cost recovery. The taxpayer may elect to use the straight line method of cost recovery when the beneficial tax treatment given to proceeds from the sale of property outweighs the disadvantages of smaller cost recovery deductions. This, however, might only occur when the taxpayer plans to sell or exchange the property in the future.

3.06 Carryover of Recovery Attributes

I.R.C. § 381 - Act § 208. Effective as to property placed in service after December 31, 1980.

In order to prevent attempts to change the recovery period or method through transfers of property among affiliated groups or certain other related parties, the acquiring corporation shall be treated as the distributor or transferor corporation for purposes of computing the cost recovery deduction. The acquiring corporation must therefore use the same cost recovery method and period with respect to the transferred property that was used by the transferring corporation. This rule applies only to the extent that the acquiring corporation's basis does not exceed the transferor's adjusted basis. Property transferred in the liquidation of a subsidiary or a tax-free organization are the transactions which will give rise to the attribute carryover rules.

3.07 Calculating Earnings and Profits Under Accumulated Cost Recovery System

I.R.C. § 312(k) - Act § 206. Effective as to property placed in service after December 12, 1980.

Since distributions by a corporation to its shareholders are taxable as dividends only to the extent the distribution is from current or accumulated earnings and profits, the increased depreciation expenses caused by ACRS would result in lower earnings and profits. This decrease would allow tax-free or capital gain distributions. To prevent this possibility, Congress mandated that the depreciation used in calculating earnings and profits must be computed by using the straight line method over extended recovery periods. These extended periods are five years for 3-year property, twelve years for 5-year property, 25 years for 10-year property, and 35 years for 15-year property. If the corporation elected to use a longer recovery period than the applicable period above, that longer period must be used to compute earnings and profits. Foreign corporations, however, compute their earnings and profits under the same rules which govern the computation of depreciation of foreign assets under ACRS.

3.08 Research and Development Credit

I.R.C. § 44F, 55(c)(4), 381(c), 6411, 6511 - Act § 221. Effective for amounts paid or incurred after June 30, 1981 and before January 1, 1986.

Under prior law, expenditures for research and development were capitalized and amortized over not less than 60 months unless the taxpayer elected to currently deduct the expenditures. To provide incentives for further expenditures for research and development, Congress created a new tax credit. Other incentives to increase research and development are the inclusion of such equipment in the 3-year class of the accelerated cost recovery system, liberalized deductions for certain charitable gifts of research and development equipment, and suspension of Treasury Regulation § 1.861-8 which required allocation of research and development expenditures to foreign income.

The new tax credit is computed as 25% of the excess of certain research and experimental expenditures for the current year over the base period research expense. To find the base period research expense, the taxpayer must average the qualified research expenditures for the three taxable years preceding the determination year. Qualified research expenses are those which are paid or incurred by the taxpayer in carrying on a trade or business for either in-house research expenses or contract research expenses. Since these expenses must be incurred for "carrying on" rather than "in connection with" the trade or business, it will be slightly more difficult to qualify for the new credit than it will be to elect for current expenditures.

Qualified in-house research expenses encompass: wages for employees engaged in research or in direct supervision of research; the cost of supplies used in research; and the cost of certain leases or other charges for computers. The term "wages" does not include fringe benefits which are not subject to withholding, nor does it include the expense of employing administrative personnel. Qualified contract research expenses are 65% of amounts paid to individuals, colleges, universities or research firms for performing qualified research. Grants to tax exempt funds also qualify if the funds are paid to a college or university for basic research.

Base period research expenses are generally the average of the qualified research expenses of the preceding three years. However, there is a transitional rule for taxpayers whose first taxable year to which the new credit applies begins in 1980 or 1981, or for taxpayers whose second taxable year to which the new credit applies begins in 1981 or 1982. In no case shall the taxpayer's base period research expenses be less than 50% of his current research expenses. This limits the increase in expenditures qualifying for the credit to a maximum of 50% of total qualified current expenditures.

Qualified research consists of the research to discover information or the application of such information to new business items or to improvements of existing business items. However, testing for quality control or efficiency surveys do not qualify. Other exclusions are research conducted outside the United States, research in the humanities or social sciences, or research funded by any grantor contract by another person or any government entity.

All corporate members of a controlled group, to which the 50% control test applies, must aggregate their research expenditures and then allocate the proportionate share of any increase of research expenditures which would give rise to the credit. This prevents artificial increases from shifting expenditures among the members of the group. In addition, all trades or businesses under common control must similarly aggregate and allocate research expenditures according to regulations to be issued. There are also special allocation rules for transactions involving the acquiring of a trade or business which paid or incurred qualifying research expenses.

This new credit is nonrefundable and can be carried back three years or carried forward 15 years. Even though the requirements of qualifying for the credit are somewhat stringent, the credit is an added advantage that did not previously exist. This advantage is restricted because special pass-through rules limit the credit to the tax attributable to the taxpayer's interest in an unincorporated trade or business, partnership, Subchapter S corporation, or trust.

3.09 Safe Harbor Leases

I.R.C. § 168(f)(2) - Act § 201(a). Committee Rep.: H.R. Rep. No. 215, 97th Cong., 1st Sess. 217 (1981). Effective immediately for property placed in service after December 31, 1980.

The Act provides a safe harbor for corporate lessors which substantially eases the conditions formerly required to deem a transaction a lease. By meeting these safe harbors, the lessor obtains depreciation deductions and investment tax credits which arise from the leased property, i.e., the lessor is treated as the owner and the transaction is treated as being a lease in substance and not a sale.

The taxpayer must comply with a number of conditions before relying on the safe harbors. First, the parties must describe the transaction as a lease and elect to have this section apply. Second, the lessor must generally be a corporation. Third, the lessor, from the time the property is first placed in service and throughout the term of the lease, must maintain an at-risk investment of not less than 10% of the property's adjusted basis. Fourth, the term of lease, including any extensions, may not exceed the greater of 90% of the useful life of the property for purposes of section 167 or 150% of the class life of that property as of the beginning of 1981. Finally, the lease must be of qualified leased property.

Qualified leased property is recovery property such as depreciable tangible property used in a trade or business or held for the production of income. Qualified lease property does not include a qualified rehabilitated building. Further, qualified leased property generally must be property referred to in new section 38 that is leased within three months of being placed in service. Certain mass commuting vehicles also qualify.

Qualified leased property, other than mass commuting vehicles, is deemed placed in service not earlier than the date such property is used under the lease. Property placed in service after December 31, 1980, but before the date of enactment, can qualify for the safe harbor rules if leased within three months of the enactment date. Where all the safe harbor tests are met the Act provides that no other factors will be considered in determining the owner of the property.

In effect, this provision allows the transfer of depreciation deductions and investment tax credits to corporations with the capacity to "buy" the deductions and credits and to use them. The lessor shelters income (presumably at a 46% marginal rate) while the lessee receives a lower cost on his equipment since the federal government bears a greater share of the cost.

3.10 Incentive Stock Options

I.R.C. § 422A - Act § 251. Effective immediately for options granted after December 31, 1975 and exercised after December 31, 1980.

A stock option is the employee's right to purchase company stock in the future at a predetermined price. Stock options offered to employees were generally taxable when granted under Code section 83. The fair market value of the option was included in the employee's gross income in the year in which it was granted as compensation. However, if the fair market value of that option was not readily ascertainable, income would not be recognized at the time of the grant. Instead, the employee would recognize the difference between the exercise price and the fair market value at the time of exercise. The employer was allowed a deduction equal to the income recognized by the employee in the same year the employee recognized the income. Under prior law, favorable tax treatment of stock options had either been repealed or severely restricted because of alleged abuses. Congress believed, however, that tax favored stock options were an important incentive device to attract new management and retain key employees by encouraging investment in the business. The Economic Recovery Tax Act favored treatment for certain stock options known as incentive stock options.

The option must meet certain restrictions to qualify under Act section 422A(b)(1)-(8). In return for meeting those restrictions, the employee recognizes income not at the time of the grant, nor at the time of the exercise, but only when the stock is sold. And, unlike stock options under prior law, the difference between the fair market value and the value at the time of exercise is not a tax preference for the add-on minimum tax.

The incentive stock option price must not be less than the fair market value of the stock at the time of grant. Also, options may be granted in any one calendar year only for stock with a value of $100,000 or less, plus any carryover allowed from previous years.

When the stock is sold, the employee receives either long-term capital gains income or ordinary income depending on the holding period and the employee's status with the company. To receive long-term capital gains treatment (and the 60% capital-gains exclusion), the employee must hold the stock for at least one year after exercise of the option and the sale must not occur earlier than two years after the option was granted. Additionally, to receive this beneficial tax treatment, the option cannot have been exercised more than three months after the termination of employment. An exception is made to the three month rule for disabled employees. They can exercise their options twelve months after terminating employment and still receive long-term capital gains treatment.

A major opportunity exists for options already outstanding. If they otherwise meet the requirements for an incentive stock option and the granting corporation elects to have this section apply, these options will qualify for incentive stock option treatment. Act section 251(c) also limits the amount of options which receive this beneficial "lookback" to an aggregate of $200,000 of the fair market value of the stock with no more than $50,000 of that attributable to any one year. This provision could give rise to refund claims for employees previously taxed on such options where the employee still holds either the option or the stock. However, the employer may lose his deductions for those options under Code section 83(h).

The Research Institute of America suggests that a pyramiding technique could be used in situations where the underlying stock appreciates to give the employee a valuable stake in the company at little cost. The technique involves paying the option price with shares of the company. More options may be then exercised with the newly received stock used as payment. This tactic works for three reasons. First, when the employee exercises an option, he realizes a gain because the fair market value of the stock received is greater than the option price. Second, by trading stock, the employee has low out-of-pocket costs. Third, the exchange of stock apparently is not taxed as a disposition which would violate the two-year holding period requirement. Of course, the number of outstanding options places a cap on use of this technique. The success of this technique, of course, is dependent on the appreciation in fair market value of the stock over time.

The return to the Code of a tax-favored stock option allows corporations to offer key employees a chance to participate in the future growth of the company. These options may be used to provide incentive to the employee to benefit the corporation by benefiting himself.

3.11 Investment Credit - New Percentages Applicable

I.R.C. §§ 46, 47, 48 - Act § 211. Effective as to property placed in service after December 30, 1980.

Under prior law, an investment credit of $3\frac{1}{3}\%$ of the purchase price was allowed for assets with useful lives of 3 or 4 years; $6\frac{2}{3}\%$ was allowed for assets with useful lives of 5 or 6 years; and 10% was allowed for assets with useful lives of 7 or more years.

Under the Economic Recovery Tax Act, investment credit is calculated by using the Accelerated Cost Recovery System (ACRS) recovery period of the property rather than its useful life. For eligible property with a recovery period of 3 years, the investment credit is 6%. For eligible property with a 5 or 10 year recovery period or public utility property with a 15 year recovery period, the investment credit is 10%.

The new law does not change the types of property which are eligible for the credit, but expands the credit's availability to facilities used to store petroleum and primary petroleum products. The new law does not limit the credit to production facilities, but extends it to also encompass distribution facilities.

The new law also changes the recapture computation for property which is disposed of prior to expiration of its recovery period. Under prior law, if the disposition occurred before the useful life had expired, the investment credit was recomputed using the actual holding period. Therefore, if an asset had been held for less than 3 years, the entire investment credit was recaptured. In comparison, the new method of recapture allows a 2% credit for each year the property is held. For example, if property is disposed of after 2 years, then only 2% is recaptured for 3 year property and 6% is recaptured for property with longer recovery periods. Another advantage of the new law is the extension of the carryforward period for unused investment credit from 7 to 15 years.

4.00 Retirement Savings Provisions

4.01 Individual Retirement Accounts - Deductions, Contributions and Eligibility

I.R.C. §§ 219, 220, 401, 405, 408, 409, 415 - Act §§ 311(a), (e), (h), 313 & 314(b). Effective after December 31, 1981.

Aware that personal savings have been declining in relation to personal disposable income, Congress responded with legislation that would improve capital formation as it generally affects the economy as well as retirement resources for individuals. To promote greater retirement security, the Economic Recovery Tax Act expanded the contribution, deduction, and eligibility requirements with respect to Individual Retirement Accounts (I.R.A.'s). Banks, savings institutions and others who may qualify as I.R.A. sponsors should also benefit from this new influx of capital.

Under prior law, an employee had to earn at least $10,000 before reaching the I.R.A. contribution limits of $1,500 or 15% of compensation. Under the Act, the annual I.R.A. contribution limit is raised to the lesser of $2,000 or 100% of compensation. An individual earning only $2,000 compensation may now deduct the entire $2,000 contribution. As under the old I.R.A. rules, "compensation" does not include passive income, such as royalties, interest, or dividends.

When the employee is married and the spouse is not employed, the I.R.A. limitation is the lesser of $2,250 or 100% of compensation. To qualify for this increased contribution limit, the employee must have filed a joint return. This prevents a non-working spouse with passive income from receiving the full deduction by filing separately. Furthermore, the contribution no longer has to be allocated equally between the accounts. Cash may be contributed and deducted up to the $2,250 limit, regardless of the proportionate allocation to the spouses.

If both spouses work, each spouse may contribute the lesser of $2,000 or 100% of compensation to his or her account. Married persons each having at least $2,000 in compensation may receive a $4,000 deduction if filing jointly, or each may receive a $2,000 deduction if filing separate returns.

Provision is also made for divorced persons in that the ex-spouse having no or insubstantial compensation may make deductible contributions up to the lesser of $1,125 or 100% of compensation plus any qualifying alimony received during the taxable year. In order to qualify, the unemployed spouses's I.R.A. must have been established at least five years prior to the year of divorce and the ex-spouse must have contributed in at least three of those five years. A divorced spouse earning more than $1,125 in compensation can still deduct up to $2,000. In effect, the divorced spouse provision benefits a spouse who has only alimony income or alimony and passive income. Such spouse would otherwise be ineligible for any I.R.A. contribution.

Collectibles, such as investments in works of art, coins, stamps, or rugs, gold, silver and jewels are not permitted to be contributed to I.R.A. accounts after December 31, 1981. Any such contribution or acquisition after this date will be treated as a distribution of the account assets and will be subject to a 10% premature penalty if distribution occurs before age 59½. However, until December 31, 1981, contributions of collectibles may be made without any penalty. In general, the appreciation on a collectible is not taxable until disposition and then the profit is taxed at long term capital gain rates, if held over 12 months. The major advantage was the acquisition of these items with tax deductible dollars. The collectible investments marketplace is attempting to have this repealed and again make collectible contributions to I.R.A. deductible. It should be noted that collectible contributions to individually directed accounts under a qualified employees trust are also banned. This applies to Keogh and qualified corporate plans in which the participant, not the trustee directs how the account assets are invested.

Under prior law, an employee who was an active participant in a qualified employer plan, simplified employee pension plan (S.E.P.), Keogh, Subchapter S plan or governmental plan was not eligible to create a separate I.R.A. account. Active plan participants may now contribute and deduct under the same limitations as for a regular I.R.A. - 100% of compensation up to $2,000 ($2,250 for a spousal I.R.A.). This separate I.R.A. account is not governed by any of the rules or requirements for qualified retirement plans, such as Code section 415 limitations on benefits and contributions. Therefore, all employees may now set up separate I.R.A.'s, irregardless of other retirement plan participation. To take advantage of the $2,000 deduction for both husband and wife, closely held business owners should consider paying their spouse a salary of at least $2,000. An employment contract should document the specific duties the spouse is to perform during the year.

A development has occurred since the passage of the Economic Recovery Tax Act. Financial institutions handling I.R.A. accounts were limited by federal regulations to paying interest rates between 8% and 16.55% on deposits invested by the institutions. As of December 1, 1981, banks, savings and loans, and credit unions may offer I.R.A. accounts without any interest payment limitations on deposits invested for 1½ years or longer. This enables these financial institutions to compete with money market and insurance funds. The previous limited interest paying CD's may be switched to the unlimited deposits, without being subject to early-withdrawal penalties. This should promote the establishment of even more I.R.A.'s, as the institutions receiving more interest will be able to pay more interest.

If $2,000 is contributed annually at the beginning of the taxable year at a 10% interest rate compounded annually, then the amount in the I.R.A. account after ten years would be $35,062, after 20 years $126,005 and after 30 years $361,887. Amounts double if both spouses work and $4,000 per year is contributed. Also, it should be remembered that the $2,000 contribution is deductible in the taxable year made. Therefore, for a taxpayer in the 50% bracket an additional $1,000 net tax savings is made every contribution year. Note, however, that the pot of gold projected by the future values may become a bread basket when the effects of inflation are considered.

4.02 Qualified Voluntary Employee Contributions (Q.V.E.C.) I.R.C. §§ 72(o), 219, 2039, 2517, 3401(A)(12) - Act § 311. Effective in taxable years after December 31, 1981.

As an alternative to establishing a separate I.R.A. account, an active plan participant may deduct up to $2,000 of personal contributions made to an employer's qualified plan which permits voluntary employee contributions. Under prior law, voluntary contributions were tax deferrable not deductible. Now a participant's voluntary contribution is deductible if made to a qualified plan, tax sheltered annuity or government plan in the form of "qualified voluntary employee contributions" (Q.V.E.C.) if: the contributions are not mandatory, the plan specifically provides for qualified employee contributions and the employee has not designated the contributions as nondeductible. Q.V.E.C. are treated as deductible unless the employee designates contributions to be nondeductible to the plan administrator by April 15th of the next calendar year, or earlier if the administrator so requires.

If the employee has a separate I.R.A. account and also makes qualified voluntary employee contributions, the total deductible contribution cannot exceed $2,000. This reduces the amount that can be deposited into the separate I.R.A. by the amount of the Q.V.E.C. made for the year. Thus, if $2,000 is contributed to Q.V.E.C., nothing may be contributed to the separate I.R.A.

If the contributions are not designated as nondeductible, any contribution in excess of the allowable $2,000 limit is treated as an excess contribution subject to penalty. Excess contributions on which no deduction was taken may be withdawn without penalty up to the due date for the return or after the due date if the contributions were not more than $2,250.

Q.V.E.C. are not subject to withholding, provided the employer reasonably expects the employee to be entitled to the deduction, whether or not the deduction is actually taken. Nor are the contributions subject to the Code section 415 limitations on contributions and benefits. Thus, the contribution and benefit limits for the qualified employer plan will not be reduced by the Q.V.E.C.

Employer plans need to be amended to accept voluntary contributions if the employer decides to offer this service to the employees. However, possible disadvantages for the employer include: (1) increased costs in reporting, disclosure, accounting and administration; (2) voluntary contributions will have to be monitored closely because employer matching contributions are not required; (3) discrimination rules may be violated if only higher paid individuals (the prohibited group) contribute; (4) employee confusion on where accounts are and why contributions are now required to be at least annually adjusted for expenses, losses, and income, since comingling of assets with the qualified plan are permitted; and (5) employee and employer confusion on distribution rules.

The new law is unclear whether the 10% limit on voluntary employee contributions for qualified plan will be effected by the voluntary contributions of Q.V.E.C. If the Q.V.E.C. is considered for purposes of the 10% limitation, then an excess contribution may be made which would jeopardize the plans qualification. However, as Q.V.E.C.'s are for the most part like an I.R.A. within a qualified plan, it follows that they should not be considered in determining the 10% voluntary contribution limitation.

Q.V.E.C. distributions are referred to as accumulated deductible employee contributions. These are net qualified voluntary employee contributions adjusted for income, gain, loss and expense. On distribution they are generally subject to the same rules as an I.R.A. However, the I.R.A. rules requiring distribution by age 70½ are not applicable to Q.V.E.C. Since Q.V.E.C. distributions do not qualify as lump sum distributions, they are includable in gross income as ordinary income at the time of distribution unless rolled over.

Rollovers into an I.R.A. or other qualified plans of accumulated deductible employee contributions may be made if the second plan administrator treats the amount transferred as accumulated deductible employee expenses and permits such transfers on a nondiscriminatory basis. If rolled over into an I.R.A., *all* I.R.A. rules apply. Thus, distributions must commence by age 70½ and distributions must be made within a prescribed period after death. Double rollovers are also permitted — a Q.V.E.C. distribution to an I.R.A. to a qualified plan — subject to the above rules for Q.V.E.C. rollovers.

Accumulated deductible employee contributions may not be applied towards life insurance. Loans to or from accumulated contributions are also prohibited. In addition, appreciation on employer securities attributable to accumulated contributions is taxable when distributed.

Accumulated contributions are treated as a benefit derived from employer contributions for gift and estate tax purposes. A Q.V.E.C. distribution is excludable from the gross estate, and a donor/employee is exempt from gift tax for amounts attributable to Q.V.E.C. that are designated to a beneficiary. The estate and gift tax exclusions arise from the treatment of deductible employee contributions made by persons other than the decedent/employee.

4.03 Keogh, Simplified Employee Plan (S.E.P.) and Subchapter S Plan I.R.C. §§ 401(a)(17, 404(e), 408(k)(5), 72(m) - Act §§ 312 (a)(b)(c)(d)(e), 314 (a). Effective in taxable years and as to distributions after December 31, 1980.

Under the new law, the Keogh, S.E.P. and Subchapter S deductible ceiling for contributions is raised to the lesser of 15% of earned income or $15,000 ($7,500 under prior law). Therefore, the maximum net tax savings in a 50% tax bracket is $7,500. The amount of earned income that may be taken into account in determining compensation is also increased from $100,000 to $200,000. The above retirement plans must be amended to qualify for these new higher limitations. If an annual contribution above $100,000 is used, the employees must receive a contribution to their accounts of at least 7.5% of the employees' compensation. As under prior law, social security intergration reduces the actual amounts that must be contributed for an employee/participant. In addition, contributions or benefits under another qualified plan of the same employer may be taken into account in determining whether the 7.5% minimum has been satisfied.

The compensation taken into account for the level of annual benefit accruals permitted under a *defined benefit* Keogh or Subchapter S corporation plan is increased from $50,000 to $100,000. A change in the annual compensation in excess of $100,000 starts a new period of plan participation.

Under prior law, a partner with less than 10% ownership interest in the partnership could borrow from the Keogh plan. Now all borrowing or use of plan assets as security for a loan is prohibited after January 1, 1982. Any borrowing or use of the assets as security is treated as a distribution. Outstanding loans that are not renegotiated, extended or renewed after December 31, 1981, will not, however, be treated as distributions.

Excess contributions to Keogh can be withdrawn to avoid the 6% excess tax, if the excess is withdrawn before the due date for filing the return. Early withdrawals (before age 59½, if not due to disability) are permitted by the owner-employee from a terminated plan without the five year ban on Keogh plan contributions being triggered.

As noted previously, all individuals with earned income may now use separate I.R.A.'s, regardless of any other retirement plans. This means an individual may make in addition to the maximum $15,000 deductible contribution, a $2,000 ($2,250 for a spousal I.R.A.) deductible contribution into the separate I.R.A. account. This $17,000 ($17,250 spousal) deductible contribution per year should help many small businesses from being forced into incorporation in order to receive the higher benefits of qualified plans, although the corporate qualified plan limitations are still significantly higher. Also, it should be remembered, the Keogh, S.E.P. and Subchapter S plans are still not adjusted for inflation as are qualified plans.

4.04 Qualified Retirement Plan - Constructive Receipt

I.R.C. § 402(a)(1) - Act § 314(c)(1). Effective in taxable years after December 31, 1981.

Section 402(a)(1) embodied a constructive receipt rule governing distributions from qualified plans, in that if all or any portion of a plan's assets were distributable upon demand by the participant, the amount "made available" was currently includable in gross income. The Economic Recovery Tax Act deletes the "made available" language, with the result that amounts "made available" in 1982 and thereafter will not be taxable until actually distributed. Congress provides no explanation for this significant change.

Under prior law, constructive receipt problems arose in two major contexts. First, if employees had unlimited access to both the principal and earnings of their voluntary contributions, the earnings were currently taxable. The typical solution was to provide a waiting period before additional voluntary contributions could be made if earnings were withdrawn. This waiting period could serve as a sufficient penalty to preclude constructive receipt. Apparently such penalty clauses are no longer required, and the fact that voluntary contribution earnings are *made available* will not affect the rule that taxation will not occur until an actual distribution.

Second, if a participant did not make an irrevocable election as to the method of payment prior to distribution, such as at retirement, the constructive receipt rules could create a problem. The entire pension distribution could be taxable at retirement, rather than when distributions were actually received - e.g., at annual intervals if an installment form of distribution was available. Under the Act it appears that the participant's right to change the method of payment will not result in immediate taxation.

Employee participants, especially in closely-held corporations, appear to be given much more flexibility in timing distributions to conform with personal and financial planning. Note, however, that the constructive receipt rules still apply with respect to nonqualified deferred compensation plans.

4.05 Employee Stock Ownership Plan - Payroll Based Credit, Leveraged ESOP's, Distributions

I.R.C. Adding §§ 44G, 404(a)(10), 404(i); Amending §§ 46(a)(2), 401(a)(22), (23) & 409A(d), (h) - Act §§ 331-37. Effective in taxable years after December 31, 1981, except for the 84 month rule, which applies to distributions after March 29, 1975. Expires December 31, 1987.

An employee stock ownership plan (ESOP) is a tax qualified plan under which the value of employer stock contributed to a tax exempt trust is deductible by the corporation. In effect, the corporation prints money, by virtue of contributing its own stock to the ESOP and receiving the deductions. In a leveraged ESOP the trust may borrow money to purchase employer stock. An employer may also contribute cash or stock to an in-investment tax credit ESOP, known as a TRASOP, and receive investment tax credit. Under prior law, the rules governing leveraged ESOP's were very restrictive and the ESOP distribution rules were burdensome. The new law liberalizes some of these prior rules, creates a new payroll-based credit ESOP and eliminates the investment credit ESOP.

Payroll Based Tax Credit

Under prior law an employer was entitled to receive an additional investment credit of one percent of the value of property which qualified for the investment credit under section 38. To qualify, employer securities had to be contributed to the investment credit ESOP, known as a TRASOP.

Congress indicated that TRASOP's had not provided sufficient incentive for the establishment of ESOP's by labor-intensive corporations, since these corporations purchased only small amounts of the machinery and equipment eligible for the investment tax credit. The new law terminates TRASOP's after 1982 and establishes an ESOP based on the aggregate compensation of employee participants after 1981. Investment tax credit may still be taken on qualifying investments to a TRASOP up to December 31, 1982, so that accelerating purchases when possible to before 1983 should be considered. If the qualifying investment is made in 1982 the employer is allowed only a partial additional investment tax credit which cannot exceed 1% if an equal contribution is also made to the payroll-based ESOP.

The new ESOP is based on the aggregate compensation of employee participants. The payroll-based credit is determined by taking a specified percentage of the aggregate compensation of employee participants. The maximum percentage for 1983 and 1984 is ½ of 1%; and for 1985 through 1987 it is ¾ of 1%. The payroll-based tax credit expires after 1987.

The maximum amount of payroll based credit that may be taken in any taxable year is limited to the corporation's first $25,000 of tax liability, plus 90% of the tax in excess of $25,000. Tax liability is defined as a corporation's regular tax for the taxable year reduced by the foreign tax credit, investment tax credit, energy tax credit, research credit and targeted job credit. If the employer is a member of a controlled group of corporations, $25,000 is subject to apportionment among the component members of such group. Any unused credit may be carried back 3 years and carried forward 15 years. Also, any remaining unused credit can be deducted at the close of the last taxable year to which it may be carried. The usual deductible contribution limits for deductions will not apply. Hence, the payroll-based credit will never be lost but may have to be deferred.

To qualify for the payroll-based tax credit, the plan must meet the qualification rules for tax credit ESOP's under Code section 409A. Also, no more than one-third of the employer contributions for the year may be allocated to officers, shareholders with more than 10% ownership or employees whose compensation exceeds the limitations under section 415 (c)(6)(b) of the Code ($83,000 for 1981). The securities must be transferred within 30 days from the due date of the tax return on which the credit is taken, regardless of whether the credit is subsequently allowed. Furthermore, a contribution of cash to a payroll-based ESOP trust is considered as a transfer of employer securities if the plan uses the cash within 30 days to purchase employer securities.

Leveraged ESOP's.

ESOP's are permitted to purchase employer securities through loans which are usually secured by the corporation/employer. As a result of using ESOP contributions to pay interest and principal the regular contribution limit of 15% may be increased to 25% plus the amount of interest paid. The debt is paid by the ESOP trust through either dividends paid by the corporation for the stock held by the ESOP or through employer contributions. The deductible limit for these contributions to the leveraged ESOP is increased by the new law from 15 to 25% if the contributions are applied by the ESOP to the repayment of loan principal. There is no deductible contribution limit for the repayment of interest, nor do the employee forfeiture limitations (when stock in the leveraged ESOP is allocated to the employee, the loan for the stock is forfeited) apply, if the benefits do not discriminate in favor of highly compensated employees, officers or shareholders with more than 10% ownership. In addition, for the employee forfeiture limitations not to apply, the security's entire purchase price must have been paid for with the proceeds of the loan to the leveraged ESOP. Where securities are purchased by the ESOP partly with loan proceeds and partly with other moneys, then the securities are treated as being purchased with loan proceeds if the securities aggregate value are not in excess of the loan proceeds.

Distributions.

Under prior law, when an employee received a stock distribution from an ESOP, the employee was deemed to have a put-option. The put-option was the right to require the employer to repurchase the securities if they were not readily tradeable on an established market.

The put-option period has now been shortened from 6 months to 60 days following the date of distribution of employer stock. An additional period, which must also be granted if the put-option is not exercised by the employee, is also shortened from 3 months to 60 days in the following plan year. No put-option is required if the ESOP stipulates that employees entitled to distributions have a right to receive a distribution in cash. This exception is based on the purpose of the put-option to ensure that employees receiving distributions may readily convert them to cash, since in many closely-held corporations the stock is not readily tradeable nor are dividends paid.

ESOP's established by banks and financial institutions are exempted from the put-option requirement. The put-option is not required by banks and similar financial institutions which may be prohibited by state law from redeeming their own securities. However, the participant must have the right to receive a cash distribution. This change aligns the federal tax laws with state laws prohibiting redemptions by banks.

An ESOP is not required to make distributions in the form of employer securities if the participants have a right to receive a cash distribution and the corporate charter (or bylaws) restricts the ownership of substantially all outstanding employer securities to employees or to a trust under a qualified plan. This provision is for closely held corporations which seek to keep control within a defined group such as the immediate family.

Generally distribution from an ESOP must not take place until 84 months after the securities were contributed to the ESOP. Under the Act, the 84 month rule does not apply if the employer corporation is sold and substantially all of its assets are transferred to the acquiring corporation. Also, the plan participant must be directly or indirectly transferred to the acquiring corporation. The 84 month rule is also waived for employees of a subsidiary when the parent company sells its interest in the subsidiary. The participant is required to remain as an employee.

5.00 Estate and Gift Tax Changes

5.01 Unified Tax Credit

I.R.C. §§ 2010 & 2505 - Act § 401. Effective upon death of donor and gifts made from 1982 through 1987.

Before the Tax Reform Act of 1976, each estate was entitled to an exemption of $60,000, and each individual was entitled to a lifetime gift tax exemption of $30,000. The Tax Reform Act of 1976 replaced both exemptions with the unified tax credit, which was phased in from $30,000 in in 1977 to $47,000 in 1981. Besides continuing that unified tax credit, the new Economic Recovery Tax Act dramatically increases it to $192,800—the equivalent of the tax on a $600,000 estate—by 1987.

The unified credit also applies to the tax on inter vivos transfers during a donor's life. Now the donor can give increasingly larger gifts without paying any tax. For example, a donor who has no taxable gifts before 1987 can give a taxable gift of $600,000 and receive a tax gift offset of $192,800 from the unified credit. (For the purpose of calculating estate tax, the amount of the taxable gift is added to the donor's assets at the time of his or her death.)

This represents a considerable change from the way transfers were handled. Before 1976, any transfer made more than three years before the donor's death was excluded from the estate. The Tax Reform Act, however, requires that all taxable transfers made after December 31, 1976, are to be added to the estate to determine estate taxes. The purpose is to eliminate any distinction between tax rates for transfers made during life and at death. Then in the calculation of the estate tax, the unified credit is deducted from the tax actually paid. Purpose aside, the effect of this plan is that all lifetime transfers, being added to the donor's other assets at death, are taxed at the highest possible marginal tax bracket.

The six-year phase-in of the unified credit and the exemption equivalent is shown below:

Briner: Economic Recovery Tax Act of 1981

Year of Death or Gift	Amount of Tax Credit	Exemption Equivalent
1981	$ 47,000	$175,000
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 after	192,800	600,000

5.02 Reduction of Transfer Taxes

I.R.C. §§ 2001(b) & (c) - Act § 402. Effective 1982 through 1985.

Under existing law, estate taxes in excess of $5,000,000 are taxed at the marginal tax bracket of 70%. The Economic Recovery Tax Act phases in a reduction, however, so that by 1985 the maximum marginal tax bracket on inter vivos transfers in excess of $2,500,000 is 50%. For transfers of less than $2,500,000, the tax rates have not been modified.

The phase-in is as follows:

Year	Marginal Tax Rate Percentage	Transfers In Excess of
1981	70%	$5,000,000
1982	65%	4,000,000
1983	60%	3,500,000
1984	55%	3,000,000
1985 and after	50%	2,500,000

The following chart shows the combined effect of the transfer tax reductions in the maximum marginal tax rate and the increase in the unified credit.

Taxable Transfer of	1981	1987	Tax Reduction
$ 600,000	131,800	0	131,800
1,000,000	265,600	119,800	145,800
5,000,000	2,112,200	1,691,400	420,800
10,000,000	4,936,200	3,515,400	1,420,800

Taxes here are applicable to both inter vivos gift transfers and estates. These calculations assume no marital deduction. They also take into account the credit for state death taxes set forth in Code section 2011, which the Economic Recovery Tax Act leaves unchanged.

5.03 Unlimited Marital Deduction

I.R.C. §§ 2012(b), 2056(b), (c) & (d), 2523(a) & 2602(c) - Act §§ 403(a) & (b). Effective at death of donor and gifts made after December 31, 1981.

The estate tax marital deduction and the gift tax marital deduction have had two marked changes in recent history. Before the Tax Reform Act of 1976, both deductions were simply 50%. But with the Reform Act, the estate tax marital deduction became the greater of two amounts, either $250,000 or one-half of the adjusted gross estate. Furthermore, in such instances when the gift tax marital deduction exceeded one-half of the gift, the estate tax marital deduction was adjusted downward by the same amount as the gift. For example, if a wife gave $90,000 to her husband, the gift tax marital deduction was $90,000. At the wife's death, however, the estate tax marital deduction had to be reduced by $45,000 ($90,000 — [90,000 x 50%]). As a result, the marital deduction was increased for all estates less than $500,000. The gift tax marital deduction, as modified by the Tax Reform Act, was as follows:

Amount of Gift	Marital Deduction	Taxable Gift
$0 to $100,000	$100,000	$100,000
$100,001 to $200,000	0	0
Over $200,000	50%	50%

The Economic Recovery Tax Act of 1981 provides for an unlimited interspousal transfer of property both during life and at death. In other words, all property passing to a spouse is exempt from gift and estate taxes. Another significant point is that these exemptions also apply to community property, as well as to separate property.

Under prior law, property placed in trust for the surviving spouse qualified for the marital deduction if, first, the surviving spouse received income at least annually for life and if, second, the surviving spouse had a general power of appointment. The surviving spouse could exercise the general power of appointment during his or her life or at death.

But, due to the general power of appointment, the property which qualified for the marital deduction was not taxed upon the death of the first spouse. Instead, it was included in the estate of the surviving spouse. In addition, if the interest in property was considered a terminable interest —such as when the first spouse's will, provided that the surviving spouse was to receive income for life with the remainder passing to the children— no marital deduction was permitted.

The Economic Recovery Tax Act of 1981 eliminates some of the confusion. For instance, a marital deduction will be allowed even if the surviving spouse receives only a life estate in the property or even if the property is a qualified terminable interest property. The provision for life estate qualified terminable interest property applies to both lifetime transfers and transfers at death. The only condition precedent to qualification for the marital deduction is that election must be made by the donor-spouse or by the executor of the decedent-spouse's estate. The purpose of these new sections is that property qualifying for the marital deduction is either included in the estate of the surviving spouse or is treated as a gift if the property is transferred.

If the income interest is granted only for a certain number of years or until some event occurs, such as remarriage, the interest does not qualify for the marital deduction. The surviving spouse must be entitled unequivocably to all the income from the property during his or her life, and such income must be paid at least annually. In addition, no third party can have the power to appoint any part of the property to any person other than the surviving spouse during his or her life. (The committee reports indicate that a trustee may have the power to invade the property for the benefit of the surviving spouse, but that property cannot be given to another individual.)

New Code section 2207A provides details about the transfer tax. First, the transfer tax is payable by the person receiving the property when it is transferred by the surviving spouse. Second, if the property other than a qualified terminable interest property is transferred and gives the surviving spouse income for life, the requirements of Treasury Regulation section 20.2056(b)-(f) must be met. Third, upon the surviving spouse's death, the fair market value of the qualified terminable interest property is included in the surviving spouse's estate. This means that, if the transferred property has appreciated, the increased value—not the value at the time of the first spouse's death—is includable in the estate.

Section 2523(f)(4) states that the election to take the marital deduction for a life estate from the qualified terminable interest property is made by either the executor or by the donor on the gift tax return. The election is made in the year that the gift is given. Furthermore, once made, the election is irrevocable.

Some commentators, articles, and newspaper reports have indicated that the new unlimited marital deduction will eliminate the need for estate planning and multiple trusts. On the contrary, both require even more careful planning. A comparison of the old and new laws proves the point.

Under prior law, the will and trust generally provided that one-half of the adjusted gross estate was either given outright to the surviving spouse or placed in trust for the surviving spouse's benefit. Typically, this meant that he or she had the income for life and the right to withdraw funds or to name the ultimate beneficiary. Generally, the other half of the deceased spouse's assets was placed in a family trust. The norm for the use of this trust was that the surviving spouse had the right to withdraw the greater of 5% of the corpus or $5,000. In addition, the trustee had the right to withdraw funds for the health, education, maintenance, and support of the surviving spouse. And upon his or her death, the property passed to the children or grandchildren. Maximization of tax savings allowed few variations of these procedures.

Because of the new law, however, the husband and wife must make several decisions at the outset; the amount of the property that is to pass directly to the surviving spouse, the amount that is to be in trust and providing the surviving spouse with only income for life, and the amount that is to be retained for the children. These decisions have tax, as well as emotional, implications.

For example, if a husband gives his total assets of $1,200,000 to his wife, no transfer tax is paid upon his death. Neither will there be any estate tax if the wife receives income for life and the husband's executor elects irrevocably to have this property included in her estate at the time of her death. And when that occurs, the estate tax, disregarding the credit for the state transfer taxes, will be $235,000.

Other decisions would, of course, have been possible, but they depend upon sound planning and good advice. Consider the previous example. One decision might have been to make available to the wife or to transfer to her only $600,000. In such case, no estate tax would have been paid at the death of either spouse, for the unified credit transfer of each would have completely eliminated the transfer tax.

Nor, as some commentators are now claiming, does a lifetime transfer to equalize the estate solve the problem. For example, if the property is transferred by gift, and the donee-spouse later decides to sell it, the adjusted basis will be the donor's basis, not the fair market value at the time of the donor's death. Careful consideration suggests another plan. Since there is no transfer tax either at death or during life and since there is a possibility that the property will eventually be sold by the donee-spouse, the property should pass at death, not during life.

One last illustration from this example helps substantiate the need for estate planning. When a husband and wife each own $600,000 of assets in their own names or $1,200,000 of assets as joint tenants, tenants by the entireities, or tenants in common, leaving all property to the surviving spouse causes serious estate tax consequences. Again, the surviving spouse's estate will be $1,200,000, and the estate tax at his or her death will be $235,000. But, if neither spouse leaves property to the surviving spouse, then the unified transfer credit will result in zero tax at the time of their deaths.

The new provisions of the Economic Recovery Tax Act make a review of wills and trusts particularly necessary. In wills and trusts executed before September 12, 1981, there is a standard but now dubious statement which gives to the surviving spouse or to the marital deduction trust:

> an amount equal to the maximum allowable marital deduction, provided that this sum shall be reduced by an amount, if any, needed to increase the taxable estate to the largest amount that will, after allowing for the unified credit against the federal estate tax, not result in a federal estate tax being opposed on the estate. The balance of the trust estate shall be set aside as a separate trust, designated for convenience as trust B or the family trust.

But Act, section 403(e)(3) now provides that any marital deduction formula clause, pecuniary or fractional share, which was executed before September 12, 1981, and which gives the surviving spouse the maximum marital deduction allowable under federal law does not qualify for the new unlimited marital deduction. The reasoning here is to prevent the transfer, based on these earlier formula clauses, of unintended amounts to the surviving spouse. Therefore, if it is the intention of the estate planner and the donor to insure the unlimited marital deduction, they must revise or amend the formula provision.

The Act also considers another possibility. What if the state of domicile of the deceased inacts a statute which construes the formula clause to mean the marital deduction currently in effect under federal law? If the document is not revised, the amount passing to the surviving spouse and qualifying for the marital deduction will be equal to the greater of $250,000 or 50% of the adjusted gross estate. The reason is that this is the amount of the marital deduction before 1982.

While the Act specifically deals with the problem of the formula clauses in documents prepared prior to September 12, 1981, there is no provision freezing the amount of the estate "cut back" provision at $175,000, the exemption equivalent of the unified transfer tax of $47,000. If a will or trust contained the wording in the preceding paragraph where the decedent's estate is increased to the amount which, after allowing for the unified credit, will result in no federal estate tax being imposed, by 1987 only assets in excess of $600,000 would pass to or for the benefit of the surviving spouse. The reason for this is that, as the unified credit is increased and phased in from $47,000 in 1981 to $192,800 in 1987, the amount which this clause requires to be held in the first spouse's estate is increased from $175,000 to $600,000. Therefore, in all estates of $600,000 or less the surviving spouse will, in effect, be disinherited. The entire amount of the estate of up to $600,000 will pass into the B or family trust.

At such time as the total family estate exceeds $1,200,000 the "cut back" clause is very beneficial in that it insures full usage of the $192,800 unified credit in the estate both of the husband and of the wife. For example, if husband has a $5,000,000 estate and desires that all property should pass to his wife, the wife will have a $5,000,000 taxable estate at her death. If, however, the "cut back" clause is utilized, the husband will have a $600,000 taxable estate and the wife's taxable estate will be reduced to $4,400,000. This results in reduction of the federal estate tax from $1,691,400 to $1,458,600, - a savings of $232,800.

5.04 Marital Deduction - Charitable Remainder Trust

I.R.C. §§ 2056(b)(8) & 2523(g) - Act § 403(d)(2). Effective at death of donor and gifts made after 1981.

Under prior law if the surviving spouse was given income for life and the remainder went to a charitable remainder annuity trust or to a charitable remainder unitrust, no marital deduction was permitted since the surviving spouse had a terminable interest.

With the revision of the law permitting unlimited marital deductions when the surviving spouse receives an income interest for life from a qualified terminable interest property, no reason exists for denying the deduction if the remainder is a charitable remainder annuity or unitrust. Therefore, the Act provides that the marital deduction terminable interest rules are not applicable where the only noncharitable beneficiary is the donor's or decedent's spouse. Under this arrangement the decedent's estate receives a marital deduction for the surviving spouse's interest in the trust and a charitable deduction for the remainder interest in the trust.

The property which is equal to the unified credit exemption equivalent will normally pass to a trust which is similar to the B or family trust currently in use. However, provision should be made so that the amount in this trust will not qualify for the marital deduction. One way of doing this is to provide that the trustee has discretion to pay the income to the surviving spouse under a sprinkling provision rather than automatically requiring the income to be paid to the surviving spouse. With this alternative, the will or trust document could state that the irrevocable election will not be applicable to the property passing to this portion of the trust.

5.05 Joint Ownership of Property

I.R.C. §§ 2040(c)(d) & (e), 2515, 2515A & 6019C - Act § 403C (c)(3). Effective at death of donor and gifts made after 1981.

Prior to the Economic Recovery Tax Act of 1981 property owned as joint tenants or tenancies by the entireties where by the property passed by right of survivorship was subject to a very complicated set of provisions relating to the creation, termination of a joint tenancy on the death of a

Primer: Economic Recovery Tax Act of 1981

joint tenant. The basic rule was that the entire value of the jointly held property was includable in the estate of the first joint tenant to die. The only exception was when the surviving joint tenant could prove contribution. The basic rule is modified by The Tax Reform Act of 1976 and The Revenue Act of 1978.

According to the Tax Reform Act of 1976, if the joint tenancy between husband and wife was created after December 31, 1976, and the creation of the tenancy was treated as a taxable gift, only 50% of the jointly held property is included in the estate of the first joint tenant to die. The Tax Reform Act of 1976 and the Revenue Act of 1978 also provided that contribution can be created based upon material participation by the noncontributing joint tenant if a family farm or business is involved.

The creation of a joint tenancy in personal property creates a taxable gift. If a joint tenancy in real property is created, section 2515 provides that there is no gift unless the contributing joint tenant elects such treatment.

The Economic Recovery Tax Act recognizes the complex and burdensome rules concerning the creation and termination of jointly held property between spouses. It also recognizes that these rules cause widespread noncompliance in the reporting and filing of gift tax returns where joint ownership in property exists. Therefore, the Act makes these rules immaterial except for the issue of the income tax basis of the property passing to the surviving spouse, and the qualification of the estate of the deceased spouse for certain provisions.

As a result, the Economic Recovery Tax Act repeals section 2515 relating to tenancies by the entirety in real property, section 2515A relating to tenancies by the entirety in personal property, and section 2019(c) relating to the gift tax returns. In other words, the significance of jointly owned property is now in the estate tax implications.

5.06 Gift Tax Exclusion - Medical and Educational Expenses

I.R.C. § 2503(e) - Act § 441(b). Effective as to transfers after 1981.

The new Act creates an unlimited exclusion from the gift tax for the payment of medical expenses and educational expenses. The payment for medical expenses must be made to the provider of the service and cannot be reimbursed to the person who received the services.

5.07 Basis of Appreciated Property Acquired by Decedent by Gift Within One Year of Death

I.R.C. § 1014(e)(2)(A) - Act § 425(2). Effective as to property acquired after August 13, 1981, by persons dying after 1981.

In the past, property which had appreciated in value was sometimes transferred to terminally ill donees to avoid payment of income taxes. The Economic Recovery Tax Act attempts to avoid such practice by removing the step-up basis equal to fair market value at the date of death. The removal is restricted, however, to property acquired within one year of death and to property which passes from the decedent back to the donor or to the donor's spouse.

5.08 Disclaimer

I.R.C. § 2518(c)(3) - Act § 426(a). Effective as to transfers creating an interest in disclaimant made after 1981.

The intention of section 2518 of the Tax Reform Act of 1976 was to create a standard, uniform, federal disclaimer, irrespective of the local state law. Prior to the enactment of the 1976 disclaimer statute, a person who refused a bequest from his father because of the substantial tax burden it would cause to his own estate would be deemed under federal law to have made a gift to his own children if, by his refusal, the gift passed to them under state law provisions.

The purpose of a qualified disclaimer is to have the disclaimant treated as if the property had never passed to him. Therefore, no gift or estate tax liability is incurred by the disclaimant. Section 2518 attempted to eliminate the problem of state law variations by treating the disclaimer as qualified under federal law if: it was in writing; it was received within 9 months after the interest was transferred to the claimant or 9 months after the disclaimant's 21st birthday; the person disclaiming did not accept any benefits; and interest passed without the disclaimant directing whom the recipient would be. The last requirement undermined the intention of the section. Since the property had to have passed to a party without direction of the disclaimant, state law was relied upon. If the disclaimer was ineffective under state law, then it was ineffective under the federal law. As a result, there was little improvement.

To correct the situation, the Economic Recovery Tax Act provides that as long as the disclaimer meets the federal requirements it is valid for federal estate and gift tax purposes, even if it is not effective under local state law.

5.09 Gift Tax - Annual Exclusion

I.R.C. § 2503(b) - Act § 441(a). Effective as to gifts made after 1981.

The 1981 Act increases the annual per donee exclusion from $3,000 to $10,000. This is the first increase in this exclusion since 1942. As an extra bonus, if spouses elect to split the gift, an individual can give $20,000 to each donee. This increase greatly expands the opportunity for transmitting estates from the older to the younger generations and for eliminating the transfer tax in the process. Just as transfers qualifying for the annual per donee exclusion are not subject to the transfer tax at the time the gift is made, neither are they required to be considered in the transfer tax calculation at the time of death.

As with any gifting program the major concern of the donors is what will happen to property in the event that the children or grandchildren incur financial problems, marital difficulties or a suit due to tort claims. One way of protecting the corpus of the gift is not to transfer the property directly to the donee but to place it in trust. The type of trust which should be used for this must qualify the gift for the annual per donee exclusion. This means the beneficiary must have a present interest in the subject matter of the gift. The vehicle which achieves these results is referred to as a "Crummey" or "Demand" Trust. This trust provides that the beneficiary has an annual noncumulative right to withdraw the lesser of the donor's contribution or the amount of the annual exclusion as set forth in section 2503(b). In the event a child or grandchild actually exercises the power to withdraw the funds, in all probability that would be the last gift the donor would place in the trust for the benefit of the donee.

A gifting program of this magnitude is ideally suited for the transfer of closely held corporation stock. The process, furthermore, is simple. Before the gifting program begins, the closely held corporation can undergo a recapitalization that creates two classes of common stock—voting and nonvoting. The parents can retain the voting stock; the children and grandchildren will receive the nonvoting stock, the subject matter of the gifts.

Other than for gifts of closely held corporation stock or interests in real estate, most taxpayers will probably not undertake substantial gift programs. Even prior to the Tax Reform Act of 1976, when large amounts could be given away and excluded from estate taxes, donors rarely transferred substantial amounts of assets to family members. The behavior is probably due to the psychological reluctance to part with property when the future needs of old age are uncertain.

Regardless of the Economic Recovery Tax Act of 1981, one disadvantage of the gifting program remains: the basis of any gifted property is equal to the donor's adjusted basis plus any gift tax paid. This contrasts with the adjusted basis of property passing at death which takes a "step up" in basis equal to fair market value at donor's death or the alternate valuation six months later. If the donees intend to dispose of the gifted property, the stepped-up basis may discourage a gifting program. However, if the donees intend to retain the property, then the carryover basis is not a serious consideration. As with any estate planning aspect, calculations of the income, gift and estate tax must be evaluated before making final recommendations.

5.10 Gifts Made Within Three Years of Donor's Death

I.R.C. § 2035 - Act § 424(a). Effective as to donors dying after 1981.

Prior to 1977 gifts made within three years preceding the date of donor's death were "presumed" to have been made in contemplation of death. As a result there was a rebuttal presumption that these transfers were made to avoid estate tax. Therefore, the property transferred within three years preceding donor's death was added to the other assets owned by decedent in calculation of federal estate tax. Specifically, the value of the property was included in the calculation of decedent's estate tax based on the fair market value of the property as of the death, not as of the time the property was given.

After extensive litigation, The Tax Reform Act of 1976 changed the rebuttable presumption into a requirement that all transfers made within three years of donor's death were to be automatically included in the calculation of the donor/decedent's federal estate tax. The only exception to the includability was if no gift tax return was required to be filed at the time the gift was made. Therefore, if the value of the gift was $3,000 or less, no gift tax return had to be filed and the subject matter of this gift was not includable. Congress also recognized that life insurance was a different type of asset. Therefore, if life insurance was transferred, even though it had a fair market value of less than $3,000, the full face value was included in decedent's estate.

It should be noted that property which was included in decedent's estate under section 2035 took a step up in basis equal to the fair market value at date of death or the alternate valuation date of six months later. This was in contrast to the normal rule that the basis of gift property was the donor's adjusted basis.

In general, the Economic Recovery Tax Act of 1981 eliminates the three-year rule. However, the following exceptions cause inclusion within decedent's estate if the gift is made within three years of death: (1) transfers of life insurance; (2) transfer of property under section 2036 where grantor has retained the right to income or the right to determine who should receive the beneficial enjoyment of the property; (3) transfers under section 2037, where decedent has retained a reversionary interest in excess of 5% of the value of the property and the beneficiary can obtain possession or enjoyment of the property only by surviving the decedent; (4) transfers under section 2038, whereby decedent has retained the right to alter, amend, revoke or terminate the transfer; and (5) property over which decedent had a general power of appointment.

Although all other transfers will no longer be included in decedent's estate if made within three years preceding the date of death, they will be included for the purposes of determining the estate's qualification under the following sections: (1) section 303, which permits closely held corporations to redeem the stock of the estate in an amount equal to the estate taxes and other administration expenses; (2) section 2032A, which provides for a special use valuation of property used in a closely held corporation or farm; and (3) section 6166, which provides for an extended period of payment of the estate tax over an extended period of payment of the estate tax over a period of fifteen years.

5.11 Gift Tax - Annual Return

I.R.C. §§ 2501, 2505, 2512, 2513, 2522, 6019 and 6075 - Act § 442. Effective as to gifts made after December 31, 1981.

Under prior law a gift tax return was required in the first calendar quarter in which cumulative taxable gifts exceeded $25,000. The returns were due on the 15th day of the second month following the close of the quarter. A gift tax return was required for the calendar year in the event taxable gifts did not exceed $25,000 in any quarter prior to the fourth.

The 1981 Act eliminates the quarterly gift tax return and requires a return to be filed annually by April 15 of the following year. If a donor has died during the calendar year, the due date cannot be later than the date for filing the donor's estate tax return.

5.12 Stock Redemptions

I.R.C. §§ 2501, 2505, 2512, 2513, 2522, 6019 and 6075 - Act § 442. 1981.

Section 303 provides that stock in closely held businesses may be purchased by the corporation from the estate in an amount equal to the estate taxes, funeral expenses and other administrative expenses. It also provides that such redemption be considered a sale or exchange. Were it not for section 303, the attribution rules of section 318 would treat the estate as owning the stock that the beneficiaries individually owned, as well as the stock that the estate owns. As a result, the sale would in many cases not meet the requirements of section 302—specifically, that the seller own less than 50% of the stock in the corporation and that the percentage that the seller owned after the redemption be less than 80% of the percentage of the stock previously owned. If this or the complete termination of interest test is not met, then the sale will be treated as a dividend to the estate rather than as a sale or exchange. In effect, sale or exchange treatment, as guaranteed by section 303, normally means that there will be no taxable income as a result of a sale by the estate to the corporation. Generally, the selling price will be at the fair market value as of the date of death. This date becomes the estate's or the beneficiary's basis in property under section 1014. Under prior law, decedent would not qualify for this sale or exchange treatment under section 303 unless the closely held corporation stock was equal to 50% or more of decedent's adjusted gross estate.

The Economic Recovery Tax Act of 1981 reduces the 50% requirement to 35% of decedent's adjusted gross estate. It should be noted that if the decedent has transferred property within three years of death, this transfer will be considered in making the calculation to determine the 35% interest. The inclusion is merely for the purpose of the calculation and has no effect on decedent's taxable estate.