Effects of 1982 Tax Law

The often misunderstood new minimum tax revision can cause tax shelter investors new headaches. But it's not the only significant change to come out of the Tax Equity and Fiscal Responsibility Act of 1982.

Eric Rothenberg

Once again Congress scampered to pass a major tax package prior to its traditional summer recess. Time was so short, in fact, that the House never even introduced a bill of its own, even though the Constitution mandates that all such bills originate in the House.[1]

The tax bill was the Senate's creation and was "attached" to a House bill in order to meet the Constitution's technical requirement; even the Constitution has its "loopholes"! So, the bill went directly from the Senate to a conference committee where it was reworked after some late night sessions. And in a single day, just prior to the Congressional recess, both houses passed the Tax Equity and Fiscal Responsibility Act of 1982.

The fact that the act was put together quickly and the fact that it represents another major tax law rewrite mean it will take some time before its impact is fully understood.

This article highlights the areas of change as they affect tax shelters and investments. Many provisions are directly and indirectly targeted at tax shelters. Most of the provisions are effective for 1983 and later.

Only three of the act's 158 sections directly affect individual income tax computations: new minimum tax rules, medical deductions, and casualty loss deductions. The minimum tax changes are the most different and the most complex, and all three changes are significant for the individual.

Alternative Minimum Tax

The act creates a new "alternative minimum tax" which totally replaces the former alternative minimum tax and the former minimum tax, combining many aspects of each into one new tax.

Under the old law (which still applies to tax returns for 1982) the "add-on" minimum tax took into account certain tax deductions called "preferences" and, under certain circumstances, an additional tax was figured.

For many individual taxpayers, these preferences were generated from investments in tax shelters. The minimum tax was then added to the regular tax liability. Once this total was determined, the alternative minimum tax was paid in place of both the regular and minimum tax when this alternative tax was larger. The alternative tax was determined by another calculation which took into consideration two additional "preferences" not used in figuring the minimum tax calculation. The alternative minimum tax was two-tiered (10 percent and then 20 percent) depending on how large the result.

The new act repeals the minimum tax "add-on" and replaces the old alternative minimum tax with a new computation.

The new tax is computed on the minimum taxable income consisting of the sum of the former preferences, four new preferences and Adjusted Gross Income (AGI). Only limited deductions are allowed: home mortgage interest, charitable donations, other limited interest expenses, and medical and casualty deductions in excess of AGI.

Minimum taxable income is taxed at a flat 20 percent of the amount in excess of $30,000 ($40,000 for joint returns, $20,000 for married filing separately).

As before, the new tax is paid if larger than the regular tax less the credits.

This new minimum tax poses several new issues. The first is the complexity of figuring alternative minimum taxable income. The taxpayer is now faced with a myriad of new computations. There are now 10 preference items, and to further complicate matters, some of these may—or may not—be avoided by making a special election (discussed later). There is the "net investment income" calculation which has special problems for those who invest in limited partnerships. The medical deduction must be recomputed using 10 percent of AGI instead of 5 percent.

All of these new computations increase the costs for effective tax planning, for preparing tax returns and in auditing tax returns.

The second problem posed by the new minimum tax is its steep rate, 20 percent. Because the computations start with AGI and there are only limited deductions, this tax will be imposed more often than ever before. This is especially true since the act eliminates the right to offset the tax with nonrefundable tax credits (other than certain foreign tax credits).

In some ways, this is very similar to a "flat tax". Many taxpayers are going to be quite surprised when they find themselves hit with an alternative minimum tax. Such taxpayers will no doubt include those who borrow money to invest in limited partnerships or Subchapter S corporations.

Limited Partnerships and Sub S Corporations

Limited partners and non-active shareholders in Subchapter S corporations can include income from such entities in their net investment income for purposes of the interest expense limitation in the alternative minimum tax.

[1] *EDITOR'S NOTE: Congressman Ron Paul, among others, has filed suit against Congress, challenging the constitutionality of this action.*

However, any interest paid to acquire or carry these holdings are not taken into account in computing AGI for the alternative minimum tax. Therefore, they are deductible only if they survive the net investment income limitation. This means that if borrowed money is used for a tax shelter the alternative tax may come into play.

In addition to this new law Congress recently passed the Subchapter S Revision Act of 1982. The new law puts Sub S corporations more on par with partnerships. Significant changes were made so that many tax shelters can now be organized as Sub S corporations.

For example, the passive income limitation is removed, opening the way for many real estate tax shelters to be operated as Sub S corporations. They formerly had to be organized as limited partnerships. The number of shareholders permitted is now increased to 35. And although there is still only one class of stock allowed, there can be differences in voting rights. The items of income, deductions, losses, and credits will be allocated to shareholders in the same manner as partnerships, and Sub S corporations will be treated like partnerships for purposes of oil and gas depletion, the windfall profits tax and the optional write-off of certain tax preferences.

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Medical and Casualty Deductions

Beginning in 1983, medical expenses will be deductible only to the extent they exceed 5 percent of AGI. Prescription drugs and insulin may only be included in medical expenses to the extent they exceed 1 percent of AGI (this limitation disappears in 1984).

Casualty losses after 1982 will only be deductible if they exceed 10 percent of AGI, after reducing each casualty by the $100 amount still in effect. These increased limitations severely curtail the tax benefits, so individuals should reevaluate insurance deductibles which may have been set high because a casualty deduction was available for the deductible less $100.

Individuals may also consider incorporating and setting up a medical reimbursement plan to avoid the 5 percent limitation.

Accelerated Depreciation

Last year's major tax bill provided depreciation schedules for property (other than real property) placed in service between 1981 and 1984. The new schedules approximated the 150 percent declining balance method. That law also provided for increases to 175 percent in 1985 and 200 percent in 1986.

This year's bill repeals those scheduled increases so that the 150 percent declining balance method will remain in effect for these and later years.

This provision does not affect real property, so many shelters are unaffected by this change. However, equipment leases which called for buying new equipment in 1985 or later and which used last year's anticipated schedules may require a fresh look.

Oil and Gas Investors

Under both the present law and the new act, certain intangible drilling costs (IDC) on oil and gas wells and certain excess percentage depletion deductions are treated as tax preferences in calculating the alternative minimum tax.

Under the new law, however, individuals who elect to write off these preferences over 10 years (five years for certain drilling costs), can avoid

treating these items as preferences.

They may elect to amortize mining exploration and development costs and research and development costs for both the regular tax and the minimum tax over 10 years. No preference will be generated if such election is made.

Limited partners may also elect 10-year write-off for IDC. Other individuals may capitalize IDC, treat the costs as five-year recovery property and be allowed an investment tax credit ITC of 10 percent (one half of the ITC will reduce the basis; see discussion below).

Use of these elections will be especially beneficial to those who have experienced net operating losses or credit carryovers.

Investment Tax Credit Changes

In the past, most tax credits did not affect the basis of a property. The new act changed this. Beginning in 1983, the basis of assets will be reduced by one-half the amount of the ITC, the historic rehabilitation credit or the energy credit credit.

In the year in which such credits expire taxpayers may deduct 50 percent of such unused credits.

The reduced basis is used to calculate the depreciation deductions as well as the gain or loss when the property is sold.

This reduction in the basis due to the ITC can be avoided by electing, on a property by property basis, to reduce the ITC by 2 percent (i.e., the 10 percent credit becomes 8 percent and the 6 percent credit becomes 4 percent).

For partnerships, including limited partnerships, the election is made at the partnership level. Partnerships must make the decision carefully because individual partners may not be able to use the entire ITC benefits. This special election is not available for the energy credit or the rehabilitation credit.

Also, the new law reduces from 90 percent to 85 percent the limit on the amount of tax in excess of $25,000 which may be reduced by ITC. Any unused credits may be carried forward 15 years.

Abusive Tax Shelters

In a continuing effort to increase revenues by improving collection of existing taxes, the act contains several provisions designed to expand information reporting and increase penalties. One such provision is the penalty for promoting abusive tax shelters.

The act imposes a new civil penalty on persons who organize or sell abusive tax shelters. The penalty for promoting an abusive shelter is the greater of 10 percent of the gross income derived (or to be derived) by the promoter or $1,000.

This penalty applies under either of two circumstances. The first is where a person knowingly makes or furnishes a false or fraudulent statement concerning a tax benefit. The second is where a person makes a gross valuation overstatement (i.e., in excess of 200 percent of the correct value) which is directly related to any deduction or credit allowable to a shelter participant.

The new penalty is effective immediately but only applies if the person both participates in the organization or sale of the shelter *and* makes a false statement or over-valuation. If both are not present, the penalty is avoided.

Where the penalty alone is insufficient to prevent further occurrences, the IRS can seek an injunction to stop the sale of the shelter.

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Injunctions The IRS can also obtain injunctions against any person who has engaged in any conduct subject to the abusive tax shelter penalty if it appears that an injunction will prevent recurrence of the sale of the abusive shelter.

The effect of this provision as well as the scope of any injunction that might be granted is unknown at this time. It will probably be useful in only a limited number of individual cases. Of more importance to the IRS is a new provision regarding the audit of partnerships.

Partnership Audits

Prior to the new law, the IRS had to audit each individual partner in its search for errors and abuses. The IRS was not able to simultaneously adjust all partners for a change at the partnership level, even if the IRS won a court case against a particular partner. The expense of having to deal individually with each partner led to enactment of a new provision allowing for the tax treatment of partnership items to be determined at the partnership level.

Consequently, a single decision will become binding on all parties in a uniform manner. Partners in one IRS jurisdiction will not fare better or worse than partners in another jurisdiction. While this provision applies to all except certain small partnerships, it will be applied initially primarily to tax shelter partnerships in order to relieve the backlog of tax shelter cases.

When the IRS selects a partnership for audit, a tax matters partner (TMP) is selected under certain rules. The IRS sends a notice of the audit to all partners (other than those with less than 1 percent in profits if there are more than 100 partners). The TMP may bind certain partners to an IRS agreement. Therefore, new partnership agreements should specifically identify the rights and duties of the TMP.

If this provision functions well in practice, there will be less of a case backlog and there may be many more tax shelters under IRS scrutiny in the near future.

Understating Tax Liabilities

Even though the 1981 law imposed a number of new penalties on taxpayers, the 1982 act added another. This new one is for "substantial understatement" of tax liability. A substantial understatement is one which exceeds the greater of 10 percent of the required tax or $5,000.

The non-deductible penalty is equal to 10 percent of the amount of underpayment attributable to the understatement and applies to all tax returns due after 1982. This means 1982 returns (filed April 15, 1983) are subject to the penalty, even where the shelter was purchased in an earlier year.

It's possible to avoid the penalty in certain cases by disclosures on the tax return. But this does not apply to tax shelters. (Tax shelters were broadly defined as *any* entity, plan or arrangement where the principal purpose of such arrangement is the avoidance or evasion of federal income tax.) Tax shelters must have substantial authority for their tax treatment of an item and reasonable cause to believe that the treatment was proper.

Future controversies for this penalty are likely to center around whether disclosure was adequate or whether there is substantial authority.

Conclusion

There is little doubt as to the Congressional intent to increase the IRS weaponry against both abusive and non-abusive tax shelters. The changes in the procedures for auditing partnerships and in providing for new and increased penalties may well nail the coffin shut on many past and present shelters. Promoters and sellers must take a hard look at what they promote or sell, and attorneys, accountants and brokers must all step carefully in preparing, reviewing or recommending such shelters for their clients. It is clear that Congress has rearmed the IRS in the war against shelters, but whether in practice this can be accomplished remains to be seen. ■

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