TAXE$$ Changes in the Law

This new law contains sweeping changes that will necessitate rethinking and reworking most wills and estate plans. The gradual increase in the unified credit (so that in 1987 a $600,000 estate will pay no estate tax) coupled with the unlimited marital deduction may require changes in most wills written to date.

Perhaps the most serious problem of this estate tax law is the possibility that people will be lured into complacency about estate planning. Even though there may be no estate tax, the failure to provide for a will can cause property to pass to those the decedent did not intend to receive it. Also, with the graduated increase in the unified credit, a flexible will becomes more important.

Increase in Unified Credit. The estate tax law provides that a unified credit is made available to apply against the estate or gift tax liability resulting from the transfer of property from one individual to another either at death or by gift. The old law, prior to 1977, provided for a $60,000 specific estate tax exemption and a $30,000 lifetime gift exemption. These were replaced in 1976 with a unified credit that could be used either against gift tax during life or estate tax at death. The unified credit was gradually increased until in 1981 the credit amounted to $47,000, which meant that a taxable estate of $175,625 would be exempt from tax. The following table sets forth the increases which will take place over the next six years and what the equivalent exemption will be:

Decedent Dying in or Gift Made in:	Unified Credit	Equivalent Exemption
1981	$ 47,000	$175,625
1982	62,800	225,000
1983	79,300	275,000
1984	96,300	325,000
1985	121,800	400,000
1986	155,800	500,000
1987 and After	192,800	600,000

Estate Tax Filing Requirement. The value of the estate is used to determine whether an estate tax return needs to be filed. The amount shown in the foregoing table shows the equivalent exemption. This is the amount which determines whether a return must be filed.

Estate Tax Rates Reduced. Under the old law, estates and gifts which totaled over $5 million paid a maximum rate of 70% tax on the value above $5 million.

The new law reduces the rate so that by 1985 an estate over $2.5 million will pay no more than 50%. This also is phased in gradually over a period of time. Thus, the maximum rate for 1982 is 65% for amounts over $4 million , 60% on amounts over $3.5 million in 1983 and 55% on amounts over $3 million in 1984.

Unlimited Marital Deduction. Prior law provided that a marital deduction was allowed when property passed from one spouse to another. This deduction was the greater of $250,000 or half of the adjusted gross estate. The gift tax marital deduction was 100% of the first $100,000 of qualifying gifts, with no marital deduction for the next $100,000 of gifts and 50% for the amount in excess of $200,000. A life interest did not qualify as property eligible for marital deduction treatment.

The new law completely changes the rules of the game by allowing an unlimited estate and gift tax marital deduction. Gift tax returns will no longer be required in the case of gifts by one spouse to another. "Qualified terminable interest property" will be eligible for the marital deduction. Such property will be taxed in the surviving spouse's estate. All of these changes are effective for estates of decedents dying, and gifts made, after 1981.

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Gifts Made Within Three Years of Decedent's Death. Under prior law, gifts made within three years of death were included in the estate at their value at the date of death. This rule no longer will apply to the estates of decedents dying after Dec. 31, 1981. The result of this is to effectively eliminate the estate tax on the increase in value between the date of gift and the date of death. Property held jointly with the right of survivorship with another individual was included entirely in the estate of the first person to die. There was an exception where the other joint owner could prove that he provided consideration for a portion of the jointly-held property. There were special rules which provided that only 50% of "certain qualified joint interest" would be included in the estate.

The new law provides that only half of jointly-held property shall be included in the estate regardless of who provided the consideration.

Annual Gift Tax Exclusion. The old law provided that $3,000 could be given to any donee without any gift tax. The new law provides that the annual exclusion is increased to $10,000 per donee. Also, a new unlimited exclusion is provided for certain medical expenses and school tuition. This increase is effective for gifts made after 1981.

Gift Tax Payment. Gift tax returns were required to be filed if annual gifts exceeded $25,000. These returns were required to be made quarterly. The new law provides that the gift tax returns and gift tax payments are made on an annual basis effective after 1981.

Current Use Valuation of Certain Farm and Other Closely Held Business Real Property. This provision of the existing law provides that farm real estate and other closely held business real estate may be valued at its current use value rather than at fair market value (development land). This valuation was not allowed to reduce the value more than $500,000. To qualify for this reduction in value for estate tax purposes, the estate must have at least 50% of the decedent's gross estate in farm or closely held business assets (both real and personal property). At least 25% of the gross estate must be closely held business real estate or farmland. These values for the purposes of these percentage tests are determined at fair market value. Under the new law, the percentage rules remain unchanged. The dollar amount of reduction is increased gradually from $500,000 in 1980 to $600,000 for decedents dying in 1981, $700,000 in

1982, \$750,000 in 1983 and thereafter. There were several liberalizations of this provision. Now, the requirement that the business property be used for five of the last eight years prior to the date of death may be satisfied if the decedent or a member of the family uses the real property in the qualified use. Fortunately, this change is made retroactive to estates of certain decedents dying after Dec. 31, 1976.

The qualified use requirement has been amended so that the 8-year period used to determine qualification ends at the date the decedent retired or became disabled. This will extend this valuation to many more estates. Also, a surviving spouse will not need to show "material participation" to receive the benefit of this special use valuation. She would need only to satisfy a lesser test of "active management." Thus, making management decisions would be sufficient for qualification rather than actually engaging in the daily operation of the farm or business.

The definition of family member has been expanded to include an individual's spouse, parents, brothers and sisters, children, step-children and lineal descendants of those individuals. The election must be made on the decedent's estate tax return (including a late return). Prior laws specified that it had to be filed by the due date of a timely filed return plus extensions. Prior law provided that, if the property was disposed of within 15 years after the date of death, the value was increased to its actual fair market value at the date of death. The new law reduces the period that the property must be held before recapture tax is no longer applicable to 10 years.

A qualified heir's income tax cost basis is the lower alternative valuation. The law was changed so that in the event the recapture tax is paid, the heir can irrevocably elect to increase the basis to the fair value. Interest will be payable by the heir if such an election is made.

A special 2-year grace period is provided for a qualified heir to commence using the real property so that the recapture tax will not be assessed. This also will extend the period for assessing the recapture tax.

Installment Payment of Estate Taxes. Under prior law, there were two installment payment provisions for estate taxes. The new law combines the better provisions of both these sections into one. This installment payment of the tax relating to the assets in the estate which are closely held business items will apply if 35% of the adjusted gross estate consists of closely held business assets. A special low interest rate of 4% is payable on the first \$1 million of closely held business interest in the estate. Thus, the estate may elect to pay interest only for the first four years and then pay the tax plus interest over the remaining 10 years. This results in a 14-year deferral of the estate tax payments. This provision is permitted unless more than 50% of the business assets of the estate are disposed of.

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Savings Incentive Provisions

Exclusion of Dividends and Interest Income. Under the prior law, a taxpayer could exclude up to \$200 (\$400 on the joint return) of dividends and interest income from domestic sources. Under the new law, the dividend and interest income exclusion is effective only for taxable years beginning in 1981. Beginning in 1982, a \$100 dividend exclusion (\$200 on a joint return) goes back into effect in the place of the \$200 (\$400 on a joint return) interest and dividend exclusion. Beginning in 1985, a taxpayer will be entitled to a 15% exclusion on up to \$3,000 of interest income (\$6,000 on a joint return).

Tax-Exempt Savings Certificates. To help provide new funds for home mortgages and farm loans, the government is allowing banks and saving institutions to issue new tax-exempt savings certificates. These tax-exempt certificates will pay interest at a rate of 70% of the yield on 1-year treasury bills and can be issued from Oct. 1, 1981, to Dec. 31, 1982. An individual taxpayer is entitled to a \$1,000 lifetime exclusion of interest earned on such a certificate (\$2,000 in the case of a joint return).

Maximum Capital Gains Tax on Individuals Reduced. Under the old law, a taxpayer was allowed to exclude from income 60% of the net capital gain. The remaining 40% of the net capital gain was taxed at ordinary rates up to 70%. Thus, the top effective tax rate on capital gains was 28% (70% of the 40% included in taxable income). Under the new law, the capital gains deduction remains at 60%; however, due to the reduction in the top tax rate to 50% in 1982, the maximum capital gains rate will be 20% (50% of the 40% included in taxable income). To avoid the postponement of sales of capital assets until the new 20% maximum rate becomes effective in 1982, a new rule allows the maximum 20% rate to be applied to sales or exchanges occurring after June 9, 1981.

Tax Straddles. Under the old law, there were no special rules dealing with straddles in commodities or commodity futures contracts. Typically, a commodity straddle is when a taxpayer holds a contract to buy a commodity in one month and at the same time holds a contract to sell the same commodity in a different month. Through the use of a straddle, a taxpayer was able to postpone income, convert ordinary income into capital gain or convert short-term capital gain into long-term capital gain. Under the new law, gains and losses for regulated commodity futures contracts must now be recorded on an annual basis under what is called a "mark-to-market rule." Under the "mark-to-market rule," a commodity future is treated as if it were sold for fair market value on the last business day of the taxable year. Any capital gain or loss on a regulated futures contract which is "mark-to-market" is treated as if 40% of the gain or loss is short-term and 60% of the gain or loss is long-term. The new law generally applies to property acquired and positions established by the taxpayer after June 23, 1981.

Dividend Reinvestment Plans. Under the old law, if a shareholder had the choice of receiving a dividend in either cash or

Last month authors James L. Keeler, Gregory W. Geisert and John L. Vincie III, all associated with Keeler, Phibbs & Co., Harrisonburg, Va., discussed individual tax reductions and accelerated cost recovery system as related to the new tax law. Here, in the second of a 2-part article, they deal with estate and gift tax changes, savings incentive provisions, retirement plans and administrative provisions.

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stock, the stock dividend was taxable at its full fair market value. The new law will permit a qualified public utility to give shareholders an option to take a stock dividend instead of cash or other property. The shareholder will be able to exclude from income up to $750 ($1,500 on joint returns) of stock dividends received from domestic public utility corporations even though the shareholder had the option to receive cash.

Retirement Plans

Increase in Deductible Contributions to Individual Retirement Accounts. Under the old law, only employees who were not "active participants" in a qualified plan were eligible to establish individual retirement accounts (IRA's). Also, the limitation on the annual deduction for contributions to an IRA was generally the lesser of 15% of compensation or $1,500. Under a spousal IRA, the contribution limit was increased from $1,500 to $1,750 if contributions were made for both spouses where one did not work. **For tax years beginning after 1981, an individual, whether or not an active participant in a qualified employer plan or in a government plan, may take an income tax deduction for his or her cash contribution to an IRA.** Also, the limitation on the annual deduction for contributions to an IRA will be the lesser of $2,000 or 100% of the individual's annual compensation. The contribution limit for a spousal IRA is increased to $2,250. Under the new law, employees who participate in their employer's qualified retirement plans will now be able to deduct voluntary contributions to their employer's plan. The limit on this new deduction for active plan participants corresponds to the general IRA deduction limit as described above. To qualify for the deductible contribution to an employer-sponsored plan, the plan must (1) provide for the acceptance of such contributions, (2) the contribution must not be mandatory, (3) the participant must not designate the contribution as non-deductible.

Under prior law, there were two installment payment provisions for estate taxes. The new law combines the better provisions of both these sections into one.

Keogh Plans. Under the old law, the maximum annual contribution to a defined contribution Keogh plan on behalf of a self-employed person was the lesser of $7,500 or 15% of the self-employed person's earned income. For purposes of the contribution limitation, only the first $100,000 of earned income of the self-employed person could be taken into account. Under the new law, the maximum annual contribution will be increased to the lesser of $15,000 or 15% of the self-employed individual's earned income. Also, for purposes of the new contribution limitation, the first $200,000 of earned income may be taken into account. This new limitation applies to taxable years beginning after 1981.

Retirement Plans of Subchapter S Corporations. Under the old law, if a Subchapter S corporation maintained a defined contribution plan, a shareholder-employee (a corporate employee or officer who owns more than 5% of the corporation's stock at any time during the taxable year) who participates in the plan was taxed currently on each year's contribution on his behalf to the extent it exceeded the lesser of $7,500 or 15% of his compensation. For purposes of the contribution limitation, only the first $100,000 of a shareholder-employee's compensation was taken into account. Under the new law, a shareholder-employee is taxed currently on contributions made on his behalf to the extent the contributions exceed the lesser of $15,000 or 15% of his compensation. For purposes of the new contribution limitation, only the first $200,000 of a shareholder-employee's compensation may be taken into account.

To help provide new funds for home mortgages and farm loans, the government is allowing banks and savings institutions to issue new tax-exempt savings certificates.

Incentive Stock Option. The new law provides for a new type of stock option called an "incentive stock option." When an incentive stock option is granted or exercised, there will be no tax consequences to the employee. The employee will be taxed generally at capital gains rates when he sells the stock if he has held the stock for at least two years from the date of the option grant and at least one year after the stock was transferred to him. There are several requirements that must be met in order for a stock option to qualify as an "incentive stock option." The new provisions generally apply to options that were granted on or after Jan. 1, 1976, and exercised on or after Jan. 1, 1981, or outstanding on such dates.

Simplified Employee Pensions. Under the old law, employer contributions to a simplified employee pension (SEP) on behalf of each employee were limited to the lesser of $7,500 or 15% of compensation. For purposes of the contribution limitation, only the first $100,000 of compensation could be taken into account. Under the new law, annual contributions by an employer to a SEP on behalf of each employee are limited to the lesser of $15,000 or 15% of compensation. For purposes of the contribution limitation, the first $200,000 of compensation for each employee may be taken into account.

Administrative Provisions

Declaration and Payment of Estimated Taxes by Individuals. Under the old law, an individual taxpayer was required to pay estimated taxes if he reasonably expected that his actual tax liability would exceed his withholding by $100 or more. Under the new law, the amount by which the individual's anticipated tax liability may exceed his withholding before he is required to pay estimated tax payments is increased according to the following schedule:

Taxable Years Beginning in:	Threshold Amount
1982	$200
1983	300
1984	400
1985 and After	500

However, if a farmer's gross income from farming is at least two-thirds of his total estimated gross income from all sources, he still may avoid paying estimated tax by filing his income tax return and paying the full amount of his tax on or before March 1 of the succeeding taxable year. But farm employees must file estimated tax returns or have the tax withheld (Rev. Rul. 65-280).

Addition to Negligence Penalty. Under the old law, the IRS could assess a negligence penalty equal to 5% of the underpayment if the underpayment was due to negligent or intentional disregard of rules and regulations without an intent to defraud. Under the new law, the IRS can still assess the 5% negligence penalty but in addition may now assess a penalty equal to 50% of the interest on the underpayment attributable to negligence or intentional disregard of rules and regulations. This penalty applies to taxes for which the last date for payment falls after 1981.

Under the new law, gains and losses for regulated commodity futures contracts must now be recorded on an annual basis under what is called a "Mark-to-market rule."

Interest on Deficiencies and Overpayments. Under the old law, the interest rate on deficiencies and overpayments was equal to 90% of the prime rate. However, once the rate was set, the IRS could not adjust it for 23 months. Under the new law, interest rates on tax deficiencies and overpayments will be recomputed annually at 100% of the prime interest rate.

Penalties for False Withholding Allowance Certificate. Both the civil and criminal penalty assessable against an individual who files a false withholding allowance certificate (Form W-4) with respect to wage withholding is increased for violations after 1981. The civil penalty goes from $50 to $500, and the criminal penalty for false wage withholding information increases from $500 to $1,000.