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ECONOMIC RECOVERY TAX ACT OF 1981

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The Economic Recovery Tax Act of 1981 has many major tax changes. Some are retroactive to 1976 and some are not effective until 1987. Some of the changes could be considered revolutionary in nature. The major income tax changes are briefly discussed in three sections. They are (1) Business Taxes, (2) Savings Incentives and (3) Personal Tax Changes. The estate taxes are not covered in this report and not all of the income tax changes are discussed.

BUSINESS TAX CHANGES

Regular Accelerated Cost Recovery System (ACRS) of Depreciation - An accelerated cost recovery system (ACRS) goes in to effect for property placed in service after 1980 for tax years ending after 1980. This new method does not apply to pre 1981 assets which will continue to be depreciated as in the past. Some facts regarding the new system are as follows.

(1) The methods and periods are the same for both new and used property.

(2) Salvage value is disregarded, no depreciation is allowed in year of disposition.

(3) The cost is recovered over a 3-year, 5-year, 10-year or 15 year period. Table 1 gives the recovery period, type of asset and amount of depreciation for each year.

If a farmer buys a new pickup in November for $10,000, a used combine for $30,000, his depreciation is as follows:

pickup $10,000 x 25% = $2500
combine 30,000 x 15% = 4500
$7000

Straight Line ACRS Method - A taxpayer may elect to use the ACRS straight line method over the regular recovery period or the optional longer recovery periods. If used the rules vary depending on whether property is real or personal.

For personal property the optional recovery periods under the straight line ACRS election are:

Class of property	A recovery period may be elected
3 year property	3, 5 or 12 years
5 year property	5, 12 or 25 years
10 year property	10, 25 or 35 years
15 year public utilities	15, 35, or 45 years

The half-year convention must be used in the year purchased and the last half year claimed following the end of the recovery period. If a taxpayer buys a $10,000 machine in 1981 with a five year life his depreciation for 1981 would be $1,000. The same recovery period must be used for all personal property of a class for which such an election is made. For example all 5 year property would have to be treated the same in a given year, either regular ACRS or straight line ACRS.

Table 1. Depreciation Regular (ACRS)

Recovery Life	Type Asset	Depreciation per year for 1981-1984* 1st	2nd	3rd	4th	5th years
3	Autos, light truck, tools, some race horses.	25	38	37		
5	Most machinery, equipment, cattle, single purpose agricultural and horticultural structure.	15	22	21	21	21
10	Utility property					
15	Buildings and other real property	5	10	9	8	7 7 (6% through 15th year)

*The rates will change in 1985 and 1986.

Real Property and ACRS - A 15-year recovery period has been assigned for real property. An extended recovery period of 35 or 45 years may be used. The IRS will provide the recovery percentages to use each year. The first year percentages will be adjusted to reflect the number of months in service in the year it is placed in service. See Table 2. For example a building placed in service in January would receive 12 percent the first year and 10 percent the second year. A building placed in service in December would receive 1 percent the first year and 12 percent the second. Only the first four years are shown. The half-year convention is not used for real property and part year depreciation is allowed in year of sale.

The straight line method may be used and a 15, 35, or 45 year life may be allowed.

The gain as a result of regular ACRS depreciation taken will be recaptured as ordinary income upon disposition for non-residential property. For residential the gain will be recaptured as ordinary income to the extent the accelerated deduction exceeded that of straight line on a 15 year recovery period. If straight line method is elected all gain is treated as capital gain for both residential and non residential.

Table 2. 15 Year Recovery Period - Real Property

	Months											
Year	1	2	3	4	5	6	7	8	9	10	11	12
1	12%	11	10	9	8	7	6	5	4	3	2	1
2	10%	10	11	11	11	11	11	11	11	11	11	12
3	9	9	9	9	10	10	10	10	10	10	10	10
4	8	8	8	8	8	8	9	9	9	9	9	9

Expensing Depreciable Assets - (After 1981) - The additional 20% depreciation is repealed for property placed in service after 1980. It is replaced by a new expense decuction that is provided for taxpayers who elect to treat the cost of qualifying property (Sect. 179) as an expense rather than a capital expenditure. No investment credit is allowed on such property. Trusts, estates, and certain non-corporate taxpayers lessors are not eligible. This new Sec. 179 expense deduction is limited to zero deduction in 1981. The maximum amount that can be expensed is $5000 in 1982 and 1983; $7500 in 1984 and 1985 and $10,000 in 1986 and later years. Half the above amounts are allowed for marrieds filing seperate returns.

About the same property that qualifies for investment credit would qualify for this expense deduction.

Leasing Arrangements - The new law liberalizes certain leasing transactions provided certain conditions are met. It assures that the lessor will be allowed investment credit and capital recovery allowances if all conditions are met.

Investment Credit Changes - Since the accelerated depreciation was introduced, congress had to make changes in investment credit. The investment credit prior to and after the new law are shown in Table 3.

Table 3. Investment Tax Credit

Life	Old Law	New Law
3 year	3 1/3%	6%
5 year	6 2/3%	10%
7 years or more	10%	10%

Thus as shown in Table 3 an item with a 3 year life qualifies for 6% investment credit and a 5 year life now qualifies for the full 10%. A light pick-up truck would qualify for only 6% even though the taxpayer chose the ACRS 5 year straight line. The maximum used property eligible for investment credit has increased from $100,000 to $125,000 in 1981.

Recapture of Investment Credit - A new recapture "two percent" rule applies. It is more liberal than the old law. Each full year the property is held reduces recapture by 2%. See Table 4.

Table 4. Recapture Investment Credit

	Recapture	
Disposed of	3 year	5 year
Within one year	6%	10%
After 1 year	4%	8%
After 2 years	2%	6%
After 3 years	-0-	4%
After 4 years	-0-	2%
After 5 years	-0-	-0-

The old recapture rules apply to investment credit property in service prior to 1981. The new law raises the amount of used property qualifying in one year from $100,000 to $125,000 beginning in 1981 and to $150,000 in 1985. Unused investment credit can be carried over 15 years instead of seven years. There are limitations on investment credit in property not "at risk".

Tax Credit for Rehabilitation Costs (After 1981 Expenditures - The new law provides a new investment credit for rehabilitating qualified buildings and for rehabilitating qualified certified historic buildings. The credits are 15% for buildings 30 to 39 years old, 20% for buildings at least 40 years old and 25 percent for certified historic structures. To qualify expenditures must be capitalized and a 15 year recovery period must be used for depreciation. The regular investment credit and energy credit do not apply to the rehabilitation credit.

Windfall Profit Tax Changes - For 1981 qualified taxpayers holding royalty interests in crude oil are entitled to credit of $2500. The credit is for crude oil removed in 1981. Last year the credit was $1,000. For 1982, 83 and 84 the royalty owners will be exempt on windfall profit tax liability on up to two barrels per day. For 1985 and after the exemption will be three barrels per day. The credit and exemption are not available for overriding royalty interest, net profit interest or an interest created out of an interest in proven property after June 9, 1981.

The taxable rate on newly discovered oil will be gradually reduced after 1981 through 1986. Stripper wells will be exempt from the windfall profit tax after 1982 if certain conditions are met.

Commodity Futures Trades and Tax Straddles - The new law severely restricts the use of straddles to defer income or to convert short term gains to long term gains. Although the law deals with straddles in general, it will primarily affect commodity futures trading. It does not apply to identified hedging transactions. The new law requires that gain and loss from commodity futures trades be reported on an annual "mark-to-market" system. Thus contracts held at year's end will be treated as sold, or closed out, at fair market value the last day of the year. The 1981 act provides a new basis for taxing commodity trading gains and losses. All gains and losses, both realized and unrealized, from futures trading on U.S. exchanges will be treated as if 60% is long term and 40% is short term - regardless of the actual holding period.

Corporate Tax Rates and Accumulated Earnings Tax Corporate tax rates below $50,000 are reduced one percentage point in 1982, and one in 1983. The minimum accumulated earning tax increases from $150,000 to $250,000 for tax years after 1981. This does not apply to personal service corporations.

Tax Option Corporations - For tax years after 1981 the maximum number of shareholders increase from 15 to 25 shareholders. Also certain trusts may be treated as shareholders in tax-option corporations for tax years after 1981.

Other Items - New credit is allowed for Research and Experimental costs, and benefits are added to Incentive Stock Options. New at-risk limitations, and LIFO Inventory changes were included in the new law. Space does not permit discussion of these.

SAVINGS INCENTIVES

Tax Exempt Saving Certificates (For tax years ending after 9/31/81). The law permits a once in a lifetime exemption of $1,000 ($2,000 for a joint return) for interest earned on the exempt saving certificate. The certificates will be sold in minimums of $500, have a maturity of one year and pay interest at the rate of 70% of one year treasury bills. Taxpayers in the 30% and above tax bracket should compare returns or these exempt certificates to returns on taxable investments.

Dividend Exclusions - Included in the Windfall Profit Tax Act of 1980 was a dividend and interest exclusion of $200 for individuals and $400 for couples which goes into effect in 1981. Under the new law this changes to a $100/$200 dividend exclusion for tax years after 1981. No portion of the interest on the qualified tax exempt certificate can be used for the regular exclusion.

Dividend Reinvestment Plans of Public Utilities - (For tax years after 1981 and stock distributions after 1981. Up to $750 ($1500 joint return) may be excluded by a taxpayer who elects to receive from a domestic public utility a dividend in the form of common stock rather than cash. A taxpayers basis will be zero in the stock received but if kept for over a year, it will qualify as capital gains. The exclusion terminates for distributions after 1985.

IRA'S and Keogh's - Starting in 1982, even those participating in employer-sponsored plans can contribute to an IRA the lesser of 100% of compensation or $2000. ($2250 for spousal IRA's).

Starting in 1982 the maximum contribution for self employed participants including Sub-chapter S will be the lesser of 15% of earned income or $15,000. The law now permits a person to have both a Keogh and an IRA. There were many other new details on tax sheltered plans including simplified Employee Pension Plans which space does not permit us to list.

Interest Exclusion. (For tax years after 1984) - The interest excluded from taxable income cannot exceed 15% of: (1) $3,000 on a single return, $6,000 on a joint return or (2) the taxpayers net interest for the year. The maximum amount therefore is $450 on a single return and $900 on a joint return. There are restrictions on the types of interest that qualify.

Employee Stock Ownership Plans - A payroll based tax credit will replace the investment based tax credit for contributions to an employee stock ownership plan at the end of 1982.

PERSONAL TAX CHANGES

Tax Rate Changes - In 1981 a taxpayer will receive a 1.25 percent tax credit which will be built into tax tables. Those using the tax rate schedules (over $50,000) will use a four line work sheet and take a 1.25 percent tax credit. In 1982 and 1983 there will be an additional 10 percent reduction each year. Thus in 1984 the total reductions will amount to 23 percent. Also beginning with the 1985 tax year the rates will be indexed to the consumer price index to eliminate "bracket creep". The high income brackets will be reduced to 50 percent in 1982.

Capital Gains - Sales and exchanges occurring after June 9, 1981 qualifying for capital gains will be subject to a maximum tax of 20%. It formerly was 28%.

Residence Replacement Period - (Sales and exchanges after July 20, 1981). A taxpayer who sells his or her principal residence and replaces it with another principal residence may postpone the gain if certain requirements are met. The replacement period has been increased from two years before to two years after the sale or exchange. The old time period was 18 months. The gain is postponed to the extent the purchase price of the replacement equals or exceeds the sale price of the residence sold. This new replacement period also applies to a residence sold prior to July 20, 1981 if the post-sale 18 month period had not expired by July 20, 1981.

Exclusion of Gain on Sale of Residence - (Sales or Exchanges after July 20, 1981). The new act increases the exclusion of gain from $100,000 to $125,000 on the sale of a residence if all requirements are met. The individual has to be 55 years of age or older and it is a once in a lifetime exclusion. The taxpayer has to have owned and used the home as a principal residence 3 or more out of a five year period preceeding the sale. The new exclusion is $62,500 for married persons filing seperate returns.

Alternative Minimum Tax - For 1981 Tax Year - The top alternative minimum tax has been reduced from 25 to 20 percent for sales after June 9 1981. A taxpayer can limit his capital gains tax to the lesser of two choices. The IRS is expected to furnish forms and instructions for those needing this information.

Minimum and Maximum Tax - New minimum tax changes apply to property placed in service after 1980. A new tax preference item is the excess of ACRS deduction for leased recovery property over the straight line method. Detailed instructions cover these computations. The maximum tax computation is eliminated for tax years beginning in 1982.

Interest Rate on Underpayments and Overpayments - The new interest rate will be 100% of the adjusted prime rate. The rate will be determined in October for 1981 and 1982 and be effective February 1 of the following year.

Penalty Changes - Both civil and criminal penalties may be assessed for filing false information with respect to wage withholding. The civil penalty goes from $50 to $500 and the criminal from $500 to $1000. Negligence penalties and penalties for failure to file information have also been increased.

A number of other changes affecting the individual taxpayer were included in the new law which are effective after the 1981 tax year. They are briefly described as follows:

- Marriage Penalty - A new deduction for two-earner married couples will be available after 1981.

- Child and Dependent Care - A non-refundable credit for child dependent care expenses will be available on three different income levels after 1981. The lower income level receives the highest credits.

- Charitable Contribution for non-itemizers - After 1981 tax year individuals may deduct 25% of the first $100 of charitable contributions from gross income. The amount is increased for later years.

- Changes in filing tax estimates go into effect in 1982.

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