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## RECENT LEGISLATIVE DEVELOPMENTS AND PROPOSALS

By MARK L. MCCONAGHY

I would like to direct my remarks to some of the highlights of the Revenue Act of 1978 and other tax legislation enacted this year, and then briefly discuss the major issues that will face the Congress in 1979.

In January, 1978, President Carter sent to the Congress a comprehensive package of tax proposals, primarily focusing on tax reduction and tax reform. For calendar year 1979, these proposals would have resulted in reducing individual and corporate income taxes by approximately \$23 billion. This \$23 billion does not take into account the extension or the making permanent of certain temporary tax cuts that were scheduled to expire at the end of 1978. The Bill (H.R. 13511) as finally enacted by Congress reduced the size of the overall tax cuts to approximately \$19 billion and either modified or deleted many of the Administration's reform proposals. Of the \$19 billion, approximately \$12.8 billion is attributable to tax changes affecting individuals, \$3.7 billion to changes affecting business, \$2.3 billion to changes affecting capital gains and minimum taxes, and \$.2 billion to miscellaneous changes.

### *Individual Income Taxes*

The reductions in individual income taxes are due primarily to the combination of rate reductions in certain brackets, an increase in the zero bracket amount for both single persons and married couples, and an increase in the personal exemption to \$1,000. These changes, while significant from the standpoint of revenue, are less significant from the standpoint of problems that will be faced by tax practitioners.

### *Deferred Compensation*

There are a number of amendments that were made by the 1978 Act relating to the taxation of deferred compensation. The changes were, in part, a response to proposed regulations issued by the Internal Revenue Service in February, 1978. These proposed regulations generally provided that if the payment of an amount of a taxpayer's fixed compensation is deferred at the election of the taxpayer to a later year than that in which the amount would have been payable but for the election, the deferred amount would be treated as received in the earlier taxable year. The regulations would have applied to plans maintained by State and local governments, as well as plans maintained by tax-exempt organizations and taxable employers. In examining this issue, Congress concluded that although employees of State and local governments should not be prohibited from participating in unfunded

deferred compensation plans, it was appropriate to impose limitations on the amounts of compensation that can be deferred under these arrangements.

Under the 1978 Act, amounts of compensation deferred by a participant in an eligible plan, such as one maintained by a State or local government, a tax-exempt rural electric cooperative, and certain tax-exempt affiliates, plus any income attributable to those deferred amounts, will be includible in the participants' income only when the amounts are paid or otherwise made available. An eligible plan, however, must limit deferral to the lesser of \$7,500 or 33 $\frac{1}{3}$  percent of the participant's includible compensation. In addition, the plan must satisfy other requirements relating to (1) the timing of an election to defer compensation, (2) the timing of distributions under the plan, and (3) the ownership of investments made with deferred amounts.

In the case of unfunded, nonqualified deferred compensation plans maintained by taxable entities, the 1978 Act generally maintains the status quo as it existed prior to the issuance of the proposed regulations. Specifically, the statute provides that the taxable year for including compensation deferred under a plan maintained by a taxable entity is to be determined in accordance with the principles set forth in regulations, rulings, and judicial decisions relating to deferred compensation that were in effect on February 1, 1978. In essence, this permits private plans to provide deferral without any limitation.

It should be noted that except for State and local governments, a tax-exempt rural cooperative, and certain of their tax-exempt affiliates, Congress did not deal with unfunded deferred compensation arrangements maintained by other tax-exempt organizations. As a result, the status of these plans is somewhat uncertain.

In the area relating to the taxation of retirement benefits, the 1978 Act raises the deduction limit for individual retirement accounts and individual retirement annuities to the lesser of \$7,500 or 15 percent of compensation if the account or annuity qualifies as a "simplified employee pension." In general, to qualify as a simplified employee pension, the employer's program must satisfy certain requirements as to withdrawals and the employer's allocation formula. If these requirements are met, the reporting requirements imposed on the employer are substantially reduced.

The 1978 Act also made a number of technical changes to the provisions relating to individual retirement accounts. First, the contribution deadline has been extended from 45 days after the end of the tax year to the due date of the return, including any extensions. Also, the Act allows an individual a deduction for a taxable year in which he corrects a previous excess contribution by contributing less than the maximum deduction allowable for the year.

With respect to rollovers, property distributed to a participant from a qualified plan after 1978 may be sold and the proceeds, rather than

the property itself, rolled over to an IRA or to another qualified plan within 60 days from the date of distribution. In addition, the requirement under prior law that a taxpayer must have been a plan-participant for at least five years to make a rollover has been eliminated. Finally, it should be noted that a separate piece of legislation (P.L. 95-458) enacted this year will permit tax-free treatment of any portion of a lump-sum distribution or distribution from a terminated plan which is reinvested in an IRA within 60 days. Participants who tried unsuccessfully to comply with previous rollover rules will be given an opportunity under the new rules to make a qualified rollover contribution before December 31, 1978. A contribution of money in lieu of the distributed property will be permitted for purposes of this "make-up" rollover.

Turning to the area of tax shelters, there are three changes made by the 1978 Act that should be mentioned. First, the Act extended the specific at risk rule to all activities (other than real estate) and repealed the partnership at risk rules. Essentially these changes are designed to make sure that all activities (other than real estate) are covered by the at risk rule. There was some question after the 1976 Act as to whether certain tax shelter activities, such as record and coal deals were covered.

The second change extends the revised at-risk rule to corporations in which five or fewer individuals own more than 50 percent of the corporate stock. An exception is provided in the case of a closely held corporation actively engaged in leasing equipment which is Section 1245 property. A closely held corporation will not be considered to be actively engaged in equipment leasing unless 50 percent or more of its gross receipts for the taxable year are attributable to equipment leasing.

The third change involves the partnership provisions. Here, the Act imposes a \$50 per month penalty for failure to file timely a complete partnership information return. In addition, the statute of limitations for assessments of deficiencies and claims for a refund of tax attributable to "partnership items" is extended to four years. This extension is applicable only to partnerships where the offering is required to be registered with the SEC or which is subject to certain SEC reporting requirements.

### *Business Income Tax Provisions*

On the business side, the 1978 Act repeals the corporate normal tax and surtax and in their place imposes a five-step tax structure on corporate taxable income. The rate structure reduces the top rate from 48 percent to 46 percent and provides a graduated rate structure on the first \$100,000 of taxable income. The corporate tax rates are 17 percent on the first \$25,000, 20 percent on the next \$25,000, 30 percent on the next \$25,000, 40 percent on the next \$25,000 and 46 percent on all amounts in excess of \$100,000.

The Act makes permanent the temporary investment credit of 10 percent, which was scheduled to return to 7 percent in 1981. The present temporary \$100,000 annual limitation on used property eligible for the credit is also made permanent. In addition, the 1978 Act increases the present 50-percent tax liability limitation to 90 percent, to be phased in at an additional 10 percentage points per year beginning with taxable years which end in 1979. Special rules are also provided for railroads, airlines, and certain utilities so that the phase-in of this increase does not reduce the amounts of investment credits these taxpayers may be entitled to use under the special increased limitations available to them under present law.

Another provision relating to the investment credit that may be of special interest specifically provides that structures or enclosures used for single purpose livestock or plant production are eligible for the investment tax credit. To be eligible, the structure must be both specially designed and used solely for the production of poultry, eggs, livestock, or plants. The provision is not intended to apply to general purpose agricultural structures such as barns and other farm structures which can be adapted to a variety of uses. I want to emphasize that this specific provision is not intended to create a negative inference regarding the eligibility of other special purpose agricultural and productive structures for the credit under existing law.

A major change which should also be important is the extension of the investment credit to certain rehabilitation expenditures incurred in connection with existing buildings. The credit is allowed for buildings used in all types of business or productive activities, except those, such as apartments, which are used for residential purposes. In order to qualify, the expenditure must be in connection with the rehabilitation or reconstruction of a building which has been in use for a period of at least 20 years before the commencement of the rehabilitation. It should be pointed out that this 20 year requirement does not mean that there must be continuous ownership for this period of time. There are a number of definitional problems that need further clarification, such as (1) what constitutes rehabilitation as opposed to mere repair, (2) what happens when a rehabilitation is accomplished in phases over a period of years, etc. Hopefully, these questions will be addressed by regulations issued in the near future.

Another area in which a number of changes were made affecting business is the tax-exempt bond area. First, the 1978 Act increased the small issue election for tax-exempt industrial development bonds from \$5 million to \$10 million. In addition, the capital expenditure limitation for facilities with respect to which an urban development action grant has been made is increased to \$20 million.

Second, the Act provides special rules for water facility industrial development bonds issued after November 6, 1978. Under present law, these bonds are eligible for tax-exempt treatment if the facilities for

the furnishing of water are available on reasonable demand to members of the general public. Generally, the 1978 Act provides that members of the general public include commercial users.

The third major change in the IDB area establishes a declaratory judgment procedure for determining whether the interest on a proposed issue of bonds is tax-exempt. The United States Tax Court is to have exclusive jurisdiction, and appeals can be made only to the District of Columbia Court of Appeals. In order to receive a declaratory judgment the proposed issuer must first exhaust all administrative remedies.

In response to the Administration's proposals relating to business meals and entertainment facilities, the Act provides that no deduction is allowed for expenses with respect to facilities generally considered to constitute entertainment, amusement, or recreation. Generally, entertainment facilities include yachts, hunting lodges, fishing camps, etc. It should be noted that the language of the Act provides an exception for "country clubs", but the conferees intended that the exception be broader and except clubs in general. As a result, this is one provision that will be slated for a technical amendment at the start of next year.

#### *Capital Gains and Minimum and Maximum Tax*

The major issue in the 1978 Act was the issue of the taxation of capital gains. The biggest change was to increase from 50 to 60 percent the amount of a net capital gain which a noncorporate taxpayer can deduct from gross income. At the same time, the 25 percent alternative tax on capital gain was repealed. The increase in the deduction to 60 percent is effective for sales or exchanges after October 31, 1978. It should be noted that the conference report states that installment payments received after this date will qualify for the 60 percent deduction even though they are attributable to sales prior to October 31, 1978. However, the conference report did not address the question of dividends received after October 31, 1978, from mutual funds, REITS, etc., which represent gain on sales prior to October 31, 1978.

In addition to increasing the deduction, the Act also provides a one-time exclusion, on an elective basis, for \$100,000 of gain realized on the sale of a principal residence after July 25, 1978. This new exclusion is only available to taxpayers who have attained age 55. However, in the case of a jointly-owned residence, only one spouse must have attained the age of 55. In addition, the taxpayer must have owned or occupied the residence for a period aggregating three out of the five years which immediately precede the sale. As under prior law, both the exclusion and the nonrecognition provisions of Sections 1033 and 1034 may be used, with the exclusion applying first.

With respect to the minimum tax, the Act retains the present "add-on" minimum tax for all preference items except the deducted amount of net capital gain and adjusted itemized deductions. In addition, the

Act establishes a new alternative minimum tax for individuals only to the extent it exceeds regular tax paid as increased by the "add-on" minimum tax.

The new alternative minimum tax is based on the sum of (1) taxable income, (2) adjusted itemized deductions and (3) the capital gains deduction. The preference for adjusted itemized deductions excludes medical and casualty deductions, state and local taxes, and the estate tax deduction for income in respect of a decedent. The remaining itemized deductions are preferences to the extent they exceed 60 percent of adjusted gross income minus the above deductions. The rate of the new alternative minimum tax is zero on the first \$20,000, 10 percent on the next \$40,000, 20 percent on the next \$40,000 and 25 percent on amounts in excess of \$100,000. It should be noted that gain from the sale of a principal residence is not included as an item of tax preference for purposes of the new alternative minimum tax or in the case of sales after July 26, 1978, for purposes of the "add-on" minimum tax.

The Act also makes two significant changes with respect to the maximum tax. First, it removes the capital gain tax preference as an offset to the amount of personal service income eligible for the maximum tax. Second, it substitutes a reasonable compensation test for the 30 percent limitation on the amount of business income that may be treated as personal service income subject to the maximum tax.

### *Major Issues in 1979*

In this section, the major tax issues to be addressed by the Congress in 1979 will be discussed. There are a number of difficult issues that were left unresolved and will have to be dealt with next year.

It appears that the first item of business to be considered by the Ways and Means Committee is the Administration's proposal for "real wage insurance." Although Treasury has not yet presented a detailed proposal, the proposal apparently will provide a tax credit for employees whose wage increases for the year are within the anti-inflation guidelines and if inflation exceeds seven percent. The credit would be a percentage of wages equal to the difference between the percentage increase in the consumer price index and seven percent, with some limitations yet to be decided. At this time, it is unclear whether the credit is to be available on an employee-by-employee basis or unit-by-unit, whether fringe benefits are to be taken into account, what record keeping will be required, whether the credit is taxable, etc. Hopefully, these questions will be addressed in detail when the proposal is sent to Congress.

The taxation of fringe benefits is an area that must be addressed by the Congress in 1979. A separate piece of legislation (P.L. 95-427) was enacted in 1978 which prevents the issuance of new regulations relating to the income tax treatment of fringe benefits prior to January

1, 1980. This was done because tax writing committees felt they could not adequately consider the matter last year.

The Ways and Means Committee has established a Task Force to do the basic ground work and make appropriate recommendations to the full committee. The Task Force, headed by Congressman Pickle of Texas, has conducted hearings and is presently reviewing submissions of written comments and recommendations. It is expected that the Task Force will report to the full committee early next year. This is a difficult area to resolve, and involves consideration of questions such as value, administrative feasibility, practicality of record keeping by employers and employees, etc.

Another issue that will have to be addressed is the employee vs. independent contractor issue. The 1978 Act provided an interim solution which generally forgave past liability and granted relief through 1979 where the taxpayer had a reasonable basis for not treating workers as employees. In addition, the Act provided three statutory "safe havens" during this period which, if met, qualify a taxpayer for the termination of employment tax liability. The three safe havens are (1) reasonable reliance on judicial precedent, published rulings, technical advice, or a ruling, (2) reasonable reliance on a past Internal Revenue Service audit of the taxpayer, and (3) taxpayer treatment which was consistent with a long-standing recognized industry practice.

In developing a permanent solution for the future, Congress will examine a number of criteria such as those suggested by the GAO and various industry groups. In addition, the Congress can be expected to explore the possibility of expanded withholding, expanded information reporting, and the establishment of new statutory classes of self-employed. It should be kept in mind that any changes that are made could well have an impact on H.R. 10 and company retirement plans, the number of individuals under the minimum wage, and the size of a collective bargaining unit for the purposes of labor negotiations.

The issue of carryover basis is another difficult area with which Congress must deal in 1979. The 1978 Act postponed its application through December 31, 1979, and did not permit the taxpayer to elect the pre-1976 law or the application of carryover during the period 1977 through 1979.

The three most commonly discussed proposals are: (1) repeal of the carryover basis proposals and return to old law, (2) simplification of the carryover basis provisions and (3) replacement of the carryover basis provisions with an appreciation tax at death. While the Congress is certainly aware of and concerned with the complexity of the present carryover statute, it is also concerned with the fact that approximately \$20 billion of appreciation passes through estates each year without being subject to income taxation. Many of the members of the tax-writing committees feel that the total cumulative amount of taxation at death, including Federal estate taxes, state death taxes and income

taxes, should not be increased and perhaps should be lowered. The question of the proper mix of these taxes, however, is subject to differing opinions.

Another area that could require Congressional action relates to energy taxes. Mandatory controls on energy pricing expire May 31, 1979. If the President decides to deregulate prices, Congress could be expected to begin work immediately on some type of severance tax, either in the form of a crude oil equalization tax or a windfall profits tax. The big issue to be resolved would be how much of the tax is to be rebated to the public and how much is to be rebated to the oil industry.

The taxation of industrial development bonds also is an area that could be considered by the Congress next year. In 1978, a taxable bond option proposal was submitted as part of the Administration's original proposals. Under this proposal, state and local governments could elect to issue taxable bonds. If the state or local governments so elected, the federal government would agree to pay a fixed portion of the actual dollar amount of the issuer's interest cost. There have been a number of objections to this proposal by both the industry groups and the state and local governments. For example, the investment brokers feel that this proposal would dry up the existing tax-exempt bond market. Also, state and local governments fear that this approach might possibly subject them to additional restrictions imposed by the federal government on bond issues.

In an attempt to overcome many of these objections, Sen. Danforth has developed a proposal which would allow an individual bond holder to elect, on an annual basis, to treat the bond as taxable or tax-exempt. If a taxpayer elected to treat the bond as a taxable bond, he or she would include the interest in gross income (grossed-up) and receive a credit. This proposal was approved by the Senate Finance Committee during its consideration of the 1978 Act, but was dropped on the Senate floor at the request of Sen. Danforth. Although Sen. Danforth feels the proposal is a good one, he did not want to jeopardize it due to the lack of adequate hearings. As a result, he intends to hold extensive hearings next year.

Another issue in the tax-exempt bond area is the issue of housing bonds. The Treasury Department has become increasingly concerned at the number of tax-exempt housing bonds that are being issued today. The Wall Street Journal recently reported that approximately one-half of the tax-exempt issues involve housing bonds. As a result, the Treasury might submit a legislative proposal to deal with their concern, perhaps recommending that tax-exempt housing bonds be limited to low and moderate income families.

Finally, there is the issue of Social Security financing. Under the present law, there will be significant increases in 1981 in both the rate and the base for social security. These increases are necessary if the

trust funds are to remain solvent but financed solely by social security taxes.

There are a number of members who would like to "roll back" the large increases that are due to take effect in 1981 and explore alternative sources of financing. These alternatives include financing from general revenues or financing with some type of transactions tax, such as a value added tax. Both Chairman Ullman and Chairman Long recently have expressed their interest in exploring a value added tax as a replacement for the social security tax, either in whole or in part, but not as an additional tax. The arguments against this type of tax are that it is regressive and could cause further inflation, as it has in other countries. On the other hand, some proponents feel that this type of tax would not necessarily fuel inflation if it were a true replacement for the present social security tax system and that it is no more regressive than the present social security taxes. In addition, proponents argue that a value added tax could be structured to improve our balance of trade if the tax was imposed on imports and rebated on exports.

A great deal of discussion can be expected about social security financing beginning in the summer and fall of 1979, which will probably result in the enactment of legislation in 1980. However, prior to that time the only serious legislative initiative dealing with social security will involve disability benefits.

In closing, it is a pleasure to say that the tax issues in 1979 seem to be more easily isolated and dealt with by the tax-writing committees on a piecemeal basis. We certainly welcome any input that you may have on any of these issues.