TAXE$$

Changes in the Law

Cattlemen, like other taxpayers, will receive many benefits from the Reagan-sponsored tax cut legislation enacted this past summer. In order that the full benefits of the legislation be realized, the cattleman and his advisers should become informed as soon as possible of the legislation's many provisions.

H.R. 4242, the Economic Recovery Tax Act of 1981, is far-reaching and complicated. Informing oneself will be no easy task. Further, like other tax bills enacted in the past, considerable time will pass before anyone concerned with the bill can be sure of the congressional intent underlying it as well as the exact meaning of some of its provisions.

This article is a summarization of most of the provisions of the new law. If you have specific questions regarding the application of this new law, you should consult with your tax adviser.

Individual Tax Reductions

Individual Tax Rates. Individual tax rates will be reduced by 1¼% in 1981, 10% in 1982, 19% in 1983, 23% in 1984 and years following. The top rate, presently at 70%, will be reduced to 50% on Jan. 1, 1982. As a result of these changes, the maximum tax rate on long-term capital gains will be reduced from 28% to 20% for sales or exchanges occurring after June 9, 1981.

Also, for tax years beginning after 1981, the top alternative minimum tax rate is being reduced from 25% to 20%. If a taxpayer has a net long-term capital gain occurring after June 9, 1981, a special alternative minimum tax applies for 1981. The effect of this special alternative tax is to tax that gain at a maximum rate of 20%.

Recommendation. Where possible, income other than earned income should be deferred to 1982, as the maximum tax rate decreases from 70% to 50%. Deductions should be accelerated to 1981 where possible.

Deduction for Married Couples. Everyone has heard much criticism about married couples with two incomes paying more tax than unmarried individuals having the same income situation. The bill provides for a deduction equal to 10% of the first $30,000 of earnings of the spouse with the lesser earnings ($3,000 maximum deduction). The deduction is phased in, with 5% being permitted in 1982 ($1,500 maximum deduction) and 10% in 1983 and thereafter. This deduction may be taken whether or not you itemize deductions.

Indexing. Perhaps the most far-reaching (and less publicized) provision of the bill is designed to do away with the increase in income taxes that results from inflation. Starting in 1985, the income tax brackets, the zero bracket amount and the personal exemption will be adjusted for increases in the consumer price index.

Child Care Credit. The maximum amount of expenses qualifying for the child care tax credit is increased from $2,000 to $2,400 for each dependent, with a maximum amount of $4,800. The rate of credit is increased from 20% to 30% for taxpayers with income of $10,000 or less and reduced by one percentage point for each $2,000 of income over $10,000 until it reaches 20% for taxpayers with income above $28,000.

Charitable Contributions. Starting in 1982, taxpayers not itemizing their personal deductions may deduct charitable contributions. For 1982 and 1983, the deduction is 25% of the first $100 of contributions and for 1984 the first $300 of contributions. For 1985 there will be no limit on the amount of contributions eligible. Further, the percentage that is deductible by non itemizers is increased to 50% for 1985 and to 100% (dollar for dollar deduction) for 1986. This provision of the bill expires after 1986. The over-all 50% of adjusted gross income remains as an over-all limit for contributions.

Sale of Residence. Present law provides for the non-recognition of gain on sale of a taxpayer's residence if a new residence with a purchase cost higher than the sales price of the old is acquired within a period beginning 18 months before and ending 18 months after the sale. The bill extends the 18-month replacement period to two years. This provision is effective for sales and exchanges occurring after July 20, 1981, or for such sales and exchanges where the 18-month reinvestment period has not expired on July 20, 1981.

Present law allows individuals 55 years of age or older to exclude up to $100,000 of gain on the sale of their residence. The Act increases the $100,000 exclusion to $125,000. This provision is effective for sales and exchanges taking place after July 20, 1981, and also to individuals who have not replaced their residence by that date.

Foreign Income. The new law changes drastically the way foreign income is reported by U.S. taxpayers.

Corporate Tax Rate Reduced. The corporate tax rate is reduced for the first $50,000 of income in the total amount of 1% each year for each $25,000 of income. Thus, the first $25,000 of income is taxed at 17% in 1981, 16% in 1982 and 15% in 1983. The next $25,000 of income is taxed at 20% in 1981, 19% in 1982 and 18% in 1983. The remaining taxing scheme remains the same for the next $25,000 at 30%, and the income between $75,000 and $100,000 is taxed at 40%, and everything over 100,000 remains at 46%.

Accelerated Cost Recovery System (ACRS)

Depreciation. This section of the bill should be of particular interest to cattlemen and farmers. Prior law permitted depreciation deductions over the period an asset was used in the business so that the deduction for the cost of an item was matched with the income produced by the asset. Under the new law, the cost of an asset is "recovered" over a pre-determined period, which likely will be shorter than the actual useful life of an asset or the period an asset is used to produce income. Gone is the flexibility many of us are used to of determining useful life based on facts and circumstances.

Most tangible depreciable property (real and personal) placed in service after Dec. 31, 1980, will use the new accelerated cost recovery system (ACRS). Under ACRS, assets are depreciated over statutory recovery periods using accelerated methods or the straight-line method when elected. The classes of recovery property and allowable methods of depreciation are as follows:

- **Personal Property**

Three years—autos, light-duty trucks, research and development equipment, race horses over two years old and other horses over 12 years old, and personal property with a mid-point life of four years or less.

Five years—most other personal property, including cattle, farm machinery and single-purpose agricultural structures.

Ten years—mobile homes used in a trade or business and certain public utility property.

Taxpayers may elect straight-line over two additional longer recovery periods. Thus, straight-line depreciation is allowed over only three periods for each type of property classification as follows: 3-year property—3, 5 and 12 years; 5-year property—5, 12, and 25 years; 10-year property—10, 25 and 35 years.

It should be emphasized that these lives are the only ones allowed. There is no more arguing the actual life of the item.

The bill changes the methods that may be used by taxpayers for calculating depreciation in certain instances. In addition to the straight-line method over the regular or optional longer recovery periods, taxpayers may use accelerated methods for personal property placed in service as follows:

Property Placed in Service	Prescribed Method
1981-1984	150% declining balance, changing to straight-line
1985	175% declining balance, changing to sum of the years' digit
After 1985	200% declining balance, changing to sum of the years' digit

These accelerated methods are computed by referring to a specific table which sets forth the percent of the cost that may be "recovered." Reproduced below is the table for 1981-1984.

For Property Placed in Service, 1981-84

If recovery year is:	Applicable percentage for the class of property is:			
	3-Year	5-Year	10-Year	15-Year Public Utility
1	25	15	8	5
2	38	22	14	10
3	37	21	12	9
4		21	10	8
5		21	10	7
6			10	7
7			9	6
8			9	6
9			9	6
10			9	6
11				6
12				6
13				6
14				6
15				6

Built into this table is the requirement that, regardless of what date the item is placed in service, only one-half year's depreciation is allowed in the year the item is placed in service. No depreciation deduction is allowed for personal property in the year of disposition. Also built into this table is the automatic switch to straight-line. Salvage value is ignored. These provisions would allow a farmer with a 5-year class cow purchased in 1981 costing $3,000 to deduct $450 (15%) in 1981. In 1982 the deduction would amount to $660 (22%), and in 1983 through 1985 the deduction would be $630 (21%) per year.

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- **Real Property**

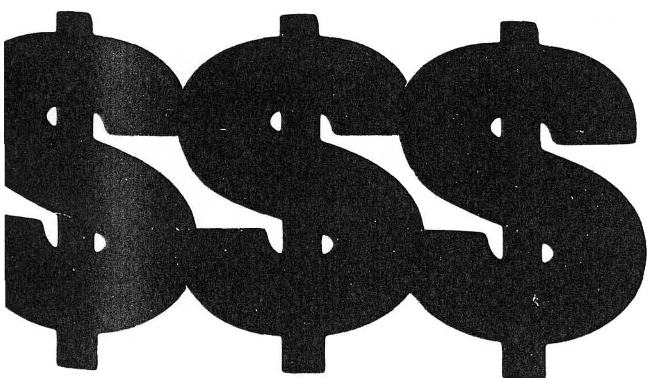
Under the old law, the guideline lives set by the IRS for real estate ranged from 40 to 60 years, with the actual lives claimed by most taxpayers under facts and circumstances in their own particular cases being somewhat shorter. Under the new ACRS, most real property (farm structures) is assigned a 15-year recovery period and is depreciated using the 175% declining-balance method with an automatic change to the straight-line method. However, a taxpayer may elect to use the straight-line method with a depreciable period of 15, 35 or 45 years. Note that single-purpose agriculture structures (poultry houses, dairy parlors, feedlot buildings other than multipurpose barns, etc.) are considered 5-year personal property.

Election to Expense Certain Assets. The provision in the prior law providing for "bonus" first-year depreciation of 20% of up to $10,000 of eligible property ($20,000 for a joint return) has been repealed effective for property placed in service after 1980. The bill replaces this provision with an election that can be utilized to expense the cost of new or used personal property used in a trade or business. The maximum amount that can be expensed is $5,000 for 1982 and 1983, $7,500 for 1984 and 1985, and $10,000 thereafter. Thus, neither benefit is available in 1981. The bill further provides that no investment credit is to be allowed for any property expensed.

Recapture of Depreciation on the Sale of Property. Under the prior law, gain on the disposition of real property was treated as ordinary income only to the extent prior depreciation taken exceeded what would have been allowable if straight-line depreciation had been used. In the case of installment sales of personal and real property, recognition of any gain (including ordinary income) could be deferred.

The capital gain treatment of non-residential real property is unchanged if the straight-line depreciation method is used. However, for non-residential real property (such as farm buildings other than single-purpose agricultural structures) depreciated under the accelerated method, gain is treated as ordinary income to the extent of all prior depreciation taken. Cattlemen will want to use accelerated depreciation for farm real estate in the future only after assessing the possibility of a future sale because of this costly new recapture provision.

Personal property remains subject to full recapture upon sale. Thus, prior depreciation taken results in ordinary income to the extent of gain on the item sold.



Recent passage of the Economic Recovery Tax Act of 1981 brings with it changes that will affect you, the taxpayer. The following article (which continues in the December issue) was prepared by principals in Keeler, Phibbs & Co., Certified Public Accountants, Harrisonburg, Va., and provides information on those changes.

It is interesting to note that the act further defines single-purpose agricultural structures as Section 1245 property, which means that upon the sale of these structures, the gain will be reported as ordinary income to the extent of all depreciation that has been taken on them in the past. It appears that the law has been made retroactive to apply to all single-purpose agricultural structures, even those placed in service prior to 1981.

Net Operating Losses. The carryover period for operating losses is extended to 15 years from the present 7-year provision. Thus, post-1975 losses may be carried forward 15 years.

Minimum Tax. Under the old law, individuals, Subchapter S corporations and personal holding companies faced the possibility of a 15% minimum tax on certain "tax preferences." These include depreciation deductions to the extent the accelerated depreciation exceeded straight-line for leased personal property. All taxpayers faced minimum tax on the excess depreciation taken on an accelerated basis compared to straight-line for real estate.

These provisions would allow a farmer with a 5-year class cow purchased in 1981 costing $3,000 to deduct $450 (15%) in 1981. In 1982 the deduction would amount to $660 (22%), and in 1983 through 1985 the deduction would be $630 (21%) per year.

The tax preference for ACRS is determined by taking the ACRS depreciation on leased recovery property (other than 15-year real property) over the straight-line depreciation. Straight-line depreciation is computed disregarding salvage value and using one-half year's depreciation in the year placed in service and a recovery period according to the following table:

Property Class	Preference Life
3-Year	5 Years
5-Year	8 Years
10-Year	15 Years
15-Year Public Utility	22 Years

Real estate compares ACRS recovery to straight-line over a 15-year life on a month-to-month basis rather than using the ½-year convention used for personal property.

A Different Life for Earnings and Profit Calculations. The corporate taxpayer determines the taxable nature of a dividend payment based on the corporation's "current and accumulated earnings and profits." A corporation must have "earnings and profits" for the dividend distribution to be ordinary income to the stockholder.

If ACRS is used, there will be a different life for computing depreciation, and only straight-line depreciation may be used. These lives are as follows:

ACRS Classification	Earnings and Profits Calculations
3-Year Property	5 Years
5-Year Property	12 Years
10-Year Property	25 Years
15-Year (Both Public Utility and Real Property)	35 Years

If the taxpayer elects the special first-year write-off, then the amount is spread over five years starting with the year acquired.

Cattlemen will want to use accelerated depreciation for farm real estate in the future only after assessing the possibility of a future sale because of this costly new recapture provision.

Investment Credit (ITC). Investment credit is available for 10% of the purchase cost of 5-, 10- and 15-year ACRS personal property. A 6% credit is available for 3-year property. This is effective for all property additions placed in service after Dec. 31, 1980.

Carryback and Carryforward of Unused Investment Credit. The investment tax credit carryover period is extended from seven years to 15 years for property placed in service after 1973.

Amount of Used Property Eligible for Investment Credit. The amount of used property eligible for the investment tax credit is increased from $100,000 to $125,000 for used property placed in service from 1981-84. In 1985, the limit goes to $150,000.

Recapture of Investment Tax Credit. The investment tax credit recapture rules were modified to reflect the liberalized credit percentages. The following table shows the percentage of qualified basis on which recapture is computed:

Years Held	3-Year Property	5-, 10-, 15-Year Property
Less Than 1	100%	100%
Between 1 and 2	66%	80%
2 and 3	33%	60%
3 and 4	-	40%
4 and 5	-	20%

Credits taken prior to 1981 will continue to be subject to recapture under the old rules.

The carryover period for operating losses is extended to 15 years from the present 7-year provision.

Investment Tax Credit Now Subject to "At Risk" Rules. Under prior law, investment tax credit was available whether or not the taxpayer was "at risk" for the property. He is "at risk" only to the extent of the money and adjusted basis of property he contributes. Added to this is the debt for which he is personally liable and debt secured by other property.

The rules are written to primarily disallow investment tax credit to those who acquire the property from a related party or with non-recourse financing. However, there is a safe harbor rule which allows amounts borrowed to be considered at risk for investment credit purposes if the taxpayer is at risk at all times to the extent of 20% of the assets basis and the amount is borrowed no later than the tax year following the year the property is placed in service. The amount must be borrowed from an unrelated creditor such as a bank, savings and loan, credit union, insurance company, pension trust, independent third-party lendor or from a federal, state or local government (or that is guaranteed by any federal, state or local government).

Expanded Investment Tax Credit for Rehabilitation of Non-residential Real Estate. Since 1978, a 10% ITC was available for "qualified rehabilitated buildings" used for business purposes other than residential uses.

This credit increases for expenditures made after Dec. 31, 1981, or for tax years ending after that date as follows:

1. Fifteen percent credit on rehabilitation expenditures incurred in connection with a non-residential building that is at least 30 but less than 40 years old.
2. Twenty percent credit on rehabilitation expenditures incurred in connection with a non-residential building that is at least 40 years old.
3. Twenty-five percent credit on rehabilitaion expenditures incurred in connection with a "certified historic structure."

Starting in 1982, taxpayers not itemizing their personal deductions may deduct charitable contributions.

This credit is probably one of the most promising tax savings opportunities available today.

A building qualifies for this credit if (1) it has been rehabilitated, (2) was placed in service before the beginning of the rehabilitation, (3) at least 75% of the existing external walls are retained in place as external walls, and (4) there were 20 years between the rehabilitation and the later of (a) the date the building was placed in service or (b) the date the building was last placed in service when a rehabilitation credit was taken.

Next month estate and gift tax changes will be discussed as will savings incentive programs, retirement plans and administrative provisions.