1977

Year End Tax Planning - Individuals

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YEAR END TAX PLANNING—INDIVIDUALS
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Introduction

In many respects, year end tax planning involves a few basic concepts and in certain other respects, highly refined and sophisticated approaches are necessary. In our rush for refinement and sophistication we often overlook that which is simple but effective. In that light, I would like to structure my remarks today with what at first blush appears to be quite elementary and perhaps almost a review of a first semester tax course and then move beyond that level to another level, recognizing that there are less than thirty calendar days in which to accomplish the minimization of income taxes for individual taxpayers whose taxable years will end on December 31, 1977.

Tax Computation

Regular Method  It probably is not necessary to review with this audience the regular method of computing income tax liability; nevertheless, certain changes were made in the Tax Reduction and Simplification Act of 1977\(^1\) which ought to be noted before the upcoming filing season. I might also point out that notwithstanding the elementary nature of this particular portion of my presentation, a fairly recent study conducted by the Comptroller General indicated that improper computation methods occurred at about the same rate for commercial and professional preparers.\(^2\)

We must accustom ourselves to a new definition of taxable income. Taxable income, in the case of individuals, now means adjusted gross income reduced by the aggregate of excess itemized deductions and personal exemptions, increased in certain instances by the unused zero bracket amount.\(^3\) Because the percentage standard deduction was replaced with a flat standard deduction ($3,200 in the case of married taxpayers filing joint returns, $2,200 in the case of a single individual who is not a surviving spouse, and $1,600 in the case of married individuals filing separate returns), certain simplification measures were possible by incorporating what was referred to under prior law as the standard deduction and what is presently referred to as the zero bracket amount into the rate tables and tax tables. Thus, in the case of an individual who itemizes deductions, itemized deductions in excess of the zero bracket amount must be computed and then taken into account to reduce adjusted gross income (and likewise such amount must be reduced by the deductions for personal exemptions and for dependents) to arrive at taxable income. The computation to arrive at

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\(^1\) Public Law 95-30, May 23, 1977.
\(^3\) Int. Rev. Code of 1954, Section 63(b).
taxable income is necessary only where the new tax tables cannot be used.

Where the tax tables can be used, tax table income must be computed which is adjusted gross income reduced by excess itemized deductions and, in certain cases, increased by the unused zero bracket amount.\(^4\) The tax tables have been prepared not only to take account of the zero bracket amount but also exemptions, to a certain extent, and the general tax credit. The tax tables may be used by any individual whose tax table income does not exceed the table ceiling amount and whose exemptions are not in excess of those provided for in the tables. The tax tables cover single taxpayers with tax table income not in excess of $20,000 and who claim 3 or fewer exemptions; for married taxpayers filing joint returns and surviving spouses, the limits are tax table income not in excess of $40,000 and nine or fewer exemptions; married taxpayers filing separately may use the tax tables so long as tax table income does not exceed $20,000 and the number of exemptions claimed are 3 or less; heads of households may use the tables so long as tax table income does not exceed $20,000 and the number of exemptions claimed are 8 or fewer.

Although simple enough to remember, and for the majority of cases it is taken into consideration, the alternative tax computation with respect to capital gains is certainly available as a combination with the regular method of tax computation to reduce income tax liability.

**Alternative Tax** Because of a simplification change under the Tax Reduction and Simplification Act of 1977 which, among other changes, incorporated the zero bracket amount into the rate schedule, the taxable income amount which was used as a general rule to ascertain whether or not an individual taxpayer would benefit from using the alternative tax computation has changed. This change, of course, is not substantive but only a reflection of the rate schedule construction. Generally, it will be beneficial to use the alternative tax computation in the following instances: (1) married taxpayers filing joint returns and the taxable income exceeds $55,200; single individuals filing separate returns and individuals who qualify as heads of households and the taxable income exceeds $40,200; and, married individuals filing separate returns and the taxable income exceeds $27,600.

As you know, the alternative tax computation provides a 25% tax ceiling on the lesser of $50,000 of long term capital gain ($25,000 in the case of married individuals filing separate returns) or the amount of net capital gain. As a reminder, the Tax Reform Act of 1976 repealed Code Sec. 1201(d) and amended Code Sec. 1222(11) by substituting the term "net capital gain" for the term "net section 1201 gain".

Although the topics will be discussed shortly, I would feel remiss if

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I did not mention that the alternative tax computation can be used in conjunction with the maximum tax computation. I would quickly point out that in the event that one is planning on reaping the benefits of this combination, the effects of the minimum tax as a tax liability add-on and the tax preference reduction in the amount of personal service taxable income must be considered.

**Income Averaging** In general, income averaging is applicable to the individual taxpayer whose current year taxable income exceeds by $3,000 120% of his taxable income for the four preceding taxable years, so-called average base period income. As you know, a taxpayer who elects the benefits of income averaging may not combine this beneficial method of computing income tax liability with either the alternative tax computation or the maximum tax computation. Thus, where a taxpayer qualifies for using these three methods to compute income tax liability, all three methods should be tested to ascertain which one will yield the smallest amount of income tax liability.

Although it appears that the main thrust behind the enactment of this income averaging provision was to provide income tax relief to certain individuals whose taxable income was the result of years of work before any income was realized and then when the income was realized it was “bunched”, the provision also may be used beneficially in cases where any qualified taxpayer can control the timing of income realization and recognition.

I would suggest that proper planning with respect to income averaging would dictate that the isolated use of this provision may not be as advantageous as spreading out the benefits over as many years as possible. In other words, given that it is possible to control the receipt of income, it may be more beneficial to recognize income over a period of years, and thus qualify for income averaging in those years rather than cause the income to be “bunched” in any one particular taxable year.

Likewise, prudent planning would dictate that the average base period income be carefully monitored. Because averageable income is a function of the four preceding taxable years’ taxable income, as the average increases it becomes more and more difficult to meet the income qualifications in order to use this provision. Thus, if the taxpayer’s average base period income has increased as a result of, perhaps, one or two taxable years during which taxable income, for one reason or another, is greater than what would otherwise be considered the norm, and if the taxpayer expects to receive a significant amount of taxable income in the future over which he can control the timing, it may be beneficial to defer the recognition of such income until the average of his base period income begins to decrease. Alternatively, the character of this income may dictate the plan. If it is personal service income, the maximum tax computation may yield results which are more beneficial than income averaging. The income may be capital gains income in
which case the effect of the minimum tax must be taken into account, as well as, of course, the alternative tax computation.

**Maximum tax on personal service income** Effective for taxable years beginning after December 31, 1976, certain significant changes brought about by the Tax Reform Act of 1976 should cause you to re-examine your understanding of the maximum tax provision. In general, earned income is now personal service income, which is a broader category of income than prior law earned income and the amount of tax preference items to be taken into account as a reduction of personal service taxable income has significantly changed.

The broader category of personal service income includes all income which was earned income (as under prior law) and also includes certain pension or annuity income. For the pension or annuity income to qualify, it appears that there must have been a connection between such pension or annuity income and with the performance of personal services.\(^5\)

Under prior law, as you recall, the aggregate tax preference items in excess of a $30,000 exemption or 20% of the aggregate tax preference items for the current and four preceding taxable years, whichever amount was greater, reduced the amount of earned taxable income which qualified for purposes of the maximum tax computation. As a result of the Tax Reform Act of 1976, the $30,000 exemption was repealed as well as the provision pertaining to averaging five years aggregate tax preference items. Thus, personal service taxable income must be reduced by the aggregate tax preference items for the taxable year.\(^6\) In addition to simplifying the maximum tax computation, this change also was intended to deny the benefits of the maximum tax computation to individuals whose aggregate tax preference items amounted to or exceeded their personal service taxable income, without regard to reduction for aggregate tax preference items, in excess of the amount which would be taxable at the 50% marginal rate bracket. Thus, aggregate tax preference items reduce, dollar for dollar, personal service taxable income. Under this dollar for dollar offset approach, aggregate tax preference items for a taxable year become critical.

As one peruses the list of tax preference items, it appears clear that there is room for planning in the area, at least insofar as timing the recognition of tax preference items is concerned. In this connection, I would suggest that planning opportunities should be viewed from the vantage point of timing and not necessarily from the point of view where a taxpayer, to avoid the minimum tax and its subsequent effect on personal service taxable income, makes what may be an irrevocable election. For example, it may be easy enough to defer recognition of ad-


justed itemized deductions and likewise postpone recognition of capital gains, and in such a plan, the taxpayer's future options with regard to these items of tax preferences are not limited; however, if to avoid all of the effects of the minimum tax, an election is made to change from an accelerated method of depreciation to straight line with respect to depreciable real property, for future taxable years, the taxpayer's depreciation method option as to that particular piece of depreciable property may be limited. 7

Minimum tax Changes brought about by the Tax Reform Act of 1976 have caused us to refocus on certain code sections which, under that Act, were amended. Although the amendments to Code Secs. 52, 57 and 58 were effective for taxable years beginning after December 31, 1975, I thought it might be prudent to focus on certain of these changes at this point.

As you recall, the minimum tax for individuals was amended as follows: (1) the minimum tax rate was increased from 10% to 15%; (2) the $30,000 exemption was repealed and in lieu thereof an individual taxpayer is entitled to reduce tax preference items to be taken into account by the larger of 50% of the current taxable year's regular tax liability or $10,000; (3) the carryover for regular taxes paid was repealed; and, (4) two additional items of tax preference income were added, adjusted itemized deductions and excess intangible drilling costs over net related oil and gas income. I should point out that the phrase "adjusted itemized deductions" is a new phrase, introduced into law by reason of the Tax Reduction and Simplification Act of 1977. This new phrase replaces the prior law phrase "excess itemized deductions" because the latter phrase was needed to describe itemized deductions in excess of the zero bracket amount.

The minimum tax has been a factor in our system of Federal taxes since its enactment under the Tax Reform Act of 1969. The intent underlying its enactment was "...to make sure that at least some minimum tax was paid on tax preference items, especially in the case of high-income persons who were not paying their fair share of taxes." 8 It appears that the minimum tax may be with us for many more years in the absence of outright repeal of those Code sections which give rise to tax preference items. Recently, an ingenious corporate taxpayer requested advice regarding whether the minimum tax was deductible under Code Sec. 162 as a Federal excise tax. The Commissioner responded that the minimum tax was not a deductible excise tax but was a non-deductible Federal income tax under Code Sec. 275(a)(1). 9

Minimum tax planning should be assaulted on two fronts, depending upon the facts and circumstances of the individual taxpayer. First, be-

7 Treas. Reg. Section 1.167(e)-1.
8 Staff of the Joint Committee on Taxation, 94th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1976 105 (1976).
cause the minimum tax will affect the overall tax burden of the individual taxpayer, deferral or acceleration of those tax preference items which are subject to such action should be considered, particularly if, for example, deferral results in equalizing the amount of tax preference items to be recognized over a period of taxable years such that full advantage is taken of the greater of the $10,000 or 50% of regular taxes offset; acceleration of tax preference items may likewise be advantageous if in the taxable year of recognition, the taxpayer for reasons other than early recognition of tax preference items, has a greater regular tax liability, 50% of which may be used as an offset. Second, because tax preference items reduce, dollar for dollar, personal service taxable income, the planning for the recognition of tax preference items must, to the extent possible, take this factor into account.

Before leaving this area, I believe two additional areas are worthy of being mentioned. As you might recall, the minimum tax liability, or a portion thereof, is deferred in the case of a taxpayer who has a net operating loss which is carried over to a succeeding taxable year. The amount of minimum tax which is deferred is the lesser of the minimum tax for the taxable year or 15% of the net operating loss carryover. Given all the moving parts involved in this relief provision, the planning may be more an academic exercise rather than one which can be applied practically. The second area worthy of your attention is the tax benefit rule as it relates to the imposition of the minimum tax.

Code Sec. 58(h) provides, in general, that regulations are to be prescribed pertaining to the timing of the recognition of tax preference items for purposes of imposing the minimum tax in cases where the taxpayer received no benefit from such tax preferences because of other provisions of the law. For example, in the case of an individual taxpayer who is a partner in a partnership and who is subject to the at-risk provisions, if any of the suspended loss is attributable to preference items, the minimum tax is not to be imposed until such time as the suspended losses are allowed as a deduction. Thus, in this situation, it is possible to time the recognition of tax preference items flowing from the partnership by increasing the partner's at-risk basis, and thus accelerate the recognition of the preference items, or by decreasing the partner's at-risk basis, and thus defer such recognition. Although this planning device can be used in connection with minimum tax planning, it may be better used, perhaps, to trigger suspended partnership losses, without regard to minimum tax effects, a subject to be discussed later.

Summary—Tax computation Knowledge of the various methods of computing income tax liability, although elementary in certain respects, can give insight into certain planning techniques. If each of the methods

10 Int. Rev. Code of 1954, Section 56(b).
are viewed in isolation without regard to the fact that they are intertwined, our objectives in performing the planning function will certainly not be met. Additionally, and this is equally applicable in the entire area of tax planning, we must not lose sight of the personal objectives of the taxpayer which may conflict with the objective of minimization of income taxes.

**Acceleration-Deferral, General**

Tax planning involves not only the structuring of a particular transaction to achieve minimization of income taxes but also the timing of when income and deductions are to be recognized. To the extent that a taxpayer can control the recognition event and cause a "mismatch" of income and deductions, tax benefits may result. As you know, almost all tax shelters were, and to a certain extent still are, predicated on this basis. Of course, other planning techniques, such as leveraging and conversion of ordinary income into capital gains income were and are a significant part of tax sheltering activities.

For the most part, tax shelters are constructed such that income is to be deferred and expenses are to be accelerated. However, given that certain individuals may need a reverse sheltering activity, i.e., income needs to be accelerated and deductions need to be deferred, the astute planner must be aware that this is a possibility and that a certain amount of imagination is required because this planning technique is not mass marketed. Before discussing certain specific planning possibilities, it might be beneficial to review the methods of accounting which are acceptable for tax purposes as well as certain derivatives including the tax treatment of special items, likewise acceptable, that will result in accelerating or deferring income or expenses.

**Cash method**

Generally, it is the cash method of accounting which allows tax advisers to develop plans which accelerate or defer income or deductions. Significant exceptions to the use of the cash method of accounting are provided in those cases where it is necessary to use an inventory\(^1\) and where it is determined that income is not clearly reflected.\(^2\)

Generally, under the cash receipts and disbursements method in the computation of taxable income, all items which constitute gross income (whether in the form of cash, property, or services) are to be included for the taxable year in which actually or constructively received. Expenditures are to be deducted for the taxable year in which actually made.\(^3\)

Viewing, first, the deduction side of the equation, we know that deductions are allowable only by statutory grace. Given that a par-

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\(^1\) Treas. Reg. Section 1.446-1(c)(2)(i).

\(^2\) Ibid., Section 1.446-1(c)(2)(ii).

\(^3\) Ibid., Section 1.446-1(c)(1)(i).
ticular expenditure is allowable as a deduction, statutory grace also
dictates the timing of the deduction, as, for example, in the case of
depreciation, 15 certain prepaid items other than interest expense, 16
interest expense other than points paid with respect to indebtedness
incurred in connection with the purchase of and secured by a principal
residence, 17 and the like. Other allowable deductions, again because of
statutory provision, are accelerated. 18 Certain itemized deductions
of individual taxpayers also can be accelerated or deferred. A specific
discussion of these items will follow in a separate section.

With respect to the income side of the cash receipts and disburse-
ments method, the doctrine of constructive receipt is of paramount
importance.

Income although not actually reduced to a taxpayer’s pos-
session is constructively received by him in the taxable year
during which it is credited to his account, set apart for him,
or otherwise made available so that he may draw upon it at
any time, or so that he could have drawn upon it during the
taxable year if notice of intention to withdraw had been
given. However, income is not constructively received if the
taxpayer’s control of its receipt is subject to substantial limita-
tions or restrictions. 19

Additionally, and equally applicable to the accrual method of account-
ing, the planner must concern himself with questions of substance and
form including the problem of income assignment.

In general, the timing of income recognition under the cash receipts
and disbursement method of accounting is subject, to a certain extent,
to direct control by the taxpayer. For the overwhelming majority of in-
dividual taxpayers who are wage earners, however, control of the
timing is out of their hands. Property dispositions, including both real
and personal property, accounting method elections with respect to
both certain investment and unincorporated business opportunities, as
well as the installment and deferred payment sales methods, for ex-
ample, are areas where the individual taxpayer has a certain amount of
discretion insofar as exercising control over timing recognition is con-
cerned.

**Accrual method** Although few individual taxpayers use the accrual
method of accounting in connection with activities outside of certain

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15 Int. Rev. Code of 1954, Sections 263(a)(1) and 167.
16 For example: With respect to business insurance premiums effective for more
than one year see Comm v. Boylston Market Assn. (1 Cir; 1942), 131 F2d 966;
to the contrary, however, see Waldheim Realty & Investment Co. v. Comm. (8
Cir; 1957), 245 F2d 823.
17 Int. Rev. Code of 1954, Section 461(g).
18 See, for example, the exceptions to the provision requiring capitalization of
certain expenditures, Int. Rev. Code of 1954. Section 263(a)(1)(A)-(F) and
Section 167(K), 169 and 191.
investment and unincorporated business opportunities, it may be benefi-
cial to review various aspects of this accounting method, particularly
since many clients are involved in investment and business opportunities
as either sole proprietors or as partners, both general and limited.

Generally, under an accrual method, income is to be in-
cluded for the taxable year when all events have occurred
which fix the right to receive such income and the amount
thereof can be determined with reasonable accuracy. Under
such a method, deductions are allowable for the taxable year
in which all events have occurred which establish the fact of
the liability giving rise to such deduction and the amount
thereof can be determined with reasonable accuracy.\textsuperscript{20}

In addition to the statutory proscriptions regarding the accrual method
of accounting, it is critical to recognize that one of the most fundamental
principles underlying this method is that of matching. "The revenues of
a particular period should be charged with the costs which are reason-
ably associated with the product represented by such revenues."\textsuperscript{21} Thus,
it is readily apparent that if revenues are matched with costs and ex-
penses, or more particularly, if taxable income and allowable deductions
associated with such taxable income are matched, the result is a better
measure of earnings flow, be it for financial statement presentation or
for purposes of levying a tax on income.

In certain circumstances, some of which were discussed earlier under
the topic of cash method of accounting, a taxpayer, even though on a
cash basis, may be required to account for various items on what appears
to be an accrual basis or a modified accrual basis. For example, certain
prepaid items, more particularly, prepaid interest,\textsuperscript{22} with certain ex-
ceptions, and, more recently, real property construction period interest
and taxes.\textsuperscript{23}

Generally, the accrual method of accounting does not lend itself to a
plan of acceleration or deferral. Because the accrual method functions
primarily on an event test, i.e., income is recognized when earned and
expenses when incurred, rather than on an activity test, i.e., income and
deductions are recognized on the basis of cash flow, there does not
appear to be a market for so-called shelters that use the accrual method.
Also, the relative ease of using the cash receipts and disbursements
method of accounting in contrast to the accrual method certainly dictates
why individual taxpayers use the former rather than the latter method.

\textit{Other accounting methods} There are a variety of other methods of
accounting as well as special methods of accounting for particular items

\textsuperscript{20} Ibid., Section 1.446-1(c)(1)(ii).
\textsuperscript{21} W. A. Paton and A. C. Littleton, An Introduction to Corporate Accounting
Standards 69 (1940).
\textsuperscript{22} Int. Rev. Code of 1954, Section 461(g).
\textsuperscript{23} Ibid., Section 189.
of income and expense.\textsuperscript{24} Additionally, one should be aware of special treatment accorded farmers, in addition to the availability to such individuals to use the cash method of accounting. Suffice it to say at this point, that these other methods of accounting must become a part of the planner's kit.

\textit{Acceleration-Deferral, Specifics}

\textbf{Capital gains and losses}

1. \textit{Holding period changes.} As you recall, the Tax Reform Act of 1976 brought about a change in the holding period with respect to long term capital gains. To achieve long term capital gain status for taxable years beginning in 1977, a capital asset must have been held for more than nine months.\textsuperscript{25} An additional three month holding period is added for taxable years beginning after 1977, culminating in a holding period of more than one year to differentiate long term and short term status.\textsuperscript{26}

2. \textit{Changes in limitation on capital losses.} In addition to the holding period changes as a result of the Tax Reform Act of 1976, in the case of taxpayers other than corporations, the maximum amount of capital loss which may be deducted from other income also was changed. For taxable years beginning in 1977, the maximum capital loss in excess of capital gains which may be deducted from other income is $2,000; this amount increases to $3,000 for taxable years beginning after 1977.\textsuperscript{27} The 2 for 1 adjustment in the case of long term capital losses remains unaltered. Thus, a $4,000 net long term capital loss incurred in 1977 will result in a deductible loss amounting to $2,000, the maximum deductible net long term capital loss for taxable years beginning in 1977.

3. \textit{General considerations.} At calendar year end 1977, three items in particular deserve your attention with respect to taxable dispositions of capital assets. First, because the provision pertaining to holding period is in transition from "more than nine months" in 1977 to "more than one year" for taxable years beginning after 1977, care must be exercised insofar as analyzing portfolios for possible dispositions. Unrealized gain from capital assets that is marginally long term at the end of calendar year 1977 (because the assets were purchased at the end of March, 1977) will become short term for at least the first three months of 1978 because of the additional three month holding period add-on to achieve long term characterization. Alternatively, unrealized losses from capital assets that likewise have been held for approximately nine months or less or have been held for more than nine months but

\begin{footnotes}
\item[25] Int. Rev. Code of 1954, Section 1222(1).
\item[26] Public Law 94-455, Section 1402(a)(2) (October 4, 1976).
\item[27] Int. Rev. Code of 1954, Section 1211(b).
\end{footnotes}
less than twelve months will be advantageously affected during this transition period because, if the taxpayer is in doubt regarding the disposition of such assets, additional time for making the decision to dispose of such asset will be available and the short term characterization will be maintained because of the three month add-on in 1978.

Second, and this particular item is also a result of a transition change, because of the increase in capital loss offset against other income from $2,000 in 1977 to $3,000 in 1978, a taxpayer may want to wait until 1978 to dispose of his capital assets that will ultimately result in capital losses. This, of course, must be balanced with the objective of avoiding a long term loss position which results in a 2 for 1 reduction.

The third item which must be considered, and this, perhaps, is the most perplexing one, is the uncertainty regarding the proposals of the Carter Administration with respect to capital gains and losses. The Carter Administration tax reform package, from what one reads in the press, will not be released, probably, until after the end of the year. Although it has been reported that there appears to be significant Congressional opposition to the proposal to repeal preferential treatment of long term capital gain, prudence would dictate that clients be aware of the uncertainty with which we are presently faced. Recently, it appears that the Administration may have decided not to propose repealing such treatment.

If changes in the preferential treatment of long term capital gains are to come about, there appears to be a planning technique available which, presumably, will preserve the long term gain characterization resulting from the disposition of capital assets, while not resulting in a bunching of income problem. Taxpayers disposing of real property may elect the installment method of reporting. The election is made on the return for the year of sale.²⁸

Aside from this problem, the usual planning techniques regarding capital gains should be considered. Generally, one should focus on whether or not the taxpayer has any long term capital losses and, depending upon the taxpayer's individual circumstances, offset the losses with gain to avoid the 2 for 1 reduction with respect to long term capital losses. Likewise, to the extent that a taxpayer has realized capital gains, the taxpayer may want to match these gains with long term capital losses.

4. **Short sales.** As most authors write, in addition to the other features of a short sale, it is possible to lock in gains while not being required to report such gain until the transaction is closed. Thus, it is possible, for example, to engage in a short sale in 1977 and not report the gain until closing in 1978.

Words of caution, however, are necessary before planning a short sale for tax purposes. The general rules with respect to a short sale are that

²⁸ Treas. Reg. Section 1.453-8(b).
if substantially identical property has been held for not more than 9 months in 1977 or for not more than 12 months in 1978 or if substantially identical property is acquired after the short sale and on or before the closing date, such gain is short term gain (assuming the asset is a capital asset)\textsuperscript{29} With respect to losses, if substantially identical property has been held by the taxpayer for more than 9 months in 1977 or for more than 12 months in 1978, any loss on the disposition is a long term capital loss (assuming the asset is a capital asset)\textsuperscript{30} Additionally, the following must be taken into consideration:

In the case of a short sale made in a taxable year beginning in 1976 and closed in a taxable year beginning in 1977, when the taxpayer owns substantially identical property, the property used to close the short sale will have to have been held by the taxpayer for more than 9 months in order for the gain or loss on the short sale to be long term. Similarly, for such short sales “against the box” closed in taxable years beginning in 1978, the holding period must be more than one year\textsuperscript{31}

5. Wash sales. Taxpayers are often faced with the difficult decision of which shares of stock or securities to dispose of, particularly at tax year end, in order to match capital gains and losses or to protect the short term position with respect to a loss security. Similar decisions affect gain stocks but the wash sales rules are not applicable to such transactions.

Generally, the wash sales rules are viewed as detrimental to the individual taxpayer and in many instances the results are clearly detrimental. The classic case is where loss stock is sold in order to recognize the loss and subsequent to the sale the stock begins to appreciate and the taxpayer resumes a position in such stock. The 30 day, substantially identical stock or securities rule negates recognition of such loss and the basis of the subsequently acquired shares of stock is adjusted to reflect the disallowed loss\textsuperscript{32} As long as the taxpayer realizes that substantially identical stock or securities may not be acquired within a period of 30 days prior to a loss sale or within 30 days after such sale, engaging in loss sell-off transactions toward taxable year end is most effective.

Alternatively, the wash sales rules can be beneficial to the taxpayer. To the extent that a taxpayer has already disposed of shares of stock or securities in a loss transaction and subsequently decides that recognition of the loss in a subsequent taxable year would have yielded better results, the taxpayer, in effect, can avoid recognizing the loss in a prior

\textsuperscript{29} Int. Rev. Code of 1954, Section 1233(b).
\textsuperscript{30} Ibid., Section 1233(d).
\textsuperscript{31} Staff of the Joint Committee on Taxation, 94th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1976 427 (1976).
\textsuperscript{32} Int. Rev. Code of 1954, Section 1091.
year by purchasing substantially identical stock or securities within 30 days of the loss sale.

**Partnership losses.** With the advent of the specific and general at risk rules with respect to certain partnerships, it has become necessary to examine the taxpayer's "at risk basis" to determine if any partnership loss for the taxable year will be deferred. As you know, the principal thrust of this legislation was to preclude a deduction for partnership losses except to the extent the partner was at risk with respect to his partnership interest. Thus, those partnerships which were heavily leveraged and used nonrecourse indebtedness have all but ceased to exist, except for certain real estate investment activities.

To the extent that a partner sustains a loss from a partnership in excess of his "at risk basis", such loss is deferred until the partner's "at risk basis" increases enough to absorb the partnership loss. Under certain circumstances, however, these at risk rules may provide planning opportunities.

First of all, the simplest case appears to be one where the partner's "at risk basis" is not sufficiently large enough to absorb the partnership loss and he "buys" his proportionate share of the loss by contributing to the partnership money, property or borrowed amounts (all of which have to meet the definition of amounts considered at risk). The contribution has to be made prior to the taxable year end of the partnership because the determination of the at risk amount is made on the basis of the facts existing at that time. It appears that a partner may "buy" all of the loss or as much of the loss as he feels is necessary. Although clearly the cost of this type of planning is greater under present law than it was under prior law, it still may be useful, particularly to shelter "70% income".

Alternatively, if a taxpayer finds himself in a position where it would be beneficial to postpone recognition of his proportionate share of a partnership loss until the following taxable year, it appears possible to reduce his "at risk basis" by increasing partnership withdrawals prior to the taxable year end of the partnership. Admittedly, in most cases this may be more academic than practical. Nevertheless, it appears to be applicable in the following two situations: (1) taxpayer's taxable income, without regard to his proportionate share of partnership loss, is quite low this taxable year and it is anticipated that taxable income in the next taxable year will be significant; (2) recognition of the proportionate share of the partnership loss in the current taxable year will result in a net operating loss in which case the taxpayer will lose the benefits of the capital gain deduction, deductions for exemptions, and itemized deductions in excess of non-trade or business income. Of

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83 Ibid., Section 465.
84 Ibid., Section 704(d).
85 Ibid., Section 172(d).
course, the value of the net operating loss deduction to the taxpayer may outweigh the benefit of deferring such partnership loss. If planning of this nature is undertaken, one should be concerned with substance and form issues.

Subchapter S corporation losses. As with partnership losses, likewise with net operating losses of Subchapter S corporations, the individual taxpayer must protect the loss flow-through. It is more critical, however, with respect to investments in Subchapter S corporations because if the loss is limited, the shareholder loses it for no provision is available that provides a carryover of the limited loss.

In general, the net operating loss of a shareholder of a Subchapter S corporation is limited to his adjusted basis in the stock of the corporation increased by any indebtedness of the corporation to such shareholder.\(^6\) If it is anticipated that a Subchapter S corporation will incur a net operating loss and a shareholder does not have sufficient basis to absorb his proportionate share of the loss, the shareholder, to protect the loss, will either have to make a capital contribution to the corporation or increase the corporation's indebtedness to him, the latter alternative probably being the preferable one. It would appear that if the corporation were to immediately (after its taxable year end) liquidate such indebtedness to the shareholder, that the form of the transaction will outweigh the substance and the loss subsequently disallowed.

Installment and deferred payment sales. The installment method of reporting, in addition to being available to dealers in personal property, is an elective alternative available to taxpayers engaged in realty dispositions and casual sales of personal property.\(^7\) Generally, taxpayers, when selling realty or personalty, would prefer to have cash in hand at the date of sale. However, to the extent that a taxpayer can take advantage of the installment method of reporting, income or gain from such disposition can be spread over a number of taxable years. The tax benefits of such an election are readily seen: income or gain is not bunched in the year of disposition; the amount of income or gain that is to be deferred until subsequent taxable years is known and thus the taxpayer has additional time to set in motion plans for the subsequent taxable years to possibly shelter the income or gain which is to be recognized.

Additionally, it is possible to elect the installment method and thus defer recognition of income or gain and still produce a non-taxable cash flow. For such a plan to work, the taxpayer need only borrow on the installments notes that he has received from the purchaser. The interest paid with respect to this indebtedness would probably be more than

\(^6\) Ibid., Section 1374(c)(2).

\(^7\) Ibid., Section 453.
enough to offset the interest income which is received on the installment obligations.\textsuperscript{38}

Also, if a taxpayer has elected to report on the installment method, in subsequent taxable years he may accelerate recognition of the deferred amount of income or gain by disposing of the installment obligations. Thus, the taxpayer may have at hand by using the installment method a device which allows him to defer recognition, accelerate recognition, or defer recognition while accelerating a nontaxable cash flow.

In cases where the taxpayer does not qualify for the installment method of reporting, the deferred payment method of recognition may provide some relief, assuming the disposition qualifies as a deferred payment sale. Generally, a deferred payment sale is applicable to dispositions of real property where the obligations of the purchaser have a fair market value less than their face value or the obligations have indeterminable value. Gain or loss is recognized in the taxable year in which the obligations are satisfied or disposed of.\textsuperscript{39}

\textit{Charitable contributions.} The planning area of charitable contributions is probably one of the areas over which the individual taxpayer has the most control, assuming he is so disposed and, of course, has the money or property to donate. The amount of taxes “saved” is a function of the effective tax rate to which the taxpayer is subject. In essence, the net cost of the charitable contribution decreases as the effective rate of income tax increases.

Because this area is somewhat complex, it should be beneficial to review, in general, various rules regarding the limitations upon charitable contributions of individuals. The taxpayer has to cope with so-called \textit{50\%} organizations as well as \textit{20\%} organizations. Charitable contributions “to” or “for the use of” must be distinguished. Decisions have to be made regarding whether cash gifts are to be given or property gifts. If property gifts are selected, capital gain property is treated different from ordinary income property. Carryforwards are provided with respect to certain donations whereas if limitations are exceeded with respect to certain other donations, no carryforward is provided and the tax benefits which otherwise might have been available to the donor are lost.

In general, cash contributions to qualified religious, scientific, and educational organizations as well as hospitals, public charities, governmental units and operating private foundations are subject to a limitation of \textit{50\%} of the contribution base.\textsuperscript{40} Contributions for the use of \textit{50\%} organizations or to or for the use of qualified organizations other than \textit{50\%} organizations are subject to a limitation of the lesser of \textit{20\%} of the contribution base or the excess of \textit{50\%} of the contribution base.

\textsuperscript{38} Ibid., Section 483.
\textsuperscript{39} Treas. Reg. Section 1.453-6.
\textsuperscript{40} Int. Rev. Code of 1954, Sections 170(b)(1)(A) and 170(c).
base reduced by the aggregate of all contributions made to 50% organizations without regard to the 30% limitation with respect to contributions of long term capital gain property. Contributions of long term capital gain property are subject to a limitation of 30% of the contribution base, hence, 30% property. For purposes of the 50% and 20% limitation, contributions other than contributions of 30% property are taken into account first and then the 30% property contributions are considered. Only contributions to 50% organizations, including 30% property contributions, are subject to a 5 year carryforward. The amount of the charitable contribution taken into account when the form of the contribution is ordinary income property is the donor's adjusted basis in the property; generally, contributions of certain capital gain property, if the use of the donee organization is unrelated to its exempt function or purpose or the donation is to or for the use of certain private foundations, must be reduced, in the cases of individuals, by 50% of the amount of long term capital gain which would have been recognized if such property had been sold rather than contributed. Other property contributions are taken into account at fair market value at date of contribution.

The ultimate composition of cash and property contributions as well as the organizations to which such contributions are made, if not properly planned, may result in the loss of contributions for tax purposes. For example, assume contributions in money and 30% property are given to 50% organizations and contributions of money are given to 20% organizations. Assume also that the aggregate of the money and 30% property contributions (without regard to the 30% limitation) is equal to 50% of the contribution base. The result is that the taxpayer will not be allowed full advantage or deduction for such contributions. Because the contributions to the 50% organizations are taken into account first and the contribution of 30% property is not adjusted by the 30% limit for purposes of determining the amount of limitation for the 20% organizations, the contribution to the 20% organizations is disallowed and the disallowed amount is not available for carryover. Also, the amount of contribution taken into account for purposes of applying the 50% limit is the aggregate of the money and not more than 30% of the contribution base with respect to the 30% property contribution, although the excess is available for a 5 year carryforward. Thus, in this example, the 20% contributions would not be allowed as a deduction and the entire amount available for the 50% contribution "basket" would not be met. For purposes of year end tax planning, then, an analysis of the entire year's contributions must be made before

41 Ibid., Sections 170(b)(1)(B) and 170(c).
43 Ibid., Section 1.170A-10.
44 Int. Rev. Code of 1954, Section 170(e).
the final contributions as to amount, form and organization choice are made.

**Interest expense** Prior to the Tax Reform Act of 1976, year end tax planning generally included plans to prepay personal as well as investment interest, the latter subject to the investment interest limitation. Since the passage of the 1976 Tax Reform Act, planning in this area has probably taken on a defensive posture because (1) interest paid by a cash basis taxpayer, in essence, is treated as if the taxpayer were on the accrual basis, except for points paid in connection with the purchase or improvement of a taxpayer's personal residence where the residence is security for the indebtedness and (2) the limitation on interest on investment indebtedness was reduced to $10,000 (prior law was $25,000) plus net investment income (prior law included, in addition to net investment income, long term capital gain plus 50% of any interest in excess of these amounts). With respect to construction period interest, certain other rules, depending upon the kind of property, are being phased in which, when fully effective, will require construction period interest to be capitalized and subject to a 10 year amortization period.47

In view of the fact that prepaid interest, except for points paid in connection with certain transactions, is deductible only in the period in which it is allocable, it appears that this particular planning area has diminished in importance. However, to the extent that a taxpayer has indebtedness where the interest is payable at the end of a particular period, other than monthly, the taxpayer may want to liquidate the debt at year end and pay all accrued interest. If the debt is refinanced, the taxpayer should either finance the interest payment with some other creditor or use his own funds. In this regard, particular care must be exercised when the debt being liquidated is the borrowed amount of the taxpayer's cash surrender value on his life insurance policies.

**Taxes.** Unless your particular taxing jurisdiction allows a prepayment for those taxes which are deductible under Code section 164, planning in this area is limited to the timing of the 4th quarter estimated state or local income tax payment. With respect to construction period taxes, as with construction period interest discussed earlier, such amounts must be capitalized and amortized over a period of ten years, once the phase-in period has run its course.48

Individual taxpayers who are subject to income tax withholding and must also pay quarterly estimates can possibly avoid the addition to the tax in the case of an underpayment of estimated tax. Assuming such individual, before taxable year end, determines that the imposition of

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45 Ibid., Section 461(g).
46 Ibid., Section 163(d).
47 Ibid., Section 189.
48 Ibid.
the addition to the tax for underpayment is unavoidable because the amount of quarterly estimates paid were too low in relation to anticipated tax liability, increasing the amount of the withholding so as to come within one of the exceptions to avoid the underpayment addition is possible. The additional withholding is deemed to have been withheld in equal parts on each installment date.49

Medical expenses For the vast majority of taxpayers who itemize their deductions, about all that is available as a medical expense deduction is 50% of their medical insurance not in excess of $150. Generally, prepayments of medical expenses are not allowed as a deduction. However, to the extent it is possible to defer payments of medical expense until a subsequent taxable year where it is anticipated that increased medical expenses will be incurred or adjusted gross income will have declined, some benefit may be derived from such expenses.

Summary. Taxpayers should also consider the deductibility of certain nontrade or business expenses50 as well as the effect of either accelerating or deferring recognition of such expenses. Additionally, for taxpayer's who qualify, individual retirement accounts should be planned.51 As you know, the Tax Reform Act of 1976 provided for an increased deduction for such plans where the taxpayer's spouse is also included.52 Although still in a conference between the House Committee on Ways and Means and the Senate Committee on Finance, it appears that legislation will emerge which will allow individual taxpayers credits for certain energy saving substances or devices. To the extent the taxpayer has already incurred expenses of this nature or is anticipating such expenses before year end, the emerging legislation should be closely monitored for taxpayer benefits.

IV. CERTAIN BUSINESS CONSIDERATIONS

My remarks today were directed at the topic “Year End Tax Planning for Individuals.” I would feel somewhat remiss, however, were I not to make some brief remarks regarding certain planning tools that are available to individuals who are in a trade or business and who operate in either a sole proprietorship or partnership form. Although many of the considerations which are to follow are also applicable to corporate entities, I shall dwell only on the ramifications to the individual taxpayer in his role as a sole proprietor or partner. The selection of the method of accounting and the opportunities involved with respect to accelerating or deferring items of income and expense are equally applicable to the sole proprietor and the partnership. Because of the

50 Int. Rev. Code of 1954, Section 212.
51 Ibid., Section 219.
52 Ibid., Section 220.
general coverage regarding this topic, earlier, I will not engage in any discussion of it at this point, but, rather, will dwell on certain other specifics.

Depreciation.—In addition to the allowable methods of depreciation which a taxpayer may elect, certain other aspects of depreciation accounting can provide tax benefits and many of them, like method selection, can be incorporated into a year end tax planning package.

For tax purposes, an asset is subject to depreciation when it is placed in service. Although the regulations do not amplify what is meant by the “placed in service” concept, generally it is a fact and circumstances test and case law can provide certain guidelines. Depending upon the tax picture of an individual taxpayer, asset acquisitions toward year end can be used to reduce tax liability. Accelerating the asset acquisition so as to be able to meet the “placed in service” concept can result in depreciation expense being claimed earlier; deferring the acquisition, of course, results in deferring the allowance for depreciation.

In the first taxable year in which an asset is subject to depreciation, the amount of depreciation allowed in addition to certain other limitations and the method selected, is a function of the averaging convention used by the taxpayer. In the case of an item account, a proportionate part of one year’s depreciation is allowed. With respect to multiple asset accounts, an averaging convention may be used so long as the convention used is consistently followed and does not substantially distort the depreciation allowance for the taxable year.

Two of the more popular averaging conventions applicable to multiple asset accounts and which are likewise mentioned in the regulations are: (1) all asset additions and retirements may be assumed to occur uniformly throughout the taxable year and depreciation is computed on the average of the beginning and ending balances of the account; (2) all asset additions and retirements occurring during the first half of a year are assumed to have occurred on the first day of such year whereas asset additions and retirements occurring in the second half of a year are assumed to have occurred on the first day of the subsequent year.

If a taxpayer has elected the provisions of the class life asset depreciation range system, the two conventions available are described in the regulations as follows: (1) the modified half-year convention treats asset additions and retirements occurring during the first part of the year as having occurred on the first day of the year and those taking place in the second half of the year as having been made on the first day of the subsequent year and (2) the half-year convention treats all

54 Ibid.
55 Ibid., Section 1.167(a)(11)(c)(2)(ii).
property in the account as placed in service on the first day of the second half of the year.\textsuperscript{56}

Salvage value considerations should also be taken into account in the depreciation equation. With respect to depreciable personal property, the amount of salvage value taken into account may be reduced by an amount not in excess of 10 percent of the adjusted basis of the property.\textsuperscript{57} Where this reduction in salvage value is applicable, if the salvage value of an asset is less than 10 percent of its adjusted basis, salvage value may be ignored.

The additional first year depreciation allowance, prior to the passage of the 1976 Tax Reform Act, had been successfully used in many tax shelters to provide additional benefits to partners, both general and limited. Under prior law, the dollar limitation pertaining to the amount of qualified property which could be taken into account was applied, in the case of individual taxpayers, at the individual taxpayer level. Because of the Tax Reform Act of 1976, the dollar limitation is applied both at the partnership and individual partner level.\textsuperscript{58} Nevertheless, additional first year depreciation is still available and should be considered in tax planning models.

**Certain credits** The investment credit, as you well know, is available with respect to qualified property placed in service in the taxable year. Because the timing of when the credit may be claimed is a function of a "placed in service" concept, the year end timing of qualified property acquisitions and getting them "placed in service" is critical. Of course, deferring the acquisition is likewise a possibility.

Particular attention should be focused on the election to claim investment credit with respect to qualified progress expenditures. In general, the expenditure, to be qualified, must be a capital expenditure for new qualified property which has a normal construction period of two years or more.\textsuperscript{59}

Earlier this year, the Congress passed and the President signed into law the Tax Reduction and Simplification Act of 1977. Among other items contained in this legislation was a so-called "jobs tax credit." In general, certain employers may claim as a non-refundable credit against Federal income tax 50 percent of the increase in their aggregate unemployment insurance (FUTA) wages for calendar years 1977 and 1978 over the aggregate FUTA wages for 1976 and 1977, respectively. The maximum credit may not exceed $100,000 per annum. The allowable credit, to the extent it exceeds tax liability after reduction for certain other credits, may be carried back 3 years or forward 7 years. An additional amount of credit is allowable in the case of vocational

\textsuperscript{56} Ibid., Section 1.167(a)(11)(c)(2)(iii).
\textsuperscript{57} Int. Rev. Code of 1954, Section 167(f) and Treas. Reg. Section 1.167(f).
\textsuperscript{58} Ibid., Section 179(d)(8).
\textsuperscript{59} Ibid., Section 46(d).
rehabilitation referrals. Any credit allowable will reduce the amount of salaries and wages deductible as a business expense. Although the FUTA wage base is to increase to $6,000 for calendar year 1978 and thereafter, for purposes of computing this credit, the present FUTA base of $4,200 will be used in lieu of the new $6,000 base.\textsuperscript{60}

\textsuperscript{60} 
\textit{Ibid.}, Sections 44B, 51, 52, and 53.