The recent passage of the new tax bill fervently supported by President Reagan and known formally as the Economic Recovery Tax Bill of 1981 (H.R. 4242) will be a tax boon to members of the Association of the Wall and Ceiling Industries-International. From changes in the corporate tax rates assessed on small business to changes in depreciation rules and investment tax provisions, the new tax bill offers many exciting tax advantages that should be of interest to AWCI members. This article describes some of the highlights of the new tax bill and the expected impact it will have on business nationwide.

**Reduction in Corporate Tax Rates For Small Businesses**

Starting in 1982, the tax rate on business with a taxable income of less than $25,000 will be reduced from the present seventeen percent (17%) to sixteen percent (16%). For businesses with a taxable income between $25,000 and $50,000, the tax rate will be reduced from twenty percent (20%) to nineteen percent (19%).

Beginning in 1983 and continuing through the later years, the tax rate on businesses with less than $25,000 in taxable income will be reduced further to 15%. Likewise, in 1983 and thereafter, the tax rate on businesses with taxable income between $25,000 and $50,000 will be reduced to 18%.

**Changes in Depreciation Methods**

The new tax bill permits businesses to accelerate the depreciation that may be taken on the equipment, tools, plant, and other kinds of property used in the business, which are subject to wear and tear, or become obsolete over time. The new depreciation system, called the accelerated cost recovery system, which is retroactive to January 1, 1981, provides that the cost of personal property and certain real property used in a business may be recovered over 3, 5, 10 or 15 years depending on the type of property used.

Previous law provided that the cost of property used in a business could be recovered depending on its actual useful life, which was determined by actual industry experience.

With the passage of this bill, the category of the property determines the period of time over which it may be recovered, irrespective of its actual useful life.

Under the new laws, the depreciation basis for the asset is not to be reduced by the “salvage value” of the asset. The prior law provided that the taxpayer first had to subtract from the depreciation basis the expected value of the asset as scrap, or value it might have if converted to other uses. The result of this change is to increase the amount of depreciation which may be taken.

The cost of trucks, tools, and other types of equipment used by members of AWCI in their business now may be recovered over three years, regardless of their actual useful life, which in most circumstances would be greater than 3 years. Prior to the passage of the new tax bill, if a new tool was purchased, and had an estimated useful life of eight years, the cost of purchasing the tool, reduced by its salvage value, would have to be deducted as depreciation over the eight years following the purchase. Because the tool qualifies as “3-year property”, the cost of purchasing the tool now can be recovered over a 3-year period, without any deduction for salvage value.

Under prior law, by year 3 only $3,750 of the $10,000 cost of the tool could be written off. Under the new law by year 3, the full $10,000 cost of the tool can be depreciated.

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The tax advantages that result in this change are illustrated in the following table.

<table>
<thead>
<tr>
<th>Year</th>
<th>Depreciation Under Prior Law</th>
<th>Depreciation Under New Law</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$1,250</td>
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<td>2</td>
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<tr>
<td>3</td>
<td>$1,250</td>
<td>$3,333.34**</td>
</tr>
<tr>
<td>4</td>
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<td></td>
</tr>
<tr>
<td>8</td>
<td>$1,250**</td>
<td></td>
</tr>
</tbody>
</table>

* This method presumes that the depreciation in the value of the tool is constant over its estimated life.
** At this point, the $10,000 investment is fully recovered.

The new tax bill also provides accelerated depreciation of real property used in a business. This should provide much needed incentive for the construction of new plants.

Previous guidelines by the Internal Revenue Service provided that commercial plants had a useful life of 40-60 years, for purposes of depreciation. Under the new tax bill, all real property is assigned a 15-year recovery period which, in most situations, is much less than the actual useful life of the real property, such as a new factory. If a business desires a longer recovery period, it may elect a 35 or 45 year extended recovery period.

Because the new tax bill is retroactive to January 1, 1981, some businesses with non-calendar fiscal years may be able to take additional depreciation not otherwise possible.

Under prior law, businesses could choose the “modified half-year rule” which permitted them to take a full-year depreciation on equipment bought in the first half of the fiscal year, and zero depreciation on equipment purchased in the last half. The new rules permit last-half depreciation for fiscal year 1981 only.

For example, assume X corporation’s fiscal year was April 1, 1980 to March 31, 1981. X purchased a $40,000 machine on September 1, the date its first half of the fiscal year ended and another piece of equipment on March 31, 1981, the last day of its fiscal year.

Under old rules, assuming straight-line depreciation and a useful life of 8 years, X could write off 12.5% or $5,000 on the first machine and zero on the second. The new rules permit X to write off 15% or $6,000 on the second machine, using the accelerated method of cost recovery.

The new law does not change the treatment accorded to gain realized on the sale of personal property. Gain on the sale of personal property, such as trucks and equipment, still is treated as ordinary income to the extent of prior depreciation taken.

Gain on the sale of real property used in a business is still treated the same, where only straight-line depreciation is used. Any gain realized on the sale of this type of property will be treated as capital gain.

The only significant change that has been made affects the treatment of gain where an accelerated method of depreciation other than straight-line depreciation is used.

Prior law provided that gain on the sale of non-residential property would be treated as ordinary income only to the extent that the depreciation that was taken exceeded the allocable amount under straight-line depreciation. For example, if gain on the sale of a factory was $50,000, and the amount of depreciation taken was $40,000, which was $20,000 more than allowed under the straight-line method, $30,000 of gain would be treated as capital gain and $20,000 would be treated as ordinary income.

Under the new bill, gain realized on the sale of real property used in a business will be treated as ordinary income to the extent that any depreciation was taken.

Thus, in the example above, of the $50,000 realized as gain in the sale of the factory, $40,000 would be treated
“With the passage of this bill, the category of the property determines the period of time over which it may be recovered, irrespective of its actual useful life.”

as ordinary income because this was the total amount of the depreciation taken.

Changes Made in the Investment Tax Credit

Under the prior law, a credit against federal income tax was available if tangible personal property with a useful life of 3 or more years, such as equipment used in connection with manufacturing or production was purchased in the taxable year.

The credit was equal to a percentage of the amount invested in the qualified property. The applicable percentages under the prior law were equal to 3-1/3% for property with a useful life of 3-4 years, 6-2/3% for property with a useful life of 5-6 years, and 10% for property with a useful life of 7 or more years.

The new tax bill has changed the percentages slightly. Now there are only two applicable percentages. For qualified property with a recovery period of 3 years, up to 6% of the amount invested can be credited against federal income tax. Only 60% of the investment qualifies for the investment tax credit. For qualified property with a recovery period of 5, 10, and 15 years, up to 10% of the amount invested is available for use as a credit on the taxpayer’s federal income tax. For property with 5 or 10 or 15-year recovery periods, 100% of the investment qualifies for the investment tax credit. For qualified property with a recovery period of 5, 10, and 15 years, up to 10% of the amount invested is available for use as a credit on the taxpayer’s federal income tax. For property with 5 or 10 or 15-year recovery periods, 100% of the investment qualifies for the investment tax credit. These new rules apply to property placed in service after December 31, 1980.

Under prior law, only $100,000 of used property which had been purchased was eligible for the investment credit. That limit has been increased to $125,000 for the 1981 tax year and to $150,000 in 1985.

A carry-over of the unused investment tax credit may now be carried forward for 15 years. Prior law provided that unused investment tax credit could be carried forward for only 7 years.

The new tax bill provides that the investment tax credit is subject to at-risk limitations, i.e., the investment tax credit is permitted with respect to funds used to purchase qualified property, if the purchaser used his own money and any borrowed funds for which he is personally liable. If the purchaser is protected against loss of the funds used to purchase the qualified property through non-recourse financing for which the purchaser is not liable, the investment tax credit is not available.

Exemptions are permitted for loans provided by banks, savings and loans, credit unions, insurance companies regulated under federal or state law, qualified pension trusts, or independent third-party lenders.

The act requires that: (1) the taxpayer have “at risk” at all times at least 20% of the cost or basis of the property; and (2) the property was acquired from an unrelated person. These rules generally apply to property placed in service after February 18, 1981.

New Leasing Rules Permit Utilization of Once Unused Investment and Depreciation Credits

One aspect of the new tax bill that may be attractive to members of AWCI is the new rules permitting transfer of investment and depreciation credits between unprofitable and profitable concerns.

Prior to the new tax bill, these credits would largely go unused by such companies because they owed too little tax. Under the new rules, Company X, in effect, can transfer these unused credits to Company Y which has a substantial tax liability. Many companies which were not
making a profit but which had accumulated an extensive amount of tax credits through investment or depreciation were unable to use the credits because they earned too little money. The new rules affect what is known as “leveraged tax leasing”, a type of transaction which is illustrated in the following example.

Assume Company X has earned little money in 1981 and has bought $5,000,000 of equipment which generates a $500,000 investment tax credit. Company Y makes a nominal investment of 10%, or $500,000 in the equipment and agrees to “lease” the equipment to Company X by giving to Company X a note for 5 years for the balance of $4,500,000.

Company Y, a profit-making concern, can immediately use the investment tax credit of $500,000, previously available to Company X. Company Y can also use the new accelerated method of depreciation on the equipment. Company Y has now taken advantage of the unused credits previously available to Company X, but which would not be used by Company X due to its poor performance during the year.

To qualify as a lease under prior law, the transaction required among other things: (1) that the lessor have at least 20% investment “at risk” in the asset; (2) that the lessor be able to show that the transaction was entered into for profit and not only for the opportunity to use the tax credits of the other company; (3) that the lessee did not put up any of the original purchase price of the asset; (4) that the lessee did not have an opportunity to purchase the asset at less than its fair market value; and (5) that the lease could not extend throughout the useful life of the asset.

The new law has significantly changed the former requirements. Now, all that is required to demonstrate that a lease arrangement is genuine is to show that: (1) the lessor and lessee agree to treat the lessor as owner of the property; (2) the lessor must have a minimum “at risk” investment of 10% in the cost of the property; and (3) the lease term does not exceed the estimated useful life of the property.

This particular change in the tax law was intended to help invigorate the economy by permitting the distribution of unused tax credits from ailing firms to healthy firms. Members of AWCI that are in need of additional tax credits may be able to make prudent use of the new rules affecting lease arrangements.

Conclusion

The new tax bill will be a catalyst toward the nation’s economic recovery.

For AWCI members, the new tax bill offers many new tax advantages, which should be carefully reviewed before major business planning is undertaken. The new rules relating to the accelerated recovery of the cost of new plants and equipment encourage the purchase of such property as a means of increasing the productive capacity of the American economy.

Increases in the investment tax credits are a signal to all producers in the country that the risks which must be run when making an investment in new plants and equipment will be rewarded.

Finally, the new tax rules such as those relating to the transfer of tax credits from unprofitable to profitable companies will likely aid in the future economic recovery of the nation.