Little known aspects of the new tax law

Eric Rothenberg

The Economic Recovery Tax Act of 1981 was signed into law by President Reagan on August 13, 1981. The act was put together and passed in a hurry before Congress recessed. Because of the rush, the act contains some internal inconsistencies and unintended consequences. And because the act was put together in so short a time, tax professionals have had little time to digest its contents to discover the effects it will have on taxpayers.

While the highlights of the act have been covered in virtually every medium, there are some provisions of the act which have not been extensively covered and they can have a significant impact on both individuals and businesses. This article points out some of those powerful but lesser-known provisions of the act.

Reduced Tax Rates

Prior to the new law, individuals had a maximum marginal tax rate of 70 percent. Special provisions provided for earned income to be taxed no higher than 50 percent and long-term capital gains no higher than 28 percent. The act reduced individual income tax rates for 1982 through 1984 by 23 percent and reduced the maximum rate on all income to 50 percent beginning this year. After 1981, therefore, earned and unearned income is taxed alike and capital gains are taxed no higher than 20 percent. However, two special rules were included for 1981 as phase-in provisions.

The first provided that the maximum rate on capital gains on post-June 9, 1981, transactions is 20 percent (which is equal to the maximum 1982 rate on capital gains). This provision was added to prevent widespread delays in selling capital assets in order to take advantage of the more favorable tax rates available in 1982. But careful planning was required because in some cases it was far better to delay.

Take, for example, a taxpayer who sustained a large business loss in 1981 (say $500,000) and who had an unrealized capital gain of $4.8 million. If the gain were realized in 1981 the tax would have been approximately $960,000 (20% × $4,800,000). The ordinary loss does not offset the capital gain under the alternative tax for 1981. If the taxpayer had delayed the sale until 1982, the 1981 loss would be carried forward and could have been utilized to offset 1982 income. The tax for 1982 would be approximately $700,000, a savings of over $250,000. Though perhaps this result is not another unintended consequence of the new law, it should demonstrate that there are no general rules that can be blindly followed.

The second phase-in provision allowed for a credit equal to 1.25 percent times the 1981 tax due. The mechanical computation of these two provisions is less simple than first appears. This is because the interplay of the 1.25 percent tax credit, the 20 percent maximum rate on post-June 9, 1981 capital gains, and the 50 percent maximum rate on earned income will be modified by a technical corrections act (not yet enacted as of the writing of this article). The Treasury Department has instructed the IRS to prepare forms with the corrections act in mind and some forms have already been released indicating the intended corrections. The two changes forthcoming are as follows:

First, the 1.25 percent tax credit will not be applied against those capital gains subject to the favorable 20 percent maximum rate. Hence, the rate will not be reduced to 19.75 percent as the act currently provides. Apparently this is an unintended consequence of the new law.

Second, the portion of earned income taxed at a maximum rate of 50 percent will not be reduced by the 1.25 percent credit. This would have reduced the tax on such earned income to 49.75 percent, which also is considered to be an unintended result of the act.

Unlimited Marital Deduction

The new law completely overhauled the estate gift taxes as never before. In addition to reducing the maximum tax rate from 70 percent to 50 percent, the act entirely eliminates any marital deduction for lifetime or testamentary gifts to a spouse. Under prior law an estate tax marital deduction was allowed for property passing

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to the decedent's spouse equal to the greater of $250,000 or 50 percent of the adjusted gross estate. This limitation, as well as the prior gift limitation, has been removed beginning this year. As with other new provisions, a relatively simple law change brings less than simple, as well as unintended, results. This happens because some states will not allow an unlimited marital deduction.

For example, Massachusetts uses an earlier version of the Internal Revenue Code, so a 50 percent limitation is still in effect. Thus, if a Massachusetts resident dies in 1982 with an adjusted gross estate of $8 million, the state death tax will be approximately $538,000. This amount, paid to the state and not to the spouse, cannot qualify for the marital deduction. The taxable estate thereby increases by $538,000. A federal estate tax is now due. This amount, too, reduces the amount which will qualify for the marital deduction and further increases the federal amount due. This circle of calculations eventually ends and the result (figured by using tax planning computer software programs) is a federal tax due of $142,597 for a total tax liability of $680,597 (almost 9 percent of the adjusted gross estate).

The complex mechanics of these interrelated calculations and the fact that a federal tax is due was not the intention of Congress. In fact, the act was intended to simplify taxes and to prevent taxes on transfers between spouses. Writers have often stated that a taxpayer can leave the entire estate to the spouse without federal estate tax. Because the states are feeling a revenue crunch, there is a strong likelihood that they will not give up future tax revenues by increasing the marital deduction.

Accelerated Cost Recovery System

One of the more significant tax law changes brought about by the new law is the Accelerated Cost Recovery System (ACRS). This provides faster write-offs for business property placed in service after 1980. It accomplishes this by allowing very short useful "lives" for assets placed in service. The write-offs are so much faster than in previous years that many tax shelters are expected to be formed to take advantage of these provisions.

In prior years, taxpayers had a choice between a "facts and circumstances" depreciation system (useful lives determined by experience) or the class life ADR (Asset Depreciation Range) system (useful lives for each asset "deemed" between a pre-defined range). The taxpayer could choose either system in any given year, as the circumstances required. The choice was often made to suit either cash needs or financial statement needs.

A significant fact about ACRS is that it is *mandatory*. The taxpayer can no longer choose another method (except in limited circumstances). Thus, all taxpayers are now under a single "system". The taxpayer may elect longer lives under ACRS, but not on an item by item basis.

Another important note to ACRS is that for property other than real property, the taxpayer will be entitled to a half-year of depreciation even for property placed in service at or near the end of the year. This may provide a useful vehicle to partnerships in operation a full year to pass through large losses in a short period of time.

Tax Straddles

In past years, many taxpayers have used "tax straddles" involving various futures transactions to defer gain until a later year or to convert ordinary income of short-term gains into long-term gains. The new act attempts to eliminate these schemes with the specific rules aimed at these transactions. One of the basic commodity transactions targeted by the act are "regulated commodity futures contracts". Any such contracts on hand at year end will be "priced" according to rules of the futures exchanges. Unrealized gains and losses will be recognized in income with 60 percent treated as long-term and 40 percent treated as short-term, regardless of the actual time held.

For 1981, taxpayers could make a special election to have such gains taxed as if the 1982 tax rates were in effect. The precise method of how this will be done has yet to be released by the IRS or the Treasury Department. The rules governing tax straddles are more complex than most of the other new provisions and require very careful tax planning.

Investment Tax Credits

Investment Tax Credits (ITC) have increased under the new law, effective

for 1981. Three-year property now will generate a 6 percent credit as opposed to 3⅓ percent in prior years. Five-year property will generate the full 10 percent (6⅔ percent in prior years). But another important change to note concerns the recapture provisions.

Under the new recapture provisions, the taxpayer receives a 2 percent ITC benefit for each full year the asset is held. Thus, at the end of five years (three years for three-year property), there is no longer any ITC to recapture. In prior years, the taxpayer had to recapture the credit based on the difference between the amount of the ITC which would have been available had the useful life been the number of years actually held and the actual ITC taken. This means that the taxpayer will no longer feel the necessity to hold assets in order to avoid the recapture tax for assets it otherwise would like to sell.

Two other credit changes of note are the 25 percent tax credit for increased research and developmental expenditures and the 25 percent credit for rehabilitating certified historic structures. It is anticipated that each of these provisions will form the basis of new tax shelters.

Penalties and Interest

The act significantly increases penalties and interest which may be applied by the IRS to underpayments of tax. These provisions are certain to play a larger role in decision making than anticipated.

Beginning February 1, 1982, the IRS will charge an interest rate of 20 percent (or pay 20 percent) for underpayments (or overpayments) of tax. This rate is fixed for 12 months and was determined by the prime rate in effect for September 1981. Even though prime now is fluctuating near 17 percent, the 20 percent rate will stay in effect for most of 1982. This high rate will certainly motivate taxpayers to take a hard look at the particular deductions or losses recognized in their tax returns.

Beginning this year, there will be a new non-deductible penalty for certain "valuation overstatements". The penalty is 30 percent of the underpayment of tax where the valuation claimed is more than 2½ times the valuation allowed. Lower penalty percentages are provided where the overvaluation is smaller. Also effective for 1982 is a new non-deductible negligence penalty equal to 50 percent of the interest amount due. This is in addition to the 5 percent negligence penalty already in place. The imposition of all these penalties and interest for a single year should not be unusual. These are the weapons of the IRS to prevent abusive tax schemes.

Especially important is the fact that the taxpayer bears the burden of proving the imposition of the penalty is erroneous. The IRS does not have to prove that it is appropriate.

Conclusions

The Economic Recovery Tax Act of 1981 is considered to be the largest piece of tax legislation to pass in recent times. Because it was patched together in so short a time, it is likely to create uncertainties for some time to come. The act simultaneously opens and closes doors. It provides favorable provisions (reduced tax rates, ACRS, ITC) and unfavorable provisions (tax straddles, penalties and interest). The nuances of the act are large and small. The subtleties are great. The impact is broad. One can only proceed with extreme caution and careful planning. ■

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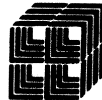

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