

PART II
TAX REFORM ACT OF 1976
TABLE OF CONTENTS

Paragraph

1.00 Tax Computation

- 1.01 Corporate Tax Rates
- 1.02 Individual Income Tax Reductions
- 1.03 Revision of Tax Tables for Individuals
- 1.04 Minimum Tax
- 1.05 Maximum Tax
- 1.06 Low Income Allowance

2.00 Income

- 2.01 Qualified Stock Options
- 2.02 Income Earned Abroad by United States Citizens
Living or Residing Abroad
- 2.03 Foreign Grant or Trust with Citizens of the United
States as Beneficiaries
- 2.04 Non-Resident Aliens Married to United States Citizens

3.00 Exclusions

- 3.01 Amounts Received Under Accident and Health Plans
- 3.02 Military Disability Pensions
- 3.03 Prepaid Legal Expenses
- 3.04 Cancellation of Student Loans and Scholarships
- 3.05 Accumulation Trusts

4.00 Deductions

- 4.01 Prepaid Interest
- 4.02 Foreign Conventions
- 4.03 State Legislators' Travel Expenses Away From Home
- 4.04 Alimony
- 4.05 Moving Expenses
- 4.06 Charitable Contributions of Inventory and Other
Ordinary Income Property
- 4.07 Eliminating Architectural and Transportation Barriers
for the Handicapped
- 4.08 Business Use of Home
- 4.09 Vacation Homes
- 4.10 Partnership Organization and Syndication Fees
- 4.11 Nonbusiness Bad Debts
- 4.12 Bad Debts Owed by Political Parties

- 4.13 Deductions Limited to Amount "at Risk" in Case of Certain Activities
- 4.14 Farming—Accrual Accounting for Large Farm Corporations and Limitations on Deductions for Farming Syndicates
- 4.15 Investment Interest
- 5.00 Tax Credit**
 - 5.01 Credit for the Elderly
 - 5.02 Disregard of Earned Income Credit
 - 5.03 Earned Income Credit
 - 5.04 Child Care Expenses
 - 5.05 Extension of \$100,000 Limitation on Used Property
 - 5.06 Investment Credit
 - 5.07 First-In First-Out Treatment of Investment Credits
 - 5.08 Employee Stock Ownership Plans
 - 5.09 Investment Credit for Movie and Television Films
 - 5.10 Investment Credit for Certain Vessels
 - 5.11 Investment Credit Limitation for Airlines
 - 5.12 Work Incentive (WIN) Program Expenses
 - 5.13 Welfare Recipient Tax Credit
 - 5.14 Treatment of Certain Pollution Control Facilities
- 6.00 Procedure**
 - 6.01 Innocent Spouse
 - 6.02 Waiver of Statute of Limitations for Activities not Engaged for a Profit
 - 6.03 Income Tax Return Preparers
 - 6.04 Administrative Summonses
 - 6.05 Public Inspection of the Internal Revenue Service's Determination Rulings, Technical Advice Memoranda, and Determination Letters
 - 6.06 Minimum Exemption from Levy for Salaries, Wages, and Other Income
 - 6.07 Joint Committee Refund Review
 - 6.08 Jeopardy and Termination Assessments
- 7.00 Loss**
 - 7.01 Net Operating Loss Carryover
- 8.00 Recapture**
 - 8.01 Recapture of Depreciation on Real Property
 - 8.02 Amortization of Expenditures to Rehabilitate Low-Income Housing

9.00 Partnerships

- 9.01 Retroactive Allocation of Partnership Income or Loss
- 9.02 Special Allocation of Partnership Income or Loss
- 9.03 Treatment of Partnership Liabilities Where a Partner is not Personally Liable

10.00 Depreciation

- 10.01 Basis Limitation for Player Contracts Transferred in Connection with a Sale of a Franchise
- 10.02 Additional First-Year Depreciation Allowance for Partnerships

11.00 Amortization

- 11.01 Construction Period Interest and Taxes
- 11.02 Preservation of Historical Structures

12.00 Property Acquired by Bequest, Devise or Inheritance

1.00 Tax Computation

1.01 Corporate Tax Rates

Code Section 11—Act Section 901

Effective Date: Taxable years ending after December 31, 1974

Before the enactment of the 1975 Tax Reduction Act, the corporate income tax was 22 percent on the first \$25,000, and 48 percent on all taxable income in excess of the \$25,000. The Tax Reduction Act increased the surtax exemption from \$25,000 to \$50,000, and changed the basic income tax rate to 20 percent on the first \$25,000 and 22 percent on the second \$25,000. Again, after \$50,000 the total tax rate is 48 percent. The Tax Reform Act of 1976 continued these rates until the end of 1977, even though the Senate's amendment provided that the rates be made permanent.

1.02 Individual Income Tax Reductions

Code Section 141—Act Section 401

Effective Date: Taxable years ending after December 31, 1975

Made permanent by the 1976 Tax Reform Act are the increases in standard deductions which originated with the Revenue Adjustment Act of 1975. The standard deduction is increased from 15 percent to 16 percent, subject to the maximum limitations as set forth in the following schedule, showing both 1975 and 1976 amounts:

	<u>1976</u>	<u>1975</u>
Single taxpayer	\$ 2,400	\$ 2,300
Married taxpayer filing jointly	2,800	2,600
Married taxpayer filing separately	1,400	1,300
Surviving spouse	2,800	2,600

Also made permanent are the increases in the low-income allowance, also known as the minimum standard deduction, as set forth in the following schedule:

	<u>1976</u>	<u>1975</u>
Single taxpayer	\$ 1,700	\$ 1,600
Married taxpayer filing jointly	2,100	1,900
Married taxpayer filing separately	1,050	950
Surviving spouse	2,100	1,900

1.03 Revision of Tax Tables for Individuals

Code Section 3—Act Section 501

Effective Date: Taxable years ending after December 31, 1975

The Tax Reform Act of 1976 has eliminated the use of the 12 optional Tax Tables which permitted a taxpayer with adjusted gross income of less than \$15,000 to turn to the table which had the specific numbers of dependency exemptions to which the taxpayer was entitled, and compute the amount of income tax automatically therefrom. Congress' version of tax simplification, which reduces the 12 tables to four tables, substitutes the concept of taxable income instead of adjusted gross income. This means that the taxpayer must deduct from his adjusted gross income the amount of the dependency exemptions to which he is entitled multiplied times \$750 each, plus either the itemized deductions or the standard deduction. Also, the burden of computing the minimum standard deduction (low income allowance) is placed upon the taxpayer. The taxpayer will thus have the problem of determining which is more advantageous, taking the minimum standard deduction, itemizing deductions, or merely taking the standard deduction.

The author submits that this method of tax simplification is of benefit only to those taxpayers who are in the business of providing income tax preparation service to other taxpayers. I believe that this change will result in thousands of more errors for the Internal Revenue Service and, additionally, force many thousands of taxpayers into the hands of professional tax preparers. It is also submitted that this concept will be changed after the Internal Revenue Service has had the opportunity to review the results of the 1976 returns. The use of these tables for computing the income tax on taxable income is mandatory for all taxable incomes up to \$20,000.

1.04 Minimum Tax

Code Sections 56 & 57—Act Section 301

Effective Date: Tax years beginning after December 31, 1975

The Tax Reform Act of 1969 introduced the concept of the minimum tax, the goal being that all taxpayers should pay at least some tax. The

purpose of this new statute was to prevent many high-income taxpayers from paying little or no income tax. The minimum tax was 10 percent on the total of all tax preferences reduced by a \$30,000 exemption and reduced by the amount of the normal income tax calculated without consideration of the minimum tax. The following are tax preference items:

- (1) Capital gains, the 50 percent portion which is excluded from the calculation of taxable income.
- (2) Accelerated depreciation in excess of straight-line depreciation on personal property which is subject to a net lease.
- (3) Accelerated depreciation in excess of straight-line depreciation on all real property.
- (4) Amortization of certified pollution control facilities in excess of the amount of depreciation normally allowable under Section 167.
- (5) Amortization of railroad rolling stock in excess of depreciation allowable under Section 167.
- (6) Stock options to the extent that the fair market value of the stock at the time of exercise exceeds the option price.
- (7) Percentage depletion in excess of the amount allowable under cost depletion.
- (8) Amortization of on-the-job training and child care facilities in excess of the amount of depreciation allowable under Section 167.
- (9) Bad debt deductions of financial institutions as permitted under law, which are in excess of the actual bad debt loss experience.

The Tax Reform Act of 1976 adds to the above list of tax preferences: intangible drilling costs in excess of the amount deductible if the drilling cost had been capitalized and then depreciated over ten years, and itemized deductions other than medical or casualty deductions, in excess of 60 percent of the taxpayer's adjusted gross income. The preference item for accelerated depreciation in excess of straight-line depreciation on personal property subject to a net lease has been amended to strike out "net lease" and is now applicable to all personal property subject to a lease. The sum of the tax preference can now be reduced by the greater of \$10,000 or one half of the taxpayer's regular income tax. The sum of the tax preferences, after deducting the exemption of \$10,000 or one half of the taxpayer's regular liability, is subject to a tax of 15 percent. It is interesting to note that Congress again failed to include the interest on state and municipal obligations to its list of preferences.

The intangible cost of drilling an unproductive oil or gas well is not considered to be a preference. An unproductive well is defined as one in which no oil or gas has been produced "in commercial quantities for any substantial period of time." (Conference Report 426). If there has been

some commercial production, then the determination of whether it is unproductive or not will take into consideration the relation of the value of the production of oil or gas to the cost of drilling the well. If the determination is made that a well is unproductive by the time the tax return for the preceding year is required to be filed, the intangible drilling cost of that unproductive well is not considered a preference. Although the tax preference is only the amount of the intangible drilling cost in excess of the amount which would have been deductible had the drilling cost been capitalized and then written off over a ten year period, this will be of little assistance to the taxpayer. Typically, a well is drilled and placed in production late in the calendar year. For example, if a well is placed in production on December 1, and the cost of the intangible drilling was \$100,000, the amount of the tax preference is \$100,000 less \$100,000 divided by the 120 months (for the ten years) or a total of 99,167. It should be noted at this point that the future write-off, if the drilling cost had been capitalized, will be of no assistance either currently or in the future in determining tax preferences.

The establishment of an item of tax preference for the itemized deductions, other than medical and casualty loss deductions in excess of 60 percent adjusted gross income, will undoubtedly cause some contraction in charitable giving, since charitable gifts along with interest, taxes, union dues, miscellaneous deductions and certain investor-related expenses, to the extent that they exceed 60 percent of the adjusted gross income, are all to be considered tax preferences and subject to the 15 percent minimum tax.

Illustration:

Assume the Jones's file a joint return and have taxable income of \$50,000 plus tax preferences of \$60,000. Their income tax would be calculated as follows:

Income tax on the \$50,000 is \$17,060. The preference is calculated by taking the total of \$60,000 and reducing it by the greater of the exclusion of \$10,000 or $\frac{1}{2}$ the taxes imposed. Since one half the taxes imposed is \$8,530, the tax preference will be reduced by \$10,000 which leads to a taxable sum of \$50,000. Applying the fifteen percent rate, the minimum tax on preference items is \$7,500. Total tax to be paid by the Jones's is \$24,560. The fifteen percent rate applies to corporations but the exemption is the greater of \$10,000 or the regular taxes paid. Also, the 1976 Tax Reform Act disallows the carryover of any previous years taxes to offset the tax preference income.

The Act eliminates the carryover of the unused regular tax as permitted under the previous act. The treasury has been instructed to provide detailed

regulations to deal with the situation whereby the taxpayer has obtained no tax benefit from the items of tax preference.

When dealing with the accelerated depreciation in excess of straight-line depreciation, the 20 percent reduction in lives due to the asset depreciation range election is now to be taken into consideration, and considered along with the accelerated depreciation in calculating the excess. However, the additional 20 percent first year bonus depreciation is not taken into consideration as this item is deductible both on straight-line as well as accelerated depreciation.

For corporations, the preferences related to intangible drilling costs and excess itemized deductions are not applicable. Special rules have, in effect, exempted timber income from the increase in the minimum tax. Also, for taxable years commencing during 1976, only one half of the increase in the minimum tax is applicable to corporations. The full increase of the minimum tax will take effect only for taxable years commencing in 1977.

1.05 Maximum Tax

Code Section 1348—Act Section 302

Effective Date: Tax years beginning after December 31, 1976

The concept of the maximum tax of 50 percent on earned taxable income was introduced by the Tax Reform Act of 1969. The purpose of this maximum tax was to minimize the need for high income bracket taxpayers to invest in various tax shelters. Income, such as salaries, wages, and professional fees were subject to the maximum tax, while the passive income items such as rents, dividends, royalties, interest and capital gains were excluded.

The Tax Reform Act of 1976 expands the maximum tax to cover personal service income, which in addition to the salaries, wages and professional fees, includes annuities, pensions and deferred compensation. Excluded from personal service income are lump sum distributions from a qualified pension plan and premature penalty distributions from a Keogh Plan. Under the 1976 Act, the income subject to the maximum tax must be reduced by the entire amount of tax preference income for the current year. Under prior law, income subject to the maximum tax needed only to be reduced by the greater of the amount which the tax preferences exceeded \$30,000 or one-fifth of the sum of the taxpayer's tax preference items for the taxable year and the four preceding taxable years.

The combination of the revisions to the minimum tax and the maximum tax will have serious consequences to individuals with high income brackets and items of tax preference, since not only will the preferential items be subject to the 15 percent tax, but the same items of preference will reduce

the amount of personal service income subject to the 50 percent maximum tax.

1.06 Low Income Allowance

Code Section 141(c)—Act Section 401(b)

Effective Date: This revision is effective for tax years ending after December 31, 1975

Prior to the Tax Reduction Act of 1975, a standard deduction of 15 percent of adjusted gross income was available to all individual taxpayers. This deduction is available only in lieu of the itemized deduction and is taken from adjusted gross income. The standard deduction was at that time subject to a maximum of \$2,000 and a minimum (low income allowance) of \$1,300.

The Tax Reduction Act of 1975 increased the percentage standard deduction from 15 to 16 percent. The low income allowance was also increased from \$1,300 to \$1,600 for single persons and to \$1,900 for married taxpayers filing a joint return. The maximum standard deduction was similarly increased from \$2,000 to \$2,300 for single persons and to \$2,600 for married taxpayers filing a joint return. These tax reductions were originally designed to provide relief for certain taxpayers during a time of economic hardship and consequently were to expire at the close of the 1975 tax year.

The Revenue Adjustment Act of 1975, however, continued a similar modification of these reductions on through June 30, 1976. This Act increased the low income allowance to \$1,700 for single persons and \$2,100 for married taxpayers filing a joint return. The maximum standard deduction was also increased to \$2,400 for single taxpayers and \$2,800 for married persons filing joint returns. Additionally, the percentage standard deduction was to remain at 16 percent during the first six months of 1976.

The full year increases envisioned by the Revenue Adjustment Act of 1975 are now to be given permanent effect. It should be noted, however, that the standard deduction is an election and can be taken only in lieu of all other deductions from adjusted gross income except those for personal exemptions. The standard deduction remains 16 percent of the taxpayer's adjusted gross income subject to the following limitations:

- (1) The maximum standard deduction is:
 - a) \$2,800 for a surviving spouse or taxpayer filing a joint return;
 - b) \$2,400 for a single taxpayer; and
 - c) \$1,400 for a married taxpayer filing a separate return.
- (2) The low income allowance or minimum standard deduction is:
 - a) \$2,100 for a surviving spouse or taxpayer filing a joint return;

- b) \$1,700 for a single taxpayer; and
 - c) \$1,050 for a married taxpayer filing a separate return.
- (3) A taxpayer for whom a dependency exemption is allowable to another cannot apply his standard deduction against unearned income. In other words, the low income allowance cannot exceed earned income, and the percentage standard deduction must be computed with reference to earned income only!

Illustration:

1) X, the dependent son of taxpayer Y, received \$1,800 in trust income during the calendar year. The dependent son himself earned \$500 in wages during the same year. The trust income is unearned and, therefore, ignored for purposes of calculating the standard deductions. Therefore, the son's taxable income is computed as follows:

Gross Income	=	\$ 2,300
Less – Personal Exemption	=	750
– Standard Deduction	=	500 (<i>i.e.</i> , limited to the amount of earned income)
		\$ 1,050

NOTE: If X's standard deduction was not limited to the amount of his earned income, he would have had *no* taxable income:

Gross Income	=	\$ 2,300
Less – Personal Exemption	=	750
– Low Income Allowance	=	1,700
		-0-

2) Y, a single taxpayer, earned \$12,000 in wages during the calendar year. If his standard deduction was based on the low income allowance, he would receive a deduction of \$1,700 only. However, in the alternative, he may wish to apply the percentage standard deduction of 16 percent to his adjusted gross income to achieve a more favorable tax advantage. Here, 16 percent of \$12,000 equals \$1,920. Y would logically choose to apply the larger deduction of \$1,920 in lieu of his low income allowance.

2.00 Income

2.01 Qualified Stock Options

Code Sections 422 & 424—Act Section 603

Committee Reports: S. Rep. No. 1236, 94th Cong., 2d Sess. 438 (1976); S. Rep. No. 938, 94th Cong., 2d Sess. 160 (1976); H. R. Rep. No. 658, 94th Cong., 2d Sess. 171 (1976)

Effective Date: Tax years ending after December 31, 1975

In effect, the new Act eliminates any advantage of qualified stock options. After May 20, 1976, stock options granted to the recipient will be ordinary income if they are capable of valuation at the time of receipt. If the option does not have a readily ascertainable market value at the time it is granted, then it is ordinary income to the recipient at the time the option is exercised. The committee reports note that the Internal Revenue Service will make every reasonable effort to determine the market value of an option at the time it is granted. If the stock option plan was adopted on or before May 20, 1976, then it can be granted after that date as long as the option is actually exercised before May 21, 1981. Also exempted from the new Act are options substitutions resulting from a corporate reorganization to which Section 425(a) applies.

2.02 Income Earned Abroad by United States Citizens Living or Residing Abroad

Code Section 911—Act Section 1011

Effective Date: Tax years beginning after December 31, 1975

Under present law, citizens of the United States who are bona fide residents of a foreign country for an entire taxable year, or who are present in a foreign country for 510 days out of a consecutive 18-month period are entitled to exclude up to \$20,000 of earned income, which consists of salaries, wages, professional fees, and payments for professional services. The exclusion is increased to \$25,000 if the citizen has been a bona fide resident of the foreign country for three uninterrupted consecutive years.

The Tax Reform Act of 1976 reduces both the \$20,000 and the \$25,000 exclusion to \$15,000. However, an exception is made for employees of American charitable organizations working abroad, whereby the exclusion is retained at \$20,000. A taxpayer who has taken advantage of this exclusion is not entitled to take a tax credit or a deduction for any foreign taxes paid on the income applicable to the excluded income. In calculating the taxpayer's income tax, the marginal tax bracket will be used as if the excluded income had not been excluded. Not eligible for this exclusion is income which is paid in a country other than the country in which it was earned if the payment was made to avoid income taxes in the country of origin.

2.03 Foreign Grant or Trust with Citizens of the United States as Beneficiaries

Code Sections 643, 678, 679, 6048 & 6677—Act Sections 1013-14

Prior to the Tax Reform Act of 1976, it was quite popular for taxpayers to transfer large sums of money to foreign trusts which then made other foreign investments which were not subject to any income tax. During the period of accumulation, the income on these accumulation trusts was not

subject to the United States income tax. When a distribution was made from these trusts, capital gains retained their distinctive nature of taxation, thus providing another benefit to these foreign or off-shore trusts. Under the Tax Reform Act of 1976, the income from these grants or trusts is to be taxed directly to the grantor, if the transferor was a U.S. citizen, resident, partnership, domestic corporation, or domestic estate and the trust had a beneficiary, who was a citizen of the United States. In addition, the Act eliminates the beneficial treatment of capital gains upon distribution by requiring that all capital gains would be treated as ordinary income to the distributee. These rules are effective for foreign trusts created after May 21, 1974 as it applies to income received in taxable years ending after December 31, 1975.

Another major attack was launched against foreign trusts by requiring that all distributions of income accumulations which had not been subject to the United States income tax would be subject at the time of distribution to a six percent tax per year. For example, if the foreign trust had untaxed income for seven years and then made a distribution, the distributee, in addition to the other income tax, would be subject to an interest penalty of six percent times seven years or 42 percent. Congress, in its benevolence, has set a limitation that the interest and the tax cannot exceed the entire distribution.

2.04 Non-Resident Aliens Married to United States Citizens **Code Sections 6013 & 879—Act Section 1012** **Effective Date: Tax years on or after December 31, 1975**

Under previous law, a joint return was not permissible if either spouse was a non-resident alien. The Tax Reform Act of 1976 permits a citizen with a non-resident alien spouse to file a joint tax return if they agree to include in the joint return their worldwide income. It is incumbent upon the taxpayers to agree to provide all necessary books and records for the purposes of audit.

3.00 Exclusions

3.01 Amounts Received Under Accident and Health Plans **Code Sections 104 & 105—Act Section 505** **Committee Reports: S. Rep. No. 1236, 94th Cong., 2d Sess. 432 (1976); S. Rep. No. 938, 94th Cong., 2d Sess. 135 (1976); H. R. Rep. No. 658, 94th Cong., 2d Sess. 150 (1976)**

Prior to January 1, 1976, employees whose salaries or wages were continued while they were sick, injured or disabled were entitled to exclude \$100 a week after a 30-day waiting period. If the wage or salary continuation plan paid less than 75 percent of the employee's normal weekly wage,

then the waiting period was reduced to seven days, unless the employee was hospitalized one of those days, in which event there would be no waiting period. In this situation the employee could exclude up to \$75 a week for the first 30 days and then \$100 per week after the first 30-day period had expired.

The Tax Reform Act of 1976 repeals this sick-pay exclusion and substitutes an exclusion of up to \$100 a week, a maximum of \$5,200 a year, for employees who have not obtained age 65 and have retired due to a permanent and total disability. The committee reports define the phrase "permanent and total disability" to mean that the employee, due to a physical or mental impairment expected to last at least a year or result in death, cannot participate in substantially gainful work. Proof of the disability will have to be substantiated by the employer from time to time. Unless a married taxpayer has lived apart from his spouse for the entire taxable year, the filing of a joint return is a prerequisite to obtaining this exclusion.

Although the maximum exclusion is \$100 per week or \$5,200 annually, this amount is to be reduced by adjusted gross income, including such disability payments, in excess of \$15,000. For example, if a taxpayer earned \$15,000 prior to disability, and then was paid \$5,200 of disability payments during the year, this individual is not entitled to any exclusion. If an employee was disabled for 25 weeks during the taxable year and his total adjusted gross income, including disability payments was \$17,000, this individual is entitled to exclude \$500 from his adjusted gross income. The \$500 exclusion is determined by taking the \$100 per week for 25 weeks, or \$2,500, and reducing this potential exclusion by the adjusted gross income of \$17,000, in excess of the \$15,000 which is \$2,000.

A special transitional rule makes this disability exclusion available to taxpayers who on January 1, 1976 will retire due to disability, or were entitled to retire on disability and who on January 1, 1976 were totally and permanently disabled, even though they were not at the date of their retirement.

Under prior law, the sick-pay exclusion was permitted to continue until the employee's mandatory retirement date, even though it exceeded age 65. Under the Tax Reform Act, the exclusion ceases at age 65 at which time the disabled taxpayer becomes eligible for the credit for the elderly. The above provisions apply to both military and civilian personnel.

3.02 Military Disability Pensions

Code Section 104(a)(4)—Act Section 505(b)

Committee Reports: S. Rep. No. 1236, 94th Cong., 2d Sess. 43 (1976);

S. Rep. No. 938, 94th Cong., 2d Sess. 152 (1976)**Effective Date: Applies to Individuals joining Services after September 24, 1975**

The Tax Reform Act eliminates the exclusion for amounts received as pension, annuity, or allowance for personal injury or sickness resulting from active service in the Armed Forces of any country, in the Coast or Geodetic Survey, a public health service, or the foreign service. The repeal of the exclusion is not applicable to individuals who were members of the above services on or before September 24, 1975 or were retired from the services and receiving disability payments therefrom. The exclusion of disability payments from the Veterans Administration is continued.

For members joining the Armed Forces after September 24, 1975, an exclusion is permitted for combat-related injuries. The committee reports define combat-related injuries as those caused by direct result of armed conflict, extra-hazardous service, or under conditions simulating war, which includes maneuvers or training, or caused by instrumentalities of war, such as weapons. In effect, the intent of Congress as expressed in the committee reports is to exclude from income any payments which are made to compensate for injuries which were incurred due to the special dangers associated with being in the Armed Forces.

A new exclusion is added for disability payments attributable to injuries resulting from an attack by terrorists while the individual was serving as an employee of the United States engaged in his official duties outside the United States.

3.03 Prepaid Legal Expenses**Code Section 120—Act Section 2134****Effective Date: Tax years beginning after December 31, 1976 and ending before January 1, 1982**

The Tax Reform Act of 1976 opens up a new area of fringe benefits for employers to provide Prepaid Legal Services. As with many other fringe benefits, the employer is entitled to a deduction for his contribution or payment while the same amounts are excluded from the employee's income. To prevent some of the abuses and litigation which were involved with the Medical Reimbursement Plan, Congress has set forth very stringent rules for a qualified legal reimbursement plan. The written plan must exclusively benefit the employees, their spouses, or their dependents. The plan must be structured so that it does not discriminate in favor of highly paid executives, shareholder employees and officers. The Act specifically requires that no more than 25 percent of the contributions to the plan may be for the benefit of shareholders who own 5 percent or more of the stock, as computed

under the attribution rules. However, if a class of employees are covered under a collective bargaining agreement, these employees may be excluded if it is shown that legal services were the subject of good faith bargaining. The Act specifically excludes from its coverage direct reimbursement of legal expenses to an employee, and requires that the contribution by the employer must be made to an insurance company, to a tax exempt trust, or to the legal firm or organization providing the service, or to any combination of the above three organizations.

The employees must be notified in detail as to the benefits which are covered, and such notification must be in a manner in which they will clearly understand the extent of their coverage. No reimbursement is provided for business-related legal services.

As a prerequisite for qualifying for a prepaid legal service plan, the Internal Revenue Service must be notified. However, notification is sufficient if it is made within 90 days following the date upon which the new treasury regulations become final.

3.04 Cancellations of Student Loans and Scholarships **Code Sections 61 & 117—Act Sections 2117 & 2130**

The Tax Reform Act of 1976 overrules Revenue Ruling 76-99, whereby the Internal Revenue Service had ruled that receipts under the Armed Forces Health Professions Scholarship Program would be treated as taxable income. The Reform Act extends the exclusion from income under P.L. 93-483 for all amounts received under this program through the end of 1979.

The Service ruled in Revenue Ruling 73-256 and Revenue Rule 74-540 that income results when an educational loan is cancelled. The problem typically arises from a state medical education loan scholarship program whereby medical students are given loans while continuing their education. If the student agrees to work in a rural or urban area upon graduation for a specified number of years, a certain portion of the loan is cancelled each year.

The Tax Reform Act of 1976 excludes from income the cancellation of loans made by the United States, its instrumentalities or agencies, or by a state or its political divisions or subdivisions, if the cancellation is based upon the requirement that the loan recipient work in a specified geographical area or for specified categories of employers.

3.05 Accumulation Trusts

Code Section 644—Act Section 701

Effective Date: This revision is applicable to all distributions made in tax years commencing after December 31, 1975

Generally, a trust is treated as a separate taxable entity and is taxed

in the same manner as an individual. However, a trust is allowed a deduction for any distribution to an individual. The beneficiary-recipient is then required to report the full amount of the distribution in his individual return as income.

Where income is distributed currently to the beneficiary, no real tax problem arises. In this case, the trust is merely treated as a conduit through which income passes to the beneficiary. The amount of income passing to the individual and, therefore, allowable as a deduction for the trust is deemed "distributable net income."

Some rather complex tax consequences generally arise in the case of accumulation trusts. Such trusts accumulate current income for distribution in later years. The distribution is then taxed to the beneficiary under the so-called throwback rule. In effect, the distribution is thrown back to the year in which it was earned, and taxed as if it had been received by the beneficiary in that year. It should be noted that the distributed income retains the same capital gain, ordinary income, tax exempt character that it had in the hands of the trustee.

The Tax Reform Act of 1969 provided two methods for determining the beneficiary's tax liability on accumulation distributions. The "exact method" required both the trustee and beneficiary to maintain detailed records such that the beneficiary's tax liability could be recomputed for those years in which the income was actually earned. In effect, the beneficiary's income for those years was recomputed to include the trust income earned at that time. The excess of the beneficiary's tax liability for these grossed-up amounts over the tax he actually paid in those years was due and payable as part of the tax for the year in which the distribution was made. The beneficiary was, however, allowed a credit for those taxes previously paid by the trust on this accumulated income prior to its distribution.

The "short cut" method was a simplified procedure which enabled the beneficiary to average the distribution over the years in which it was earned and to apply that average to his income for the three years immediately preceding the year of distribution. The old law required the taxpayer to compute his tax liability under both methods to determine which would have the least severe tax consequences. Therefore, the "short cut" method did not provide any real simplification to the individual taxpayer. The old rules also encouraged tax avoidance by enabling a trust in a lower tax bracket to accumulate and pay tax on its income rather than distribute it to a beneficiary in a higher bracket.

The Tax Reform Act of 1976 offers one simplified method of computation to replace the two alternate methods of applying the throwback rule.

This new method is in effect a revision of the old "short cut" method. The tax attributable to the distribution is now determined by averaging the distribution over the number of years equivalent to that over which the income was earned. Under this new method, a fraction of the income received from the trust is included in the beneficiary's income for each of five years immediately preceding the distribution. This fraction is based upon the number of years in which the income was accumulated by the trust. The revised procedure for taxing an accumulated trust distribution can best be illustrated through the five-step analysis of the following example:

Illustration:

X received an accumulation distribution of \$25,000 from a trust in 1982. The accumulated income was earned in each year that the trust was in existence, the trust having been established in 1970. X's taxable income for the five years immediately preceding the distribution was as follows: \$20,000 in 1981; \$28,000 in 1980; \$18,000 in 1979; \$25,000 in 1978, and \$30,000 in 1977. The trust had previously paid \$5,000 in taxes under the undistributed net income rules of the Code. X elects to file a joint tax return with his spouse who had no taxable income for the tax period in question. X's tax liability is computed by using the following five-step analysis:

(1) *Determine the number of throwback years:*

Throwback years are simply those prior tax years in which the distribution was earned. It should be noted that a distribution cannot be thrown back to a tax year beginning prior to January 1, 1969.

The number of throwback years in this example is 12. (The trust was established in 1970 and income was accumulated through 1981).

(2) *Determine the base period:*

The base period is similar to that under the old law. The base period is now defined as the five taxable years immediately preceding the year of distribution less the one taxable year in which the beneficiary's income was the highest as well as the one year in which it was the lowest. Thus the beneficiary is left with a three year base period upon which to base his computations.

X's three-year base period includes only the years 1981, 1980, and 1978. The years 1977 and 1979 are omitted from further consideration since they represent the years of the taxpayer's highest and lowest income levels respectively.

(3) *Compute the average accumulation distribution:*

Here those taxes previously paid by the trust on the amount cur-

rently distributed are added to the total amount of the accumulation distribution. This sum is then divided by the number of throwback years to determine the average accumulation distribution.

In the instant case, the average accumulation distribution equals:

$$\frac{\$5,000 \text{ (taxes paid by trust)} + \$25,000 \text{ (amount of distribution)}}{12 \text{ (throwback years - from step 1)}}$$

$$= \$30,000/12 = \$2,500$$

- (4) *Compute the average increase in X's tax liability over the three year base period:*

The average amount of the accumulation distribution is now added to X's taxable income for each of the three years, and X's tax liability is recomputed based on these amounts. X's tax liability is then averaged over the three-year base period and that average is multiplied by the number of throwback years to determine X's tax liability for the distribution.

X's tax liability for the three-year base period is computed as follows:

1978	Tax on \$25,000 taxable income	\$ 6,020
	Tax on \$27,500 (\$25,000 + \$2,500)	<u>6,920</u>
	Increase in tax liability	\$ 900
1980	Tax on \$28,000 taxable income	\$ 7,100
	Tax on \$30,500 (\$28,000 + \$2,500)	<u>8,050</u>
	Increase in tax liability	\$ 975
1981	Tax on \$20,000 taxable income	\$ 4,380
	Tax on \$22,500 (\$20,000 + \$2,500)	<u>5,180</u>
	Increase in tax liability	\$ 800

The average increase in X's tax liability over the three-year base period is as follows:

$$\frac{\$900 + \$975 + \$800}{3} = \$891.67$$

- (5) *Compute X's tax liability for the accumulation distribution:*

Therefore, X's tax liability for the accumulation distribution equals:

$$\begin{aligned} & \$891.67 \times 12 \text{ (number of throwback years)} \\ & = \$10,700.04 \end{aligned}$$

However, X is entitled to a credit for the taxes already paid by the trust. As a result, the taxes due upon the accumulation distribution to X are:

$$\begin{aligned} & \$10,700.04 - \$5,000 \text{ (taxes previously paid)} \\ & = \underline{\underline{\$5,700.04}} \end{aligned}$$

It should be noted that the new law has provided a special rule to deal with accumulation distributions flowing to the same beneficiary under three or more trust instruments in the same year. Furthermore, throwback rules do not apply to distributions accumulated while the beneficiary is a minor unless the distributions are to flow from multiple trusts. This provision in effect prohibits the beneficiary from receiving a credit for taxes previously paid by the trust on income distributed from the third or any additional trust.

The capital gain throwback rule under the old law has now been repealed. However, a new provision has been added which taxes the trust on any gain from the sale of appreciated property within two years of the date of transfer. This rule is applicable only where there is a bargain element in the original transfer. The gain is taxed to the trust at the grantor's tax rates as if the grantor had realized the gain and had transferred to the trust the net proceeds after the sale.

4.00 Deductions

4.01 Prepaid Interest

Code Section 461(g)—Act Section 208

Effective Date: Taxable year ending after December 31, 1975

Under prior law, Revenue Ruling 68-643 denied a deduction for interest prepaid more than 12 months in advance. The Revenue Ruling stated that interest for periods not in excess of 12 months would be deductible if there were not a material distortion of income and indicated that the decision would be reached after a case by case examination. Revenue Ruling 69-582 provided that points paid to a creditor for the use of money were currently deductible, even though the period of time over which the loan would be paid extended in excess of 12 months. In contrast to this rule, accrual basis taxpayers were required to deduct the prepaid interest over the period of time in which the loan was required to be repaid.

The Tax Reform Act of 1976 requires capitalization of prepaid interest by cash basis taxpayers and allocation of this deduction of interest over the period to which it applies. No longer will the prepaid interest be deductible at the time it is paid. This rule applies to all taxpayers, whether they are individuals, corporations, estates, trusts, or partnerships, and whether or not the loan is for personal, business, or investment purposes.

The Act also requires that points which are paid for the use of money, normally paid at the time the loan is closed, can no longer be expensed,

but must be deducted over the period of time for which the loan runs. An exception to this rule for the deduction of points is permitted if the loan is for the improvement or acquisition of the taxpayer's principal residence. It is important to note that the funds must actually be used for the improvement or acquisition of the residence and not merely as a loan upon the residence and then used for other purposes. The deductibility of points is subject to two further limitations: (1) that points are the customary method of doing business in the taxpayer's area, and (2) that the points are not in excess of what is normally being charged in that area.

A transitional rule provides for an exception of interest payments before January 1, 1977, made according to a binding contract or under a loan commitment in effect on September 16, 1975.

4.02 Foreign Conventions

Code Section 274(h)—Act Section 602

Committee Reports: S. Rep. No. 1236, 94th Cong., 2d Sess. 436 (1976); S. Rep. No. 938, 94th Cong., 2d Sess. 159 (1976); H. R. Rep. No. 653, 94th Cong., 2d Sess. 167 (1976).

Effective Date: Tax years after December 31, 1976

Congress has now acted to limit the number of foreign conventions for which a deduction can be taken to two in any taxable year. In the event a taxpayer travels to more than two foreign conventions, the taxpayer has the option of electing the conventions for which a deduction are applicable. A foreign convention "means any convention, seminar," symposium, etc., which occurs "outside the United States, its possessions, and the Trust Territory of the Pacific." (Code Section 274(h)(6)(A)). Therefore, conventions in Nome, Alaska, Honolulu, Hawaii, or San Juan, Puerto Rico are not foreign conventions while conventions in Mexico City, London or Lisbon are. Even though a deduction is permitted for travel to two foreign conventions, the deduction is severely limited. For a transportation expense to be deductible, it must not exceed coach or economy fare. Also, the taxpayer must have spent more than one half of the total trip in business-related activity. For this calculation, travel days to and from are disregarded. If the taxpayer spent less than one half of his total days in business-related activities, then only that portion of the transportation cost applicable to the business days are deductible. For example, if the taxpayer attended the American Bar Association Convention in London for six days, and stayed on in London for sightseeing purposes an additional four days, and the flight took one day each way, he would qualify for a deduction of the entire transportation cost. The reason for this is that of the ten trip days, excluding travel to and from, 60 percent was spent in business-related activities. Had the taxpayer only attended the convention for three days, then only 30 percent of the transportation cost would be deductible.

The deductibility of meals, lodging, tips, taxi and other personal subsistence expenditures is limited to the per diem rate for United States civil servants in the particular area. Another limitation on the subsistence allowance is that there must have been at least six hours of scheduled business activities on that day, and that the individual taxpayer attended at least two thirds of these hours. In the event of a half day session, there must have been at least three hours scheduled and the taxpayer must have attended two thirds of these hours. An alternate calculation is available on an overall basis if the taxpayer can show that he attended at least two thirds of all scheduled business activity.

It is interesting to note that the committee reports indicate that the amount of time spent at social functions, parties, cocktail hours, or banquets will not count toward the three or the six hour business activities. However, if there is a speaker at the luncheon or banquet, then only the amount of time which is devoted to the speech is counted for the three or six hour limit.

To substantiate this deduction, both the individual attending the convention and an officer of the organization sponsoring the convention must submit reports showing the total days of the trip, the amount of time devoted to business activities, the attendance by the individual taxpayer, and a summary of the program presented.

The preceding limitations apply both to the individual attending the convention as well as to his employer. If the employer chooses to reimburse the individual attending for subsistence expenses in excess of the per diem limitation and for travel by first-class accommodations, the employer's deduction is limited as set forth above and, in addition, the employee will, in all probability, have taxable income.

4.03 State Legislators' Travel Expenses Away From Home

Code Section 162—Act Section 604

Effective Date: Tax years beginning before January 1, 1976 that are open for assessment or collection before the date of enactment

Congress has now cleared up the confusion which existed under present law as to where a state legislator's home was for the purpose of computing expenses while away from home. The Act applies to all years beginning prior to January 1, 1976 for which the tax years are still open or subject to audit. However, there is a limitation that the deduction cannot exceed the amount which was originally claimed under the previously filed return.

The legislator is given the option of electing to have his tax home considered to be his residence in his legislative district. For the purposes of deducting expenses while away from home, the legislator is deemed to

have spent an amount equal to the per diem allowance paid to employees of the United States government. This per diem allowance is permitted for all days that the legislature is in session plus all days of recess, if the recess is less than four days. In addition, the legislator is entitled to count days of attendance at committee meetings during a recess in excess of four days. It is interesting and unusual that the deduction is permitted for the number of days the legislature is in session, not the number of days which the legislator attended such sessions. Under prior law the legislator was permitted to deduct the cost of traveling to and from the state capital from his home in the legislative district.

4.04 Alimony

Code Section 62 (13)—Act Section 502

Effective Date: January 1, 1977

Under prior law, alimony could be deducted by a taxpayer who itemized his deductions. If the standard deduction was elected, then no deduction was allowed for alimony.

The Tax Reform Act of 1976 changes this by adding Item 13 to Section 62, which enumerates the items that are deductible in arriving at adjusted gross income. This change will permit many additional taxpayers to take advantage of this deduction even if they take the standard deduction.

4.05 Moving Expenses

Code Section 217—Act Section 506

Effective Date: January 1, 1977; Military Provisions, January 1, 1976

Prior to 1970 only employees were permitted to deduct the cost of moving their household goods and family in connection with job-related transfers. The Tax Reform Act of 1969 liberalized this deduction to include house-hunting trips after obtaining employment to and from the new location, meals and lodging while occupying temporary quarters at the new location, and certain qualified expenses in connection with the sale or purchase of a residence or termination and acquisition of a lease. To qualify for this deduction, the distance between the taxpayer's new job location and the old residence had to be 50 miles greater than the distance between the old residence and the old job location. Also, the taxpayer had to be a full-time employee in the general location of the new job for at least 39 weeks of the following 12-month period. However, if the individual was self-employed, then the residence requirement during the next 24-month period was 78 weeks.

The deductions were also made available to self-employed individuals

who were moving to new locations as well as employees. The deduction for house-hunting trips, temporary living expense at the new location, and qualified expenses in connection with the sale and purchase of a residence or lease were limited to \$2,500, with a sublimitation of \$1,000 on house-hunting trips and temporary living expenses.

The Tax Reform Act of 1976 reduces the mileage requirement from 50 to 35 miles and increases the overall expense limitation on house-hunting trips, temporary living expenses, and qualified expenses in connection with a sale and acquisition of a residence or lease to \$3,000 from \$2,500. Also, the sublimitation on house-hunting trips and temporary living expenses is increased to \$1,500 from \$1,000. As under prior law, if separate returns are filed, the above amounts are cut in half to \$1,500, and \$750 respectively.

Code Section 217(g) exempts members of the armed forces from the time limitations and the mileage requirements of this code section. Specifically excluded from income are moving and storage expenses, whether furnished in kind or reimbursed for a member of the armed forces, his spouse and dependents. The exclusion applies both to the transfer of the member of the armed forces as well as a separate move of his family, when they are not permitted to accompany him to his assigned post. The Secretary of Defense and the Secretary of Transportation are exempted from the requirement of reporting the amount of the moving expense to the employee.

4.06 Charitable Contributions of Inventory and Other Ordinary Income Property

Code Section 170(e)3—Act Section 2135

Effective Date: Contributions made after October 8, 1976

Under previous law, donors of appreciated property, which is sold, were limited to their basis in the property as a charitable contribution deduction. Ordinary income property included inventory as well as capital assets held for less than six months. The new Act opens the door for contribution of inventory and ordinary income property by a corporation, other than a Subchapter S corporation, to charitable organizations. The requirements are that the property donated must be used for the care of the ill, needy or infants and the transfer must be an outright gift with no consideration passing to the donor. The donee is required to provide the donor with a statement of the intended use and disposition of the property, indicating that it meets the above qualifications. The amount of the charitable deduction is the donor's basis plus one half of the appreciation, subject to the limitation that the deduction cannot exceed 200 percent of the property's basis. No deduction is permitted for the unrealized appreciation to the extent that had the property been sold, it would have been subject to the recapture

provisions of depreciation, mining exploration, excess farm losses and certain soil and water conservation expenditures, and certain land clearing expenditures.

Again we should note that this provision is applicable only to corporations and not to individuals.

4.07 Eliminating Architectural and Transportation Barriers for the Handicapped

Code Sections 190 & 263—Act Section 2122

Committee Reports: S. Rep. No. 1236, 94th Cong., 2d Sess. 503 (1976); S. Rep. No. 938, 94th Cong., 2d Sess. 438 (1976)

Effective Date: For years beginning after December 31, 1976 and ending before January 1, 1980

Enacted for tax years beginning after December 31, 1976 and ending before January 1, 1980, Congress has given taxpayers engaged in a trade or business the option of electing to expense, rather than to capitalize, improvements to any facility or public transportation vehicle which increases the usability or excessability by the elderly and the handicapped. This election is subject to a \$25,000 maximum in each taxable year.

Congress defines the elderly as individuals over the age of 65 or of retirement age. Handicapped individuals are defined to be those with a physical or mental disability, including, but not limited to, blindness or deafness, which constitutes a functional limitation which substantially limits the activities of the individual.

The Senate Report indicates that the barrier removal must meet the standards promulgated by the Secretary of the Treasury with the concurrence of the Architectural and Transportation Barriers Compliance Board. The Treasury is instructed to prescribe regulations within 180 days after the date of enactment of the Tax Reform Act of 1976.

4.08 Business Use of Home

Code Section 280A—Act Section 601

Effective Date: For tax years beginning after December 31, 1975.

Prior to the passage of the Tax Reform Act of 1976, a controversy raged between taxpayers and the Internal Revenue Service as to the deductibility of offices in the taxpayer's home. The problem arose in connection with employees and professionals who were provided an office elsewhere. The self-employed individual who operated solely out of his home was permitted a deduction for the percentage of the expenses based on the portion of the

home used for business. As to employees and professionals, the Service maintained that the business use of the home must be required as a condition of employment and that there must be regular use of the facility. Over a period of years, a line of cases developed which permitted the deduction if the office was merely "appropriate and helpful" to the taxpayer's trade or business, or of his position of being an employee.

Congress enacted Section 280(A) for the expressed purpose of foreclosing this controversy and denying deductions to individuals and Subchapter S corporations who use a dwelling unit as a residence during the taxable year. Deductions for interest, taxes, and casualty losses which are deductible under other specific code sections are excluded from this blanket disallowance.

A deduction is permitted for the exclusive and regular use of a specific portion of the dwelling for a trade or business, which is the taxpayer's principal place of business or is used by the taxpayer to meet patients, clients, or customers in the normal course of his trade or business. A deduction is also allowed if there is a separate structure unattached to the dwelling which is used in connection with the taxpayer's trade or business. No deduction is allowed if an area, such as a family room, is used for office work several hours each evening and on weekends and is also used by the spouse for sewing in the mornings and by the children for viewing television after school in the afternoon.

If the deduction is claimed by an employee, in addition to the exclusive and regular use test, the employee must prove that it was for the convenience of the employer. The fact that such use is appropriate and helpful will no longer be a determinative factor.

If the taxpayer is involved in the business of selling at wholesale or retail, a deduction is permitted for that portion of space within the dwelling unit which is used for the storage of the taxpayer's inventory. If the preceding tests are met, the amount of the deduction is limited to the gross income derived from the taxpayer's trade or business reduced by that portion of the deduction such as interest, taxes and casualty losses attributable to the business use of the property. For example, assume that a law professor who has limited outside practice and uses 15 percent of his house on an exclusive and regular basis for seeing clients generates \$1,000 of gross income. His total interest in taxes, which are deductible whether the property is used for business or not, totaled \$3,600. Total maintenance and depreciation total \$5,000. Taxpayer's deduction for his home office expense is calculated as follows:

Gross Income from Business	\$1,000
Less: 15% of Interest and Taxes of \$3,600.	<u>540</u>
Limitation on Deduction of Other Business Related Expenses	<u>460</u>
Maintenance and Depreciation Expense	\$5,000
	x 15%
	<u>\$ 750</u>
Amount of Business-Related Expenses From the Dwelling Deductible	\$ 460

4.09 Vacation Homes

Code Section 280A—Act Section 601

Effective Date: For tax years beginning after December 31, 1975.

Section 280 of the Tax Reform Act of 1976 places severe limitations upon the deductibility of expenses incurred in maintaining a vacation home which is deemed to have been used as a taxpayer's residence during the taxable year. The Code sets forth a mechanical test whereby the property is considered to have been used as a residence if the number of personal days of use exceed the greater of 14 days or 10 percent of the days actually rented. If the property was not used as a residence under the preceding test, then deductibility of expenses is determined under existing Code Section 183, activities not engaged in for profit. Under this section an activity is presumed to have been engaged in for profit if income exceeds expenses in two out of five successive years.

The taxpayer is considered to have used the property for personal uses for any day that it was used by himself, brothers, sisters, spouse, ancestors or lineal decedents. Also considered to be days of personal use are days which it is rented for less than a fair rental value and days for which the unit was occupied by an individual under a reciprocal arrangement which permitted the taxpayer to use some other dwelling unit. The consideration of a reciprocal use as a personal day is designed to eliminate the situation where both Mr. Jones and Mr. Smith own condominiums in Naples, Florida; however, Mr. Jones never stays in his condominium but always stays in the Smith condominium and vice-versa.

If the property was used as a residence under the preceding test, the deductions are limited to the excess gross rental income over the portion of the expenditures deductible under other Code sections, such as taxes, interest, and casualty losses, which are attributable to the period the unit was rented. Expenditures not deductible under other Code sections are deductible only to the extent attributable to rental days. The mechanical calculation involves

multiplying total expenditures not deductible under other Code sections times the fraction, the numerator which is the days of rental use over a denominator of total days of use (both personal and rental). The actual calculation is more fully illustrated by the following example:

Taxpayer owns a cottage on a lake in Vermont which he occupies during June. The cottage is rented in July, August, and September for \$1,000 per month or a total of \$3,000 for the year. Taxpayer's cost of owning the cabin are: Interest—\$1,600; Real Estate Taxes—\$800; Maintenance—\$1,200; Utilities—\$400; and Depreciation—\$2,000.

Expenditures Deductible Under Other Sections	Total	Rental Use $\frac{3}{4}$	Personal Use $\frac{1}{2}$
Interest	\$1,600	\$1,200	\$400
Taxes	<u>800</u>	<u>600</u>	<u>200</u>
Total	<u><u>\$2,400</u></u>	<u><u>\$1,800</u></u>	<u><u>\$600</u></u>
Expenditures Deductible If Attributable to Rental	Total	Rental Use $\frac{3}{4}$	Personal Use $\frac{1}{2}$
Maintenance	\$1,200	\$ 900	\$300
Utilities	400	300	100
Depreciation	<u>2,000</u>	<u>1,500</u>	<u>500</u>
Total	<u><u>\$3,600</u></u>	<u><u>\$2,700</u></u>	<u><u>\$900</u></u>

The deduction is calculated as follows:

Gross Rentals	\$3,000
Reduced by Portion of Expenditures Other- wise Deductible Attributable to Rental	<u>1,800</u>
Limitation on Deduction of Maintenance, Utilities and Depreciation	<u><u>\$1,200</u></u>

Although the taxpayer is entitled to deduct the entire \$2,400 of interest and taxes, the deduction for maintenance, utilities, and depreciation is limited to \$1,200, not the total expenditure of \$2,700.

It is worthwhile to note that had the test been made under existing Section 183, as prescribed by Treasury Regulation 1.183-1(d)(3), example (i), the deduction for maintenance, utilities, and depreciation would be limited to \$600 since the limitation is based on the excess of gross rentals over the entire amount of expenditures deductible under other Code sections.

Gross Rental	\$3,000
Less Total Interest and Taxes	<u>2,400</u>
Deduction	<u><u>\$ 600</u></u>

Congress has established a de minimis rule whereby both income and expenses are to be ignored if the property was rented for less than 15 days during the taxable year. Congress also extends the sweep of this drastic disallowance not only to dwelling units but also to houses, apartments, condominiums, motor homes, boats, or similar property, as well as all adjoining property. If the property is owned by a Subchapter S corporation, an estate, a trust, or a partnership, days of personal use will be considered to be that used by any beneficiary, partner, and/or shareholder. Specifically, the new rules do not apply to a corporation. However, it is presumed that the Internal Revenue Service has enough ammunition under the normal ordinary and necessary business expense provision to disallow any non-related corporate use of this type of a facility.

4.10 Partnership Organization and Syndication Fees

Code Section 709—Act Section 213(b)

Committee Reports: S. Rep. No. 1236, 94th Cong., 2d Sess. 421 (1976); S. Rep. No. 938, 94th Cong., 2d Sess. 92 (1976); H. R. Rep. No. 638, 94th Cong., 2d Sess. 120 (1976)

Effective Date: For taxable years of partnership beginning after December 31, 1975

Amortization: Over 60 months effective for partnership taxable years beginning December 31, 1976

Prior to the Tax Reform Act of 1976, the cost of organizing a partnership was permitted to be deducted in the year of payment. This was in contrast to the cost of organizing a corporation which was required to be capitalized, and amortized over a period of 60 months. Section 709 now requires that all costs of organizing a partnership which are incidental to the creation of the partnership, and which are chargeable to a capital account, and which if incident to the creation of a partnership would normally be amortizable over the life of the partnership, are to be capitalized and the cost recovered through amortization over a period of 60 months. Since many partnerships, more specifically limited partnerships, were involved with the issuing and marketing of various partnership interests in the organization and had incurred commissions, legal and accounting fees, and printing costs, Congress elected to delete these costs of syndication from the 60-month amortization provision. The Conference Report indicates that this amendment is not designed to cast any inferences as to the deductibility or non-deductibility of organization and syndication fees incurred prior to January 1, 1976.

4.11 Nonbusiness Bad Debts

Code Section 166(d)—Act Section 605

Effective Date: December 31, 1975

Section 166(d) has been repealed by the 1976 Tax Reform Act. After December 31, 1975, the effective date of the repeal, a noncorporate taxpayer who guarantees a loan and suffers a loss will be able to deduct the loss in the same fashion as deducting a loss from a direct loan. However, the manner of deduction will be determined by the guarantor's motive. The guarantor will be able to deduct any loss against ordinary income if the guarantee involved the guarantor's trade or business. However, the guarantor will be only allowed a short-term capital loss if he entered into the transaction for profit and the loan had no connection to the trade or business. If the guarantor entered into the guarantee for other reasons than those previously mentioned, he is not entitled to a deduction. The guarantor also will not be permitted to make a deduction if he voluntarily made a payment where there was no legal obligation or where there was a worthless debt.

4.12 Bad Debts Owed by Political Parties
Code Section 271(c)—Act Section 2104
Effective Date: December 31, 1975

A taxpayer is precluded under Section 271 from deducting a bad debt owed by a political party. A political party is defined as a party nominating candidates for elective office, a committee of the party, or a committee or organization which accepts contributions and makes expenditures for the purpose of influencing elections. Candidates, themselves, are not included. The major reason for this preclusion is the desire to prevent the deduction of concealed campaign contributions. The only institution exempted from this prohibition is a bank.

The 1976 Tax Reform Act has amended Section 271 for the purpose of benefiting accrual income taxpayers. Under the old law, an accrual income taxpayer had to report the account receivable as income even though no income was actually realized and he could not deduct the bad debt because of Section 271. The taxpayer, now, can deduct a bad debt from a political party if (1) he is involved in a bona fide sale of goods or services with a political party; (2) the sale was in the taxpayer's ordinary course of business; (3) the goods or services are used for a political campaign or candidate; (4) more than thirty percent of the taxpayer's accrued receivables during the year are from political parties; and (5) the taxpayer has made a substantial and continuing effort to collect the debt, though no lawsuit is necessary to show intent. If the taxpayer fulfills these requirements, he can deduct any bad debt after the effective date of December 31, 1975.

4.13 Deductions Limited to Amount "at Risk" in Case of Certain Activities
Code Section 465—Act Section 204
Effective Date: Taxable years beginning after December 31, 1975

In the past, highly compensated executives and professionals have been sold tax shelters upon the promise of large tax deductions in the early years of operation. Although the normal rule is that a loss is limited to the investor's investment in the project, the investment in the past has included nonrecourse loans which the tax shelter has obtained, and for which the individual investor is not personally liable. Therefore, it has been possible for investors to deduct amounts greatly in excess of their actual investment in a tax shelter. This concept has been used not only by limited partnerships but also by Subchapter S corporations which permit a pass through of any operating losses to the individual shareholders. With the promise of large losses from the tax shelter in the early years, many individuals have invested in projects which are not otherwise sound.

To combat these tax shelters, Section 704(d) has been revised and Section 465 has been added to the Internal Revenue Code for the purpose of limiting losses to the amount which the investor has "at-risk". Section 465 addresses itself to certain specified activities which include motion picture and video tape production, exploration for oil and gas wells, farming, and the leasing of equipment. Section 704(d), which will be discussed subsequently, addresses itself to losses incurred by a partnership which is not engaged in one of those activities set forth in Section 465.

The amount at risk is the total of the cash and adjusted basis of other property invested in the activity plus those funds borrowed and invested in the activity. For borrowed funds to be considered at-risk, the taxpayer must be personally liable or must have pledged personal or real property which he owns as security for the nonrecourse loans. Borrowed funds are not to be considered at-risk if:

- (1) the indebtedness is secured by an interest in the specified activity; or
- (2) the indebtedness was borrowed from an individual who has an interest in the specified activity, other than as a creditor. (This limitation eliminates the possibility of a general partner lending funds to a limited partner for their investment); or
- (3) the creditor has one of the following relationships to the taxpayer as set forth in Section 267(b):
 - (a) Members of a family (brothers, sisters, spouse, ancestors, and lineal descendants);
 - (b) An individual and a corporation more than 50 percent in value of outstanding stock of which is owned, directly or indirectly, by or for such individual;
 - (c) Two corporations, more than 50 percent in value of outstanding stock of each of which is owned, directly or indirectly, by or for the same individual, if either one of such corpora-

- tions, with respect to the taxable year of the corporation preceding the date of the sale or exchange was, under the law applicable to such taxable year, a personal holding company or a foreign personal holding company;
- (d) A grantor and a fiduciary of any trust;
 - (e) A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;
 - (f) A fiduciary of a trust and a beneficiary of such trust;
 - (g) A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;
 - (h) A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust; or
 - (i) A person and an organization to which Section 501 applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual.

It should be noted that if the property which has been pledged is actually used in the activity, then it is not considered to be at-risk. If the taxpayer has entered in to any type of arrangement whereby he is guaranteed against incurring a loss in excess of a specified amount, or has obtained insurance to cover any loss caused by his personal liability, he will not be considered to be at-risk. He will also not be considered to be at-risk to the extent of any nonrecourse loans which he may have invested in the activity.

Losses, as described in Code Section 465, are defined to mean the amount by which deductions permitted under other code sections exceeds the income generated by the specified activity. Losses incurred in the current year are deemed to reduce the amount at-risk for subsequent year calculations. The determination of the amount at-risk and the loss deductible from each activity must be calculated with respect to each film or video tape, each piece of personal property which is leased or held for leasing, each farm, and each oil or gas property. The significance of this requirement is that each individual activity is considered as a separate entity and, consequently, a loss nondeductible from one activity due to an insufficient amount at-risk cannot be used to offset an amount at-risk in another activity. For example, a loss in excess of the amount at-risk in a leased jet aircraft cannot be applied against a farm where the amount at risk exceeds the loss. A loss which cannot be deducted in the current year due to the at-risk limitation can be carried over indefinitely to future years and deducted at such time

as the amount at-risk for that particular activity has increased sufficiently to cover part or all of the loss.

In summary, it is interesting to note that if property itself is invested in the activity, the amount at-risk is limited to the adjusted basis of the property; but, if the property is pledged as security for a loan and the proceeds of the loan are then invested in the activity, the amount at-risk is the fair market value of the property at the time it is pledged. Corporations, other than Subchapter S corporations, are not subject to the at-risk provisions of Section 465. Although Section 465 and Section 704(d) are both designed to eliminate the deduction of losses in excess of the investor's actual economic investment, Section 465 takes precedence where the specific activities of investing include:

- (1) Holding, producing or distributing motion picture films or video tapes.
- (2) Farming.
- (3) Leasing any Section 1245 property, or
- (4) Exploring for, or exploiting, oil and gas resources as a trader business or for the production of income.

Section 704(d) is the overall general limitation on the deduction of losses arising from a partnership operation. It should be noted that under both of these new sections, real estate is exempted from coverage. These Code Sections have application only to the deduction of losses, not to the determination of the adjusted basis of the investor in the specific asset or trade or business.

4.14 Farming-Accrual Accounting for Large Farm Corporations and Limitation on Deductions for Farming Syndicates **Code Section 447 & 464—Act Section 207** **Effective Date: For tax years beginning after December 31, 1976**

In an effort to tighten up those tax shelters resulting from farming operations by high bracket taxpayers, the Tax Reform Act of 1969 established the concept of the excess deductions account, Section 1251. The purpose of the excess deductions account was to accumulate deductions over a period of years which were used to offset nonfarm income. Furthermore, it converted what would otherwise have been long term capital gain into ordinary income at the time certain farm property was sold or disposed of. In effect, this was similar to the concept of the recapture of depreciation. To insure that the ordinary farmer would not be caught by this preventive legislation, the rules applied only to a taxpayer whose nonfarm gross income exceeded \$50,000, whose net farm loss was over \$25,000 and who used

the cash basis of accounting. The only amount which was added to the excess deductions account were the farm losses in excess of \$25,000. And as previously mentioned, the balance in this account would then be used to convert what would otherwise have been long term capital gain into ordinary income at the time of sale of depreciable personal property held for more than six months, cattle and horses held for more than two years, other livestock held for more than one year for breeding, draft, dairy or sporting purposes, land held for more than six months, and unharvested crops growing on land which had been held for more than six months.

The Tax Reform Act of 1976 provides that no additions to an excess deductions account are required to be made for net farm losses incurred for taxable years beginning after December 31, 1975. The recapture rules in effect since January 1, 1970 until the present time will still operate to recapture farm losses. However, income earned after January 1, 1976 can be used to reduce the amount of the existing balance in the excess deductions account. Also, tax free divisive reorganizations under Section 368(a)(1)(D) will not trigger the recapture of excess deductions. Section 447 requires all corporations other than Subchapter S corporations, family corporations of which 50 percent of the combined voting power of all classes of stock or 50 percent of the total number of shares of all classes of stock are owned by members of the same family, and corporations with gross receipts of less than one million dollars or certain corporations using hybrid accounting methods for a period of at least ten years, and partnerships of which one member of a partnership is a corporation to use the accrual method of accounting. Also, preproductive period costs are required to be capitalized. Specifically exempted from these requirements are corporations engaged in the nursery business or engaged in the harvesting or raising of trees (other than fruit and nut trees). The preproductive expenses are generally considered to be those which are required to be expended during the period preceding the date of the first marketable crop or yield. Interest, taxes, and casualty losses are exempted from this capitalization requirement.

Section 464 prohibits farming syndicates from deducting the cost of feed, seed, fertilizer and other farm supplies prior to the time they are actually used or consumed. The cost of poultry acquired for future resale cannot be deducted until the year of sale, and the cost of poultry, such as egg-laying hens, must be deducted ratably over the lesser of twelve months or their actual useful life in the trade or business. Section 278(b)(3) requires that preproductive development expense of groves, orchards and vineyards in which fruit or nuts are grown must be capitalized and then depreciated over their useful life, commencing with the first year in which commercial quantities of the fruit or nuts are produced.

A farming syndicate is defined as a partnership or other enterprise other than a corporation whereby more than 35 percent of the losses are allocated to limited partners or a limited entrepreneur, or a partnership or other enterprise which is required to register their offering with any federal or state agency. This last requirement means that there may be discrepancies between various states as to what organizations are covered by Section 464, due to the difference in state laws requiring registrations of offerings.

4.15 Investment Interest

Code Section 163—Act Section 209

The Tax Reform Act of 1969 introduced the concept of limiting the amount of investment-related interest which could be deducted. The purpose of this statute was to prevent taxpayers from incurring large amounts of interest expense to carry relatively unproductive property and currently offsetting the deduction against their salary and other ordinary income. For the years of 1970 and 1971 excess investment interest was categorized as a tax preference. However, for years beginning in 1972 and thereafter, the excess investment interest was disallowed and was permitted to be carried over to future years. The deduction for the interest incurred for carrying investment property was limited to \$25,000 plus net investment income, plus the excess of long-term capital gain over net short-term capital losses, plus one-half of the excess investment interest over the total of the three preceding items.

The Tax Reform Act of 1976 continues the above philosophy, but even more severely limits the deduction of investment interest by permitting a deduction only to the extent of \$10,000 plus the net investment income. Excluded from this limitation is an additional \$15,000 of interest incurred to acquire either corporate stock or an interest in a partnership in which the taxpayer, his spouse and children own at least 50 percent of the stock in the case of the corporation, or 50 percent of the capital investment in the case of a partnership. Although not mentioned in either the Act or in the committee reports, it is assumed that interest incurred in connection with a self-employed individual's business would also be deductible without limitation, since this would be interest incurred in connection with a trade or business, not an investment.

Again, interest incurred after December 31, 1975 is deductible under the above rules and may be carried forward. The carry over of pre-1976 interest is deductible under the rules as set forth in the 1969 Tax Reform Act. It should be noted that the above limitation of \$25,000 and \$10,000 are reduced by 50 percent if a married individual is filing separate returns.

5.00 Tax Credit

5.01 Credit for the Elderly

Code Section 37 — Act Section 503

Effective Date: This revision is effective for those tax years beginning after December 31, 1975

In 1962 a retirement income credit was introduced to assist those elderly taxpayers receiving little or no Social Security benefits or other forms of tax exempt retirement income. The credit was designed to insure that these taxpayers were treated on essentially the same basis as those receiving such benefits.

In general, the credit was limited to 15 percent of the first \$1,524 (or \$2,286 for joint returns) of retirement income received by a taxpayer who is at least 65 years old. Retirement income included only dividends, interest, rents, taxable annuities and pensions. Earned income was not considered in computing the amount of credit allowable. Moreover, the amount of retirement income must be reduced by the amount of any tax exempt pension income (including Social Security) received by the taxpayer during the tax year. Taxpayers under the age of 72 faced a further reduction in the amount of one-half the earned income between \$1,200 and \$1,700 per year and the entire excess of earned income above \$1,700 per year.

To be eligible to receive the tax credit, the taxpayer must have achieved the age of 65 and must have received earned income in excess of \$600 per year in each of any ten preceding calendar years.

The Tax Reform Act of 1976 attempts to eliminate the difficulty of computing the amount of the retirement income credit under the old law. The new credit incorporates the present value of the dollar as well as the various effects of revised Social Security benefits. It should be noted that a major overhaul of the credit was required since these amounts had been essentially unchanged since the credit was first introduced in 1962.

The new law significantly liberalizes the availability of the credit and redesignates it as "credit for the elderly." The credit is now computed on earned income as well as the so-called retirement income. Therefore, the credit is now available to taxpayers of age 65 and over regardless of whether they receive retirement income or earned income. Furthermore, individual earnings in excess of \$600 per year in each of ten preceding calendar years are no longer a prerequisite to eligibility for the credit. In other words, prior employment experience is no longer essential to the credit's availability. Taxpayers under the age of 72 will no longer be required to reduce their income base by one half the earned income between \$1,200 and \$1,700 per

year and the entire excess of annual earned income above \$1,700. However, all eligible taxpayers will still be required to reduce their income by the amount of any tax-exempt pension income (including Social Security) that they receive during the tax year. The revised law also introduces a new reduction that is equivalent to one-half the excess of all adjusted gross income above \$7,500 for single taxpayers and \$10,000 for married persons filing a joint return. This reduction is applicable to all taxpayers eligible to receive the credit and is taken from their income base for figuring the credit allowable.

The credit itself is still computed at the rate of 15 percent; however, the maximum amount of income to which this rate can be applied has been raised to \$2,500 for a single eligible taxpayer and for a married couple filing jointly where only one spouse has attained the age of 65 and \$3,750 for a married couple filing jointly where both spouses are fully eligible to receive the credit. As under the old law, the credit is not refundable and, therefore, cannot exceed the amount of tax for the year in question. In addition, the credit is generally available to married couples only if they file a joint return.

Act Section 503 made further modifications pertaining to the credit available to public retirees under the age of 65. (*i.e.*, those individuals receiving pension income from the government). Generally speaking, the old retirement income provisions will still apply to these individuals although the maximum amount of such income subject to the credit has been increased to \$2,500 for single persons and \$3,750 for married couples filing joint returns. However, the old requirement that a taxpayer's eligibility to receive the credit is predicated upon his earned income exceeding \$600 in each of ten preceding calendar years has been eliminated.

Illustration:

X, a 65 year old taxpayer, receives combined annual income of \$4,000 from dividends, interest and rental of real property. He also has earned income of \$3,500 annually. His wife is 61 years old and a public retiree. She receives earned income of \$2,500 annually from her part-time job in addition to her annual government pension of \$2,000. Neither X nor his wife receives social security or other types of tax exempt pension payments. X and his wife elect to file a joint return.

The maximum amount of income subject to the credit is \$2,500 since X and his wife are filing a joint return, but only X is eligible to receive the credit. This amount is now subject to a reduction of one-half the taxpayer's combined adjusted gross income (AGI) in excess of \$10,000. Here their combined AGI is \$12,000. Therefore, the income subject to the credit must be reduced by one-half of \$2,000 or \$1,000. X and his wife have a credit that is based on retirement income of only \$1,500 (\$2,500-\$1,000). The

credit is computed at the rate of 15 percent of this amount, leaving an available credit of \$225.

5.02 Disregard of Earned Income Credit

Code Section 43 — Act Section 402

Effective Date: This revision is effective for only those tax years ending after December 31, 1975 and before January 1, 1978

The Revenue Adjustment Act of 1975 supplemented the earlier Tax Reduction Act of 1975 and provided for a refundable tax credit to certain eligible taxpayers. The Revenue Adjustment Act of 1975 in effect provided that those refunds received before July 1, 1976 as a result of the earned income credit were to be disregarded in determining the eligibility of the recipient taxpayer for any federal or federally assisted aid program. The earned income credit was to be discarded only if the taxpayer was a beneficiary of such aid programs in the calendar month before the refund was actually received.

The Revenue Adjustment Act of 1975 retained the refundable credit through June 30, 1976 and further provided that the amount of the credit was to be ignored in determining which taxpayers were eligible to receive benefits under various federal aid programs.

5.03 Earned Income Credit

Code Section 43 — Act Section 401(c)

Effective Date: This revision is effective for only those tax years ending after December 31, 1975 and before January 1, 1978

The Tax Reduction Act of 1975 was designed to provide a stimulus to a sluggish economy. Part of that Act featured a refundable tax credit of 10 percent of the first \$4,000 of earned income. This credit was limited to a maximum of \$400 reduced by 10 percent of the excess earned income over \$4,000. Therefore, once earned income reached \$8,000 the credit was reduced to zero. The credit as originally designed was for 1975 only and was available only to a taxpayer who maintained a household within the United States and had at least one dependent child who qualified for a personal exemption under Code Section 151(e)(1)(B) (*i.e.*, who is either under the age of 19 at the close of the tax year or a student).

The Revenue Adjustment Act of 1975 (Public Law 94-164) retained the refundable credit through June 30, 1976 and further provided that the amount of the credit was to be ignored in determining which taxpayers were eligible to receive benefits under various federal aid programs.

The Tax Reform Act of 1976 in effect extends the earned income credit through 1977 and further modifies Code Section 43(c)(1) pertain-

ing to the eligibility of taxpayers receiving the credit. The taxpayer's eligibility is no longer dependent upon having at least one dependent child qualifying for a personal exemption under Code Section 151(e)(1)(B). Act Section 401(c) requires only that the taxpayer maintain a household for any child who is under the age of 19 or a student. Moreover, the eligibility requirements have been expanded to include a taxpayer who maintains a household for a disabled child (of any age) for whom a personal exemption may be claimed. Therefore, a taxpayer is now eligible to receive the credit if he maintains a household for a dependent child or for any child (dependent or nondependent) who is under the age of 19 or a student. It should be further noted that for married taxpayers a joint return must be filed in order to qualify for the credit.

5.04 Child Care Expenses

Code Section 44A — Act Section 504

Effective Date: This revision is effective for tax years ending December 31, 1975

Code Section 214 provided a deduction for those expenses relating to the care of a dependent child or disabled dependent. The maximum deduction allowable was \$4800 per tax year. However, the amount of those expenses incurred was to be reduced by one-half the excess of the taxpayer's adjusted gross income over \$35,000. Section 214 placed further limitations upon the amount of the deduction allowable where the expenses were incurred outside the home. Also, payments to related individuals, as defined in Code Section 152(a) were expressly omitted from the deduction. Furthermore, both spouses generally had to be gainfully employed in order to qualify for the deduction. The eligible expenses were to be reduced by the amount of any disability income. These limitations, in effect, eliminated the practical availability of the child care expense deduction. In addition, taxpayers taking the standard deduction were precluded from using child care expenses as a deduction since itemized deductions must be taken from adjusted gross income.

Due to the severe restrictions upon the availability of the child care expense deduction, Congress chose to eliminate it altogether and establish a new credit that is more attractive to the taxpayer. As a result, Code Section 214 has been repealed and replaced by Section 44A.

Act Section 504 establishes a non-refundable tax credit equal to 20 percent of the employment-related expenses incurred from the care of a dependent child under the age of 15 or for an incapacitated dependent (including a spouse) in order to enable the taxpayer to work. This credit is available without regard to the taxpayer's income and consequently will not

be subject to reduction once the taxpayer's adjusted gross income reaches a certain level. However, the credit is itself limited to \$400 for one dependent and \$800 for two or more dependents. In other words, child care expenses cannot exceed \$2000 per year for one dependent and \$4000 a year for two or more dependents.

The Tax Reform Act of 1976 also eliminates some of the burdensome restrictions associated with Code Section 214. The distinction between child care expenses incurred inside and outside of the home has been eliminated. Additionally, payments to relatives may be considered in computing the credit, but only if these payments are subject to the social security tax. The new law also modifies the old requirement that both spouses must be gainfully employed. The credit has been extended to married couples where either one or both work on a part-time basis only, but the eligible expenses are limited to the earnings of the spouse earning the smaller amount. It is also extended to married couples when one spouse is a full-time student and the other is gainfully employed. Furthermore, the credit has been made available to a divorced or separated spouse who has custody of a child under the age of 15 even though that parent does not qualify for a dependency exemption for the child.

This extreme overhaul will make the child care expense deduction available to a significantly larger number of taxpayers. Also, the elimination of a variety of restrictions will considerably ease the burden of computing the new credit.

5.05 Extension of \$100,000 Limitation on Used Property Code Section 48 — Act Section 801

Effective Date: This revision is effective only for those tax years ending after December 31, 1974 and before January 1, 1984

Code Section 48 defines that depreciable property which is subject to the investment tax credit. This section imposed a limitation of \$50,000 on the cost of used property that may be taken in a given year as a qualified investment for purposes of the investment tax credit. The Tax Reduction Act of 1975 increased the limitation to \$100,000 for tax years ending prior to January 1, 1977 as an incentive to stimulate the economy.

Act Section 801 simply extends the \$100,000 limitation on used property through December 31, 1980. Thus, \$100,000 of the cost of used property will remain available as a basis to compute the investment tax credit for four additional years. The dollar limitation will revert to \$50,000 for tax years beginning after December 31, 1980.

By limiting the extension of the increased amounts to four years, Con-

gress recognized the need to provide a further stimulus to the economy, but at the same time, has concluded that permanent increases are not justified. The downward adjustment to \$50,000 for tax years beginning after December 31, 1980 should ensure maximum use of the credit prior to that time.

5.06 Investment Credit

Code Section 46 — Act Section 802

Effective Date: The revision is effective for tax years beginning after December 31, 1975 and ending prior to January 1, 1981

Prior to the Tax Reduction Act of 1975, a taxpayer could receive a seven percent credit for investment in certain qualified property. The credit rate for investment in certain public utility property was four percent. The Tax Reduction Act increased the investment credit to 10 percent for all taxpayers investing in either qualified investment property or public utility properties. The 10 percent rate was to remain in effect only for the period January 22, 1975 through December 31, 1976.

Act Section 802 extends the effective date of the 10 percent rate through December 31, 1980. By extending the higher rate for additional years, Congress hopes to provide a further stimulus to the economy without enacting a permanent change to the seven percent investment credit rate (four percent in the case of certain public utility property). As a result, the investment credit rate will be adjusted downward to the old rates for tax years commencing after December 31, 1980.

5.07 First-In First-Out Treatment of Investment Credits

Code Section 46(a)(2) — Act Section 802

Effective Date: This revision applies to all tax years beginning after December 31, 1975

Code Section 46(b) called for utilization of current year investment credits prior to any carryover or carryback of investment credits. Consequently, a taxpayer could lose the benefits of any unused credit where that credit plus other credits arising in the carry-back-carry-forward period exceeded the restrictions placed on the amount of credit available imposed by Code Section 46(b)(2). Frequently, a credit arising in a given tax year was unable to be fully utilized under the old rule because the cumulative unused credits during the seven year carry-over period exceeded prescribed dollar restrictions.

Congress has attempted to ensure maximum utilization of the investment tax credits by providing that any unused credits carried into a given tax year shall be applied before the credit that actually arises in that year. Therefore, investment tax credits carried "over" from a prior tax year are

consumed first and then current investment credits are applied to the extent that the dollar limitations imposed on the credit have not been exceeded. Revised Code Section 46(a) simply states that the allowable credit for a given tax year will be made up of carryovers to that year, followed by credit actually accrued in that particular year, and finally carry-backs to that year. In this manner, the oldest credit is always used first, thereby reducing the likelihood that it will expire unused at the end of the seven year carry-over period.

5.08 Employee Stock Ownership Plans

Code Section 46 — Act Section 803

Effective Date: This revision is effective for tax years beginning after December 31, 1974 and ending prior to January 1, 1981

Section 4975(e)(7) (which addresses prohibited transactions for tax qualified plans) generally defines an Employee Stock Ownership Plan (ESOP) as a written and defined contribution plan designed primarily for investing in employer securities. In essence, such plans are established to enable employees, or participants in the plan, to purchase stock of the employer thereby providing a viable incentive for increased efficiency and productivity. Congress has enacted a variety of provisions to encourage the adoption of ESOP's. The Tax Reduction Act of 1975 entitled an employer to an additional percentage point of investment credit if he contributed to an ESOP employer securities equal in value to the additional one percent credit. Therefore, a qualifying employer is entitled to an 11 percent investment credit in lieu of the 10 percent credit generally available under Code Section 46. This additional credit was to expire under the Tax Reduction Act of 1975 on December 31, 1976.

The Tax Reform Act of 1976 extends the additional percentage point of investment credit to qualifying employers through December 31, 1980. As under the old law, a qualifying employer is generally one who contributes employer securities equal in value to the additional percent of investment credit to an ESOP.

An additional one half percent credit is now available where the employee, as well as the employer, contributes that one half percent to the plan. Thus a total investment credit of 11.5 percent is allowable but only to the extent of employee matching contributions to the ESOP. This new provision is allowable only for qualified property acquired after December 31, 1976 and before January 1, 1981.

The Act also provides for a number of technical changes to the investment tax credit provisions of ESOP's. If any part of the investment credit is subject to recapture or disallowance, the amount of such a decrease can

be applied to offset employer contributions in future years or may be taken as a deduction under Code Section 404. In addition, stock from a member of a controlled group of corporations, such as brother-sister corporations, may be used as employer securities for ESOP purposes. A third important technical change allows the taxpayer to defer his contribution of additional credit to the plan in certain situations. Here, if the entire amount of the credit is not allowed in a given tax year because it exceeds the tax liability for that year, the additional credit can be contributed to the plan as it is allowed. Therefore, the taxpayer will no longer be denied the effect of the additional credit merely due to a technicality that was not designed to operate in that manner.

It should be further noted that the additional credit will not be available to a public utility if a public service or regulatory commission requires a "flow-through" of any part of the additional credit to consumers. This provision becomes effective for tax years commencing on January 1, 1976.

Numerous other changes have been made to a variety of technical provisions relating to the establishment and administration of ESOP's. The new Code provisions should be directly consulted to ascertain the impact of these changes on a particular plan.

5.09 Investment Credit for Movie and Television Films

Code Section 48(K) — Act Section 804

Effective Date: This revision is effective for those tax years beginning after December 31, 1974

In general, the investment tax credit is available on tangible personal property having a useful life of at least seven years and having no predominant foreign use during a given tax year. Motion pictures and television films have been deemed to constitute tangible personal property for investment tax purposes. However, the useful life of motion pictures, the basis of such films, and the predominance of foreign use have all been sources of frequent litigation.

The Tax Reform Act of 1976 attempts to eliminate this litigation and develops two sets of rules with respect to the investment tax credit treatment of films placed in service in the past and those to be placed in service in the future. In both instances, however, the credit is available for only those new films and tapes produced primarily for public entertainment or educational purposes. It is clearly not available for used films or those which are topical or transitory in nature.

For those films placed in service in future years, taxpayers will generally receive two-thirds of the full investment credit without regard to the film's

useful life or foreign use. As an alternative, the taxpayer may elect to determine the useful life and applicable tax credit rate on a film-by-film basis. If this alternative is elected, the taxpayer would be entitled to a full credit if the particular film had a useful life of seven years or more but would receive no credit if the film's useful life were for any shorter period. It should be noted that under this alternative, the film's useful life is treated as ended at the close of first taxable year in which 90 percent of the basis of the film has been recovered through depreciation.

The general rules for placing films in service in the future were designed to encourage domestic film production and to create jobs. Therefore, under the new rules, the basis of the film for investment credit purpose includes all direct costs which are allocable to domestic production. Furthermore, if at least 80 percent of all direct production costs are allocable to United States production, then the credit basis is expanded to include all indirect production costs such as general overhead, screen play development costs, etc.

For those films placed in service in the past (tax years beginning before January 1, 1975), the taxpayer may select one of three alternative methods for computing the investment credit for qualified films. Generally, the taxpayer will select to compute the credit on a film-by-film basis. In this instance, the taxpayer must demonstrate that the film is qualified by meeting both the useful life and foreign use requirements existing under the old law. The 90 percent rule described above may be applied to determine the film's useful life. The film is said to have a predominant foreign use when at least 50 percent of the film's revenues resulted from showings outside of the United States.

Secondly, the taxpayer may elect a 40 percent credit on all qualified films. Within six months of the enactment of the Tax Reform Act of 1976, such an election is required and is irrevocable without the consent of the Commissioner. The primary advantage to this election is that the credit is allowable without regard to the film's useful life or predominant foreign use.

Finally, where a taxpayer initiated an action in a competent court prior to January 1, 1976 with no result to date, he may elect to have the investment tax credit for tax years beginning prior to January 1, 1975 determined under prior law. Again, such an election is irrevocable and can be made only where proper litigation has not yet been concluded.

5.10 Investment Credit for Certain Vessels

Code Section 46(g) — Act Section 805

Effective Date: This revision is effective for those tax years beginning after December 31, 1975

In 1936 Congress enacted the Merchant Marine Act (46 U.S.C. §1177) to encourage domestic ship building. The Amended Act provides for the deferral of income taxes on income realized from domestic shipping where such income is set aside in a capital construction fund. This money can be withdrawn only for the acquisition, construction or reconstruction of qualified vessels to be used in domestic trade. However, when these funds are withdrawn for such uses they have no tax basis and consequently the tax basis of the vessel itself is reduced accordingly. As a result, property constructed solely from this capital construction fund has no basis for determining either depreciation or the investment tax credit.

Act Section 805 adds Code Section 46(g) to provide for a limited investment tax credit for certain qualified vessels placed in service after December 31, 1975. The taxpayer is now permitted to receive a tax credit equal to one-half of the allowable credit on the untaxed monies withdrawn from the special capital construction funds and used to construct or acquire qualified vessels. Furthermore, the taxpayer may be able to sue in court to collect the other one-half of the investment credit based upon the Court's interpretation of whether such a credit is allowable under present law.

It should be noted that the new law has made no changes with respect to the depreciation of these vessels. Therefore, ships, or any portions thereof, that are constructed from special capital construction funds will remain not amenable to depreciation.

5.11 Investment Credit Limitation for Airlines

Code Section 46(a)9 — Act Section 1703

Effective Date: This revision is effective for those tax years beginning after December 31, 1976 and ending prior to January 1, 1983

Under existing law, the investment credit for airlines is generally limited to the first \$25,000 of tax liability plus one-half of that liability in excess of \$25,000. In an effort to spur the future expansion and modernization of the airline industry, Congress has enabled the airlines to use their investment tax credits to offset as much as 100 percent of their tax liability in excess of \$25,000 for tax years ending in 1977 and 1978. However, the tax credit limitation will be reduced by 10 percentage points per year for tax years beginning in 1979 until it returns to its current rate of 50 percent in 1983. Thus in effect Congress has given the airlines the following percentage limitations in addition to the 50 percent limit already imposed by Code Section 46(a)(2):

Year Tax	Additional Percentage Available	Maximum Investment Credit (Assume Tax Liability Exceeds \$25,000)
1977	50%	Total Tax Liability
1978	50%	Total Tax Liability
1979	40%	\$25,000 plus 90% of excess tax liability over \$25,000
1980	30%	\$25,000 plus 80% of excess tax liability over \$25,000
1981	20%	\$25,000 plus 70% of excess tax liability over \$25,000
1982	10%	\$25,000 plus 60% of excess tax liability over \$25,000
1983 and thereafter	0	\$25,000 plus 50% of excess tax liability over \$25,000

The rule in effect for tax years subsequent to 1982 is identical to that for tax years ending prior to 1977. It should be pointed out that this additional investment credit is available only where the qualified investment in airline property is greater than 25 percent of the taxpayer's total qualified investment property. This new Code provision applies to common carrier airlines subject to the control of either the Federal Aviation Administration or the Civil Aeronautics Board. Lessors of airline property, however, are not eligible to receive the additional credit.

5.12 Work Incentive (WIN) Program Expenses

Code Section 50A — Act Section 2107

Effective Date: This revision became effective on October 4, 1976, the date of enactment of the Tax Reform Act of 1976

Under prior law, taxpayers could take a tax credit equal to 20 percent of the wages they paid during the first twelve months of employment to employees undergoing training under a Work Incentive Program. An employer was entitled to receive the credit for only those employees certified by a local WIN agency. No credit was available unless the employment relationship continued for an additional twelve months (*i.e.*, for 24 months from the original date of hiring). The credit, however, was available if employment was terminated in a shorter period of time if the employee was discharged for misconduct, voluntarily quit, or became disabled. The amount of credit available in any tax year was limited to the first \$25,000 of the employer's tax liability plus 50 percent of his tax liability in excess of \$25,000.

The Tax Reform Act of 1976 makes essentially three changes to existing law. The credit is now available if employment is not terminated without cause prior to the first six months of employment. Therefore, in effect the credit is allowable from the date of hiring if employment is not terminated prior to 90 days after the first 90 days of employment. In addition, the

employer will not be required to recapture a claimed credit if the employee is laid off prior to these statutory time limitations because of a decrease in business. Thus, today the credit will not be lost due to early termination of employment if such termination is caused by either the employee's voluntary departure, employee misconduct, employee disability, or a decrease in business. Lastly, the amount of the credit allowable has been doubled to the first \$50,000 of the employer's tax liability plus 50 percent of the excess liability over \$50,000.

5.13 Welfare Recipient Tax Credit

Code Section 50B — Act Section 2107

Effective Date: This revision is effective for tax years ending prior to January 1, 1980

The welfare recipient tax credit was closely related to the WIN credit and was enacted as an employment incentive for welfare recipients. The credit expired on July 1, 1976 and was available to all employers, including those providing employment for private household workers, who employed qualified welfare recipients who had been receiving benefits for a period of at least 90 days. As under the WIN credit, qualified recipients were those employees who had been certified by a state or local welfare agency. The credit allowable was limited to twenty percent of all eligible wages paid to a qualified recipient and, for a given tax year, was further limited to the first \$25,000 of tax liability plus 50 percent of the excess liability above \$25,000 for business employees.

The welfare recipient tax credit has been extended to December 31, 1979. To introduce consistency with WIN tax credit provisions, the Congress has now limited the period for which the wages of any one employee would be eligible for the credit to twelve months. A second change to the welfare recipient tax enables local WIN agencies to certify eligibility for the credit. Lastly, the amount of the credit allowable has been doubled to the first \$50,000 of the employer's tax liability plus 50 percent of the excess liability over \$50,000. As a result of these changes, the welfare recipient credit has been modified to more closely resemble the WIN credit in all major aspects.

5.14 Treatment of Certain Pollution Control Facilities

Code Section 169 — Act Section 2112

Effective Date: (1) The revision applying to the extension of the 5-year amortization election is effective for tax years beginning after December 31, 1975

(2) The revision applying to the investment tax credit is effective for tax years beginning after December 31, 1976

From 1969 through December 31, 1975, a taxpayer who installed a

new certified pollution control facility in connection with property that was in operation prior to January 1, 1969 could elect to amortize that facility over a 60-month period. If such an election was made, the facility became ineligible for the investment tax credit. The availability of the election expired on January 1, 1976.

The five-year amortization election has now been made a permanent feature of the Code as an incentive for installing pollution control equipment. As an added incentive, an investment credit is allowable for tax years beginning after December 31, 1976 despite the taxpayer's election of an accelerated amortization schedule. This credit, however, is limited to one-half of the normally allowable investment credit and is applicable to only that property having a useful life of more than five years. In addition, the definition of a certified pollution control facility has been expanded to include facilities that will prevent the creation or emission of pollutants when installed at the site of other property in existence prior to January 1, 1976. Such a facility must not significantly "increase the output or capacity, extend the useful life, or reduce the total operating costs of such plant or other property" or significantly "alter the nature of the manufacturing or production process or facility." A significant change for purposes of amended Code Section 169 is more than five percent. Thus, a pollution control facility eligible for this new tax credit includes such property as a recovery boiler that removes pollutants from material at some point in the production process without changing the process itself.

6.00 Procedure

6.01 Innocent Spouse

Code Section 6013(e) — Act Section 2114

Section 6013(a) permits a married couple to file a joint return for the taxable year in lieu of filing separate, individual returns. There is no requirement that both spouses realize income during the year. However, both must sign the return and both are jointly and severally liable for the tax. Prior to 1971, if a married couple filed a joint return and one of the spouses omitted to report a portion of his or her gross income, the innocent spouse would be held liable for the tax deficiency on the omitted amount. Congress, thus, enacted the "innocent spouse" rule in 1971 to limit the spouse's liability on the deficiency for the omitted income. Section 6013(e) precludes the innocent spouses's liability only if: (1) the omission exceeds 25 percent of the gross income stated on the return; (2) the omission is attributable solely to the other spouse; (3) the innocent spouse had no knowledge of the omission; and (4) under the circumstances, it would be inequitable to hold the innocent spouse liable. Congress also instituted Section 6653(b) to relieve

the innocent spouse of the civil fraud penalty, even if the provisions of Section 6013(e) were not met.

The innocent spouse rule was only effective for those who could obtain relief at the time of the enactment and during any years retroactively permitted. For those who had received an adverse judicial decision or had permitted the statute of limitations to run, the innocent spouse rule was not applicable. The 1976 Tax Reform Act, however, changes this rule and permits any innocent spouse to file for a refund in any tax year beginning with 1962. This redetermination is permitted only for those who received an adverse judicial decision or allowed the statute of limitations on a refund action to run at the time of the rules' enactment in 1971. The taxpayer can file for the refund only during 1977 and cannot take advantage of the innocent spouse rule after January 1, 1978.

6.02 Waiver of the Statute of Limitations for Activities not Engaged for a Profit

Code Section 183(e) — Act Section 214

Effective Date: December 31, 1969

Section 183 of the Internal Revenue Code allows a deduction in certain circumstances from gross income for an activity not engaged in for profit. There are several presumptions which regulate the administration of the hobby loss deduction; mainly the activity is considered engaged in for profit when the activity's gross income exceeds the deductions two out of five consecutive taxable years. However, a taxpayer may elect to postpone final determination of this presumption until the end of a certain period, usually the end of the fourth year after the initial activity engagement. The 1976 Tax Reform Act has given the taxpayer added relief by extending the statute of limitations on the assessment for the deficiency until two years after the due date for the tax return on the last year of the determination period. Thus, a tax deficiency may not have to be paid until at least seven years after the initial engagement in the activity.

6.03 Income Tax Return Preparers

Code Sections 6060, 6107, 6109, 6696, 7407, 7427, 7701

— Act Section 1203

Committee Reports: S. Rep. No. 1236, 94th Cong., 2d Sess. 483 (1976); S. Rep. No. 838, 94th Cong., 2d Sess. 349 (1976); H. R. Rep. No. 658, 94th Cong., 2d Sess. 273 (1976)

Effective Date: December 31, 1976

The 1976 Tax Reform Act is an indication that Congress is attempting to reform the area which governs the liability of the income tax preparer. Prior to 1977, sections 7206 and 7207 were the only sections which regulated

the income tax preparer. However, these provisions only regulated willful conduct and the Internal Revenue Service had a difficult time enforcing those particular sections. Thus, Congress enacted new sections in order to give the Secretary more power to regulate the tax return preparers.

Under newly enacted Section 7701(a)(36), an income tax preparer is one who prepares fully or partially a return for compensation or employs another who prepares fully or partially for compensation. An income tax preparer is not one who furnishes mechanical or typing assistance, prepares a return for his or her fulltime employer, prepares a return for a trust and estate as fiduciary, or prepares a claim for a refund when the taxpayer is in the process of being audited or contesting a deficiency statement. An example of an income tax preparer would be one who for a fee gives sufficient advice to the taxpayer to make completion of the return a mere clerical exercise for the taxpayer. However, if the advisor gives advice on hypothetical matters not relating to the taxpayer's actual liability, the advisor is not an income tax preparer, even though he is paid a fee. A fee must have a monetary worth. A dinner, a vacation with no known monetary worth, or a minor service performed is not considered compensation.

Sections 6694, 6696, and 7427 all regulate the income tax return preparer's liability for understating the amount of the tax deficiency. If a person has prepared the return for compensation and has understated the liability, he is an income tax return preparer and is subject to a statutory fine. Section 6694(a) states that if the preparer negligently or intentionally disregards the regulations and rules governing the determination of the tax liability, the preparer is subject to \$100 fine if an understatement occurs. A good faith dispute over a statute's interpretation will not be grounds for the penalty. Both the Senate and House Committees believe that the dispute must be undertaken in bad faith to warrant liability.

Section 6694(b) states that if there is a willful and intentional attempt to understate the liability, the preparer is subject to \$500 fine. A willful understatement of liability is an intentional disregard of facts which causes either an understatement of the tax liability or an overstatement of the net amount refundable. A tax return preparer is also subject to a \$500 fine if he guarantees refunds. Section 6694, however, limits the amount of the penalty to \$500 even though the preparer is guilty of intentional disregard of the rules and regulations and intentional understatement of the liability. The burden of proof in an action for willful understatement of the tax liability lies with the government. The burden is on the tax preparer in an action for negligent or intentional disregard of the rules and regulations. The statute of limitations in an action for disregarding the rules is

three years. There is no statute of limitations on an action for willful understatement of liability.

Section 6107 requires that a copy of the tax return be presented to the taxpayer no later than the time he must sign the form for filing purposes. Failure to comply warrants a \$25 fine against the income tax preparer. The tax preparer is also required to retain a copy of the return for three years after the filing date (April 15) and he must be prepared to present the return to the Secretary for inspection. Failure to fulfill these requirements warrants a \$50 fine.

The income tax preparer is required under Section 6109(a) to disclose his identification number on the return. In many cases, the identification number will be the preparer's social security number. Section 6060 requires the income tax return preparer to file an information return which provides the name of the preparer, the preparer's identification number, and place of employment. If one employs several tax preparers, that person must file an information return for each employee. The employee does not have to file an information return even though he is an income tax preparer. Section 6695 provides that each violation of Section 6109 will cause the preparer to be fined \$100 minimum with each additional violation causing \$5 to be added onto the penalty. The maximum penalty is \$20,000.

If there is a penalty assessed against the income tax return preparer by the government, the government must give a notice and demand to the preparer. The preparer has two options. The first option is to pay the penalty and file for a refund within three years from the date of payment. Denial of the refund claim gives the preparer the right to appeal the administrative decision to the District Court. The second option is to pay fifteen percent of the penalty within thirty days of assessment and file for a refund at that time. Further collection on that penalty is delayed until after the refund claim is heard. Denial of the refund claim allows the preparer to file an appeal in the appropriate district court which will decide the entire amount of liability. It should be noted that payment of the penalty is not the final act in this area. If there is a judicial or administrative decision finding that the return does not declare an understatement of tax liability, the preparer will be entitled to a refund on the penalty paid.

Section 7407 permits the government to seek an injunction against an income tax return preparer prohibiting any future engagement in the field by the preparer because of conduct which is unbecoming a preparer. Specific types of conduct are: (1) failure to follow the rules and regulations governing disclosure; (2) negligent or willful disregard of the rules and regulations; (3) willful understatement of the tax liability; (4) criminal

conduct relating to tax matters; (5) misrepresentation of the preparer's eligibility for practice; (6) misrepresentation of his experience and education as an income tax preparer; (7) guaranteeing a tax refund payment; (8) allowing a tax credit; and (9) other conduct interfering with the administration of the internal revenue laws. The government may file the action in the district of the preparer's residence, preparer's principal place of business, or residence of the taxpayer with respect to whose return the action arises. The court has the power to enjoin the preparer from practice, active or passive, if the preparer is guilty of any form of conduct mentioned above. It should be noted that not only may the preparer be subject to criminal penalty for such conduct, the preparer may also be enjoined from the practice of income tax preparation. The preparer may prevent the institution of this action if he files with the Internal Revenue Service a bond of \$50,000 as surety for all penalties that might accumulate.

The 1976 Tax Reform Act has greatly reformed this area of the law. Prior to 1977, a tax preparer was subject to a limited amount of penalties which proved to be unenforceable. The Tax Reform Act has given the government power to penalize preparers for misconduct. Congress, in effect, is telling the preparers to watch their step.

6.04 Administrative Summonses

Code Sections 7609 and 7610 — Act Section 1205

Effective Date: December 31, 1976

Congress, in enacting the 1976 Tax Reform Act, attempted also to clarify the area of administrative summonses. Section 7609 states that if a summons is presented to a third party recordkeeper to compel the production of records made or kept of business transactions or affairs, notice must be given within three days to the person who is described in the summons as the principal party. A third party recordkeeper is defined as a savings and loan association, a cooperative bank, a mutual savings institution, a commercial bank, a credit union, a state or federally created savings institution, a credit bureau, consumer reporting agency, a broker, an attorney, or an accountant. Records are books, papers, and other data which pertain to the taxpayer's business transactions or affairs. Included in the notice to the taxpayer is a copy of the summons and directions on the method of staying compliance with the summons.

Notice to the taxpayer is accomplished in three ways: (1) by personal service on the taxpayer; (2) by certified or registered mail to the last known address; and (3) by personal service on the person summoned, if the person's whereabouts are unknown. The Service is permitted to forward the notice by registered or certified mail to the last known address of the fiduciary of

the taxpayer even if the fiduciary is deceased or incompetent. No notice is required for a "John Doe" summons, a summons to determine if business records do exist, or a summons used to identify a particular person.

The summons to be valid must identify the taxpayer, unless it is a John Doe summons, or the person to which the records pertain. The summons must also describe the records specifically enough in order to be located.

The taxpayer, upon receipt of the notice, the summons, and the description of the staying action, can personally intervene or give notice of noncompliance within fourteen days of notice. The notice of noncompliance must be given to the third party recordkeeper and to the appropriate office which the Secretary designates in the description of the staying action. Upon the issuance of the notice of noncompliance, the statute of limitations on civil actions, principally the assessment and collection of the tax liability, and the criminal prosecution are stayed. Furthermore, the Service cannot examine the records during the fourteen day period in which the taxpayer can file notice of noncompliance and cannot examine after the notice is given unless a judicial body rules such noncompliance is unreasonable.

The Service can apply to the court for a "John Doe" summons. The Secretary must establish that the summons relates to a particular person, ascertainable group, or ascertainable class of persons. Usually, the Secretary cannot specifically identify the person or persons described in the summons. The Secretary must prove to the District Court that there is probable cause to believe that there is in the process noncompliance with the Internal Revenue laws and that the information is not readily available from other sources. The court can issue a summons without notice if probable cause is shown.

"John Doe" summons usually are given in ex parte proceedings. The Secretary merely has to present a petition and affidavit to the court. Denial of the application is a final appealable order. Section 7609 further states that this type of proceeding will be given preferential treatment in the docket. The Secretary must file this action in the district where the taxpayer is residing or in the district where the taxpayer is found.

Section 7610 gives further powers to the Secretary in this area. The Secretary, after December 31, 1976, can establish a fee and cost rate schedule for witnesses in the actions concerning the business records. Fees and costs do include mileage, costs for locating records, and costs for the production of the records. The Secretary does not have to provide reimbursement if there is a proprietary interest in the records on the part

of the witness or the witness is an officer, employee, agent, accountant or attorney of the taxpayer.

**6.05 Public Inspection of the Internal Revenue Service's Determination Rulings, Technical Advice Memoranda and Determination Letters
Code Section 6110 — Act Section 1201**

Committee Reports: S. Rep. No. 1236, 94th Cong., 2d Sess. 474 (1976); S. Rep. No. 938, 94th Cong., 2d Sess. 303 (1976); H. R. Rep. No. 658, 94th Cong., 2d Sess. 312 (1976)

Effective Date: October 31, 1976

Effective as of November 1, 1976, any written determination issued by the Service and background file on the determination prepared by the Service will be open to the public's inspection. The public will be allowed to inspect the determinations made prior to November 1, 1976, subject to certain exceptions discussed later. For definitional purposes, a written determination is either a ruling, determination letter, or technical advice memorandum. The Senate Finance Committee further states that a written determination must contain the relevant facts, the applicable law, and the application of the law to the facts. A background file relates to the written determination and includes: (1) the request for the written determination; (2) any material which supports the request; and (3) any communication between the Service and an outside third party which concerns the written determination. It should be noted that the supporting material does not have to be written in a formal manner and that a communication between the Service and the Department of Justice does not have to be disclosed if it relates to a criminal or civil action or investigation. A background file does not include an internal memorandum concerning Internal Revenue Service's legal position on the matter.

In providing for public inspection, Congress intended to open to inspection only those documents which recite the relevant facts in a tax dispute, the applicable provisions of law, and the relation of the law to the facts. Documents which relate solely to the administration of tax laws in a specific situation, such as notices of deficiencies, claims for refunds and similar documents are exempted from the edict of Section 6110(a). Furthermore, a technical advice memorandum which is an item to be disclosed will not be subject to disclosure in a situation of civil fraud or criminal investigation or a situation concerning jeopardy or termination assessments. Disclosure is not required for a general written determination and related background file which affects a taxpayer's annual accounting period, a taxpayer's method of accounting, a partner's or partnership's taxable year, and the funding method of a qualified pension plan. This is subject to Section 6103 which requires the Service to disclose any documents which are the

subjects of a request made after October 3, 1976. A closing agreement which closes the taxpayer's tax liability is not a written determination. Further, disclosure of a compromise of liability will not be disclosed in its entirety, even though two executive orders require a summary of a compromise to be disclosed.

Prior to November 1, 1976, the Freedom of Information Act permitted nondisclosure in several situations. The reason was to prevent burdening the various agencies with mass disclosure. The 1976 Tax Reform Act has embodied these exemptions in Section 6110. The Internal Revenue Service will be allowed to: (1) delete the name, addresses, and other identifying details of the person referred to in the determination; (2) classify for nondisclosure any information concerning national defense or foreign policy; (3) suppress information exempt from disclosure under another federal statute pertaining to the Internal Revenue Service; (4) protect trade secrets or confidential and privileged financial information given by a third party; (5) protect by nondisclosure the personal privacy of those affected by the determination; (6) regulate without fear of nondisclosure any financial institution subject to the guidelines of an agency report; and (7) protect any information pertaining to geological and geophysical research. Concerning exemption (1) any information which may identify the subject of the determination will be governed by the standard of a reasonable person generally knowledgeable about an appropriate community. An example is a person knowledgeable of the automobile industry who can identify the company by referring to the contents of the written determination. The criteria which will help establish the determination of confidentiality in exemption (2) will be set forth by an executive order. In all other exemptions, the Service's regulations will establish the extent of the Service's power to delete or suppress. The Commissioner can also be required not to disclose if he (1) made a prior agreement; or (2) is subject to an order from the Tax Court not to do so. Failure to fulfill these past two requirements subjects the Commissioner to a civil action in the Court of Claims. The victim of the non-deletion has to prove a wilful or intentional failure to delete.

Once a request for disclosure is granted by the Service, the locations for inspection are in various areas. A written determination is available in the reading room at the issuing National or District Internal Revenue Offices. All rulings or technical advice memoranda are available in the Service's public reading room in Washington, D. C. A subject matter index will be available in the reading rooms but a specific index will not. Background files are not available in the public reading rooms.

Section 6110(f) requires the Service to notify the person concerned

that it intends to disclose the written determination. This section is effective only after November 1, 1976, and is not retroactive. Section 6110(f) also pertains to the disclosure of a background file. The person notified has sixty days to discuss with the Service any information to be deleted. Disclosure will not occur if there is a disagreement over several items of information. If there is an exhaustion of administrative remedies which would resolve the disagreements, the person who has an interest in the determination may file for a judicial determination of the disagreement. The statute of limitations is sixty days after the final intent to disclose given by the Internal Revenue Service. Notice must be given to the Commissioner who has 15 days to inform all others. Section 6110 does permit subsequent intervention, but once the original petition is filed, no subsequent petition can be filed. The Tax Court's decision will determine the extent of disclosure.

After the disagreements are settled and all parties agree to the disclosure, the determination will be made available for disclosure no earlier than fifteen days after settlement and no later than thirty days. If there has been a court action, then the Internal Revenue Service has thirty days to disclose the determination.

However, the final settlement of the disagreements for disclosure is subject to attack by third parties. Section 6110(f)(4) permits a third party to file administratively for additional information. Exhaustion of administrative remedies allows the third party to file in the Tax Court or the District Court for the District of Columbia. The action will be a *de novo* action and will be governed by the procedure of the Freedom of Information Act. The third party must notify the Commissioner who in turn must notify all interested parties. The Commissioner is not required to be an active participant nor is he liable for any additional disclosure. The statute of limitations for an action for additional information is three years after the disclosure of the determination.

Section 6110 permits a retroactive disclosure of determinations, but the exemptions which govern the disclosure after November 1, 1976, are different from those prior to November 1, 1976. One deterrent to disclosure is the amount of funds available to the Service for the specific purpose of disclosing prior determinations. If there are no funds, pre-November, 1976 determinations will not be disclosed. Disclosure, if there are funds, will be done on a priority basis. [The priority list begins with prior determinations issued under the 1954 Code and used as a reference for other determinations.] Those determinations begin with the most recent. General determinations or non-guideline determinations issued after July 4, 1967, will be the next priority. Third will be pre-1954 Code specific guideline determinations.

The pre-July 5, 1967 general determinations are last on the priority list and the requester is subject to a monetary charge.

There are other written determinations which are exempted from disclosure because under prior revenue laws the exemptions were in effect. They include: (1) exempt status of charitable organization determination; (2) letters and documents concerning the exempt status of a pension, profit sharing, or stock bonus plan or individual retirement annuity or account issued prior to September 2, 1974; (4) Commissioner approvals; (5) determination letters; and (6) background files for non-guideline written determinations prior to July 5, 1967. Notice of intent to disclose must be given by the Service in the Federal Register. The Service must also wait ninety days after notice is given before disclosing the material. A court action to prevent disclosure will toll the statute until final determination. The Service will have thirty days to disclose after the final determinations.

6.06 Minimum Exemption from Levy for Salaries, Wages, and Other Income

Code Section 6331(d)(3), 6334(d)—Act Section 1209

Effective Date: December 31, 1976

After 1976, there will be an exemption from federal tax levies on salaries, wages, and other income. This exemption is in addition to the exemptions which protect a portion of wages and salary designated by court order for child support. The exemption is \$50 per week plus \$15 for the spouse and each dependant. Notice must be given to the employer who must comply with the levy. Thus, if a taxpayer has a weekly income of \$350, and he has a spouse and four dependants, \$125 is exempt from the tax levy. Provision is made for those who are paid bi-monthly or monthly. The levy will be viable on all non-exempt income until the liability is extinguished or unenforceable.

6.07 Joint Committee Refund Review

Code Sections 6405(a)(c), 8023(a)—Act Section 1210

Effective Date: January 1, 1977

One of the duties of the Joint Committee on Taxation is the review of refund claims or income, gift, or estate credits in excess of \$100,000. The 1976 Tax Reform Act has expanded and limited the Committee's authority. The Act expands the refund review to pension plans and private foundations, but has limited the review to amounts in excess of \$200,000.

6.08 Jeopardy and Termination Assessments

Code Sections 7429, 6863(b)(c), 443(a), 6213(a) and 6851(b)—

Act Section 1204

Committee Reports: S. Rep. No. 484, 94th Cong., 2d Sess. 484 (1976); S. Rep. No. 938, 94th Cong. 2d Sess. 359 (1976); H. R. Rep. No. 658, 94th Cong., 2d Sess. 299 (1976)
Effective Date: December 31, 1976

Sections 6851, 6861, and 6862 permit the Secretary to make a jeopardy or termination assessment when the Secretary or his agents believe that a tax deficiency would be jeopardized if an assessment were not made immediately. These sections do not require judicial or administrative review of the assessments and do not restrict any means of collection upon the assessment by the Service. The termination restriction will create a shorter taxable year if the Secretary believes that the current year's deficiency will be jeopardized by concealment of property, flight of the taxpayer, or transfer of property to another.

The 1976 Tax Reform Act has changed the administration of the jeopardy and termination assesment. Under recently enacted Section 7429, the Secretary must provide various administrative remedies to the taxpayer and the latter, in turn, may file for a judicial determination in the appropriate District Court when all administrative remedies are exhausted. The Secretary, within five days of the initial assesment, must provide the taxpayer with a written statement outlining the assesment. The taxpayer then has thirty days to request an administrative review of the assesment, in which the Secretary must determine whether, under the circumstances, the assesment is reasonable and the amount assessed is appropriate. The taxpayer may file for a judicial determination within thirty days of the Secretary's ruling or within fifteen days of the filing for the administrative determination. The District Court has twenty days to determine the reasonableness of the assesment or the appropriateness of the amount assessed. The taxpayer can file for an extension of forty days if he has reasonable grounds to do so. If the District Court holds in favor of the taxpayer, it will order the Secretary to either abate such assesment, redetermine the assesmed amount, or take further appropriate action. The new Act states that the court's determination will be final with no right of apeal to a higher court.

Section 7429 also has instituted a new method in computing the time period for a determination of the review and determining the venue of the District Court. Weekends and holidays are included in the time periods except when they are the final days of the period. Venue is governed by 28 U.S.C. §1402 which states that venue will be in the taxpayer's residential district or, if a business, in the district where the principal place of business is or where the tax return is made.

Congress has also instituted a new burden of proof for a jeopardy or termination assesment. In an action determining the reasonableness of an

assessment, the burden is upon the Secretary. However, in an action determining the appropriateness of the amount assessed or demanded, the Secretary will provide information on his determination but the taxpayer will have the burden to prove the amount inappropriate. Congress has instituted the same burden as in the civil fraud action. The reason for the division of this burden of proof appears in the Senate Committee report which states:

The burden of proof as to the reasonableness of the assessment is placed on the Treasury Department because the making of a jeopardy or termination assessment involves more severe consequences to the taxpayer than a normal assessment . . .

The Committee Report, however, emphasizes that the analogy of this division in the burden to the civil fraud division does not carry over the civil fraud's standard of "clear and convincing" evidence. If the District Court orders a redetermination of the tax liability, a Section 7429 action will not affect the subsequent proceedings.

Prior to 1977, there were no restraints placed upon the government's attempts to levy on the taxpayer's property. The 1976 Tax Reform Act has placed several limitations on the levying upon property. Property cannot be sold unless it is perishable, the taxpayer consents to the sale, or the maintenance expenses are extremely high.

Section 6851 has also been amended by the 1976 Tax Reform Act. Congress, having enacted the procedure under Section 7429, amended Section 6851 to provide that a termination assessment does not terminate a taxable year, create a deficiency, or require the Service to give the taxpayer a notice of deficiency within sixty days of the assessment. A taxable year under the Reform Act will not end at the time of the assessment, but will continue until its normal end.

7.00 Loss

7.01 Net Operating Loss Carryovers

**Code Sections 172(b), 172(g), 812(b), 382, & 383 — Act Section 806
Effective Date: December 31, 1975**

Prior to January 1, 1976, an individual taxpayer or corporation who suffered a loss during that particular tax year was entitled under Sections 172 and 812 to carryback that loss for three years and to carryover that loss for five years. A regulated transportation company could carryover for seven years. The reason for this was to permit the taxpayer to deduct as much of the loss as possible. The 1976 Tax Reform Act has amended these sections and now permits the carryover period to be extended to seven years for individuals, corporations, and insurance companies, and nine years for

regulated transportation companies. The net operating loss carryback is now subject to an election by the taxpayer. However, if the taxpayer elects not to use the carryback period, he cannot extend his carryover period past the statutory limit.

The Tax Reform Act has also limited and expanded the amount of the loss available to the taxpayer. Under the previous Section 382(a), the carryover amount was controlled by a highly restrictive "purchase" rule. The carryover was eliminated if: (1) during the preceding two tax years fifty percent of the stock value changed hands, and (2) the trade or business of the corporation was changed by the stock transfer. This rule included a present shareholder increasing his ownership of stock by fifty percent. The Reform Act amends the purchase rule of Section 382 by (1) changing the period for the stock transfer prior to the loss from two to three years; (2) eliminating the changing trade or business determination; (3) amending the complete elimination of the net operating loss when the stock transfer increased the transferee's holdings by fifty percent by simply instituting a reduction in the amount permitted by statute; and (4) basing the stock holding increase as a percentage against either the value of the loss corporation's participating stock or the value of its entire stock.

In relation to above subsection (3), the amount of the carryover will be limited if one of the fifteen largest shareholders increases his holdings by 60 percent over a two-year period. The fair market value is eliminated as a determinant and the percentage is determined in accordance with above mentioned subsection (4). The increase in stock ownership results either (1) by purchase of the loss corporation's stock, stock of another corporation owning stock in the loss corporation, or interest in a partnership or trust owning stock in the loss corporation; (2) acquisition by contribution, merger or consolidation of an interest in a partnership owning stock in the loss corporation or acquisition by the same methods by a partnership; (3) liquidation of a partner's interest in a partnership owning stock in the loss corporation; (4) a decrease in the amount of the loss corporation's outstanding stock or the amount of the outstanding stock of the loss corporation's stock; or (5) a partial or total tax-free exchange of property for stock. Thus, if any of the preceding occurs and the increase amounts to over 60 percent, the net operating loss will be reduced by $3\frac{1}{2}$ percent for each percentage point which is greater than 60 percent but lower than 80 percent. For instance, if a shareholder increases his holdings by 65 percent, the net operating loss will be reduced by $17\frac{1}{2}$ percent or $3\frac{1}{2}$ percent multiplied by 5. Each point in excess of 80 percent will reduce the loss by $1\frac{1}{2}$ percent. However, if the shareholders owned at least 40 percent of the stock prior to the transfer there will be no deduction.

There are several types of transactions which are exempted from the purchase rule of the 1976 Tax Reform Act. The net operating loss will not be reduced if: (1) there are start up losses from a new corporation; (2) the transferee had constructively owned the stock prior to transfer; (3) there was an acquisition from an estate or by gift; (4) there was an acquisition by a creditor or a security holder in satisfaction of a claim; (5) there was an acquisition of stock for a key employee over a thirty-six month period; (6) there was an acquisition by a qualified employee retirement plan; (7) there was an acquisition by an investment credit ESOP; or there was an acquisition for a recapitalization controlled by Section 368(a)(1)(e). The new purchase rule is effective as of June 30, 1978.

Similar rules apply for mergers and tax-free reorganizations. Under the old law, if the shareholders of the merged or reorganized company retain less than twenty percent of the stock interest in the acquiring corporation, the net operating loss is reduced by five percent for each percentage point under 20 percent. There is no requirement that the merged company continue the same trade or business the previous companies maintained. The 1976 Tax Reform Act amends this rule and now requires that the shareholder retain at least 40 percent of the stock to qualify for the full net operating loss. The loss is reduced proportionately by $3\frac{1}{2}$ percent for each percentage point under 40 percent but greater than 20 percent and $1\frac{1}{2}$ percent for each percentage point under 20 percent. The reference for the value of stock owned is either the total value of the acquiring corporation's participating stock or the total value of the stock. This rule also governs the "stock for stock" exchange reorganization, the "triangular" reorganization, and holding company reorganization.

The Internal Revenue Service can deny any carryover if the transferee is attempting to avoid his tax liability by purchasing a loss corporation with a net operating loss. However, the Service must prove that the taxpayer has attempted to circumvent the purpose of the carryover restrictions.

8.00 Recapture

8.01 Recapture of Depreciation on Real Property

Code Section 1250 — Act Section 202

Effective Date: Taxable years beginning after December 31, 1975

Recapture is a concept which transforms what would ordinarily have been long term capital gain into ordinary income when certain depreciable assets are sold or exchanged. Section 1245, which applies to personal property, requires that all depreciation, whether straightline or accelerated, taken after January 1, 1963, be recaptured as ordinary income when the asset is sold. Section 1250 applies to real property and requires the recapture of

depreciation in excess of straight line taken after January 1, 1964. Again note that when dealing with real property only depreciation in excess of straightline is required to be recaptured.

For the period from January 1, 1964, to December 31, 1969, Congress made no distinction between residential and commercial property. One hundred percent recapture was required if the property was held twenty months or less, and the recapture percentage decreased by one percent for every full month the property was held after the initial twenty months. Therefore, there was no recapture of the excess of accelerated over straightline depreciation if the property was held one hundred twenty months (10 years).

The Tax Reform Act of 1969 provided for the full recapture of all accelerated depreciation in excess of straightline taken after January 1, 1970 on commercial or industrial real property. For residential real property there was a 100 percent recapture of the excess depreciation for the first one hundred months, and then the recapture percentage decreased by one percent per month for every full month the property was held after the initial one hundred months. Therefore, there was no recapture of the excess of accelerated over straightline depreciation deducted from January 1, 1970 through December 31, 1975, if the residential real property was held for two hundred months (16 years, 8 months).

Now the Tax Reform Act of 1976 eliminates the distinction between commercial, industrial and residential real property and provides that the excess of accelerated over straightline depreciation taken after December 31, 1975 will be recaptured in full at the time of sale. However, the declining recapture percentage rules which were in effect from January 1, 1970 through December 31, 1975, are continued for low-income rental housing if it qualifies under the National Housing Act property, or low-income housing rehabilitation expenditure property, under Section 8 of the Housing Act of 1937.

In all of the above calculations the amount of depreciation subject to recapture is limited to the lesser of the amount of depreciation taken during the applicable time period or the amount of gain upon the sale of the property as determined by deducting adjusted basis from the selling price. In calculating the recapture, the excess depreciation attributable to post December 31, 1975 years is recaptured first, followed by the excess for the period beginning January 1, 1970 through December 31, 1975, and finally the excess for the period commencing January 1, 1964 through December 31, 1969.

8.02 Amortization of Expenditures to Rehabilitate Low-Income Housing Code Section 167(k) — Act Section 203

Expenditures made or incurred prior to December 31, 1978 to rehabilitate low-income housing can be amortized over a sixty month period. This rapid amortization applies to expenditures between \$3000 and \$20,000 per dwelling unit. Low-income housing is defined by the Leased Housing Program under Section 8 of the Housing Act of 1937. This act section merely extends a program that was initiated with the Tax Reform Act of 1969.

9.00 Partnerships

9.01 Retroactive Allocation of Partnership Income or Loss

Code Sections 704(a) and 706(c) — Act Section 213

Effective Date: For tax years beginning after December 31, 1975

Congress amended the above code sections in an effort to reduce the amount of year-end acquisitions in tax shelters by a partnership interest. Prior to the Tax Reform Act of 1976, it was not uncommon for taxpayers to purchase an interest in a limited partnership in late December and, under the partnership agreement, be allocated the partnership's losses for the entire year, not just for the period in which the taxpayer held his partnership interest. Since case law was unclear and it was generally uncertain whether or not this could be done, the allocation of partnership losses to an incoming partner became a frequent source of confrontation between the Service and the taxpayer.

The Act specifically provides that the income or loss will be allocable to a partner only for the portion of the year for which he was a member of the partnership. There can be no retroactive allocation of income or loss prior to the date of entry into the partnership.

9.02 Special Allocation of Partnership Income or Loss

Code Section 704(b) — Act 213

Effective Date: For partnership taxable year beginning after December 31, 1975

Code Section 704(a) and (b) permitted a partnership agreement to establish different methods of allocating income, gain, loss, deductions, or credits. The regulations required that the allocations have a "substantial economic effect". In essence this meant that the allocation of dollars should correspond basically with the tax consequences thereof. Also, many limited partnerships engaged in the practice of allocating the net profit or loss differently for different years between the general and the limited partner. For example, in the early years when the limited partnership would be

incurring large amounts of construction period interest, taxes, etc., with little or no income, the net loss would be allocated almost entirely to the limited partners who had purchased their interest for this tax shelter. Subsequent to these loss years, the profits then would be allocated on some other basis, perhaps equally between the general and the limited partners. The statute has now been amended to disallow special allocations which lack a "substantial economic effect" so as to prevent the use of special allocations for tax avoidance or tax shelter purposes. However, the possibility of using these allocations where a genuine business purpose exists has been retained.

If the allocation based on the partnership agreement is disallowed, then the individual shares will be determined in accordance with the partner's interest in the entire partnership, taking into account all the relevant facts and circumstances. Some of the facts and circumstances to be considered include: the partner's interest in profits and losses, if different from that of the taxable income or loss; the cash flow to each partner, and the respective rights of each partner to a distribution upon liquidation of the partnership.

9.03 Treatment of Partnership Liabilities Where a Partner is not Personally Liable

Code Section 704(d) — Act Section 213

Effective Date: Liabilities incurred after December 31, 1976

Under pre-existing law, a partner's distributive share of the partnership loss was deductible by him only to the extent of his interest in the partnership at the end of the partnership year. However, a limited partner was permitted to add to his interest, not only his investment in the partnership, but also his proportionate share of all partnership liability, even though he was not personally liable on this indebtedness. This had the effect of materially increasing the number of deductions which could be passed through to a limited partnership, thereby facilitating the use of tax shelters.

Section 704(d) has been amended by adding a sentence which prohibits the inclusion in a partner's interest of any partnership liability for which the partner is not personally liable. Specifically exempted from this provision is any partnership which has as its principal activity investment in real property (other than mineral interest). Also exempted are those activities which are covered by the more extensive, at-risk provisions of Section 465. It is interesting to note that Section 704(d), as amended, is applicable to "any" partners, but Section 465 is made non-applicable to corporations, other than Subchapter S corporations and personal holding companies.

10.00 Depreciation

10.01 Basis Limitation for Player Contracts Transferred in Connection with a Sale of a Franchise

Code Section 1056 — Act Section 212

Effective Date: Sport Franchises purchased after December 31, 1975

To eliminate the problems which occurred under pre-existing law, Congress has set forth rules for determining the basis of player contracts. When a player contract is transferred as part of the sale of a sports franchise, the basis to the purchaser of each of the player contracts shall be the basis to the seller of the contract plus the amount of gain the seller recognized. The new law also establishes a presumption that no more than 50 percent of the consideration paid for the sports franchise can be allocated to player contracts. However, this presumption may be overcome if the purchaser can establish to the satisfaction of the Secretary of the Treasury that the amount in excess of 50 percent is justifiable.

10.02 Additional First-Year Depreciation Allowance for Partnerships

Code Section 179(d)(8) — Act Section 213

Effective Date: Tax years beginning after December 31, 1975

The additional or bonus first-year depreciation was designed to assist small businessmen in recovering the cost of new capital equipment. The statute provided that self-employed individuals filing a Schedule 1040(C) and filing a joint return, were entitled to a 20 percent additional depreciation on the first \$20,000 of equipment acquired during the year, or an additional depreciation of \$4,000. For corporate taxpayers, the limitation was a 20 percent bonus depreciation on the first \$10,000 of assets acquired, or an additional depreciation of \$2,000. However, for partnerships the rules were applied as to each individual partner. Therefore, if a partnership had ten individual partners and each individual partner filed a joint return, they were each entitled to a \$4,000 additional bonus depreciation, or a total additional first-year depreciation of \$40,000.

The Tax Reform Act of 1976 places an overall limitation of \$10,000 on the cost of assets to which the additional first-year depreciation is applicable. Now, the partnership and the corporation are on equal footing and the maximum amount of additional first-year depreciation is \$2,000 (\$10,000 of assets times 20 percent additional first-year depreciation.)

11.00 Amortization

11.01 Construction Period Interest and Taxes

Code Section 189 — Act Section 201

Committee Reports: S. Rep. No. 1236, 94th Cong., 2d Sess. 408 (1976); S. Rep. No. 938, 94th Cong., 2d Sess. 40 (1976); H. R. Rep. No. 653, 94th Cong., 2d Sess. 85 (1976)

Under prior law a taxpayer had the option of deducting or capitalizing real property taxes and the interest cost of carrying both unproductive land and property which was under construction. This option provided what was considered to be a tax loophole, in that many limited partnerships and other real estate ventures were able to deduct large amounts of interest and property taxes during the time that the facility was being constructed.

Congress, in reaction to these large deductions, now requires that the interest and taxes incurred during the construction period of the facility must be capitalized and amortized over a period of time in which it is being phased-in. This rule is applicable to interest and real property taxes on business or investment property during the period in which it is under construction.

If the property is sold before the interest and real property taxes have been fully amortized, then the unamortized amount will be added to the basis of the real property for purposes of calculating gain or loss. However, if the property is transferred in a tax-free exchange, such as a like-kind exchange or a transfer to a control corporation, where a carryover basis is involved, the taxpayer is required to continue to amortize the property for the remainder of the amortization period. The Act segregates the business investment property into three categories and sets different effective dates for each as follows:

- (1) Non-residential real estate for years beginning after December 31, 1975,
- (2) Residential real estate for taxable years beginning after December 31, 1977, and
- (3) Low-income housing for taxable years beginning after December 31, 1981.

Ultimately all construction period interest and taxes will be capitalized and then amortized over a ten-year period commencing with the taxable year in which the real property is ready to be placed in service or ready to be held for sale. However, Congress has authorized a seven year phase-in period for each of the three different types of investment property as set forth in the following schedule:

AMORTIZATION SCHEDULE

<i>Year</i>	<i>Commercial Real Estate</i>	<i>Residential</i>	<i>Low-Income Housing</i>
1977	20%	—	—
1978	16 2/3	25%	—
1979	14 2/7	20	—
1980	12 1/2	16 2/3	—
1981	11 1/9	14 2/7	—
1982	10	12 1/2	25%
1983	10	11 1/9	20
1984	10	10	16 2/3
1985	10	10	14 2/7
1986	10	10	12 1/2
1987	10	10	11 1/9
1988	10	10	10

For amounts paid or accrued for years commencing in 1976, 50 percent will be deductible in 1976, with the remaining balance being deducted equally over the following three years at the rate of 16 2/3 percent. This applies to non-residential realty. A committee report gives the following illustration of the phase-in:

Assume that \$120,000 of interest and taxes are paid or accrued in 1980 with respect to the construction of residential real estate (other than government subsidized) and that the property is ready to be placed in service in 1982. For taxable year 1980, the \$120,000 must be capitalized under this provision, but a deduction is to be allowed for \$20,000 (1/6 of the amount capitalized). The remaining \$100,000 (i.e. 5/6 of the total) is to be deducted ratably over a five year period beginning in 1982 (the year in which the property is placed in service). Thus, \$20,000 is to be allowed as a deduction for taxable year 1982 and each of the next four years.

Again, interest incurred after December 31, 1975 is deductible under the above rules and may be carried forward. The carry over of pre-1976 interest is deductible under the rules as set forth in the 1969 Tax Reform Act. It should be noted that the above limitations of \$25,000 and \$10,000 are reduced by 50 percent if a married individual is filing separate returns.

11.02 Preservation of Historical Structures

Code Sections 191, 280, 167(n), 167(o), 170(f)(3)(C) — Act Section 2124

Effective Dates as cited below

Congress has again turned to the tax statutes to achieve economic and social goals by giving out rewards and penalties for those who respectively

improve and maintain or destroy historical structures. Section 191(d) defines a certified historic structure as real property which is subject to the allowance for depreciation and which is listed in the National Register, is located in a Registered Historic District, and is certified by the Secretary of Interior as being of historical significance to the district, or is located in a historic district designated under a statute of the individual state or local government provided that such statute is certified by the Secretary of the Interior to the Secretary of Treasury as containing criteria which will substantially achieve the objective of preserving and rehabilitating buildings of historical significance.

Under existing law, a deduction is permitted for the expense of demolishing a building and also for the unamortized adjusted basis of the building if the property was not acquired with the intent of demolishing and removing the existing building. If a building located in a Registered Historic District is demolished without the prior certification of the Secretary of the Interior that such a building is not of a historical significance to the district, no deduction shall be permitted for the cost of demolition or for the unadjusted basis of the building demolished, and the cost thereof shall be added to the capital account of the land. In effect, this means that no immediate deduction is permitted nor is a deduction permitted for depreciation over the useful life of the newly constructed building. This section is effective for demolitions commencing after June 30, 1976 and before January 1, 1981.

Section 167(n) penalizes taxpayers who construct property on a site formerly occupied by certified historical structure, which was demolished or substantially altered, by denying the use of accelerated depreciation. Depreciation is thereby limited to the straight-line method for a structure constructed on the site of a former historical structure. This limitation on accelerated depreciation applies to additions commencing after December 31, 1975 and before June 15, 1981.

As an incentive to taxpayers to improve and rehabilitate historical structures, Congress has authorized the use of accelerated depreciation, 150 percent declining balance for commercial structures and 200 percent declining balance for residential buildings, if within the last 24 months the rehabilitation expenditures have exceeded the greater of taxpayer's adjusted basis in the structure or \$5,000. Under existing law, a taxpayer would be limited to straight-line depreciation for commercial buildings and 125 percent declining balance depreciation for residential property for any improvements made to used buildings for which he was not the original user. The adjusted basis, which is one of the determining factors as an alternate to \$5,000, is the adjusted basis on the first day of the 24-month period, which

ends on the last day of the taxable year. This section applies to additions occurring during the period of July 1, 1976 through June 30, 1981.

As an alternative to the accelerated depreciation, the taxpayer may elect to amortize the rehabilitation cost over a period of 60 months if the rehabilitation of the certified historical structure has been certified by the Secretary of the Interior to the Secretary of the Treasury as being consistent with a historical character of the property or with the district in which the property is located. It should be noted that the provision for rapid amortization is applicable only to the rehabilitation cost, not to the underlying historical structure. Upon sale, the amortization in excess of the depreciation which would otherwise be allowable, based on the historical structure, will be recaptured as ordinary income. This section applies to additions to the capital account made after June 14, 1976 and before June 15, 1981.

The third and last carrot held out to the taxpayer is the promise of a charitable contribution deduction of a lease, an option to purchase, or an easement in connection with real property for at least 30 years duration, which is granted to a charitable organization exclusively for conservation purposes. Also, a charitable deduction is authorized for a remainder interest in real property granted to a charitable organization for conservation purposes. The phrase "conservation purposes" means to preserve land for public outdoor recreation, education or scenic enjoyment, or to preserve historical lands, or structures or to protect the natural environment of the land. This charitable deduction applies not only to income tax, but also to the gift and the estate tax. This section applies to transfers made after June 13, 1976 and before June 14, 1977.

While the preservation of these historically significant structures is a desirable social goal, it appears that Congress has overlooked their goal of tax simplification by establishing a myriad of effective dates.

12.00 Property Acquired by Bequest, Devise or Inheritance

Prior to the Tax Reform Act of 1976, the basis of property acquired from a decedent was the fair market value at date of death or the alternate valuation date six months after death if the property was included in the decedent's gross estate. If the value of decedent's property had appreciated in value from the time it was purchased, the beneficiary of the property did not have to pay any income tax on this appreciation when the property was sold. Therefore, it was common to refer to inherited property as taking a "stepped up basis." This is in contrast to gift property which had a basis to the donee of the donor's basis plus any gift tax paid. Here the basis of gift property was referred to as "carryover basis."

The 1976 Tax Reform Act eliminates the stepped up basis of property acquired from decedents and substitutes the concept of carryover basis property. In general the basis of carryover basis property for decedents dying after December 31, 1976 will be the decedent's basis immediately before his death with certain adjustments.

Excluded from the definition of carryover basis property are the following:

- (1) Life Insurance proceeds
- (2) Income in respect of a decedent. (Section 691)
- (3) Joint and survivor annuities taxed under Section 72
- (4) Deferred compensation and stock option plans, if income to beneficiary
- (5) Property transferred within three years preceding death (Section 2035)
- (6) Stock in a personal holding company
- (7) Personal and household goods, such as clothing, furniture, sporting goods, jewelry, collections of coins, stamps or firearms, silver, china, crystal, cooking utensils, books, cars, television, stereo equipment, etc.
 - a. An executor is permitted to exclude \$10,000 worth of these personal and household goods from the effect of the carryover basis rules by electing which items are not to receive carryover basis treatment
 - b. These items will receive a stepped up basis as under pre-1976 Tax Reform Act law. Note that basis cannot exceed fair market value at date of death.

(1) *Adjustment to Basis of Carryover Basis Property:*

For the purpose of determining gain, but not loss, on any property acquired prior to and held by decedent on December 31, 1976, all taxpayers are provided with a "Fresh Start." Note that *Fresh Start* applies to property acquired by decedent from a prior decedent or donor who held the property on December 31, 1976.

- a. All marketable bonds and securities which are listed on any national, city or regional exchange for which quotations appear on a daily basis are to be taken on a basis equal to the market value at December 31, 1976.

Example: IBM stock acquired by decedent in 1930 for \$30, valued at \$270 on December 31, 1976 and valued at \$476 on June 15, 1987 when decedent dies has a basis of \$270.

- b. All other property, whether it be closely held corporation stock, a house, land, equipment, an apartment or commercial building is valued at decedent's original acquisition cost increased by that por-

tion of the appreciation in value from acquisition to date of death which is applicable to the period held from acquisition to December 31, 1976. The formula assumes a linear appreciation throughout the entire holding period. The formula for non-depreciable property is:

$$\begin{array}{r} \text{Decedent's Basis} \\ + \text{Fair Market Value at Death} \\ - \text{Decedent's Basis} \end{array} \quad \begin{array}{r} \text{Number of days property} \\ \text{X held prior to 12/31/76} \\ \hline \text{Total number of days property held} \end{array}$$

Illustration:

Fair Market Value at Death		\$25,000
Decedent's Basis		10,000
Date of Acquisition	1/1/73	
Date of Death	12/31/82	
Holding Period before	12/31/76	4 years
Total Holding Period		10 years
Fair Market Value at	12/31/76	\$20,000
Basis = \$10,000 + (\$25,000 — 10,000 × 4/10)		
Basis = \$10,000 + (\$15,000 × 40%)		
Basis = \$10,000 + \$6,000		
Basis = \$16,000		

If depreciable property is involved the calculation takes on an additional complexity. The Formula is:

$$\text{Multiply: Decedent's Basis (at Death) + Number of Days Property held prior to 12/31/76}$$

$$\text{Number of Days property held}$$

by

$$\begin{array}{r} \text{Value at Death} \\ - \text{Decedent's Basis} + \text{Depreciation by 12/31/76} \\ \hline - \text{Total Depreciation} \end{array}$$

Illustration:

Fair Market Value at Death	\$60,000
Decedent's initial cost	30,000
Depreciation to date of Death	5,000
Depreciation to 12/31/76	4,000
Total Holding Period	5 years
Holding Period to 12/31/76	4 years
Decedent's Basis at Death (\$30,000—\$5,000)	\$25,000
\$25,000 + 4/5 × (\$60,000—\$25,000—\$5,000) + 4,000	
\$25,000 + (4/5 × \$30,000) + \$4,000	
\$25,000 + \$24,000 + \$4,000	
Basis to Distributee = \$53,000	

Note: The above complex calculations are required because Congress wanted to avoid the inconvenience to taxpayers which would be necessitated by requiring an appraisal of all property held on December 31, 1976.

(2) *Adjustment for Federal and State Estate Taxes:*

To eliminate the inequity of requiring taxpayers to pay both an estate tax and an income tax on the appreciation in value of each asset, the carry-over basis is increased by the estate taxes, both federal and state, paid by the estate, *attributable to the appreciation*.

Note: The basis is not increased by the total estate taxes paid, but only the estate taxes attributable to the appreciation from date of acquisition to date of death.

Note: This adjustment is applicable only to property which is subject to the estate tax. Therefore, property for which a marital deduction or charitable contribution is allowed does not qualify for this adjustment. The formula is:

$$\frac{\text{Net Appreciation}}{\text{Value of Property Subject To Estate Tax}} \times \text{Total Estate Taxes}$$

Illustration:

Value of Stock at Death	\$250,000
Decedent's Basis (Cost)	50,000
Estate Tax on \$250,000	70,800

$$\frac{200,000}{250,000} \times 70,800$$

$$80\% \times 70,800$$

$$56,640 = \text{Adjustment for Federal and State Estate Taxes}$$

(3) *Adjustment for \$60,000 Minimum Basis:*

The 1976 Tax Reform Act provides that the total basis of all property may be increased to \$60,000 minimum basis. Only property covered by the carryover basis rule is considered for this adjustment. Therefore, the personal and household property of up to \$10,000 is not included in this computation.

The sequence in which the four adjustments are made is vital in that the \$60,000 minimum basis is applied only after the fresh start basis is calculated and then increased by the federal and state estate taxes.

Example 1: Assume the fresh start basis of the property is \$53,000 and the applicable federal and state estate taxes are

\$5,000. The adjustment for the \$60,000 minimum basis is limited to \$2,000 [$\$60,000 - (\$53,000 + \$5,000)$]

Example 2: If the fresh start basis in the preceding example was \$55,000 or more and the federal and state estate taxes remained at \$5,000, no minimum basis adjustment is permitted.

Note: This adjustment is applicable only when the total of the basis of all the individual assets in the estate, after adjustment for federal and state estate taxes, is less than \$60,000. Again, the \$60,000 minimum basis refers to basis, not the fair market value used for valuation of the gross estate.

This adjustment is prorated to all the individual assets based on the following formulae:

$$(60,000 - \text{Total Basis}) \times \frac{\text{net appreciation of each carryover basis asset}}{\text{total appreciation of all carryover basis assets}}$$

Illustration:

Estate Consisting of	(1) Carryover Basis	(2) F.M.V. at Death	(3) Appreciation (Col. 2 - Col. 1)	(4) Minimum Basis Adj.	(5) Distribution Basis (Col. 1 & Col. 4)
(1) Stock (XYZ Co.)	40,000	75,000	35,000	(1)7,000	47,000
(2) Lot-Sand Dune Estate	10,000	25,000	15,000	(2)3,000	13,000
	50,000	100,000	50,000	3,000	53,000

$$(1) (60,000 - 50,000) \times \frac{35,000}{50,000}$$

$$10,000 \times 7/10 = 7,000 = \text{minimum basis adjustment}$$

$$(2) (60,000 - 50,000) \times \frac{15,000}{50,000}$$

$$10,000 \times 3/10 = 3,000 = \text{minimum basis adjustment}$$

(4) *Adjustment for State Succession Taxes:*

The fourth and final adjustment to basis of carryover basis property is for state estate inheritance, legacy and succession taxes attributable to the appreciation paid by the distributee of the property for which the estate is not responsible. This adjustment applies only to property which is subject to the tax. If inheritances by a minor are exempt from the estate tax, no adjustment is permitted for assets passing to the minor. The formula for the adjustment is:

$$\text{State Succession Taxes Paid} \times \frac{\text{Appreciation of each asset received}}{\text{Total Appreciation of all assets received}}$$

Adjustment Summary:

All adjustments are required to be made in the order as set forth here.

There is an overall limitation on the amount of adjustments, in that the adjusted basis *cannot* exceed the fair market value of the property. Fair market value is deemed to be the value as reported on the federal estate tax return, whether this value is at date of death, the alternate valuation date six months later, or the special value of a farm or closely held business.

Note: If the property passing from the estate to the beneficiary would have been subject to the recapture provisions of Section 1245 and Section 1250 had the decedent sold the property prior to the death, the recapture potential will pass to the beneficiary and upon sale by the beneficiary will convert what would have been capital gain into ordinary income.

The preceding rules are applicable to property given by decedent within three years of death per Section 2035 provided the donee has not disposed of the gift property prior to decedent's death.

Property Acquired by Gift:

Section 1015 provides that the donee's basis of property received by gift is the same basis as it was in the hands of the donor, increased by the amount of gift tax paid on the net appreciation in value from date acquired by donor to date of gift. This is the rule if gain is to be calculated. If a loss is incurred by the donee upon sale, the rule is that the donee's basis is the same as in the hands of the donor or the last preceding donor by whom it was acquired by gift, or the fair market value at the time of gift, whichever is lower. Also, we shall see that it is possible to have neither a gain nor loss on the sale by a donee.

For the purpose of determining gain, the following formula applies:

$$\text{Basis to Donee} = \text{Donors Basis} + \text{Gift Tax} \times \frac{\text{Fair Market Value at Date of Gift} - \text{Basis}}{\text{Fair Market Value of Gift}}$$

Illustration:

Cost	20,000
FMV at Date of Gift	100,000
Unified (Gift) Transfer Tax	23,800

$$\begin{aligned}
 &= 20,000 + 23,000 \times \frac{100,000 - 20,000}{100,000} \\
 &= 20,000 + 23,800 \times \frac{80,000}{100,000} \\
 &= 20,000 + 23,800 \times 80\% \\
 &= 20,000 + 19,040 \\
 &= 39,040
 \end{aligned}$$

Illustration:

Assume that Albert purchased bonds for \$2,000 five years before making a gift to Bob. At the time of the gift, the bonds had a fair market value of \$1,600. Also assume for this illustration that no gift tax was paid by the donor.

For determining gain, the donee's basis is \$2,000.

For determining loss, the fair market value at the date of gift was less than the basis in the hands of the donor, \$1,600.

If the donee sells the bonds for \$2,400, his gain is \$400 (\$2,400 — \$2,000).

If the donee sells the bonds for \$1,400 his loss is \$200 (\$1,600 — \$1,400).

If the donee sells the bonds for any amount between \$1,600 and \$2,000 there is neither gain nor loss.

