INCOME TAX PROVISIONS OF
THE ECONOMIC RECOVERY
TAX ACT OF 1981

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W. D. Eickhoff
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The material presented in this report is based upon an interpretation of the Internal Revenue Service Tax Code and analyses provided by various tax advisory services. This interpretation of the 1981 Tax Act is believed to be accurate. However, action taken as a result of this report is solely the responsibility of the user.
ECONOMIC RECOVERY TAX ACT OF 1981

The Economic Recovery Tax Act of 1981 contains tax cutting provisions that will affect the tax liability of individuals and business. The tax act reduces individual tax rates, increases certain deductions, broadens selected credits, provides a new accelerated system for property depreciation, and provides incentives for savings. Provisions of the law will be phased in over a period of time, with some changes applicable to the 1981 tax year while others will not be fully effective until 1985 or later. Highlights of the new tax law are summarized below.

1. **Individual Income Tax Rates**

   Tax rates were reduced for all income brackets by 23 percent. The full reduction will be phased in over a four-year period beginning in 1981 with the full impact not reflected until 1984.

   Beginning on October 1, 1981, individual tax rates will be reduced by 5 percent. The effective rate reduction for calendar year 1981 will be 14 percent. This reduction will be built into tax tables and will require no extra computation by taxpayers. For a taxpayer with a tax liability of $6,000 in 1980, tax liability in 1981 will be $5,925, a savings of $75.

   In 1982 tax rates will be reduced by another 10 percent. This will effectively reduce tax rates by approximately 10 percent below 1980 levels.

   In 1983 another 10 percent reduction in tax rates will occur, effectively reducing rates by about 19 percent below 1980 levels.
In 1984 the final reduction will be in effect, reducing tax rates by the full 23 percent.

Table I lists comparisons of tax rates under prior law and for 1982, 1983 and 1984 for selected taxable income brackets.

Table 1. Individual Tax Rates for Joint Returns, 1980, 1982, 1983 and 1984

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<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>($ 0- 3,400)</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>3,400- 5,500</td>
<td>14</td>
<td>12</td>
<td>11</td>
<td>11</td>
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<tr>
<td>16,000-20,200</td>
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<td>19</td>
<td>18</td>
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<tr>
<td>35,200-45,800</td>
<td>43</td>
<td>39</td>
<td>35</td>
<td>33</td>
</tr>
<tr>
<td>60,000-85,600</td>
<td>54</td>
<td>49</td>
<td>44</td>
<td>42</td>
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<tr>
<td>215,400 &amp; over</td>
<td>70</td>
<td>50</td>
<td>50</td>
<td>50</td>
</tr>
</tbody>
</table>

When the tax rates are in full effect in 1984, individual rates will range from 11 percent to 50 percent, compared to prior law of 14 and 70 percent. NOTE: With tax rates being cut sharply each succeeding year, tax savings can be accomplished by deferring income from current to future tax years. Before deferring income, taxpayers should estimate tax liability for current and future years and also the earning potential of current after-tax income.

Fiscal Year Taxpayers: The individual rate reductions for 1981-1984 apply to taxable years beginning in those years. For example, the 1¾ percent reduction applies to taxable years beginning in 1981 and therefore applies to fiscal 1981-82. There is no proration for fiscal years overlapping two calendar years. EXAMPLE: Smith has taxable income of
To avoid having taxpayers postpone the sale of capital assets until 1982, Congress passed a special alternative capital gain tax applicable to sales or exchanges occurring after June 9, 1981.

An individual taxpayer who had net capital gains after June 9, 1981 will pay a tax equal to the lesser of:

a. the tax computed in the regular way on all taxable income, including 40 percent of net capital gain, or

b. the tax computed in the regular way, excluding 40 percent of net capital gain, plus a tax of 20 percent on net capital gain.

EXAMPLE: Mr. Jones, a married taxpayer filing a joint return, had 1981 earned income of $40,000 and capital gain income of $25,000. The capital gain income was from the sale of land on August 1, 1981. Total taxable income was $50,000 ($40,000 plus 40 percent of $25,000). Jones' tax computed in the regular way on $50,000 of taxable income would be $13,626. Jones' tax computed by excluding 40 percent of net capital gain, plus a tax of 20 percent on net capital gain would be $10,994 (regular tax of $8,994 on income of $40,000 and $2,000 tax on net capital income). Jones would pay $10,994 in income tax for 1981.

4. Tax Relief for Two-Earner Married Couples

Married persons, filing jointly, are subject to tax rate schedules that differ from rates applicable to single persons or single heads of households. These rate schedules for married persons give rise to a "marriage penalty" when two individuals with approximately equal incomes marry.
The 1981 Act attempts to alleviate the marriage penalty by providing for a deduction for two-earner married couples. This deduction is based on "qualified earned income."

In 1982 two-earner married couples will be able to deduct 5 percent of the lesser of:

- $30,000, or
- the qualified earned income of the spouse with the lower income.

Qualified earned income generally means wages, salaries and other amounts received for personal services rendered. It does not include tax-free income, pension or annuity income, distributions from IRAs, deferred compensation, or salary paid by a taxpayer to his employee spouse.

For 1982 the maximum deduction allowed will be $1,500 (5 percent x $30,000).

In 1983 the deduction increases to 10 percent. The maximum deduction allowable in 1983 and later years will be $3,000 (10 percent x $30,000).

If earned income for each spouse is the same, a deduction can be computed for either spouse. The deduction is allowed in computing adjusted gross income. Therefore, taxpayers do not have to itemize to claim this deduction.

5. Dividend and Interest Exclusions

   For 1981 individual taxpayers can exclude up to $200 ($400 on a joint return) of interest and/or dividend income. The $400 joint return exclusion is available even if all the interest or dividend income was earned by one spouse. Interest available for
this exclusion includes interest earned on passbook savings, certificates of deposit and money market funds. This exclusion does not include interest earned on "all-savers certificates."

NOTE: For tax years beginning after 1981 this exclusion is repealed by the 1981 Tax Act.

b. Dividend Exclusion (1982)

Beginning in 1982 taxpayers will be entitled to a dividend exclusion of $100 ($200 on a joint return). This is the same exclusion that was available prior to 1981. One change is that the $200 joint return exclusion is available even if all the dividend income is earned by one spouse.

c. Qualified Savings Certificates

Under the 1981 Tax Act an individual taxpayer can exclude up to $1,000 of interest ($2,000 on a joint return) earned on depository institution tax-exempt savings certificates (also known as all-savers certificates). These certificates must be issued after September 30, 1981 and before January 1, 1983. Interest received after 1982 will be eligible for the exclusion.

The $1,000 ($2,000 on a joint return) exclusion is a lifetime exclusion. Once an individual excludes up to $1,000, he has used up his lifetime exclusion.

EXAMPLE: John Smith purchases a $50,000, one year, all-savers certificate on October 1, 1981 bearing 12 percent interest. His earnings would be $1,500 for 1981 and $4,500 in 1982. He can exclude $1,000 of interest for 1981. The remaining $500 of interest in 1981 and the full $4,500 of interest in 1982 is fully taxable. John used up his lifetime exclusion in 1981.
EXAMPLE: Jim Jones, Married and filing jointly, purchases a $15,000, one year, all-savers certificate on October 1, 1981 bearing 12 percent interest. Jim's earnings of $450 for 1981 and $1,350 for 1982 qualify for interest exclusion. If Jim purchased another certificate prior to December 31, 1982, he would have $200 of unused exclusion to apply against interest earned.

To qualify for the earned interest exclusion, the certificate must meet certain requirements.

1) Must be issued by a qualified savings institution.
2) Must have a maturity of one year.
3) Must be in denominations of $500. (Can be issued in other denominations.)
4) Must be issued between October 1, 1981 and December 30, 1982.
5) Must yield 70% of the average investment yield for the most recent auction of 52-week United States Treasury Bills.

If any portion of an all-savers certificate is redeemed or disposed of before maturity, none of the interest earned is eligible for the interest exclusion. All interest earned on the certificate would be taxable.

d. Interest Exclusion (1985 and later)

For taxable years beginning after 1984 an individual may exclude a maximum of $450 ($900 on a joint return) of interest income. The total amount excludable is 15% of the lesser of -the first $3,000 ($6,000 on a joint return) of interest received, or -the excess of interest received over qualified interest expense.
Qualified interest expense is interest paid for which a deduction is allowed, excluding interest paid on a home mortgage or in a trade or business.

6. Child Care Credits

Beginning in 1982 credits for child and dependent care are increased and the definition of employment related expenses has been broadened. Specific provisions of the new law are as follows:

a. Employment related expenses eligible for the credit are increased to $2,400 for one qualifying individual and to $4,800 for two or more qualifying individuals (up from $2,000 for one and $4,000 for two).

b. Qualifying individuals include: (1) persons under 15 years of age and for whom the taxpayer may claim a dependency exemption; (2) a physically or mentally incapacitated dependent; and (3) a physically or mentally incapacitated spouse.

c. Expenses incurred for out-of-home care of a qualifying individual are eligible for the credit. The credit is available provided the dependent spends at least 8 hours each day in the taxpayer's home. Under prior law credit was allowed for care outside the home only if a dependent was under 15 years of age.

d. The amount of credit is increased to 30 percent for taxpayers with adjusted gross incomes of $10,000 or less. The credit is reduced by 1 percent for each $2,000 of income or fraction thereof, in excess of $10,000. For taxpayers with adjusted gross income of $28,000 or more, the credit is 20 percent.
EXAMPLE: In 1982 a taxpayer has an adjusted gross income of $24,500 and incurred $4,000 of employment related expenses for two qualifying individuals. The available credit would be $880 (22 percent x $4,000).

7. Charitable Contributions for Non-Itemizers

Beginning in 1982 taxpayers who do not itemize deductions will be able to claim a percent of charitable contributions as deductions. These direct charitable deductions will be a deduction from adjusted gross income and not an itemized deduction. The deduction is phased in with four steps and then expires on December 31, 1986.

- For 1982 and 1983 non-itemizing taxpayers can deduct 25 percent of the first $100 ($50 for married persons filing separately) of charitable contributions for a maximum deduction of $25.
- In 1984 a taxpayer can deduct 25 percent of the first $300 ($150 for married persons filing separately) of contributions for a maximum deduction of $75.
- In 1985 the deduction is increased to 50 percent of all charitable contributions.
- In 1986 the deduction is 100 percent of all contributions.
- The law expires after 1986.

EXAMPLE: Miss Jones, a single taxpayer does not itemize deductions. For 1982 through 1986 she makes charitable contributions of $500 each year. Her direct charitable deductions would be:

1982: 25 percent x $100 = $25 deduction.
1983: 25 percent x $100 = $25 deduction.
1984: 25 percent x $300 = $75 deduction.
1985: 50 percent x $500 = $250 deduction.
1986: 100 percent x $500 = $500 deduction.

1987: After 1986 the law expires.

8. Sale and Exchange of Residence

The 1981 Tax Act increased the period for the tax-free rollover of gain from the sale of a principal residence from 18 months to two years. The rollover begins two years before the sale and ends two years after sale. The two-year period is applicable to taxpayers who either buy or build a new residence.

The change is effective for principal residences sold after July 20, 1981. As under prior law, any gain is taxable only to the extent that the selling price of the old residence exceeds the cost of the new residence.

EXAMPLE: Jim Jones sold his principal residence on August 1, 1981 for $100,000. The house had cost $40,000 in 1960 and $5,000 had been added in permanent improvements for a basis (cost) of $45,000. Jim had a capital gain of $55,000 on the sale of his old residence. In January 1982 he purchases a new residence for $95,000. Since the new residence costs $5,000 less than the sale price of his old residence, Jim has a taxable gain of $5,000. The remaining gain of $50,000 is deferred and reduces the basis of the new residence. Jim's adjusted basis for the new residence is $45,000 ($95,000 less $50,000).

9. Exclusion of Gain on Sale of Residence

The 1981 law increases from $100,000 to $125,000 the amount of gain excludable on the sale of a taxpayer's primary residence. A married taxpayer filing separately can now exclude $62,500 of gain, up from $50,000.
This once in a lifetime exclusion is available to taxpayers who are 55 years of age or older. The taxpayer must have lived in the residence for three of the five-year period ending on the date of sale or exchange. The property must be the principal residence of the taxpayer. The higher exclusion applies to residences sold or exchanged after July 20, 1981.

EXAMPLE: A married couple, filing a joint return, with both over 55 years of age, sold their primary residence on August 1, 1981 for $175,000. Their basis in the house purchased in 1950 was $25,000. They realized a capital gain of $150,000. Of this gain $125,000 is excludable from taxable income. The remaining $25,000 is taxable as long-term capital gain.

EXAMPLE: Same facts as above except one spouse is under 55 years of age. If the home was jointly owned and the couple filed a joint return in the year of sale they could exclude $125,000 of gain.

10. Retirement Savings Programs

To promote greater retirement income security, the 1981 Tax Act included significant changes in retirement savings programs. Specifically, the changes enacted allow larger contributions and deductions and broadened eligibility to include more participants.

a. Individual Retirement Accounts (IRA's)

Beginning in 1982 an individual will be allowed to contribute 100 percent of the first $2,000 of earned income to an IRA. Present law (1981) is 15 percent of earned income with a limit on contributions of $1,500.

EXAMPLE: In 1982, an individual earning $30,000 a year can contribute up to $2,000 to an IRA. An individual with earned income
of $1,500 can contribute the entire amount. A third individual with earned income of $6,000 could contribute up to $2,000. These changes particularly benefit part-time employees, such as housewives.

The 1981 Tax Act also broadened eligibility requirements. Individuals already covered by employer or government retirement programs or a Keough pension plan will be allowed to contribute to IRA's. Contributions are subject to the $2,000 limitation. This provision will enable individuals with earned income to contribute to an IRA, effectively deferring income until retirement age.

b. Spousal IRA's

Under the 1981 Tax Act a married individual with an unemployed spouse can contribute the lesser of $2,250, or earned income, to an IRA. One of the spouses must have no compensation. Contributions to separate IRA's do not have to be equal but cannot exceed $2,000 for either individual.

EXAMPLE: John Smith is married and earned $20,000 in 1982. Mary, his wife, is unemployed. They could contribute $2,000 to an IRA for John and $250 to an IRA for Mary. Or they could divide the $2,250 contribution in whatever proportion they elected, provided individual contributions did not exceed $2,000.

c. Keoughs (H.R. 10 Plans)

Under present law, contributions to Keough plans for a self-employed individual are limited to 15 percent of earned income or $7,500, whichever is less. The 1981 Tax Act retains the 15 percent provision but increases the dollar limitation to $15,000 beginning in 1982.
EXAMPLE: A self-employed taxpayer earns $80,000 in 1982. His contribution to a Keough plan would be limited to $12,000 (15 percent x $80,000). If the same taxpayer had an income of $120,000, his contribution would be $15,000 (the lesser of $15,000 or 15 percent x $120,000).

NOTE: Beginning in 1982 an eligible taxpayer can contribute to both a Keough plan and an IRA. Maximum contribution would be $17,000 ($15,000 to a Keough plan and $2,000 to an IRA).

11. Carryover for Net Operating Losses and Credits
   a. Net Operating Losses
      Under prior law a net operating loss could be carried back three tax years or carried forward seven years. The 1981 Tax Act extended the carryover period for net operating losses from seven to fifteen years. The 15-year carryover is applicable for net operating losses arising in taxable years after 1975.
   b. Investment and WIN Credits
      The carryover period for unused investment and WIN credit was extended from seven to fifteen years. The extension is applicable to any unused credit occurring after 1973. Therefore, a carryover of unused credit from 1974 which would be expiring in 1981 can now be carried forward for another eight years.
   c. Other Credits
      - New employee credits were extended from seven to fifteen years for any unused credit arising from tax years beginning after 1976.
      - Alcohol fuel credits were extended from seven to fifteen years for any unused credits arising after September 30, 1980.

For tax years beginning after 1981, corporate tax rates that apply to taxable incomes of $50,000 or less will be reduced by 1 percent in both 1982 and 1983. A comparison of rates for tax years beginning in 1981, 1982, and 1983 and later is listed in Table 2.

Table 2. Corporate Tax Rates, 1981-1983

<table>
<thead>
<tr>
<th>Corporate Taxable Income</th>
<th>1981</th>
<th>1982</th>
<th>1983 and later</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0 to 25,000</td>
<td>17</td>
<td>16</td>
<td>15</td>
</tr>
<tr>
<td>25,001 to 50,000</td>
<td>20</td>
<td>19</td>
<td>18</td>
</tr>
<tr>
<td>50,001 to 75,000</td>
<td>30</td>
<td>30</td>
<td>30</td>
</tr>
<tr>
<td>75,001 to 100,000</td>
<td>40</td>
<td>40</td>
<td>40</td>
</tr>
<tr>
<td>100,001 or more</td>
<td>46</td>
<td>46</td>
<td>46</td>
</tr>
</tbody>
</table>

NOTE: The maximum tax savings is $500 (1 percent x $50,000) for tax years beginning in 1982 and $1,000 (2 percent x $50,000) for tax years beginning in 1983.

Corporations whose tax year overlaps an effective date for changes in tax rates are required to follow statutory procedures for tax proration as specified in Code Section 21. Taxes are computed for the entire corporate year by applying the rate for the period before the effective tax rate change to taxable income earned in that period, and the rate for the period after the rate change to taxable income earned after the effective date. The tax due for each period is computed using the proration of days in each period. Total tax liability is obtained by summing the tax liability for each period.
EXAMPLE: XYZ Corporation has taxable income of $24,000 for the fiscal year of July 1 to June 30. They would compute their taxes for 1981-82 by multiplying taxable income of $24,000 x 1981 rates (17%) and 1982 rates (16%). Tentative taxes would be $4,080 using 1981 rates and $3,840 using 1982 rates. Then the proportion of the tax year falling under 1981 rates would be computed (184 days ÷ 365 = .5041). The proportion of the tax year for 1982 would be .4959 (181 ÷ 365). Tax liability would be .5041 x $4,080 plus .4959 x $3,840 for a sum of $3,960.60.


The 1981 Tax Act completely revamped prior depreciation laws, replacing old depreciation methods with a new capital cost recovery system called the Accelerated Cost Recovery System (ACRS).

The ACRS applies to all depreciable property placed in service after 1980. Property placed in service before 1981 will continue to be depreciated under prior law.

Under the new ACRS method for recovering costs of property:

- Salvage value is no longer considered.
- Useful life concept is abandoned.
- No distinction is made between new and used property.
- Additional first year depreciation is repealed. It will be replaced by an expensing provision beginning in 1982.
- Component depreciation for real property is disallowed.

Recovery Periods

With ACRS the cost of depreciable property will be recovered over a 3-year, 5-year, 10-year or 15-year recovery period, depending on the type of property. Depreciable personal property and depreciable real
property, whether new or used, are assigned to one of five (5) recovery periods. Recovery periods are defined as follows:

a. 3-year property: Includes Section 1245 property with an Asset Depreciation Range midpoint life of four years or less. Section 1245 property is personal property used in a trade or business or held for investment which is subject to depreciation or amortization. Includes automobiles, light duty trucks, breeding swine, machinery and equipment used in research and experimentation (defined in Code Section 174), and race horses over two years of age and other horses over twelve years of age.

b. 5-year property: Includes all Section 1245 property that is not included in any other class. Most of the qualifying property used in farming or in business qualifies as 5-year property. Personal property included in this class is as follows:

- heavy duty trucks, tractors and equipment, other machinery and equipment, breeding cattle, single purpose agricultural and horticultural structures.
- non-race horses under twelve years of age.
- lathes, most production line machinery, office furniture, ships, and aircraft.
- facilities used for the storage of petroleum and its primary products.
- public utility property with a present ADR midpoint life of 18 years or less.

c. 10-year property: This class includes public utility property with an ADR midpoint life of 18.5 to 25 years and Section 1250 class property with an ADR life of 12.5 years or less.

Under these rules 10-year property includes:
- railroad tank cars
- manufactured homes (mobile, etc.)
- theme park structures
- coal utilization property used in a public utility power plant.

Includes coal burners or boilers which replace gas boilers or burners and equipment for converting to coal a pre-1981 oil or gas boiler and burner.

d. 15-year real property: Includes all 1250 class property with an ADR class life of 12.5 years or more. This class includes all real property (buildings, etc.) except theme park structures and single purpose agricultural structures.

e. 15-year public utility property: Include public utility Section 1245 property with ADR midpoint life of 25 years or more.

This class includes:
- water utility property
- electric steam production plants
- gas production plants of gas utilities
- telephone distribution plants

Cost Recovery Methods

Once the recovery period for a particular asset is identified, a taxpayer has the option of using the Accelerated Cost Recovery System, straight line depreciation or units of production.

a. Accelerated Cost Recovery System (ACRS)

If a taxpayer chooses ACRS, the annual recovery deduction for both personal and real property is determined by multiplying a statutory percentage times the unadjusted basis of the property. Percentages are based on 150 percent declining method switching to straight line with a mandatory half year convention. The same
Cost recovery is obtained regardless of the time of year an asset is placed in service. The statutory percentage is fixed for each property class. Table 3 lists these percentages for property placed in service after 1980 and before January 1, 1985.

Table 3. Statutory Percentages for ACRS, 1981-84

<table>
<thead>
<tr>
<th>If the recovery year is:</th>
<th>3-year</th>
<th>5-year</th>
<th>10-year</th>
<th>15-year public utility</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>25</td>
<td>15</td>
<td>8</td>
<td>5</td>
</tr>
<tr>
<td>2</td>
<td>38</td>
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<tr>
<td>15</td>
<td>21</td>
<td>9</td>
<td>6</td>
<td>6</td>
</tr>
</tbody>
</table>

Example: A taxpayer bought a tractor in 1981 for $30,000. The tractor is 5-year property. Deductions would be computed by multiplying the applicable percentage times the unadjusted basis as follows:

1st year: $30,000 \times 0.15 = $4,500
2nd year: $30,000 \times 0.22 = 6,600
3rd year: $30,000 \times 0.21 = 6,300
4th year: $30,000 \times 0.21 = 6,300
5th year: $30,000 \times 0.21 = 6,300

Total $30,000

$30,000
If sold, any sales price up to the original cost would represent cost recovery recapture and gain would be taxed as ordinary income. For example, assume the tractor was sold after the fifth year for $4,000. Since the tractor had a zero adjusted basis, the gain of $4,000 is cost recovery recapture and is fully taxable as ordinary income.

NOTE: Statutory percentages will change for property placed in service in 1985 and after 1985. Changes will provide for faster cost recovery.

b. Straight Line ACRS

A taxpayer can elect to use the straight line method for recovering costs. If this election is made, the new law makes it mandatory that a half-year convention be used. This, in effect, extends the recovery period for one tax year.

Under the straight line method a taxpayer can elect to use optional recovery periods for each class of property. These optional recovery periods using the straight line method for cost recovery are as follows:

<table>
<thead>
<tr>
<th>Optional Recovery Period</th>
<th>3-year property</th>
<th>5-year property</th>
<th>10-year property</th>
<th>15-year real property</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>3, 5 or 12 years</td>
<td>5, 12 or 25 years</td>
<td>10, 25 or 35 years</td>
<td>15, 35 or 45 years</td>
</tr>
</tbody>
</table>

EXAMPLE: A taxpayer bought a $30,000 tractor in 1981. The tractor is 5-year property and cost can be recovered over a 5, 12, or 25 year period. A mandatory half-year convention must be used. Recovered costs using a 5-year recovery period are as follows:
### Table: 5-Year Reinvestment Table

<table>
<thead>
<tr>
<th>Year</th>
<th>5-Year Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>1981</td>
<td>$3,000</td>
</tr>
<tr>
<td>1982</td>
<td>6,000</td>
</tr>
<tr>
<td>1983</td>
<td>6,000</td>
</tr>
<tr>
<td>1984</td>
<td>6,000</td>
</tr>
<tr>
<td>1985</td>
<td>6,000</td>
</tr>
<tr>
<td>1986</td>
<td>3,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$30,000</strong></td>
</tr>
</tbody>
</table>

If the taxpayer had elected the optional recovery period of 12 years, $1,250 of costs would be recovered in 1981, $2,500 would be recovered each year for the period of 1982-1992, and $1,250 in 1993.

c. **Units of Production**

A taxpayer may elect to exclude property from the ACRS rules and depreciate it under the units of production or any method not expressed in terms of years. For example, cost recovery for equipment could be made where life was based on hours of performance, units manufactured, etc.

**NOTE:** Once a taxpayer elects to use straight line ACRS he must elect it also for all property of that class placed in service for that year. Class is defined as the period of recovery (3-year property, 5-year property, etc.). For example, a taxpayer buys 5-year property consisting of a heavy duty truck, office furniture and equipment in 1981. If he elects to use straight line on the truck, he must use the same method for the furniture and equipment.

### Real Property

Under the 1981 Tax Act, most real property is classed as 15-year property. This class applies to most depreciable real estate such as multipurpose farm buildings, business buildings, and rental residential buildings.
a. Accelerated Cost Recovery

If ACRS is used for real property, cost recovery each year is determined by statutory percentages. These percentages are based on 175 percent declining balance method (200 percent for low income housing), switching to straight line in the eighth year to maximize the deduction.

For real property first year cost recovery is based on the number of months the property was in service. The half-year convention does not apply. The ACRS table for real estate is listed in Table 4.

Table 4. ACRS Cost Recovery Tables for Real Estate

<table>
<thead>
<tr>
<th>If the recovery year is:</th>
<th>All Real Estate (Except Low-Income Housing)</th>
<th>The applicable percentage is:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(Use the column for the month in the first year the property is placed in service)</td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>12</td>
<td>2</td>
</tr>
<tr>
<td>2</td>
<td>10</td>
<td>12</td>
</tr>
<tr>
<td>3</td>
<td>9</td>
<td>10</td>
</tr>
<tr>
<td>4</td>
<td>8</td>
<td>9</td>
</tr>
<tr>
<td>5</td>
<td>7</td>
<td>8</td>
</tr>
<tr>
<td>6</td>
<td>6</td>
<td>7</td>
</tr>
<tr>
<td>7</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>8</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>9</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>10</td>
<td>5</td>
<td>6</td>
</tr>
<tr>
<td>11</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>12</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>13</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>14</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>15</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>16</td>
<td>-</td>
<td>4</td>
</tr>
</tbody>
</table>

TO
EXAMPLE: A taxpayer purchased a two-unit apartment as an investment on August 1, 1981 for $120,000. The apartment was placed in service during the 7th month of the year. His cost recovery for 1981 would be $7,200 (6 percent x $120,000). Cost recovery for subsequent years would be based on the statutory percentages in column 7 for the appropriate recovery period.

b. Straight Line

Rather than using ACRS, taxpayers can elect to use the optional straight line method over either the regular or the extended recovery periods. Optional recovery periods are 15, 35 or 45 years.

If the straight line method is used, cost recovery begins when the property is placed in service. Cost recovery must be prorated over the number of months the property is in service during the first and last year.

EXAMPLE: A taxpayer placed in service in October 1981 a multipurpose farm building. The cost or unadjusted basis was $190,000. The building is 15-year property and cost is recovered with the straight line method.

Using the straight line method, cost recovery would be $6,000 annually. Since the property was in service for only 3 months in 1981, the taxpayer would have a deduction of $1,500 ($6,000 ÷ 4) for 1981.

c. Property by Property Election

For 15-year real property a taxpayer can elect to use different cost recovery methods for each individual piece of property. The cost recovery method is on a property-by-property basis.
EXAMPLE: A taxpayer placed in service three multipurpose buildings in 1981. He could elect to recover costs by using ACRS for one, straight line with a 15-year recovery period for the second, and straight line with a recovery period of 35 years for the third building.

d. Improvements

Substantial improvements are treated as new buildings for cost recovery purposes. A substantial improvement is defined as
- improvements made during a two-year period which equal or exceed 25 percent of the adjusted basis, and
- improvements made at least 3 years after the building is placed in service.

If an improvement qualifies as a "substantial improvement," a taxpayer may elect to use a cost recovery method different from that method used for the primary building.

Disposition and Recapture

Cost recovery recapture under the 1981 Tax Act depends upon the cost recovery method used and the type of property.

a. Personal Property: Any gain up to cost recovery deductions is ordinary income. No cost recovery deduction is allowed for the year of disposal if property is disposed of before the end of the recovery period.

b. Real Property:

- No cost recovery recapture if the straight line method is used.
- If ACRS for non-residential property is used, recapture applies to all prior cost recovery deductions allowed. This is true even if the optional straight line method is used for substantial improvements to the property.
For all residential rental property, cost recovery deductions are recaptured to the extent that the cost recovery deductions under ACRS exceed the deductions that would have been taken using the straight line method.

If real property is disposed of before the end of the recovery period, a cost recovery deduction is allowed for the year of disposal.

**Anti-Churning Rules**

To avoid having taxpayers transfer property only to gain advantages of the new Accelerated Cost Recovery System, Congress passed anti-churning rules. These rules were designed to prevent property placed in service prior to 1981 from being brought within ACRS by the same taxpayer or a related person or entity. Specifically, property is not eligible for ACRS if:

a. It was owned or used at any time during 1980 by the taxpayer or a related person.

b. It was acquired from a person who owned such property during any period in 1980 and as part of the transaction the user of the property did not change.

c. The taxpayer leased such property to a person (or a person related to such person) who owned or used such property at any time during 1980.

d. After property is acquired the user does not change and the property is not recovery property because the transferor acquired it under conditions b and c above. This rule prevents converting pre-1981 property into eligible property by selling it more than once after 1980, unless the user also changes.
Expensing

The 1981 Tax Act repealed the additional first year (20%) depreciation deduction for property placed in service after 1980. As a replacement, beginning in 1982, taxpayers can elect to expense certain qualifying property placed in service. But, for 1981 taxpayers cannot claim additional first year depreciation or elect to expense qualifying property.

For property (Code Section 179 property) placed in service after 1981, taxpayers can elect to expense a certain amount each year. These amounts will be increased over a five-year period.

<table>
<thead>
<tr>
<th>Property Placed in Service in</th>
<th>Dollar Limitation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1981</td>
<td>$0</td>
</tr>
<tr>
<td>1982</td>
<td>5,000</td>
</tr>
<tr>
<td>1983</td>
<td>5,000</td>
</tr>
<tr>
<td>1984</td>
<td>7,500</td>
</tr>
<tr>
<td>1985</td>
<td>7,500</td>
</tr>
<tr>
<td>1986 &amp; later</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

The basis of property must be reduced by the amount expensed before computing cost recovery deductions and investment credit. For example, a taxpayer purchases a tractor for $30,000 in 1982, and takes an expense deduction of $5,000. Cost recovery and investment credit would be computed on an adjusted basis of $25,000 ($30,000 less $5,000).

When sold, any gain from the sale of such property will be recaptured and treated as ordinary income. Recapture is treated the same as under ACRS.
Investment Credit

Under the 1981 Tax Act cost recovery and investment credit interact. The period on which investment credit is based depends on the recovery period. For example:

- A 6-percent credit is available for 3-year property.
- A 10-percent credit is available for 5-year property, 10-year property, and 15-year public utility property.

Since investment credit is tied to class of property (3-year, 5-year, etc.), a taxpayer cannot increase the credit for 3-year property by using a longer optional recovery period. For example, 3-year property for which an optional recovery period of 5 years is used does not qualify for 10 percent investment credit since 3-year property investment credit is limited to 6 percent.

Recapture

Recapture guidelines for early disposition of property were simplified by allowing a 2 percent credit for each year the property is held. Each full year the property is held before disposition reduces investment credit recapture by 2 percent. Recapture guidelines for 3-year and 5-year property are as follows:

<table>
<thead>
<tr>
<th>If property is disposed of:</th>
<th>Percent Recapture</th>
</tr>
</thead>
<tbody>
<tr>
<td>3-year</td>
<td>5-year</td>
</tr>
<tr>
<td>Within one year</td>
<td>6%</td>
</tr>
<tr>
<td>After one year</td>
<td>4%</td>
</tr>
<tr>
<td>two years</td>
<td>2%</td>
</tr>
<tr>
<td>three years</td>
<td>-</td>
</tr>
<tr>
<td>four years</td>
<td>-</td>
</tr>
<tr>
<td>five years</td>
<td>-</td>
</tr>
</tbody>
</table>

NOTE: For investment credit taken on qualifying property placed in service before 1981, recapture guidelines under prior law will be followed.
Used Property

The limitation on the amount of used property which qualifies for investment credit was increased to $125,000 for 1981 through 1984. In 1985 and later years, the limitation will be $150,000 each year.

14. Target Jobs Credit

The 1981 Tax Act extended the target jobs credit to the end of 1982. The program had been scheduled to terminate at the end of 1981. The Act also merged the Work Incentive Credit (WIN) with the targeted jobs credit beginning in 1982. After 1981 all WIN employees will become targeted job employees.

The targeted jobs credit provides that business employers who have certain members of target groups may get a credit of 50 percent of first year and 25 percent of second year wages, up to $6,000 of wages per eligible employee. For example, an employer who hired an eligible worker and paid wages of $7,000 could deduct $3,000 (50 percent x $6,000) as a credit for the first year. Assuming the same wage was paid the second year, the credit would be $1,500 (25 percent x $6,000).

Qualifying employees include:

a. Eligible work incentive employees.

b. CETA employees involuntarily terminated after December 31, 1980 as a result of budget cuts.

c. Vietnam veterans of any age.

To receive a credit an employer must receive certification from a local designated agency that the employee is a member of a target group. This certification is generally done by local job service agencies.