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1978 Tax Legislation

- Individuals: capital gains, tax shelters, deferred compensation
- Business: lower corporate rates, expanded investment credits
- Energy taxes, retirement plans, expatriates
- Small business, farms, estate tax
- Other provisions affecting the tax laws of the United States

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INTRODUCTION

Tax legislation in 1978 continues what has been an ever accelerating pace of tax change. In the closing days of the 95th Congress, much significant tax legislation was passed and sent to the President for approval. There was a special tax act for energy problems. Treasury was told to delay any action on fringe benefits. For 1977, U.S. citizens residing abroad will still be allowed a $20,000 or $25,000 exclusion from income, but for 1978 and later years, a new system of special deductions and exclusions has been established. And, of course, we have the Revenue Act of 1978.

As has been true of all major tax legislation, the 1978 Act affects taxpayers at all levels of income, and both business and nonbusiness transactions; in many ways it will make more difficult the ability of even the most sophisticated to understand our tax system and how it affects them. We suggest that the constant pattern of change of recent years may be counter-productive: not only do ever changing rules make compliance more difficult but the uncertainty of tax consequences may act as a deterrent in the expansion of our economy.

The Act in its final form developed at breakneck speed with a race against the adjournment clock. It is possible that many members of Congress were not at all sure of what they approved. As a point in its favor, however, we note that many of its changes are prospective in effect so that they need not be taken into account in this current year's tax thinking, and there is at least some time to study the provisions to see what effect they will have next year. Of course, as with all tax rules, there is an important exception and that is the November 1, 1978 effective date of certain aspects of capital gain taxation.

There are numerous technical provisions, and it is difficult to single out any of them as being the most signficant. Individual tax rates have been reduced and there are increased exemptions and zero bracket amounts allowed, although the general tax credit has been repealed. On the other hand, scheduled social security tax rate increases and inflation may more than offset any saving, particularly for lower income taxpayers. Corporate tax rates also have been reduced. Probably the most signficant change in rates is in the treatment of capital gains with an increase in the deduction for noncorporate taxpayers. However, running counter to this thrust is the repeal of the alternative tax and the substitution of a new concept, the alternative minimum tax.

Other changes include a postponement of the effective dates of the carryover basis rules for inherited property and of rules dealing with acquired loss corporations. Congress has decided not to permit any deductions for yachts, hunting lodges and similar entertainment facilities, although club dues continue to be deductible.

The investment tax credit has been liberalized. Some problems, such as who is an independent contractor, have not been solved; but IRS has been told to take no action until Congress has the opportunity to study the question further. These and other changes are explained in this booklet.

We are sure that much will need to be done in the future. Tax legislation tends to breed more legislation. Errors, unintended benefits and inequities have to be corrected. Operating at the pace of the closing days of this last Congress, it would be surprising if technical and substantive problems did not arise in the future. The last major tax law enacted in 1976, for example, had two important changes which the 1978 Act postpones, and there were a host of needed small corrections to that Act which have been enacted in this.

It is unfortunate that Congress finally had to act under such time pressures. The 1978 actions of the Conference Committee, final votes of Congress and adjournment all took place within a matter of hours and, with the House-Senate conference concluding in a marathon Saturday session that adjourned at 4:00 Sunday morning, you may imagine the physical and mental environment in which many decisions were made. In short, it is reasonable to anticipate a 1979 or 1980 Act, though perhaps not as far-reaching as this one, if for no other reason than to correct some of the mistakes that had to creep into 1978 tax legislation.

OVERVIEW AND HIGHLIGHTS

1978 tax legislation – and most particularly the Revenue Act of 1978 – differs from both the 1969 and 1976 tax "reform" legislation. It creates few new concepts; instead, it focuses on coping with inflation, repairing defects in the 1976 and other legislation, and – in a new departure – curbing a number of attempts by IRS and Treasury to go further with administrative changes and interpretations than Congress believed appropriate. In this section, we will touch on some of the highlights – the rest of the booklet will explore the details of these and numerous other aspects of several tax laws passed within recent months.

New Concepts

1. Capital gain provisions should create less disincentive to high income sellers, because of a 60 percent (instead of the old 50 percent) capital gain deduction and related changes. Under 1977 rules (through October 31, 1978), $1 million of long-term capital gain might net, after tax, only $508,750. After January 1, 1979, the same $1 million could net as much as $720,000 – a 42 percent increase – for a taxpayer who had not substantially sheltered his income.

2. An alternative minimum tax is added to the concept of tax on preferences. Capital gain and excess itemized deduction preferences no longer fall under the regular, or add-on, minimum tax – only under the new alternative minimum tax. Bottom line is that for all but a handful of taxpayers, capital gains and excess itemized deductions are no longer tax preference items.

3. "At-risk" concepts, introduced in the 1976 legislation, having failed to curb tax shelter abuses (at least as the government sees it), are extended to cover almost every activity except real estate. The result could even threaten ordinary operating loss deductions of legitimate businesses (except for larger corporations) where nonrecourse financing is utilized.

4. The first $100,000 of corporate taxable income is taxed on a graduated basis – the rate going from 17 percent to 40 percent in brackets $25,000 wide, and then becoming 46 percent over $100,000. Thus, greater premium will be put on

multi-corporate structures that don't run afoul of the brother-sister or parent-subsidiary corporation rules. A family business owned by three brothers would pay $118,750 tax on $300,000 taxable income if in one corporation; but would pay only $80,250 tax if each brother owned his own separate corporation and each earned $100,000.

5. The investment credit now covers rehabilitation of nonresidential buildings, if in use at least 20 years. The credit is based on rehabilitation cost and not acquisition cost, and the rehabilitation must not involve replacing more than 25 percent of the exterior walls. This could have a dramatic impact on the perceived investment attractiveness of inner-city rehabilitation projects.

Some of the more important other points in this year's tax legislation are summarized below.

Coping with Inflation

1. Widening of tax brackets for individuals.
2. Small increases in the standard deduction (or zero bracket amount).
3. Increase in the personal exemption from $750 to $1,000.
4. Increase in earned income credit.
5. Increase in political contribution credit.
6. Increase in size of tax exempt industrial development bond "small" issues.
7. Increase in ordinary loss deduction on small business corporation stock to $50,000 ($100,000 on a joint return) – and increase in amount of such stock a corporation can issue to $1 million.
8. Increase to $5,000 of small claim procedure availability in U.S. Tax Court.

Repairing Defects

1. Carryover basis applied to property acquired from a decedent is postponed – perhaps forever, but certainly until after 1979. Thus, property inherited from a person who dies this year or

next (or who died in 1977, for that matter) will have as its basis for depreciation, gain or loss, etc., its fair market value at the date of death.

2. New rules limiting use of net operating loss deductions of corporations involved in reorganizations and other changes of ownership have been postponed until 1980 to permit further study. Basic issue: Should owners of a loss corporation be able to sell the tax benefit of that loss and thus recoup some of their loss? Both the present and the proposed law answer, "Yes, but. . . ." We believe the postponed provisions, which allow the carryover only if the old owners remain in the corporate picture, represent the way Congress will go – if some way can be found to make the rules more understandable and workable.

3. Simplified employee pension plans, utilizing Individual Retirement Accounts for each employee, are made practical for smaller businesses. Such a plan, before the change, limited to $1,500 per employee the amount that could be contributed. That limit goes to $7,500. But note that the $1,500 limit remains on direct employee contributions to an IRA.

4. Changes are also made to liberalize the tax treatment of IRAs not meeting the simplified pension plan tests.

5. Fifteen, rather than ten, shareholders are initially permitted for a subchapter S corporation, and the time for making an election is extended.

6. The general jobs credit, which many viewed as a subsidy to small businesses for hiring people they would have hired anyway, is changed to a targeted one. It is available mainly for people who are part of the "hard-to-employ" unemployed; and, for hiring such people, offers substantial enough incentive to interest the very largest businesses as well as the small employer.

7. Taxation of Americans working abroad was changed by the 1976 tax law, but the changes created such inequities that Congress had postponed their effective date once before. The new law on this keeps the pre-'76 rules for 1977 returns, and allows liberalized deductions for 1978 and later years for

expenses incurred by Americans abroad that they would not face if they remained in the U.S. However, for most expatriates, the familiar exclusion for income earned abroad will be gone.

8. Complexity of the 1976 Tax Reform Act caused numerous errors in substance or draftsmanship. Thirty-two separate subject areas of the 1976 Act income tax provisions were amended – some by numerous subsidiary amendments within a subject; 18 estate tax subject areas were amended; and well over 50 changes were made to correct spelling, punctuation, and erroneous cross-reference errors.

Curbing Administrative Overenthusiasm

1. Educational assistance to employees by employers has often resulted in taxable income to employees and in withholding tax problems for employers. The new law will eliminate these problems for employers who adopt a written plan and make such assistance available to a broad range of their employees.

2. IRS rulings are often a practical necessity (and occasionally a statutory sine qua non) in order to consummate certain types of transactions. Rulings on the exempt status of interest on bond issues of states and municipalities are often needed before the bonds can be sold. To cut down on IRS arbitrariness as to when it will even rule, and to speed up IRS processing of rulings, the new law allows appeal from IRS action (or inaction) to the U.S. Tax Court.

3. IRS attempted earlier this year to change long-standing rules on taxation of deferred compensation. The new law retains the old rules for the private sector, and provides limits on deferral for the public sector.

4. "Cafeteria" plans allow employees to pick from a range of taxable and tax-exempt benefit plans. IRS had shifted position and wanted to tax benefits in such situations. The new law freezes the old rules in general, but requires that such plans be in writing and creates income for highly compensated employees unless the plan is nondiscriminatory.

5. The new law freezes the existing distinctions between who is an employee and who an independent contractor – as well as

relieving from pre-1979 tax employers who had a ''reasonable basis'' for treating employees as independent contractors and providing relief through 1979 for employers with such reasonable basis.

6. Tips added to credit card charges had to be accounted for by restaurants, according to IRS. This had created much confusion and complicated record keeping - especially for smaller business units. The 1976 Act suspended the IRS ruling, and the new law substantially rejects it, providing that the only record an employer will have to keep will be copies of charge slips and employee tip statements, and that the only tips the employer will need to report to IRS will be those reported to the employer by the employee.

7. Treasury has been interested for some time in taxing more fringe benefits to their recipients. Another bill, recently passed by Congress and signed by the President, freezes present rules in this area and prohibits any administrative change until 1980, by which time Congress will have greater opportunity to participate in any changes to be made.

CAPITAL GAINS AND TAX PREFERENCES

Introduction

For 40 years, individual taxpayers have included in income only 50 percent of net long term capital gains, and since 1942 an alternative top tax on such gains of 25 percent has been part of the law. Favored tax treatment of capital gains has been a tenet of our tax statutes since 1921, not many years after such U.S. Supreme Court cases as *Doyle* v. *Mitchell Brothers Company* (1918) and *Eisner* v. *Macomber* (1920) laid to rest the question of whether a Constitutionally approved tax on *income* could even reach an increment on capital.

While more than one generation of taxpayers have grown up in our free enterprise society with the understanding that capital appreciation was more desirable than earned income or investment income (at least as reflected in that portion of the return to be rendered unto Caesar), government concern has grown as to the energies being diverted into securing capital gain treatment for transactions by structuring them – in some cases artificially – to tread, ever so softly, through the convoluted sections, subsections, paragraphs, and subparagraphs of the Internal Revenue Code, with the intent of ultimately landing on one of the pages of that document marked "guaranteed capital gain."

For reasons at least as strongly connected with perceived abuses in the tax shelter area as with the question of capital gains, Congress included in the 1969 Tax Reform Act a minimum tax on tax preferences, and included as a preference the "untaxed" one-half of net long term capital gains; thus increasing by indirection the potential effective rate on capital transactions. In the 1976 Reform Act, the maximum rate was increased still further by provisions reducing the amount of regular tax which could be used as an offset in computing preferences subject to minimum tax, by raising the minimum tax rate to 15 percent (from its prior 10 percent), and by permitting the same dollars of preference which gave rise to minimum tax also to convert earned to unearned income in computing the maximum tax on earned income (which, since 1972, has been 50 percent).

As a result of these changes, the maximum rate on long term gains rose from the 25 percent taxpayers had known since 1942, to a possible 49.125 percent in 1977. In fact, the original proposals submitted by the Carter Administration in January, 1978 to the Congress would have removed altogether the regular tax as an offset in computing the minimum

tax, as well as repealing the 25 percent alternative tax; and these proposals could have had the result of raising the maximum tax on long term gains to 52.5 percent, a rate higher than the maximum rate on earned income. Without commenting on the economic merits of the debate, suffice it to say that numerous individuals and groups were quite vocal to the effect that the increase in capital gain effective taxation over the past nine years corresponded with a severe slowdown in capital formation in this country; and if the impact of rate changes on capital gains was combined with the 1976 Reform Act rules requiring a carryover basis on assets transferred at death, the result became a very severe ''lock-in'' effect as to the holders of capital assets. Thus, it became apparent rather early in calendar 1978 – at least to many members of Congress – that the Administration had badly misread the mood and needs of the American taxpayer, and that far from increasing top rates on capital gains, some reversal of the last nine years would be in order.

The bill which passed the House of Representatives was along those lines. As desired by the Administration, it would have eliminated the alternative 25 percent tax on the first $50,000 of noncorporate taxpayers' long term gains (thus, *raising* capital gain rates on that first $50,000 from a maximum of 25 percent to a maximum of 35 percent). However, the House bill removed capital gains completely from the minimum tax provisions (which had the effect of also preventing them from ''poisoning'' earned income subject to the maximum tax). Noncorporate taxpayers would have continued to be subject to present minimum tax provisions on other tax preferences, but a special alternative minimum tax (AMT) would have applied in the case of net long term gains – but only at a 10 percent rate. If one-half of such gains (less a $10,000 exemption), taxed at 10 percent, was greater than the so-called ''regular'' tax, this greater AMT would be payable. The alternative minimum tax, in its House version, was clearly aimed at those taxpayers realizing significant long term gains and then sheltering them through other means.

The Treasury Department, and opponents of the House approach, were quick to deride the House AMT as a ''micro-mini'' tax. Senator Russell Long, Chairman of the Senate Finance Committee, publicly stated his intention to advocate a substantial lowering of capital gain tax rates, but also a substantial toughening of the alternative minimum tax so that taxpayers successfully sheltering long term gains would wind up paying appreciably more than under the House version. It is the Long version of capital gain taxation and tax preference revision which has, essentially, been adopted into the 1978 Revenue Act (but the House is also strongly represented through the new rules on exclusion of gain on sale of a home).

Senator Long also proposed, and the Senate approved, an increase in the capital gain deduction available to noncorporate taxpayers from 50 percent to 70 percent. In order to compromise with an Administration which was publicly threatening a veto of the entire tax bill if the 70 percent deduction remained in, the increase in that deduction has only gone to 60 percent. The alternative minimum tax, however, as passed by the Senate, has remained in the final Act.

Capital Gain Deduction for Noncorporate Taxpayers

The deduction a noncorporate taxpayer receives for net long term gains, in the computation of his income – which has been at a 50 percent rate since 1938 – is increased to 60 percent under the new law. Thus, but for the minimum tax rules, the top rate on long term gains would be 28 percent (a 70 percent maximum bracket on individuals times the 40 percent of net long term gains remaining in income).

Certain conforming amendments are also made to reflect the new 60 percent deduction for net long term gains. Since 1969, the contribution rules for individuals giving appreciated capital assets to charity have required a reduction in the value of the contribution equal to a portion of the appreciation in the property which would have produced a capital gain had the property been sold. This reduction reflects the fact that giving the property to charity has resulted in the forgiveness of a tax on disposition of the property as well as a current deduction against income for the value of that same property. In order to eliminate this double tax benefit in the case of certain types of charitable transfers, the 1969 Tax Reform Act required a scaling down of the appreciation in capital gain property that could be claimed as a charitable contribution.

Under the '69 Act, the appreciation element in tangible personal property given to a donee for use unrelated to its exempt activities (gift of a painting to a museum for sale rather than for exhibition, for example), or to most private foundations, must be reduced 50 percent in valuing the gift for charitable contribution purposes. With the capital gain deduction, however, rising to 60 percent, the appreciated property contribution provision is also being changed so that only 40 percent of the appreciation element will now have to reduce the contribution deduction.

Interestingly, even though the capital *gain* deduction is being increased to 60 percent, no changes are being made in the treatment of net capital losses for individuals. Thus, in determining the amount of a net

capital loss which can be deducted in a particular year against ordinary income, it will only be necessary to reduce the amount of the net loss 50 percent (rather than the, perhaps, more logical 60 percent) before comparing that number against the $3,000 capital loss allowable against ordinary income in the year.

To prevent the securities markets from drying up prior to January 1, 1979, the effective date of these provisions has been made November 1, 1978. This will cause some interesting transition problems. Technically, the new rule applies to all transactions occurring after October 31, 1978. For taxable years ending after October 31, 1978, but beginning before November 1, 1978 (calendar 1978 for most individual taxpayers), pre-November 1 and post-October 31 transactions will have to be accounted for separately. Net gains in both parts of the year will result in a 50 percent deduction on the pre-November 1 segment and 60 percent for the post-October 31 segment. A pre-November net capital loss (excluding capital loss carryovers from prior years) will reduce the post-October gains qualifying for the 60 percent deduction. Likewise, a post-October net loss will reduce pre-November net gains, producing only a 50 percent benefit in the capital gain deduction computation.

The table illustrates the application of these transition rules. Although calendar 1978 produces a net long term gain of $20,000 in each instance, the timing of the transactions results in different amounts being reported on the 1978 return:

January 1 - October 31	November 1 - December 31	Net Long Term Gain	Capital Gain Deduction
$(40,000)	$ 60,000	$20,000	$12,000
60,000	(40,000)	20,000	10,000

If our analysis of the transition rules is accurate, however, the tax planning possibilities inherent in the new provisions could still cause some abnormal market timing. For taxpayers in a net loss position at the date of enactment, it may make some sense to realize additional capital losses, as permitted by investment prudence (but not in excess of $6,000), before the end of October; and wait until January 1 to recognize any gains. In that manner, net losses will only have to be reduced by 50 percent in determining current year tax; whereas any gain recognized in the last two months of calendar 1978 will "soak up" pre-November losses, thus

reducing the tax benefit of those losses from 50 percent to 40 percent. See also the discussion below on the effective date of the alternative minimum tax provisions, which leave the present minimum tax rules in effect until January 1, 1979, thus possibly further discouraging the recognition of additional capital gains until after that date.

An interesting problem arises as to installment payments where the installment sale occurred in a prior taxable period. According to the Conference Committee report, the 60 percent capital gain deduction is effective "for taxable transactions occurring, and installment payments received, after October 31, 1978." Thus, for pre-1978 installment method sales, where a payment is received in November or December 1978, the report indicates that the profit element of the payment (assuming a capital asset is involved) would qualify for the 60 percent deduction.

Such may have been Congressional intent; however, the statute itself contains a special transition rule for taxable years including November 1, 1978, and the statutory language refers only to "sales and exchanges after October 31, 1978." An asset sold on the installment method in 1977 is unlikely to qualify as a sale or exchange after October 31, 1978, even though an installment payment may be received in November or December of this year. We expect, therefore, that committee report language to the contrary, such payments will qualify only for a 50 percent capital gain deduction.

On the other hand, it seems quite clear that installment payments received after the end of the fiscal or calendar year which includes November 1, 1978, from a pre-November 1, 1978 sale, will qualify for the new 60 percent deduction.

Repeal of Alternative Tax for Noncorporate Taxpayers

As pointed out in the introduction to this section, there has been an alternative tax computation for individuals under which the first $50,000 of net long term gains in any year cannot be taxed at a rate higher than 25 percent. Repeal of this alternative tax was high on the list of President Carter's priorities in January of this year. In the final Act, the alternative tax is repealed, for taxable years beginning after December 31, 1978.

As a result, some taxpayers whose top bracket exceeds 50 percent may have an *increase* in capital gain taxes as this provision becomes effective, since all net long term gains (including the first $50,000 in a year) can be

subject to tax at a 28 percent rate. However, the three percentage point potential increase is hardly likely to have a major impact on investment decisions; further, a taxpayer will have to be in a higher than 62 percent bracket before the marginal rate on capital gains exceeds 25 percent (a 62 percent bracket individual will pay a capital gain top rate of 24.8 percent after including only 40 percent of the gain in income).

Exclusion of Gain on Sale of Principal Residence

Prior law has contained two relief provisions allowing liberal tax treatment where a principal residence was sold at a gain. The first, applicable to all taxpayers, requires the deferral of realized gain to the extent that sales proceeds are reinvested in another home within certain time limitations. In exchange for the deferral, the tax basis of the new home is decreased by the nonrecognized gain. Thus, in the normal course of family development, gain on sales of prior residences would be deferred until family size decreased (with children leaving for work or marriage) or retirement occurred, accompanied by the need for a smaller home. At this point, the deferred taxes from prior sales would be paid, but often, at lower tax rates (for example, in a retirement situation).

The second relief provision has permitted taxpayers over 65 years of age to exclude (rather than defer) a portion of the gain attributable to $35,000 sales price of a principal residence, again assuming certain time limitations are met.

One problem for taxpayers going into a smaller home (or not purchasing another residence) was that the then realized capital gain (often substantial) qualified as a tax preference for minimum tax purposes – with a minimum tax imposed. The 1978 Act addresses this problem and further liberalizes the exclusion provisions (the deferral, or rollover provision applicable to all taxpayers remains in effect). For sales of principal residences after July 26, 1978, recognized gain on such sales (for taxpayers of any age) will no longer be a tax preference, either under the add-on minimum tax or the new alternative minimum tax. Thus, even should gain be ultimately recognized, it can never be taxed at a rate higher than 28 percent.

The more extensive change, under the 1978 Act, expands the rules on exclusion of gain. Also effective for sales after July 26, 1978, a taxpayer aged 55 or over may elect – once in his or her lifetime – to exclude up to $100,000 of gain on the sale of a principal residence. The residence for

which the exclusion is elected must have been owned and occupied as a principal residence for three of the five years preceding the sale. And, even though the excluded gain will probably be attributable in part to sales of prior residences (via the basis reductions giving rise to part of the gain on sale of the present residence), there will not be any tacking on of holding periods for prior homes owned, and the three-out-of-five-year test must be met with respect to the specific residence sold for which the exclusion will apply.

The election for married individuals will apply to both, not separately for each spouse. Regulations, when issued, may choose to deal with problems of divorce and remarriage, or death and remarriage, where an election has been made during the first marriage but the remarriage is to a party never having elected; we would anticipate that any such regulations would take quite a strict approach precluding an election during the second marriage.

Taxpayers electing the $100,000 exclusion will also be eligible to use the rollover provisions for that part of the gain not excluded. Assume, for example, a basis of $50,000 and selling price of $175,000. Of the $125,000 gain, the first $100,000 may be excluded altogether and the remaining $25,000 may be deferred subject to the mechanics of the rollover rule. Assuming that Treasury and IRS follow the same approach as under regulations for the present exclusion rules (for taxpayers over age 65), only the sales proceeds less the amount of gain excluded ($75,000 in our example) need be reinvested in a new principal residence to obtain full rollover benefits.

One difficult decision that may be faced by eligible taxpayers is when to make the election. Assume an otherwise eligible taxpayer sells his home at a $60,000 gain at age 55. Since the election may only be made once, should it be made now – in which case a potential additional exclusion of $40,000 is forever lost – or should taxpayer wait to satisfy the holding period rules for another (presumably higher) gain in the future? The gamble here is that taxpayer will not die prematurely, as death cuts off the election completely.

It will be interesting to see whether techniques are developed for sale-leaseback of principal residences late in life, or even on the deathbed – to family members or outsiders – so as not to permanently lose the exclusion. In fact, it may not be beyond the realm of possibility that Congress will be asked, in a few years, to enact legislation to close a new

tax loophole: sales in contemplation of death. On the other hand, with carryover basis rules postponed until at least 1980, it may be said that bets are hedged, at least until then.

Rollover of Gain on Sale of Principal Residence

As described above, taxpayers of any age may defer gain on the sale of a principal residence where replacement occurs within a stated time. In general, the time for replacement runs from 18 months before the sale to 18 months after. However, only the last principal residence purchased and used as such during this replacement period qualifies as the new residence for rollover purposes.

Inasmuch as occasions have arisen where an employer transferred an employee more than once during the replacement period, unintended hardship has resulted. The 1978 Act permits the use of more than one residence as a new residence, so that more than one gain can be rolled over within the replacement period – so long as the purchase and sale of each residence is attributable to the taxpayer's relocation for employment purposes. ''Employment'' can include work for a new employer or in a self-employed capacity.

As with the exclusion rules, these provisions are effective for sales of principal residences after July 26, 1978.

Tax Preferences and the Alternative Minimum Tax

The new Act makes dramatic changes in the approach to certain tax preferences and the minimum tax thereon. First, the present (or add-on) minimum tax is retained in the law, but with certain modifications. The capital gain deduction is no longer a preference for purposes of the add-on minimum tax, effective January 1, 1979. As a corollary, however, the November 1, 1978 effective date for the new 60 percent capital gain deduction means that for the months of November and December 1978, 60 percent of net long term gain will be a preference under the add-on minimum tax rules.

The present preference consisting of the excess of specified itemized deductions over 60 percent of adjusted gross income, is also removed from the add-on minimum tax base, for years beginning after December 31, 1978. Finally, with respect to the add-on minimum tax, the 1977 rule as to intangible drilling costs is made permanent, as discussed in the next section.

Thus, for many taxpayers, the most significant change in the add-on minimum tax provisions will be the removal of the long term gain preference. That preference, and the excess itemized deduction preference as well, have not been completely forgotten, however. They have been moved to a new section of the Code where they help form the base for a completely new tax - the alternative minimum tax. Thus, we will now be able to cope with a regular tax, a minimum tax, a maximum tax, and a new alternative minimum tax, but individuals have lost the alternative tax. So much for tax simplification.

Before continuing with a discussion of the alternative minimum tax details, we should point out that – at least in our tentative judgment – this new tax will affect very few taxpayers. It is designed essentially to be applicable to taxpayers having very substantial capital gains who, for the same tax year, succeed in sheltering those gains either through traditional tax shelters or "excess" itemized deductions. Without that combination of circumstances, it is virtually impossible for the alternative minimum tax to apply.

The mechanics of the alternative minimum tax (AMT) are as follows: taxpayer will take taxable income (including negative income if appropriate), and add to that income the preference for capital gains (the deducted 60 percent of net long term gains) and the preference for excess itemized deductions (discussed below). This amount forms the AMT taxable base, to which is applied a different set of graduated tax rates, as follows:

$0 - $20,000	0%
$20,000 - $60,000	10
$60,000 - $100,000	20
Over $100,000	25

The tax computed from this table is then compared with the tax computed from regular tax tables (including any add-on minimum tax). If the AMT is the higher number, it becomes taxpayer's tax for the year.

In analyzing the tax base for the alternative minimum tax, and its interplay with AMT tax rates, one can determine that the thrust of the tax is, indeed, to create a new method of taxing capital gains. Ignoring itemized deductions for a moment, the AMT base is computed by taking taxable income (which includes 40 percent of net long term gains) and adding to it 60 percent of net long term gains – in other words, imposing a tax of up to

25 percent on 100 percent of net long term gains. Since the first $100,000 of this base is taxed at less than 25 percent, it also becomes apparent that it would take a really significant amount of net long term gains in a year before the effective rate approached 25 percent ($2 million of gains in a year would produce an effective rate of 24.35 percent, for example). And, since the regular tax top rate on long term gains is 28 percent, it should also be apparent that the 25 percent AMT cannot be effective unless regular taxable income or tax is substantially reduced – via shelters, itemized deductions, etc.

Traditional tax shelters have been left to the add-on minimum tax and to expansion of the at-risk rules (discussed in another section). Itemized deductions, however, have been moved to the AMT base as a preference – but here they have changed a good deal from the excess itemized deduction preference that taxpayers were just beginning to get used to under the add-on minimum tax concept. The intent in drafting the AMT preference for excess itemized deductions was to make particular expenses neutral insofar as computation of the preference is concerned, since they are conceptually beyond taxpayer's control; but to permit other itemized deductions to be a preference if they were "excess." The neutral deductions include medical expenses, casualty losses, and state and local taxes. With respect to this latter, it is not only the thought that liability for state and local taxes is beyond the control of a taxpayer, which caused the item to be excluded as a preference; but also that any taxpayer who was already paying significant taxes to state or local authorities should not have those same payments be an additional detriment to him by potentially causing him to be subject to a minimum tax under Federal laws.

To make these deductions neutral in the computation of the preference amount, they are removed both from the determination of itemized deductions *and* the calculation of adjusted gross income. To the extent the remaining itemized deductions exceed 60 percent of remaining AGI, that excess is a tax preference under the AMT.

Assume a taxpayer with $50,000 adjusted gross income and $45,000 of itemized deductions, of which $1,000 are medical and $9,000 state and local taxes. The following table shows the computation of the excess itemized deduction preference under the 1978 rules for the add-on minimum tax and the 1979 rules for the AMT:

	1978	1979
Deductions	$45	$45
Less: Medical	$ 1	$ 1
Taxes	-	9
Adjusted deductions	$44	$35
Adjusted gross income (AGI)	$50	$50
Less: Medical and tax deductions	-	10
Adjusted AGI	$50	$40
x 60%	$30	$24
Preference: Adjusted deductions less 60% AGI	$14	$11

Special provision is made for certain credits, in applying the AMT rules. Because the United States gives parity of treatment to income taxes paid foreign governments, by allowing them as a credit against U.S. taxes due, the foreign tax credit is permitted to offset the alternative minimum tax much as it would the regular tax. In determining foreign tax credit limitations, it will be necessary to allocate AMT preference items between domestic and foreign sources – which will certainly add some further complexity to an already difficult set of foreign tax credit rules.

With respect to other so-called nonrefundable credits (primarily the investment tax credit), the new law assures that imposition of the AMT will not cause loss of credits from which no benefit has been obtained in the current year. To illustrate, consider a proprietorship with a regular tax liability of $12,000, before applying a current year investment credit of $5,000. The alternative minimum tax computation produces an AMT of $10,000 – less than the $12,000 gross regular tax, but $3,000 more than the net regular tax. Since the AMT is higher than the determined regular tax, it becomes the liability. As a result, taxpayer has been able to use only $2,000 of investment credit – enough to bring his liability from $12,000 to $10,000 – and the other $3,000 of credit has been wasted. This otherwise lost credit will now become a carryback or carryover to other taxable years, available in accordance with appropriate rules found elsewhere in the Code.

This provision will become particularly important as we approach the 90 percent tax liability offset for investment tax credits in 1982 and thereafter (see discussion in investment credit section), since some noncorporate businesses may have virtually all of their regular tax liability eliminated in a year of major capital investment, via the investment credit. The above provision will ensure that the congressional intent of encouraging added capital investment is not frustrated by introduction of the AMT concept.

The alternative minimum tax goes into effect for taxable years beginning after December 31, 1978, including the subjecting of any installment sale payments received in such taxable years to possible preference treatment under the AMT.

Intangible Drilling Costs and the Minimum Tax

The Tax Reform Act of 1976 added certain "excess" intangible drilling costs as a tax preference item for purposes of computing the minimum tax. The preference was computed by taking the excess of intangible drilling costs (IDC) for oil and gas wells incurred during the year over the amount allowable through cost depletion or ten-year amortization, had the IDC been capitalized. The Tax Reduction and Simplification Act of 1977 provided that, for taxable years beginning *only* in 1977, the preference computed as above would be reduced by net income from oil and gas properties. Net income is defined as gross income less deductions attributable to the properties, excluding intangible drilling costs subject to the preference. The Revenue Act of 1978 has made permanent the 1977 rules: IDC is only a preference to the extent the calculation exceeds net income from the property.

With regard to dry hole costs in the computation of the above net income, the House and Senate conferees "clarified" (their word) that deductions attributable to properties with no gross income are *not* to be taken into account for purposes of computing net income from oil and gas properties. Result: to the extent of dry hole costs, net income from oil and gas properties is increased, and the IDC preference is correspondingly decreased. However, we have been informed, in conversations with the staff of the Joint Committee on Taxation, that for purposes of excluding dry hole costs, it will be necessary to look to the income of the property rather than to an individual well. Therefore, if regulations follow this approach, costs attributable to dry holes drilled on productive properties will not be excluded from the computation of net income from oil and gas properties.

The 1978 Energy Tax Act has extended parallel treatment to geothermal wells, effective for geothermal wells commenced on or after April 20, 1977 in years ending on or after such date.

Changes in Maximum Tax on Personal Service Income

As pointed out earlier in this section, the effective rate on capital gains prior to the enactment of the 1978 Act, has been as high as 49.125 percent. The increase of top capital gain rates from 25 percent to 49 percent has been due, in large part, to the so-called "poisoning" of earned (or personal service) income by the preference element of capital gains. The 1976 Tax Reform Act introduced the concept of having each dollar of capital gain preference – i.e., the excluded one-half of net long term gains – convert one dollar of earned income subject to maximum tax of 50 percent, to unearned income subject to a top rate of 70 percent.

This decision has been reversed by the 1978 Revenue Act; effective for sales and exchanges after October 31, 1978, in taxable years ending after that date, the preference element of long term gains will not offset earned or personal service income subject to the 50 percent maximum tax. The October 31 date gives parallelism with the timing of the change in capital gain deduction from 50 percent to 60 percent.

The 1978 Act makes one other change in taxation of personal service income. For businesses in proprietorship or partnership form, where capital is a material income producing factor, prior law has limited the amount of personal service income subject to the maximum tax to 30 percent of net income from the trade or business. This 30 percent limitation is removed for taxable years beginning after December 31, 1978, and a "reasonable compensation" test is substituted. Since the subject of reasonable compensation has produced a good deal of past litigation as to its deductibility by a business, there is no reason to anticipate a dearth of interpretations (administrative or judicial) on this subject in the future.

Corporate Capital Gains

Under present law corporate capital gains are taxed at a rate of 30 percent. For taxable years ending after December 31, 1978, the corporate tax rate on capital gains will be reduced to 28 percent. While the House, in order to create parallel treatment between corporate and noncorporate taxpayers, eliminated capital gains as a corporate tax preference, the Senate did not. The Senate approach prevailed in conference, and capital gains remains a preference for corporations.

Thoughts on Investment Timing Strategy

In reviewing the multitude of changes made by the 1978 Act that can affect investors – particularly when the differing effective dates are considered – it becomes virtually impossible to come up with any "best answer" approach covering all individual taxpayers with respect to 1978 versus 1979 timing of sales. Probably the most important point to remember is that the sale of assets should be, first and foremost, an investment decision and not a tax one. Only after recognizing the investment soundness of the decision should taxes be permitted to help dictate the timing.

Given the validity of the investment decision, however, there are quite a number of factors that must be taken into consideration, recognizing that we are operating under one set of tax rules for the balance of calendar 1978 and another beginning in 1979 (this discussion will assume calendar year, cash basis individuals). For November and December 1978, the following tax rules will be applicable:

1. Net long term gains are 60 percent deductible.
2. The top rate of 25 percent on the first $50,000 of gains will apply.
3. There is no alternative minimum tax.
4. The add-on minimum tax applies, and the 60 percent deductible part of capital gains is a preference.
5. The new definition of excess itemized deductions for preference purposes is not in effect.
6. The maximum tax calculation is not poisoned by the capital gain preference.

Given the above, the following thoughts may be considered in planning. They should be looked at only as general ideas; no proper decision can be made until one puts pencil to paper and actually computes the likely tax effect of selling in 1978 as opposed to 1979.

1. In computing 1978 income, the year will have to be segmented for capital gain purposes, with gains and losses for the first ten months looked at separately from those for the last two months. Net long term gains for the first ten months are 50 percent excludible, for the last two months 60 percent.

However, net loss rules do not change, and they continue to be reduced by only 50 percent in offsetting ordinary income. Since, however, losses must first be netted against gains, the effect will be that any loss utilized against a post-October 31 long term gain becomes, in effect, one whose benefit is reduced 60 percent rather than 50 percent.

Thus, for 1978, if taxpayer has net losses not exceeding $6,000 through October 31, and no gain transactions thereafter, the losses will be reduced by only 50 percent in determining taxable income for the year (since $3,000 ordinary income may be offset). If, however, net long term gains are recognized for the last two months of the year, those 50 percent losses now become reduced 60 percent.

The same point is true for subsequent years, but again with a $6,000 limit in a year; to the extent net losses exceed $6,000, the excess becomes a carryover to future years and, if then offset against long term gains, is subject to 60 percent reduction.

2. For taxpayers not in a net loss position at October 31 (and even for many who may be), the retention of the alternative tax for the last two months of the year may well dictate sales of securities at a gain during those months, if taxpayer is in a higher than 62 percent 1978 bracket. This is particularly true because of an unintended omission on the part of Congress in failing to conform the alternative tax calculation to the new 60 percent gain deduction. As a result, in computing the alternative tax, even though only 40 percent of the gain is includible in taxable income, the mechanics of the calculation remove *50* percent of the gain in computing the ordinary income element of the tax. This gives certain limited advantages to high bracket taxpayers which, as mentioned above, are unintended; and which will expire on December 31, 1978.

3. Recognizing the value of the 25 percent maximum rate on the first $50,000 of gains, it must also be remembered that for many taxpayers – particularly at brackets below 50 percent, whether through the use of shelters or otherwise – the opportunity for an add-on minimum tax to apply for calendar

1978 is increased. First, the capital gain preference after October 31 is increased by definition. Second, that 60 percent deduction further reduces adjusted gross income, thus increasing the ratio of itemized deductions to AGI.

4. While we never like to suggest the postponement of deductions, a taxpayer potentially subject to a 1978 minimum tax, and faced with an excess itemized deduction preference, might wish to consider deferring payment of any remaining state or local taxes until 1979. For 1978, state and local taxes are part of the excess itemized deduction preference under the add-on minimum tax; for 1979, they are removed from any preference determination, under either of the two minimum taxes. Deferral of payment might apply, for example, to the fourth quarter estimated state income tax or a semiannual payment of real estate tax on the home.

5. Remember that securities sold at a gain at the end of December, but with a settlement date in January 1979, will have to be reported under 1979 rules. The 1978/1979 effective date cutoffs are all stated in terms of taxable years beginning after December 31, 1978, not transactions occurring after 1978. Thus, year-end sale timing can be critical, depending on which year it is intended for the transaction to be reported, and care should be paid to this point. Loss transactions are reported in the year of the trade date, not the settlement date.

PROVISIONS PRIMARILY AFFECTING INDIVIDUALS

Increase in Personal Exemptions

The personal exemption has been increased from $750 to $1,000. Exemptions are allowed for taxpayer and spouse, for qualifying dependents, and additional exemptions are provided for taxpayers (or spouse) who are blind or age 65 or older. A corresponding amendment has been made in the amount of gross income allowed, without tax consequence, to a dependent – this amount has also been increased to $1,000. Thus, an otherwise allowable dependency deduction will not be lost because the dependent's gross income reaches $1,000, and a dependent without earned income can now receive dividends (after the $100 exclusion) or interest of up to $1,000 before tax is due. The exemption increase is effective for taxable years beginning after December 31, 1978.

The $250 increase in the personal exemption will replace the existing general tax credit ($35 per exemption or two percent of the first $9,000 of taxable income) which will be allowed to expire at the end of 1978.

Fiscal year taxpayers with taxable years including December 31, 1978 will be able to utilize proportionate parts of the increase in personal exemptions and of the expiring general tax credit in such taxable year.

Zero Bracket Amount (Standard Deduction)

The zero bracket amount has been increased from $2,200 to $2,300 for single persons and heads of household, from $3,200 to $3,400 for married couples filing a joint return, and from $1,600 to $1,700 for married persons filing separate returns. The increases are effective for taxable years beginning after December 31, 1978. Fiscal year taxpayers will receive a pro rata benefit.

Changes in Filing Requirements

The changes in the zero bracket amount and in the personal exemption have caused corresponding increases in the filing requirements for income tax returns. The new filing levels are:

	Gross Income
Single person and head of household	$3,300
Married couple filing joint return (both under age 65)	5,400
Married couple filing joint return (one over age 64)	6,400
Married couple filing joint return (both over age 64)	7,400
Dependent of another with no earned income	1,000

Payments to Grandparents Eligible for Child Care Credit

The statutory language of the child care credit (enacted in 1976) was such as to preclude the credit where payments were being made to grandparents for child care. Under the 1978 Act, payments to grandparents for care of their grandchildren will generally qualify for the child care credit, provided that the parents are not also entitled to a dependency deduction for the grandparents. Effective for taxable years beginning after December 31, 1978.

Unemployment Compensation

Unemployment compensation paid under most government programs has traditionally been exempt from taxation. The bill applies a phase-out formula to determine the amount if any, of such unemployment compensation subject to income tax. The amount of such unemployment compensation includible in income will be limited to one-half the excess of:

1. The sum of the taxpayer's adjusted gross income, plus all such unemployment compensation, plus all disability income (even though excludible from income under another Code section) over
2. The taxpayer's "base amount."

The base amount is $25,000 for married individuals filing a joint return (zero for married individuals filing a separate return, unless he or she lives apart from their spouse for the entire taxable year), and $20,000 in the case of all other individuals.

This change applies to unemployment compensation paid after December 31, 1978.

Political Contributions

The Act eliminates the present deduction for political contributions of up to $100 per year ($200 in the case of a joint return). However, taxpayers may still claim an income tax credit equal to one-half of political contributions, and the allowable credit has been increased to $50 ($100 on a joint return). The repeal of the alternative deduction and the increase in the credit are effective for contributions made after December 31, 1978, in taxable years beginning after that date.

Earned Income Credit

The earned income credit, which was due to expire at the end of 1978, has been made permanent. The credit will be increased to 10 percent of the first $5,000 of earned income, resulting in a maximum credit of $500. This maximum credit will be reduced if either earned income or adjusted gross income rises above $6,000 and the credit will be zero for families with incomes over $10,000.

There were minor changes in the definition of earned income and in the eligibility requirements for the credit.

These changes are effective for taxable years beginning after December 31, 1978.

Until this 1978 Act, eligible individuals could not obtain the benefit of the earned income credit until after the end of the year, when they filed their income tax return. Under the Act, the credit is refundable to the extent it exceeds the individual's income tax liability. Effective for compensation received after June 30, 1979, eligible individuals may elect to receive advance payments of the earned income credit from their employer through "negative withholding." The election will be made by filing a certificate with the employer, containing sufficient information to allow the employer to compute the credit from tables to be developed. The credit will be added to the employee's paycheck and will be reflected at year-end in the employee's Form W-2.

Itemized Deduction - Gasoline Tax

Effective for taxable years beginning after December 31, 1978, an itemized deduction will no longer be available for state and local gasoline taxes. While not part of the Energy Tax Act, energy policy was much on the minds of the drafters of this provision.

Claim of Right Carryback

Under present law if a taxpayer has received cash or has an unrestricted right to such cash or funds that represent income, he is required under the tax doctrine of "claim of right" to recognize income in the year the cash is received. However, if in some future year, it is determined that he must restore the amount previously recognized as income, he will be entitled to deduction in the year of repayment computed at the same tax rate he paid when the item was initially recognized as income in a prior year. For example, assume that a taxpayer recognizes $1,000 under claim of right, and that his tax rate in the year of recognition is 50 percent. If, in the future, he is required to restore the $1,000 and his tax rate is 40 percent, he will be entitled to a deduction in the year that he makes the repayment, but at the original rate of 50 percent.

Under prior law if the taxpayer was entitled to recompute taxes for the prior year by excluding amounts previously included in income for that year, and the resulting tax reduction was significant enough to eliminate his current year's tax liability and result in a refund, there was no provision under the law for the Internal Revenue Service to make a prompt refund. Under these circumstances a taxpayer could conceivably wait years for his refund while the Internal Revenue Service audited his return for the year of repayment. Effective for claims filed after the date of enactment of the Revenue Act of 1978, a taxpayer under these circumstances will be allowed to apply for a "quick" refund for an overpayment of tax in the current year, similar to carryback of a net operating loss. Under this procedure the Internal Revenue Service is required to act upon the claim within 90 days.

COMPENSATION AND FRINGE BENEFITS

Deferred Compensation

In 1960 the IRS published Revenue Ruling 60-31 providing that the constructive receipt and cash equivalent doctrines would not result in taxation of employees participating in nonqualified deferred compensation arrangements, so long as certain guidelines were met. In subsequent years, the concept was liberalized, and even limited funding was allowed in some instances. By the early 1970s, deferral had become popular with employees in both private and public sectors, and many employers obtained favorable private rulings from IRS with respect to their plans. However, in 1977 the IRS suspended issuance of such private rulings and began a study of whether their position should be reconsidered. On February 3, 1978 proposed regulations were issued which would generally have taxed the compensation in the year it would have otherwise been received but for the deferral election. These proposals met stiff opposition from public and private sectors alike, with the result that Congress has now responded.

State and local government plans. The 1978 Act retains, for public sector employees, the ability to defer limited amounts of compensation via an eligible deferred compensation plan maintained by a state or local government unit. Such plan must limit the deferral to the lesser of $7,500 or one-third of includible compensation for the taxable year. The calculation of includible compensation and allowable deferral are readily determinable in most cases as most such compensation is set by contract, statute, or salary scale. A participant would not be taxable on the deferred amount or on any income attributable to the investment of such deferred amount, until paid or otherwise made available to him or his beneficiary.

An election to defer compensation for any calendar month must be made before the beginning of such month. Benefits cannot be made available to participants in eligible deferred compensation plans until the earlier of: (1) separation from service, or (2) the occurrence of an unforeseeable emergency.

All plans (whether currently in existence or not) will have until January 1, 1982 to satisfy statutory requirements for classification as an eligible deferred compensation plan. However, the limitation on amounts deferrable under such plans will apply for all taxable years beginning after December 31, 1978.

For state or local plans not meeting eligibility requirements, deferred compensation will be taxed currently to employees unless subject to a substantial risk of forfeiture; however, earnings on the invested amounts would not be taxed until made available to the employee, and then under the rules applicable to annuity taxation.

Private nonqualified deferred compensation plans. For employees of taxable entities, the bill rejects the proposed regulation issued by the IRS on February 3, 1978, by providing that the taxability of compensation deferred under private nonqualified plans is to be determined in accordance with regulations, rulings, and judicial decisions in effect on February 1, 1978, and making the provision effective for taxable years ending on or after February 1, 1978.

Participants in such plans would not be subject to the annual deferral limitations discussed above for participants in state and local government plans, but may elect (in advance of earning the compensation) that portion to be deferred.

Tax exempt organization employees. Employees of tax-exempt charitable or educational organizations are not covered by the above provisions for public or private sector plans. The Senate version of the 1978 bill would have included exempt organization employees in the private plan rules, but the Conference Committee eliminated that provision. Exempt organization employees are eligible for some limited deferral through participation in a tax sheltered annuity not available to other types of employees (and the rules on these have been somewhat liberalized under the 1978 Act – see discussion under Retirement Plans), but it would now appear – given the specific rejection of their participation in the private plan rules – additional deferral for such employees will likely invite IRS attack, including a possible one under the February 3 proposed regulations.

Timing of deduction for payments to independent contractors. An employer generally is not permitted a deduction for deferred compensation provided under a nonqualified plan until the year such compensation is includible in income of the employee, even though the employer is on the accrual basis and would otherwise be permitted such deduction. This required delay in the timing of the deduction, however, only applies where there is an employer-employee relationship.

Accrual basis taxpayers have, therefore, been able to obtain current deductions for compensation owed to independent contractors which were

deferred under an unfunded compensation agreement. The bill denies the business a deduction until the deferred compensation is includible in the income of the independent contractor, effective for taxable years beginning after December 31, 1978.

Cafeteria or flexible benefit plans. Under a "cafeteria" or "flexible benefit" plan, an employee may choose from a package of employer provided fringe benefits, some of which may be taxable and some (such as health and accident insurance) nontaxable. Depending on when the plan was established, and payments made, differing tax rules could apply.

The Act provides permanent rules for existing and future cafeteria plans, effective for years beginning after December 31, 1978. In general, employer contributions under a written cafeteria plan are excluded from the gross income of an employee to the extent that nontaxable benefits are elected. Nontaxable benefits include: group term life insurance up to $50,000, disability benefits, accident and health benefits, and qualified group legal service plan benefits. Specifically excluded from cafeteria plan treatment are deferred compensation plans. Plan participation must be limited to employees, former employees, and their beneficiaries.

Amounts contributed on behalf of a highly compensated employee will be included in gross income to the extent that he could have elected taxable benefits, unless the plan meets specified antidiscrimination standards with respect to coverage and eligibility for participation in the plan, and with respect to contributions or benefits. A commonly controlled group of businesses will be treated as a single employer in applying the antidiscrimination tests. Finally, the Senate Finance Committee report indicates an intention that an employer maintaining two or more cafeteria plans may choose to aggregate such plans for purposes of the antidiscrimination tests.

Cash or deferred profit-sharing plans. There are plans which permit an employee to elect whether to receive a current salary payment or to have that amount contributed on his behalf to a profit-sharing plan. The IRS had attempted to tighten up on current taxation of these plans via proposed regulations in 1972. In 1974, the Employee Retirement Income Security Act (ERISA) mandated continuation of the pre-1972 rules for plans in existence at that time, but not for any plans adopted later. Congress has now adopted permanent rules for all such plans.

A qualified plan for such a cash or deferred profit-sharing arrangement may now be established, but it must satisfy pension plan

qualification rules. In addition, the plan must not permit the distribution of amounts attributable to employer contributions merely because of the completion of a stated period of plan participation or the passage of a fixed period of time. Employer contributions pursuant to an employee's election must also be nonforfeitable at all times.

Special antidiscrimination rules are provided to limit the actual deferral for the highest paid one-third of all eligible participants in relation to the actual deferral of all other eligible participants.

The amendment is effective for taxable years starting after December 31, 1979. A transitional rule is provided for those plans in existence on June 27, 1974 in which their qualified status for plan years beginning before January 1, 1980 will be determined in accordance with certain earlier revenue rulings.

Employer Assisted Education Programs

Under regulations issued by IRS in 1967, an employee is entitled to a deduction for educational expenses only where the education does not qualify him for a better position than the one he presently holds; deductibility is only permitted for education that maintains or improves skills in his present position or is required by law or regulation for the retention of such position. Where an employer reimburses the employee for such education, or pays the education costs directly, IRS rulings require him to determine in advance whether the employee will be entitled to an education expense deduction. If not, such payment or reimbursement is compensation to the employee, and the employer is required to withhold appropriately.

The subjective determination of the employee's deduction is often a matter of great complexity, and since the promulgation of those regulations, there have been over 150 cases litigated on the subject of whether a particular course qualified for deductibility by the employee. To avoid the necessity for such subjective determination, education assistance provided by an employer under a qualified program will be deductible by the employer and nonincludible in the employee's income, on a five-year trial basis effective for taxable years beginning after December 31, 1978.

Qualified programs must be written, for the exclusive benefit of employees, and nondiscriminatory (in this case, nondiscriminatory will mean that no more than five percent of the annual costs under such program may benefit officers, highly compensated employees, or owners of more

than five percent of the business). A program will not be qualified if it gives an employee the option of choosing education assistance or taxable compensation and thus could not be part of a cafeteria program.

Excludible education assistance expenses may include tuition, fees, books and supplies; but may not include living expenses or any benefits for instruction involving sports, games, or hobbies. Training leading to promotion, or to qualification for a new position (night law school for a CPA firm employee, for example) will qualify.

Medical Expense Reimbursement Plans

A medical expense reimbursement plan is any plan or arrangement where the employer reimburses the employee for medical expenses incurred by the employee or his dependent. Under prior law, medical expense reimbursement plans could be discriminatory, so that a company could limit the plan strictly to its highest paid officers and employees. Effective for taxable years beginning after December 31, 1979, uninsured medical expense reimbursement plans will have to meet the breadth-of-coverage requirements applicable to qualified pension plans. In order for medical expense reimbursements to be excluded from the employee's income, the plan must not discriminate in favor of key employees. If a plan fails to meet the new breadth-of-coverage rules, all or part of the amount reimbursed to key employees will be includible in their income. The amount included in a key employee's income under a discriminatory plan will be determined by a fraction, the numerator of which is the amount reimbursed to the employee under the plan for the year, and the denominator of which is the total reimbursed under the plan to all employees of the employer for that year.

Other Aspects of Fringe Benefits

In September 1975, the Treasury Department prepared proposed regulations re-examining the government's administrative position with respect to the taxation of many types of fringe benefits. Covered in the Treasury Department draft were such areas as substantially discounted air travel for airline employees, furnishing of cars or limousine service to company executives or salesmen, employee discounts in department stores, periodic social functions given by a business for its employees, and many others.

In order for a proposed tax regulation to be issued in the Federal Register as a formal notice of proposed rulemaking, it must be signed by

both the Secretary of the Treasury (or his delegate) and the Commissioner of Internal Revenue. Then Commissioner Donald Alexander refused to sign the regulation draft on the grounds that it changed substantive law in a manner beyond that appropriate for administrative or executive agencies. Accordingly, the proposed regulation was issued by Treasury as a discussion draft only.

Subsequent to 1975, there has been substantial debate on fringe benefit taxation, and Chairman Al Ullman of the Ways and Means Committee this year designated a task force from within his Committee to look anew at the entire subject, with the idea of proposing legislation on such taxation, if appropriate. Meanwhile, however, Congress has also acted to ascertain that neither Treasury nor IRS would currently change the present rules applicable to this subject.

In a separate bill (HR 12841), signed by President Carter in October 1978, Congress has dictated to Treasury and IRS that no changes are to be made, by final regulation or administrative ruling, in the present law (rulings, regulations, and court decisions) affecting the taxation of fringe benefits, until at least January 1, 1980. It will be permissible to issue *proposed* regulations, for comment by the public and members of Congress, but no final rules may be adopted until after 1979.

In the same bill, Congress has dictated to IRS that a 1976 revenue ruling which would change certain rules relating to commuting expenses, is not to be put into effect before 1980. It is clearly anticipated that Congress will be devoting some time to these subjects in 1979, and we should expect that any changes in present rules will either be legislative changes (rather than administrative) or, at least, will be put into effect only with legislative blessing.

PROVISIONS AFFECTING RETIREMENT PLANS

Simplified Pension Plans

Administrative complexities have caused the termination of many pension and profit-sharing plans. In an effort to encourage greater use of Individual Retirement Accounts (IRAs), which are much simpler to administer and operate, the 1978 Act substantially increases the allowable annual contributions to an IRA, if such contributions are made by an employer to his employees' IRAs. An employer may now contribute the lesser of $7,500 or 15 percent of the employee's earned income on an annual basis, to an employee's IRA.

Employees will now also be able to deduct contributions to their IRA even though the employer makes contributions to the same plan. The bill does not change the annual limit on employee contributions to his own IRA (the lesser of $1,500 or 15 percent of earned income), but does allow the employee to contribute and deduct the difference if the employer contribution to the employee IRA is less than the individual's annual limit. Assume, for example, that an employee earns $20,000 and his employer contributes $1,000 to his IRA. The employee could contribute, and deduct, an additional $500 to his IRA ($750 to a spousal IRA). There are no provisions, however, for contributions by an employee based on prior years' unused limitations.

Employer contributions to employee IRAs require a written plan or formula, nondiscrimination in coverage for employees 25 years of age or over with three years of employment, and nondiscrimination in contributions as to officers, shareholders or highly compensated employees. Employer contributions would be fully vested immediately. These provisions are effective for taxable years starting after December 31, 1978.

Defined Benefit Plan Limits Adjusted in Certain Collectively Bargained Plans

Under prior law, the annual benefit in a defined benefit pension plan could not exceed the lesser of $75,000 (adjusted annually for cost of living increases) or 100 percent of the participant's average compensation in his highest three consecutive years of participation. The bill removes the 100 percent limitation for plan participants in certain collectively bargained defined benefit pension plans but, for such participants, also reduces the

$75,000 limit to $37,500 (adjusted for cost of living). The amendment applies for years beginning after December 31, 1978.

Tax-sheltered Annuities for Exempt Organizations

Employees of a tax-exempt charitable organization or educational institution (such as a hospital or school) may have a portion of their compensation set aside for purchase of a tax-sheltered annuity or the stock of a regulated investment company (mutual fund, etc.). Such amounts are generally excluded from the employee's income. The bill liberalizes the allowable distributions from a custodial account holding regulated investment company stock, to conform to existing allowable payments from a tax-sheltered annuity. Distributions of mutual fund stock will now be allowable after an employee dies, becomes disabled, separates from service, attains age 59½, or encounters hardship. This is effective for taxable years beginning after December 31, 1978.

The law concerning tax-sheltered annuities for exempt organization employees has also been changed to conform to 1978 Act amendments regarding partial or complete rollovers of lump sum distributions. Recipients of such distributions from tax-sheltered annuities will be eligible to roll over (completely or partially) the otherwise taxable portion to an individual retirement plan, or to elect ten-year averaging with respect to such distributions if they are not rolled over. The new rules are effective for distributions made after December 31, 1978, in taxable years beginning after such date.

Individual Retirement Accounts

The Individual Retirement Account (IRA) allows individuals, not otherwise covered by a qualified employer pension plan, a deduction of up to $1,500 annually ($1,750 where a nonworking spouse is included) for contributions to their own retirement plan. Since inception in 1975, the overly burdensome tax rules governing IRAs have tended to discourage rather than encourage their use as a savings vehicle for retirement. The Revenue Act of 1978 makes a number of reforms to the IRA rules which extend the time for making contributions, eliminate severe penalties for excess contributions, eliminate several restrictions on rollovers of distributions from qualified pension plans, and provide criteria for the waiver of penalties on failure to distribute IRA funds upon retirement. The new IRA provisions can be summarized as follows:

1. Effective for taxable years beginning after December 31, 1977, the time limit for making contributions to an IRA has been

extended from a rigid 45 days after the close of the taxable year to the date of filing the individual's return (including extensions).

2. Under prior law, excess contributions, which are subject to penalty, could be applied against future year contributions, provided the amount did not exceed $1,500 (or $1,750 for a spousal IRA) per year. However, no deduction was allowed for the excess contributions, either when made or when ultimately utilized. Effective for taxable years beginning after December 31, 1975, an individual will be entitled to a deduction for subsequent utilization of an excess contribution. For excess contributions prior to 1978, the tax year starting in 1978 is designated as the appropriate year for deduction, so refund claims will not be necessary.

3. Under prior law, excess contributions that exceeded $1,750 were subject to severe penalties. Effective for taxable years beginning after December 31, 1975, excess contributions withdrawn before the filing of an individual's return (including extensions) will not be subject to penalty. However, excess contributions not withdrawn by this date are still subject to the 6 percent annual penalty tax. A one-time catch-up rule provides penalty-free distributions of excess contributions made in taxable years before January 1, 1978.

4. Unlike prior law, individuals will be able to contribute a portion of a retirement plan lump sum distribution to an IRA rather than having to roll over the entire amount. This partial rollover provision applies to distributions from plans made after December 31, 1978. To the extent not rolled over, however, the distribution is currently taxable and not subject to ten-year averaging.

5. Individuals receiving property (e.g., corporate stock) as part of a lump sum distribution from a qualified retirement plan will be entitled to a tax free sale of this property and subsequent rollover to an IRA, if completed within 60 days after the date of distribution. This provision applies to rollover distributions completed after December 31, 1978, in years ending after that date.

6. Effective for taxable years beginning after December 31, 1977, there is no longer a five-year participation requirement in a

qualified retirement plan in order to qualify for a tax free rollover to an IRA. In addition, effective for taxable years beginning after December 31, 1977, individuals will be able to shift IRA funds from one investment medium to another on an annual basis, rather than only once every three years.

7. The Act gives the Internal Revenue Service the ability to waive the 50 percent penalty tax in circumstances where the failure to distribute IRA funds upon reaching age 70½ was due to a reasonable error and the individual is taking steps to remedy the distribution problem. This provision is retroactive to taxable years beginning after December 31, 1975.

8. Beginning with tax returns filed for years starting in 1978, a special IRA tax form will no longer be required in cases where there is no penalty tax and no IRA activity other than deductible contributions and permissible deductions.

PROVISIONS AFFECTING TAX SHELTERS

Expansion of At-risk Rules

Although tax shelters were significantly curtailed by the 1976 Tax Reform Act, Congress is continuing to tighten the rules. There have, to date, been two types of at-risk rules – specific and partnership – with the specific applying to four particular activities: (1) farming, (2) oil and natural gas, (3) motion picture films or videotapes, and (4) personal property leasing. All types of taxpayers have come within the ambit of these rules except corporations (but subchapter S corporations and personal holding companies were included in their coverage).

The second at-risk rule – partnership – generally applies to any activity engaged in through a partnership except for the four specific activities above, and except for investments in real estate.

The thrust of the at-risk provisions is to limit a taxpayer's loss from covered activities in any taxable year to a taxpayer's economic investment in the activity; i.e., the amount at risk which could actually be lost.

Because of the 1976 clampdown on the four specific activities mentioned previously, other forms of tax shelter investment activities have sprung up to fill the void – including coal mining, books, master phonograph records, etc. The 1978 Act, therefore, extends the specific at-risk rule to *all* activities except real estate, and repeals the partnership at-risk rule as redundant.

Under the 1976 Reform Act, if an individual invested directly in several items of leased equipment or several videotapes, each item was treated as a separate activity and the loss from each activity was limited to the amount at risk in each activity. However, if a partnership or subchapter S corporation invested in several items of leased equipment, they were all treated as one activity and the losses of the aggregate activity were limited to the aggregate amount at risk. Recognizing the generally more favorable treatment from aggregation, the 1978 Act seems to liberalize the rule for some individuals who invest directly in shelters and tighten it for others. If an individual invests directly in items now covered by the extended at-risk rule, and also participates actively in the management of the trade or business, all activities of that trade or business may be aggregated in applying the at-risk rule. Likewise, if a trade or business is carried on by a partnership or a subchapter S corporation, aggregation of all activities will

be permitted if 65 percent or more of the losses for a taxable year are allocable to persons who actively participate in its management. IRS is given specific authority to prescribe regulations interpreting the new aggregation and separation rules, and it will probably surprise no one if the regulations are not pro-taxpayer. The regulations are to take into account tax shelter characteristics of the activity, including the presence of accelerated deductions, mismatching of income and deductions, substantial nonrecourse financing, novel financing techniques, property whose value is subject to substantial uncertainty, and the marketing of the activity to prospective investors as a tax shelter.

Although real property is still excluded from the purview of the at-risk rules, the Ways and Means Committee report gives examples of instances in which personal property associated with the real property will have to be split off and treated as a separate activity subject to the at-risk rules. If personal property is incidental to making real property available as living accommodations, the statute provides it shall be treated as part of the activity of holding such real property. For example, personal property used in the operation of a hotel, motel or furnished apartment is considered incidental to making such real property available as a living accommodation and would therefore be exempt from the at-risk rules. In other situations not involving living accommodations, real property is to be split off from the personalty and an allocation of the income, deductions, and basis of the activities will have to be made. One example given in the report is of an individual owning and operating a restaurant which incurs a loss. The loss would be allocated between the ownership of the realty and the operation of the restaurant on the ratio of the deductions apportioned to each activity. If the fair rental value of the building could be determined, that would be an acceptable alternative as the income allocable to the real estate.

The repeal of the partnership at-risk rule provides an unexpected, if narrow, benefit to some corporate partners. Corporations (other than subchapter S and personal holding companies) were specifically exempted by the 1976 Act from the specific at-risk rule on the four enumerated investment activities. Corporate partners were subject, however, to the at-risk rules if their partnership invested in activities other than the enumerated four and other than real estate. Consequently, the repeal of the partnership at-risk rule results in the narrowing of the at-risk concept for widely-held corporations.

Treasury and IRS have developed increasing concern over tax shelter activities of closely-held corporations that were neither subchapter S nor

personal holding companies (already subject to the at-risk provisions). The 1978 bill, therefore, extends the at-risk rule to all corporations in which five or fewer individuals (including attribution) own more than 50 percent in value of the corporate stock at any time during the last half of a taxable year. Subchapter S corporations would also still be subject to the at-risk rules. However, specifically excluded are closely-held companies actively engaged in the leasing business – those having at least 50 percent of gross *receipts* from the leasing and selling of tangible personal property (other than recordings, tapes, books, lithographs, etc.).

Under literal interpretation of prior law, an individual was required to be at risk only at year-end, in an amount sufficient to cover losses for the year, to obtain a deduction. Subsequent to year-end, amounts originally placed at risk could be withdrawn without any recapture of the previously allowed losses (or financing could then be changed from recourse to nonrecourse). The Act now provides for a recapture of the previously allowed losses if the amount at risk is reduced below zero. The amount recaptured is limited to the excess of the losses previously allowed in that activity over any amounts previously recaptured. Reduction of the at-risk amount can occur by distributions to the taxpayer, by changes in the status of indebtedness from recourse to nonrecourse, by the commencement of a guarantee or other similar arrangement which affects the taxpayer's risk of loss, or by other means).

The amendments to the at-risk rules generally apply to taxable years beginning after December 31, 1978. A transitional rule provides that if a taxpayer's amount at risk in an activity at the close of the last taxable year beginning before January 1, 1979, is less than zero, no recapture of that excess occurs. Only further decreases in the at-risk basis would result in recapture.

Penalty for Failure to Timely File Partnership Returns

The proliferation of tax shelter partnerships has caused the IRS problems in auditing partnership returns. The Service complains that many of the complex tax shelter partnerships (often composed of more than 100 partners) do not file partnership returns, or file incomplete returns, making it difficult for IRS to audit the income and expenses of the entity, and also to locate partners where adjustments of partnership income have been made. The new law provides a penalty for each month, or fraction of a month (but not to exceed five months) that a partnership return is late or incomplete. The monthly penalty is $50 multiplied by the total number of partners who were partners at any time in the year.

Waiver of the penalty is possible for reasonable cause. The Ways and Means Committee report recognizes that small partnerships (those with ten or fewer partners) often do not file partnership returns because each partner files a detailed statement of his share of partnership income and deductions with his own return. The Ways and Means Committee report states that it is reasonable not to file a partnership return in such instance.

Penalties may be imposed beginning with returns for taxable years that start after December 31, 1978.

Extension of Statute of Limitations on Partnership Items

The normal statute of limitations for adjustment of a tax return is three years from the due date of the return or the date of filing the return, whichever is later. Because of complaints from the IRS about the difficulty of auditing partnerships with many partners, and in tracking partnership adjustments through to the returns of each partner, the bill extends the statute of limitations from three years to four years with respect to partnership items flowing from "federally registered partnerships." If a partnership return does not properly disclose the name and address of each partner, the statute will also not expire until one year after that information is furnished to the IRS.

A federally registered partnership means any partnership in which interests have been offered for sale in an offering required to be registered with the SEC, or any partnership which is or has been subject to the annual reporting requirements of the SEC.

The partnership provisions are effective for items arising in partnership returns for taxable years beginning after December 31, 1978.

Amortization for Low Income Rental Housing

Under current law, investors are able to depreciate rehabilitation expenditures for buildings providing housing to low and moderate income families, using a straight-line method over a period of five years. Special rules limit the amount of aggregate qualified rehabilitation expenditures to $20,000 per dwelling unit. The special depreciation procedure was scheduled to expire on December 31, 1978. In order to encourage this type of rehabilitation, the five-year amortization of low income rental housing has been extended to December 31, 1981.

PROVISIONS AFFECTING ESTATE TAXES

Postponement of Carryover Basis Rules

Prior to the Tax Reform Act of 1976, the basis of inherited property was generally stepped up (or down) to its value on the date of the decedent's death. Under the 1976 Act, the basis of inherited property was "carried over" from the decedent, effective for all property passing from decedents dying after December 31, 1976, but with transition rules allowing a "free step-up" to actual or imputed value of assets at December 31, 1976.

Administrative problems have been immense since enactment of the carryover basis rules, and Congress has decided to defer the effective date of the provisions to allow time for a determination of whether the carryover basis provisions can be fixed. The previous stepped-up basis rules will therefore apply for any property transferred by decedents dying before January 1, 1980.

There are many who believe that the two-year deferral is the first step to a permanent repeal of carryover basis. It may be dangerous to one's financial health to plan on that assumption, however; the issue is a highly charged one, politically, and waiting in the wings could still be the alternative approach dear to the hearts of tax reformers: stepped-up basis for assets transferred by death, but with a capital gain tax imposed for unrealized appreciation at date of death.

There was a great deal of sentiment in the Conference Committee to allow an election to estates of decedents, dying between December 31, 1976 and enactment date of the 1978 Act, to use the carryover basis rules if they would prove beneficial. The Committee was unable to agree whether to allow an election of the carryover basis provisions (complex as they are) or some simplified version to be developed in conference. Since agreement was not reached, no such election is in the final Act; however, Chairman Ullman of Ways and Means has promised to develop such a transition election early in 1979.

Lump Sum Distributions

Prior law has precluded an estate tax exclusion for death benefit distributions from qualified plans if they were eligible to be treated as lump sum distributions. The reason for this rule is that such amounts qualify for the ten-year averaging rules under income taxation, and it was not desired

to give both an income tax and estate tax advantage. However, wording of the statute was such that even if ten-year averaging was *not* elected for income tax purposes, the estate tax exclusion was not available.

For estates of decedents dying after December 31, 1978, such death benefit distributions will qualify for exclusion from estate tax if ten-year income tax averaging is not elected. Distribution can be from any qualified plan, including ESOPs or TRASOPs.

Congressional Estate Planning for Jointly-Owned Businesses

In the absence of proper tax planning, the value of jointly-held property is included in a deceased joint tenant's gross estate except for that portion of the value attributable to consideration furnished by the surviving joint tenant. Services performed by a wife in the operation of a trade or business have not heretofore constituted consideration furnished by the wife. If the husband dies first (which is generally the case), jointly-held property would be includible in the husband's estate even though the wife may have participated materially in the operation of the business.

The Act provides that, if the decedent's estate so elects, services of a spouse are to be taken into account as consideration furnished for the acquisition of jointly-owned property used in a trade or business (including a farm). The spouse would be given annual credit at the rate of two percent times the value of the joint interest less the amount attributable to the original consideration furnished (including an assumed annual six percent growth). The two percent credit would be for each year the spouse materially participated in operation of the farm or business, but the aggregate percentage could not exceed 50, nor could the imputed estate tax exclusion exceed $500,000.

The provision applies with respect to estates of decedents dying after December 31, 1978.

PROVISIONS PRIMARILY AFFECTING CORPORATIONS

Corporate Tax Cuts

The Tax Reduction Act of 1975 revised corporate tax rates to a normal tax of 20 percent on the first $25,000 of taxable income, 22 percent on the next $25,000, with the balance in excess of $50,000 taxed at 48 percent. Subsequent legislation extended these rates through the end of 1978.

For taxable years beginning after December 31, 1978, corporate tax rates have been cut from 48 percent to 46 percent for taxable income in excess of $100,000. In addition, a four-step graduated rate structure replaces the present $50,000 surtax exemption. The new tax rates will generate savings of $7,750 on the first $100,000 of taxable income as compared to present rates:

Taxable Income	Rate After 1978	Tax	Current Rate	Tax	Difference
$ -0- to $ 25,000	17%	$ 4,250	20%	$ 5,000	$ 750
25,000 to 50,000	20	5,000	22	5,500	500
50,000 to 75,000	30	7,500	48	12,000	4,500
75,000 to 100,000	40	10,000	48	12,000	2,000
					$7,750

For fiscal year corporations, computations will be made using both rate tables for the 1978-9 year, and prorating the tax based on number of days in 1978 and in 1979.

Excess Liabilities on Tax Free Incorporation

For federal income tax purposes, no gain or loss is recognized on the transfer of property and its related liabilities to a new corporation, provided that the exchange is for the corporation's stock and that the transferors control the corporation immediately after the exchange. One exception to this nonrecognition rule is that gain will be recognized to the extent liabilities exceed the basis of the property transferred.

This is usually a problem encountered with the tax free incorporation of an ongoing cash basis business, where both receivables and payables are transferred as part of the consideration for stock. Since receivables have a zero basis to a cash method taxpayer, the balance of accounts payable is often in excess of the basis of other assets, thus resulting in gain recognized from the excess liabilities. While it has been possible to avoid the problem (for example, by not transferring the payables and retaining enough receivables to pay the liabilities in the normal course of collections) this required a certain level of tax sophistication which, in turn, created a tax trap for the unwary.

Effective for transfers of property to corporations made on or after the date of enactment of the Revenue Act of 1978, liabilities for currently deductible items (e.g., accounts payable) will not be considered "liabilities" for purpose of the excess liability rule. Therefore, a taxpayer with an ongoing cash basis business will be able to have a tax free incorporation without the threat of accounts payable causing a taxable event.

Postponement of Effective Date for Special Limitations on Net Operating Loss Carryovers

The Tax Reform Act of 1976 provided new restrictions on the transfer of net operating loss carryovers from companies involved in a purchase of or a tax free reorganization with a loss corporation. Under 1976 law, the new provisions would apply to plans of reorganization adopted on or after January 1, 1978, and to sales or exchanges in taxable years beginning after June 30, 1978. Due to technical problems involved in the net operating loss carryover rules, effective dates of these new restrictions have been extended with respect to plans of reorganization until January 1, 1980, and with respect to sales or exchanges until June 30, 1980. For acquisitions or reorganizations made pursuant to contracts executed before September 27, 1978, taxpayer may make an election to have the 1976 Act provisions apply to the transaction, provided that the acquisition or reorganization occurs before the close of the taxpayer's first taxable year beginning after June 30, 1978.

With respect to purchases, prior to the enactment of the 1976 Act, net operating loss carryovers were disallowed in full where the new owners purchased more than 50 percent in the loss corporation during a two-year period. If this ownership requirement was met, the net operating loss carryovers could still be disallowed by the new corporation failing to carry

on substantially the same kind of business as the loss corporation. Effective June 30, 1980, sales or exchanges occurring after that date would fall under the provisions of the 1976 Act, under which continuity of the prior trade or business is not required to permit the transfer of net operating loss carryovers. Instead the carryover is reduced by 3½ percent for each new ownership percentage point in excess of 60 percent to 80 percent, and by 1½ percent for each point in excess of 80 percent.

As to loss carryovers in tax free reorganizations, the present law provides that the carryover will be reduced by 5 percentage points for each percentage point less than 20 which the former owners receive in the new company. Unlike the purchase rule, continuation of the loss company's business has not been relevant to the transfer of the net operating loss carryovers. Effective January 1, 1980, plans of tax free reorganizations adopted after that date will fall under the provisions of the 1976 Act and be subject to more stringent restrictions on the transfer of net operating loss carryovers. In cases where the owners of the loss company fail to receive at least 40 percent of the new company, the net operating loss carryovers will be reduced by 3½ percent for each percentage point below 40 percent to 20 percent, and 1½ percent for each ownership percentage less than 20 percent.

Small Business (Subchapter S) Corporations

Provisions affecting shareholders. Under prior law, subchapter S corporations were limited to ten shareholders, with a special provision that for a small business corporation in existence for a period of five consecutive years the number of shareholders can be increased to fifteen. Effective for taxable years beginning after December 31, 1978, the number of shareholders permitted to qualify and maintain subchapter S status is increased from ten to fifteen.

For purposes of determining the number of shareholders for the above limitation, prior law contained a provision that stock owned by husband and wife would be treated as one shareholder if the stock was held under a legal form of joint ownership, including community property, joint tenancy, tenancy in common, or tenancy by the entireties. Effective for taxable years beginning after December 31, 1978, a husband and wife (and their estates) will be treated as one shareholder for the purposes of determining the number of shareholders in a corporation without reference to the legal form of ownership.

Extension of period for making election. One of the most troublesome areas involved with subchapter S corporations was the

necessity of making a timely election. Under prior law, the election had to be filed during a two-month period which began one month before the start of the taxable year and ended one month after. Numerous court cases have litigated the issue of untimely filings, generally holding that an untimely election nullifies the subchapter S status, and resulting in a corporation being taxed as a regular corporation for all years under audit.

Effective for subchapter S elections made for taxable years beginning after December 31, 1978, the period of time for making an election is expanded to include the entire preceding taxable year of the corporation, in addition to the first 75 days of the taxable year for which the election is effective. Stockholder consent for the subchapter S election is made by those stockholders who hold stock on the date of the election rather than the effective date of the transition to subchapter S status.

Small Business Corporation Stock (Section 1244)

Under the general rule of taxation, when stock becomes worthless, a taxpayer is entitled to a capital loss which can be offset against other capital gains, or against ordinary income as provided by statute. However, if corporate stock qualifies under section 1244 of the Code, a taxpayer would be entitled to a worthless stock loss which could be offset against ordinary income to a maximum of $25,000 ($50,000 in the case of a joint return). Losses in excess of the above limitation would be subject to capital loss treatment.

In order for a corporation's stock to qualify as section 1244 stock, under prior law it must have been issued under a written plan designating such stock as section 1244 stock, and the amount of stock offered under the plan could not exceed $500,000. Although the requirement for a written plan qualifying a corporation's stock as section 1244 stock is relatively simple, many taxpayers have not been aware of this provision and, when the stock became worthless, were not entitled to ordinary loss treatment.

Effective for common stock issued after the date of enactment of the Revenue Act of 1978, a written plan will no longer be required to qualify for section 1244 treatment. The $25,000 loss limitation has been increased to $50,000 ($100,000 in the case of a joint return). The old $50,000 limitation on section 1244 stock issues has been increased to a $1 million limit. If the $1 million common stock limitation is exceeded in a given year, regulations will provide a formula for determining which shares issued that year qualify under section 1244.

Employee Stock Ownership Plans - ESOPs and TRASOPs

The 1976 Tax Reform Act established certain benefits for Employee Stock Ownership Plans meeting specified qualifications, which were scheduled to expire at December 31, 1980. Provision has been made to incorporate these TRASOP provisions into the Internal Revenue Code and to defer the expiration date to December 31, 1983.

A TRASOP will be required to be a tax qualified plan. Unlike other tax qualified plans, however, it may be treated as qualified from its effective date even though it is not actually established until the filing of the employer's tax return (this can be important, since other plans must be qualified the last day of the taxable year for which a benefit is claimed).

Under prior law, every TRASOP participant for any portion of a year was entitled to an allocation of an employer contribution. Because TRASOPs will now be required to be tax qualified, employer contributions need only be allocated to plan participants in accordance with general rules applicable to such plans, but in proportion to total compensation of all participants for the plan year (excluding individual compensation over $100,000).

For ESOPs and TRASOPs of publicly held corporations, voting rights must be passed through to plan participants. ESOPs and TRASOPs of closely held corporations are only required to pass through the vote on corporate actions which must be decided, under state law, by more than a majority vote of common shareholders (e.g., merger, consolidation, or sale of assets).

Prior law allowed subsidiaries to contribute their parent corporation's stock to an ESOP only in those situations where the parent controls 80 percent or more of the subsidiary. This has now been lowered to a 50 percent control test. The bill also provides that first and second tier subsidiaries will not recognize gain or loss on a contribution to a TRASOP maintained by it, of stock in the parent corporation.

Employers contributing to a TRASOP are entitled to an additional one percent or 1.5 percent investment tax credit. This reduces their income tax liability, but that also reduces the tax liability offset against preference income subject to the minimum tax. Therefore, the bill provides that any additional investment tax credit resulting from a TRASOP contribution will not result in additional minimum tax to the employer.

The only employer securities which will be allowed to be held by a leveraged ESOP or by a TRASOP are common stock or preferred stock readily convertible into common.

Under prior law employers were allowed to withdraw contributions from a TRASOP in the event of investment credit recapture. Such withdrawals are no longer permitted.

Under prior law, all distributions from an ESOP or a TRASOP were required to be in the form of employer securities. Distributions can now be made entirely in cash or partly in cash and partly in employer securities, but a participant must have the right to demand his entire distribution in the form of employer securities.

Participants receiving employer stock which is not publicly traded, from a leveraged ESOP or a TRASOP, must have a "put" option to the employer.

The new lump sum death benefit distribution rules (see estate tax section) will apply to ESOPs or TRASOPs.

The above described changes are generally effective for years beginning after December 31, 1978.

PROVISIONS AFFECTING THE INVESTMENT CREDIT

Permanent Increase and Revisions in Investment Tax Credit

The Tax Reduction Act of 1975 temporarily increased the investment tax credit from seven percent to ten percent until 1981, at which time the credit was scheduled to return to seven percent. The credit can presently be used to offset the first $25,000 of tax liability, plus 50 percent of the liability in excess of $25,000.

The 1978 Revenue Act sets the credit permanently at 10 percent of qualified investment. The present $100,000 limitation on used property eligible for the credit, which was scheduled to revert to $50,000 in 1981, is also made permanent. The new law continues the 11 percent investment tax credit available to employers who contribute to certain employee stock option plans, and also the .5 percent available to companies where employees contribute the amount of the additional credit to an ESOP. Note that the 1978 Energy Tax Act provides for certain additional investment credits, and these are discussed in the Energy section of this booklet.

Starting with taxable years *ending* in 1979, the former 50 percent tax liability limitation will be increased 10 percent a year to a maximum of 90 percent in fiscal or calendar 1982 and subsequent years (i.e., 1979 – 60 percent, 1980 – 70 percent, 1981 – 80 percent, and 1982 and subsequent years – 90 percent).

Rehabilitation Expenditures for Certain Existing Structures

Under prior law, buildings and their structural components were not eligible for the investment tax credit, nor were expenditures for renovating such existing buildings or structures. Effective for years *ending* after October 31, 1978, expenditures for rehabilitation and renovation of existing structures will qualify for the investment tax credit provided that the structure is at least 20 years old. The credit does not apply to residential structures such as apartments, but it does apply to all other types of business buildings including factories, warehouses, office buildings, hotels, and retail and wholesale stores. The cost of acquiring a building, or of acquiring an interest in a building (such as a leasehold), will not be a qualifying expenditure. Qualified expenditures will normally be considered new property and will thus not be subject to the $100,000 used property limitation. Examples of qualified capital expenditures for purposes of this

credit include expenditures for the replacement of plumbing, electrical wiring, and expenditures for heating and air-conditioning systems. Qualified rehabilitation expenditures must have a useful life of at least five years.

Single Purpose Agricultural or Horticultural Structures

Although under present law, buildings and their structural components are not generally eligible for the investment credit, certain special purpose structures which are used as an integral part of a production activity are eligible for the credit. However, the Internal Revenue Service has ruled (in Revenue Ruling 66-89) that barns, stables, and poultry houses are buildings and not eligible for investment tax credit. IRS has taken a similar position regarding greenhouses which provide an atmosphere for controlled growth of flowers and other plants.

During discussion of the Revenue Act of 1978 by the Senate Finance Committee, there was expression by several senators that it was the intent of Congress in 1971 – when the investment credit was restored – to apply the credit to special purpose agricultural structures. Therefore, under the new law effective for taxable years which end on or after August 15, 1971, structures which are specially designed and used solely for the commercial production of poultry, eggs, livestock, or plants will qualify for the investment tax credit.

The Conference Committee report explains that the credit is applicable to structures housing "the full range of livestock breeding, raising and production activities," but points out that qualifying facilities must contain equipment for providing feed and care to the livestock. With respect to plants, the statute specifically includes mushrooms.

Refund claims may well be in order.

Increased Investment Credit for Pollution Control Facilities

Under prior law, pollution control facilities for which five-year amortization had been elected would generate investment tax credit, but only on 50 percent of the qualified investment. For pollution control facilities acquired or constructed after December 31, 1978, investment tax credit may be claimed on the entire amount of purchase, regardless of the five-year amortization period (transition rules are provided for facilities in the process of construction at December 31, 1978, to permit the more liberal credit for the part of construction after that date). Pollution control

facilities which have a useful life of three or four years will continue to be subject to the present law which limits the credit to one-third of the full credit.

If the facilities subject to the five-year amortization election were financed with tax exempt industrial development bonds, the prior 50 percent rules remain in effect, and the maximum allowable credit will still be five percent.

Investment Credit for Cooperatives

Under present law, cooperatives are taxed as corporations, with the significant exception that cooperatives are allowed to distribute taxable income to their members by way of a patronage dividend without the income being taxed at the cooperative level. Due to this tax-free distribution, most agricultural cooperatives generate very little taxable income after deduction of the patronage dividends.

For taxable years prior to 1979, investment credit which could be used to offset a cooperative's taxable income, was limited by a fraction, with a numerator of the cooperative's taxable income and denominator of taxable income plus the deductible payments made to patrons and shareholders. There are no provisions similar to a partnership whereby the investment credit flows through to the cooperative's owners. The result of these provisions is that investment credit is severely limited as an offset to taxable income, although the cooperative may have purchased vast quantities of machinery and equipment.

Effective for taxable years *ending* after October 31, 1978, the above limitations will be deleted and cooperatives will be able to claim the investment credit to the same extent available to other taxpayers. Credits in excess of limitations for the current year will not be carried back or forward, but will be allocated directly to patrons. Credit recapture, however, will only be made at the cooperative level, not from each member.

PROVISIONS AFFECTING SPECIAL INDUSTRIES

Accrual Accounting for Farming Corporations

The Tax Reform Act of 1976 required that all corporations engaged in the business of farming, including farming partnerships with corporate partners, would be required to compute income on the accrual method of accounting. Under the accrual method, farmers are required to capitalize all growing costs as inventory which results in a matching of those costs with the related sale. Prior to the effective date of this provision, corporate farmers had been allowed to deduct the cost of seed and other growing costs on the cash method of accounting.

One exception to the general rule that accrual basis accounting applies to all corporate farmers is for small business and family corporations. If a corporation is a subchapter S corporation, or at least 50 percent of the total combined voting power of all classes of stock is owned by the same family, the corporate farm has remained exempt from the accrual method. Effective for taxable years beginning after December 31, 1977, an additional exception to this general rule holds that corporate farms controlled by two or three families will be exempt from the required accrual accounting. In order for this multi-family exception to apply, two families must own at least 65 percent of the total combined voting power of all classes of stock, or three families must own at least 50 percent of the total combined voting power of all classes of stock, with substantially all remaining stock owned by the corporation's employees. And, these ownership requirements must have been met at all times since October 4, 1976 (enactment date of the 1976 Act), with the corporation having been engaged in farming at all times since that date.

Accounting for Costs of Growing Crops

Prior to 1976, the Internal Revenue Service consistently held that farmers, nurserymen, and florists who had elected the accrual method of accounting would not be required to inventory growing crops. However, in 1976, IRS reversed this position and announced (in Revenue Ruling 76-242) that such taxpayers would henceforth be required to inventory crops.

Effective for taxable years beginning after December 31, 1977, the Revenue Act of 1978 permits noncorporate farmers, nurserymen, and florists who are on the accrual method of accounting to continue without

inventorying crops in the manner allowed prior to the above revenue ruling. This provision also allows these taxpayers an election, without IRS approval, to change from the accrual method of accounting (without inventorying crops) to the cash receipts and disbursements method, provided that the election is initiated prior to January 1, 1981.

Certain Cost-sharing Payments Received by Farmers

The Department of Agriculture and several states have various programs which grant farmers funds for soil conservation activities. It is felt that farmers can rarely afford to make investments to prevent soil erosion, and the public benefits from the programs which reduce severe water pollution and prevent the high cost of soil conservation from affecting the price of food. Under prior law, such federal and state cost-sharing payments were considered taxable income to the farmer.

Effective with respect to grants made under such programs after September 30, 1979, payments from designated water or soil conservation programs will be excluded from gross income of the recipient. Although income is not recognized when payments are received, ordinary income recapture is provided for the disposition of any property acquired or improved with such payments before the expiration of twenty years. The recapture is reduced ten percent per year after the first ten years. Further, property acquired (or improvements made) with such payments will not qualify for any deduction (such as depreciation) or credit (such as the investment credit).

Regulated Investment Companies (Mutual Funds)

For income tax purposes, regulated investment companies (i.e., mutual funds) are generally treated as a conduit entity whose taxable income is distributed to investors on an annual basis without being subject to tax at the company level. Regulated investment companies are currently required to distribute at least 90 percent of their taxable income to investors within 12 months after the end of the taxable year.

Under prior law, there were no exceptions from the 90 percent distribution requirement, so that a subsequent taxable income adjustment resulting from an audit by the Internal Revenue Service could cause the company to fail the distribution requirement. For taxable years beginning after the date of enactment of the Revenue Act of 1978, regulated investment companies sustaining subsequent audit adjustments by IRS will

be allowed a deficiency dividend procedure under which the company may pay deficiency dividends to its shareholders in an amount necessary to meet the 90 percent distribution requirement for the year under audit.

To discourage funds from initial underdistribution of income, in reliance on availability of a later deficiency dividend, statutory interest will be charged on the amount of the deficiency dividend, and an additional penalty (nondeductible) equal to the interest charge may also be imposed. The penalty may not, however, exceed 50 percent of the deficiency dividend.

Safe Harbor Rule for Real Estate Investment Trusts

A real estate investment trust (REIT) is treated as a conduit for income tax purposes, and distributions to shareholders are not taxed at the REIT level. In order for the REIT to obtain this conduit privilege, the company is not permitted to engage in an active trade or business which includes holding property primarily for sale. With regard to property acquired through a mortgage foreclosure, special rules allow the REIT a period of up to four years to liquidate the property without losing the conduit privilege (although IRS approval was needed if the period was over two years).

Under prior law, in order to retain REIT qualification while holding such property for resale, a 100 percent penalty tax was imposed on gain when the property was sold. This penalty tax allowed the REIT to retain its special tax status, but eliminated all profit from holding such property for sale.

Effective for years ending after date of enactment of the 1978 Act, an REIT will be able to hold property primarily for sale without the threat of the 100 percent penalty tax provided that the property meets four conditions: (1) it has been held by the REIT for at least four years, (2) total expenditures during the four-year period prior to sale do not exceed 20 percent of the selling price of the property, (3) the REIT does not sell more than five properties during the taxable year, and (4) if the property consists of land or improvements not acquired through foreclosure, it must be held by the REIT for rent for a period of at least four years.

In addition to the above provisions, effective on the date of enactment of the Revenue Act of 1978, the four-year holding period for foreclosure property has been increased to six years. IRS permission is still necessary to extend the holding period of the property beyond two years.

Accounting Treatment for Discount Coupons Redeemed After the Close of the Taxable Year

Under prior law, issuers of premium coupons or trading stamps are allowed to establish a reserve for the estimated cost of redeeming such coupons outstanding at the close of the taxable year. The Internal Revenue Service has determined that this tax accounting treatment does not apply to discount or ''cents off'' coupons, where coupons are applied against the purchase price of products acquired in the future.

Effective for taxable years ending after December 31, 1978, issuers of qualified discount coupons may elect to deduct the cost of coupons redeemed within six months after the close of the taxable year. The provision is not to affect the present treatment of premium coupons or trading stamps.

With respect to the transitional adjustment caused by the above change in accounting method (which is normally amortized ratably over a period of ten years), special rules provide that any adjustment decreasing taxable income will be placed in a suspense account, which could defer any deduction from taxable income until the taxpayer no longer issues discount coupons in connection with his trade or business. An adjustment increasing taxable income will be subject to the usual ten-year spread.

Accounting Treatment for Magazines, etc., Returned After Close of the Taxable Year

A significant factor in accounting for magazine and paperback publishers is that a certain percentage of all items distributed will be returned unsold to the publisher. This same principle applies to records distributed by recording companies. Under prior law, the Internal Revenue Service had taken the position that an accrual basis publisher and distributor of magazines, paperbacks, or records, must include the sales proceeds of these items in income when they are shipped to purchasers, without reduction for estimates of items to be returned unsold in a succeeding year. Effective for taxable years beginning after September 30, 1979, accrual basis magazine publishers or distributors will be entitled to exclude from income those items returned within two months and fifteen days after the close of the taxable year in which the sales of the items were made. With respect to paperback and record distributors, items returned within four months and fifteen days after the close of the taxable year will be excluded from income in the year of sale.

Under present law, when a taxpayer changes his method of accounting, the net transitional adjustment as a result of the change is amortized ratably, usually over ten years. With respect to the above reserve for returnable items, the transitional adjustment attributable to magazines is to be amortized over five years. The transitional adjustment attributable to paperbacks and records is placed in a suspense account, however, which could defer the deduction from the adjustment until the taxpayer is no longer in the trade or business of publishing or distributing paperbacks or records.

Reporting Requirements for Charge Account Tips

In 1975 and 1976, the IRS issued two rulings (Rev. Ruls. 75-400 and 76-231) requiring an employer to report to the IRS charge account tips paid to employees whether or not such tips were reported to the employer as having been received by the employees. The effective date of these two revenue rulings was deferred until January 1, 1979 by the 1976 Tax Reform Act. This bill permanently overturns the two rulings, with the result that prior law will remain in effect: employers will only be required to report those tips which are, in turn, reported on to them by employees.

It is understood that this will undoubtedly continue to result in underreporting by employees, but the accounting and controls burden on employers was recognized as being extremely cumbersome and costly for the minor increase in tax revenues that would have been generated.

OTHER PROVISIONS AFFECTING BUSINESS

Expenses Related to Entertainment Facilities

Under prior law, all expenses related to entertainment facilities were deductible provided the taxpayer could provide support that the facility was used primarily for the furtherance of his business and that the expenses were directly related to the active conduct of such business. Effective for expenditures paid or incurred after December 31, 1978, no deduction will be allowed for any expenses paid or incurred with respect to particular types of facilities used for entertainment, amusement, or recreation. Such entertainment facilities include yachts, hunting lodges, fishing camps, swimming pools, tennis courts, and bowling alleys. In addition, the investment credit will not be permitted on acquisition of such facilities. These facilities may also include airplanes, automobiles, hotel suites, apartments, and houses located in recreational areas; except that this second category is not affected by this provision unless the property is used in connection with entertainment.

The Senate had approved extending nondeductibility to an additional group of entertainment expenses, including dues or fees paid to any social, athletic, or country club, but the Conference Committee agreed to permit a deduction for country club dues as in the past; i.e., limited to use directly related to the trade or business. Also, charges at any club (e.g., greens fees, meals, etc.) would be deductible subject, of course, to substantiation and that the expense was ordinary and necessary. The nondeductibility provisions also will not apply to dues or fees paid to civic or social organizations, or to business luncheon clubs, if such fees are otherwise deductible (i.e., an ordinary and necessary business expense).

Additional presently deductible business expenses which are not affected by this provision include: (1) tickets to sporting and theatrical events, (2) bona fide business travel, convention, and entertainment activity expenses, (3) facilities located on the taxpayer's business premises and used in connection with furnishing food and beverages to employees, (4) certain employee recreational facilities, (5) facility expenses treated as employee compensation, (6) facilities made available to the general public, (7) facilities used in connection with the taxpayer's trade or business of selling entertainment for adequate and full consideration in bona fide transactions, and (8) facilities actively used in the taxpayer's business of selling such facilities. Thus, purchase of a yacht by a taxpayer for use in charters to the public would still permit normal trade or business deductions

by the owner (subject to other limitations such as showing a profit in two out of five years, and loss of deductions connected with personal use).

The charges are certainly more restrictive than prior law but not as severe as proposed by the President in his tax message. Also, there are signs of increased interest in this area generally when tax returns are examined. The courts also are supporting the Service in its application of rules on substantiation.

Ten Year Carryback of Product Liability Net Operating Losses

In general, net operating losses from a business can be carried back to offset taxable income of the three preceding taxable years, and carried forward to offset taxable income of the next seven years succeeding the loss year.

Effective for net operating losses incurred in taxable years beginning after September 30, 1979, that part attributable to product liability losses can be carried back to the ten years preceding the year of the loss and carried forward to the seven years succeeding the year of the loss. In effect, a business will be able to offset a large product liability loss against the taxable income of up to eighteen years. Affected taxpayers may elect not to use the special carryback provisions, but utilize the normal three-year carryback instead. Service liability losses (legal, medical) are not covered by this provision.

In addition, accumulating reasonable amounts for product liability losses will be statutorily exempt from the penalty tax on unreasonably accumulated earnings. The committee report states that this provision "merely clarifies" present law, but apparently it seemed worthwhile to include it anyway.

Targeted Jobs Credit

Under pre-1979 law, employers were entitled to two types of jobs credits: a new jobs tax credit based upon an employer's wage base under the Federal Unemployment Tax Act (FUTA), and a work incentive credit (WIN) available for hiring welfare recipients and participants in social security work incentive programs.

The FUTA jobs tax credit was enacted by Congress in 1977 to fight unemployment during taxable years 1977 and 1978, and will be discontinued for taxable years beginning January 1, 1979. A revised version of the credit has been enacted for the years 1979 to 1981.

Effective for amounts paid or incurred after December 31, 1978, in years ending after that date, a targeted jobs tax credit will apply in order to direct employment incentives to those individuals who have high unemployment rates even when the national unemployment rate is low. The credit is available to employers who hire from seven target groups: vocational rehabilitation referrals, economically disadvantaged youths, economically disadvantaged Vietnam veterans, economically disadvantaged individuals convicted of a felony, disabled recipients of Supplemental Security Income, youths age 16 through 18 who are participants in a qualified cooperative education program and general assistance recipients. Computations are based upon the first $6,000 in wages paid to qualifying employees, with a rate of 50 percent in the first year of employment and 25 percent in the second year. As under prior law, the amount of the credit reduces the employer's deduction for wages.

The table below illustrates a net tax benefit for a corporate employer hiring a qualifying employee as $1,620 in the first year of employment, and $810 in the second year.

Year	Wages of single employee subject to credit	Applicable percentage	Maximum credit from each qualified employee	Credit plus tax benefit of wages not subject to credit (46% tax rate)	Normal tax benefit from deduction at 46% tax rate	Net tax benefit per employee at 46% tax rate
1	$6,000	50%	$3,000	$4,380	$2,760	$1,620
2	6,000	25	1,500	3,570	2,760	810

Note that, unlike the expiring general jobs credit, the new targeted credit is elective. Some taxpayers had encountered problems in using the general jobs credit, and the election will ensure that the new credit need not prove an administrative millstone.

While it is clear that the credit is elective, and not mandatory, with respect to payments made after December 31, 1978 (i.e., under the targeted credit approach), what is less clear is the impact of the election amendment on the general jobs credit which has been available for the past two years. The Conference Committee report, discussing a possible extension of the general jobs credit (which had been proposed by the Senate) points out that the general credit is to be allowed to expire "except that the credit is made elective for taxable years beginning after December 31, *1976*." (Emphasis

supplied.) However, the statute itself provides otherwise, and in unambiguous terms: "... the amendments made by this section shall apply to amounts paid or incurred after December 31, 1978, in taxable years ending after such date."

We have discussed this inconsistency with the responsible individual on the staff of the Joint Committee on Taxation, and have been informed that it was most definitely congressional intent to permit, retroactively, the availability of the general jobs credit as an election. This could have some importance: under prior law, an employer's compensation deduction was required to be reduced by the amount of the jobs credit, even though not all of that credit might be available for use on the employer's tax return (due to various limitations). Further, because many states conform their definition of taxable income to the federal definition, numerous employers found themselves losing a compensation deduction on state returns, even though the state did not permit a comparable credit. Thus, many employers would not have elected the jobs tax credit for 1977 and 1978 had they had the choice.

It will be interesting to see how the effective date rules are finally decided. Granted that congressional intent may be clear, unfortunately the statute appears to be clear also. It is conceivable that remedial legislation may be required next year to put congressional intent into effect; however, those employers who would have preferred to retain the compensation deduction and forego the credit will want to keep abreast of developments so that appropriate refund claims may be filed.

Work Incentive (WIN) Tax Credit

Under prior law, the work incentive (WIN) tax credit provisions provided a credit equal to 20 percent of the wages paid during the first twelve months of employment for individuals who have received aid to families with dependent children for at least 90 days. Effective for taxable years beginning after December 31, 1978, the WIN credit will be expanded to allow a credit equal to 50 percent of the first $6,000 of wages for the first year of employment and 25 percent of such wages for the second year of employment. The employer's deduction for wages is reduced by the amount of the credit. The WIN credit will also now apply to the hiring of qualified individuals in situations that do not constitute a trade or business (e.g., household employees). For employment not in a trade or business, the credit is 35 percent of the first $6,000 of wages for the first taxable year of employment. Eligible nonbusiness wages are limited to $12,000 for any employer.

Employment Tax Status of Independent Contractors

Amounts paid to employees are subject to employment taxes (FICA, FUTA) whereas amounts paid to independent contractors are not. Further, an employer is required to withhold income taxes on account of an employee, but not for an independent contractor. A determination of employer-employee relationship is generally made under common law rules. In recent years, IRS has taken an increasingly strict position on examination of returns, seeking to hold more individuals to be employees, especially insurance salesmen and real estate brokers.

In one example of exercising the Congressional prerogative to determine when an executive agency goes too far in creating new law through administrative interpretation, the 1978 Act terminates pre-1979 employment tax liabilities of taxpayers who had a reasonable basis for treating workers other than as employees and who file all required federal tax returns for periods after December 31, 1978; extends relief prospectively through 1979 for taxpayers having a reasonable basis for their classifications of workers; and prohibits the issuance of regulations and rulings on common law employment status before 1980. The provision becomes effective upon enactment.

INDUSTRIAL DEVELOPMENT BONDS

One major exception to the general rule excluding from federal tax interest received from bonds issued by state and local government, is the industrial development bond (IDB), on which interest is generally taxable. IDBs are issued by state and local governments for the purpose of providing funds to private industry for construction of facilities beneficial to the local government. In a typical situation, the proceeds from an IDB issue would be used by the local government for such construction, which would be in turn leased to a private trade or business for a rental payment necessary to service the debt. The facility constructed from the proceeds of the IDBs would be used as security for the bonds.

There have been two "exceptions to the exception" regarding taxability of interest earned from IDBs: (1) small issues, and (2) IDBs used to provide certain exempt facilities including airports, docks, wharves, mass commuting facilities, parking, or storage and training directly related to the above installations.

Small Issues Exception

Under prior law, issues of industrial development bonds in amounts of $1 million or less, which are used to acquire, construct or reconstruct land or depreciable property, or to redeem all or part of a previous issue which was used in the above purposes, generally result in tax exempt interest to the bondholders. Prior law also allowed an election by the issuer to increase the $1 million limitation to $5 million, provided that the issuer restrict IDB projects to less than $5 million over a six-year period. Effective for bonds issued after December 31, 1978, and capital expenditures after that date for bonds issued earlier, the $5 million aggregate limitation has been increased to $12 million.

Advance Refundings for Exempt Public Projects

The other exception to taxability of IDB interest is where proceeds are used to provide the exempt activities described above. However, due to fluctuating interest rates, it has been a common practice of local governments to take advantage of lower rates by issuing new bonds, the proceeds of which would be used to redeem bonds outstanding at the higher rate. Prior to December 1977, such refunding of a previously exempt IDB would qualify for the same exempt status.

On December 6, 1976, the IRS issued new proposed regulations holding that a refunding bond issue sold more than 180 days prior to the date the original issue is redeemed, would result, generally, in taxable interest to the bondholders. The IRS position on this matter was that since the proceeds of the new issue were not used immediately for a tax exempt function, the new issue should then fall under the general rule of taxability for IDBs. Due to the proposed regulations, the exempt status of these bonds has become unclear.

Effective with the date of enactment of the Revenue Act of 1978, advance refundings of certain outstanding exempt industrial development bonds would be allowed as exempt if all proceeds of the refunded issue were used to provide qualified public facilities, including public airports, public docks or wharves, public mass commuting facilities, public convention or trade show facilities, and public facilities for parking, storage, or training that are directly related to any of the facilities described above.

Bonds for Water Facilities

Under prior law, interest related to industrial development bonds used to provide facilities for furnishing water to the general public, is usually tax exempt. In various revenue rulings, the Internal Revenue Service has interpreted this exemption for water facilities to exclude facilities used by a small number of industrial consumers. Effective for IDBs issued after the date of enactment of the Revenue Act of 1978, this IRS interpretation has been rejected, and the term general public, for purposes of the water facilities exemption, will include electric utility, industrial, agricultural, and other commercial users.

Declaratory Judgment on Tax Exempt Status of State and Local Government Bonds

Marketing tax exempt bonds issued by state and local governments requires either receiving an advance ruling from the Internal Revenue Service assuring the tax exempt status of the bonds, or obtaining a legal opinion to the same effect. Effective for ruling requests filed with the Internal Revenue Service after December 31, 1978, state and local governments will be entitled to receive a declaratory judgment from the U.S. Tax Court as to the tax status of their proposed municipal bond issues. Such declaratory judgment actions will first require that the proposed bond issuer either receive an adverse ruling from the IRS or wait 180 days after filing the ruling request. Main impact of this provision should be to make IRS more responsive to such ruling requests.

TAXATION OF U.S. CITIZENS WORKING ABROAD

Delay of Effective Date of 1976 Act

Prior to the Tax Reform Act of 1976, U.S. citizens working abroad could exclude up to $20,000 of earned income a year if the taxpayer was present in a foreign country for 17 out of 18 months, or if he qualified as a bona fide resident of the foreign country for the entire year. Exclusion of $25,000 was available to U.S. citizens who had resided abroad for 3 years or more.

The Tax Reform Act of 1976 included a number of unpopular and controversial reforms affecting taxation of U.S. citizens abroad. In place of the $20,000/$25,000 exclusion, the Act permitted only $15,000 per year, and from the taxpayer's lowest tax brackets. In addition, the Act disallowed the foreign tax credit for any foreign taxes attributable to the $15,000 of excluded income. The provisions established by the 1976 Act were to become effective for taxable years beginning after 1975, but were delayed to 1977 by subsequent legislation.

Effective with the signing of HR 9251, the Foreign Earned Income Act of 1978, the Tax Reform Act rules are repealed for 1977. For taxable years beginning on or after January 1, 1978, U.S. citizens living abroad will be taxed under completely new rules. Under these provisions, the earned income exclusion is repealed with minor exceptions, and replaced by a series of provisions which allow deductions for excess cost of living, housing, education, and certain other expenses.

Earned Income Exclusion for Employees in Camps

The Foreign Earned Income Act of 1978 provides only one exception to the repeal of the earned income exclusion. A $20,000 annual income exclusion is available to employees residing in camps in hardship areas who are bona fide residents of a foreign country for the entire taxable year or who are present in a foreign country seventeen out of eighteen months. Camp-style lodging is defined as substandard housing provided in remote hardship areas close to the jobsite where alternative housing is not available on the open market. The value of the lodging supplied by the employer is excluded from the income of the employee. The $20,000 annual exclusion for employees in camps is an election in lieu of the living, housing, schooling, and home leave deductions discussed below. Hardship areas are

those foreign locations designated as such by the Secretary of State, and for which a federal government post differential of at least 15 percent is or would be allowed.

Deduction for Excess Foreign Living Costs

U.S. citizens who have been living in a foreign country seventeen out of eighteen months, or who are bona fide residents of a foreign country, are entitled to a deduction, starting January 1, 1978, for the excess cost of living over the cost of living in the highest cost metropolitan area in the continental United States excluding Alaska (that is to say, New York City). The amount of the deduction will be determined under an IRS table showing the excess cost of living in various foreign places for families of various sizes. The deductions on this table will be based on the spendable income of a person paid the salary of a federal government employee, at the GS-14, step 1, level (currently $32,442).

Excess Housing Costs

Effective for taxable years beginning in 1978, qualifying U.S. expatriates will be entitled to a deduction equal to the excess of the individual's housing expenses over his "base housing amount," which is defined as one-sixth of the excess of his earned income (minus certain applicable business deductions) over his deductible excess foreign living costs. If, due to the adverse living conditions of his place of employment, a taxpayer maintains a separate household outside of the U.S. for his family, he will be entitled to deduct the full cost of his own housing abroad. The Conference Committee report on the tax bill indicates that requirement of "adverse living conditions" at the place of employment is to be liberally construed.

Educational Costs

U.S. taxpayers living abroad will be able to deduct the reasonable schooling expenses for the education of their dependents at the elementary and secondary level. This includes the cost of tuition, fees, books, and local transportation. If an adequate U.S. type school is not available within reasonable commuting distance, taxpayers who send their dependents to schools in other countries, will be entitled to deduct the room and board, and transportation costs associated with such schooling expenses.

Home Leave Transportation

U.S. citizens working abroad will be able to deduct the reasonable costs of one round trip annually for taxpayer, spouse, and each dependent, from their foreign location to the location of last principal residence in the U.S. If the taxpayer does not have a principal residence in the United States, the home leave transportation deduction is measured by the cost of a round-trip fare from the foreign location to the nearest port of entry in the continental United States. (''Reasonable costs'' include coach or economy class airfare only.)

Hardship Post Deduction

Taxpayers who work in hardship areas throughout the world will be entitled to an additional hardship deduction of $5,000 a year, based on the number of days in such hardship area. To the extent that taxpayer lives in a camp in such area (see above), he may elect the $20,000 maximum annual exclusion instead of this and the prior four deductions.

Deduction for Moving Expenses

Taxpayers are generally allowed to deduct as moving expenses their temporary living costs for a 30-day period, to a maximum of $1,500. The Foreign Earned Income Act of 1978 extends the temporary living arrangements period from 30 to 90 days, and raises the ceiling from $1,500 to $4,500. Deductible moving expenses connected with a move to a foreign country will also include the cost of storing goods while abroad. Special rules eliminate the moving expense deductibility ceilings for retirees returning to the United States after working abroad and the survivors of Americans who died while working overseas.

Suspension of Period to Reinvest Proceeds from Sale of Home

Under the general rules for the tax-free rollover on the sale of a residence, a taxpayer must reinvest the proceeds on the sale of his home within eighteen months. For U.S. citizens, while living in a foreign country, that period is extended to a maximum of four years after the date of sale of the old residence.

ENERGY

In recent years, we have become increasingly aware of the limited supply of traditional energy sources. This country has been defining and reshaping its policies to encourage the conservation of existing resources, the search for new sources of energy, and the development of technology to ascertain that we meet our energy needs for home and industry. The Energy Tax Act of 1978 sets out a number of provisions aimed at helping achieve this goal.

Individual Energy Credits

Individuals, both homeowners and renters, are allowed tax credits for qualified "energy conservation" and "renewable energy source" expenditures made on or after April 20, 1977, but before January 1, 1986.

A 15 percent tax credit on the first $2,000 of energy conservation expenditures made each year is available for insulation, storm doors and windows, better furnace burners, clock thermostats and other similar energy conserving devices that have their original use with the individual and an expected operational life of at least three years.

Individuals installing renewable energy source property, such as solar and wind energy devices, are allowed an additional credit equal to 30 percent of the first $2,000 of qualified expenditures plus 20 percent of the next $8,000, or a maximum additional credit of $2,200. The expenditures must be made for the individual's principal residence and meet certain performance and quality standards. The property must have its original use with the individual claiming the credit and have an expected operational life of at least 5 years.

Qualifying energy expenditures made in 1977 (after April 19, 1977) are deemed to have been made in 1978 and, thus, are to be claimed in that year's return. These credits cannot exceed the individual's tax liability, but any unused portion may be carried forward to the next year. To minimize the paper work involved, credits of less than $10 will not be allowed in any one year but may be added to other energy credits in subsequent years.

Generally these energy expenditures will increase the basis of the individual's property. However, to the extent energy credits are allowed, the basis is reduced.

Business Energy Credits

An additional investment credit is allowed for qualified investments in energy property acquired after September 30, 1978 but before January 1, 1982. This is in addition to the regular investment credit and, with the exception of solar and wind energy equipment, is not refundable but may be applied against 100 percent of the tax liability.

Energy property essentially includes equipment that uses a fuel other than oil or gas (such as boilers and burners), solar and wind equipment, specially defined energy conservation devices, and certain recycling and shale oil equipment. With the exception of energy conservation devices, the credit is not available to public utility companies. Energy property acquired with tax exempt industrial development bonds is allowed an additional 50 percent of the normal credit.

Other than the credit limitations based on tax liability, the regular investment credit provisions regarding the amount of the credit, recapture and unused credits generally apply to the energy credit. Thus, for an asset which cost $100,000, with a five-year useful life, the investment credit would be:

Regular credit	$6,667
Energy credit	6,667
	$13,334

Commuter Vehicles

Employers acquiring certain vans and other commuter vehicles after date of enactment, that are placed in service before January 1, 1986, are entitled to the full 10 percent investment credit if the vehicles have:

- A useful life of at least three years,
- A seating capacity of at least eight adults (excluding the driver), and
- At least 80 percent of the mileage use is expected to be transporting employees between their residences and place of employment using at least half the seating capacity (excluding the driver).

Recapture rules apply if the vehicle fails to meet the 80 percent mileage use requirement for any taxable year.

The value of the commuting service is not required to be included in the employee's gross income provided that the employer has established a written plan that does not discriminate in favor of officers, shareholders and highly paid employees and provide that the transportation is in addition to any compensation otherwise payable to the employee.

Geothermal Deposits

Geothermal energy producers may take a current deduction for labor, fuel and other intangible drilling costs. As with oil and gas, geothermal IDC may be a tax preference item for minimum and maximum tax purposes, calculated in a manner similar to that for oil and gas (see section on tax preferences).

The Act also provides for percentage depletion of geothermal deposits at a rate of 22 percent of gross income from geothermal production for 1978 through 1980, after which it will phase down to 15 percent by 1984. The depletion allowance is a tax preference item to the extent it exceeds taxpayer's basis, and is limited to 50 percent of taxable income (excluding depletion) from that property.

These provisions are effective for taxable years ending on or after October 1, 1978. However, with respect to IDC, the wells must have commenced on or after October 1, 1978.

Boilers

The 10 percent investment credit and accelerated depreciation methods are no longer available for boilers fueled by oil and natural gas which are used in manufacturing, production or mining. This provision applies to property placed in service after September 30, 1978, except for property for which a binding contract was in effect on that date.

However, effective with taxable years beginning after date of enactment, taxpayers will be authorized to redetermine the useful life of an oil or natural gas combustor and use this shortened life over which to depreciate the remaining basis. Taxpayer must use the straight-line method of depreciation if the provision is elected, and must have a reasonable basis to conclude the combustor will be retired or replaced at the end of the shortened useful life.

CORRECTION OF 1976 LEGISLATION

Shortly after the Tax Reform Act of 1976 was enacted, it was clear that it contained a significant number of technical and clerical errors. These were in such varied income tax areas as retirement income credit, minimum tax on preferences, vacation homes, the real estate exclusion from at risk rules, and foreign income. There were also estate tax problems such as the orphan's exclusion, generation skipping trusts, carryover basis, etc. A large number of these, perhaps 100 or more, were made the subject of a bill originally identified as The Technical Corrections Bill of 1977, and ultimately incorporated in the Revenue Act of 1978.

All of these changes have been characterized as "technical, clerical, conforming and clarifying." For example, one change is that a U.S. citizen residing abroad would not be subject to the limitations on deducting his attendance at a foreign convention so long as it is in the country of residence. Another change would clarify the application of carryover basis rules (when they become effective in 1980) to redemptions of section 306 stock. Another change is made in the effective date of generation skipping provisions so that they apply to transfers after June 11, 1976 rather than April 30, 1976. While we see no need to describe the technical changes to 1976 legislation in detail here, we would not dismiss them lightly. Any affected taxpayer will certainly have to consider them as carefully as any so-called major change. The effective date of these changes generally is the same as the provisions of the 1976 Act they seek to correct.

MISCELLANEOUS PROVISIONS

Excise Tax on Investment Income of Private Foundations Reduced

The four percent excise tax on net investment income of private foundations is reduced to two percent effective for taxable years beginning after September 30, 1977.

Small Tax Case Procedures Before U.S. Tax Court

Taxpayers have been able to request "small case" procedures on tax cases involving less than $1,500 in tax. Small cases are heard by commissioners rather than Tax Court judges, the rules of evidence are relaxed, and neither party is required to file a brief. Effective 180 days after enactment, the small case procedures will be extended to amounts involving $5,000 or less. The IRS will have the right to request transfer of the case into the regular Tax Court in appropriate circumstances - such as a case in which a decision will provide a precedent for the disposition of a substantial number of other cases.

Interest Income on Deposits in Puerto Rican Branches for U.S. Savings and Loan Associations

Interest on deposits with a Puerto Rican branch of a U.S. commercial bank are treated as Puerto Rican source income. The bill extends similar treatment to interest on deposits in Puerto Rican branches of U.S. savings and loan associations, effective for taxable years of such interest recipients beginning after the date of enactment. The effect of the change is to permit parity between deposits in commercial banks and S & L associations with respect to certain tax advantages derived by recipients of Puerto Rican source income; particularly, those devolving on so-called possessions (or section 936) corporations.

General Stock Ownership Corporations - GSOC

Congress has authorized an experimental program permitting a state to form a private corporation for the benefit of its citizens to give them an ownership stake in the private enterprise system. The concept was designed with Alaska in mind, although any state is eligible to form a GSOC. A GSOC would be formed by a state with a share of stock issued to each resident (as defined by the state). GSOC stock cannot be transferred for five

years after issuance unless the holder dies or moves from the state. It is envisioned that a GSOC would be 100 percent leveraged and would invest in various business enterprises (reportedly, oil and mineral exploration and development in the case of Alaska).

A GSOC may elect to be exempt from federal taxation but the income would be passed through to the shareholders. Net operating losses could not be passed through to the shareholders, but can be carried forward for a ten-year period. A GSOC is required to pay out 90 percent of its income to its shareholders.

The GSOC program is experimental and will apply to any qualifying corporation chartered in the five-year period beginning after December 31, 1978.

CONCLUSION

For what was expected to be a relatively simple bill, the 1978 Act has added a myriad of new rules to our tax laws. While this booklet touches on most of them, neither time nor space has permitted addressing every item. Among the areas omitted are excise tax changes on slot machines, certain distribution requirements for private foundations, technical changes affecting initial qualification of a cooperative housing corporation, and a host of others which, in our judgment, were of less general import than those we included.

We could not conclude this report, however, without a comment on one minor provision. The Act directs the Secretary of the Treasury to establish a task force to study ways of simplifying tax forms and instructions for individuals. Clearly, this must have been important in one of our two legislative chambers: the bill coming from the Senate contained not one, but two similar requirements (the final law has managed to include it only once).

It is ironic that a tax bill which contains additional layers of complexity (e.g., taxation of unemployment compensation for the first time, a second minimum tax on tax preferences), also requires such a study. Not only does the remainder of the Act move simplification further from the realm of possibility than heretofore, but it was enacted so late in the year that IRS had already begun printing the 1978 individual income tax forms and instructions based on the law in existence before the 1978 Act. IRS is now faced with the job of either reprinting the bulk of the forms or attempting somehow to get information to taxpayers about modifications in the printed form.

We believe that form and instruction simplification will come only with Code simplification, not through Treasury studies. And, for an example of how the 1978 Revenue Act has itself simplified tax rules, let us leave you with but one sentence from a new section added by the Act. It deals with how a cash or deferred profit-sharing plan can qualify to meet the nondiscrimination rules necessary for a participant to defer reporting an employer's contribution to the plan:

> "(3) Application of participation and discrimination standards –
>
> (A) A qualified cash or deferred arrangement shall be considered to satisfy the requirements of subsection

(a)(4), with respect to the amount of contributions, and of subparagraph (B) of section 410(b)(1) for a plan year if those employees eligible to benefit under the plan satisfy the provisions of subparagraph (A) or (B) of section 410(b)(1) and if the actual deferral percentage for highly compensated employees (as defined in paragraph (4)) for such plan year bears a relationship to the actual deferral percentage for all other eligible employees for such plan year which meets either of the following tests:

(i) The actual deferral percentage for the group of highly compensated employees is not more than the actual deferral percentage of all other eligible employees multiplied by 1.5;

(ii) The excess of the actual deferral percentage for the group of highly compensated employees over that of all other eligible employees is not more than three percentage points, and the actual deferral percentage for the group of highly compensated employees is not more than the actual deferral percentage of all other eligible employees multiplied by 2.5."

Perhaps you will be surprised, now, to learn that Congress is granting Treasury only two years to complete its study.