97th Congress }
1st Session }

COMMITTEE PRINT

1981 FEDERAL INCOME TAX LEGISLATION: HOW IT AFFECTS OLDER AMERICANS AND THOSE PLANNING FOR RETIREMENT

(A Summary of the Provisions in the Economic Recovery Tax Act of 1981)

AN INFORMATION PAPER

PREPARED BY THE STAFF OF THE

SPECIAL COMMITTEE ON AGING
UNITED STATES SENATE

AUGUST 1981

This document has been printed for information purposes. It does not offer findings or recommendations by this committee

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U.S. GOVERNMENT PRINTING OFFICE

83-061 O WASHINGTON: 1981

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402

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PREFACE

Many provisions in the Economic Recovery Tax Act of 1981 will have a direct bearing on the elderly and those who are planning for retirement.

The staff of the Special Committee on Aging has prepared this summary of the new law to highlight these provisions, so that older Americans will not overlook them in preparing their annual tax returns or in doing their financial planning.

This summary is not intended to be an all-inclusive description of all the provisions in the law. Individuals should consult the Internal Revenue Service (IRS) or their financial advisers for more detailed information.

JOHN HEINZ, *Chairman*.

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1981 FEDERAL INCOME TAX LEGISLATION: HOW IT AFFECTS OLDER AMERICANS AND THOSE PLANNING FOR RETIREMENT

INDIVIDUAL INCOME TAX REDUCTIONS

Across-the-Board Cuts in Tax Rates

Under prior law, individual income tax rates begin at 14 percent on taxable income above $3,400 (joint return) and $2,300 (single return). The tax rates increase up to 70 percent on joint returns with taxable incomes of $215,400 or $108,300 on a single return. But the top tax rate on personal service income is 50 percent, payable on taxable personal service incomes above $60,000 (joint return) and $41,500 (single return).

Long-term capital gain, i.e., gain from the sale of assets held for more than 1 year, receives a deduction of 60 percent of the net gain. The remaining 40 percent of the net gain is taxed at ordinary rates up to 70 percent. Therefore, the maximum effective tax rate on long-term capital gains is, under prior law, 28 percent (i.e., 70 percent tax rate times 40 percent of net gain).

The new law provides for a 5-percent, across-the-board cut in individual income tax rates beginning on October 1, 1981, followed by an additional 10 percent tax cut on July 1, 1982, and a final 10 percent cut on July 1, 1983. The top marginal tax rate is reduced from 70 to 50 percent, effective January 1, 1982, and the maximum tax rate on long-term capital gains is reduced from 28 to 20 percent for sales or exchanges after June 9, 1981.

Indexing

The individual income tax is based on various fixed amounts, such as the amounts that define the thresholds for the tax brackets, the zero bracket amount, and the personal exemption. These dollar amounts are not adjusted for inflation.

The new law provides that starting in 1985, all individual income tax brackets, the zero bracket amount (the old standard deduction), and the personal exemption will be adjusted annually for increases in the Consumer Price Index. As a result, individual taxpayers will no longer be pushed into higher tax brackets because of inflation.

New Deduction for Two-Earner Couples

In 1981, a married couple with two wage earners of relatively equal income sometimes pays a higher income tax than two single people earning the same amount of income.

The new law allows married couples with two earners a deduction equal to 10 percent of the first $30,000 of the earnings of the spouse with the lower earnings. The maximum deduction is, therefore, $3,000. But it will be phased in over 2 years: A 5-percent deduction (maximum of $1,500) in 1982 and a 10-percent deduction in 1983.

Charitable Contributions

In 1981, individuals can only deduct contributions to a charitable organization if they itemize deductions for Federal income tax purposes.

The new law provides that all taxpayers can, beginning in 1982, deduct charitable contributions regardless of whether they itemize deductions. For those who do not itemize deductions for taxable years 1982 and 1983, the allowable deduction will be 25 percent of the first $100 of contributions, rising to 25 percent of $300 in 1984. The allowable deduction will be 50 percent of contributions in 1985 and 100 percent of contributions in 1986. The provision expires in 1987. The limits on contributions are the same for joint and single returns.

The provisions regarding charitable contributions by those who *do* itemize deductions are not affected by the new law.

Age 55 Exclusion of Capital Gains From Sale of Principal Residence

Prior law allows individuals who have attained age 55 to exclude from taxable income—for one time only—up to $100,000 of gains from the sale of their principal residence. In general, the individual must be 55 on the date of the sale and must have owned and used the property as a principal residence for 3 years or more during the 5 years preceding the sale.

The new law increases the excludable gains from $100,000 to $125,000 for sales and exchanges of a principal residence after July 20, 1981.

For those who do not elect this option, and for all other taxpayers, the new law also extends the time period during which the taxpayer can "rollover" the gains from the sale of a home by purchasing a new home, thereby deferring the payment of capital gains tax.

Prior law provides that an individual can defer the gains from the sale of a home by purchasing another home as a principal residence within a period beginning 18 months before, and ending 18 months after, the sale.

The new law extends—from 18 months to 2 years—the replacement period during which taxpayers can reinvest the proceeds from the sale in the new principal residence and not pay capital gains tax on the sale. This applies to sales and exchanges of principal residence after July 20, 1981, or to residences sold before that date, if the replacement period expires after July 20, 1981.

ESTATE AND GIFT TAX PROVISIONS

Estate and Gift Taxes

Under present law, estate and gift transfers are unified so that a single progressive tax rate schedule is applied to cumulative gifts and bequests. In 1981, estate and gift taxes range from 18 percent for the first $10,000 in taxable transfers, to 70 percent on taxable transfers of more than $5 million. Generally, the tax owed is computed by applying the progressive rate schedule to the taxable estate or gift amount, and then subtracting what is called a "unified credit." The amount of the estate or gift tax is, therefore, the total estate or gift tax minus the unified credit. In 1981, the unified credit is $47,000, which means there is no estate or gift tax on transfers up to $175,625.

The new law increases the unified credit—in steps—between 1982 and 1987. As a result, transfers which are exempt from taxes will rise from $175,625 in 1981, to $225,000 in 1982, $275,000 in 1983, $325,000 in 1984, $400,000 in 1985, $500,000 in 1986, and $600,000 in 1987 and thereafter.

The new law also reduces the maximum estate and gift tax rate 5 percentage points a year, beginning in 1982 and ending in 1985. As a result, the maximum tax will fall from 70 percent in 1981, to 65 percent in 1982, 60 percent in 1983, 55 percent in 1984, and 50 percent in 1985 and thereafter.

The new law also eliminates the dollar limits on marital deductions for gift and estate taxes. In 1981, there are limits on how much one spouse can transfer to another spouse through gifts or bequests, without paying taxes. The new law allows one spouse to transfer an unlimited amount of property, tax free, to the other spouse, beginning in 1982. Also, for property held in joint-tenancy with right of survivorship, only one-half of the property (instead of the full amount) will be included in the estate of the first spouse to die.

Annual Gift Exclusions

Under prior law, a donor is allowed to give up to $3,000 a year to any recipient ($6,000 if the gift is split between husband and wife) without paying taxes on the gift. The new law increases to $10,000 ($20,000 for a couple's split gift) the value of gifts to any one person—per year—which can be made tax free, beginning January 1, 1982.

The new law specifically exempts from the gift tax, beginning January 1, 1982, certain gifts made to pay for medical expenses or school tuition. In these cases, the donor must pay the gift directly to the person providing the medical care or to the school in question.

Also, the new law requires that gift tax returns only be filed on an annual basis, instead of the quarterly basis required in some cases under prior law.

SAVINGS INCENTIVES

The new law makes significant changes in tax law which are specifically intended to encourage savings by reducing Federal income taxes in the following ways:

Partial Interest and Dividend Exclusion

In 1981, individuals can exclude from taxable income as much as $200 ($400 on a joint return) of dividends and interest earned from domestic sources.

The new law terminates the present $200 exclusion of dividends *and* interest ($400 for a joint return) after 1981. The allowable deduction will be $100 of *dividends* on a separate return, and $200 on a joint return, beginning in 1982.

Also, starting in 1985, taxpayers will be able—for the first time—to exclude 15 percent of interest income but only to the extent that interest income exceeds nonbusiness and nonmortgage interest deductions. The maximum interest exclusion will be $450 ($900 for joint returns).

Exclusion of Reinvested Stock Dividends From Public Utilities

In 1981, stock dividends paid to all shareholders on a pro rata basis are taxable when the dividend is disposed of or sold. Stock distributions that are not made on a pro rata basis are taxable at fair market value when the shares are initially received. If the shareholder has the option to receive cash or stock, distributions are taxable at fair market value when received.

The new law provides that shareholders in a domestic public utility corporation who choose to receive their dividends in the form of common stock, can exclude from taxable income up to $750 ($1,500 for a joint return). The income will be treated as a capital gain when the taxpayer sells the stock. The exclusion applies for the years 1982 through 1985.

Note that this provision applies only to stock dividends, and not to cash dividends. The stock must be common stock newly issued for this purpose and valued between 95 and 105 percent of the stock's value immediately before the distribution date.

Tax-Exempt Savings Certificate

Prior law has no provision that specifically excludes interest earned on savings certificates. The new law exempts from taxation up to $1,000 ($2,000 for a joint return) of interest on qualified savings certificates. These certificates must be issued between September 30, 1981, and January 1, 1983, and must have a yield equal to 70 percent of the yield on 1-year Treasury bills. The certificates must be issued by financial institutions which invest in residential financing or agricultural loans.

Individual Retirement Accounts (IRA's)

In 1981, deductions to an individual retirement account (IRA) are limited to the lesser of 15 percent of compensation or $1,500. Under the new law, for taxable years after December 31, 1981, the limit on contributions will be the lesser of 100 percent of compensation or $2,000.

Further, the new law allows workers covered by a company pension plan to participate in IRA accounts. Such workers are excluded from IRA's in 1981. For taxable years after December 31, 1981, the $2,000 limit on contributions will apply to contributions the employee may make to an IRA or as a voluntary contribution to the company plan. Such voluntary contributions and earnings from the voluntary contributions will generally be subject to IRA-type rules.

IRA's for Nonemployed Spouses

After December 31, 1981, the limit on contributions to a spousal IRA will be increased from $1,750 to $2,250. Also, the new law deletes the previous requirement that contributions under a spousal IRA be equally divided between the spouses. The new law has no such rules on allocation, except that no more than $2,000 can be contributed to the account of either spouse.

Prior law forbids the nonearning spouse from making contributions to a spousal IRA after a divorce. Without wage or salary income, an individual cannot continue making contributions to his or her one-half share of a spousal IRA.

The new law, effective January 1, 1982, allows a divorced spouse to continue making contributions to a spousal IRA under certain conditions. The individual's former spouse must have established the spousal IRA at least 5 years before the divorce, and the former spouse must have contributed to the spousal IRA for at least 3 of the 5 years preceding the divorce. If those requirements are met, then the divorced spouse may continue to make contributions to the spousal IRA up to a maximum of the lesser of $1,125 or the divorced spouse's total compensation and alimony includable in gross income.

KEOGH PLANS FOR SELF-EMPLOYED

In 1981, the maximum contribution to a Keogh plan is limited to 15 percent of compensation or $7,500, whichever is lower.

The new law retains the present limit of 15 percent of compensation. But, effective with taxable years after December 31, 1981, it increases the maximum deduction for employer contributions to a defined contribution Keogh plan, to a defined contribution plan maintained by a subchapter S corporation, or to a simplified employee pension (SEP). The maximum deduction is increased from $7,500 to $15,000. To provide a similar increase in the level of benefits permitted under a defined benefit Keogh or subchapter S corporation plan, the compensation taken into account in determining permitted annual benefit accruals is increased from $50,000 to $100,000.

RETIREMENT INVESTMENTS IN COLLECTIBLES

Prior law generally makes no stipulation as to what types of investments qualify for tax deferral under an IRA, Keogh, or other individually directed plan.

The new law specifies that after December 31, 1981, the acquisition of collectibles through an IRA or through any self-directed account in a qualified plan, will be treated, for tax purposes, as a distribution from such an account. In other words, in 1982, the acquisition of collectibles will no longer be tax deferrable; the value of the acquisition will be taxed as ordinary income; and the acquisition may incur tax penalties relating to premature distribution.

Collectibles are defined as any work of art, any rug or antique, any metal or gem, any stamp or coin, any alcoholic beverage, or any other tangible personal property specified in regulations.

EMPLOYEE STOCK OWNERSHIP PLANS (ESOP'S)

In 1981 and 1982, prior law provides an investment tax credit for employers making contributions to employee stock ownership plans (ESOP). The new law terminates, after 1982, the investment-based tax credit for ESOP contributions and replaces it with a payroll-based tax credit for wages paid in calendar years 1983–87. Although this provision will not have any direct effect on taxes paid by individuals, the change from an investment tax credit to a payroll-based credit is intended to encourage the spread of ESOP plans among labor-intensive firms. Under present law, such firms derive little tax benefit from the investment-based credit.

A FINAL REMINDER: DON'T OVERLOOK ESTIMATED TAX PAYMENTS

Retired Americans often don't realize that the receipt of unearned income from taxable pensions, annuities, dividends, and interest, may require that they file a declaration of estimated tax. You must file such a declaration if your taxable income not subject to withholding is expected to result in a tax obligation of $100 or more during a year's time, *and* your estimated gross income includes more than $500 of taxable income not subject to withholding. The declaration of estimated tax must be filed by April 15 of the year in which the tax obligation is incurred. And, thereafter, quarterly tax payments are required by April 15, June 15, September 15, and December 15. If you are required to file the declaration and pay estimated taxes, but fail to do so, you are subject to penalty and interest charges.

You may ask your pension plan administrators if they can withhold the tax due from your pension payments. Or, if you are working, you can ask your employer to withhold enough to meet your full tax liability. But, in the latter case, remember that the total income tax withheld, together with any estimated tax payments, must equal at least 80 percent of the tax due on your income from all sources, or you will be subject to penalty and interest charges.

IRS ASSISTANCE

If you have questions about the new tax law or if you need assistance on any Federal income tax matter, help is available at the Internal Revenue Service (IRS). The toll-free telephone number for your area is listed in your telephone directory under "United States Government, Internal Revenue Service," and also in your tax forms instruction booklet. Should you need to visit an IRS office, call the toll-free number to find the location of the office nearest you.

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