REVENUE ACT OF 1978*

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INTRODUCTION

THE REVENUE ACT OF 1978 is a continuation of Federal Income Tax Developments: 1978 which appeared in the Fall, 1978 issue of the Akron Law Review. This survey examines the substantive changes in federal tax law resulting from the passage of the Revenue Act of 1978 and other legislation. This author has again engaged the most able assistance of several members of the Akron Law Review. Without their substantial contributions and complete dedication, this article would not have been possible. Special appreciation is extended to Linda Robison for her dedicated efforts.

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1.01 Carryover Basis Rules Suspended

Code Sections 691, 1023—Act Section 515

Effective Date: Decedents Dying after December 31, 1976

Prior to the Tax Reform Act of 1976, effective January 1, 1977, the basis of property received from a decedent in the hands of the recipient, heir, devisee, or legatee, was equal to the fair market value at the date of death or the alternate valuation date six months later. This was referred to as stepped-up or stepped-down basis. The actual cost to the decedent had no relevance to the basis in the hands of the recipient beneficiary. As the quid pro quo for the increase in the amount of the estate tax exemption from $60,000 to $175,000 by 1981 and the increase in the marital deduction to the greater of one-half of the adjusted gross estate or $250,000, Congress, in the Tax Reform Act of 1976, substituted the concept of carryover basis for the old stepped-up basis rules for decedents dying after December 31, 1976.

The basis to the beneficiary for property acquired after December 31, 1976, received from a decedent dying after that date would be equal to the decedent's cost, or adjusted basis. The result of this change and its effect on the beneficiary can be illustrated by an example where a father originally acquired a parcel of land at a cost of $10,000 and at the date of the father's death the land had a value of $100,000. If the decedent died prior to January 1, 1977, the basis to the heir would have been the fair market value at date of death, or $100,000. However, after the Tax Reform Act of 1976 the basis to the father of $10,000 would be carried over and would become the basis to the beneficiary. The result of the step-up in basis was that prior to January 1, 1977, the beneficiary who sold the property for an amount equal to the fair market value at the date of death, or $100,000. However, after the Tax Reform Act of 1976 the basis to the father of $10,000 would be carried over and would become the basis to the beneficiary. The result of the step-up in basis was that prior to January 1, 1977, the beneficiary who sold the property for an amount equal to the fair market value at the date of death or the alternate valuation date six months later had no income tax liability as a result from the gain. After January 1, 1977, the beneficiary would have a taxable gain equal to the difference between the selling price of $100,000 and the basis of $10,000 or a gain of $90,000. This gain, of course, would qualify for long-term capital gains treatment assuming that the asset was a capital asset and had been held for the requisite holding period.

For property which was acquired prior to January 1, 1977, and the decedent died after that date, the concept of a fresh start basis was introduced by the Tax Reform Act of 1976. The fresh start basis of stock or securities which were listed on a recognized exchange took a basis equal to their value on December 31, 1976. Other properties such as land, farms, apartment houses, office buildings, automobiles, antiques, etc. required a special calculation to determine their fresh start basis. The basis of these
assets in the hands of the beneficiary was equal to the decedent’s cost plus a portion of the appreciation equal to a fraction, the numerator of which was the number of days held from date of acquisition by decedent to December 31, 1976 over a denominator which was the total number of days the property was held from date of acquisition until decedent’s death times the appreciation in value from acquisition until death. An illustration of this calculation is set forth below:

The formula for non-depreciable property is:

\[
\text{Decedent's Basis} + \text{Fair Market Value at Death} \times \frac{\text{Number of days property held prior to 12/31/76}}{\text{Total number of days property held}} - \text{Decedent's Basis}
\]

**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 \times 4/10) |
| Basis = $10,000 + ($15,000 \times 40\%) |
| Basis = $10,000 + $6,000 |
| Basis = $16,000 |

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

Multiply: Decedent’s Basis (at Death) + Number of Days Property held prior to 12/31/76 

\[
\frac{\text{Value at Death} - \text{Decedent's Basis} \times \text{Depreciation by 12/31/76}}{\text{Total Depreciation}}
\]
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 \rightarrow $5,000) 25,000  

\[ \begin{align*} 
\text{Basis to Distributee} &= \frac{4}{5} \times (60,000 - 25,000 - 5,000) + 4,000 \\
&= 25,000 + (4/5 \times 30,000) + 4,000 \\
&= 25,000 + 24,000 + 4,000 \\
&= 53,000 
\end{align*} \]

To the fresh start basis as calculated under one of the preceding two methods was added an adjustment for federal estate taxes, an adjustment for a $60,000 minimum basis and an adjustment for state succession taxes.

The carryover basis rules and the fresh start basis rules have probably generated more criticism and valid complaint from the practitioner than any other Code section or revision resulting from the Tax Reform Act of 1976. It placed an almost unworkable burden upon practitioners to attempt to determine the decedent's original cost. In addition, the inartful drafting of the Code sections resulted in many practical problems that surfaced after the law was enacted. The reader should remember that the Tax Reform Act of 1976, as well as the Revenue Act of 1978, were enacted without public hearings where practitioners and other tax experts could have had the opportunity to review the proposed drafts of the legislation and submit comments prior to enactment. This has proven to be a serious deficiency in our legislative process in a field as vitally important as taxation. It is impossible to estimate the millions of dollars and hours that have been spent by practitioners in the field of taxation in an attempt to solve and to comply with what the government has thrust upon us.

As a result of the problems which surfaced in the committee hearings, the Revenue Act of 1978 retroactively suspends the carryover and fresh start basis rules for decedents dying from January 1, 1977 through December 31, 1979. Therefore, the stepped-up basis rules under prior law are applicable and have been reinstated.

As a result of this retroactive change it will be incumbent upon beneficiaries and heirs who have sold property prior to the effective date of the Revenue Act of 1978 to amend returns and recalculate their gain or loss.
To the extent the selling price was equal to the fair market value at date of death or six months later, as used on the federal estate tax return, no gain or loss is recognized.

Estates of decedents which held flower bonds which were used to pay federal estate taxes should file amended returns since the value of the flower bond for determining basis will be equal to the bond's face value. The retroactive reinstatement of the carryover basis rules creates a problem where the fresh start basis or the decedent's basis exceeded the estate tax value of the asset in question. The Senate proposed that taxpayers should have an option to elect whether to use fresh start or carryover basis. However, this proposal was eliminated at the conference level. Some commentators and Congressmen have indicated that there will be some type of legislation to clear up problems which resulted during the period when fresh start and carryover basis rules were in effect. It would also appear that the taxpayer has no constitutional right to utilize a law which has been revised retroactively.

It should also be noted that although the rules have been suspended until December 31, 1979, the fresh start date is still December 31, 1976. The Act also provides a simplified method of determining the fresh start value for tangible personal property through the application of a proximate 8% discounted value from fair market value at the date of decedent's death. The value is determined as of death and then discounted for the number of years that it was held prior to death to eliminate the problem of determining decedent's actual basis. The Act also clears up the question of whether or not a different fresh start calculation was required depending on whether the asset was sold at a gain or at a loss. The Act states that the basis will be the same under fresh start calculations for both a gain and loss.

1.02 Special Use Valuation—Effect on Pecuniary Bequest

A pecuniary bequest is one which sets forth a specific amount as the bequest. This is in contrast to describing the bequest or devise in terms of a fraction of the entire amount. If the devise or bequest of a specific amount is satisfied in kind with property which has appreciated in value from the value which was used for estate tax purposes, taxable gain results to the estate. The Tax Reform Act of 1976 addressed itself to the problem of whether or not gain should be recognized from the carryover basis value to the value of the pecuniary bequest and indicated that no gain would be recognized due to the establishment of carryover basis. However, the Reform Act did not answer the question of what occurs when special use valuation
is elected for farm or closely held businesses and this property is distributed
to an heir in satisfaction of a pecuniary bequest.

The Revenue Act of 1978 clears up any question as to this matter and
states that gain will be recognized only to the extent that the date of distri-
bution value exceeds the fair market value at date of death, irrespective of
whether or not the Section 2032 special use valuation was utilized for estate
tax purposes.

1.03 Transfers Within Three Years of Decedent's Death—$3000
Annual Exclusion

Code Section 2035(b)—Act Section 702(f)
Effective Date: Decedents Dying after December 31, 1976 or
Transfers Made after December 31, 1976

Prior to the Tax Reform Act of 1976 there was a rebuttable presump-
tion that transfers made within three years of a decedent's death were made
in contemplation of death and, therefore, were includable in the decedent's
estate for estate tax purposes. This presumption gave rise to a great amount
of litigation and the Tax Reform Act of 1976 removed the presumption
and changed the law to provide for automatic inclusion in a decedent's
estate of all transfers made within the three years preceding death. A gift
within this three-year period that had a value at the time of gift and at
the time of death of less than $3,000 was excluded based on the $3,000
annual per donee exclusion.

However, the Tax Reform Act left a great deal of confusion as to the
status of gifts which had a value of less than $3,000 at the time of gift
but a value in excess of $3,000 at the date of the decedent's death.

The Revenue Act of 1978 provides an exclusion for any gift which
is excludable in computing the taxable gifts by reason of Section 2035(b)
which relates to the $3,000 annual exclusion. The Senate committee report
explains this provision as meaning that if a transfer is required to be re-
ported on a gift tax return, the gifts made within three years of decedent's
death are required to be included in the decedent's gross estate. By impli-
cation, in the event the gift was less than $3,000 and no gift tax return
was required to be filed, nothing is to be included in decedent's estate even
if the gift property appreciates in value to an amount in excess of $3,000
as of the date of decedent's death. The Senate committee report specifically
mentions that this exception is not applicable to a gift of a life insurance
policy. If a share of stock with a value of $3,001 is given and donor dies
within three years when the stock has a fair market value of $10,000,
the entire $10,000 is includable in the decedent’s estate. There is no
provision in the Revenue Act of 1978 which permits the gross amount
at date of death to be reduced by the $3,000 annual exclusion. When a gift is made, the actual amount of the gift as shown on the gift tax return is reduced by the annual exclusion of $3,000.

However, if the stock had a value of $2,999 at the time of the gift and at the date of decedent’s death had appreciated to $100,000, nothing is includable in the decedent’s estate. The test is whether or not at the time of gift, a gift tax return was required to be filed. If a life insurance policy with a cash surrender value (interpolated terminal reserve value) of $2,900 and a face value of $100,000 is the subject matter of a gift, the entire face value of the policy $100,000 is includable in decedent’s estate if death occurs within three years after making the gift.

If a husband and wife make a gift of $6,000, they are entitled under Code Section 2513 to elect to split the gift so that in effect the gift, for gift tax return purposes, has been made $3,000 by the husband and $3,000 by the wife even though the entire amount of funds came from one of the spouses individually. Since the election to split the gift can be made only by the filing of a return, the full amount of the gift corpus is required to be included in the decedent’s estate in the event of death within three years.

The Senate committee report indicates that the rule as to life insurance does not apply to any premiums paid by the decedent within three years of death if such payments would not have caused inclusion under pre-existing law. This comment is merely reflective of the status of the law on transfers of life insurance outside a three-year period immediately preceding the decedent’s death where the decedent continues to pay the premiums. Although the premiums paid within the three-year period are includable in the estate, no amount of the face value is included.

The $3,000 annual exclusion can be used only for gifts of a present interest. The annual exclusion cannot be used to offset a gift of a future interest where possession or enjoyment is limited to commence at some time in the future. Therefore a gift of a $1.00 future interest would require the filing of a gift tax return and the inclusion of the value of the gift corpus in the decedent’s estate, based on the date of death value.

1.04 Joint Property—Spousal Participation in Business or Farm of Decedent

Code Section 2040—Act Section 511

Effective Date: Decedents Dying after December 31, 1978

Section 2040(c) of the estate and gift tax provisions provides a statutory alternative to the “consideration furnished test” which has developed under Section 2040(a). Under old law the surviving spouse of a farmer or business owner was required to prove that he/she satisfied the “consideration furnished test” for the land or other business property included in the joint
tenant's gross estate in order to exclude any of the property from the deceased's estate. Such proof is not always an easy task.

The court decisions have interpreted what is meant by the "money or money's worth" provisions of Section 2040(a) in several ways. Cases have inconsistently defined what is adequate consideration when such consideration is the result of services performed by the surviving spouse, mortgages and loans received jointly, and income from property purchased by the deceased spouse, yet managed by the surviving spouse.

Under the Revenue Act of 1978 the decedent's estate may elect the statutory exclusion of Section 2040(c) which is determined by applying a two percent rate to the excess of the value of the joint interest over the amount of the original consideration for each year the spouse materially participated in the business, subject to a fifty percent limitation. For purposes of this statute, original consideration includes the actual amount contributed by the surviving spouse plus six percent simple interest for the period of the investment. Although such statutory provision simplifies the burden of proof on decedent's estate in showing that the decedent did not furnish all the consideration, situations may arise in which a greater exclusion could be obtained under previous law, particularly if the surviving spouse does not meet the "material participation" requirement.

This new subsection (as provided in Section 2040(c)(9)) is elective. Logically, if the estate does not elect the provision, the estate would still have the alternative of proving consideration furnished as developed by case decisions under Section 2040(a). In those situations where the exclusion under 2040(a) would be greater than that allowed under 2040(c), the estate would not elect the new subsection.

A 1934 United States Court of Claims decision\(^1\) held that a school teacher wife's services to her attorney husband in managing property which they purchased as joint tenants and in helping her husband in his law practice were not consideration for the jointly purchased property. All the property was included in the deceased husband's estate. If under the new statute the wife could show material participation,\(^2\) the estate could have excluded two per cent of the value of the joint interest for each year she materially participated up to fifty percent of the total value of the property.

Since that time the Tax Court, as well as circuit and district courts, has been more liberal in construing what is meant by money's worth and have eased the requirements for satisfying the estate's burden of proof.

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1 Bushman v. United States, 8 F. Supp. 694 (Ct. Cl. 1934).
2 Material participation is determined in a manner similar to the manner used for purposes of Section 1402(a) relating to net earnings from self employment.
In *Estate of Otte*, a husband and wife operated a farm for forty-five years on land originally purchased by the husband for $9,000. With income received from the farm, the two purchased other property. Although the Service contended that all such property belonged in the husband’s estate, the Tax Court included only one-half. Under the new statute, the result would have been the same as long as the wife materially participated for at least twenty-two and a half years of the forty-five years.

Similar results were reached in the Third Circuit where a peddler and his wife started a grocery store. Although there was no partnership agreement, half of the business was considered as belonging to the wife. The court rejected the Service’s contention that the wife made a gift of her services to the husband who in turn gifted one-half of the joint tenancy property to her.

Although there have been no cases defining original consideration for Section 2040(c) purposes, cases under Section 2040(a) have defined original consideration. There appears to be no viable reason for not determining original consideration in the same manner for Section 2040(c). A case, *Bremer v. Luff*, interpreting original consideration, has held that where a husband and wife are both personally liable on an existing mortgage, jointly assumed, and one was not merely an accommodation maker of the other, each is treated as having made an original contribution to the extent of one-half the mortgage.

In *Drummond’s Estate v. Paschal*, a district court held that where a husband and wife were each personally liable on an unsecured note for construction of rental property, and the rental proceeds received on the completed property then paid off the loan, only half of such property should be included in the deceased spouse’s estate.

If Section 2040(c) had been applicable in *Bremer* and the wife did not materially participate, one-half the mortgage plus six percent simple interest for the period of the investment would have been excluded from the estate. The *Bremer* decision did not address the question of what extent appreciation of the property would be attributed to the wife’s share.

A greater portion of the property value would have been included in the deceased’s estate under Section 2040(c) than in *Drummond’s Estate* if the wife had not materially participated and the increase in value of the property had been more than six percent. Although the burden of proof

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4 Berkowitz v. Commissioner, 108 F.2d 319 (3rd Cir. 1939).
5 7 F. Supp. 148, 156 (N.D.N.Y. 1933).
6 75 F. Supp. 46 (E.D. Ark. 1948).
is on the decedent's estate to show that the deceased did not furnish all
the original consideration, the Tax Court has been very liberal in this
regard. In Estate of Carpousis, the Tax Court accepted the uncorroborated
testimony of a widow of a joint owner that she furnished the money portion
of the consideration.

Section 2040(c) requires that the spouse of the decedent materially
participate in the farm or other business. This terminology raises the question
of what constitutes material participation. Section 2040(c)(7) provides
that material participation shall be determined in a manner similar to the
test used for purposes of Section 1402(a) relating to net earnings from
self-employment.

Logically, the way in which Section 1402 defines material participation
should provide the answer. However, the material participation language
discussed in Section 1402(a) of the Self Employment Contribution Act
refers to rental income derived by the owner or tenant of land from an
arrangement whereby the owner or tenant materially participates in the
production or the management of the production of such agricultural or
horticultural commodities and with respect to any such agricultural or horti-
cultural commodity. The Regulations provide that the individual is materially
participating and farm rental income counts for Social Security purposes
if the rental arrangement provides for a significant part of production or
management activities. If the individual meets one of the following four
tests, he is said to be materially participating:

Test 1: He/she does three of the four following activities; consults
with the tenant, furnishes tools, equipment and livestock, or shares produc-
tion expenses.

Test 2: Frequently and regularly makes decisions which affect the
success of the farm operation.

Test 3: Takes part in the work by working at least 100 hours over
five or more weeks in work connected with crop production.

Test 4: Test one, two, and three may be considered together to con-
stitute material participation.

Since material participation thusly determined does not address the
material participation requirement for a husband and wife in joint tenancy
property, Congress undoubtedly was referring to the line of cases related
to Regulation Section 1.1402(a)(2) which has determined whether a

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8 Treas. Reg. § 1.1402(a).
husband or wife in a jointly owned and operated business or farm is required to pay self-employment tax or is entitled to receive benefits under the Social Security Act.

Although the Social Security Administration contends that in order for both husband and wife of a jointly owned and operated business to be credited with self-employment income, the business must be operated as a partnership within the meaning of Section 211(a) and 211(d). Section 211(d) provides that the term "partner" and "partnership" have the same meaning as used in Subchapter K of the Internal Revenue Code. Neither all the cases arising under the Social Security Act nor the cases arising under Section 2040(a) of the Internal Revenue Code have required a formal partnership arrangement. However, Regulation 1.402(a)-2(f) does provide that partners not recognized as such for income tax purposes, as in the case of certain family partnerships, would not be recognized for self-employment tax either.

In *Rasmussen v. Gardner*, the court held that the existence of a partnership is not a necessary condition of dividing self-employment income. In *Rasmussen*, the Tenth Circuit allowed the husband to file amended returns on behalf of his deceased wife in order to obtain Social Security benefits for their children. The court stated that even if the husband had, in paying the self-employment tax, deliberately claimed all the income of the family business for himself, such was only the assertion of a position which may have been the result of a misapprehension of the law, and was not sufficient to deny benefits to which otherwise entitled.

Revenue Ruling 54-75 provides that "net earnings" from self-employment may include income derived by a wife as a participant in a husband-wife partnership, even if such partnership is not valid under the laws of the state in which it was organized.

Furthermore, the cases arising under Section 2040(a) have not required a formal partnership arrangement in order to reduce the includable amount of joint tenancy property in the deceased spouse's estate. This position leads to the conclusion that in order to meet the material participation requirement of Section 2040(c) a formal partnership arrangement would not be required.

A final question to be examined is whether in order to qualify under the material participation requirement, the wife must pay self-employment tax. At least one expert has stated that the "material participation require-

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10 *Id.* at 10,608 B.587, Social Security Rul. 68-48C.
11 374 F.2d 589, 594 (10th Cir. 1967).
12 1954-1 CUM. BULL. 169.
ment will limit the usefulness of subsection (c) because of the necessity that the wife pay self-employment tax." He then raises the question of how much tax the wife must pay, that is, will a threshold degree of participation be sufficient. Covey contends that it should. Although Covey's position has merit, if Congress had intended that the payment of self-employment tax was a prerequisite to subsection (c) election, it would have been easy to so state. Since the only requirement is that material participation be determined in a similar manner to that of Section 1402, there may be no necessity to pay self-employment tax.

Although designed as a statutory alternative to the consideration furnished test, new Section 2040(c) is wrought with ambiguities. The surviving spouse who is depending upon Section 2040(c) as a means of excluding a portion of joint tenancy property used in farming or other business is still confronted with difficulties. Hopefully when the Treasury Department issues regulations explaining this new subsection, the problems and questions will be answered.

1.05 Section 306 Stock

Code Section 306(a)—Act Section 702(a)(1)

Effective Date: Section 306 Stock distributed before January 1, 1977, which is acquired from a decedent dying after December 31, 1979

When a corporation issues preferred stock as a dividend on common stock, the receipt of the stock is not a taxable event. However, such stock is considered "Section 306 stock" and if the issuing corporation has accumulated earnings and profits at the time of distribution, the person receiving the stock will generate ordinary income rather than capital gains when the stock is sold. Prior to the Tax Reform Act of 1976 the ordinary income "taint" disappeared at the shareholder's death. After the Tax Reform Act of 1976 the stock did not lose its "taint" and therefore continued to generate ordinary income to the beneficiary or estate who sold the stock. The Revenue Act of 1978, in an attempt to mitigate the harshness of this rule, adopted special provisions for tainted stock distributed prior to January 1, 1977 and which is acquired from a decedent dying after December 31, 1979. The ordinary income is limited to the selling price minus the adjusted basis of the stock plus the other fresh start adjustments as established under the carryover basis rules. The reader should note that during the interim period from December 31, 1976 through December 31, 1979, Section 306 stock takes a step-up in basis equal to the fair market value at date of death under the stepped-up basis rules. However, once the moratorium period ends, ordinary

13 Covey, Recent Developments Concerning Estate, Gift, and Income Taxation, 13th Inst. on Estate Planning 157, 164 (Univ. of Miami 1979).
14 Id.
income will be the result upon sale other than for stock issued prior to January 1, 1977.

The Revenue Act of 1978 clarifies the confusion which resulted from the overlap of the tainted stock rules of Section 306 and the redemption rules of Section 303. Section 303 provides that sale or exchange treatment shall result if stock is sold to a corporation by an estate or an heir in amount not in excess of the administration expenses, federal and estate taxes, and funeral expenses. Therefore, to the extent that a corporate redemption qualifies under Section 303, long-term capital gain will be the result after the moratorium on carryover basis ends. Again, as of this date, the stock sold to the corporation would take a step-up in basis equal to the fair market value at date of death and if sold at this price would result in neither gain nor loss.

1.06 Disclaimers

Code Section 2518(b)(4)—Act Section 102(m)
Effective Date: Transfers creating an interest in the party disclaiming made after December 31, 1976

Prior to the Tax Reform Act of 1976 a problem existed as to whether or not a person who inherited or was devised or was bequeathed property could disclaim such inheritance without having the disclaimer treated as a gift by the disclaimant to the party who would otherwise take the disclaimed property under the will or intestate succession. The deciding factor was whether or not the person was permitted to disclaim under state law. This caused a substantial amount of litigation and confusion in the administration of estates. The Tax Reform Act of 1976 created a new Code Section 2518, which authorized the use of a disclaimer for federal transfer tax purposes, even if not authorized under applicable state law. The requirements under Section 2518 are that the disclaimer 1) must be in writing; 2) must be made by the transferor of the interest or his legal representative within nine months after the date on which the interest was created or the date on which the person making the disclaimer attains age 21; 3) the person disclaiming must not have accepted any interest or benefits from the property prior to making the disclaimer; and 4) the interest must pass to a person other than the disclaimant. In addition, the disclaimant must not have any control over who will receive the property after the disclaimer.

The problem which this last requirement left unsolved was whether or not a spouse who had been left an amount which overfunded the marital deduction trust could affect a valid disclaimer if the residue of the estate and the disclaimed property passed to the family trust under which a wife received income for life, either directly or under a sprinkling provision and
the trustee had a power to invade for the health education maintenance and support of the surviving spouse.

The Revenue Act of 1978 attempts to clear up this ambiguity by amending Section 2518(b)(4) to read as follows: "As a result of such refusal, the interest passes without any direction on the part of the person making the disclaimer and passes either to the spouse of the decedent, or to a person other than the person making the disclaimer." Therefore, it appears that the surviving spouse can disclaim an amount which otherwise would have resulted in an overfunding of the marital deduction trust, or in an outright gift to the spouse and have the disclaimed property pass to the family trust whereby the surviving spouse receives an income interest provided that the income does not result from any direction by the surviving spouse, and the disclaimer meets the other requirements of Section 2518.

A serious problem for estate planners and professional advisers still remains when the residuary passes to the family trust, if in addition to providing for income to the surviving spouse, it also vests in that spouse an annual noncumulative right to withdraw the greater of 5% of the trust corpus or $5,000. A literal reading of the Code would lead an adviser to believe that the 5% or $5,000 power would cause no problems. However, a review of the Senate Finance Committee Report indicates that "the disclaimer will be valid although the surviving spouse receives an income interest with respect to the property if the income interest does not result from any direction by the surviving spouse and the disclaimer is otherwise qualified." The Senate Report is certainly more restrictive than the broad language of Section 2518(b)(4) and should the courts adopt the narrower definition from the Senate Report, estate planners are faced with the dilemma of whether or not to include the 5% or $5,000 power in the family trust. A question could also be raised as to the effect of the trustee's power to distribute for the spouse's health, education, maintenance, and support on a disclaimer. Here, although the spouse has no power to compel the distribution of these funds, a very narrow interpretation could hold that there was a power for the principle to return to the disclaiming spouse. These two problems remain unsolved and whether or not the Treasury regulations will solve the problem cannot be answered at this time.

Notwithstanding the problems previously mentioned, the disclaimer provides a great opportunity for the attorney who did not engage in estate planning prior to the client's death, to rectify some of his or her mistakes on a post mortem basis. But for the disclaimer statute, as amended in the Revenue Act of 1978, it is the author's opinion that a great many small practitioners who have prepared "simple" wills leaving all the client's property to the surviving spouse may now have an opportunity on a post mortem
basis to extract themselves from a very serious problem which otherwise may have resulted in large malpractice claims against the attorney for excessive estate taxes paid at the death of the surviving spouse.

1.07 Retention of Voting Rights by Grantor

Code Section 2036(b)—Act Section 702(i)

Effective Date: Decedents dying after December 31, 1976

In *Byrum v. United States,* the Supreme Court held that where the taxpayer created an irrevocable trust for stock in three family controlled corporations and named an independent corporation as trustee with broad power of control and management of the trust, the corpus of the trust was not includable in the grantor's (decedent's) estate even though he retained the power to vote the corporate shares, to disapprove the sale or transfer of trust assets, to approve investments and reinvestments, and to remove the trustee and designate a successor corporate trustee. Although *Byrum* did not have a legally enforceable right to control the flow of income to the trust beneficiaries, in effect he did have the power to control the declaration of dividends since he was a majority shareholder, taking into consideration the shares individually owned and the right to vote those shares held in trust. The majority of the Supreme Court determined that because of fiduciary duties owed by a majority shareholder to minority shareholders, there were definite ascertainable external standards and also that the directors operated under a legally enforceable duty to pay dividends and to manage the corporation for the benefit of all shareholders.

In the Tax Reform Act of 1976 Congress enacted legislation to overrule and reverse the decision in *Byrum.* The amendment to Section 2036 provided that if the grantor retained voting rights in any stock transferred to an irrevocable trust, this would be sufficient power to cause inclusion of the trust corpus in the decedent grantor's estate.

This broad language accomplished the purpose of overruling *Byrum* and also resulted in overkill since under the wording as enacted, an individual who transferred one share of IBM stock to a trust and retained the power to vote that stock would cause the value of the transferred stock to be includable in his estate.

The Revenue Act of 1978 limits the applicability of the abovementioned rule from the Tax Reform Act of 1976 to the transfer of stock from a controlled corporation. A controlled corporation is defined as one which at the time of the transfer and during a three-year period ending on the date of the decedent's death the decedent owned or had the right to vote stock possessing at least 20% of the total combined voting power of all 10.

10 408 U.S. 125 (1972).
classes of stock. To determine the 20% ownership all shares which are attributable to the grantor through the attribution rules of Section 318 are included in addition to the grantor's individually owned shares.

Under Section 318 the grantor would be considered to own the shares owned by his spouse, his children, grandchildren and parents plus the proportionate number of shares of stock held by a partnership or estate. Ownership of stock by a partnership or estate is attributed to the individual partner or estate beneficiary based on their proportionate ownership interest. The attribution of stock from a trust to a beneficiary is based on the beneficiary's actuarial interest in the trust. Attribution from a corporation to the individual is applicable only where the individual owns 50% or more in value of the stock of the corporation, either directly or indirectly. If the individual meets this test, then he is attributed with the number of shares of stock which is equal to his proportionate ownership of the corporation.

1.08 Income in Respect of a Decedent

Code Section 691—Act Section 515
Effective Date: Decedents dying after December 31, 1976 and prior to January 1, 1980

Income to which a cash basis taxpayer was entitled at the date of death, but had not yet received is categorized as income in respect of a decedent. Also includable in this category are payments made subsequent to death which are attributable to the decedent's income earning capacity, such as a bonus. Income in respect of a decedent is an exception to the rule of Section 102 which provides that inheritances, devises and bequests are received by the beneficiary free of any income tax and also take a step-up in basis under Section 1014. The reason for the exception is to place the decedent and the estate in the same position as if the decedent had received the payment which would have resulted in taxable income immediately prior to decedent's death.

The result of income in respect of a decedent is that if the individual was entitled to the funds at the date of death, then the receipt of funds are includable in the decedent's estate, and also results in taxable income to the recipient, whether it be the estate or a named beneficiary. Since the item of income in respect of a decedent is subject to both income and estate taxes, Section 691(c) provides that the individual or estate which reports the income is entitled to a deduction for the estate tax attributable thereto. Prior to the Tax Reform Act of 1976 the deduction applied only to federal estate taxes and was calculated at the highest marginal tax bracket. The calculation was determined by calculating what the estate tax would have been had the item of income in respect of a decedent not
been included and making calculation with the item included. The difference then was the amount of the deduction which the estate or individual reporting the income was entitled to take.

The Tax Reform Act of 1976 expanded the deduction to include state inheritance and estate taxes as well as the federal estate tax. However, another change was made so that the estate tax attributable to the inclusion of this item of income in respect of a decedent was calculated at the average rate, rather than at the highest marginal rate.

With the moratorium on carryover basis, the revisions instigated by the Tax Reform Act of 1976 have been suspended until January 1, 1980 and the law now reverts to the pre-January 1, 1977 rule whereby the tax attributable to the income in respect of a decedent is based on the highest marginal rate and applies only to the federal estate tax.

1.09 Holding Period—Inherited Property
   Code Section 1223—Act Section 702(c)(5)
   Effective Date: Decedents dying after December 31, 1979

Prior to the Tax Reform Act of 1976, inherited property received a step-up in basis equal to the fair market value at date of death. It was also deemed to have been held by the heirs or beneficiary for a period of time sufficient to qualify for long-term capital gain treatment in the event the property was sold. This result was accomplished by reference in Section 1014 to stepped-up basis property.

The Tax Reform Act of 1976 substituted the concept of carryover basis, whereby the basis of the property to the decedent was carried over and given to the heir as the heir's basis. All references to the holding period were made to property which received a step-up in basis at death. Therefore after January 1, 1977, property had to be held for nine months in 1977 and twelve months in 1978 to qualify for long-term capital gain treatment.

The Senate Report indicates that this was not the intended result of the change, so the Revenue Act of 1978 applies the automatic holding period rule to carryover basis property. The reader should remember at this point that the carryover basis rules have been suspended until December 31, 1979, and until such time the basis of inherited property continues to be equal to the fair market value at date of death.

1.10 Lump Sum Distributions from Qualified Plans
   Code Section 2039—Act Section 142
   Effective Date: Decedents Dying after December 31, 1978

Distributions from a qualified plan may be made in either a lump sum or as an annuity. If the payment is made in a lump sum, then the pay-
ment qualifies for partial capital gains treatment applicable to the pre-January 1, 1974 portion and/or the favorable ten-year averaging method of calculating the income tax. Under the ten-year averaging method, the lump sum distribution was divided by ten and the individual tax rate was applied to this amount and then multiplied by ten to arrive at the actual tax on the distribution. This calculation is an "off 1040—individual tax return" calculation. The amount of the distribution, or the averaging process, does not enter into taxpayer's taxable income for the year in question, but the tax from the ten-year averaging form is merely carried over and added to the individuals other income tax.

Prior to the Tax Reform Act of 1976, pension plan distributions were excluded from the decedent's estate. The Tax Reform Act of 1976, however changed the rule as to lump sum distributions. In effect, if the benefits were to be obtained from the ten-year averaging then the lump sum distribution was required to be included in the decedent's estate. The other method of distributing the pension proceeds as an annuity, over a period of at least twelve months, resulted in exemption from the federal state tax but the individual payments were included in the distributee's taxable income in the year of receipt. Thus executors and professional advisers were faced with the problem of determining whether or not the benefits from lump sum ten-year averaging outweighed the cost of the additional estate tax.

The Revenue Act of 1978 eliminates this problem by providing that a lump sum distribution can be excluded from the decedent's estate, if there is an irrevocable waiver of the right to use the favorable ten-year averaging method of calculating the income tax.

1.11 Subordination of Lien—Special Use Valuation

Code Sections 6324B, 6324—Act Section 513

Effective Date: Decedents dying after December 31, 1976

The Tax Reform Act of 1976 provides that if certain requirements are met, property used for farming or in connection with a closely held business may be valued at its use to the farm or to the business rather than the highest and best use as required under prior law. However, if the heirs do not continue to use the land for farm or closely held business purposes for a period of fifteen years, there is a provision for the recapture of the difference in the estate tax. To secure the government's interest in the additional estate taxes, the property is made subject to a "super lien" in favor of the government.

The Revenue Act of 1978 permits the Service to subordinate this lien if it is satisfied that the interest of the government will be adequately protected after the subordination. This means that in the event the farmer
or closely held business person needs to borrow money from the bank for business purposes and use the land as security, the taxpayer should be able to obtain subordination of the government's lien. This is particularly important when farm land is involved, since the Federal Land Bank will not loan money unless they can have a first mortgage on the land. Had the property been subject to the lien under Section 6324B, it would have been impossible to give the Federal Land Bank a first mortgage.

Although this provision for subordination is a move in the right direction, it remains to be seen what impediments the IRS will find to place in the way of taxpayers attempting to avail themselves of this benefit.

It should be kept in mind that while there is a provision for the subordination of the lien resulting from the special use valuation, no subordination provision is applicable to the super lien placed on farm or other closely held business property to secure the payment of estate taxes which are being paid over a ten-year period as authorized by Section 6166(a) or deferred for a period of five years and then paid equally over the remaining ten years per Section 6166. It would appear to the author that if there was a valid reason to provide for subordination of the lien resulting from the special use valuation, the same line of reasoning should permit the extended payment of the estate tax lien to also be subordinated.

1.12 Extended Payment of Estate Tax Lien

Code Section 6324A(e)(2)—Act Section 702(e)

Effective Date: Decedents dying after December 31, 1976

When a taxpayer elects to extend the payment of estate taxes for up to ten years under Code Section 6166(a) or to defer payment for five years and then make payments over the remaining ten years under Section 6166, the Tax Reform Act of 1976 provided for a lien on the property involved in the amount of the deferred tax liability plus the total interest that would be payable over the ten or fifteen year period.

The Revenue Act of 1978 now relaxes this lien requirement by reducing it to the amount of the deferred taxes plus the amount of interest for the first four years of the deferral period. However, this “super lien” remains a serious problem for the heirs who may require financing in the future.

1.13 Special Use Valuation—Involuntary Conversions

Code Section 2032A—Pub. L. No. 95-472, Section 4

Effective Date: Involuntary Conversions after December 31, 1976

When property is sold which was valued under the special use valuation provisions of Section 2032, there is a recapture of the amount of the difference in estate tax which would have been paid had the valuation based on the

highest and best use been used instead of the special use valuation of land to a closely held business or farm. This rule resulted in hardship to taxpayers who held special use valuation property which was subject to an involuntary conversion. The Revenue Act of 1978 eliminates this problem by providing that no recapture will result where the proceeds from an involuntary conversion are reinvested in property used for the same purpose as the converted property.

2.00 Corporations

2.01 Corporate Tax Rates

Code Section 11—Act Section 301

Effective Date: Tax years beginning January 1, 1979 and fiscal years ending in 1979

For taxable years commencing after December 31, 1978, the new corporate tax rates have been substantially reduced. Under prior law, the corporate income tax rate was 20% on the first $25,000 of taxable income and 22% on taxable income from $25,000 to $50,000. Taxable income in excess of $50,000 was subject to an additional 26% surtax which made the total tax rate equal to 48%. The new tax rates are as follows: $0 to $25,000, 17%; $25,000 to $50,000, 20%; $50,000 to $75,000, 30%; $75,000 to $100,000, 40%; and taxable income in excess of $100,000, 46%. The tax savings are as follows with corporations with the indicated amount of taxable income:

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax Savings</th>
</tr>
</thead>
<tbody>
<tr>
<td>$25,000</td>
<td>$750</td>
</tr>
<tr>
<td>50,000</td>
<td>1,250</td>
</tr>
<tr>
<td>75,000</td>
<td>5,750</td>
</tr>
<tr>
<td>100,000</td>
<td>7,750</td>
</tr>
</tbody>
</table>

The reduction for a corporation with a $200,000 income would be $9,750. The corporate capital gain rates have also been reduced from 30% in 1978 to 28% in 1979.

The tax reduction will have to be prorated for corporations whose fiscal tax year commenced in 1978 and ends in 1979. To determine the actual tax liability, the income tax is calculated under both the old and the new rate structure. The tax calculated under the old rate structure is utilized for the number of days from the start of the tax year till December 31, 1978 over a denominator of 365 days, and the tax calculated under the new rate structure is used for a fraction of the time the numerator of which is the number of days remaining in the tax year in 1979 over a denominator of 365 days. An example of the calculation is set forth below:

Corporation has a taxable income of $100,000 and its fiscal year commences on June 1, 1978 and ends on May 31, 1979. Therefore, there
are 151 days in 1979 and 214 days in 1978. The calculation of the tax due is calculated as follows:

\[
\text{Tax calculated based on 1978 rates} = \$34,500 \times \frac{214}{365} = \$20,227
\]

\[
\text{Tax calculated based on new rates} = \$26,750 \times \frac{151}{365} = \$11,066
\]

Total tax for fiscal year $31,293

2.02 Tax Free Incorporation—Assumption of Liability

Code Sections 357, 358—Act Section 365

Effective Date: Tax free incorporations after November 6, 1978

Under Section 351 no gain or loss is recognized when an unincorporated taxpayer or a partner transfers property to a newly formed corporation. Were it not for the protection of Section 351, such a transfer would be considered a sale or exchange giving rise to capital gain which would be recognized by the transferor of the property. Section 351 requires that there be a transfer of property to the corporation and that the transferor receive stock or securities in exchange for the property transferred. Under Section 351 stock refers to an equity interest and securities refer to debt instruments. Another requirement of Section 351 is that the transferors be in control immediately after the transfer occurs. Control is defined in Section 368(c) as being at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock. If any other property or cash is received then gain is recognized to the lesser of “boot” received or the gain realized.

Section 357(a) provides that if the property transferred to the corporation is subject to a liability or if the corporation assumes a liability in relation to that property, such liability shall not be considered as boot for the purposes of triggering gain upon the transaction. However, Section 357(b) requires that the liability be considered as boot if the liability was incurred to avoid federal income tax on the exchange or if there was no valid business purpose for the acquisition of the indebtedness. Also, Section 357(c) requires that gain be recognized to the extent that the liabilities assumed, or to the extent the property is subject to liabilities, exceeds the adjusted basis of the assets transferred to the corporation.

The problem which has arisen in various courts can be illustrated as follows:

An attorney who maintains his accounting records on the cash basis transfers accounts receivable in the amount of $10,000 and liabilities for
expenses incurred in the amount of $8,000 to a newly formed corporation. A literal reading of Section 357(c) requires that a gain of $8,000 be recognized. The reason for this recognition is that the liability of $8,000 exceeds the adjusted basis of the accounts receivable which is zero. The reason that the accounts receivable have a zero basis, even though they have a value of $10,000, is that the taxpayer maintains his records on a cash basis and reports no income until cash is actually received from the clients. In the Tax Court decision of Focht v. Commissioner,\textsuperscript{16} the court determined that the term "liability" in Section 357(c) should be limited to those obligations that, if transferred, cause gain recognition. To the extent that the obligation transferred would be deductible if paid by the transferor should not be considered as a liability for the purposes of Section 357(c). Hence, the holding of this case was that if the liabilities were for consumable supplies or other items which would normally be deductible in the ordinary course of business, this amount of liabilities would not be taken into consideration. Since the $8,000 of liabilities were for operating expenses, no gain would be recognized upon transfer of the accounts receivable and the accounts payable to the corporation.

In the Revenue Act of 1978 Congress acted to remedy the harsh results which some court decisions had visited upon unsuspecting cash basis transferors to newly formed corporations and also to eliminate the conflict among the various court decisions.\textsuperscript{17} Congress, in effect, adopted the rationale of Focht and added Section 357(c)(3) which provides that accounts payable assumed by a corporation will not be considered liabilities because the transferor would be entitled to a deduction if such liabilities had been paid by the transferor. It should be noted that this rule will not be applicable in the event that the liabilities apply to anything other than deductible expenditures, or in the event that the incurrence of the liability resulted in the creation of an increase in the basis of any property. Therefore, if a word processing machine with an adjusted basis of $10,000 is transferred to a corporation and the corporation assumes a liability of $12,000, gain will be recognized by the transferor, since this liability was not for a deductible expenditure.

Section 358(d), prior to the Revenue Act of 1978, provided that liabilities assumed by the corporation would reduce the amount of the transferor's basis in the stock received, the same as if the transferor had received cash or other property. Section 358(d) has now been amended to provide that if the liabilities are not taken into consideration under the

\textsuperscript{16} 68 T.C. 223 (1977).
\textsuperscript{17} See Thatcher v. Commissioner, 61 T.C. 223 (1977), rev'd in part and aff'd in part, 533 F.2d 1114 (9th Cir. 1976); Bongiovanni v. Commissioner, 470 F.2d 921 (2d Cir. 1972); Raich v. Commissioner, 46 T.C. 604 (1966).
newly enacted portion of Section 357(c), the liability will not be used to reduce the transferor's basis of the stock received.

2.03 Section 1244 Stock  
**Code Section 1244—Act Section 345**  
**Effective Date:** Common Stock issued after November 6, 1978

An individual who purchases stock of a corporation acquires a capital asset. If this individual has held this stock for a period of more than twelve months, any loss resulting from the disposition of the stock due to a sale or to the bankruptcy of the corporation will result in a long-term capital loss. This means that in effect one-half of the loss is not going to be deductible unless it can be offset against future capital gains. In addition, the deduction of capital losses, long or short-term, are limited to a $3,000 deduction in any one year. For example, if an investor lost $60,000 on corporate stock, and anticipated no future capital gains, his loss would be deductible only to the extent of $30,000 and would have to be deducted at the rate of $3,000 per year against ordinary income over the next ten years.

To mitigate these harsh results and to encourage capital formation for small businesses, the Small Business Investment Act of 1958 provided that losses of up to $50,000 on a joint return, $25,000 for other taxpayers, would be treated as ordinary loss with the remaining loss being subject to the capital loss rules. Basically, the requirement to qualify for this favorable treatment was that the stock of the small business corporation be issued under a plan and that the stock to be issued could not exceed $500,000. There was also an additional requirement that the total stock issued by the corporation could not exceed $1 million.

Since one of the requirements was that the stock be issued under a plan, much litigation resulted as to whether or not the plan was proper and qualified under the Code.

The Revenue Act of 1978 materially liberalized the use of the small business corporation Section 1244 election by eliminating the requirement that the plan be in writing and substituting the requirement that the issuing corporation qualify as a small business corporation, that the stock be issued in exchange for money or property, and for the five years preceding the date the stock is issued that less than 50% of the corporation's gross income was derived from passive sources such as royalties, rents, dividends, interest, etc. It should also be noted that the passive income requirement is applicable only in the event that the corporation's deductions and expenses exceed its gross income.

In addition, the Act has increased the amount of stock to be issued under such a plan from $500,000 to $1 million and has increased the
amount of the loss which can be deducted as an ordinary loss to $100,000 on a joint return and $50,000 on returns filed by other individual taxpayers. Also the overall $1 million limitation on the corporation's total capital has been eliminated.

2.04 Subchapter S Corporation—Time to Make Election
Code Sections 1372(a),(c),(e)—Act Section 343
Effective Date: Taxable years beginning after December 31, 1978

Under prior law the time period in which a newly formed corporation could make a Subchapter S election was limited to a one-month period after it started business. Existing corporations were permitted to make a Subchapter S election only during a time period commencing one month before and ending one month after the start of their taxable year. These strict time limitations caused a great deal of difficulty for corporations who thought they had made timely elections, but upon audit the determination was made that the election had not been within the prescribed time period. This caused difficulty not only in the initial year for which the election was intended, but also for subsequent years when the shareholders and the corporation thought that they were operating under Subchapter S rules.

The rules have now been liberalized so that an existing corporation can make an election at any time during the preceding year or within the first seventy-five days after the commencement of the new taxable year. All newly formed corporations have seventy-five days in which to make the election. The Revenue Act of 1978 also provides that in the event that the election was not timely made for the year in question, it is effective for the next taxable year. If an election is made by an existing corporation at some time during the preceding year, the only shareholders who are required to consent to the election are those who hold stock on the day that the election is made and even if in fact new shareholders acquire stock prior to the starting of the next taxable year for which the election is effective, their consent is not required. It should be noted that the Tax Reform Act of 1976 changed the law and did away with the requirement of consent by shareholders who are acquiring stock. Now a shareholder who acquires stock must affirmatively refuse to consent.

2.05 Subchapter S Corporation—Number of Shareholders
Code Section 1371—Act Section 341
Effective Date: Taxable years beginning after December 31, 1978

Prior to the Revenue Act of 1978 a Subchapter S corporation could initially only have ten shareholders. The Tax Reform Act of 1976, however, increased the number of shareholders which the corporation could have to fifteen if the corporation had been in existence as a tax-option corporation for five consecutive years, or if the additional shareholders had acquired
their interest by inheritance. After the effective date of the Revenue Act of 1978, a tax option corporation can have fifteen shareholders irrespective of the time that they acquire the stock or the number of years in which the corporation has made the election.

2.06 **Subchapter S Corporation—Husband and Wife Treated as One Shareholder**  
**Code Section 1371(c)—Act Section 342**  
**Effective Date: Taxable years beginning after December 31, 1978**

Under pre-existing law a husband and wife were counted as one shareholder for determining the number of eligible shareholders in a Subchapter S corporation if the stock was owned as joint tenants, tenants in common, tenants by the entirety or held as community property. The law also treated the surviving spouse and the estate of the deceased spouse as one shareholder if they qualified as one shareholder at the time of their death. The Revenue Act of 1978 eliminated these rules and treats a husband and wife as one shareholder irrespective of how the stock is held. They are one shareholder whether or not the stock is held individually by the husband, individually by the wife, jointly or as tenants in common.

2.07 **Subchapter S Corporation—Grantor Trust**  
**Code Section 1371(F)—Act Sections 342(b), 701(y)**  
**Effective Date: Taxable years beginning after December 31, 1976**

Under the general rules a trust is not permitted to be a shareholder of a Subchapter S corporation. The Tax Reform Act of 1976 permitted a “grantor trust” to be a shareholder for a period of sixty days while at the time at which stock was transferred to the “grantor trust.” A grantor trust is one where the grantor has retained sufficient control, such as the retention of income or the right to revoke and change beneficiaries, so that income from the trust will be taxable to the grantor rather than to the trust itself. A problem occurred under pre-existing law when the grantor of a grantor trust died. At this time the trust became irrevocable, thereby disqualifying the trust as being a qualified shareholder in a Subchapter S corporation and the election was automatically terminated. The prior law also permitted other individuals, such as aliens, partnerships, corporations and trusts to establish a grantor trust and thereby obtain the benefits of Subchapter S treatment whereas as an individual, alien, corporation, partnership or trust they would not be permitted to be a Subchapter S shareholder.

The Revenue Act of 1978 treats the person who established the grantor trust as the shareholder rather than the grantor trust itself and thereby requires that the grantor must be an individual who is a citizen or resident of the United States. The grantor trust can continue to be a shareholder for sixty days subsequent to grantor’s death or for up to two
years in the event the grantor trust is includable in the decedent's estate. It should be noted that the rules which caused the income from a grantor trust to be taxable to the grantor are different from the rules which require that the trust be included in the grantor's estate. To be included in the estate of the grantor at death, the trust must have been subject to a power in the grantor to alter, amend, revoke or terminate or subject to a power to control the income.

3.00 Deductions

3.01 Entertainment Facility Expenses

Code Section 274—Act Section 361
Effective Date: Taxable years beginning January 1, 1979

The Revenue Act of 1978 provides that no deductions shall be allowed for expenses incurred in connection with an entertainment facility. The term "entertainment facility" is broadly interpreted to include hunting lodges, yachts, fishing lodges, swimming pools, tennis courts, bowling alleys, apartments, hotel suites, condominiums, automobiles, airplanes, and homes and vacation resorts. The term "facility" also includes fees paid to social and athletic clubs. Also the deductibility of the facility-related expenses has been subject to attack by the general public and by Congress. The deductibility of expenses in connection with entertainment facilities has long been attacked by the IRS and has caused a great deal of litigation as taxpayers attempt to prove that these facilities were utilized in connection with the furtherance of their business.

Specifically exempted by the Act from the definition of an entertainment facility are dues paid to a country club. Prior to the Revenue Act country clubs were considered to be an entertainment facility, the same as the above-mentioned facilities. As a prerequisite to the deduction of any expenses related to the country club, the taxpayer is required to prove not only that the expenses are ordinary and necessary, but also that the facility was primarily used for business and such uses were directly related to the conduct of the taxpayer's trade or business. To illustrate this rule assume that the country club was used 100 times during the year of 1979. Of these uses taxpayer used the club twenty-five times for directly-related purposes and thirty times for associated-with types of entertaining. The club was used forty-five times by taxpayer's spouse and children for personal purposes. The test is two-fold, first more than 50% of the uses must be for business related purposes. Since the directly-related and associated-with types of entertaining are considered to be business related, in the example, 55% of the uses were for business, hence it was used primarily for business related uses are entitled to be deducted. In the example, 25% of the uses purposes. However, only the country club dues applicable to the directly-
were directly related, hence only 25% of the country club dues would be deductible. It should be noted that in addition any food or beverage incurred in connection with either the directly-related or the associated-with types of entertaining would be deductible under the general rules applicable to entertainment expense.

Directly-related entertaining occurs when there is active conduct of the business in a clear business setting. Associated-with entertainment occurs directly preceding or following a substantial and bona fide business discussion.

Box seats and season tickets to theatre and sporting events are not considered to be an entertainment facility, but deductibility is determined on the basis of each individual use. However, the expenses in connection with a lodge would be considered as an entertainment facility and therefore disallowed.

Investment credit in connection with the acquisition of an entertainment facility is also disallowed after January 1, 1979. As under pre-existing law, the loss on the sale of a facility is nondeductible. The entire amount of dues paid to a business luncheon club continue to be deductible as under pre-existing law.

3.02 Gasoline Taxes

Code Section 164(a)(5)—Act Section 111
Effective Date: Taxable years beginning after December 31, 1978

In order to decrease the effect of multiple taxation on any individual taxpayer, under prior law the taxpayer who itemized deductions could deduct state and local taxes imposed upon gasoline, diesel and other motor fuels, whether or not used in business or investment activities. However, the Revenue Act repeals the itemized deduction for taxes on motor fuels not used in business or investment activities. Previously the taxpayer was allowed to estimate his state and local motor fuel taxes from his car mileage and any reasonable estimate was acceptable. Such leniency in verification will probably continue under the new law whenever a taxpayer makes an itemized deduction for the taxes paid in motor fuels used in business or investment activities.

3.03 Political Contributions

Code Section 41—Act Section 113
Effective Date: Taxable years beginning after December 31, 1978

Previously, a taxpayer who itemized his deductions was allowed a deduction for political contributions. The deduction was allowed for the full amount contributed, not exceeding a ceiling of $100 for individual
taxpayers or $200 for taxpayers filing a joint return. If the taxpayer exceeded the ceiling, the amount in excess of this ceiling could not be carried over to the following taxable year. Alternatively, a taxpayer could elect an income tax credit equal to one-half of such political contributions not exceeding $25 for individual returns or $50 for joint returns.

The Revenue Act repeals the itemized deduction for political contributions. However, the tax credit is retained and the maximum amount increased to $50 for individual returns and $100 for joint returns. If the taxpayer exceeds the ceiling, the excess cannot be carried over to the following taxable year. The contribution must have been made to a candidate for election or nomination in a special, primary, or general election at the federal, state or local level.

3.04 United States Citizens Working Abroad

Code Section 913—Foreign Earned Income Act Section 203(a)

Effective Date: Taxable years beginning after December 31, 1977

Prior to the Tax Reform Act of 1976, United States citizens who lived abroad in a foreign country for seventeen out of eighteen months were entitled to exclude up to $20,000 of income each year. This exclusion also was applicable to individuals who were bona fide residents of the foreign country during the entire year. If the United States citizen had lived outside the United States for three years or more, then the exclusion was increased to $25,000. The Tax Reform Act of 1976 eliminated the $20,000 and $25,000 exclusion and substituted a $15,000 exclusion.

The Foreign Earned Income Act of 1978 eliminates the exclusion and substitutes a series of deductions in lieu of the exclusion. However, a $20,000 exclusion survives in the event that the United States citizen is an employee who is living in a camp in a hardship area for the entire taxable year or who is present during seventeen out of eighteen months. The Committee Report indicates that a camp refers to substandard housing provided in enclaves in remote hardship areas close to or on the job sites.

For taxable years commencing in 1978, taxpayers are provided an option to deduct the excess foreign living costs as authorized under the Foreign Earned Income Act of 1978 or to take the $15,000 foreign income exclusion. This option is applicable only for years commencing in 1978 and expires for years commencing after 1978.

The deductions which will be explained in more detail below include a deduction for excess foreign living costs, excess housing costs, educational costs, home leave transportation, hardship post deduction, moving expense deduction and an extended period of time to reinvest proceeds from a sale of a home. These deductions are available to United States citizens living
abroad who have been a bona fide resident of a foreign country for an entire tax year or who have been present in a foreign country or countries for a period of 510 days (seventeen months) out of eighteen consecutive months. The deductions, as set forth below, cannot exceed an individual's earned income from sources outside of the United States for the year in question reduced by allowable deductions and the amount of income excluded under Section 119, whereby the employee is permitted to exclude the meals and lodging furnished on the business premises, such as in the hardship camp.

A deduction is permitted for the qualified cost of living differential which the employee in the foreign country is required to pay over the cost of living for the highest cost metropolitan area in the continental United States excluding Alaska for a family whose income is equal to the salary of a United States employee compensated at the rate equal to the annual rate paid for step 1 of GS-14 (currently $32,442). The IRS will prepare a table showing the excess cost of living for various foreign posts of assignment.

A deduction is allowed for housing cost in excess of a base housing amount. The base housing amount is defined as being 20% of the individual's earned income reduced by the sum of the qualified cost of living differential, the qualified educational expenses, the qualified home leave travel expenses, the qualified hardship area deduction and certain housing expenses. If an individual, due to hardship condition, is required to maintain a separate household for the spouse and family at a place other than the tax home in the hardship area, the entire amount of the additional home is deductible. This additional household must be maintained outside of the United States.

Educational expenses incurred by taxpayers living abroad are deductible to the extent that they permit their children to be educated in a United States type school. The educational deduction is applicable only to grades in kindergarten through high school. No deduction is permitted for college or graduate education. Costs which are deductible under this provision include tuition, fees, books, local transportation and other miscellaneous school expenses. In the event no United States type school is available near the residence, then room, board and certain travel expenses are allowable.

A deduction for transportation in connection with a home leave is available once every twelve months for economy or coach fare for the taxpayer, dependents and spouse to return from their overseas tax home to their principal residence in the United States. In the event there is no
principal residence in the United States, then the transportation deduction is to the nearest port of entry in the continental United States. The reasonable cost of transportation will be interpreted to mean economy or coach fare for a round trip ticket, provided that such transportation is available.

An individual who is assigned to work in an area which the Secretary of State has defined as a hardship post because the living conditions are difficult due to unhealthy conditions and excessive physical hardships, is entitled to a deduction, computed on a daily basis, of $5,000 per year.

Moving expenses in connection with house hunting, temporary living and residence related sale or acquisition costs have been increased for individuals involved in job related overseas moves. The overall limitation on the preceding items is increased from $3,000 to $6,000. There is a limitation on house hunting and temporary living expenses of $4,500 as compared with $1,500 under prior law or for moves within the United States. Temporary living expenses may be incurred for up to ninety days as compared with thirty days for United States related moves. In addition to these specifically enumerated items, a moving expense deduction is also available for the cost of transporting household goods and personal effects and for the storage of such goods and effects during the time that the taxpayer is assigned to the overseas post. It should be noted that these provisions apply to foreign moves which means the commencement of work by a taxpayer at a post outside of the United States. The United States is defined to cover not only continental United States but also its possessions. The rules for the deductibility of moving expenses are also expanded to cover retirees who are returning to the United States and survivors where the deceased spouse had a place of work outside of the United States. Such a move by a surviving spouse or dependent must commence within six months after the date of the decedent’s death.

Section 1034(k) has been added to provide that an individual whose tax home is outside of the United States has a period of four years following the date of sale of a personal residence to replace the residence with a new home and thereby defer capital gains tax on the gain from the sale. If the individual had made a move within the United States, the replacement of the personal residence must have occurred within eighteen months from the date of sale. It should be noted that if the individual constructs a new home, the eighteen month limitation for United States residents is increased to twenty-four months. There is no comparable increase in the number of months for individuals having residences outside of the United States.
3.05 Vacation Home—Conversion to or from Personal Residence  
Code Section 280A(d)(3)—Act Section 701(h)  
Effective Date: Taxable years beginning after January 1, 1976

The Tax Reform Act of 1976 provided for a limitation on the deductions attributable to a vacation home if it was used for personal purposes during the taxable year and such use exceeded the greater of fourteen days or 10% of the number of days during the year which the home was actually rented. This limitation caused a problem when a taxpayer converted a vacation home to a principal residence or where the principal residence is converted to a vacation home which is then rented. The Revenue Act of 1978 provides that if the property is rented for a "qualified rental period" the disallowance rule shall not be applicable. The "qualified rental period" is a period of twelve months or more beginning in the taxable year or a period of less than twelve months which commences in a taxable year and ends at the time that the unit is sold or exchanged. During this "qualified rental period" the property must be rented to an individual other than a brother, sister, spouse, lineal descendant or ancestor of the taxpayer at a fair rental value or at least held for rental at a fair rental value.

This revision has the effect of permitting a taxpayer to deduct the expenses, without the limitation as imposed by the Tax Reform Act of 1976, in the situation where the taxpayer lived in the personal residence for the first three months of 1979 and then rented the property for twelve months while he worked in another city. The total amount of deductions, including taxes, interest, depreciation and maintenance applicable to the rental period would be deductible both for the year 1979 and for 1980. Prior to the Revenue Act of 1978 the expense deduction would be limited since the taxpayer would have lived in the home for the greater of fourteen days or 10% of the rental days.

3.06 Foreign Conventions  
Code Section 274(h)—Act Section 701(g)  
Effective Date: Conventions beginning after January 1, 1977

The Tax Reform Act of 1976 limited the deductibility of costs incurred in connection with foreign conventions outside the United States, its possessions or trust territory in the Pacific, to two conventions per year. Transportation cost was limited to the lowest economy rate available at that time of year and meals, lodging, and other subsistence costs were limited to the per diem allowance paid to federal employees for the location where the convention was held. The deduction was also conditioned upon the taxpayer attending at least two-thirds of the regularly scheduled meetings which was required to be at least six hours per day.

The Revenue Act of 1978 has cleared up the question which arose
 subsequent to the Tax Reform Act of 1976 as to whether or not the disallowance rules for more than two foreign conventions apply to only the employee or independent contractor attending the convention or also to the employer. The Revenue Act of 1978 makes it clear that the expenses incurred by the employer in connection with foreign conventions will not be disallowed where the individual attending the convention is required to include the convention expense as income on his personal tax return. This requires that the employer provide the employee or independent contractor with a Form W-2 or Form 1099. The employer or payor corporation could have the expenditure disallowed in the event that these forms are not provided.

The Act also provides that at least one-half of the trip days be devoted to business, when a deduction is to be obtained for the entire amount of the transportation costs. The Tax Reform Act of 1976 required that more than one-half of the total trip days be devoted to business in order that the entire transportation costs be deductible. If less than half of the entire trip days were devoted to business, then the transportation costs had to be prorated based on the number of days devoted to business versus personal vacationing.

Assume that an individual travels to a foreign convention, which otherwise qualifies as an ordinary necessary business expense, and the coach air fare is $2,000 round trip. Also assume that five days are devoted to the business convention and that the individual stays on to vacation for an additional ten days. In this instance only one-third of the transportation costs of $2,000, or $667, would be deductible since the individual did not devote at least one-half of the travel days to the business.

The Revenue Act of 1978 provides that the foreign convention rules are not applicable to an individual who is a United States citizen but also resides in the country in which the convention is held. For example, a United States citizen employed by a United States subsidiary in Colmar, France, is not subject to the foreign convention rules when attending a convention in Paris, France.

3.07 Product Liability Losses
Code Sections 172(b), 537(b)—Act Section 371
Effective Date: Taxable years beginning after September 30, 1979

A net operating loss incurred in a trade or business can be carried back to the three preceding years and carried forward to the following seven years. This permits a taxable loss of one year to be spread backwards and forwards and in effect, offset profits in those years. The Tax Reform Act of 1976 increased the carry forward from five to seven years and also
provided that the taxpayer could elect to carry forward to the seven years rather than carrying back to the three years first.

The Revenue Act of 1978 provides that that portion of the net operating loss which is attributable to product liability losses can be carried back for a period of ten years and then carried forward seven years. The Act provides that product liability losses are those losses incurred from product liability claims, expenses in connection with investigation thereof, and settlements. Excluded from the definition is the type of work which would normally be covered under a warranty. In addition, the definition does not include liabilities related to services performed by the taxpayer. Hence, malpractice claims and payments by a professional would not qualify for the ten year carryback provision.

The term "product liability" is defined by the Act to include liabilities of the taxpayer for damages on account of physical injury or emotional harm to individuals or for loss of the use of property on account of a defect in the product which is manufactured, leased, or sold by the taxpayer, if such injury, harm, or damage arises after the taxpayer has completed or terminated operations with respect to and has relinquished possession of the product.

Section 537(b) has been amended by adding a new paragraph which provides that an accumulation of reasonable amounts for the anticipated product liability losses shall be considered as a reasonably anticipated need of the business. This section in effect requires that the IRS take into consideration the taxpayer's product liability requirements in determining whether or not there has been an unreasonable accumulation of earnings and profits which would otherwise be subject to the penalty tax of 27 1/2% of the first $100,000 of accumulations in excess of $150,000 and 37.5% on accumulations in addition to that amount.

3.08—Low Income Housing—Rehabilitation Expenditures

Code Section 167(k)—Act Section 367
Effective Date: Extended for contracts entered into before January 1, 1982

The Tax Reform Act of 1969 provided for a rapid five-year write off of rehabilitation expenditures of low or moderate income rental housing. This was initially scheduled to expire on December 31, 1978. The Revenue Act of 1978 now extends this five-year write off for all expenditures which result from contracts entered into prior to January 1, 1982.

It should be noted that this type of rehabilitation expenditures would not qualify for the new investment credit, since residential rental units are involved rather than the rehabilitation of business property.
3.09 Regular Corporate Nonqualified Plans
Act Section 132
Effective Date: Taxable years beginning on or after February 1, 1978

The Revenue Act of 1978 foreclosed the constructive receipt rule proposed by the Treasury in February, 1978 in Proposed Regulation Section 1.6116 as applied to employees of taxable entities with unfunded nonqualified deferred compensating plans. Under the Treasury's proposed plan, the Service would have taxed compensation even though it had not been received if the deferral was at the sole discretion of the taxpayer. The Revenue Act requires that the law existing before the proposed regulation be presently applied. Therefore, under present law, if one is employed by a regular corporation and elects to defer a portion of his salary (in advance of actually earning the sum) such portion will not be taxed until it is received at a later time when the individual's earnings may be subject to a lower tax rate. The existing rules for exclusion of compensation are described in Revenue Ruling 60-31\(^{18}\) which states that the employer's promise to pay at a later date does not result in currently taxable income for the employer even though there may be no forfeiture risks involved. The employer may not deduct for the deferred compensation (unless the plan is a qualified one) until it is received by the employee.

Since tax-exempt organizations were not included in the private plan rules, it appears likely that such rules will not apply to nonqualified plans provided by this type of exempt organization.

3.10 Independent Contractors
Code Section 404—Act Section 133
Effective Date: Taxable years beginning January 1, 1979

Under prior law, the rule that an employer is not allowed a deduction for deferred compensation under a nonqualified plan until the year the payment was made did not extend to the employer-independent contractor relation. Thus, accrual basis taxpayers were obtaining current deductions for future payments to independent contractors. After December 31, 1978, no deduction will be allowed an employer of an independent contractor until that compensation is includable in the employee's gross income. However, this provision will not affect normal year-end accruals for compensation to independent contractors which are paid within a reasonable time after the close of the taxable year.

\(^{18}\) 1960-1 CUM. BULL. 74.
3.11 Government Plans  
Code Section 457—Act Section 131  
Effective Date: Taxable years beginning January 1, 1979

Under new Section 457(4), state and local government employees as well as tax-exempt rural electric cooperatives can defer limited amounts of compensation under an eligible plan provided by a state or local government unit. The employee can elect to defer the lesser of $7,500 or one-third of his annual includable compensation.

The statute requires that the election to defer compensation must be made at the beginning of each month for which compensation is to be deferred, and that no benefits may be made available except with death, separation from service, retirement, or an unforeseeable emergency. The plan may provide the participant with a choice of investment alternatives without adverse tax results. The plan has until January 1, 1982 to meet statutory eligibility requirements. However, if after that date the plan does not meet the eligibility requirements, the deferred compensation will be taxed in the first taxable year in which there is no substantial risk of forfeiture to the employee.

Although employees may participate in more than one plan, they are subjected to a single $7,500 limit.

3.12 Qualified Salary Reduction Plans  
Code Sections 401(1), 402(a)(8)—Act Section 135  
Effective Date: Taxable years beginning January 1, 1980

Under this type of plan, the employee may choose to have part or all of his yearly compensation paid to him in cash with the remainder paid into a qualified profit sharing plan thereby deferring income. Inequities arose in this arrangement following passage of the Employee Retirement Income Security Act (ERISA) since employer contributions to plans in existence before June 27, 1974, were not taxed to the employee, and contributions to plans set up after that date were currently taxed to the employee. The 1978 Revenue Act ends this discrimination between employers with pre-1974 and post-1974 plans in accordance with the requirements of Section 402(a). A participant in a qualified cash or deferred profit sharing plan will choose whether or not to elect to defer his current income to a tax qualified profit sharing or stock bonus plan, and pay no current taxes on the amount deferred.

To be eligible as a tax qualified plan, the arrangement must meet the normal pension plan qualification rules as well as the following additional requirements:

1. The employer's contributions must be nonforfeitable at all times.
2. Plan distributions may be made only in the case of death, disability, retirement, separation from service, hardship, or the reaching of age 59½.

3. Nondiscrimination requirements including the requirement that the deferral percentage for the highest paid one-third of employees does not exceed fifty percent of that paid in by remaining eligible employees must be met.

Plans in existence before June 27, 1974 will receive their present treatment whether or not they meet the new qualification requirements until January 1, 1980. Earlier Revenue Rulings\(^{10}\) will be in effect as to these plans until January 1, 1980.

3.13 Cafeteria Plans

**Code Section 125—Act Section 134**

**Effective Date: Taxable years beginning January 1, 1979**

Under a cafeteria plan or flexible benefit plan as they are sometimes called, an employee may choose his own company paid fringe benefits, some of which were taxable and some of which were not. After ERISA, those employees who received benefits under plans established before June 24, 1974 were not taxed if they chose nontaxable benefits; however, those employees choosing taxable benefits under plans not in existence on June 24 were taxed on the income to the extent they could have elected nontaxable benefits.

After 1978, a participant in a written plan will not be taxed solely because he can choose among benefits in the plan. The rules do not apply to highly compensated individuals unless certain nondiscriminatory standards as to benefits provided, contributions made, and ability to participate are met. If the plan is discriminatory, the new Act says that the highly compensated individual's benefits are taxable to the extent he may "choose among the benefits of the plan." Benefits are defined as including taxable and nontaxable benefits.

A plan will be considered nondiscriminatory if made under an agreement which the Treasury finds is a collective bargaining agreement or if the total benefits provided highly compensated employees are not significantly greater than total or nontaxable benefits attributable to other employees.

All employees of commonly controlled groups of businesses are treated as employees of a single employer for the purpose of determining discrimination.

3.14 Education Reimbursement Programs
Code Section 127—Act Section 164
Effective Date: Taxable years beginning January 1, 1979, and ending before January 1, 1989

Employer's reimbursements for education are not tax-exempt by the employee if the payments are made under a separate written plan for the exclusive benefit of the employee and meet certain nondiscrimination requirements. The Act no longer requires that the educational benefits provided by the employer be job related. Payments may now qualify even if they lead to a promotion or a new type of job. Examples of eligible courses include law school, C.P.A. training courses or courses which may lead to promotions.

The program will be considered discriminatory if more than five percent of the payments paid for educational benefits can go to persons owning more than five percent of the stock or capital interest of the employer company. Although the program must benefit a broad class of employees, it will not be considered discriminatory merely because it is used more by one class of employees than another. The benefits may depend on successful completion of a course at a specified proficiency level.

Excludable payments may be made for tuition, books, supplies, or other equipment, but may not be made for employer provided meals, lodging, or transportation. Neither may the course pertain to sports, games, or hobbies unless they are directly related to the employer's business. If the employee may choose taxable benefits such as cash instead of the educational training, income will result to the employee.

Eligible employees must be notified of the plan's existence, and informed of its terms. If it is unreasonable for the employer to believe that the payment is an excludable benefit, no withholding is required.

It should be noted that this exclusion is in effect a "trial balloon" since Congress decreed that it expires in ten years.

3.15 Medical Reimbursement Plans
Code Section 105(h)—Act Section 366
Effective Date: Taxable years beginning January 1, 1980

Under prior law it was common practice to discriminate in favor of the highly compensated executives and employees by drafting a clause so that the medical expense reimbursement plan would cover all employees who were licensed to practice law (medicine) in the State of Ohio. In effect, this would eliminate any participation by the clerical, secretarial and/or clinical employees. Other cases involving nonprofessionals showed that in certain instances where the plan was truly for the benefit of the employees, it could
still be limited to employees who were also officers. To eliminate this type of discrimination, Congress in the 1978 Revenue Act moved to place severe restrictions on this type of benefit.

The committee report indicates that if the limitation on the medical expense reimbursement plan is a percentage of compensation, it shall be considered discriminatory per se. This is to eliminate the advantage to the highly compensated employee of providing a medical expense reimbursement plan equal to 5% of their compensation. For the professional earning $100,000 the limitation on reimbursement would be $5,000, whereas the clerical employee earning $10,000 would be entitled to only a $500 reimbursement limitation. It is the committee's intent to eliminate this type of discrimination. The author notes that while the committee states this is the rule, a foundation for such an interpretation is not clearly laid or set forth in the amended statute. It is the author's opinion that tax law should be found in the Code sections and not in committee reports, which should be relegated to the position of providing interpretation and not legislation.

All medical expense reimbursement plans which have been drafted in the past and which refer to percentage limitation or to restrictive categories should be carefully reviewed and amended.

Noninsured medical reimbursement plans may no longer discriminate in favor of highly compensated individuals. For purposes of this section, highly compensated individuals include the five highest paid company officers, stockholders owning more than 10% of the value of the stock, or individuals among the highest paid 25% of all employees excluding officers and stockholders. The plan may not provide greater benefits for these individuals than for other employees. The plan must benefit 70% of all employees or 80% of those eligible to participate. For meeting coverage requirements, the plan may exclude employees with less than three years service, part-time employees, and employees covered by a bargaining unit's plan.

If the plan fails to meet the coverage requirements by providing a benefit to a key employee which is not available to all other employees, the entire reimbursement paid under the plan will be taxable income to the employee to whom the benefit is made.

If the plan merely discriminates by providing greater benefits to key employees, only the portion of the reimbursement that is in proportion to the total amount of payments that went to key employees will be includable in income.
All other employees will receive a full tax exclusion for benefits received, even if the plan is found to be discriminatory.

3.16 Commuting Expense

Public Law No. 95-427

Effective Date: Applicable law is as existed on November 2, 1976

While a taxpayer is permitted to deduct the cost of transportation in connection with a trade or business, no deduction is allowed for the travel expense incurred between the taxpayer's home and place of business. This expense is referred to as commuting expense and is nondeductible since it relates to a personal living expense. In 1976 the IRS announced that all transportation expenses incurred in traveling between the taxpayer's residence and place of employment, even though the employment may have been temporary, was to be nondeductible commuting expense regardless of the type of work being performed, the distance taxpayer was required to travel to the job, the method of transportation or the degree of necessity in utilizing private transportation. The Ruling also provided that if the taxpayer received reimbursement for this type of travel, the reimbursement would be considered as wages for the purposes of FICA, FUTA and Income Tax Withholding. Although this ruling was to have been effective for expenses incurred after December 31, 1976, and before January 1, 1980, the IRS on three occasions suspended the effective date of this ruling. On September 23, 1977, the IRS announced that the ruling would be suspended indefinitely and that proposed regulations would be promulgated. Congress determined that they should have additional time to study this area of the law and, therefore, prohibited the IRS from issuing any rulings or final regulations prior to January 1, 1980. Therefore, any decisions relating to the deductibility of commuting expense would be made in accordance with the law as it existed prior to November 22, 1976, when Revenue Ruling 76-453 was issued.

3.17 Fringe Benefits

Public Law No. 95-427

Effective Date: October 7, 1978

Congress has mandated that the IRS adopt no new Treasury Regulations concerning taxation of employee fringe benefits before January 1, 1980, although proposed regulations may still be issued. Such areas as employee discounts, free air fare for airline employees, and cars to executives were covered in proposed regulations issued in 1975.
4.00 Individuals

4.01 Individual Income Tax

Code Sections 1, 63(d), 151—Act Sections 101(a), 101(b), 102(a)

Effective Date: Taxable years beginning January 1, 1979

There are basically four changes in the Revenue Act of 1978 that will provide individual taxpayers with income tax reductions. These four areas are: (a) the widening of the tax brackets, (b) the reduction of several of the tax rate schedules, (c) an increase in the zero bracket amount, and (d) an increase in the personal exemption amount.

Under previous law there were twenty-five brackets for both single and joint returns. This number of brackets has been decreased to fifteen for joint and sixteen for single returns. The tax rates still range from a low of 14% to a high of 70%; however, the rationale for the change is to prevent higher earnings due to inflation from being pushed into higher tax brackets. The brackets are:

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>1978 Tax</th>
<th>% on Excess</th>
<th>Taxable Income</th>
<th>1979 Tax</th>
<th>% on Excess</th>
</tr>
</thead>
<tbody>
<tr>
<td>15,200</td>
<td>2,260</td>
<td>25%</td>
<td>16,000</td>
<td>2,265</td>
<td>24%</td>
</tr>
<tr>
<td>19,200</td>
<td>3,260</td>
<td>28</td>
<td>20,200</td>
<td>3,273</td>
<td>28</td>
</tr>
<tr>
<td>23,200</td>
<td>4,380</td>
<td>32</td>
<td>24,600</td>
<td>4,505</td>
<td>32</td>
</tr>
<tr>
<td>27,200</td>
<td>5,660</td>
<td>36</td>
<td>29,900</td>
<td>6,201</td>
<td>37</td>
</tr>
<tr>
<td>31,200</td>
<td>7,100</td>
<td>39</td>
<td>35,200</td>
<td>8,162</td>
<td>43</td>
</tr>
<tr>
<td>35,200</td>
<td>8,660</td>
<td>42</td>
<td>45,800</td>
<td>12,720</td>
<td>49</td>
</tr>
<tr>
<td>39,200</td>
<td>10,340</td>
<td>45</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(Note the decrease in the brackets and the reduction of the rates for 1979.)

There is a substantial tax reduction at the medium income level. For example, a married couple filing a joint return with a taxable income of $35,200 in 1978 had to pay tax of $8,660, while in 1979 under the same factual situation, the couple would have to pay a tax of $8,162.

The zero bracket amount which replaced the standard deduction has been increased:

<table>
<thead>
<tr>
<th>1978</th>
<th>1979</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single taxpayer</td>
<td>2,200</td>
</tr>
<tr>
<td>Married taxpayer filing jointly</td>
<td>3,200</td>
</tr>
<tr>
<td>Married taxpayer filing separately</td>
<td>1,600</td>
</tr>
<tr>
<td>Surviving spouse</td>
<td>3,200</td>
</tr>
</tbody>
</table>

The fourth change benefiting the taxpayer is the increase in the personal exemption. The personal exemption for each taxpayer and his
dependents has been increased from $750 to $1,000. This increase also affects additional exemptions for blindness and those over age 65. However, the general tax credit expires in 1979 and will not be continued. For example, a married couple files a joint return for 1978 with a taxable income of $25,000. They have a personal exemption deduction of $1,500, plus a general tax credit of $70. In 1979 the same couple would have a personal service exemption deduction of $2,000 and no general tax credit.

The following chart combines the changes into zero bracket and personal exemption amounts to indicate the new filing requirements:

<table>
<thead>
<tr>
<th></th>
<th>1978</th>
<th>1979</th>
</tr>
</thead>
<tbody>
<tr>
<td>Married couple, joint return</td>
<td>$4,700</td>
<td>$5,400</td>
</tr>
<tr>
<td>Married couple, joint return, one spouse age 65 or older</td>
<td>5,450</td>
<td>6,400</td>
</tr>
<tr>
<td>Married couple, joint return, both spouses age 65 or older</td>
<td>6,200</td>
<td>7,400</td>
</tr>
<tr>
<td>Married taxpayer, separate return</td>
<td>750</td>
<td>1,000</td>
</tr>
<tr>
<td>Surviving spouse</td>
<td>3,950</td>
<td>4,400</td>
</tr>
<tr>
<td>Single taxpayer, including head of household</td>
<td>2,950</td>
<td>3,300</td>
</tr>
<tr>
<td>Single taxpayer, age 65 or older</td>
<td>3,700</td>
<td>4,300</td>
</tr>
<tr>
<td>Dependent child with “unearned” income in excess of $750 or $1,000, respectively</td>
<td>750</td>
<td>1,000</td>
</tr>
</tbody>
</table>

4.02 Sales of Residence—Exclusion of Gain
Code Section 121—Act Section 404
Effective Date: Sales and exchanges after July 26, 1978

Under prior law a taxpayer aged sixty-five or older was permitted a one-time election to exclude from gross income the entire gain realized on the sale of his principal residence where the sale price of the residence was $35,000 or less, or to exclude a portion of gain if the adjusted sales price of the residence exceeded $35,000. The taxpayer was required to have owned and used the home as a residence for at least five years during the eight years preceding the sale.

The Revenue Act provides that for sales and exchanges occurring after July 26, 1978, a taxpayer who is aged 55 or older may elect to exclude up to $100,000 of the gain on the sale or exchange of his principal residence. The taxpayer is required to have owned and used the home as a residence for at least three years during the five years preceding the sale. As under prior law the new provisions permit the use of Section 1034 for deferring all or part of the gain not excluded.
Illustration:

On his 55th birthday, July 27, 1978, a taxpayer sold his residence for $150,000. The home was purchased in 1974. The taxpayer's basis in the home was $102,000 and the selling expenses were $23,000. Therefore the taxpayer's gain is $25,000. If the taxpayer elects to take the $100,000 exclusion, then the $75,000 of the exclusion not used is forfeited. That is, if he purchases another home and then sells it three years later, making a profit of $70,000, none of the $100,000 exclusion would be applicable. However, the taxpayer could defer his gain of $25,000 by buying another home costing at least $127,000. Then, if he sold that residence at least three years later at a profit of $70,000, he could elect to apply the $100,000 exclusion to the $70,000 profit and the $25,000 of deferred gain, and thereby incur no federal income tax liability for either sale.

4.03 Sale of Residence—Multiple Sales Within Eighteen Months

Code Section 1034(d)—Act Section 405

Effective Date: Sales and exchanges after July 26, 1978

A taxpayer may defer the gain realized on the sale of his principal residence where a new residence is purchased at a price greater than the adjusted sales price of the old residence. But if another principal place of residence is purchased within eighteen months of the subsequent sale, then only the last residence qualifies for the deferred gain and all gain on the prior sale is recognized.

If after selling his old home in March, 1978 and purchasing a new one in the same month, an individual is transferred by his employer, under prior law the individual would be required to report a gain on the sale of his new residence. The law provides relief for this individual. If the taxpayer must relocate for employment purposes and meets the requirements of Section 217 dealing with the deduction for moving expenses, the subsequent sale of his new residence will qualify for deferred gain treatment even though he purchases another home at the same location within eighteen months of the March sale.

The taxpayer, in order to receive full non-recognition treatment, would be required to purchase a home at his new location at least as expensive as the last residence sold.

4.04 Unemployment Compensation

Code Sections 85, 6050(B)—Act Section 112

Effective Date: Taxable years ending after December 31, 1978

Previously, federal or state unemployment compensation was not includable in gross income. However, beginning in 1979 a recipient of unemployment compensation could be liable for federal income tax on such
payments. Unemployment compensation is taxable to the extent that it exceeds one-half of the amount by which the taxpayer's adjusted gross income, including the unemployment compensation, exceeds $20,000 for unmarried taxpayers, $25,000 for married taxpayers filing jointly, or $0 for married taxpayers filing separately. Although there is no withholding requirement, any person making payments of unemployment compensation is required to furnish to the Service the aggregate amount of such payments and the name and address of the individual to whom the compensation was paid.

4.05 Income Averaging
  Code Sections 402(e), 1302(b)—Act Section 101(d)
  Effective Date: Taxable years beginning after December 31, 1977

The Revenue Act of 1978 provides for a mechanical adjustment so that the tax rate tables can be utilized by a taxpayer who is income averaging. For years prior to 1977, the zero bracket amount of $3,200 for joint returns, $2,200 for single individuals and $1,600 for married individuals filing separately must be added to the taxpayer's base period income for the pre-1977 years. The zero bracket amount would be used for years 1978 and thereafter.

For lump sum distributions from a pension plan, the ten-year averaging method used the $2,200 zero bracket amount applicable to a single individual as part of the calculation. For years commencing in 1978 and thereafter the new zero bracket amount for single individuals of $2,300 is to be used.

5.00 Capital Gains

5.01 Capital Gains Deduction
  Code Section 1202—Act Section 402
  Effective Date: Taxable years ending after October 31, 1978

Capital gains are considered income and must be included in gross income. However, a special deduction from gross income is allowed on the excess of net long-term capital gain over net short-term capital gain. Long-term capital gains or losses result from sales or exchanges of capital assets held one year or longer. Short-term capital gains or losses result from sales or exchanges of capital assets held less than one year. Under prior law the excess net long-term capital gain has been subject to a 50% deduction. Effective November 1, 1978, 60% of the excess net long-term capital gain will be deductible from gross income. Since this is a mid-year change, the taxpayer having long-term capital gains throughout the 1978 taxable year will have to separate the gains into pre-November and post-November gains. Thus, 50% of the pre-November capital gains and 40% of the post-
November capital gains will be included in the taxpayer's gross income. For subsequent years, only 40% of the net long-term capital gains will be includable in income.

The 60% long-term capital gain deduction, as the previous 50% long-term capital gain deduction, is a tax preference item for the minimum tax in 1978. However, beginning in 1979 the long-term capital gains preference will not be used against the minimum tax, but will be subject to a new alternative minimum tax.

5.02 Capital Gains—Reduction of Personal Service Income
Code Section 1348(b)(2)(B)—Act Section 441
Effective Date: Taxable years beginning after October 31, 1978
The Revenue Act of 1978 eliminates the capital gains preference as a reduction of personal service income, otherwise subject to the limit of the 50% maximum marginal tax bracket rather than the 70% passive income tax bracket. All long-term capital gains deductions prior to November 1, 1978 reduce personal service income subject to the 50% maximum tax, which means that the 50% maximum tax ceiling is partially withheld from the higher tax bracket individuals. For example, a taxpayer has:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal service income for all of 1978</td>
<td>$60,000</td>
</tr>
<tr>
<td>Pre-November 1, 1978 long term capital gains</td>
<td>$20,000</td>
</tr>
<tr>
<td>Post-November 1, 1978 long term capital gains</td>
<td>$12,000</td>
</tr>
</tbody>
</table>

In computing maximum tax, the taxpayer must take 50% of the pre-November long-term capital gain and reduce his personal service income by that amount ($60,000-$10,000 = $50,000 of personal service income). The amount of long-term capital gains after November 1, 1978, does not reduce the personal service income of that individual. Thus, the earned income is not exposed to the higher passive income bracket. This change is very important, since the amount of long-term capital gains deductible as of November 1, 1978 is 60%. Hence the new Revenue Act has increased the long-term capital gains deductible amount while ceasing to apply it to decrease the individual's personal service income. All of which is conducive to the Administration's philosophy of increasing capital investments.

5.03 Capital Gains Alternative Tax Repealed
Code Section 1201(b)—Act Section 401
Effective Date: Taxable years beginning after December 31, 1978
In keeping with the Administration's philosophy of decreasing tax advantages applicable primarily to higher bracket taxpayers, the Revenue Act of 1978 has repealed the alternative capital gains computation.
Under prior law a taxpayer could deduct from gross income 50% of the amount of any net capital gain for the taxable year. The remaining 50% of the net taxable gain was includable in gross income and taxed at the applicable rates. In lieu of taking 50% of net capital gains at regular rates, an alternative tax of 25% of the net capital gains was available.

5.04 Alternative Minimum Tax

Code Section 55—Act Section 421

Effective Date: Taxable years beginning after December 31, 1978

Long-term capital gain deductions and the adjusted itemized deductions (excluding medical expenses and casualty losses) preferences have been removed from the 15% minimum tax. However, a new alternative minimum tax based only upon those two preferences has been enacted. This alternative minimum tax is much more flexible than the 15% minimum tax. The old 15% minimum tax was introduced in the Tax Reform Act of 1969 under the philosophy that all taxpayers should pay some amount of federal income tax. The Tax Reform Act of 1976 added to the initial list of tax preferences, while the Revenue Act of 1978 has excluded these two items and developed a new minimum tax for these two excluded preferences.

The alternative minimum tax is computed by adding taxable income, long-term capital gain preferences and adjusted itemized deduction preferences and subtracting from that amount a $20,000 exemption to determine the base amount. The base amount of the taxable income is then subject to the following tax rates:

<table>
<thead>
<tr>
<th>Taxable Income Range</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1 to $40,000</td>
<td>10%</td>
</tr>
<tr>
<td>$40,001 to $80,000</td>
<td>20%</td>
</tr>
<tr>
<td>$80,000</td>
<td>25%</td>
</tr>
</tbody>
</table>

The taxpayer compares the alternative minimum tax to his regular tax, and pays whichever is higher, but not both. For example, a taxpayer has $60,000 of earned income and $100,000 of net long-term capital gain. For taxable years beginning after 1979, his tax would be computed as the greater of his regular tax or the alternative minimum tax. His regular tax would be based upon $60,000, plus $40,000 of taxable income and long-term capital gain, less whatever deductions and credits he may have. The alternative minimum tax would be based upon $100,000 of taxable income (60,000 salary plus 40,000 taxable net long-term capital gain) plus the $60,000 of untaxed long-term capital gain. From that amount $160,000, the $20,000 exclusion would reduce the amount to $140,000 upon which the alternative minimum tax would be:
10% on $40,000 ..................................................$ 4,000
20% on second $40,000 ........................................$ 8,000
25% remaining $60,000 .........................................$15,000

Total alternative minimum tax ................................$27,000

Hence, if his regular tax is computed at less than $27,000 he would pay the alternative minimum tax and, on the other hand, if the regular tax was in excess of $27,000 he would pay the regular tax.

It should be noted that except for the foreign tax credit, the taxpayer may not use any other type of credit, for example, child-care credit, against the alternative minimum tax. In the situations where the foreign tax credit is used to offset the alternative minimum tax, the alternative minimum tax is computed by taking:

\[
\frac{(\text{regular U.S. tax} + \text{alternative minimum tax}) \times \text{(alternative minimum tax from foreign source)}}{\text{entire minimum taxable income}}
\]

However, the credit cannot exceed the amount for the actual tax plus the lesser of the foreign tax or the alternative minimum tax.

6.00 Tax Credits

6.01 Investment Credit of Ten Percent Becomes Permanent

Code Section 46(a)(2)—Act Section 311

Effective Date: January 1, 1981

The Revenue Act of 1978 makes permanent the 10% investment credit and the qualification of up to $100,000 of used property for the investment credit. Both of these temporary increases, from 7% and from $50,000, were scheduled to terminate on December 31, 1980.

Section 301(d) of the Energy Act adds Code Section 48(a)(10) whereby the investment credit is denied for boilers which are fueled by either oil or gas and are placed in service after September 30, 1978, unless a binding contract was executed prior to that date. The only exception to this rule is in the event that the use of coal is prohibited under local or federal pollution standards.

6.02 Investment Credit—Limitations

Code Section 46(a)—Act Section 312

Effective Date: Taxable years beginning after December 31, 1978

For tax years beginning prior to January 1, 1979 there is an overall limitation on the amount of investment credit which can be used to offset tax liability equal to the first $25,000 of tax liability plus 50% of the tax liability in excess of $25,000. The percentage is gradually increased
from 60% in 1979, 70% in 1980, 80% in 1981 to 90% by 1982. This means that by 1982 the taxpayer can utilize investment credit to offset the first $25,000 of tax liability plus 90% of the tax liability in excess of $25,000.

6.03 Investment Credit—Rehabilitation Expenditures
Code Section 48—Act Section 315
Effective Date: Tax years ending after October 1, 1978

The cost of acquiring or constructing buildings does not qualify for the investment credit. To encourage business to rehabilitate existing buildings the Revenue Act of 1978 has expanded the concept of eligible property to include the rehabilitation of buildings used for business purposes. If the rehabilitation has a life of at least five years, then the expenditures of up to $100,000 are eligible for a 10% investment credit. The investment credit acts as a direct deduction dollar for dollar of the taxpayer’s federal income tax liability and does not reduce the basis of the property for the purposes of calculating depreciation.

To be eligible for this credit the building must have been in existence for at least twenty years and be placed in service prior to the time that the taxpayer commences making the rehabilitation expenditures. There is also an additional limitation which provides that no more than 25% of the building’s existing external walls may be replaced. In effect, this requirement is to insure that the credit is going to be applied only to the renovation and rehabilitation and not to the construction of a new structure. Qualified property includes buildings used in business or for productive purposes, but does not include buildings which will be used for residential purposes. An exception to the residential purposes would be a hotel or motel where it is rented to transients, and not to long-term tenants.

The Tax Reform Act of 1976, in an effort to encourage the preservation of historical structures, authorized taxpayers to amortize their rehabilitation expenditures of a certified historical structure over a period of five years. Now a taxpayer has the option, in the event that a certified historical structure is involved, of whether to use a five-year amortization to recover the rehabilitation expenditures or to elect the 10% investment credit. The use of both of these tax incentives is not permitted on the same building.

The replacement of an interior of a building or the installation of new plumbing, wiring, heating, and/or air conditioning systems will qualify as a rehabilitation expenditure for which the investment credit is available. The cost of these expenditures will be recovered over the normal useful life as set forth in the normal rules of determining depreciable lives.
6.04 Investment Credit—Livestock and Horticultural Buildings  
Code Section 48—Act Section 314  
Effective Date: Taxable years ending on or after August 15, 1971  

Congress has now clarified what special use agricultural and horticultural buildings will qualify for the investment credit. Under prior law numerous questions and a great amount of litigation had arisen over which special use buildings qualified for the investment credit. As previously stated, the general rule is that buildings are not eligible for the investment credit. However, if a structure is specifically constructed to accomplish a productive process, then the investment credit is applicable. The IRS had disallowed the investment credit where there was a possibility that the structure could provide places or space for employees to work in addition to performing the specific function for which the structure was designed.

This problem has now hopefully been solved by Congress specifically setting forth that buildings used for a single purpose to produce livestock, poultry, eggs or horticultural projects are eligible for the investment credit. There is a requirement that the building be used specifically and exclusively for the agricultural or horticultural purpose for which it was designed and constructed. Included as an integral part of the structure must be the necessary equipment to actually feed, raise, and care for the specific type of livestock involved. While space in the building, if used for the structure's purpose, will not disqualify the building for investment credit; utilization of space for storage or for selling functions will cause a disqualification.

Professional advisors should note that if a taxpayer filed his tax returns in accordance with the IRS rulings and regulations, amended returns should be filed for any open years during which a special purpose building was constructed and no investment credit was taken.

6.05 Investment Credit — Pollution Control Facilities  
Code Section 46(C)(5)—Act Section 313  
Effective Date: Tax years beginning January 1, 1979  

Under prior law, if the construction of a pollution control facility qualified for the rapid five-year amortization, only one-half of the facility's cost was eligible for the investment credit. For tax years commencing after December 31, 1978, the investment credit may be claimed on the entire cost of the facility, regardless of whether or not the rapid five-year amortization is elected. If the cost of the facility is being amortized over a period of five years, the 10% investment credit, however, would apply to only two-thirds of the facility's cost. A facility must have a life of at
least seven years to qualify for the 10% investment on the entire amount of the cost.

If the facility's cost is being financed by tax-exempt industrial development bonds, then only 50% of the facility's cost will be eligible for the investment credit if the five-year rapid amortization is elected.

6.06 Targeted Jobs Tax Credit
Code Section 51—Act Section 321
Effective Date: Tax years beginning January 1, 1979

For the years 1977 and 1978 taxpayers were permitted a job tax credit equal to 50% of the increase in the employer's wage as determined under FUTA above 102% of the wage base in the prior years. The wage base for making these calculations on which the credit could be based was limited to $4,200 per employee. This credit was subject to the four following limitations: (1) the credit could not exceed 50% of the increase in total wages paid by the employer for the year in excess of 105% of the total wages paid by the employer in the previous year; (2) the credit could not be more than 25% of the current year's FUTA wages; (3) the credit could not exceed $100,000; and (4) the credit could not exceed the employer's tax liability, meaning that no refund could result from this tax credit. The deduction to which the employer would otherwise have been entitled for the payment for salaries or wages was reduced by the amount of the credit.

Prior law also provided for a credit of 10% of the first $4200 of the FUTA wages paid to handicapped individuals while undergoing vocational rehabilitation.

The above job-related tax credits have been eliminated and a targeted job credit has been substituted. The goal of the new job credit is to provide employment for specific areas of hard-core unemployed individuals. A credit equal to 50% of the first $6,000 of wages will be allowed for the hiring of the following individuals: (1) individuals receiving Supplemental Security Income; (2) handicapped individuals undergoing vocational rehabilitation; (3) persons aged eighteen to twenty-four who are members of economically disadvantaged families, which had income during the preceding six months of less than 70% of the Bureau of Labor Statistics lower living standard; (4) disadvantaged members of families of Vietnam veterans; (5) individuals who have been receiving general assistance relief for thirty days or more; (6) youth between the ages of sixteen and eighteen participating in a qualified cooperative education program, (this would include the hiring of high school students currently enrolled in and graduates of a distributive graduation program); and (7)
convicts who are members of economically disadvantaged families who are hired within five years after the day of release from prison.

Fortunately the Act requires that a single employment agency within each locality be designated to certify that an individual applicant qualifies under one of the seven headings. To prevent the dislocation of existing employees, there is a requirement that wages eligible for the credit cannot exceed 30% of the FUTA wages for all employees during the preceding calendar year. Also the employer's deduction for the wages paid to the targeted group of employees is reduced by the amount of the tax credit. For example the savings in the first year of employment is $1,620 calculated as follows:

The $3,000 tax credit is reduced by the corporate tax rate for a corporation earning over $100,000 of 46% ($1380 or a net savings of $1620). In the second year of employment the credit is equal to 25% of the first $6,000 of wages. The savings in the second year is $810. In the event the corporate tax rate is less than 46%, the savings are greater.

There is an overall limitation on the targeted jobs tax credit of 90% of the employer's tax liability after reduction for the foreign tax, the credit for the elderly, the investment credit and the WIN-Welfare Credit, political contributions credit and the credit for child and dependent care services. The wages paid must be for services rendered in a trade or business of the employer and not for personal or household services. Qualifying wages also exclude any wage for which an employer is receiving on-the-job payments.

Unused targeted jobs credit can be carried back three years and forward seven years.

6.07 Energy Credit—Individuals
Code Section 44(c)—Energy Act of 1978, Section 101
Effective Date: Residences substantially constructed prior to April 20, 1977

As an incentive to individuals to save energy in relation to their personal residences, the Act provides for a 15% tax credit on the first $2,000, limited to the taxpayer's tax liability, of energy conserving expenditures which have an expected life of at least three years. Included in the list of energy conserving expenditures are (1) replacing a furnace burner with a more efficient one, (2) modification of flue openings designed to increase efficiency of furnaces, (3) replacement of gas pilot lights with mechanical or electrical ignition systems, (4) storm or thermal windows and doors, energy saving thermometers which cut back the heat during hours when the house is used at a minimum, (5) caulking or
weatherstripping of exterior doors and windows, (7) energy display meters, and (8) other items as specified by the regulations.

6.08 Energy Credit—Solar and Wind Energy Equipment  
Code Section 44(c)—Energy Act of 1978, Section 101  
Effective Date: Expenditures made on or after April 20, 1977 and prior to January 1, 1986

Again, to encourage the conservation of energy in connection with the taxpayer's personal residence, the Act provides for a credit in an amount equal to 30% of the first $2,000 and 20% of the next $8,000 of expenditures for qualifying solar and wind energy equipment expenditures which are installed on the taxpayer's principal residence. The maximum credit resulting from a $10,000 expenditure is $2,200. As with the preceding credit this credit is limited to the amount of the taxpayer's liability.

6.09 Energy Credit—Business  
Code Sections 46(a)(2), 46(a)(10), 48(l)—Energy Act of 1978, Section 301  
Effective Date: Equipment placed in service after September 30, 1978 and before January 1, 1983

Investment in the following six categories qualifies for a 10% energy tax credit. This is in addition to the 10% investment credit. The qualifying type of expenditures are (1) alternate energy equipment; (2) solar or wind property; (3) specially defined energy property; (4) recycling equipment; (5) shale oil and (6) shale oil equipment to process natural gas from geopressed brine. The energy tax credit is reduced from 10% to 5% in the event that the project is financed with tax-exempt industrial bonds.

This equipment must be utilized in the taxpayer's trade or business and in the event the property is sold or disposed of prior to the end of the property's useful life, the energy credit is subject to recapture.

6.10 Commuter Vehicles  
Code Sections 46(c)(6), 124—Energy Act of 1978, Sections 241, 242  
Effective Date: Transportation provided from January 1, 1979 through December 31, 1985

To encourage employers to provide commuting vehicles for their employees, the Energy Act of 1978 provides that if an employer purchases a commuter vehicle, such as a new van, with a useful life of at least three years and which has seating facilities for eight or more persons, not including the driver, and if at least 80% of the vehicle's mileage is used for transporting employees between work and their residence while one-half of the seating capacity is utilized, the employer will be entitled to an investment credit of 10% of the cost of the van. This is in contrast to the normal rule which would permit the employer to take an investment credit of 10% on only 1/3 of the van's acquisition's cost, since only 1/3 of the cost of the
equipment qualifies for the investment credit when the useful life is between three and five years. To qualify for 10% on the entire acquisition cost a life of seven years is normally required.

To eliminate the question of whether or not the transportation services provided to an employee creates additional income, the Act specifically excludes this type of fringe benefit from includable income as long as such transportation services are provided on a nondiscriminatory basis and are not in lieu of any other type of compensation. This provision eliminates any possibility of obtaining an investment credit and also the exclusion from income for an executive who is provided limousine service to and from his residence.

6.11 Geothermal Deposits

Code Sections 48(l), 263(c), 465(c), 613, 1254(a)—

Energy Act of 1978, Sections 301, 402, 403

Effective Date: Wells drilled after September 20, 1978 and before January 1, 1984

A geothermal deposit is a reservoir consisting of natural heat that is stored in rocks or in an aqueous liquid or vapor. The intangible drilling costs in connection with the drilling and exploration for geothermal wells can be deducted currently. As with oil and gas intangible drilling costs, this amount may be a tax preference for the purpose of calculating the minimum and maximum tax. The calculations are similar to those used for oil and gas. In the event that a taxpayer, who elects to currently deduct the intangible drilling costs, later disposes of the geothermal properties, recapture is required to the extent that the intangible drilling costs exceeded the amount which would have been allowed had the cost of drilling been capitalized and subject to depletion deductions.

As with other oil and gas investments, the taxpayer is subject to a limitation that the losses cannot exceed the amount which he is "at risk." Therefore, the amount of a taxable loss is limited to the amount of the actual investment plus the amount of the liability for which the taxpayer is personally liable.

Percentage depletion is authorized for geothermal deposits commencing at a rate of 22% for production in 1978 through 1980 and then is subject to a phase down to 15% by 1984. Again, the depletion allowance, to the extent that it exceeds the taxpayer's basis, is a tax preference.

6.12 Child Care Payments to Related Individuals

Code Section 44—Act Section 121

Effective Date: Taxable years beginning after December 31, 1978

The Code provides a 20% tax credit for household and dependent
care expenses incurred in order to enable the taxpayer to work. The maximum tax credit for one year’s qualifying expenses is $400 for one dependent and $800 for two or more dependents.

Under prior law payments to relatives were not includable in the computation of the credit unless the services rendered constituted employment for social security purposes. The Revenue Act eliminates this requirement. The new provisions, however, do not affect the prior law that disallows the credit for payments to a relative who could be claimed as a dependent by the taxpayer.

6.13 General Tax Credit
Code Section 42—Act Section 102
Effective Date: Taxable years ending after December 31, 1978

The general tax credit which was introduced into the Code in the Tax Reduction Act of 1975 as an antirecession measure was eliminated by the Revenue Act of 1978. For the year 1978 taxpayers were entitled to a credit which was equal to the greater of $35 for each person entitled to be claimed as an exemption deduction or 2% of taxable income not in excess of $9,000. In effect this credit has been incorporated into the personal exemption which was increased from $750 to $1,000.

6.14 Earned Income Credit
Code Section 43—Act Sections 103, 104, 105
Effective Date—Taxable years beginning after December 31, 1978

The earned income credit is a refundable tax credit, which means that a qualifying taxpayer is entitled to the full benefit of the credit even though there is no tax liability. To a limited extent it would appear to be very similar to a negative income tax. The tax was to have expired on December 31, 1977, but was made permanent by the Revenue Act of 1978.

The earned income credit for 1979 and thereafter is equal to 10% of the first $5,000 of an individual’s earned taxable income. However, to the extent the individual’s income exceeds $6,000, the credit will be reduced by 12.5% of the amount by which his earned income exceeds $6,000. For example, a taxpayer with earned income of $7,000 is entitled to an earned income credit for the year 1979 of $375 ($500 less 12.5% of $1,000). Under prior law the credit was equal to 10% of the first $4,000 of earned income and was reduced by 10% of the amount that the individual’s earned income exceeded $4,000. Therefore, under prior law an individual with $7,000 of income was entitled to a credit of only $100 ($400 less 10% of $3,000).
7.00 Tax Shelters

7.01 Partnership Provisions

Code Sections 6501, 6511, 6998—Act Sections 211, 212

Effective Date: Taxable years beginning after December 31, 1978

Individuals who invest in partnerships are entitled to deduct partnership losses on their individual tax returns to the extent of their basis in the partnership. Prior to the Tax Reform Act of 1976 an individual's basis in his partnership investment included not only the cash or property which he had contributed but also his pro rata portion of indebtedness which the partnership had incurred. This was true whether or not the individual investor was personally liable on the indebtedness. The typical format for a tax shelter partnership involved limited partners making the investment and a general partner who was personally liable for indebtedness in determining the limited partner's basis. His pro rata share of the nonrecourse debt was added to his other investment.

To combat these tax shelters the Tax Reform Act of 1976 established a new rule which permitted the investor to count as his basis, only such amount of the indebtedness on which he was personally at risk. In the situation where the general partner was the only party personally liable for the debt, the investor after the Tax Reform Act of 1976 was not entitled to add the pro rata portion of this debt to his basis. Basis was limited to the cash contributed, the adjusted basis of property contributed to the activity and the amount borrowed by the taxpayer to the extent that the taxpayer was personally liable on the loan. The 1976 Act established a partnership at risk rule and also an activity at risk rule. Section 465, the activity at risk rule, applied when the partnership was engaged in activities of investing in 1) holding, producing or distributing motion picture films or video tapes; 2) farming; 3) leasing any Section 1245 property; or 4) exploiting, oil and gas resources as a trade or business or for the production of income. The partnership at risk rules under Section 704(d) merely added a sentence which prohibited the inclusion in a partner's interest of any partnership liability for which the partner was not personally liable. While the partnership at risk rules applied to all partners whether they be individuals or corporations, the activity at risk rule of Section 465 did not apply to general corporations, although it was applicable to individuals, Subchapter S corporations and personal holding companies. If an activity would have qualified under both the activity at risk and partnership at risk rules, Section 465 controlled. Specifically exempted from both of these provisions is a partnership which has as its principal activity the investment in real property.

The Revenue Act of 1978 eliminates the partnership at risk rule and
substitutes for them an expanded Section 465(c). The expanded rule now applies to all activities other than real estate. The law also makes the at risk rules applicable to individuals so as to eliminate the utilization of tax shelters such as the sale of master phonograph records, books and coal mining to individual taxpayers. These sales were still possible after the Tax Reform Act of 1976 since they were not made through a partnership and did not fit within the specific activity at risk rules of Section 465. It is possible that this vast expansion of the at risk rules can also trigger the disallowance of losses by a taxpayer who is actually engaged in another type of business which is generating tax losses. It also appears that each separate investment which is not a part of a trade or business will be treated as a separate activity and multiple investments will not be aggregated. This places each individual investment which is generating a tax loss in clear view for the IRS to examine and disallow the loss generated therefrom. The Act permits the IRS to issue regulations which will give more definite rules as to what activities can or cannot be aggregated.

The rules are specifically extended to apply to corporations where five or fewer individuals own 50% of the stock, either directly or through the attribution rules of Section 318.

The Act also requires that losses which have been previously allowed be recaptured as ordinary income when the amount of the investor's interest at risk is reduced below zero. The reduction of the amount at risk could be caused by distributions from the operation, the change of a recourse loan to nonrecourse or the triggering of a stop loss arrangement after a certain number of years. Losses so disallowed can be carried forward to future years and can be deducted at that time in the event that the amount at risk is increased or to the extent that income is earned and not distributed.

Specifically exempted from the at risk rules is equipment leasing by a closely held corporation which generates 50% or more of its gross income from the sale and/or leasing of equipment. Equipment leasing so exempted, refers to the lease of tangible personal property such as computers, aircraft, cars, over the road tractor-trailers and railroad rolling stock. Not exempted from the at risk rules are leases of tangible or intangible assets connected with literary, artistic or musical properties and the specific activities set forth in the Tax Reform Act of 1976, films, video tapes, farms and oil and gas production.
8.00 Retirement Plans

8.01 ESOPs

Code Sections 46, 48, 56, 409, 6699—Act Sections 141, 143

Effective Date: Taxable years beginning January 1, 1979

An Employee Stock Ownership Plan (ESOP) is a qualified retirement plan that allows a corporate employee to invest in the corporation's securities, and the corporation will receive an extra investment tax credit of up to one and one-half percent for qualifying contributions to such plan. There are two types of ESOPs—leveraged and unleveraged—which may be eligible for a tax credit. Under the 1978 Revenue Act they are referred to as leveraged ESOPs (LESOPs), or ESOPs. The term "TRASOP" described below does not appear in the 1978 Revenue Act. In the first type of arrangement, the employer contributes its common stock directly to a trust set up for the qualified retirement plan. The employer receives a deduction for the contribution, but the employee is not taxed until he receives a distribution from the trust. In the second type referred to as a LESOP, the trust borrows from a lending institution to buy the employer's stock. The employer's cash contributions to the trust made at a later date generally allow the trust to repay the principal and interest of the loan.

The one and one-half percent credit is composed of the employer's contribution equal to one percent of the qualified investment made by the employer plus another one-half percent credit given when the employee matches the employer's contribution of up to another one-half percent of the qualified investment.

The 1978 Revenue Act has made a number of important changes in both the Tax Reduction Stock Ownership Plan (TRASOP—an ESOP that meets the requirements of the 1975 Tax Reduction Act) and ESOP:

1. The TRASOP rules, after having been modified by the Tax Reform Act of 1976, are now incorporated in the Code, and are effective until December 13, 1983. (Code Section 409 A(a)—1978 Revenue Act Section 141(a)).

2. All ESOP contributions must be made to a tax qualified plan meeting the requirements of Section 401(a). A plan will be considered tax-qualified if it is established by the due date of the employer's return for the taxable year for which the credit is claimed and meets the requirements for a qualified plan. (Code Section 409A(c)—Revenue Act Section 141(a).)

3. Employer contributions to TRASOP must be allocated to the participants in proportion to total compensation to the extent the participant is entitled to a share under the rules governing tax-
qualified plans. Participants with compensation over $100,000 are not included in determining total compensation of all participants. (Code Section 409 A(b), A(d), and A(g)—1978 Revenue Act Section 141(a).)

4. Each participant must have a nonforfeitable right to those securities allocated to his account. (Code Section 409 A(c)—1978 Revenue Act Section 141(a).)

5. The only type of employer's securities which the ESOP may acquire and hold are common stock of the issuing corporation or preferred stock of the issuing corporation which is readily converted into common. A subsidiary may contribute its parent's stock to an ESOP whom the parent controls. The parent must own fifty percent of the subsidiary (reducing the control test from eighty percent under prior law). The eighty percent test is still in effect for second-tier subsidiaries. (Code Section 409 A(1) and 409 A(n)—1978 Revenue Act Section 141(a).)

6. The additional investment tax credit resulting from the ESOP or TRASOP contribution will not result in additional minimum tax to the employer. (Code Section 56(c)—1978 Revenue Act Section 141.)

7. Withdrawals in the event of investment credit recapture are no longer allowed. The employer may either reduce the amount required to be transferred to the current or succeeding year by an amount equal to the recaptured portion, or may deduct an amount equal to the recaptured portion or reduction of the credit up to the limit on deductions for contributions under deferred compensation plans. (Code Section 404.) The employer may use a combination. (Code Section 48(n)—1978 Revenue Act Section 141(b).)

8. Although the distribution from an ESOP may be in cash or in the employer's securities, the participant may demand the entire distribution in the form of employer securities. If the participant receives a distribution from an ESOP in the employer's securities which are not publicly traded, he must be given the right to require the employer to repurchase them under a fair valuation formula. This put option as it is called would give the participant six months to require the purchase after which time the option would lapse. (Code Section 409 A(h)—1978 Revenue Act Section 141(a).)

8.02 Closely-Held Stock—Voting Rights
Code Section 401(a)(22)—Act Section 143(a)
Effective Date: Acquisitions of securities beginning January 1, 1980

For tax years beginning after December 31, 1979, participants in a
tax-qualified defined contribution plan must be given voting rights in employer's securities, if the plan holds more than 10% of its assets in such securities and the employer's securities are not publicly traded. Voting rights must be extended on any corporate issue which by law must be decided by more than a majority vote of common shareholders voting on an issue.

8.03 Individual Retirement Account—Spousal

Code Section 2503(d)—Act Section 702(j)(2)

Effective Date: Spousal IRA's established after December 31, 1976

An individual who is not covered by another retirement plan or an HR-10, Keogh Plan is entitled to contribute 15% of his adjusted gross subject to a maximum of $1,500 to an individual retirement account. This amount is then deducted on the individual's income tax return. This is a method of providing a pension benefit for those individuals who are not fortunate enough to work for a large corporation which provides this type of benefit. If the individual also has a spouse who is not employed or is not covered under another plan, the amount of the contribution can be increased to $1,750.

The question has arisen as to whether or not the transfer of the additional funds would be considered as a gift, and if it is considered as a gift whether it is a gift of a present or a future interest. It would appear that without legislation it would be a gift of a future interest because the spouse's enjoyment is postponed until a future date. Therefore, the transfer would not be eligible for the $3,000 annual per donee exclusion.

The Revenue Act of 1978 adds Section 2503(d) which provides that the transfer shall be considered as a gift of a present interest, thereby qualifying for the annual exclusion.

8.04 IRA Contribution Date Extended

Code Sections 219(c) and 220(c)(4)—Act Section 157(a)

Effective Date: January 1, 1978

The date for making a contribution to an IRA account has been extended to the taxpayer's filing date (including extensions) rather than forty-five days after the preceding tax year as allowed under prior law. The new law does not change the requirement that an IRA account may be started on the same day as the contribution is made, meaning for example, that a 1978 account may be opened on the filing date in 1979.

8.05 Alternative Treatments for Excess Contributions to IRA

Code Sections 408(d), 4973(b), 219(c), 220(c)—Act Section 157(s)

Effective Date: January 1, 1978 unless otherwise stated below

If a taxpayer contributes no more than $1,750 (excluding rollovers)
to an IRA account, but such amount is in excess of the allowed contribution, he may withdraw this excess at any time as long as he has not previously deducted it. Such withdrawals will no longer be subject to the 6% excess contribution tax, the 10% premature distribution tax, or the income tax. There are no dollar limitations if the excess is withdrawn before the filing date. Taxpayers who paid penalties on excess contributions withdrawn may be eligible for refunds. Furthermore, if the withdrawal was made for a tax year beginning after December 31, 1975 and before January 1, 1978, the $1,750 limit does not apply.

As an alternative to the above, excess contributions may be deducted in the following tax year, changing the rule that excess contributions could only be applied, but not deducted. For example, if a taxpayer mistakenly contributes $1,200 to an IRA account in 1978, but he is only allowed a deduction of $900, the taxpayer may deduct the excess $300 as part of his contribution in 1979.

Furthermore, the new provisions allow that prior year excess contributions may be deducted in 1978.

8.06 Property Distributions
   Code Section 402(a)(6)(D)—Act Section 157(f)(1)
   Effective Date: Taxable years beginning January 1, 1979

If, after 1978, an individual receives property as part of a lump sum or a plan termination distribution from a qualified retirement plan, he may sell the property and rollover the proceeds to another IRA or other qualified plan without being taxed. Such transfer must be completed within sixty days of the distribution date. The spouse of a deceased participant is also allowed to rollover these distributions but only to another IRA plan. (Code Section 402(a)(7)(A) added by Act Section 157(g)(1).)

8.07 Partial Rollovers of IRA Distributions
   Code Sections 402 and 403—as added and amended by Pub. L. 95-458
   Effective Date: January 1, 1975

Under prior law, a taxpayer was required to transfer the entire sum of a lump sum distribution or termination distribution to another qualified retirement plan to obtain a tax free rollover. This is no longer the situation. For years beginning after 1974, the taxpayer may reinvest only a portion of the distribution in order to receive tax free treatment. The portion retained by the taxpayer will be treated as ordinary personal service income.

8.08 Spouse Allowed Rollovers
   Code Sections 402(a)(7) and 408(d)(3)—Act Section 157(g)
   Effective Date: Taxable years beginning January 1, 1979

Again, after 1978, the surviving spouse of a plan participant may
rollover a lump sum distribution to another IRA account. Even though the plan participant could have transferred the funds to another IRA or a qualified plan, the spouse is limited to another IRA.

8.09 **Rollover Restrictions Eased**

**Code Sections 402 and 408—Act Section 157(h)**

**Effective Date: January 1, 1978**

An IRA participant may now, beginning in 1978, rollover funds from one investment to another once a year rather than only once every three years as allowed under prior law. In 1978, taxpayers will no longer be required to have participated in the qualified plan for a minimum of five years in order to make a tax free rollover from plan distributions. Such requirement has been completely eliminated, meaning that regardless of how long one has participated in the plan, the distribution will receive tax free treatment if transferred within sixty days.

8.10 **Fixed Premium Contracts Eliminated**

**Code Section 408(b)(2)—Act Section 157(d)(2)**

**Effective Date: Taxable years beginning January 1, 1978**

Fixed premium contracts which required a fixed payment over a fixed time period have been eliminated for IRA annuities exchanged after November 6, 1978. Under the new law every individual retirement annuity contract must provide for a flexible payment of premiums. Furthermore, if an individual exchanges a fixed premium contract for a flexible premium contract, the exchange may be treated as a nontaxable exchange.

8.11 **Reporting Requirements Simplified**

**Code Sections 6058(d), 7701(a)(37)—Act Section 157(k)(1)(2)**

**Effective Date: Taxable years beginning January 1, 1978**

Beginning in 1978, an individual who establishes an IRA may report deduction information on a regular Form 1040. As long as there is no 10% premature distribution tax, 6% excess contribution tax or a 50% excess accumulation tax, IRA participants will be freed from filing Form 5329.

8.12 **Penalty Tax**

**Code Section 4974(c)—Act Section 157(i)(1)**

**Effective Date: Taxable years beginning January 1, 1976**

The IRS can waive the penalty tax for failure to distribute an IRA prior to reaching age 70½, if the failure was due to a reasonable error, and the individual is taking measures to remedy the distribution problem.
8.13 Simplified Pension Plans  
Code Sections 401 and 408—Act Section 152  
**Effective Date—January 1, 1978**

With the goal of promoting the growth of pension and profit sharing plans, the 1978 Revenue Act has simplified the employers' use of Individual Retirement Accounts. For taxable years beginning in 1979, the employer may contribute the lesser of $7,500 or 15% of the employee's annual salary to an IRA type arrangement and receive a tax deduction for his contribution. If the employer contributes under this provision (Section 408(k)) to an IRA, he may have to reduce his contribution to another qualified plan.

To qualify under this provision as a simplified employee pension, the employer's contribution must be nondiscriminatory as to officers, shareholders, or the highly compensated; and must be provided to all employees over twenty-five years of age who have been employed for three of the last five years. Furthermore, the employer may not impose requirements against withdrawals, and employer's contributions must vest immediately. The employer may take into consideration FICA contributions and self-employment tax in determining the amount he may contribute for each employee and maintain the nondiscriminatory aspect of the plan.

8.14 Limitations on Pension Benefits  
Code Section 415(b)(7)—Act Section 153  
**Effective Date: Taxable years beginning January 1, 1979**

Under prior law, benefits paid under a defined benefit plan, that is a plan which pays a specific annual benefit upon retirement, would be disqualified if projected annual benefits exceeded the lesser of $75,000 or 100% of the participant's average compensation for his or her high three years. Starting in 1979, this last restriction is removed for an employee in a collectively bargained plan which meets the following criteria:

1. The plan must have at least 100 participants.
2. The plan must allow participation after not more than sixty days of consecutive service.
3. Full vesting must be reached after the participant has completed four years of service.
4. Benefits must be determined by multiplying a uniform amount by the participant's years of service.

If the plan meets the above criteria and the 100% restriction is removed, the plan will not be disqualified, but the $75,000 annual benefit limit will be reduced to $37,500.

The 100% of compensation limitation will not be removed as to an individual participant if in any three of the last ten years of plan par-
ticipation his compensation is more than the average compensation for all plan participants for each of the same three years. Furthermore, the Senate Committee Report states that the bill would not apply to one who is covered by another plan maintained by one or more of the employers maintaining the collectively bargained plan.

8.15 Changes in Tax Sheltered Annuities
Code Section 403(b)(7)—Act Section 154
Effective Date: Taxable years beginning January 1, 1979

Mutual fund stock investments are now treated the same as annuity contracts when made by tax-exempt charitable organizations or educational institutions, and held in a custodial account. Such amounts are excluded from the employee’s income. Distributions from such accounts will qualify under the tax sheltered annuity rules if the distribution can be made only when the participant dies, attains age 59½, separation from the service of the employer, becomes disabled, or encounters a financial hardship.

After 1978, recipients of lump sum distributions from either custodial or tax sheltered annuities may rollover qualifying distributions received into either an IRA or another tax sheltered annuity providing the rollover takes place within sixty days of receipt. This puts distributions from tax sheltered annuities provided by charitable organizations and schools on a par with lump sum distributions of qualified pension plans, profit sharing, and stock bonus plans.

8.16 Government Annuity Contracts
Code Section 805(d)(b)—Act Section 155
Effective Date—Taxable years beginning after December 31, 1978

Beginning in 1979, federal, state, and local governments may enter annuity contracts with life insurance companies to pay pension benefits, and the resulting income from such arrangements will be tax-exempt. The result is the same tax treatment for government unfunded, deferred compensation plans or nonqualified pension trusts as that applied to reserves purchased under qualified employee pension plans.

9.00 Administrative Procedures

9.01 Disclosure of Tax Returns
Code Section 6103(m)—Act Section 701(bb)
Effective Dates: January 1, 1977 and November 6, 1978

With the problems of Watergate in the background, the Tax Reform Act of 1976 protected taxpayers against unlawful disclosure of their tax returns and related information. Although there were allowable disclosures, under very particular situations, unlawful disclosures were punishable both
criminally and civilly. However, the Revenue Act of 1978 in effect has broadened these disclosure rules.

Specifically, the IRS may now disclose upon written request by the Commissioner of Education, the location of those who have defaulted on their student loans. The IRS is allowed to give the mailing address of a taxpayer who has defaulted on any student loan that is made directly under the Higher Education Act of 1965, if such address is used for purposes of locating that taxpayer in order to collect the money owed. Furthermore, such addresses may also be disclosed to any educational institution which the Commissioner of Education has an agreement with under the Higher Education Act, where the employee, or collector being hired by such institution has the duties of collecting the student loans owed by such a taxpayer. Hence, a taxpayer who has defaulted on a student loan could have his mailing address turned over to a collection agency hired by the Educational Institution.

The Revenue Act of 1978 also allows the disclosure to state tax officials of the returns and any information thereon with respect to a special few of the excise taxes reported under Chapter 31 of the Code.

There is also broadened scope of the disclosure to the Justice Department and other federal agencies. The name and address of the taxpayer, along with other information on the return which could be related to any violation of a federal law can be disclosed, even if such information is received from sources other than the taxpayer or his representative.

The criminal sanction was limited in application by the Revenue Act of 1978. The Code now expressly provides that the criminal penalties for any unlawful disclosure will apply only where such disclosure is made willfully. The application of the civil penalties has also been limited by the Revenue Act of 1978. Civil penalties applicable for prohibitive disclosures will not apply unless such disclosure was not in good faith, that is, any disclosure done in good faith, although clearly erroneous in interpretation of allowable disclosure, would not be subject to the civil penalty. The limitation of civil liability is made effective to any disclosures beginning after November 6, 1978. The remaining provisions were made effective January 1, 1977.

9.02 Charge Account Tips

Code Sections 6001 and 6041—Act Section 501
Effective Date: Taxable years beginning January 1, 1979

Only tips reported by the employee to the employer on Form 1070 must be reported by the employer to the IRS on the employee’s W-2 form.
The Act eliminates the requirement that the employer is required to report any charge account tips not reported by the employee.

9.03 Preparer Requirements—Banks and Fiduciaries
Code Sections 6695(f) and 7701(a)—Act Section 701(cc)
Effective Date: Documents prepared in tax years beginning January 1, 1977

The 1976 requirement that an income tax return preparer may not negotiate a client’s tax refund check will no longer apply to a preparer bank which deposits the full amount of a customer’s tax refund check into the customer’s own account. Such rule gives statutory authority to Regulation Section 1.6695(f) (2).

The new law also expands the fiduciary exception of income tax return preparers to include conservators and guardians as well as fiduciaries for trusts and estates allowed under previous law.

9.04 Partnerships—Timely Returns Required
Code Section 6698—Act Section 211
Effective Date: Taxable years beginning January 1, 1979

A civil penalty in addition to criminal penalties will now be imposed on a partnership that fails to file a timely and complete information return. A partnership will be penalized $50 per month times the number of partners involved in the partnership. The assessment of this penalty is not subject to deficiency procedures. This means that the penalty must be paid before a refund suit can be brought in district court or the Court of Claims. The penalty will not be imposed if there is reasonable cause for failure to file or failure to supply all the required information.

9.05 Partnerships—Extended Statute of Limitations
Code Sections 6501 and 6511—Act Section 212
Effective Date: Taxable years beginning January 1, 1979

The normal three-year statute of limitations as applied to deficiency assessments or refund claims has been extended four years for a “federally registered partnership.” Any partnership which has been required to register with the Securities Exchange Commission prior to the close of the taxable year is subject to the annual reporting requirements and is considered for statute of limitations treatment as a “federally registered partnership.”

Under this provision, the deficiency assessment period will begin the latter of:

1. four years after the prescribed filing date or the actual filing date, if earlier, of the year for which the item arose; or,
2. a year after the information properly showing the name and address of the person to be assessed the deficiency is supplied to the IRS.
A taxpayer may extend the statute of limitations beyond the four years. If he does so, the time for filing a refund claim will not expire until six months after the time extension for assessment.

9.06 Small Tax Cases

Code Sections 7463 and 7656—Act Section 502
Effective Date: November 6, 1978

The jurisdictional limit for hearing small tax cases has been increased to $5,000 rather than $1,500. Thus the amount in dispute for an income tax case for any one calendar year and for estate taxes is the entire disputed amount up to $5,000.

The chief judge of the Tax Court may assign small claim cases to commissioners who may enter a decision in such cases. Such decision will be subject to review or other conditions as the court wishes; the new law expressly authorizes Tax Court commissioners to administer oaths, issue subpoenas, and prepare reports of small tax case proceedings they conduct.