Agricultural Economics Miscellaneous Report No. 57

November 1981

ECONOMIC RECOVERY TAX ACT OF 1981
SELECTED PROVISIONS

by

David M. Saxowsky

Department of Agricultural Economics
North Dakota Agricultural Experiment Station
North Dakota State University
Fargo, North Dakota 58105

FOREWORD

A change in the law, especially tax law, creates a need for a description and explanation of the changes. The Economic Recovery Tax Act of 1981 is no exception. The intent of this report is to explain those changes resulting from the Economic Recovery Tax Act which will be of most importance to farmers.

The author gratefully acknowledges the manuscript review and valuable suggestions received from the faculty and staff of the Department of Agricultural Economics, North Dakota State University. Dr. Ron A. Anderson, Ms. Karen Maki and Dr. Glenn Pederson have been especially helpful throughout the writing and review process.

This publication is not intended to substitute for competent tax advice. Readers are urged to consult their tax advisors for appropriate interpretation of tax law as it applies to their specific circumstances.

TABLE OF CONTENTS

HIGHLIGHTS

The Economics Recovery Tax Act of 1981 will affect all Americans. The majority of Americans will experience a change, most often a reduction, in their tax liability. Both individual and corporate income tax rates have been lowered effective January 1, 1982. The tax reduction for 1981 is in the form of a 1.25 percent credit.

A new deduction allows married couples to reduce their income by an amount equal to 5 percent of the earned income of the spouse with the lower earned income. This is an effort to reduce the so-called marriage penalty tax and the maximum deduction for 1982 is $1,500.

The 1981 Act provides an exception to the requirement that a 9 percent annual rate of interest be specified for any sale of property paid over time. If all requirements are met, an agreement to sell land to a relative needs to specify only a 6 percent annual rate of interest.

The most dramatic change involves depreciation. For most farm assets, the wear and tear allowance will be known as cost recovery rather than depreciation. The deduction allowance is a specified percentage of the property's unadjusted basis.

Additional first year depreciation has been replaced by an election to expense all or part of the cost of a business asset. The maximum amount that may be expensed is $0 in 1981 and $5,000 in 1982 with additional increases in 1984 and 1986.

The period of time that a taxpayer must own an asset in order to avoid recapture of investment credit has been shortened. Property qualifying for 10 percent investment credit needs to be held only five years rather than seven.

A phased in increase of the Unified Credit will reduce the estate and gift tax burden. The unlimited marital deduction, available after December 31, 1981, provides greater flexibility for married persons planning their estates. Also beginning January 1, 1982, the annual gift exclusion will be $10,000 per recipient rather than $3,000.

ECONOMIC RECOVERY TAX ACT OF 1981
SELECTED PROVISIONS

by

David M. Saxowsky*

The Economic Recovery Tax Act of 1981, signed by the President on August 13, 1981, amends income, estate and gift tax statutes in an effort to reduce taxes. The intent of the law is that individuals and businesses will use would-be tax dollars for investments to stimulate the economy. Only select provisions of the Act are addressed in this report. The first three sections discuss provisions affecting either individual or business income taxes. The final section addresses changes in estate and gift taxation.

Individual Income Tax Provisions

The first provision of the Act reduces individual income tax rates. The reduction is phased-in over three years beginning with tax years after January 1, 1982. First, the top tax bracket will be reduced from 70 percent to 50 percent. Prior to passage of the Act, unearned income was subjected to tax rates in excess of 50 percent. Second, the brackets will be adjusted upward. For example, a married couple filing a joint return will need to have a taxable income of $162,400 in 1984 before reaching the 50 percent tax bracket. Prior to the Act's passage, a married couple with a $45,800 taxable income would have been in the 49 percent bracket. The Act includes similar changes for single, head of household, and married filing separately taxpayers as well as for estates and trusts. This combination of lowering the tax rate of the top bracket and adjusting the brackets upward will reduce the amount of income tax paid by individuals.

1981 Tax Credit

Tax rates for tax years beginning in 1981 are not changed; however, included in the act is a provision to reduce 1981 income tax liability by allowing a credit equal to 1.25 percent of the amount of tax imposed. For workers whose wages are subject to withholding for Federal income tax purposes,

---

*Assistant Professor, Department of Agricultural Economics and member of the North Dakota Bar.

the amount withheld as of October 1, 1981, reflects a 5 percent reduction in tax rates. Since this is only for the last quarter of 1981, it is approximately equal to the 1.25 percent credit. Adjustments in the amount of withholding to reflect the tax rate reduction for 1982 and 1983 will not be made until July 1 of the respective years.

Reducing the Marriage Penalty Tax

Beginning in 1982, married individuals filing a joint return will be allowed to deduct from their income a percentage of the earned income of the spouse with the lower earned income. This is an effort to reduce the so-called marriage penalty tax. For 1982 the percentage rate is 5 percent, increasing to 10 percent in 1983 and remaining at that level. However, the maximum earned income of the spouse qualifying for the deduction is $30,000. This means the maximum deduction is $1,500 in 1982 and $3,000 thereafter.

Direct Charitable Deduction

Prior to the Act, individuals were only able to take a deduction for charitable contributions if they itemized. Beginning in 1982, individuals will be allowed a direct charitable deduction for any tax year in which they do not itemize. Restated, the taxpayer will be able to deduct charitable contributions directly from gross income rather than not realizing any tax reduction as a result of the charitable contribution. A taxpayer who itemized will not be allowed to use the Direct Charitable deduction but will instead continue, as in the past, by including charitable contritutions as an itemized deduction.

In 1982, 1983, and 1984 only 25 percent of charitable contributions may be directly deducted. This increases to 50 percent for 1985 and to 100 percent for 1986. Also, for 1982 and 1983, the maximum amount of charitable contributions for computing the direct deduction is $100--a maximum direct deduction of $25 for each of the two years. This maximum increases to $300 for 1984--a maximum direct deduction of $75. There is no limit for 1985 and 1986. This provision will not apply to contributions made after 1986. At that time the law will revert to pre-1981 rules.

Sale of Residence

The period in which a taxpayer may acquire another principal residence when selling the present principal residence without recognizing the gain resulting from the sale has been lengthened. In the past, the "rollover" period was 3 years (18 months prior to the date of sale to 18 months after the date of sale). The new period is 4 years (2 years prior to sale through 2 years after the sale). This provision is effective for all sales after July 20, 1981, and those sales before that date for which the rollover period had not expired.

The one time exclusion of gain from sale of principal residence by an individual 55 years of age or older has been increased from $100,000 to $125,000 effective for sales after July 20, 1981.

Dependent Care Expense

The credit allowable for expenses for dependent care service necessary for gainful employment has been increased. To qualify, the taxpayer must maintain a household that includes at least one qualifying member who is either 1) a dependent of the taxpayer and is under 15 years of age, or 2) a dependent or spouse of the taxpayer and is physically or mentally incapable of caring for him- or herself. The percentage of employment-related expenses will be increased from 20 percent to 30 percent, but will be decreased (but not to less than 20 percent) by 1 percent for each $2,000 (or fraction thereof) by which the taxpayer's gross adjusted income for the tax year exceeds $10,000. Likewise, the Act increases the dollar limit of employment-related expenses from $2,000 to $2,400 ($4,000 to $4,800 if there is more than one qualifying member in the household). The Act also allows a deduction of up to $1,500 for reasonable and necessary expenses related to adopting a child to whom adoption assistance payments are made under the Social Security Act.

Indexing Federal Income Tax

Federal income tax brackets and exemption amounts will be indexed beginning in 1985. Indexing adjusts the maximum dollar amount on which no tax is imposed and the minimum and maximum dollar amounts for each tax bracket by the Consumer Price Index (CPI) for all urban consumers. The amount of adjustment will be based on the extent to which the CPI for the calendar year

preceding the adjustment exceeds the CPI for the calendar year 1983. The same adjustment will apply to the $1,000 exemption. Indexing also applies to the zero-bracket amount and as the zero-bracket amount is adjusted upward the need to itemize personal deductions may decrease. The Act only addresses increasing dollar amounts and an increased CPI. This seems to indicate that if the CPI ever drops below the CPI for 1983, the tax brackets will not be adjusted downward.

Interest Income

The Act changes the amount of interest and dividend income that may be excluded from taxation. Beginning in 1982, $100 of dividend income may be excluded from taxation, $200 in case of a joint return. There will be no interest exclusion. This is actually a return to pre-1981 rules. For 1981 only, a taxpayer may exclude $200 interest and dividend income ($400 in the case of a joint return).

As a substitute for the interest income exclusion which was repealed, a taxpayer will be allowed, beginning in 1985, to exclude up to $450 interest income ($900 in the case of a joint return). The amount to be excluded is 15 percent of the interest income for the year minus interest expense for the year, but interest expense does not include interest expense incurred in 1) acquiring property to be primarily used by the taxpayer as a dwelling unit, or 2) conducting a trade or business. For example, a taxpayer with $3,000 interest income and interest expenses of $250 for credit cards and $3,500 on account of the home mortgage will be able to exclude $412.50 (15 percent of $2,750 which is $3,000 minus $250) from that year's gross income. The $3,500 interest expense resulting from the home mortgage is not considered when computing the amount of interest income to be excluded.

For the period from October 1, 1981, to December 31, 1983, interest earned on certain savings certificates will be excluded from taxation. The total amount of interest income that may be excluded during this period is $1,000 ($2,000 in the case of a joint return). To qualify, the interest must have been earned on a tax-exempt savings certificate issued by a qualified institution between October 1, 1981, and December 31, 1982, with a maturity of 1 year, issued in denominations of $500, and having an investment yield equal to only 70 percent of the yield on 52-week Treasury bills.

Qualified institutions include banks, mutual savings banks, cooperative banks, building and loan associations, credit unions, or any other savings or thrift institution chartered and insured by either Federal or state law. These institutions are required to use at least 75 percent of the proceeds from tax-exempt savings certificates for residential or agricultural financing. Because of the required yield level, these certificates will be most attractive to persons in tax brackets over 30 percent without comparable investment alternatives yielding more than 52-week Treasury bills.

Provisions Affecting Either Individual or Business Income Taxes

Reducing the maximum tax rate to 50 percent reduces the maximum tax rate for net capital gains to 20 percent.[1] However, even though the maximum tax rate is not lowered to 50 percent until 1982, the maximum tax rate for 1981 net capital gains will be 20 percent. The amount of net capital gains for 1981 that qualifies for this lower maximum tax rate is either the net capital gains for the entire year, or the net capital gains realized since June 9, 1981, whichever is less.

Imputed Interest Rates

If an agreement for sale or exchange of property includes payments over time and a low interest rate, the IRS will impute ordinary income (interest income) to the seller at a higher rate of interest. As a result, gain that would otherwise appear to qualify for capital gain treatment is instead taxed as ordinary income.

Sales entered into prior to July 1, 1981, were required to specify an interest charge of 6 percent or the IRS would impute interest at a rate of 7 percent compounded semiannually. Sales after July 1, 1981 must specify at least 9 percent or the IRS will impute interest at a rate of 10 percent compounded semi-annually. However, the Act includes a provision that for sales of land between related parties, entered into after July 1, 1981, the imputed interest rate will not exceed 7 percent compounded semiannually. This, in conjunction with an existing provision requiring the specified rate to be at

---

[1]Maximum tax rate (50 percent) times 40 percent of net capital gains (only 40 percent is subject to taxation as the other 60 percent is excluded) equals 20 percent.

least 1 percent less than the imputed rate, means that sales of land between relatives may continue specifying a 6 percent rate of interest. Relative, in this case, means spouse, sibling, parents, grandparents, children, and grandchildren.

If for any year such sales between relatives exceed $500,000, then the imputed interest rate will be 10 percent compounded semiannually unless the agreement specifies at least a 9 percent interest rate for the portion of the sale price in excess of $500,000. These higher interest rates can be avoided by entering into no more than $500,000 in land sales to any one relative in any one year.

The IRS has announced that land for imputed interest purposes means only the soil and does not include buildings or other depreciable real property. If this interpretation holds, relatives selling land to one another will need to specify a 9 percent rate of interest for the portion of the sale that does not pertain to soil.

Business Income Tax Provisions

The most dramatic change involves depreciation. For certain property placed in service after December 31, 1980, the allowance for wear and tear will be known as cost recovery rather than depreciation. For the remaining property, depreciation will continue without change.

Accelerated Cost Recovery System

The new wear and tear allowance is known as the Accelerated Cost Recovery System (ACRS) and applies to "recovery property." Recovery property means tangible property subject to depreciation and used in trade or business or held for production of income. Recovery property includes all tangible depreciable property. Intangible depreciable property will continue under the same rules as in the past. Obviously, most farm property subject to a wear and tear allowance is recovery property.

Recovery property is divided into four classes depending on the number of years of recovery: 3-year, 5-year, 10-year, and 15-year. Within the 15-year class there are two subclasses: 15-year public utility property (not of much importance to farmers) and 15-year real property. Fifteen-year real property is further divided into five groups: 1) residential rental, 2) used primarily outside the United States, 3) housing assisted by certain Federal

government programs, 4) property the taxpayer has elected out of ACRS, and 5) all other 15-year real property. It is the last two subgroups, 3-year, and 5-year property that are most important to farmers. Table 1 summarizes ACRS property classes and suggests an ACRS classification for certain farm properties.

Three-year property is all Section 1245 property (depreciable personal property) with a class life under the Asset Depreciation Range classification system (ADR) of four years or less. Hogs are included. However, the Act also explicitly includes cars, light pickup trucks, and certain horses (race horses over two years of age and all other horses over 11 years of age) as 3-year property.

Five-year property is all other §1245 property, including equipment, machinery and cattle. The Act explicitly includes single-purpose agricultural and horticultural structures as 5-year property. This class also includes all other recovery property not fitting another class.

Ten-year property includes all §1250 (depreciable real) property with an ADR class life of less than 12.5 years. Fifteen-year real property includes all §1250 property with an ADR class life in excess of 12.5 years. The only §1250 property included in ADR under the heading of agriculture are farm buildings with a class life of 20 to 30 years. This means farm buildings will be 15-year real property except single purpose agricultural and horticultural structures which are explicitly 5-year property.

Some depreciable property, such as water wells and buried pipe used for irrigation, are not listed in ADR and subsequently do not have an ADR class life. This, in conjunction with 5-year property's broad definition (all recovery property which does not fit another class), means such property will be included as 5-year property rather than either 10-year or 15-year real property. As a result, few farm assets will be classified as 10-year property and only certain farm buildings will be 15-year real property.

The allowable deduction under ACRS is a specified percentage of the property's unadjusted basis. Unadjusted basis is the property's basis minus Section 179 expense which replaces additional first year depreciation, discussed later. ACRS is being phased-in over six years, thus the specified percentage varies until 1986. These percentages are included in the Act and summarized in Table 2.

Table 1. Property Classes Under Accelerated Cost Recovery System and Farm-Related Examples*

3-Year	5-Year	10-year	15-Year					
			Real Property					Public Utility
			All Others	Elected out of ACRS	Residential Rental	Government Assisted Housing	Outside United States	
Hogs Cars Light pick-up trucks Certain horses	Livestock Equipment Machinery Single purpose agriculture & horticulture buildings Grain bins Fences All recovery property not in another class		Multi-purpose farm building	Multi-purpose farm building				

*Property classes 3-year, 5-year, and 10-year could also have "elected-out" columns as does 15-year real property, but the significance of "electing-out" is most important for 15-year real property. Recapture of cost recovery applies only to 3-year, 5-year, 10-year, and "all other" 15-year real property. Fifteen-year real property elected-out is not subject to recapture and is the reason for the separate subgroup.

Table 2. ACRS Phased-in Specified Percentages

Year	3-Year			5-Year			10-Year			15-Year Real*
	1981-1984	1985	1986	1981-1984	1985	1986	1981-1984	1985	1986	
1	25	29	33	15	18	20	8	9	10	12
2	38	47	45	22	33	32	14	19	18	10
3	37	24	22	21	25	24	12	16	16	9
4	--	--	--	21	16	16	10	14	14	8
5	--	--	--	21	8	8	10	12	12	7
6	--	--	--	--	--	--	10	10	10	6
7	--	--	--	--	--	--	9	8	8	6
8	--	--	--	--	--	--	9	6	6	6
9	--	--	--	--	--	--	9	4	4	6
10	--	--	--	--	--	--	9	2	2	5
11-15	--	--	--	--	--	--	--	--	--	5(each year)

*Specified percentages for property placed in service during the first month of the tax year. IRS announcement reproduced in Harl, Neil E., Economic Recovery Tax Act of 1981, September 23, 1981

The charts in the Act do not include 15-year real property. Instead, the Act states that cost recovery allowance for 15-year real property will be 175 percent declining balance switching to straight line to maximize deductions and will be specified in a table prescribed by the IRS. Table 2 includes the specified percentages for 15-year real property placed in service during the first month of a tax year. The specified percentages for 15-year real property placed in service during the remainder of a tax year are found in Table 3.

A taxpayer does not have to use ACRS, but the options are limited. One alternative requires the deductible allowance to be calculated under a straight-line method using one of the specified periods for recovery. These specified periods are equal to or longer than the class recovery period and the taxpayer elects which of the specified periods will be used. The specified periods, based on the property's ACRS class, are as follows:

In the case of:	The taxpayer may elect a recovery period of:
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 real property	15, 35, or 45 years

Table 3. ACRS Cost Recovery Tables for Real Estate (Except Low-Income Housing)

If the Recovery Year is:	The applicable percentage is: (Use the Column for the Month in the First Year the Property is Placed in Service)											
	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
5	7	7	7	7	7	7	8	8	8	8	8	8
6	6	6	6	6	7	7	7	7	7	7	7	7
7	6	6	6	6	6	6	6	6	6	6	6	6
8	6	6	6	6	6	6	5	6	6	6	6	6
9	6	6	6	6	5	6	5	5	5	6	6	6
10	5	6	5	6	5	5	5	5	5	5	6	5
11	5	5	5	5	5	5	5	5	5	5	5	5
12	5	5	5	5	5	5	5	5	5	5	5	5
13	5	5	5	5	5	5	5	5	5	5	5	5
14	5	5	5	5	5	5	5	5	5	5	5	5
15	5	5	5	5	5	5	5	5	5	5	5	5
16			1	1	2	2	3	3	4	4	4	5

(Note: This table does not apply for short taxable years of less than 12 months.)

SOURCE: IRS Announcement, Reproduced from Harl, Neil E., Economic Recovery Tax Act of 1981, September 23, 1981.

The election applies throughout the recovery period of that property and can be revoked only with the consent of the IRS. Also, the election, including the elected recovery period, applies to all property in the same ACRS class placed in service during the year in which an election was made. This means that if a taxpayer places a tractor and a grain bin (both 5-year property) in service the same year, and elects to recover the cost of the bin by using straight line for 12 years, the tractor's cost will also have to be recovered using 12 years straight line. However, the election for 15-year real property may be exercised on a property by property basis.

The second alternative allows the property to be depreciated by using any method allowed by prior law. However, the first year's deduction must be based on units-of-production or some method of depreciation that is not expressed in a term of years. Also, property depreciated using a method allowed by the second alternative may not qualify for investment credit.

In the year of acquisition, under ACRS, the deduction allowance for 3-, 5-, and 10-year property will be the full amount allowed with no adjustment for having held the property less than the full year. For 15-year real property, the first year allowance will be based on the number of months in the tax year during which the property was in service. The allowance for subsequent years will be the remaining portion of the prior tax year's allowance plus a portion of the present tax year's allowance based on the number of months until the end of the tax year.

For example, a farm shop placed in service any day during the month of June 1981, will be considered as having been placed in service June 1, 1981, and, assuming a calendar year taxpayer, will be in service for seven months during the 1981 tax year. Deduction for 1981, under ACRS, will be 7/12 of the first year's specified percentage multiplied by the building's unadjusted basis. The deduction for 1982 will be calculated by multiplying the sum of the remaining 5/12 of the first year's specified percentage plus 7/12 of the second year's specified percentage by the property's unadjusted basis. The IRS has announced the specified percentages for 15-year real property which take into account the necessary adjustment because the property was not placed in service during the first month of a tax year (Table 3).

For 3-, 5-, and 10-year property for which the taxpayer elected straight cost recovery, half year convention rules apply. Simply, half-year convention rules state that only half the amount of cost recovery that would have been allowed for a full year may be deducted the first year the property is in service. If the property is held for the entire recovery period, a half year of cost recovery is deducted for the year following the last year of the property's recovery period.

No cost recovery deduction will be allowed in the year of disposition for 3-, 5-, or 10-year property. The cost recovery allowance for the year of disposition of 15-year real property will depend on the number of months the property is in service during that year. Salvage value will not be taken into account under ACRS or any of its options.

As part of the phase-in of ACRS, certain property acquired between January 1, 1981, and December 31, 1985, will not qualify for ACRS, if any of the following exists:

1) property was owned or used at any time during 1980 by the taxpayer or a related person;

2) property was acquired from a person who owned such property during 1980 and as part of the transaction, the user of such property does not change (this includes sale by a lessor to a different lessor without a change in lessee, or the lessee buying from the lessor); or

3) taxpayer leases property to a person or persons related to such person who owned or used the property during 1980, (this includes sale-leaseback arrangements).

The intent is to prohibit use of ACRS for property likely to be transferred for tax purposes. Related persons include spouse, siblings, parents, grandparents, children, grandchildren, and partnerships and corporations in which the taxpayer owns at least 10 percent.

Another section of the Act binds a taxpayer who receives recovery property in a transfer to the method of recovery used by the transferor of the property if the transferor and transferee are related as defined in the paragraph above. This requirement of using the same method of recovery applies only to the amount of the transferee's basis which is equal to the transferor's adjusted basis.

Leasing Depreciable Property

In the past, leases have been scrutinized and the rental cost disallowed if the arrangement did not appear to be a lease. Factors such as stating in the lease a price at which the lessee could at the end of the lease purchase the property or a lease lasting nearly the life of the property would disqualify the arrangement as a lease.

The Act creates a safe harbor for certain leases; that is, if the requirements are met, the IRS will not disallow the rental deduction. This does not mean that no other arrangements will qualify as a lease. It merely means that if the requirements are met the taxpayers are assured lease treatment regardless of other factors.

The first requirement is that the parties to the arrangement agree to specify it as a lease and elect to have the subsection apply. Second, the lessor must be a corporation (other than a Subchapter S or personal holding company) or a partnership in which all partners are corporations (with the same limitations as for a corporation). Third, the minimum investment of the lessor at the start of the lease and throughout the duration of the lease must be equal to or greater than 10 percent of the property's adjusted basis. And finally, the lease, including extensions, cannot exceed the greater of 90 percent of the

property's useful life or 150 percent of the property's class life. Property qualifying for treatment under this subsection is limited to new property which qualifies for investment credit. Again, if all requirements are met, no other factor will be considered in determining whether the arrangement will be treated as a lease. This means leases meeting all the requirements can explicitly state a price at which the lessee may acquire the property at the end of the lease.

Election to Expense Business Assets

Additional first year depreciation has been repealed for all property placed in service after December 31, 1980. Instead, a buyer may elect (under Code Section 179) to deduct, in the tax year the asset is placed in service, all or part of the cost of depreciable business assets up to a limit. The limit is being phased-in with the allowable expense $0 in 1981; $5,000 for 1982 and 1983; $7,500 for 1984 and 1985; and $10,000 for 1986 and thereafter. Because of this (and the Committee report states so explicitly), taxpayers have neither additional first year depreciation nor the new expense allowance in 1981.

The taxpayer, in order to qualify for the election to expense part of the cost of certain business assets, must have purchased the property from some entity other than a related party. If the purchase involves a trade-in, only the amount paid as "boot" qualifies for this deduction. Assets which qualify for this election are those assets which qualify for investment credit. However, no investment credit is allowed to the extent that this expense deduction is elected. The election to expense is available only for the tax year during which the asset was first placed in service by the taxpayer.

Unlike additional first year depreciation, Section 179 expense is not a percentage of the asset's basis. Instead, it is a stated amount and may be used, up to the limit, as the taxpayer chooses, applying it all to one asset or using some on each of several assets. Accordingly, the taxpayer is required to maintain an accurate record of how §179 expense is used. Another difference between §179 and additional first year depreciation is that married couples will not be allowed to double the limit.

Recapture of Recovered Cost Allowances

The Act continues the concept of recapture of depreciation. Previously, two sections (§1245 and §1250) dealt with recapture of depreciation. Section

1245 required all depreciation allowed or allowable for personal property to be recaptured at the disposition of the property. Section 1250 dealt with depreciable real property and recaptured all depreciation claimed beyond what straight line depreciation would have allowed; that is, the amount of depreciation claimed in excess of what would have been allowed by the straight line method.

Section 1245, as amended, will recapture all recovery cost claimed on all property under ACRS except 15-year public utility property and certain subgroups of 15-year real property. These subgroups are 1) residential rental, 2) used primarily outside the United States, 3) housing assisted by certain Federal government programs, and 4) property which the taxpayer elected out of ACRS (that is, elected to use straight line, as discussed above). The result is that a taxpayer who uses ACRS to recover the cost of farm buildings will be required to recapture all cost recovery deductions whereas the taxpayer who uses the straight line method will not have to recapture any cost recovery deduction. Three subgroups of 15-year real property (1. residential rental, 2. used primarily outside the United States, and 3. housing assisted by certain Federal government programs) will be subject to recapture under §1250; that is, recapture all cost recovered in excess of what would have been recovered had straight line cost recovery been used.

The new Act imposes a harsher penalty for using a method other than straight line to depreciate farm buildings. Under the old law, the passage of time would eliminate recapture of depreciation taken on farm buildings. That is, with time the amount of depreciation claimed would not be greater than the amount allowed by straight line. The new law requires recapture of all costs recovered under ACRS regardless how long the building has been in service. The benefits of accelerated cost recovery for buildings must be weighed against the potential cost of recapture at the time of disposition. An election to recover the cost of farm buildings using straight line for 15 years is worth investigating.

All cost recovery must be recaptured on 10-year property while the previous law required recapture of only the accelerated portion. However, this is of little consequence to farmers since few farm assets will be 10-year property.

Any cost deducted under the Election to Expense (§179) will also need to be recaptured. In the special case of an installment sale of property for which

the taxpayer has taken a deduction under the expense election, the total amount deducted as Section 179 expense must be recaptured in the year of the sale.

Investment Credit

The Act also changes some of the rules pertaining to investment credit. All 10-year and 5-year property now qualify for 10 percent investment credit whereas 3-year property qualifies for 6 percent. These percentages do not change regardless of how long the taxpayer intends to actually own the property.

Allowing 10-year property to qualify for investment credit may qualify some property for investment credit that would not have qualified before this Act. However, since few, if any, farm assets are 10-year property, there is little practical change for farmers as to what qualifies for investment credit.

The cost of used property qualifying for investment credit will be increased. In the past, the limit was $100,000 cost. This will increase to $125,000 for 1981, 1982, 1983 and 1984, and to $150,000 for 1985 and thereafter.

The rules pertaining to investment credit for the expense of rehabilitating a building are changed. In addition to the rule that 75 percent of the exterior walls must remain standing, a building must be substantially rehabilitated, meaning the rehabilitation cost must exceed the greater of $5,000 or the building's adjusted basis. The Act requires that 30 years have lapsed since the building was placed in service. If these conditions are met, the credit available is 15 percent. If 40 years have lapsed, the credit is 20 percent. However, only expenditures that will be recovered by a straight line method qualify for this credit. Furthermore, it appears that a qualified rehabilitation expenditure also qualifies for §179--Election to Expense Business Assets (discussed above).

Investment credit continues to be recaptured if the property is disposed of before a specified period. For 5-, 10-, and 15-year property, that period is five years; for 3-year property, it is three years. The amount of credit to be recaptured is a percentage of the credit claimed. The percentage is based on the number of years the property was in service (Table 4).

The Act extends the period for which unused investment credit can be carried forward to 15 years rather than 7. A net operating loss can also be carried forward 15 years.

Table 4. Recapture of Investment Credit

If recapture of investment credit is triggered during:	The recapture percentage is: For 3-year property	For 5-, 10- and 15-year property
First year of use	100	100
Second year of use	66	80
Third year of use	33	60
Fourth year of use	--	40
Fifth year of use	--	20

Corporate Tax Rates

Finally, income tax rates for corporations will be reduced. The first $25,000 is presently taxed at 17 percent. This will be lowered to 16 percent for 1982 and to 15 percent thereafter. The second $25,000 is presently taxed at 20 percent. This will decrease to 19 percent in 1982 and 18 percent thereafter. The third $25,000, fourth $25,000, and everything over $100,000 will continue at present tax rates, 30 percent, 40 percent, and 46 percent respectively.

Estate and Gift Tax

The concept of a unified estate and gift tax is continued by the Act. One of the more important changes affecting these two transfer taxes is a phased-in increase of the unified credit. Presently, the unified credit is $47,000, allowing an individual to transfer $175,625 without imposition of either estate or gift tax. This exempted amount may be transferred during life as gifts, at death, or some during life with the remainder transferred at death. The amount of credit will be increased each year, beginning in 1982, until 1987 when the credit will be $192,800, which is an equivalent exemption of $600,000. Table 5 shows the phase-in of credit and each year's equivalent exemption.

This increase in the equivalent exemption does not mean that estate planning is over for persons with taxable estates of less than $600,000. Inflation, coupled with future earnings, is capable of increasing the value of an estate more rapidly than generally realized. Couples may still find it

Table 5. Phase-in Increase of Unified Credit

Year	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	192,800	600,000

advantageous to develop and maintain separate estates, nearly equal in value, to make maximum use of the equivalent exemption. This estate planning objective is more easily reached if a plan is developed early, reviewed and updated regularly, and adhered to over the years even though there are presently no estate tax concerns.

It is also important to remember that the increases in the unified credit are being phased-in and not until 1987 will a $600,000 taxable estate be free of tax.

Reduction in Maximum Tax Rate

A second major change is a reduction in the maximum tax rate. For gifts made and for estates of persons dying after December 31, 1984, the maximum tax rate will be 50 percent for the part of the taxable transfer that exceeds $2,500,000. The maximum tax rate will remain at 70 percent for 1981 with reduction of this rate being phased-in over the next four years. The Act did not change the rate of taxation for taxable amounts less than $2,500,000.

Unified Gift and Estate Tax

The concept of unifying gift and estate taxes was first enacted in 1976 and, as mentioned, has not been changed by the Economic Recovery Tax Act of 1981. While oversimplified, the basic mechanics of the unified tax are explained here. Each individual has one transfer tax tract for his or her lifetime. To compute tax presently due, the taxpayer calculates the tax owed for all taxable transfers since 1976 and subtracts all taxes paid on gifts since 1976. Under prior law, the amount of gift tax to be subtracted was gift taxes actually paid. The new law changes this so that the amount to be subtracted in computing estate tax is the amount of taxes that would have

been paid had the gifts been taxed at the same (lower) rates which apply to the estate.[2]

Unlimited Marital Deduction

A third major change in transfer taxes pertains to the extent to which a taxpayer may transfer property, either as a gift or at death, to the spouse without imposition of tax. This is called the marital deduction. Since 1976, very generally, a taxpayer could transfer one-half of the estate to the spouse without a tax being imposed. The 1981 Act repeals the limits on the marital deduction. If the taxpayer is willing to transfer the property to the spouse, granting ownership rights to such an extent that the transferred property is included in the spouse's taxable estate, then the taxpayer may transfer all property without imposition of either gift or estate tax.

An unlimited marital deduction does not eliminate the need to plan either. Principles adhered to prior to this Act are still worthy of consideration. Do not overfund the marital deduction. Likewise, placing highly appreciating property in the spouse's taxable estate may increase future tax liability beyond what is presently being saved. On the other hand, other factors may outweigh the possibility of additional tax; factors such as a personal objective that the surviving spouse have maximum freedom with respect to the property, or that the spouse's estate, even after inflation, will be less than the equivalent exemption.

The first spouse to die should not use the marital deduction to such an extent that none of the decedent's unified credit is used, especially if such a plan leaves the surviving spouse's taxable estate greater than the equivalent exemption. As mentioned above, however, other personal objectives should not be neglected on account of possible future tax liability.

It has been common to include in a taxpayer's will language instructing the estate to transfer to the surviving spouse the maximum amount qualifying for

---

[2]The result is that for individuals with taxable transfers already in excess of $2,500,000, any further taxable gifts prior to 1985 will cause an increase in total transfer taxes. However, it is important to remember taxes are also saved by removing rapidly appreciating property from one's taxable estate. Therefore, in determining whether to make gifts (before 1985) beyond $2,500,000 lifetime taxable transfers, each individual must give careful consideration to their personal situation.

the marital deduction. This is called a maximum marital deduction formula clause. Under prior law, the maximum amount which would be transferred was generally one-half of the decedent's estate. With the elimination of a marital deduction limit, such a clause would pass 100 percent of the decedent's estate to the surviving spouse, possibly resulting in something different than the decedent had originally intended.

To remedy this without requiring all existing wills with a formula clause to be changed, the Act states that for all wills and trusts with formula language executed before 30 days after the Act becomes law (about September 13, 1981) the new unlimited marital deduction will not apply. As a result, persons with pre-deadline wills or trusts and who desire to transfer all their property to the surviving spouse under the marital deduction must amend their wills and trusts, noting particular reference to the formula language. For wills and trusts executed after the deadline date, unless taxpayers intend to use the unlimited marital deduction, they should not use formula language or use it only in conjunction with a specified limit.

Not all transfers to a surviving spouse qualify for the marital deduction. Generally, any transfer of property which would not be included in the surviving spouse's taxable estate does not qualify for the marital deduction. This includes life estates, limited powers of appointment, and trusts with the right to the income held by the surviving spouse. The Act now allows an additional type of transfer to qualify for the marital deduction. The transfer must entitle the surviving spouse to all income from the property, for life, and no one may have the power to appoint any part of the property to anyone other than the surviving spouse during the surviving spouse's lifetime. In order to be treated in this different manner, the executor of the decedent's estate must irrevocably elect this treatment. Of course, making the election means that the property will be included in the surviving spouse's taxable estate. Also, this election may disqualify the property for either Use Valuation or a step-up in basis at the death of the surviving spouse. Moreover, it should be made clear that this election pertains only to tax law and will not alter the spouse's interest or rights in the property.

Special Use Valuation for Certain Real Property

A fourth change in estate tax law deals with Special Use Valuation of real property used in farming. There is a phased-in increase of the maximum

amount by which the value of the gross estate may be reduced as a result of Use Valuation. The limit was $500,000 for 1980. The limit is $600,000 for 1981; $700,000 for 1982; and $750,000 for 1983 and thereafter.

There are numerous requirements that must be met to qualify for Special Use Valuation. Two of these requirements are that the decedent or a member of the decedent's family materially participate in the operation of the farm and that the land be used for a qualified use such as farming. The qualified use requirement appeared easy to meet until the IRS in 1980 defined qualified use to mean that the decedent must have an equity interest in the farm operation. This meant that land cash rented to a family member would not qualify for Special Use, and that a crop-share lease was required. Earlier this year, the IRS reversed its position with respect to cash leases with family members and the Act adds permanence to this move by now allowing the equity interest requirement (that is, the qualified use requirement) to be met by either the decedent or a member of the decedent's family.

A related change is a narrowing of the definition of family member. After 1981, family member will mean an ancestor, spouse, or lineal descendant of the decedent. Also included is any descendant of the decedent's spouse (stepchildren) and any lineal descendant of any parent of the decedent (brother, sister, nephew, or niece). The old law defined family member to include all of the above plus any lineal descendant of the decedent's grandparents which would have included the decedent's uncle, aunt, and first cousins.

The requirement used to be that the decedent or a member of the decedent's family had to materially participate in operation of the property for periods aggregating 5 years or more during the 8-year period ending on the date of the decedent's death. This has been changed. If the material participation requirement is not met on the date of death, then the last eight years before the owner's continuous retirement or continuous disability will be the critical period. The period of retirement or disability must be continuous, and retirement is defined as receiving old-age benefits from Social Security. Disability means physical or mental impairment rendering the person incapable of material participation. This change should help ease qualifying for Special Use Valuation.

Special Use Value of farmland is based on the average of the five most recent annual gross cash rentals for comparable farmland divided by the average of the five most recent annual effective interest rates for all new Federal Land

Bank loans. The problem with this formula was identifying comparable farmland for which cash rent information was available. To help ease this, an estate is now allowed to use the average of the five most recent annual net share rental whenever there is no comparable cash rent farmland. Net share rental means the value of the produce received by the lessor grown on the leased land minus cash operating expenses of growing the produce which, under the lease, are paid by the lessor.

After the decedent's death, the heir who received the farmland must continue to materially participate and use the land for the qualified use. Prior law required the heir to continue this for 15 years or an additional tax would be imposed (based on the amount of estate tax saved on account of Special Use Valuation). That period has now been shortened to 10 years.

The Act provides a 2-year period, beginning at the date of the decedent's death, in which the heir must begin to use the property as required for use valuation. In other words, during a period which begins on the date of the decedent's death but for no longer than two years, the qualified use requirement is suspended. Also suspended for that period is the beginning of the 10-year post-death period. This provision reduces the danger of triggering recapture during settlement of the estate.

Another provision states that certain heirs will not need to materially participate during the post-death requirement period but rather that active management is all that is necessary. Heirs qualifying for this special treatment must be one of the following: 1) the spouse of the decedent, 2) less than 21 years of age, 3) disabled, or 4) a student. Active management means making management decisions for the business other than daily operating decisions. The impact of requiring active management rather than material participation means, for the retired surviving spouse, that income from the land will not be earned income and thus will not jeopardize Social Security benefits, and that the level of required activity will not be so great as to tax the elderly person's ability or desire to be active in the business.

An involuntary conversion (example: condemnation) followed by an acquisition of qualified replacement property or a like-kind exchange (trading property for property of like kind) will not trigger imposition of the additional tax unless the cost of the replacement property is less than the amount received as a result of the involuntary conversion or if other property (example: cash) is involved in the like-kind exchange. Likewise, the later acquired property must be used for the same qualified use as the original property.

The heir's basis in inherited property is generally equal to the value of the property for Federal estate tax purposes. This means the Special Use Value becomes the heir's basis in the land. Prior to the Act's passage, imposition of the additional tax did not result in an increase in the basis of the property. This Act changes that, allowing the basis of the property to be increased to the value on which the additional tax is based.

Special Use Valuation is very complex and any taxpayer whose estate plan contemplates use of this election should consult with a competent tax advisor about specific requirements.

Joint Tenancy With Right of Survivorship

Spouses owning property as joint tenants with the right of survivorship can result in adverse estate tax consequences. The general rule with respect to property held in joint tenancy with right of survivorship is that the entire value of the property so held is included in the gross estate of the deceased tenant unless the surviving tenant(s) can prove contribution. In cases where the only joint tenants were spouses, and the surviving spouse could not prove any contribution, the property was included in the gross estate of both spouses and subjected to the possibility of being taxed twice. Amendments since 1976 attempted to remedy this but were less than successful.

The 1981 Act repeals the subsections dealing with the surviving spouse's material participation or the election to treat creation of a joint tenancy as a gift. Instead the law is amended so that for property held by spouses as joint tenants with right of survivorship, in which the spouses are the only joint tenants, only one-half of the value of the property will be included in the decedent's gross estate. Of course, the entire value of the property will be included in the gross estate of the surviving spouse.

As a result of the 1981 law changes, one-half of the property held in joint tenancy will be included in the gross estates of both spouses and the other half included in only the gross estate of the surviving spouse. Also, the one-half included in the gross estate of the first spouse to die will pass to the surviving spouse tax-free under the new unlimited marital deduction. This means joint tenancy property will not be taxed in the estate of the first spouse to die. In fact, if a large portion of the couple's property is held by them in joint tenancy, the <u>taxable</u> estate of the first spouse to die will be small. And,

if a taxable estate is less than the equivalent exemption ($225,000 in 1982 increasing to $600,000 in 1987), there will be no Federal estate tax imposed on the estate of the first spouse to die.

The problem arises in that the entire value of the joint tenancy property will be included in the gross estate of the surviving spouse. This means the gross estate of the surviving spouse will be larger than the gross estate of the first spouse to die even without considering inflation. Also, the estate of the surviving spouse does not have the important marital deduction (unless of course the surviving spouse remarried). As a result, the taxable estate of the surviving spouse can be much larger than the taxable estate of the first spouse to die. Federal estate taxes will need to be paid if the taxable estate exceeds the equivalent exemption.

Generally, total tax liability for the two estates would be lower if the taxable estate of the first spouse is larger, and some of the couple's property is kept out of the surviving spouse's gross estate (and subsequently, taxable estate). In fact, if each spouse's taxable estate is less than the equivalent exemption, the couple would pay no Federal estate tax. This is the notion of balanced estates and not overfunding the marital deduction; that is, to have approximately half of the couple's property included in each spouse's gross estate. However, even with the recent tax law changes, balanced estates cannot be readily achieved as long as the couple's property is held in joint tenancy with right of survivorship. There continues to be little tax advantage to holding property as joint tenants with right of survivorship and couples should give consideration to owning property in some other form.

The unlimited marital deduction also applies to gifts between spouses. This eases splitting the estate between the spouses and will be most helpful when dissolving joint tenancies owned by the couple. In fact, the privilege of splitting the estate without taxation may be more significant than an unlimited marital deduction for transfers at death.

Installment Payment of Federal Estate Taxes

Rules pertaining to the extension of time for payment of estate tax have been changed. Previously, there were two different extensions. One allowed estate taxes, due to a closely held business, to be paid with interest over a 10-year period; the other allowed payment of interest only on taxes due to a closely held business for 5 years and then an additional 10 years to pay, with

interest, the taxes. The extension the estate qualified for depended upon what percentage of the gross estate was comprised of closely held business. The requirements were 35 percent and 65 percent, respectively.

The 10-year installment has been repealed; only the 5-year deferral/10-year installment is still available. Also, the 65 percent requirement was lowered to 35 percent. In the past, these extensions have eased the liquidity needed at the time of death. Increased availability of this favorable treatment should be beneficial to estates comprised in part of a closely held business, such as a family farm.

Orphan's Deduction

One other change in estate tax pertains to the orphan deduction. The orphan's deduction allowed $5,000 for each year an orphan's age was less than 21 to be deducted from the gross estate of the parent. It was a type of substitute for the marital deduction for a family with minors when the last parent died. This provision has been repealed and no substitute was enacted.

Gift Tax

The remainder of this report addresses changes in gift tax law. A major change was the increase in the annual exclusion (the amount of gifts a donor could give to each donee, each year without imposition of gift tax) from $3,000 to $10,000 for gifts after 1981. For example, a married couple will be able to transfer up to $40,000 to their two children each year without incurring gift tax rather than $12,000 as under prior law. In addition, tuition to an educational organization and paying the cost of medical care for dependents are not gifts.

Generally, when a donee receives property, the donee's basis in the property is the donor's adjusted basis in the property. And, when an heir receives property, the heir's basis in the property is the value placed on the property for Federal estate tax purposes, usually fair market value. As a result, a taxpayer with appreciated property could give the property (possibly incurring gift tax) to another individual who will, at the time of their death, pass the property back to the donee with a step-up in basis. Under a new statute, in the case of such a series of transfers where the gift was within one year of the donee's death, the donor/heir will not receive a step-up in basis but will continue at the donee/decedent's basis.

Previously, any gift (except the annual exclusion) made within three years of the decedent's death was included in the decedent's gross estate and at the value at the time of death rather than the value at the time of the gift. The new law requires inclusion of only certain gifts made within three years of death. The types of gifts required to be included in the donor/decedent's gross estate are gifts of life insurance and interests in property otherwise included in the gross estate because the transfer involved a retained life estate, a power to appoint, or a power to revoke, or the transfer took effect at death.

The common straightforward gift will not be included in the donor's gross estate even though the gift was within three years of death. As a result, any appreciation in the value of the property after the gift will not be subject to a transfer tax. However, since the transfer is a gift, the donee's tax basis for the property will be the same as the donor's basis rather than a stepped-up basis. It is also important to note that gifts made immediately before death will not save taxes unless there is an increase in the value of the property between the time of the gift and the time of the donor's death. This is a result of the Unified Gift and Estate tax.

Conclusion

The Economic Recovery Tax Act of 1981 addresses numerous areas not discussed in this report. The Act's effectiveness in promoting the recovery of the nation's economy is still being debated and the outcome is not known. Regardless of the economy's recovery, taxpayers will need to become accustomed to the changes and adjust their tax planning accordingly.

LIST OF TABLES