4

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SUMMARY
OF
H.R. 4242

THE ECONOMIC RECOVERY TAX ACT OF 1981

PREPARED BY THE

STAFF OF THE

JOINT COMMITTEE ON TAXATION

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CONTENTS

II. Summary of Provisions of H.R. 4242—Continued

INTRODUCTION

This pamphlet summarizes the provisions of H.R. 4242, the Economic Recovery Tax Act of 1981; it also presents the estimated revenue effects of the Act.

The summary descriptions contained in this pamphlet are intended to be informative, rather than inclusive. The official legislative history of the Act is contained in the Statement of Managers and committee reports.

I. OVERVIEW OF PRINCIPAL PROVISIONS

The following is an overview of the principal provisions of H.R. 4242, the Economic Recovery Tax Act of 1981 (the "Act").

Individual Income Tax Reductions

Individual tax rates

The Act provides cumulative reductions in individual income tax rates of 1¼ percent in 1981, 10 percent in 1982, 19 percent in 1983 and 23 percent in 1984 and subsequent years. These tax reductions will be reflected in reduced withholding on October 1, 1981, July 1, 1982, and July 1, 1983. The top marginal tax rate is reduced from 70 percent to 50 percent on January 1, 1982, and the maximum tax rate on long-term capital gains is reduced to 20 percent for sales or exchange after June 9, 1981.

Deduction for two-earner married couples

The Act allows two-earner married couples a deduction equal to 10 percent of the first $30,000 of earnings of the spouse with the lesser amount of earnings (maximum deduction of $3,000). The new deduction is phased in so that a 5-percent deduction applies in 1982 (maximum deduction of $1,500) and the 10-percent deduction takes effect in 1983.

Indexing

The Act adjusts the income tax brackets, the zero bracket amount and the personal exemption for increases in the consumer price index, starting in 1985. The first such adjustment will take place for 1985 tax returns based on price increases between fiscal year 1983 and fiscal year 1984.

Child care credit

The Act increases the maximum amount of expenditures eligible for the child care tax credit from $2,000 to $2,400 for each of the taxpayer's first two dependents. In addition, it increases the rate of the child care credit from 20 percent to 30 percent for taxpayers with incomes of $10,000 or less. The rate of the credit is reduced by one percentage point for each $2,000 of income, or fraction thereof, above $10,000 until it reaches a rate of 20 percent for taxpayers with incomes above $28,000.

Charitable contributions deduction for nonitemizers

The Act allows taxpayers to deduct charitable contributions even if they do not itemize their personal deductions. For the years 1982 and 1983, the deduction is 25 percent of the first $100 of contributions. For 1984, the contribution cap is raised to $300. For 1985, the deduction is allowed for 50 percent of contributions with no cap, and for 1986 the deduction is allowed for 100 percent of contributions. This provision expires after 1986.

82-761 O - 81 - 2

Gain on sale of residence

The Act extends from 18 months to 2 years the replacement period during which taxpayers must reinvest the proceeds from the sale of their principal residence in a new principal residence if they are to be eligible for the rollover treatment on the gain from that sale. Also, the Act increases from $100,000 to $125,000 the maximum amount of capital gain on the sale of a residence excludible from gross income by a taxpayer age 55 or over.

Foreign earned income

The Act replaces the present system of deductions and exclusions for excess living costs for income earned abroad with an exclusion. The maximum amount excludible will be $75,000 in 1982, and it will increase in $5,000 increments to the permanent level of $95,000 in 1986 and thereafter. In addition, there is an exclusion for excess housing costs.

Capital Cost Recovery Provisions

The Act replaces the present system of depreciation with the Accelerated Cost Recovery System.

For tangible personal property (i.e., machinery and equipment) assets are grouped into four classes with recovery periods of 3, 5, 10 and 15 years. The 3-year class consists of autos, light duty trucks, equipment used in research and development, other short-lived property, racehorses over 2 years old and other horses over 12 years old. The 5-year class includes most other equipment except long-lived public utility property. The 10-year class includes utility property with an ADR midpoint life between 18 and 25 years, railroad tank cars, theme park structures, mobile homes, and utility coalburning equipment used to replace or convert oil and gas-fired boilers. The 15-year class includes public utility property with an ADR midpoint life above 25 years.

For the years 1981 through 1984, taxpayers will use a statutory method of cost recovery which approximates the 150-percent declining balance with a switch to the straight-line method. For property placed in service in 1985, the method will accelerate to approximate the 175-percent declining balance method with a switch to the sum-of-the-years-digits method. For 1985 and subsequent years, the method will approximate the 200-percent declining balance method with a switch to the sum-of-the-years-digits method.

The investment tax credit will be 6 percent for property in the 3-year class and 10 percent for all other eligible property.

Real property will be written off over a 15-year period using the 175-percent declining balance method with a switch to the straight-line method (200 percent for low-income housing). When a taxpayer sells nonresidential real property for which the accelerated method has been used, gain will be treated as ordinary income to the extent of all recovery deductions previously taken. When a taxpayer sells residential real property for which the accelerated method has been used, ordinary income recapture will be limited to the excess of the accelerated over straight-line cost recovery. If a taxpayer uses straight-line recovery, all gain will be treated as capital gain.

Businesses may elect to expense up to $5,000 of personal property in 1982 and 1983, $7,500 in 1984 and 1985, and $10,000 thereafter.

The Act raises the amount of used property eligible for the investment credit from $100,000 to $125,000 for 1981 through 1984, and to $150,000 in 1985 and subsequent years.

The Act greatly liberalizes the rules under which a leasing transaction will be recognized as such for tax purposes.

The Act limits the amount of property eligible for the investment credit to the extent to which the taxpayer is at risk; that is, has invested his own money or is personally liable for loans. There are, however, exceptions from this rule for loans from financial institutions and other commercial lenders and for the energy investment credit.

Tax Credit for Rehabilitation Expenditures

The Act replaces the present 10-percent investment credit for expenditures to rehabilitate nonresidential structures with a graduated credit. The new credit is 15 percent for rehabilitation of nonresidential buildings 30 to 39 years old, 20 percent for rehabilitation of nonresidential buildings over 39 years old, and 25 percent for rehabilitation of certified historic structures. For the 15-percent and 20-percent credits, the basis for determining cost recovery deductions will be reduced by the amount of the credit.

Incentives for Research and Experimentation

Tax credit for research and experimentation

The Act provides a 25-percent tax credit for certain expenditures incurred in research and experimentation in excess of the amount of such expenditures during a base period. This new credit will apply to expenditures made after June 30, 1981, and before 1986.

Charitable contributions of research equipment

The Act permits corporations which contribute newly manufactured scientific equipment to colleges and universities to claim a charitable deduction equal to the taxpayer's basis plus 50 percent of the appreciation, but not to exceed twice the basis.

Allocation to U.S.-source income

For 2 years, taxpayers are allowed to allocate expenditures for research and experimentation conducted in the United States entirely to U.S.-source income.

Small Business Provisions

Accumulated earnings credit

The Act increases the credit against the accumulated earnings tax from $150,000 up to $250,000.

Subchapter S corporations

The Act increases the maximum number of shareholders for a subchapter S corporation from 15 to 25 and allows certain trusts to be qualified shareholders.

Inventory accounting

The Act provides for the simplification of LIFO inventory accounting for small businesses. Businesses with average gross receipts of less than $2 million for the prior 3 years are allowed to use a single dollar-value LIFO pool, and taxpayers switching to LIFO are given 3 years to take into income the inventory write-downs from prior years. Also, the Treasury Department is directed to issue regulations that would simplify the use of dollar-value LIFO inventory accounting through the use of published government indexes.

Windfall Profit Tax Provisions

Royalty owner credit and exemption

For 1981, royalty owners are allowed a credit against the first $2,500 of windfall profit tax liability. For 1982 through 1984, the Act provides an exemption from the windfall profit tax for up to 2 barrels a day of royalty production; and after 1984 it provides a 3-barrel-a-day exemption.

Stripper oil exemption

The Act exempts stripper oil produced by independent producers, starting in 1983.

Newly discovered oil tax rate

The Act reduces the windfall profit tax rate on newly discovered oil from 30 percent to 27.5 percent in 1982, 25 percent in 1983, 22.5 percent in 1984, 20 percent in 1985 and 15 percent in subsequent years.

Corporate Rate Reduction and Other Business Provisions

Corporate rate reduction

The Act reduces the tax rate on the first $25,000 of corporate taxable income from 17 percent to 16 percent in 1982 and 15 percent in subsequent years. It also reduces the rate on the next $25,000 of taxable income from 20 percent to 19 percent in 1982 and 18 percent in subsequent years.

Incentive stock options

The Act reinstates capital gains treatment for stock options which meet certain conditions. There will be no tax consequences when these options are granted or when they are exercised, and employees will be allowed capital gains treatment on any gain on the sale of the stock. The aggregate amount of stock subject to such options for any employee in any calendar year is limited to $100,000. However, employees are allowed a 3-year carryover of up to $50,000 if they do not use up the full $100,000 in any one year. In the case of options granted before 1981, the aggregate amount of stock for which any employee may be granted incentive stock options cannot exceed $50,000 per year and $200,000 in the aggregate.

Targeted jobs credit

The Act extends the targeted jobs tax credit through 1982. It adds AFDC recipients and WIN registrants as additional targeted groups, as well as Vietnam veterans age 35 or over and employees laid off from CETA programs. It limits the credit for cooperative education students to the economically disadvantaged. Also, the Act makes a number of administrative improvements in the credit.

Motor carrier operating rights

The Act allows taxpayers who owned motor carrier operating rights on July 1, 1980, to amortize the basis of those rights over a 60-month period.

Savings Incentives

Interest and dividend exclusion

The Act terminates the present $200 exclusion ($400 for a joint return) after 1981. After 1981, the law will revert to the prior $100 dividend exclusion with some technical modifications. Starting in 1985, taxpayers will be able to exclude 15 percent of interest income to the extent it exceeds nonbusiness and nonmortgage interest deductions up to a maximum exclusion of $450 ($900 for joint returns).

Qualified savings certificates

The Act excludes up to $1,000 ($2,000 for a joint return) of interest on qualified savings certificates. These certificates must be issued between September 30, 1981, and January 1, 1983, and must have a yield equal to 70 percent of the yield on 1-year Treasury bills. The certificates must be issued by financial institutions which invest in residential financing or agricultural loans.

Individual retirement accounts

The Act increases the limit on deductions for contributions to individual retirement accounts from the lesser of 15 percent of compensation or $1,500 ($1,750 for a spousal IRA) to the lesser of 100 percent of compensation or $2,000 ($2,250 for a spousal IRA). Also, the bill makes active participants in tax qualified plans eligible for IRA deductions.

Self-employed retirement savings

The Act increases the maximum annual deduction for a contribution to a self-employed retirement plan (Keogh or H.R. 10 plan) from $7,500 to $15,000.

Employee stock ownership plans

The Act replaces the existing extra investment credit for employee stock ownership plans (ESOPs) with a credit equal to a percentage of payroll. For 1983 and 1984, the credit is one-half of one percent of compensation paid to employees under the plan, and the percentage increases to three-fourths of one percent after 1984. The payroll-based ESOP credit expires at the end of 1987.

Dividend reinvestment plans

The Act excludes from income up to $750 ($1,500 for a joint return) of dividends from public utilities which are reinvested in the stock of the utility under a dividend reinvestment plan. The income will be treated as a capital gain when the taxpayer sells the stock. The exclusion will apply for the years 1982 through 1985.

Estate and Gift Tax Provisions

Unified credit

The Act increases the unified credit against the estate and gift taxes. As a result, the cumulative transfers exempt from these taxes increases from $175,625 under present law to $225,000 in 1982, $275,000 in 1983, $325,000 in 1984, $400,000 in 1985, $500,000 in 1986, and $600,000 in 1987 and subsequent years.

Rate reduction

The Act reduces the top estate and gift tax rate from 70 percent to 65 percent in 1982, 60 percent in 1983, 55 percent in 1984, and to 50 percent in 1985 and subsequent years.

Marital deduction

The Act removes the quantitative limits on the marital deduction under both the estate and gift taxes so that no transfer tax is imposed on transfers between spouses. It also makes certain terminable interests eligible for the deduction.

Current use valuation

The Act increases the maximum amount by which the taxable estate may be reduced under the provision for current use valuation from $500,000 to $600,000 in 1981, $700,000 in 1982, and $750,000 in 1983 and subsequent years. It also makes a number of technical modifications making current use valuation easier to use and liberalizing eligibility for it.

Gift tax exclusion

The Act increases from $3,000 to $10,000 the limit on the annual exclusion from the gift tax for gifts to any single donee. It also exempts from the gift tax certain gifts made to pay for medical expenses and school tuition.

Tax Straddles

Gain or loss on straddles

The Act requires that commodity futures contracts be marked to market at the end of each year and treated as if 60 percent of the capital gains and losses on them were long-term and 40 percent were short-term. It provides a 3-year carryback for losses on marked-to-market assets. Under a transition rule, tax due on gains rolled forward from prior years into 1981 may be paid in 5 annual installments with interest.

For straddles involving property other than futures contracts, losses are allowed only to the extent of unrealized gains on offsetting positions. Other losses are deferred, and the wash sale and short sale principles of present law are extended to straddles.

Interest and carrying charges

The Act requires that interest and carrying charges for commodity investments be capitalized if the investments are part of a straddle.

Hedging

The Act exempts hedging transactions from the mark-to-market, loss deferral and capitalization rules.

Treasury bills

The Act treats Treasury bills as capital assets. The characterization of the income from a Treasury bill as capital gain or ordinary income is based on a pro rata amortization of the market discount to the taxpayer.

Dealer identification of securities

The Act requires dealers to identify securities as investments on the first day after the date of acquisition. A 7-day lookback applies to floor specialists with respect to the stocks for which they are registered specialists.

Sale or exchange of capital assets

The Act provides that taxable dispositions of capital assets are treated as sales or exchanges.

Administrative Provisions

Interest on deficiencies and underpayments

The Act provides for more current adjustment of the interest rate (at 100 percent of the prime rate) applicable to tax deficiencies and underpayments to the prime interest rate.

Penalty for valuation overstatements

The Act provides an additional penalty in the case of underpayments of tax which result from taxpayers' claiming excessive valuations for property on their tax returns.

Other administrative provisions

The Act provides a series of changes in penalties for negligence, filing false withholding certificates, failure to file information returns, and overstated tax deposits. It increases the Tax Court filing fee and provides for confidentiality of IRS information used to develop standards for auditing tax returns.

Corporate estimated tax payments

The Act increases the minimum amount of the current year's tax liability which large corporations must cover with estimated tax payments from 60 percent to 65 percent in 1982, 75 percent in 1983, and 80 percent in subsequent years.

Individual estimated tax payments

The Act increases the exemption from the estimated tax penalty for individuals from $100 to $500 over a 4-year period.

Railroad retirement tax

The Act increases the railroad retirement tax on employers from 9.5 percent to 11.75 percent and provides for a new tax of 2 percent on the compensation of employees. It makes a number of other technical changes to the railroad retirement program.

Miscellaneous Provisions

State legislators business travel expenses

The Act allows State legislators to treat their district residence as their tax home and allows them to treat as business expenses an amount equal to the greater of the Federal per diem or the State per diem, with certain limitations, and without regard to the "away-from-home" rule. The changes apply to taxable years beginning after December 31, 1975.

Fringe benefit regulations

The Act extends through December 31, 1983, the prohibition on issuing regulations on fringe benefits.

Group legal services plans

The Act extends through 1984 the present exclusion for employer contributions to, and benefits provided under, qualified group legal services plans and the tax exemption of trusts under such plans.

Corporate charitable contributions

The Act increases from 5 percent to 10 percent of taxable income the limit on the deduction for corporate charitable contributions.

Telephone excise tax

The Act extends the telephone excise tax at a 1-percent rate for 1983 and 1984.

Amortization of construction period interest and taxes

The Act permanently exempts low-income housing from the requirement that interest and taxes paid during the construction period of a building be capitalized.

Amortization of low-income housing rehabilitation expenditures

Under certain limited circumstances, the Act raises from $20,000 to $40,000 the maximum amount of expenditures eligible for 5-year amortization in connection with the rehabilitation of low-income housing.

Deduction for adoption expenses

The Act provides a new itemized deduction for up to $1,500 in connection with the adoption of a "hard-to-place" child.

II. SUMMARY OF PROVISIONS OF H.R. 4242

A. Individual Income Tax Reductions

1. Individual income tax rate reductions

Under present law, individual income tax rates begin at 14 percent on taxable income above $3,400 on a joint return and $2,400 on a single return. The rates range up to 70 percent on taxable incomes, in excess of $215,400 on a joint return, and $108,300 on a single return.

The highest marginal rate is 70 percent on taxable income in excess of $215,400 on a joint return and $108,300 on a single return. However, the top rate on personal service income is limited to 50 percent (the maximum tax). This rate applies above $60,000 on a joint return and $41,500 on a single return.

A deduction from gross income is allowed for 60 percent of any net capital gain for the year. The remaining 40 percent of any net capital gain is taxed at the ordinary rates up to 70 percent. Thus, the top effective tax rate on capital gains is 28 percent (70 percent rate times the 40 percent included in taxable income).

The Act provides for cumulative across-the-board reductions in individual income tax rates of 23 percent by 1984 on the following schedule:

1981	1¼ percent
1982	10 percent
1983	19 percent
1984	23 percent

Withholding changes take place on October 1, 1981, July 1, 1982, and July 1, 1983. The Act makes several other withholding changes to give the Secretary the authority to issue regulations to permit workers to adjust their withholding to more closely match their tax liability.

The Act reduces the top marginal rate from 70 percent to 50 percent (and, thus, the maximum effective rate on capital gains from 28 percent to 20 percent) in 1982 and repeals the maximum tax in 1982.

A special alternative tax for 1981 provides that a maximum 20-percent rate on net capital gains applies to sales or exchanges occurring after June 9, 1981. Thus, this provision does not apply to taxable receipts after June 9, 1981, of proceeds of sales or exchanges which occurred prior to that date. However, proceeds received in taxable years after 1981 will be taxed at the rate in effect for that year.

2. Deduction for two-earner married couples

Under present law, married taxpayers generally are treated as a single taxpaying unit. If married taxpayers elect to file separate rather than joint returns, they usually pay a higher tax. The differing rate schedules for single and married taxpayers give rise to a marriage penalty when two single wage earners with relatively equal incomes marry.

The Act allows couples filing a joint return a deduction in computing adjusted gross income equal to a percentage of the lower earning spouse's qualified earned income (up to $30,000 of income). In 1982, the percentage will be 5 percent (up to a $1,500 maximum deduction) and in 1983 and subsequent years the percentage will be 10 percent (up to a $3,000 maximum deduction).

3. Indexing

Under present law, the individual income tax is based on various fixed amounts including the amounts that define the tax brackets, the zero bracket amount, and the personal exemption. These amounts are set by statute and are not adjusted for inflation.

Under the Act, the income tax brackets, zero bracket amount, and personal exemption are adjusted for inflation (as measured by the Consumer Price Index), starting in 1985. The first adjustment, for 1985, will be based on the increase in the CPI between fiscal year 1983 and fiscal year 1984.

4. Child and dependent care credit

Present law provides a tax credit equal to 20 percent of expenditures, for the care of children and other dependents, which are incurred in connection with the taxpayer's employment. The maximum amount of expenditures that may be taken into account is $2,000 (one dependent) or $4,000 (two or more dependents). Thus, the maximum credit is $400 or $800. In general, expenses incurred for services outside the household are not creditable unless incurred for the care of a dependent under the age of 15.

The Act increases the child and dependent care credit to 30 percent of employment-related expenses for taxpayers with adjusted gross income of $10,000 or less. For each $2,000 (or fraction thereof) above $10,000, the percentage of creditable expenses is reduced by one percent (but not below 20 percent). Taxpayers with adjusted gross income in excess of $28,000 will be entitled to a credit of 20 percent of employment-related expenses.

The Act also increases the amounts of employment-related expenses that may be taken into account to $2,400 (one dependent) and $4,800 (two or more dependents). Furthermore, the Act provides that qualified, employer-provided child care will not be included in an employee's gross income.

The provisions are effective for taxable years beginning after December 31, 1981.

5. Charitable contribution deduction for nonitemizers

Under present law, individual taxpayers may claim deductions for charitable contributions only if they itemize deductions.

The Act provides that all taxpayers may deduct charitable contributions, whether or not they itemize deductions. The deduction for nonitemizers will be phased in over a five-year period, with a cap on the amount of contributions that qualify for deduction in the first three years, as follows:

Year	*Percentage*	*Cap*
1982	25	$100
1983	25	100
1984	25	300
1985	50	
1986	100	
1987	Provision expires	

The contributions' cap is not doubled for married taxpayers filing jointly. Thus, in 1982, for example, the maximum deduction for a nonitemizer who files a joint return, or who is single, will be $25. The maximum deduction for a married taxpayer filing separately in 1982 will be $12.50.

6. Gain on sale of residence

a. Rollover of gain time on sale of residence

Present law provides for the nonrecognition, or rollover, of gain on the sale of a taxpayer's principal residence if a new principal residence is purchased and used by the taxpayer within a period beginning 18 months before, and ending 18 months after the sale.

The Act extends the 18-month replacement period of present law to 2 years. This change is effective for sales and exchanges of principal residences after July 20, 1981, and for such sales and exchanges with respect to which the 18-month rollover period has not expired on July 20, 1981.

b. Exclusion of gain on sale of residence

Present law allows individuals who have attained the age of 55 to elect a one-time exclusion of up to $100,000 of gain on the sale of their principal residence. Generally, the individual must have owned and used the property as a principal residence for three years or more out of the five-year period preceding the sale.

The Act increases from $100,000 to $125,000 the amount of gain excludable from gross income on the sale or exchange of a principal residence by an individual who has attained the age of 55.

The provision is effective for sales and exchanges of a principal residence after July 20, 1981.

7. Foreign earned income

Present law allows a variety of deductions and exclusions for U.S. citizens and residents living abroad, including deductions for excess cost of living, housing, education expenses, and home leave. Also, an exclusion is provided for the value of food and lodging in a camp in a hardship area.

The Act replaces the existing provisions for income earned abroad with an exclusion for the first $95,000 of such income and an exclusion for excess housing costs. The maximum foreign earned income exclusion will be $75,000 in 1982 and will be phased up to $95,000 by 1986 in $5,000 per year increments. The combination of housing and earned income may not exceed earned income of the taxpayer for the year.

The provision is elective, and once an election is made it is binding. An exclusion for camps whether or not in hardship areas is provided.

The provisions are effective with respect to taxable years beginning in 1982.

B. Capital Cost Recovery Provisions

1. General concept

Prior law was designed to allocate depreciation deductions over the period the asset is used in business so that deductions for the cost of an asset were matched with the income produced by the asset.

Under the Act, the prior law Asset Depreciation Range (ADR) system is terminated for recovery property placed in service after December 31, 1980 and replaced with the Accelerated Cost Recovery System (ACRS). Under ACRS, the cost of an asset is recovered over a pre-determined period generally shorter than the useful life of the asset or the period the asset is used to produce income.

2. Eligible property

Assets used in a trade or business or for the production of income are depreciable if they are subject to wear and tear, decay or decline from natural causes or obsolescence. Assets that do not decline in value on a predictable basis or that do not have a determinable useful life, such as land, goodwill, and stock, are not depreciable.

Under the Act, most tangible depreciable property (real and personal) is covered under the accelerated cost recovery system (ACRS). However, ACRS does not apply to (1) property not depreciated in terms of years (except certain railroad property), and (2) property amortized (e.g., leasehold improvements and certain rehabilitation expenditures.)

3. Useful lives and methods

a. Personal property useful lives and methods

Under prior law, a principal method used to determine useful lives for personal property was the Asset Depreciation Range (ADR) system. For assets not eligible for ADR and for taxpayers who did not elect ADR, useful lives were determined according to the facts and circumstances pertaining to each asset or by agreement between the taxpayer and the IRS.

The Act provides that the cost of eligible personal property (and certain real property) is recovered over 3, 5, 10, or 15 years. The classification of property by recovery period is as follows:

3 years________Autos, light-duty trucks, R&D equipment, racehorses over 2 years old and other horses over 12 years old and personal property with an ADR midpoint life of 4 years or less.

5 years________Most other equipment except long-lived public utility property. Also includes single purpose agricultural structures and petroleum storage facilities, which are designated as section 1245 property under the Act.

10 years------- Public utility property with an ADR midpoint life greater than 18 but not greater than 25 years; burners and boilers using coal as a primary fuel if used in a public utility powerplant and if replacing or converting oil- or gas-fired burners or boilers; railroad tank cars; mobile homes; and real property with an ADR midpoint life of 12.5 years or less (e.g. theme park structures).

15 years------- Public utility property with an ADR midpoint life exceeding 25 years (except certain burners and boilers using coal as a primary fuel).

Under a flexibility provision (described below), taxpayers may elect to use the regular recovery period or one of two longer recovery periods as set forth below:

3-year property	3, 5 and 12 years
5-year property	5, 12 and 25 years
10-year property	10, 25 and 35 years
15-year property	15, 35 and 45 years

Under prior law, taxpayers could use the straight-line method, a declining balance method at a rate up to 200-percent of the straight-line rate, or the sum of the years-digits method with respect to new personal property. For used personal property, taxpayers could use either the straight-line method or a declining balance method at a rate up to 150-percent of the straight-line rate.

Under the Act, taxpayers have the option to use the straight-line method over the regular or optional longer recovery period or a prescribed accelerated method over the regular recovery period. The prescribed accelerated method for property placed in service in the following years is based on depreciation methods as set forth below, using a half-year convention and no salvage value limitation:

Year property placed in service:	*Prescribed method*
1981–1984	150 percent declining balance, changing to straight-line
1985	175 percent declining balance, changing to SYD
After 1985	200 percent declining balance, changing to SYD.

b. Real property

Prior to the Act, IRS guideline lives ranged from 40 to 60 years for real property, but actual lives claimed under a facts and circumstances approach could be shorter. Non-residential property could be depreciated using a 150-percent declining balance method (if new) or the straight-line method. New residential property could be depreciated using straight-line, the 200-percent declining balance method, or the sum of the years-digits method. Used residential could use up to the 125-percent declining balance method (if 20 years useful life remaining) or straight-line. Taxpayers could use different lives for each separate component of a building, such as plumbing, wiring, etc. (component depreciation) or use a single life for the building and all components (composite depreciation).

Under the Act, real property is assigned a 15-year recovery period, but taxpayers may elect a 35- or 45-year extended recovery period. Composite depreciation is required. For real property other than low-income housing, the property can be depreciated using the 175-percent declining balance method, changing to the straight-line method to maximize acceleration. Low-income housing can be depreciated under the 200-percent declining balance method changing to straight-line. As an option, taxpayers may elect to use the straight-line method over 15, 35, or 45 years.

4. Election to expense certain depreciable business assets

Under prior law, a deduction was provided for "bonus" first-year depreciation up to 20-percent of up to $10,000 of eligible property ($20,000 for individuals filing a joint return) (sec. 179).

The Act repeals the "bonus" depreciation provision (sec. 179) and replaces it with an election to expense the cost of new or used personal property used in a trade or business. The maximum annual amount a person can expense is $5,000 for 1982 and 1983, $7,500 for 1984 and 1985, and $10,000 for years after 1985. No investment credit is allowed for expensed property.

5. Recapture of depreciation

Under prior law, gain on the disposition of personal property was treated as ordinary income rather than capital gain to the extent of prior depreciation taken (sec. 1245). Gain on the disposition of real property was treated as ordinary income rather than capital gain only to the extent prior depreciation taken exceeds what would have been allowable if straight-line depreciation had been used (sec. 1250). In the case of installment sales of personal and real property, the recognition of any gain realized could be deferred (sec. 453).

Under the Act, the treatment of personal property is unchanged, except that the recognition of gain cannot be deferred by installment sales treatment to the extent a deduction was taken for the property under the special expensing election. The treatment of residential real property is unchanged. The treatment of nonresidential real property is unchanged if the straight-line depreciation method is used. However, for nonresidential real property depreciated under an accelerated method, gain is treated as ordinary income to the extent of all prior depreciation taken.

6. Flexibility

Under prior law, taxpayers had several options that permit a degree of flexibility in computing depreciation deductions and net operating losses. Taxpayers have an option to use a useful life 20 percent shorter or longer than ADR midpoint life. There was an option to use straight-line or accelerated methods, where allowed. In determining the date of additions to and retirements from a depreciation account, taxpayers had an option to use an averaging convention for personal property. In general, net operating losses, and operating losses of certain insurance companies, could be carried back 3 years and forward 7 years.

Under the Act, taxpayers have an option to use one of two recovery periods that are longer than the recovery period prescribed for each class of property. In addition, taxpayers have an option to use an accelerated or straight-line method over the regular recovery period. Under the Act, the carryover period for operating losses is extended to 15 years. Net operating losses of a financial institution are carried back 10 years and forward 5 years as under prior law. The carryover period for Cuban expropriation losses remains at 20 years.

7. Earnings and profits

Distributions by a corporation to its shareholders are taxable as dividends only to the extent the distribution is out of current or accumulated earnings and profits. Earnings and profits for U.S. corporations were computed, under prior law, using straight-line depreciation over the useful life of the property. The 20-percent ADR useful life variance could be used to determine the useful life for this purpose. Under the Act, earnings and profits for U.S. corporations are based on straight-line depreciation over extended recovery periods as set forth below:

Property	*Extended recovery period*
3-year property	5 years
5-year property	12 years
10-year property	25 years
15-year property	35 years

If, to compute the recovery deduction under section 168, a taxpayer uses a recovery period longer than the applicable extended recovery period described above, the taxpayer must use such longer period in lieu of the regular extended period to compute earnings and profits.

8. Depreciation of assets held outside the United States

Property used outside the United States for more than half the taxable year generally is considered a foreign asset. The investment tax credit generally is not allowed for such property (sec. 48(a)(2)). However, railroad rolling stock owned by a domestic railroad and used within and without the United States is not considered a foreign asset, even if it is used outside the United States for more than half the taxable year.

Under prior law, foreign assets were depreciated using useful lives based on facts and circumstances or the guideline lives under the ADR system, but the 20-percent useful life variance under ADR could not be used. Accelerated methods of depreciation generally could be used with respect to such property.

The Act provides that foreign personal property is depreciated using the 200-percent declining balance method, changing to the straight-line method, over the ADR midpoint life in effect for the property on January 1, 1981, or 12 years if no ADR midpoint life is in effect at such time. Taxpayers have the option to use the straight-line method over the regular recovery period (ADR midpoint life or 12 years, whichever is applicable) or an optional recovery period. Foreign real property can be depreciated over 35 years using the 150-percent declining balance method, changing to the straight-line method, or the straight-line method over 35 or 45 years.

The Act also provides that railroad rolling stock used within and without the United States is not treated as a foreign asset, whether it is owned by a domestic railroad or other U.S. person. However, this provision does not apply to rolling stock not owned by a domestic railroad if it is leased to a foreign person for periods aggregating more than 12 months out of any 24-month period.

9. Add-on minimum tax and maximum tax

A 15-percent minimum tax is imposed on a portion of a taxpayer's items of tax preference. Accelerated depreciation on leased personal property is an item of tax preference for taxpayers other than corporations (but including subchapter S corporations and personal holding companies). Under prior law, accelerated depreciation on real property is an item of tax preference for all taxpayers. Under prior law, the amount of the preference item was the excess of depreciation taken over what would have been allowable using the straight-line method over the property's useful life (ADR midpoint life for property depreciated under the ADR system).

Under the Act, accelerated depreciation is an item of tax preference for only individuals, subchapter S corporation, and personal holding companies.[1] The amount of the tax preference item for accelerated depreciation is the excess of the depreciation taken over the amount that would have been allowable using the straight-line method over prescribed periods as set forth below:

Property	*Prescribed period*
3-year property	5 years
5-year property	8 years
10-year property	15 years
15-year real property	15 years
15-year personal property	22 years

10. Regular investment credit

a. Eligibility for the credit

The regular investment credit applies to tangible personal property and other tangible property used in connection with manufacturing, production and certain other activities not including distribution. Petroleum storage facilities were ineligible under prior law unless used in connection with production. Property used predominately outside the United States is not eligible. Although there is an exception from the foreign use rule permitting the credit for railroad rolling stock of a domestic railroad that was used within and without the United States, railroad rolling stock of other persons used within and without the United States was not eligible under prior law.

The Act adds to eligible property facilities used for storage of petroleum and its primary products, even if used in connection with distribution and not production.

The Act retains the prior law "within and without" foreign use exception for rolling stock of a domestic railroad and adds to that excep-

[1] The elimination of the tax preference item for accelerated depreciation of real property for corporations other than subchapter S corporations and personal holding companies is a technical error and was not intended.

tion rolling stock of other U.S. persons. However, rolling stock owned by a U.S. person other than a domestic railroad and used within and without the U.S. is not eligible if it is leased for periods aggregating more than 12 months in any 24-month period to a foreign person.

b. Amount of credit

Under prior law, the amount of regular credit was determined as follows:

Estimated useful life (years):	*Credit (%)*
Less than 3	0
3–4	3⅓
5–6	6⅔
7 or more	10

Under the Act, the regular credit amount is as follows:

Recovery period (years):	*Credit (%)*
3	6
5, 10 and 15	10

c. Used property limitation

Under prior law, only $100,000 of used property was eligible for the investment credit.

The Act raises the limitation to $125,000 for 1981 through 1984 and to $150,000 in 1985.

d. Recapture of credit

Under prior law, the credit was recomputed on early disposition of property as if the actual useful life had been used to determine the amount of credit.

Under the Act, the credit is recomputed on early disposition by allowing a 2-percent credit for each full year the property is held. Thus, no recapture is required for eligible 5-year, 10-year, or 15-year property actually held for at least 5 years, or for eligible 3-year property held at least 3 years.

e. Carryover of credit

Under prior law, unused investment credit could be carried back 3 years and forward 7 years. The Act extends the carryover period to 15 years.

11. Normalization rules for public utility property

Under prior law, a public utility could use an accelerated depreciation method only if it also used a normalization method of accounting, unless the company used flow-through accounting for accelerated depreciation in 1969. A public utility that had to normalize accelerated depreciation could use the ADR system only if it normalized certain differences between the ADR useful life and the ratemaking useful life of eligible property. Similarly, a utility that had to normalize accelerated depreciation also had to normalize the investment tax credit. In addition, some utilities not required to normalize accelerated depreciation were required to normalize all or part of the investment credit.

Under the Act, except as provided in relevant transition rules, normalization of accelerated depreciation, useful lives, and the investment credit is mandatory for all public utilities with respect to property depreciated under ACRS. Under transition rules, taxpayers are considered to satisfy the new normalization requirements for depreciation or the investment credit under a rate order that complies with the prior law requirements if (1) the rate order was put into effect before the date of enactment of the Act and (2) a superseding rate order determining cost of service is put into effect complying with the new applicable normalization requirement before January 1, 1983.

12. Investment credit at-risk limitation

Under prior law, there was no at-risk limitation on the allowance of investment credits.

Under the Act, the allowance of investment credits is subject to an at-risk limitation. The limitation applies to business activities, the losses from which are subject to limitation under the at-risk rules of section 465, engaged in by individuals, subchapter S corporations, and certain closely held corporations. The investment credit is not allowed with respect to amounts invested in qualifying property to the extent the invested amounts are not at risk, within the meaning of section 465 (b) (without regard to subsection (b) (5)).

The Act contains an exception for certain qualified lenders and direct or guaranteed Federal, State or local government loans, if the taxpayer has a minimum 20-percent at-risk investment in the property. Qualified lenders include banks, savings and loan institutions, credit unions, insurance companies, pension trusts and unrelated third parties engaged in the business of loaning money. For this exception, the lender must be unrelated to the borrower, the promoter, and the seller. In addition, the borrower must be unrelated to the seller.

The Act also contains a safe harbor rule for certain loans related to certain energy property. This special safe harbor rule applies only to solar or wind energy property, recycling equipment, qualified hydroelectric generating property, biomass property, equipment for converting alternative substances into alcohol fuels, geothermal equipment, and to ocean thermal energy equipment. The special safe harbor rule also applies to energy property which comprises a system for using the same energy source for the sequential generation of electrical power, mechanical shaft power, or both, in combination with steam, heat, or other forms of useful energy.

Amounts borrowed with respect to these types of property would be considered, under certain circumstances, at risk, even though such amounts are not otherwise considered at risk under the Act. In order to qualify under the safe harbor, the taxpayer must have a minimum 25-percent at risk investment in the property. In addition, any nonrecourse financing for the property (other than financing by a qualified lender that is considered at risk) must be a level payment loan. A level payment loan is a loan repaid in substantially equal installments which include both principal and interest. If the taxpayer does not make adequate repayments of loan principal, some of the credit allowed will be recaptured, and additional interest added to the increase in tax, determined as if the increase in tax were for the taxable year in which the property was placed in service.

13. Qualified progress expenditures

Under prior law, the investment credit was available for qualified progress expenditures made for property with a 2-year normal construction period and at least a 7-year useful life.

The Act repeals the 7-year useful life requirement. Thus, the amount of credit allowed with respect to progress expenditures will be determined in accordance with the recovery period the taxpayer expects the property to have when the property is placed in service.

14. Leasing

Under prior IRS guidelines, a transaction was characterized as a lease if—(1) the lessor's minimum at-risk investment in the property throughout the lease term was 20 percent of cost; (2) the lessor had a positive cash flow and a profit from the lease independent of tax benefits; (3) the lessee did not have a right to purchase the property at less than fair market value; (4) the lessee did not have an investment in the lease and does not lend any of the purchase costs to the owner, and use of the property at the end of the lease term by a person other than the lessee must be commercially feasible to the lessor.

The Act creates a safe harbor that guarantees that a transaction will be characterized as a lease for purposes of allowing investment credits and cost recovery allowances to the nominal lessor. To come within the safe harbor, both the lessor and the lessee must elect affirmatively to treat the lessor as the owner of the property. The lessor must be a corporation, a partnership of corporations, or a grantor trust, the grantor and beneficiaries of which are all corporations. At all times during the term of the lease and at the time that the property is in service, the lessor must have a minimum "at risk" investment of not less than 10 percent of the adjusted basis of the property. In addition, the term of the lease (including all extensions) cannot exceed the greater of (1) 90 percent of the useful life of the property under section 167 or (2) 150 percent of the present class life (ADR midpoint as of January 1, 1981).

Only property that is new section 38 property (or certain mass commuting vehicles) may come within the safe harbor rules. The leased property must be leased within 3 months after its acquisition or, in the case of a sale-leaseback transaction, it must be purchased by the lessor within 3 months of the lessee's acquisition for a purchase price that does not exceed the adjusted basis of the property in the hands of the lessee at the time of the lessor's purchase.

If a transaction meets the requirements above, the parties will be treated as lessor and lessee without regard to (1) whether the lessor or lessee must take into account tax benefits to derive a profit or cash flow from the transaction (2) the fact that the lessee retains title and the burdens, benefits, and incidents of ownership, (3) whether a person other than the lessee may use the property at the end of the lease, (4) the fact the property may be purchased at the end of the lease at a fixed or determinable price that is more or less than its fair market value at that time, (5) the fact the lessee has provided financing or has guaranteed financing (other than for the lessor's minimum 10 percent investment), and (6) the fact an obligation of any person is subject to a contingency or offset agreement.

15. Effective dates and phase-in provisions

In general, the capital cost recovery provisions apply to property placed in service after December 31, 1980. Although there is no phase-in period, the most accelerated method of depreciation for personal property is not available until 1986. In general, the rules for extension of the carryover period for operating losses apply for operating losses in taxable years ending after December 31, 1975. A special rule applies for losses of a former REIT. The effective dates for extension of the carryover periods for various credits are as follows:

(1) Investment credit and WIN credits—Unused credit years ending after December 31, 1973.

(2) New employee credit—Unused credit years ending after December 31, 1976.

(3) Alcohol fuel credits—Unused credit years ending after September 30, 1980.

The at risk rule for the investment credit applies to property placed in service on or after February 19, 1981, except for property acquired by the taxpayer pursuant to a binding contract entered into on or before February 18, 1981. A technical amendment to section 46(e) relating to investment credit for non-corporate lessors applies to leases entered into after June 25, 1981. The rules relating to railroad rolling stock apply for taxable years beginning after December 31, 1980.

Special rules are provided to prevent the taxpayer from bringing its property used during 1980 (pre-1981 property) within the system by certain post-1980 transactions (i.e., "churning" transactions). Similar rules are provided to prevent the taxpayer from taking advantage of the increased recovery percentages available after 1984 for its property used before 1985 (pre-1985 property). Under these anti-churning rules ACRS will not apply to personal property in use during 1980 unless the property is transferred after 1980 in a transaction in which the owner and user (if different) change. Also ACRS does not apply to personal property leased back to a person that owned or used the property during 1980 or to a person related to that person.

For the anti-churning rules, a corporation is not a related person to the taxpayer if either (1) the person is a distributing corporation in a transaction described in section 334(b)(2)(B) and 80 percent of the stock is acquired by purchase after December 31, 1980, by the taxpayer or (2) if the person is a distributing corporation in a complete or partial liquidation to which section 331 applies and 80 percent of the stock of that corporation is acquired by purchase by one or more taxpayers or by persons related to the taxpayer after December 31, 1980.

C. Rehabilitation Expenditures

1. Tax credit for rehabilitation expenditures

Under prior law, the 10-percent investment tax credit (and additional energy credit) was available for expenditures to rehabilitate a building that is at least 20 years old. The credit allowed did not reduce the basis of the property for purposes of depreciation. In lieu of the investment credit, the taxpayer could elect with respect to rehabilitation of a certified historic structure to amortize the expenditures over a 60-month period. (sec. 191.)

Under the Act, the 10-percent regular investment credit (and the additional energy credit) for rehabilitation expenditures and the 60-month amortization provision for certified historic rehabilitation expenditures are replaced by a 3-tier investment credit. The credit is 15 percent for structures at least 30 years old, 20 percent for structures at least 40 years old, and 25 percent for certified historic structures. No credit is allowed for rehabilitation of a building (other than a certified historic structure) less than 30 years old.

The 15- and 20-percent credits are limited, as under prior law, to nonresidential buildings. However, the 25-percent credit for certified historic rehabilitation is available for both nonresidential and residential buildings. These credits are available only if the taxpayer elects to use the straight-line method of cost recovery with respect to rehabilitation expenditures. In addition, there must be a substantial rehabilitation of the building to qualify for the credit.

For rehabilitation credits other than the credit for certified historic rehabilitations, the basis of the property must be reduced by the amount of the credit allowed. If subsequently there is a recapture of the credit, the resulting increase in tax (or adjustment in carrybacks and carryovers) will increase the basis of the building immediately before the recapture event.

No credit is available for a certified historic structure if approval of the rehabilitation is not obtained from the Secretary of Interior. The Act treats a noncertified building in an historic district as a certified historic structure for this purpose unless the taxpayer obtains a certification from the Secretary of Interior that it is not of historic significance to the district. This changes the prior law rule under which a building in an historic district was not a certified historic structure unless the Secretary of the Interior took action to designate the property as being of historic significance to the district.

Under the Act, the prior law rule denying investment credit for property leased to tax-exempt organizations (sec. 48(a)(4)) or governmental units (sec. 48(a)(5)) does not apply to the portion of the basis of the building attributable to qualified rehabilitation expenditures. This corrects a clerical error in the enrollment of the Miscellaneous Revenue Act of 1980. Due to the error, this provision was omitted from the Act.

The Act applies to expenditures made after December 31, 1981. Rehabilitation expenditures which are paid or incurred both prior to January 1, 1982, and after that date, can qualify for the prior law credit of 10 percent for buildings over 20 years old, or for the credits under the Act after December 31, 1981, for other qualifying buildings. Thus, some expenditures may be subject to two different credit rates as a rehabilitation is completed. For a certified historic structure, the taxpayer may use either the prior law 10-percent credit or 60-month amortization for pre-1982 expenditures, but generally is allowed only the 25-percent credit for post-1981 expenditures. However, if a rehabilitation begins before January 1, 1982, on a certified historic structure that does not qualify for the new credits because of the substantial rehabilitation requirement, 60-month amortization or the 10-percent credit will continue to apply to both post-1981 and pre-1982 expenditures. The rule permitting a rehabilitation credit for property leased to tax-exempts applies to uses after July 29, 1980.

2. Demolition of historic structures

Under prior law, buildings constructed or reconstructed at the site of a demolished or substantially altered certified historic structure had to be depreciated using the straight-line method over its useful life (sec. 167(n)). Demolition costs had to be capitalized as part of the basis of land and, thus, could not be deducted as a loss or depreciated.

The Act retains the loss deduction prohibition of present law, but repeals the straight-line depreciation requirement. The provision applies to expenditures made after December 31, 1981.

D. Incentives for Research and Experimentation

1. Tax credit for research and experimentation

Under present law, a taxpayer may elect to deduct currently the amount of research or experimental expenditures incurred in connection with the taxpayer's trade or business, or may elect to amortize certain research costs over a period of 60 months or more (sec. 174). These rules apply to the costs of research conducted by the taxpayer and, in general, to expenses paid for research conducted on behalf of the taxpayer by a research firm, university, etc. Treasury regulations define qualifying expenditures to mean "research and development costs in the experimental or laboratory sense," and provide illustrations of qualifying and nonqualifying expenditures.

The Act provides a 25-percent tax credit for certain research and experimental expenditures paid in carrying on a trade or business of the taxpayer, but only to the extent that current-year expenditures exceed the average amount of research expenditures in a base period (generally, the preceding three taxable years). Subject to certain exclusions, the Act adopts the definition of research used for purposes of the special income tax deduction rules under section 174.

Under the Act, research expenditures qualifying for the new incremental credit consist of (1) "in-house" expenditures for research wages and supplies, plus certain lease or other charges for research use of computers, laboratory equipment, etc.; (2) 65 percent of amounts paid (e.g., to a research firm or university) for contract research; and (3) 65 percent of corporate grants for basic research to be performed by universities or certain scientific research organizations (or of grants to certain funds organized to make basic research grants to universities).

The credit under the Act applies to research expenditures made after June 30, 1981, and before 1986.

2. Charitable contributions of newly manufactured equipment to universities for research

Under present law, the amount of charitable deduction for a contribution of inventory or other ordinary-income property generally is limited to the amount of the taxpayer's basis in the property. An exception is provided for corporate contributions of certain property for use in the care of the needy, the ill, or infants; in such case, 50 percent of any appreciation plus the basis (but not more than twice the basis) may be deducted.

The Act allows a deduction equal to the taxpayer's basis plus 50 percent of any appreciation (but not to exceed twice the basis) for qualified corporate contributions, by the manufacturer, of new scientific equipment or apparatus to a college or university for research or experimentation, including research training, in the United States in the physical or biological sciences. This provision applies to qualified charitable contributions made after the date of enactment of the Act.

3. Allocation of research expenditures to domestic income

Taxpayers must allocate and apportion research and experimentation expenditures between their domestic and foreign source income. To the extent that such expenditures are allocated to foreign source income, the taxpayers foreign tax credit limitation is reduced, which may reduce utilization of foreign tax credits. Other results also flow from the allocation.

The Act provides that for two years, taxpayers must allocate or apportion all research and experimental expenditures paid or incurred in activities conducted in the United States to U.S. source income. The Treasury is required to study the impact of its allocation regulations on domestic research and development and on the foreign tax credit.

The provision is effective for the first two taxable years of a taxpayer beginning after the date of enactment of the Act.

E. Small Business Provisions

1. Accumulated earnings credit

Under present law, an accumulated earnings tax is imposed on earnings accumulated in a corporation to avoid income tax on the corporation's shareholders. In computing the tax base, a credit (of not less than $150,000) is allowed for earnings retained for the reasonable needs of the business.

The Act increases the minimum accumulated earnings credit to $250,000 except for service corporations in health, law, engineering, architecture, accounting, actuarial science, performing arts and consulting. The provision is effective for taxable years beginning after December 31, 1981.

2. Subchapter S corporations

Under present law, a subchapter S corporation may not have more than 15 shareholders and, generally, trust may not be shareholders.

The Act increases the number of permitted shareholders to 25 and allows "section 678" trusts to be shareholders. In addition, under the Act the sole income beneficiary of a trust which distributes all its income currently can elect to be treated as the owner, under section 678, of the stock of any subchapter S corporation held by the trust, and the trust will be eligible as a shareholder of that subchapter S corporation. The income beneficiary must be a U.S. citizen or resident, and must be a beneficiary for his life unless the corpus of the trust is to be distributed to the income beneficiary upon termination of the trust. The election under this section may be made retroactive for up to 60 days.

The provision is effective for taxable years beginning after December 31, 1981.

3. LIFO inventory and small business accounting

Taxpayers with inventories must use accrual accounting rather than cash accounting. LIFO is a method of accrual accounting that, during periods of inflation results in the highest cost goods being deducted from income, thus, producing low taxable income. Dollar-value LIFO is an advantageous method of computing LIFO inventories but because of its inherent complexity it is considered by some, especially small businessmen, as unworkable.

Under the Act, businesses with average gross receipts of less than $2 million for the 3 years (ending with the taxable year) may elect one inventory pool for purposes of dollar-value LIFO inventory accounting. Also, taxpayers electing LIFO will have 3 years (beginning with the year of the election to LIFO) to take back into income inventory writedowns taken in years prior to the year of the LIFO election. The Secretary shall also prescribe regulations providing for the simplification of LIFO inventory accounting through the use of published government indexes.

Also under the Act, the Secretary of the Treasury is directed to conduct a full and complete study of methods of tax accounting for inventory (including but not limited to the LIFO method and the cash receipts and disbursements method) with a view toward the development of simplified methods. The Secretary is also directed to submit to the Committee on Ways and Means of the House of Representatives and to the Committee on Finance of the Senate a report on this study, together with such recommendations as he deems appropriate, by December 31, 1982.

F. Windfall Profit Tax and Other Energy Provisions

1. Royalty owners credit and exemption

Qualified royalty owners were allowed a credit (or refund) of up to $1,000 against the windfall profit tax imposed on their royalty oil during calendar year 1980.

The Act makes the royalty owner credit available for calendar year 1981 and increases it from $1,000 to $2,500.

For 1982 and subsequent years, the Act provides a limited exemption from the windfall profit tax for specified amounts of royalty production. For 1982 through 1984, the exemption is 2 barrels a day; starting in 1985 the exemption is 3 barrels a day.

2. Producer exemption

Independent producers are eligible for reduced windfall profit tax rates on up to 1,000 barrels a day of tier 1 and tier 2 oil. The reduced rate applicable to an independent producer's tier 2 oil (including stripper oil) is 30 percent rather than 60 percent.

The Act exempts from the windfall profit tax, starting in 1983, stripper oil production of independent producers. The Act also provides that stripper oil cannot qualify for this exemption if it is produced from a stripper well property which has been transferred on or after July 23, 1981, by a producer other than an independent producer.

3. Reduced tax rate on newly discovered oil

Under present law, newly discovered oil is taxed at a 30-percent rate on the difference between its removal price and a severance tax adjustment plus a base price of $16.55 adjusted for grade, quality, location and inflation plus 2 percent.

The Act reduces the tax rate on newly discovered oil from 30 to 15 percent, over 5 years, in accordance with the following schedule:

Year	***Rate (%)***
1982	27.5
1983	25.0
1984	22.5
1985	20.0
1986 and thereafter	15.0

4. Exemption for qualified charities

Under present law, oil production attributable to certain qualifying charitable interests is exempt from the windfall profit tax. A charitable organization for the residential placement, care, or treatment of delinquent, dependent, orphaned, neglected, or handicapped children is not within this exemption.

The Act extends the existing windfall profit tax exemption for qualified charities to oil production attributable to economic interests held by charitable organizations, described in Code section 170(c)

(2), which are organized and operated primarily for the residential placement, care, or treatment of delinquent, dependent, orphaned, neglected, or handicapped children.

5. Production credit for certain gases

Present law allows a credit for the production of specified alternative fuels, including several types of natural gas which are eligible for incentive prices under the Natural Gas Policy Act of 1978 (NGPA). The credit phases out as the price of uncontrolled domestic oil rises from $23.50 to $29.50 a barrel, adjusted for inflation. Because of the phase out based on the price of oil, the credit generally was not available during 1980.

Section 107(d) of the NGPA provides that gas production is not eligible for an incentive price if any special tax provision applies and if the producer does not file a price election with the Federal Energy Regulatory Commission within 30 days of enactment of the special tax provision.

The Act provides that no production credit is available unless the taxpayer elects it on the appropriate tax return. This has the effect of allowing the producer to elect the incentive price under the NGPA after the 30-day period has elapsed.

The Act does not change any provision of the NGPA or deal with the FERC's administration of that Act. It is intended, however, that the amendment be administered by Treasury and, to the extent appropriate, by FERC so as to prevent any producer from obtaining the benefits of the production credit and the incentive price.

G. Corporate Rate Reductions and Other Business Provisions

1. Corporate rate reduction

The corporate income tax has been imposed on taxable income under the following schedule:

Taxable income:	*Rate (%)*
Less than $25,000	17
25,000–50,000	20
50,000–75,000	30
75,000–100,000	40
Over $100,000	46

The Act reduces the tax rate on taxable income below $50,000 in two steps.

Taxable income:	*Rate (%)*
In 1982—	
Less than $25,000	16
$25,000–$50,000	19
1983 and later years—	
Less than $25,000	15
25,000–$50,000	18

2. Incentive stock options

Under present law, the taxation of stock options granted by an employer to an employee as compensation is governed by section 83. The value of the option constitutes ordinary income to the employee when granted only if the option itself has a readily ascertainable fair market value at that time. If the option does not have a readily ascertainable value when granted, it does not constitute ordinary income at that time. Instead, when the option is exercised, the difference between the value of the stock at exercise and the option price constitutes ordinary income to the employee. Ordinary income on grant or on exercise of a stock option is treated as personal service income and, hence, generally is taxed at a maximum rate of 50 percent.

An employer who grants a stock option generally is allowed a business expense deduction equal to the amount includible in the employee's income in its corresponding taxable year (sec. 83(h)).

The Act provides for "incentive stock options," under which there will be no tax consequences when an incentive stock option is granted or when the option is exercised, and the employee will be taxed at capital gains rates when and if he sells the stock received on exercise of the option. Similarly, no business expense deduction will be allowed to the employer with respect to an incentive stock option.

The term "incentive stock option" means an option granted to an individual, for any reason connected with his or her employment, by the employer corporation or by a parent or subsidiary corporation of the employer corporation, to purchase stock of any of such corporations.

To receive incentive stock option treatment, the Act provides that the employee must not dispose of the stock within two years after the option is granted, and must hold the stock itself for at least one year. If all requirements other than these holding period rules are met, the tax will be imposed on sale of the stock, but gain will be treated as ordinary income rather than capital gain, and the employer will be allowed a deduction at that time.

In addition, for the entire time from the date of granting the option until three months (12 months if disabled) before the date of exercise, the option, a parent or subsidiary of that corporation, or a successor corporation. This requirement and the holding period requirements are waived in the case of the death of the employee.

For an option to qualify as an "incentive stock option," the following conditions must be met:

1. The option must be granted under a plan specifying the number of shares of stock to be issued and the employees or class of employees to receive the options. This plan must be approved by the stockholders of the corporation within 12 months before or after the plan is adopted.

2. The option must be granted within ten years of the date the plan is adopted or the date the plan is approved by the stockholders, whichever is earlier.

3. The option must by its terms be exercisable only within 10 years of the date it is granted.

4. The option price must equal or exceed the fair market value of the stock at the time the option is granted. This requirement will be deemed satisfied if there has been a good faith attempt to value the stock accurately, even if the option price is less than the stock value.

5. The option by its terms must be nontransferable other than at death and must be exercisable during the employee's lifetime only by the employee.

6. The employee must not, immediately before the option is granted, own stock representing more than 10 percent of the voting power or value of all classes of stock of the employer corporation or its parent or subsidiary. However, the stock ownership limitation will be waived if the option price is at least 110 percent of the fair market value (at the time the option is granted) of the stock subject to the option and the option by its terms is not exercisable more than five years from the date it is granted.

7. The option by its terms is not to be exercisable while there is outstanding any incentive stock option which was granted to the employee at an earlier time. For this purpose, an option which has not been exercised in full is outstanding for the period which under its initial terms it could have been exercised. Thus, the cancellation of an earlier option will not enable a subsequent option to be exercised any sooner. Also, for this purpose an option is considered to retain its original date of grant even if the terms of the option or the plan are later amended to qualify the option as an incentive stock option.

8. In the case of options granted after 1980, the terms of the plan must limit the amount of aggregate fair market value of the stock (determined at the time of the grant of the option) for which any

employee may be granted incentive stock options in any calendar year to not more than $100,000 plus the carryover amount. The carryover amount from any year after 1980 is one-half of the amount by which $100,000 exceeds the value (at time of grant) of the stock for which incentive stock options were granted in such prior year. Amounts may be carried over 3 years. Options granted in any year use up the $100,000 current year limitation first and then the carryover from the earliest year.

The Act provides that stock acquired on exercise of the option may be paid for with stock of the corporation granting the option. The different between the option price and the fair market value of the stock at the exercise of the option will not be an item of tax preference.

Additional cash or other property may be transferred to the employee at the time the option is exercised, so long as such property is subject to inclusion in income under the provisions of section 83.

An option will not be disqualified because of the inclusion of any condition not inconsistent with the qualification requirements.

The Act will apply to options granted after January 1, 1976, and exercised after December 31, 1980, or outstanding on such later date.

However, in the case of options (including qualified options) granted before January 1, 1981, an option is an incentive stock option only if the employer elects such treatment for an option. The aggregate value (determined at time of grant) of stock for which any employee may be granted incentive stock options prior to 1981 shall not exceed $50,000 per calendar year and $200,000 in the aggregate.

In the case of an option granted after January 1, 1976, and outstanding on the date of enactment, the option terms (or the terms of the plan under which the option was granted may be changed, or shareholder approval obtained, to conform to the incentive stock option rules, within one year of the date of enactment, without the change giving rise to a new option requiring the setting of an option price based on a later valuation date.

All such changes relate back to the time of granting the original option. For example, if the option price of a ten-year option granted in 1978 is increased during the one year after date of enactment to 100 percent (110 percent, if applicable) of the fair market value of the stock on the date the option was granted in 1978, the price requirement will be met. Likewise, if the term of an option held by a 10-percent shareholder is shortened to five years from the date the option was granted, the 10-percent stock ownership limitation will not apply.

3. Extension and modification of targeted jobs tax credit

Under present law, the targeted jobs tax credit, which applies to eligible trade or business wages paid before January 1, 1982, is available on an elective basis for hiring individuals from one or more of seven target groups. In general, the credit is equal to 50 percent of the first $6,000 of first-year wages and 25 percent of the first $6,000 of second-year wages. Qualified first-year wages are limited to 30 percent of FUTA wages (the first $6,000 per calendar year) for all employees.

In the case of trade or business employment, taxpayers are allowed a WIN tax credit equal to 50 percent of qualified first-year wages and 25 percent of qualified second-year wages paid to WIN registrants and AFDC recipients. For employment other than in a trade or business, the credit is 35 percent of qualified first-year wages.

The Act extends and modifies the targeted jobs credit as follows:

Extension and eligible wages.—The Act provides that the full credit is available for targeted employees who begin work before January 1, 1983. The provision limiting qualified first-year wages to 30 percent of FUTA wages is repealed.

Targeted groups.—AFDC recipients and WIN registrants are added as a targeted group, and the WIN credit is terminated. Eligible cooperative education students are limited to those who are economically disadvantaged, effective for wages paid after December 31, 1981. The age limitation for Vietnam veterans (under age 35) is eliminated, and employees laid off from public service employment funded by CETA are made eligible for the credit.

Changes in certification requirements.—Certifications issued or requested after the individual begins work are invalid, and certifications based on false information provided by the employee are revoked prospectively. These requirements generally apply to all individuals, regardless of the date they begin work for their employer. However, for an individual, other than a cooperative education student, who began work earlier than 45 days before the date of enactment, the certification has to have been requested or received before July 23, 1981. For an individual who begins work for the employer during the 90-day period beginning with the date 45 days before the date of enactment or for a cooperative education student who begins work before the end of this period, the certification must be requested or received before the last day of this 90-day period.

In addition, certifications that individuals are members of economically disadvantaged families are valid for a period of 45 days; certification and marketing are to be performed by State employment security agencies; and the credit is not allowed for rehires.

Hiring of relatives.—The credit is denied for hiring relatives of the employer.

Authorization for administrative expenses.—For fiscal year 1982, $30 million of appropriations is authorized for program administration, of which $5 million is to be used for a quality control program.

4. Motor carrier operating rights

Taxpayers are not allowed a loss deduction for the diminution in the value of a license or permit if the license or permit continues to have value as a right to carry on a business.

Under the Act, an ordinary deduction is allowed ratably over a 60-month period for the adjusted bases of motor carrier operating authorities held by the taxpayer on July 1, 1980. The Act provides a special stock acquisition rule for cases in which a corporation acquired the stock of another corporation that directly or indirectly held an operating authority. The provision applies to taxable years ending after June 30, 1980.

5. Bad debt deduction of commercial banks

Under present law, commercial banks compute their bad debt deductions under either the experience method or the percentage of outstanding loans method (sec. 585). Under the Tax Reform Act of 1969, the percentage of outstanding loans method is phased out over an 18-year period. Under the phase-out of the method, bad debt deductions generally are permitted to the extent necessary to increase the bad debt reserve to the following percentages of eligible outstanding loans: 1969 to 1975, 1.8 percent; 1976–1981, 1.2 percent; and 1982–1987, 0.6 percent. After 1987, the bad debt deduction of commercial banks is to be computed under the experience method.

The Act provides that the applicable percentage under the percentage of eligible loans method is to be 1.0 percent for taxable years beginning in 1982. For years after 1982, and before 1988, the applicable percentage will continue to be 0.6 percent.

6. Reorganizations involving financially troubled thrift institutions

Under present law, a tax-free merger or other reorganization is permitted only if shareholders of the acquired corporation acquire stock in the acquiring corporation in the transaction. This restriction is a nonstatutory requirement generally described as the "continuity of interest" requirement. Net operating losses of the acquired corporation in a reorganization are restricted where the shareholders of the acquired corporation are not shareholders of the surviving corporation (sec. 382(b)). Distributions by a domestic building and loan association from its bad debt reserve are recaptured as ordinary income (sec. 593(a)). Contributions to a corporation are excluded from income (sec. 118) but, when made by a nonshareholder, require a reduction in the basis of the corporation's property (sec. 362(c)).

The Act amends the reorganization provisions to permit, in the case of a mutual savings bank, a domestic building and loan association, or a cooperative bank (i.e., a thrift institution to which sec. 593 applies), a transaction to qualify as a reorganization even though the shareholders of the transferor do not receive stock or securities in the acquiring corporation. The amendment applies only to thrift institutions and only after certification by the Federal Home Loan Bank Board, the Federal Savings and Loan Insurance Corporation, or, where neither has supervisory authority, an equivalent State authority that one of the grounds in section 1464(d)(6)(A), (i), (ii), or (iii) of 12 U.S.C. exists with respect to the transferor or, without action by the appropriate agency, will exist in the near future. The amendment requires that substantially all the assets of the transferor be acquired by the transferee and that substantially all of the liabilities of the transferor, including deposits, before the transfer become liabilities of the transferee.

The Act provides that in applying section 382(b) to operating loss carryovers to the surviving corporation after a reorganization of a thrift institution which has been certified by the appropriate agency as described above, deposits in the acquired corporation which become deposits in the transferee are treated as stock of both corporations. Deposits in the transferee are also treated as stock for this purpose.

The Act provides that distributions out of excess bad debt reserves in redemption of the principal amount of an interest of the Federal Savings and Loan Insurance Corporation in the distributing domestic building and loan association received in exchange for financial assistance is not subject to recapture under section 593(e).

The Act excludes from income of a building and loan association all money or property contributed to the association by the Federal Savings and Loan Insurance Corporation under its financial assistance program without any reduction in the basis of property.

7. Tax treatment of mutual savings banks that convert to stock associations

Under present law, building and loan associations, cooperative banks, and nonstock mutual savings banks compute their bad debt deduction under a special set of rules (sec. 593). Under one of these rules, called the percent of taxable income method, these institutions are allowed a bad debt deduction equal to 40 percent of the institution's taxable income (computed without regard to the bad debt deduction). However, in order to qualify for the full amount of this deduction, at least 82 percent of its assets in the case of a building and loan association or cooperative bank, or 72 percent of its assets in the case of a mutual savings bank, must be invested in certain assets (hereafter called "qualified assets").

Present law also provides rules which recapture excess bad debt deductions of building and loan associations when there are dividends in excess of post-1951 earnings and profits or when there are liquidations or redemptions of stock (sec. 593(e)). Finally, present law permits mutual savings banks to compute the tax on their life insurance business as if the life insurance business was in a separate corporation subject to the special rules applicable to life insurance companies (sec. 594).

The Act makes two changes which are designed to facilitate the conversion of mutual savings banks into stock associations. First, the Act provides that a stock association which is subject to the same regulation as a mutual savings bank is to be treated as a mutual savings bank and, thus, is eligible to compute its bad debt deduction under section 593. However, consistent with the treatment of building and loan associations which may be organized as stock associations, such stock associations would compute their bad debt deduction under the percentage of eligible loan method under the same rules applicable to building and loan associations (i.e., 82 percent of their assets would have to be invested in qualified assets in order to receive the full 40-percent deduction). Similarly, the Act requires recapture of excess bad debt deductions by such stock associations in the same manner as building and loan associations (sec. 593(e)).

Second, the Act extends the special rule under which mutual savings banks can compute their tax on life insurance business as if it were a separate corporation to stock associations which are regulated as mutual savings banks. The Act also clarifies that amounts paid to depositors of such stock associations are deductible to the same extent as mutual savings banks (sec. 591).

H. Savings Incentives Provisions

1. Partial dividend and interest exclusion

Under present law, individuals may exclude from income up to $200 ($400 on a joint return) of dividends and interest earned from domestic sources in 1981 and 1982. After 1982, only the $100 per taxpayer dividend exclusion of prior law will be available.

The Act repeals present law after 1981 and reinstates the $100 dividend exclusion of prior law for 1982 and subsequent years; however, the $100 per taxpayer limitation for the reinstated dividend exclusion is replaced by a limitation of $100 per separate return and $200 per joint return.

Effective in 1985, the Act provides for a 15-percent net interest exclusion on up to $3,000 of net interest ($6,000 on a joint return). For taxpayers who itemize deductions, interest is eligible for the percentage exclusion only to the extent it exceeds the taxpayer's qualified interest expense. Qualified interest expense is interest allowed other than interest paid on a home mortgage or in connection with a trade or business.

2. Tax-exempt savings certificates

Individuals may exclude $200 ($400 on a joint return) of interest and dividends from income in 1981 and 1982 under present law.

The Act provides tax exemption for an aggregate of $1,000 ($2,000 on a joint return) for interest received on a qualified savings certificate. Certificates are 1-year obligations and may be issued between October 1, 1981, and December 31, 1982, by qualified depository institutions (banks, thrift institutions, and credit unions). The certificates must pay interest at rates equal to 70 percent of the rate on the most recently issued 52 weeks Treasury bill. Seventy-five percent of the proceeds must be used for residential financing and agricultural loans, except for credit unions which are limited in the amount of savings certificates they may issue. Residential financing includes 2, 3, and 4 family residences and loans on stock of a cooperative housing corporation.

Interest (other than a qualified savings certificate) will not be eligible for exclusion after 1982, and the dividend exclusion will be limited to $100 ($200 on a joint return). (See, however, the description of the net interest exclusion under No. H.1. above.)

3. Individual retirement accounts

In the case of an individual who is not an active participant in an employer-sponsored plan, the annual contribution limit is raised from the lesser of $1,500 or 15 percent of compensation to the lesser of $2,000 or 100 percent of compensation. The limit for a spousal IRA is increased from $1,750 to $2,250, and the present-law requirement that contributions under a spousal IRA be equally divided between the spouses is deleted.

In the case of an employee who is an active participant is a plan, a deduction is allowed of up to $2,000 for contributions to an IRA or for voluntary contributions to the plan. The voluntary contributions and earnings thereon under a plan are subject to IRA-type rules, except that (1) distributions starting at age 70½ are not mandated and (2) rollovers may be made to an IRA with regard to the present law rule limiting rollovers to one per year.

Under the Act, benefits under a qualified plan (including deductible employee contributions and earnings thereon) are taxed only when paid to the employee or a beneficiary and are not taxed if merely made available. As under present law, if benefits are paid with respect to an employee to a creditor of the employee, a child of the employee, etc., the benefits paid would be treated as if paid to the employee.

Under present law, individuals generally may self-direct IRA investments or investments under an account in a qualified plan. Under the Act amounts invested in collectibles (antiques, art, gems, stamps, etc.) under an IRA or a self-directed account in a qualified plan are treated as distributions for income tax purposes.

Under the Act, the proceeds of a redeemed U.S. retirement bond which is distributed under a qualified bond purchase plan may be rolled over, tax-free, to an IRA. U.S. retirement bonds purchased for an employee may be redeemed only after the employee attains age 59½, dies or becomes disabled. Also, the Act clarifies the treatment of IRA retirement bonds acquired in a taxfree rollover.

In addition, the Act provides that a divorced spouse is allowed a deduction for contributions to a spousal IRA established by the individual's former spouse at least 5 years before the divorce if the former spouse contributed to the IRA under the spousal IRA rules for at least three of the five years preceding the divorce. If these requirements are met, the limit on the divorced spouse's IRA contributions for a year is not less than the lesser of (1) $1,125, or (2) the sum of the divorced spouse's compensation and alimony includible in gross income.

4. Self-employed retirement savings (Keogh plans)

The deduction limit for employer contributions to a defined contribution Keogh plan, to a defined contribution plan maintained by a subchapter S corporation, or to a simplified employee pension (SEP) is increased from $7,500 to $15,000. The 15-percent limit on contributions is not changed. To provide a similar increase in the level of benefits permitted under a defined benefit Keogh or subchapter S corporation plan, the compensation taken into account in determining permitted annual benefit accruals is increased from $50,000 to $100,000.

The Act also increases the amount of compensation which may be taken into account to determine contributions to a Keogh plan, to a subchapter S plan, or to a SEP. Under the Act, the includible compensation limit is increased from $100,000 to $200,000. However, if annual compensation in excess of $100,000 is taken into account, the rate of employer contributions for a plan participant who is a common-law employee cannot be less than the equivalent of 7½ percent of that participant's compensation.

The Act also extends to all partners the present-law rule under which a loan from a Keogh plan to an owner-employee or his use of an interest in the plan as security for a loan is treated as a distribution.

In addition, the Act permits (1) the penalty-free correction of an excess contribution to a Keogh plan if the excess is withdrawn before the return filing due date and (2) early withdrawals from a terminated Keogh plan by an owner-employee without regard to the 5-year ban on Keogh plan contributions for the owner-employee.

5. Employee stock ownership plans (ESOPs)

Present law provides an investment tax credit for contributions to employee stock ownership plans (ESOP).

The Act terminates, after 1982, the present law investment-based tax credit for ESOP contributions and replaces it with a payroll-based tax credit. The payroll-based credit is allowed for wages paid in calendar years 1983 through 1987. For calendar years 1983 and 1984, the credit is limited to 0.5 percent of compensation paid to employees under the plan, and to 0.75 percent of such compensation for 1985, 1986, and 1987.

For profit-sharing plans, the present law rule requiring a flow through of voting rights is deleted, effective January 1, 1980. This requirement continues to apply to other defined contribution plans.

6. Dividend reinvestment plans

Under present law, stock dividends received as part of a pro rata distribution to all shareholders are taxable when the dividend is disposed of or sold. Stock distributions that are not on a pro rata basis are taxable at fair market value when the shares are initially received. Distributions are taxable at fair market value when received if the shareholder has the option to receive cash or stock.

The Act provides that shareholders in a domestic public utility corporation who choose to receive a dividend in the form of a common stock dividend, instead of cash or other property, may exclude up to $750 ($1,500 on a joint return) from income.

These shares will have a zero basis, and the full amount will be taxed as a capital gain if sold after a year. If sold within a year, the stock will be taxed as ordinary income. Only individual shareholders are eligible for dividend reinvestment.

The stock must be common stock newly issued for this purpose and valued between 95 and 105 percent of the stock's value immediately before the distribution date. Penalties will be applied to a corporation which purchases its stock for distribution under this plan.

I. Estate and Gift Tax Provisions

1. Increase in unified credit and reduction in rates

Under present law, estate and gift taxes are unified so that a single progressive rate schedule is applied to cumulative gifts and bequests. Estate and gift tax rates range from 18 percent for the first $10,000 in taxable transfers to 70 percent on taxable transfers in excess of $5 million. Generally, the estate or gift tax liability is determined by first computing the gross estate or gift tax and then subtracting the unified credit to determine the amount of estate of gift tax. The amount of the present unified credit is $47,000. With a unified credit of $47,000, there is no estate or gift tax owed on transfers up to $175,625.

The Act increases the unified credit as follows:

Year of death	*Amount of credit*	*Equivalent amount*
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 thereafter	192, 800	600, 000

The Act also reduces the maximum estate and gift tax rate by 5 percentage points a year over a four-year period from 70 percent to 50 percent, beginning in 1982.

2. Marital deduction

The Act eliminates the present quantitative limits on both the gift and estate tax martial deductions so that one spouse can transfer an unlimited amount of property tax-free to the other spouse. In addition, transfers of community property and transfers of certain terminable interests will qualify for the marital deduction. With regard to property held in joint tenancy by spouses with right of survivorship, only one-half of the property will be included in the estate of the first spouse to die. A transition rule will continue present law for marital deduction clauses in wills executed before 30 days after the date of enactment and not subsequently amended to specifically indicate an intent to adopt an unlimited marital deduction.

3. Changes to current use valuation provision

The Act expands the current use valuation provision in several ways:

(1) The present $500,000 limit by which the fair market value of farms, and other business real property can be reduced for estate tax purposes is increased over three years to $750,000, as follows:

1981	$600,000
1982	700,000
1983 and thereafter	750,000.

(2) The required trade or business use during pre-death periods can be that of a member of the decedent's family as well as that of the decedent. This change is retroactive to January 1, 1977.

(3) The material participation requirement for retired and disabled decedents is measured before the beginning of the disability or retirement.

(4) "Active management" by a surviving spouse of a decedent whose estate was eligible for current use valuation with respect to property is treated as material participation in determining whether the spouse's estate qualifies for the provision.

(5) Replacement property acquired in a like-kind exchange within five years before death is not automatically ineligible for current use valuation.

(6) Replacement property acquired following an involuntary conversion occurring within five years before death is not automatically ineligible for current use valuation.

(7) The election to specially value property can be made on a late return as long as the return is the first return filed. As under present law, the election is irrevocable.

(8) Net share rentals can be used in the formula valuation method for farm real property when no cash rentals are available.

(9) Property transferred to a discretionary trust is eligible for current use valuation, provided all trust beneficiaries are qualified heirs. The change is retroactive to January 1, 1977.

(10) The definition of family member is expanded to include lineal descendants of the surviving spouse who are not descendants of the decedent.

(11) Family membership is redefined to include lineal descendants of an individual's parents rather than his grandparents.

(12) Property purchased from a decedent's estate by a qualified heir can be specially valued in certain circumstances. This change is retroactive to January 1, 1977.

(13) The recapture period is reduced to 10 years (from 15 years).

(14) A 2-year grace period immediately after the decedent's death is provided during which failure by a qualified heir to commence the qualified use does not trigger recapture. The change is retroactive to January 1, 1977.

(15) Active management by surviving spouses, minor and disabled heirs, and full-time students is treated as material participation.

(16) Like-kind exchanges of specially valued real property do not automatically result in imposition of a recapture tax. This change applies to exchanges occurring after December 31, 1981.

(17) The requirement of an election to avoid imposition of the recapture tax in the case of an involuntary conversion of specially valued property is repealed. This change applies to conversions occurring after December 31, 1981.

(18) If a recapture tax is imposed, an election can be made to step-up (to fair market value as of the decedent's death) the heir's income tax basis in specially valued property. The heir is required to pay interest on the amount of the recapture tax.

(19) Standing timber can be specially valued as an interest in the underlying real property. A recapture tax is imposed when such timber is severed or disposed of within 10 years of death.

4. Gifts made within 3 years of death

In general, the Act provides that section 2035(a) (which generally requires that gifts made by a decedent within 3 years of death be included in the decedent's gross estate at their value as of the date of death or alternate valuation date) does not apply to decedents dying after December 31, 1981. However, present law continues to apply to certain types of property covered by sections 2036, 2037, 2038, 2041, and 2042. In addition, all gifts made within 3 years of death are included for purposes of qualifying for current use valuation, deferred payment of estate tax, qualified redemptions of stock to pay estate tax, and estate tax liens.

5. Installment payment of estate tax attributable to closely held business

The Act combines the more liberal provisions of present law sections 6166 and 6166A, relating to the deferred payment of estate taxes attributable to interests in closely held businesses, into one provision. The new provision permits deferred payment if interests in closely held businesses exceed 35 percent of the adjusted gross estate. Conforming changes are made to section 303, which permits redemption of stock in a closely held business to pay estate taxes, funeral expenses, and administration expenses. The Act also provides that any remaining unpaid estate tax balance will not be accelerated upon the death of the decedent's heir or a subsequent transferee, provided the interests in closely held businesses passes to a member of the heir's family.

6. Disclaimers

The Act provides that a timely transfer of property to the person who would have received it had an effective disclaimer been made under the applicable local law is considered an effective disclaimer for purposes of Federal estate and gift taxes where the other Federal requirements of qualified disclaimers are met.

7. Basis of property received within 1 year of death

The Act provides that the basis of appreciated property acquired by gift within one year of death is not adjusted to its fair market value at date of the decedent's death (as is done under present law) if it is returned to the donor (or donor's spouse).

8. Certain charitable contributions

The Act provides that a charitable estate and gift tax deduction will be allowed for a transfer of a copyrightable work of art to a qualified charitable organization, whether or not the copyright itself is simultaneously transferred to the charitable organization.

9. Certain bequests, etc., to minor children

The provision of present law which allows deduction from a parent's gross estate of $5,000 for each year that an orphaned child is below age 21 is repealed.

10. Annual gift tax exclusion

Under the Act, the annual gift tax exclusion is increased from $3,000 to $10,000 per donee ($20,000 in the case of a married couple who elect to split gifts). In addition, an unlimited gift tax exclusion is provided for amounts paid directly to the service provider for the benefit of the donee for medical expenses and school tuition. A transition rule allows present law to continue to apply to existing trusts, which contain provisions referring to the maximum annual exclusion amount.

11. Annual filing of gift tax returns

Under the Act, gift tax returns are required to be filed only on an annual basis, rather than quarterly as is required in some cases under present law.

12. Generation-skipping transfer tax

The Tax Reform Act of 1976 imposed a tax on generation-skipping transfers. A transitional rule exempts from the tax generation-skipping trusts created by wills or revocable trusts in existence on June 11, 1976, if (1) such wills and trusts were not amended after that date to create or increase the amount of a generation-skipping transfer, and (2) the testator or trust grantor dies before January 1, 1982. Under the Act, the January 1, 1982, date contained in the present transitional rule is extended one additional year to January 1, 1983.

13. Effective dates

Except as indicated otherwise in the discussion of specific provisions, the changes to the estate tax are effective for estates of decedents dying after December 31, 1981, and the changes to the gift tax are effective for gifts made after December 31, 1981.

J. Tax Straddles

1. Gains or losses on straddles

In Revenue Ruling 77–185, the Internal Revenue Service denied deductions for losses on certain partial dispositions of straddles on the grounds that the transactions were incomplete, tax-motivated and not reflective of true economic position. The theory of this ruling is currently in litigation.

The Act marks all commodity futures contracts to market at year end and treats them as if 60 percent of the capital gains and losses on them were long-term and 40 percent were short-term. Net losses under the mark-to-market rule may be carried back three years against mark-to-market gains. Taxpayers may elect to mark their futures to market for the entire 1981 year as if 1982 rates were in effect. Tax due on gains rolled forward from prior years into 1981 may be paid in five annual installments with interest. The first installment payment is due with the taxpayer's 1981 taxes.

In the case of straddles involving property other than futures which are marked-to-market, the Act allows straddle losses only to the extent such losses exceed the unrealized gains on offsetting positions. Disallowed losses are deferred. The wash sale and short sale principles of present law are extended to straddles by regulation. The loss deferral rule applies to actively-traded personal property but not to such property as real estate, stock and short-term stock options. Hedging transactions are excepted from this provision. The provision applies to property acquired and positions established by the taxpayer after June 23, 1981.

2. Interest and carrying charges

Present law allows a current deduction for interest and carrying charges for purchasing or carrying commodity investments. The Act requires that such charges be added to the basis of the commodity if it is part of a straddle. Hedging transactions are excepted from the capitalization rule.

This rule applies to property acquired and positions established by the taxpayer after June 23, 1981.

3. Hedging exception

The Act excepts hedging transactions from the mark-to-market, loss deferral and capitalization rule. Syndicates are not entitled to the hedging exemption.

4. Characterization of Treasury bills

Under present law, gain and loss on certain governmental obligations (including Treasury bills) issued at discount and payable at a fixed maturity date less than one year from issue date are treated as ordinary income and loss. The Act treats such obligations as capital assets and the discount on these obligations as ordinary income.

5. Dealer identification of securities held for investment

Present law requires dealers to identify securities held as investments within 30 days of the date of acquisition. The Act requires identification of securities by the close of business on the date of acquisition. Securities acquired after the date of enactment and before January 1, 1982, must be identified by the close of business on the first day after the date of acquisition. Floor specialists are allowed seven business days to designate stock for which they are registered specialists.

6. Sale or exchange of capital assets

Under present law, for gain or loss to be capital gain or loss, it must result from the sale or exchange of a capital asset. The Act provides that taxable dispositions of capital assets which are commodity-related property are treated as sales or exchanges. This change applies to property acquired after June 23, 1981.

K. Administrative Provisions

1. Interest on deficiencies and overpayments

Under present law, the interest rate applicable to deficiencies and overpayments is set by Treasury regulations at 90 percent of the adjusted prime rate for September, and is effective on February 1 of the immediately succeeding year. The interest rate, however, cannot be changed more frequently than every 23 months.

The Act provides that the interest rate is to be set annually at the prime rate. Starting in 1983, changes in the interest rate are to be effective on January 1, rather than on February 1, of the year immediately succeeding that in which the rate is established.

2. Penalties for false withholding allowance certificate

Under present law, a civil penalty of $50 may apply for claiming withholding allowances based on false information. The criminal penalty for willfully failing to supply information, or for willfully supplying false or fraudulent information, in connection with wage withholding is a fine of up to $500 and/or up to one year imprisonment.

The Act increases to $500 the civil penalty for filing false information with respect to wage withholding. The penalty, however, may be waived by the Secretary.

The Act also increases the criminal penalty for willfully failing to supply information, or for willfully supplying falsified information, in connection with wage withholding to $1,000.

These provisions are effective for acts and failures to act after December 31, 1981.

3. Penalty for failure to file information returns

Present law requires taxpayers to file a variety of information returns with the Secretary. Generally, such returns relate to payments to, and transactions with, other persons. The penalty for failure to file most information returns is $1 per return, subject to a maximum of $1,000 for any calendar year. Present law generally does not require a taxpayer who must file an information return to furnish a copy to the person to whom the payment relates. However, such a requirement is imposed as to some information returns.

The provision generally requires that information returns be furnished to the person to whom the payments on the return relate.

The Act also increases the penalty for failure to file most information returns with the Secretary.

The increased penalty is $10 for each return, subject to a maximum penalty of $25,000 for any calendar year. As under present law, the penalty does not apply if the failure is due to reasonable cause and not to willful neglect.

The provision is effective as to returns and statements required to be furnished after December 31, 1981.

4. Penalty for overstated tax deposits

Present law requires periodic deposits of various taxes prior to the close of the taxable year. Taxpayers who fail to comply with these depository requirements may be subject to a penalty of 5 percent of any underdeposit amount not deposited on or before the prescribed date, unless it is shown that the failure is due to reasonable cause and not due to willful neglect. In addition, criminal penalties may apply with respect to taxpayers who make a false return claiming to have made deposits of tax or who fail to collect, account for, or pay over collected taxes.

The Act contains a specific penalty applicable to persons who make an overstated deposit claim. The penalty is 25 percent of the overstated deposit claim, and applies in addition to any other applicable penalty. However, the overstated deposit claim penalty does not apply if the overstated deposit claim is due to reasonable cause and not due to willful neglect.

5. Penalty for valuation overstatement

Present law imposes an addition to tax, or penalty, with respect to certain tax underpayments due to negligence or civil fraud. The penalty for negligence is 5-percent of any underpayment that is due to negligent or intentional disregard for rules and regulations. The civil fraud penalty is 50 percent of any underpayment.

The Act provides a graduated addition to tax applicable to certain income tax "valuation overstatements." The addition to tax applies only to the extent of any income tax underpayment which is attributable to such an overstatement, and only if the taxpayer is an individual, a closely held corporation, or a personal service corporation.

If there is a valuation overstatement, the following percentages are used to determine the applicable addition to tax:

If the valuation claimed is the following percent of the correct valuation—	*The applicable percentage is—*
150 percent or more but not more than 200 percent	10
More than 200 percent but not more than 250 percent	20
More than 250 percent	30

The penalty is effective for returns filed after December 31, 1981.

6. Addition to negligence penalty

Present law imposes an addition to tax, or penalty, with respect to certain tax underpayments due to negligence or civil fraud. The penalty for negligence is 5 percent of any underpayment that is due to negligent or intentional disregard for rules and regulations. The civil penalty is 50 percent of any underpayment.

The Act imposes a nondeductible addition to tax equal to 50 percent of the interest attributable to that portion of an underpayment which is attributable to negligent or intentional disregard for rules or regulations.

7. Confidentiality of certain IRS information

Under the present law provisions that restrict the disclosure of tax returns and return information it is unclear whether the IRS legally can refuse to disclose information that is used to develop standards for auditing tax returns. The Act provides that the IRS can refuse to disclose such information if the Secretary determines that disclosure will seriously impair assessments, collection, or enforcement under the internal revenue laws. The Act applies to disclosures after July 19, 1981.

8. Tax Court filing fee

Under present law, the Tax Court is authorized to impose a fee of up to $10 for the filing of any petition. The comparable filing fee for the U.S. district courts is $60.

The Act authorizes the Tax Court to impose a filing fee of up to $60 for petitions filed after December 31, 1981.

9. Cash management: corporate estimated tax payments

Under present law, corporations whose taxable income exceed $1 million in any of the three preceding taxable years must pay estimated tax of at least 60 percent of current year's tax liability regardless of their prior year's tax liability.

The Act increases the amount of estimated tax that a large corporation must pay currently, without regard to prior year's tax liability, from 60 percent to 80 percent. This increase is phased in over a three-year period. In 1982, large corporations will have to be at least 65 percent current with estimated tax payments. This will increase to 75 percent in 1983, and to 80 percent for 1984 and subsequent years. The provision is effective for taxable years beginning after December 31, 1981.

10. Declaration and payment of estimated taxes by individuals

In general, present law provides that individuals whose tax liability, over amounts withheld during the year, is less than $100 are not required to file a declaration of estimated taxes.

The Act increases the tax liability threshold for payment of estimated taxes from $100 to $500 over a four-year period, as follows:

Taxable year beginning in—	*Threshold amount*
1982	$200
1983	300
1984	400
1985 and thereafter	500

Individuals whose tax liability, in excess of withholding, does not exceed the threshold amount would not be required to declare or pay estimated tax nor would they be penalized for underpayment of estimated tax.

The increase in the tax liability threshold begins in taxable years beginning after December 31, 1981.

11. Railroad retirement taxes

Present law imposes an industry pension (tier-II) tax on railroad employers of 9.5 percent of the taxable compensation of their employees. Payments by railroad employers of employee railroad taxes are excluded from compensation for purposes of the railroad retirement tax. The law is unsettled as to whether, or in what circumstances, the Railroad Retirement Tax Act applies to compensation when paid or when earned.

The Act increases the employer tier-II tax to 11.75 percent and imposes a new 2-percent tax on the income of railroad employees. In addition, the Act amends the definition of compensation to include employer-paid railroad employee payroll taxes. Furthermore, the Act provides special rules defining the term "compensation" for the purposes of the Railroad Retirement Tax Act. The amendments, effective for taxable years beginning after December 31, 1981, established that compensation paid in one calendar month but which would be payable in a prior or subsequent taxable month but for the fact that the prescribed payment date falls on a weekend or legal holiday shall be deemed to have been paid in the prior or subsequent month. The Act also provides that employee compensation made through the employer's payroll shall be presumed, absent contrary evidence, to be compensation in the period with respect to which the payment is made.

Finally, the Act provides for limited advance transfers to the Railroad Retirement Account of amounts anticipated to be transferred for the fiscal year to the Account under the financial interchange with the Social Security Trust Funds.

L. Miscellaneous Provisions

1. State legislators business travel expenses

For taxable years before 1981, State legislators were allowed an election to treat their residences within the district represented as their tax home for purposes of computing business deductions for expenses while away from home. If such an election is made, the allowable deduction is equal to the sum of the legislator's legislative days multiplied by the Federal per diem for the State capital.

The Act extends, and modifies, the State legislator provision for all taxable years beginning on or after January 1, 1976. Under the Act, an electing State legislator is deemed to have expended for business purposes an amount equal to the individual's legislative days multiplied by the greater of the Federal per diem or the State per diem (but not over 110 percent of the Federal per diem). This amount is deductible without regard to the away-from-home rule. The State legislator rule does not apply to legislators living within 50 miles of the capitol building.

2. Fringe benefit regulations

Prior to June 1, 1981, the Treasury was prohibited from issuing final regulations, under Code section 61, relating to the income tax treatment of fringe benefits. The Act extends this prohibition until December 31, 1983.

3. Qualified group legal services plans

Employer contributions to, and benefits provided under, a qualified group legal services plan are excluded from an employee's income. This income exclusion was scheduled to expire on December 31, 1981.

Under the Act, the income exclusion for qualified group legal services plans is extended through December 31, 1984.

4. Campaign funds

Under present law, candidates for election to Congress must designate *one* "principal campaign committee" to receive contributions and make expenditures on the candidate's behalf (2 USC 432(e)). A campaign committee may be designated as a "principal campaign committee" by only one candidate, and such a designated committee may not support any other candidate. A statement of designation must be filed with the Federal Election Commission (FEC) and, as appropriate, with the Clerk of the House or the Secretary of the Senate. A congressional candidates's principal campaign committee must coordinate the submission of FEC reports of affiliated campaign committees.

Under Code section 527, a candidate's campaign organization generally is exempt from taxation. However, "political organization taxable income," e.g., interest on account balances, etc., is subject to the highest rate, rather than the graduated rates, of the corporate income tax.

The Act, for taxable years beginning after December 31, 1981, applies the generally applicable corporate income tax rates to political organization taxable income of a Congressional candidate's "principal campaign committee," as defined under present law (2 USC 432(e)). Under regulations prescribed by the Secretary, candidates have to furnish the Secretary with the principal campaign committee's designation. No change is made to the present law rules applicable to other campaign or political organizations.

5. Tax-exempt bonds for purchase of mass transit equipment

A State or local government may issue tax-exempt industrial development bonds to provide certain exempt facilities, which include mass commuting facilities. These facilities do not include the equipment used for commuting in a mass transit system.

Under the Act, a State or local government may issue tax-exempt obligations, if the proceeds are used to provide qualified mass commuting vehicles that are leased to a mass transit system which is wholly owned by one or more governmental units. A qualified mass commuting vehicle is defined to mean any bus, subway car, rail car, or similar equipment used in a mass transit system for mass commuting purposes. Tax-exempt obligations may be issued for this purpose after the date of enactment and before January 1, 1985.

6. Tax-exempt bonds for volunteer fire departments

In general, obligations issued by States or their political subdivisions are exempt from Federal income tax. Volunteer fire departments are not considered to be political subdivisions and, thus, cannot issue tax-exempt bonds on their own behalf.

The Act permits volunteer fire departments to issue tax-exempt obligations on their own behalf if certain requirements are met. A volunteer fire department, for this purpose, is an organization (1) that is organized and operated to provide firefighting or emergency medical services in an area that is not provided with any other firefighting services, and (2) that is required, by written agreement, to furnish such services. An obligation issued by a qualified volunteer fire department is tax-exempt if the obligation is issued as part of an issue substantially all of the proceeds of which are to be used for acquiring, constructing, reconstructing, or improving a firehouse or firetruck used or to be used by the fire department.

The provision generally applies to obligations issued after December 31, 1980. However, the provision has retroactive effect with respect to certain obligations held by the First Bank and Trust Company of Indianapolis, Indiana, which were issued after December 31, 1969, and before January 1, 1981.

7. Payout requirement of private foundations

Under present law, private foundations (other than operating foundations) are required to distribute annually the greater of their minimum investment return or their adjusted net income, less certain taxes (sec. 4942). The minimum investment return basically is 5 percent of the foundation's net investment assets. Under the definition of an operating foundation, the foundation is required (among other requirements) to spend for charitable purposes substantially all of its adjusted net income (sec. 4942(j)).

The Act reduces the required payout for private foundations so that they must distribute only their minimum investment return. The Act also provides a comparable amendment to the definition of an operating foundation. The Act is effective for taxable years beginning after December 31, 1981.

8. Charitable contributions by corporations

Under present law, a corporation's deduction for charitable contributions may not exceed 5 percent of its taxable income.

The Act increases the limitation on a corporation's charitable contributions deduction to 10 percent of taxable income, effective for taxable years beginning after December 31, 1981.

9. Unemployment tax status for certain fishing boat services

Under present law, certain crew members of fishing boats are treated as self-employed individuals rather than as employees for purposes of the Federal Insurance Contributions Act (FICA) and income tax withholding. However, services which are not subject to FICA taxes are not exempt for purposes of the Federal Unemployment Tax Act (FUTA) if the services are related to catching halibut or salmon for commercial purposes or if the services are performed on a vessel of more than ten net tons.

The Act provides that, during 1981, wages paid to fishing boat crew members who are self-employed for purposes of FICA and income tax withholding will not be subject to FUTA taxes.

10. Two-year extension of telephone excise tax at 1 percent

Under present law, the excise tax imposed on communication services (local telephone, toll telephone and teletypewriter services) for 1981 is 2 percent of amounts paid for services. The tax was scheduled to be 1 percent for 1982 and to expire as of January 1, 1983.

Under the Act, the telephone excise tax will be extended at a 1-percent rate for two additional years, or for 1983 and 1984, and will expire as of January 1, 1985.

11. Modification of foreign investment company provisions

Under present law, gain on the sale or exchange of stock in a foreign investment company is taxed as ordinary income to the extent attributable to earnings and profits derived after 1962. Once a foreign corporation becomes a foreign investment company, the ordinary income treatment applies even to earnings and profits derived before the foreign corporation became a foreign investment company.

Under the Act, gain on the disposition of stock in a foreign investment company attributable to earnings and profits derived before the foreign corporation became a foreign investment company will not be subject to tax under section 1246 of the Code. Gain not covered by section 1246 is covered by section 1248 where that section is otherwise applicable, and the provisions only apply to companies that become foreign investment companies because they meet the requirements of section 1246(b)(2) of the Code.

The provision is effective for sales or exchanges after the date of enactment of the Act in taxable years ending after that date.

12. Foreign investment in U.S. real property

Under present law, foreign persons selling U.S. real estate after June 18, 1980, are subject to United States taxation on that sale. Foreign persons selling stock in a U.S. corporation having 50 percent or more of its gross asset value comprised of U.S. real property interests are subject to taxation. Finally, the distributions (liquidating or nonliquidating) of U.S. real property interests by a foreign corporation generally are subject to tax. The taxation of dispositions of U.S. real property interests apply to transactions covered by a treaty, but, in general, not until January 1, 1985, if such taxation would be contrary to the applicable treaty.

The Act makes certain technical changes in the foreign investment in U.S. real property provisions generally clarifying present law.

Virgin Islands Corporations.—A U.S. real property interest includes an interest in real property located in the United States or the Virgin Islands. Double taxation by both the U.S. and the Virgin Islands is prevented by providing that a person subject to tax because of section 897 pays that tax and files the necessary returns only with the jurisdiction (the U.S. or the Virgin Islands) where the underlying property is located. Disposition of an interest in real property located in the Virgin Islands is foreign source income to the United States taxpayers.

Partnership assets.—For purposes of determining whether a corporation is a U.S. real property holding corporation, a corporation partner takes into account its proportionate share of all assets (not only U.S. real property interests) of the partnership. The same rules apply to trusts and estates in which a corporation has an interest.

Taxation in carryover basis cases.—The Act makes clear the Treasury's authority to provide for nonrecognition of gain by a foreign corporation on a distribution where a carryover basis transaction is entered into for purposes of avoiding Federal income tax on the transaction. Taxation is specifically provided for if, at the time of receipt of the property, the distributee would not be subject to tax on a later disposition of the property by the recipient, or if the basis of the property in the hands of the distributee is greater than the basis of the property before the distribution increased by any gain recognized by the distributing corporation.

Nondiscrimination.—The Act makes clear that under present law any foreign corporation may make an election to be treated as a domestic corporation for purposes of section 897 of the Code and the related reporting requirements if the corporation owns a U.S. real property interest and under any treaty obligation of the United States the foreign corporation is entitled to nondiscriminatory treatment with respect to that interest. It is made clear that the election provided by this provision is the exclusive remedy for any person claiming discriminatory treatment because of the foreign investment in real property taxation provisions or the reporting requirements or both of them.

Indirect holdings.—For purposes of determining whether a foreign corporation has substantial U.S. real property investors, a foreign corporation must look through to the assets of any U.S. corporation in which the foreign corporation has an interest.

Contributions to capital.—The Act specifically makes clear that gain is recognized by a nonresident alien individual or a foreign corporation on the transfer of a U.S. real property interest to a foreign corporation, if the transfer is made as paid in the surplus or as a contribution to capital. Taxation applies to the extent the fair market value of the property transferred exceeds the adjusted basis of the property plus any gain recognized by the transferor.

Liquidation of foreign corporations.—Foreign corporations that were acquired during the period that began after December 31, 1979, and before November 26, 1980, may elect to be treated as a U.S. corporation for purposes of liquidating under section 334(b)(2). For all other purposes, the foreign corporation will be treated as a foreign corporation.

The Act relieves the double tax burden that applies to a U.S. person that purchases the stock of a foreign corporation which holds U.S. real property by giving those shareholders who acquire their interest between December 31, 1979 and November 26, 1980, to the effective date of the Foreign Investment in Real Property Tax Act, a credit against any tax imposed on them on the surrender of their stock in the liquidating foreign corporation. The credit is equal to the tax imposed on the liquidating foreign corporation on the sale of the U.S. real property. The rule applies only if the U.S. persons continuously held the stock since June 18, 1980, the effective date of the foreign investment in U.S. real property legislation.

Application of treaties.—It is made clear that in order for a new treaty to begin the 2-year period provided for in current law during which an old treaty will remain applicable, it must have been signed on or after January 1, 1981 and before January 1, 1985. The Act also makes clear that the old treaty with that country will take precedence over the legislation for two years after the new treaty is signed, even if that two-year period ends after December 31, 1984.

13. Amortization of construction period interest and taxes

Under prior law, taxpayers other than most corporations, in general, were required to capitalize and amortize construction period interest and taxes (sec. 189). This rule is not applicable to low-income housing until after December 31, 1981.

The Act repeals the rules relating to capitalization of construction period interest and taxes for low-income housing.

14. Amortization of low-income housing rehabilitation expenditure

Under prior law, the taxpayer could elect to amortize qualified low-income housing rehabilitation expenditures over a 60-month period. The amount of expenditures was limited to $20,000 per dwelling unit (sec. 167(k)).

The Act increases the amount of expenditures eligible for amortization under section 189 to $40,000 per unit if the rehabilitation is conducted pursuant to a program under which tenants who demonstrate home ownership responsibilities may purchase their units at a price that limits the profit to the seller. The program must be certified by the Secretary of Housing and Urban Development or by a State or local governmental unit and the tenants must occupy the units as their principal residence. The program must provide that the sum of the taxable income and the amount realized on sale must not exceed the excess of (1) the taxpayer's basis in the property (without adjustment for deductions under section 167) over (2) the net tax benefits from the section 167 deduction less tax on the taxable income from leasing.

The provision applies to amounts paid or incurred after December 31, 1980.

15. Maximum rate of imputed interest for sales of land between related persons

Present law requires that a minimum portion of payments under an installment sales contract be treated as interest. The current rate used for this purpose is 10 percent in the case of contracts that do not provide for at least 9 percent interest.

Under the Act, the maximum rate of imputed interest on qualified sales of land is 7 percent. An installment sale of land qualifies for this lower rate if the installment sale takes place between members of the same family (within the meaning of section 267(c)(4)) and if the sale price of property sold or exchanged between the same family members during the calendar year does not exceed $500,000. If the $500,000 limit is exceeded, the lower rate is available only as to the first sales or exchanges up to the limit.

16. Deductibility of gifts and awards

Present law generally disallows deductions for business gifts to the extent that the cost of all gifts to the same individual during the taxable year exceeds $25. This general rule does not apply, however, to items costing $100 or less which are awarded to an employee by reason of length of service or for safety achievement.

The Act increases the ceiling on the deductibility of employee awards, and expands the purposes for which they may be given. The Act allows employee awards for length of service, productivity, or safety achievement, and increases the ceiling from $100 to $400 per item. The Act also allows a deduction for such awards to the extent that the item is awarded as part of a qualifying, permanent, written plan or program that meets specified rules. The provision is effective for taxable years ending after the date of enactment.

17. Restricted property

Under present law, property transferred to an employee as compensation for services is taxable at the time the property is not subject to a substantial risk of forfeiture or is transferable. The Tax Court has ruled that the provisions of section 16(b) of the Securities and Exchange Act of 1934 do not restrict transferability for this purpose.

Under the Act, the provisions of section 16(b) are taken into account to postpone taxation until the provisions no longer may apply. A similar rule applies to certain restrictions under the SEC accounting rules. The Act is effective for taxable years ending after December 31, 1981.

18. Deduction for certain adoption expenses

Under present law, expenses that are paid or incurred in connection with the adoption of a child are nondeductible, personal expenses.

The Act permits itemizers to deduct up to $1,500 of expenses paid or incurred in connection with the adoption of certain children (generally, children with respect to whom adoption assistance payments are made under the Social Security Act). The provision is effective for taxable years beginning after December 31, 1980.

III. ESTIMATED REVENUE EFFECTS OF H.R. 4242

Table 1.—Summary of Estimated Revenue Effects of H.R. 4242, Fiscal Years 1981–86

[In millions of dollars]

Provision	1981	1982	1983	1984	1985	1986
Individual income tax provisions	−39	−26, 929	−71, 098	−114, 684	−148, 237	−196, 143
Business tax cut provisions	−1, 562	−10, 657	−18, 599	−28, 275	−39, 269	−54, 468
Energy tax provisions		−1, 320	−1, 742	−2, 242	−2, 837	−3, 619
Savings incentive provisions		−247	−1, 797	−4, 208	−5, 740	−8, 375
Estate and gift tax provisions		−204	−2, 114	−3, 218	−4, 248	−5, 568
Tax straddles provisions [1]	37	623	327	273	249	229
Administrative provisions		1, 182	2, 048	1, 856	718	592
Miscellaneous provisions	−1	−104	243	535	53	−275
Total revenue effect	**−1, 565**	**−37, 656**	**−92, 732**	**−149, 963**	**−199, 311**	**−267, 627**

[1] See footnote 9 for table 2.

Table 2.—Estimated Revenue Effects of the Provisions of H.R. 4242, Fiscal Years 1981–86

[In millions of dollars]

Provision	1981	1982	1983	1984	1985	1986
Individual income tax provisions:						
Rate cuts [1]		−25, 793	−65, 703	−104, 512	−122, 652	−143, 832
20 percent rate on capital gains for portion of 1981	−39	−355				
Deduction for 2-earner married couples		−419	−4, 418	−9, 090	−10, 973	−12, 624
Indexing					−12, 941	−35, 848
Child and dependent care credit		−19	−191	−237	−296	−356
Charitable contributions deduction for nonitemizers		−26	−189	−219	−681	−2, 696
Rollover period for sale of residence	(3)	(4)	(4)	(4)	(4)	(4)
Increased exclusion on sale of residence	(3)	−18	−53	−63	−76	−91
Changes in taxation of foreign earned income		−299	−544	−563	−618	−696
Total, individual tax reductions	**−39**	**−26, 929**	**−71, 098**	**−114, 684**	**−148, 237**	**−196, 143**
Business tax cut provisions:						
Capital cost recovery provisions	−1, 503	−9, 569	−16, 796	−26, 250	−37, 285	−52, 797
Corporate rate reductions		−116	−365	−521	−565	−610
Credit for rehabilitation expenditures	−9	−129	−208	−239	−302	−409
Credit for used property	−24	−61	−74	−85	−137	−198
Credit for increasing research activities		−448	−708	−858	−847	−485

Permit complete allocation to domestic deductions of all domestically performed R. & D.		-57	-120	-62	([2])	----------
Charitable contributions of scientific property used for research	([2])	([2])	([2])	([2])	([2])	([2])
Increase in accumulated earnings credit		([2])	-33	-36	-40	-44
Subchapter S shareholders		([2])	([2])	([2])	([3])	([2])
LIFO inventories and small business accounting		-68	-184	-192	-145	-64
Reorganizations of certain savings and loan associations [5]	([2])	([2])	([2])	([2])	([2])	([2])
Commercial bank bad debt deduction		-15	-15	----------	----------	----------
Conversion of mutual savings banks	-5	-10	-12	-18	-22	-25
Extension and modification of targeted jobs tax credit		-63	-13	57	117	161
Incentive stock options	([2])	([2])	([2])	([2])	11	21
Motor carrier operating rights [6]	-21	-121	-71	-71	-54	-18
Total, business tax cut provisions	**-1, 562**	**-10, 657**	**-18, 599**	**-28, 275**	**-39, 269**	**-54, 468**
Energy provisions:						
$2,500 royalty credit for 1981; exemption for 1982 and thereafter		-1, 220	-947	-986	-1, 193	-1, 279
Reduction in tax of newly discovered oil		-75	-255	-520	-867	-1, 528
Exempt independent producer stripper well oil			-525	-721	-762	-797
Exemption from windfall profit tax for child care agencies		-25	-15	-15	-15	-15
Total, energy provisions		**-1, 320**	**-1, 742**	**-2, 242**	**-2, 837**	**-3, 619**

Table 2.—Estimated Revenue Effects of the Provisions of H.R. 4242, Fiscal Years 1981–86—Continued

[In millions of dollars]

Provision	1981	1982	1983	1984	1985	1986
Savings incentives provisions:[7]						
Individual retirement savings		−229	−1, 339	−1, 849	−2, 325	−2, 582
Self-employed plans		−56	−157	−173	−183	−201
Exclusion of interest on certain savings certificates		−398	−1, 791	−1, 142		
15-percent net interest exclusion					−1, 124	−3, 126
Repeal of $200 exclusion of interest and return to $100 dividend exclusion		566	1, 916			
Reinvestment of dividends in public utility stock		−130	−365	−416	−449	−278
Employee stock ownership plans		([2])	−61	−628	−1, 659	−2, 188
Total, savings incentives provisions		**−247**	**−1, 797**	**−4, 208**	**−5, 740**	**−8, 375**
Estate and gift tax provisions:						
Increase in unified credit		([2])	−1, 077	−1, 981	−2, 811	−3, 834
Reduction in maximum rates of tax		([2])	−172	−371	−556	−890
Unlimited marital deduction		([2])	−303	−304	−311	−300
Current use of certain farm, etc., real property		−18	−280	−295	−326	−319

Extensions of time for payment of estate tax		(2)	−20	−16	−15	−12
Tax treatment of contributions of works of art, etc.		(2)	(2)	(2)	(2)	(2)
Transfers of gifts within 3 yrs. of death		(2)	−58	−50	−42	−38
Repeal of deduction for bequests to minor children		(8)	(8)	(8)	(8)	(8)
Increase in annual gift tax exclusion		−123	−204	−201	−187	−175
Annual filing and payment of gifts taxes		−63	(2)	(2)	(2)	(2)
Total, estate and gift tax provisions		−204	−2, 114	−3, 218	−4, 248	−5, 568
Tax straddles [9]	**37**	**623**	**327**	**273**	**249**	**229**
Administrative provisions:						
Changes in interest rate for overpayments and underpayments		100	(2)	100	−100	60
Changes in certain penalties	(8)	(8)	(8)	(8)	(8)	(8)
Cash management—changes in estimated tax payment requirements for large corporations		614	1, 522	1, 190	201	−142
Individual threshold for filing estimated payments increased to $500		−44	−29	−38	−40	−38
Financing of railroad retirement system		512	555	604	657	712
Total, administrative provisions		**1, 182**	**2, 048**	**1, 856**	**718**	**592**

Table 2.—Estimated Revenue Effects of the Provisions of H.R. 4242, Fiscal Years 1981–86—Continued

[In millions of dollars]

Provision	1981	1982	1983	1984	1985	1986
Miscellaneous provisions:						
State legislators travel expenses		−9	−5	−6	−6	−7
Group legal service plans		−16	−24	−26	−8	
Taxation of investment income of campaign funds	([2])	([2])	([2])	([2])	([2])	([2])
Tax-exempt bonds for volunteer fire departments		([10])	([10])	([10])	([10])	([10])
Charitable contributions by corporations		−44	−93	−102	−112	−123
Unemployment tax status of fishing boat services		([10])				
Excise tax on telephone service			435	766	309	
Amortization of construction period interest and taxes		−14	−33	−27	−23	−21
Amortization of low-income housing rehabilitation expenditures	−1	−8	−16	−25	−35	−39
Foreign investment in U.S. real property	([2])	([2])	([2])	([2])	([2])	([2])

Payout requirements of private foundations	([2])	([2])	([2])	([2])	([2])	([2])
Imputed interest rates on installment sales	([2])	([2])	([2])	([2])	([2])	([2])
Deduction for gifts and awards		−4	−5	−6	−7	−9
Industrial development bonds for mass transit		([10])	−7	−29	−54	−64
Deduction for certain adoption expenses		−9	−9	−10	−11	−12
Total, miscellaneous provisions	**−1**	**−104**	**243**	**535**	**53**	**−275**
Grand Total All Provisions	**−1, 565**	**−37, 656**	**−92, 732**	**−149, 963**	**−199, 311**	**−267, 627**

[1] These figures include the increase in outlays attributed to the earned income credit which results from reduction in tax rates. These outlays are: $4 million in fiscal year 1982, $31 million in 1983, $44 million in 1984, $41 million in 1985, and $38 million in 1986.
[2] Loss of less than $5 million.
[3] Negligible.
[4] Loss of less than $10 million.
[5] This estimate is based on limited information about reorganizations that were planned even without this provision. If such reorganizations would have increased markedly without this provision, the revenue loss could be substantial.
[6] Includes a portion of the $36 million in tax liabilities for calendar year 1980.
[7] These estimates were made using the rate schedule proposed by the bill. This approach results in a lower revenue loss than one that would have been obtained if the present law rates had been used.
[8] Gain of less than $5 million.
[9] Revenue effects do not reflect transactions entered into after Dec. 31, 1981. Total revenue effects of subsequent years might be affected by judicial decisions interpreting present law.
[10] Loss of less than $1 million.