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THE TAX REFORM ACT OF 1986: ITS EFFECT ON BUSINESS AND INDIVIDUALS

by

Kelly Ragan Green
Bachelor of Science
Texas A&M University, 1984

An Independent Study

Submitted to the Graduate Faculty of

The University of North Dakota

in partial fulfillment of the requirements

for the degree of

Master of Business Administration

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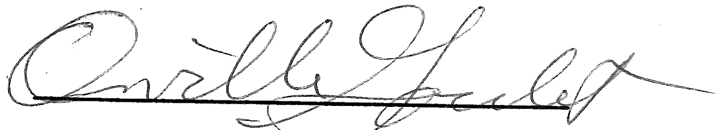

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ACKNOWLEDGEMENTS

I would like to express my sincere appreciation to my husband, Justin, who has been so supportive of me while pursuing my academic goals. He has been my role model both academically and professionally, as well as, a true friend and companion.

I would also like to thank the AFIT faculty and staff for all the help they've given me while working on my Masters degree. Special thanks goes to Dr. Goulet for his help and guidance as my professor and academic advisor.

Lastly, I appreciate all the love, encouragement, and support my parents and family have given me throughout my education.

ABSTRACT

The Tax Reform Act of 1986: Its Effects on Business and Individuals

Kelly Ragan Green

The Univesity of North Dakota Graduate Center, 1988

Faculty Advisor: Dr. Orville Goulet

The Tax Reform Act of 1986 represents the most massive revision in the history of tax law. It provides for major reductions in the top tax rate for both individuals and corporations. The individual top rate for 1988 will be the lowest since 1931. The tax burden on corporations has become stiffer after being relaxed for 20 years. In addition, the Act repeals or limits many of the tax credits and deductions that encourage certain kinds of investment, particularly those that taxpayers use to avoid paying taxes. The new tax code no longer uses steeply progressive tax rates, and therefore, does not significantly redistribute the tax burden between high- and middle-income taxpayers. However, it compensates for this by limiting the tax preferences heavily used by high-income taxpayers. On the lower end of the spectrum, the Act reduces the tax burden on poor families by removing them from tax rolls. These provisions were made with the goal of simplifying the tax system and making it more fair for all taxpayers.

CHAPTER I

INTRODUCTION TO TAX REFORM '86

The Tax Reform Act (TRA) of 1986 involves a host of major changes for both corporate institutions and individual taxpayers. The President, Congress, and the public debated the details of the tax package for more than two years before the new legislation was passed by Congress on September 27, 1986. It was then signed by President Reagan on October 22nd, beginning a new tax era. It represents the most massive tax overhaul in 40 years and has America's 108 million taxpayers scrambling to cope with all the changes. The new legislation has created 2,704 changes in the Internal Revenue Code, 42 new regulations, 32 revenue rulings, 65 announcements, and 48 new tax forms.[1]

Preceding the Tax Reform Act of 1986, there were several other significant changes in the U.S. tax code. The decade began with the Economic Recovery Tax Act of 1981 which contained one of the largest tax reductions in history. In the next few years, Congress passed three more pieces of major tax legislation. Each of these increased taxes for the purpose of reducing the growing federal deficit or restoring the solvency of the social security trust fund. These pieces of legislation included the Tax Equity and Fiscal Responsibility Act of 1982, the Social Security

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[1] Annetta Miller, et al., "The Tax Nightmare." Newsweek, 29 February 1988, 40 - 41.

Amendments of 1983, and the Deficit Reduction Act of 1984. Most recently, the Tax Reform Act of 1986 became law and was designed to neither increase nor decrease Federal receipts compared with the previous tax laws.[2]

The basic objective of TRA '86 was to reduce tax rates and broaden the tax base, while keeping the total level of tax collections constant. This constraint was imposed by political reality, although the growing federal deficit makes the constraint unrealistic. The reformer's goal was to strengthen both economic efficiency and equity by taxing more income at lower rates. It was argued that productivity could be increased by reducing marginal tax rates and avoiding tax subsidies to unprofitable projects. The reformers hoped that fairness could be enhanced by limiting the use of tax shelters and imposing tough new minimum taxes.[3]

The 1986 Act imposes significant tax burdens on business investments in order to recoup revenue losses generated by large reductions in individual tax rates. More specifically, individual tax rate reductions and increases in the standard deduction will reduce revenue about $360 billion between 1987 and 1991. Corporate rate reductions will reduce revenue by another $116 billion. To recoup almost $500 billion over the next five years, the new tax code has broadened the tax base.

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[2] Joseph C. Wakefield, "The Tax Reform Act of 1986." *Survey of Current Business* (March 1987): 18 - 25.

[3] Lawerence H. Summers, "A Fair Act That's Bad for Business", *Harvard Business Review* (March - April 1987): 53 - 59.

For example, approximately $154 billion will be raised by changes affecting the recovery of investment outlays, such as abolishing investment tax credits and scaling back depreciation allowances. A projected $200 billion will be recouped from closing loopholes such as corporate and individual minimum taxes, deductions for tax shelter losses, and accounting rule changes. In addition, eliminating various incentives will increase revenues by over $100 billion. These include deductions for IRA contributions, state sales taxes, and some employee business expenses.[4]

Each business and individual has a different tax situation, so it is important for each of them to determine the effect of tax reform on their tax liability. With all the new provisions, it has become necessary to evaluate their effects and to establish a new tax strategy. Many of the provisions are interactive and are likely to bring about major changes in taxpayer behavior. Overall, the new tax code is enormously complex and will ultimately affect almost everyone in some way.

The purpose of this study is to present the major provisions in the new tax law and discuss their impact on both businesses and individuals. Tax legislation relating to businesses will be addressed in Chapter II, while tax regulations governing individuals will be addressed in Chapter III. A literature search was accomplished to collect information regarding the Tax Reform Act of 1986. The information required for this study was found in business periodicals, journals, and magazines.

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[4] Ibid, pp. 53 - 59.

CHAPTER II

IMPLICATIONS OF TAX REFORM ACT '86 ON BUSINESS

Business owners should pay particular attention to the 1986 Tax Reform Act (TRA) since it will have significant impact on their companies. The complexity of tax reform legislation makes it difficult to generalize about its effects on the nation's 14 million small businesses.[5] Some businesses will benefit and others will be hurt by tax reform. It is not initially obvious whether a company's taxes will be raised or lowered, so a company must consider how each modifications in the new tax law will affect them. Overall, the new tax law is expected to increase corporate taxes about $120 billion over a five year period.[6]

For small businesses, the impact of TRA depends on various factors including how the business is organized, what industry it is in, and the extent to which the business made use of previous tax preferences, deductions, and credits. For example, approximately 80% of small businesses are organized as sole proprietorships, partnerships, and S-corporations and will benefit from lower individual rates.[7] However, small businesses

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[5] "Tax Reform's Varied Impact," Nation's Business (October 1986): 14.

[6] "The Tax Bill: Unknown Country," Nation's Business (October 1986): 12 - 13.

[7] Joan C. Szabo, "Roses Among the Tax Thorns," Nation's Business (December 1986): 45 - 47.

of the C-corporation form, which generate the majority of small business dollars, will be affected differently and generally not as favorably as the other groups. The reasons for this include higher corporate rates, the tough new corporate alternative minimum tax, and stricter limitations related to ownership, control, organizational status, and fiscal year-end changes.[8]

Also, the creation of new jobs will be slowed down a bit over the next two years while it adjusts to tax reform. "About 510,000 fewer jobs will be created by the end of 1988 than could have been expected under the old tax law," according to economist Donald Walls. Manufacturing will be the hardest hit by tax reform with an estimated loss of 200,000 jobs.[9]

General reform items will also impact businesses in varying degrees. For example, manufacturing, capital-intensive, and real estate businesses that make heavy use of depreciation write-offs, the investment tax credit, and the lower long-term capital gains rate are expected to be hurt by the tax reform. On the other hand, labor-intensive, service, and retail businesses are generally expected to prosper. Tax reform is expected to stimulate significant growth in the retailing and service sectors.[10] The following sections will discuss how the major changes in the Tax Reform Act will impact businesses.

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[8] M.J. Bullen, R.H. Hermanson and R.T. Mott, "Small Business Meets Tax Reform '86," Business (January - March 1987): 13 - 24.

[9] Roger Thompson, "Sorting Out Job Trends," Nation's Business (March 1987): 8.

[10] Bullen, "Small Business Meets Tax Reform '86," 13 - 24.

Depreciation Cost Recovery Revision

Under prior law, the Accelerated Cost Recovery System (ACRS) provided write-offs under five classes of assets for 3-, 5-, 10-, 15-, and 19-year property. The TRA retains the basic ACRS structure, but it generally provides less liberal write-offs by reclassifying assets. For example, it reclassifies automobiles and light trucks which are now depreciated over 5 years, compared with 3 years under previous law. Also, most types of manufacturing equipment are depreciated over 7 years, compared with 5 years under previous law.[11] Besides reclassifying assets, the modified ACRS assigns property in eight classes of assets instead of five classes under prior law. These new classes of property used for depreciation purposes include 3-, 5-, 7-, 10-, 15-, 20-, 27.5-, and 31.5-year classes. Many assets that would have been classified as 5-year property under old law are now in 7-, 10-, 15-, and 20-year classes.[12]

The modification of the ACRS lengthens the period over which assets can be depreciated. However, the longer required lives are offset by larger depreciation write-offs in the earlier years. For example, most equipment write-offs will be depreciated using the 200% declining balance instead of the 150% declining balance method used previously. More specifically, the 3-, 5-, 7-, and 10-year classes depreciate assets using the 200% declining balance method, switching to the straight-line method

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[11] Wakefield, "The Tax Reform Act of 1986," 18-25.

[12] "Tax Credits, Depreciation Draw Tax Reform Spotlight," Journal of Accounting (October 1986): 14 - 15.

at a time to maximize the depreciation allowance. However, 15- and 20-year classes retain the use of the 150% declining balance method. This will permit faster write-offs in the first years after an investment is made.[13]

The write-off period for buildings increased from 19 years to 27.5 years for residential rental property and to 31.5 years for all other real estate. The straight-line method for computing depreciation is used for buildings. The consequences of this change could have a considerable effect since it will take longer for a taxpayer to recover an investment. This new law could severely restrict new commercial building as well as new rental properties.[14]

Recovery is generally dependent on the Asset Depreciation Range (ADR) "midpoint life" assigned to the property. Therefore, taxpayers should be more aware of that life than under prior law.[15] Overall, the new depreciation laws generally limit deductions. In addition, they will create burdensome compliance and record keeping requirements for taxpayers with assets placed in service under prior depreciation systems. These taxpayers will be required to maintain three sets of records which include pre-1981, 1981-1986, and post-1986.[16]

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[13] Wakefield, "The Tax Reform Act of 1986," 18 - 25.

[14] Samuel Frumer, "Just What Does the Tax Reform Act of 1986 Reform?" Business Horizons (January - February 1987): 3 - 11.

[15] "Tax Credits", 14 - 15.

[16] Bullen, "Small Business", 13 - 24.

Expensing Option Increase

Under the new law, expensing the cost of personal property used in a business, rather than recovering the cost through the use of ACRS, has been increased from $5,000 to $10,000 a year. However, the amount expensed is limited to the taxable income derived from any active trade or business. This new law applies to property placed in service after 1986.[17] Also, the $10,000 ceiling is reduced dollar-for-dollar when the cost of tangible personal property is greater than $200,000. A small business is more likely to stay below this ceiling when purchasing eligible assets in order to deduct the entire $10,000.[18] For small business, the expensing option will generally be more advantageous, especially since the investment tax credit was repealed and, in some cases, less generous depreciation was allocated. As a consequence, some small businesses may be able to expense more than the depreciation deductions would have allowed them under prior law.[19]

Investment Tax Credit Repeal

Under prior law, a tax credit was allowed for up to 10% of a taxpayer's investment in certain tangible depreciable property.

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[17] C. Clinton Stretch and Frank C. Devlin, "The 1986 Tax Reform Act: The New Rules For Business," The Practical Accountant (November 1986): 50 - 70.

[18] William T. Diss, "Small Business: Winner or Loser Under Tax Reform?" Journal of Accountancy (December 1986): 164 - 171.

[19] Bullen, "Small Business," 13 - 24.

The amount of the regular ITC was based on the ACRS recovery class to which the property was assigned. Also, the amount eligible for the tax credit was limited to $125,000 of a taxpayer's investment in used property per year.[20] Under new law, assets placed in service after December 31, 1985 no longer qualify for the investment tax credit. However, transition rules allow the tax credit on assets purchased in 1986 if there was a binding contracts for these purchases before Dec. 31, 1985.[21]

Prior law allowed taxpayers a 3-year carryback and a 15-year carryforward on the full amount of unused ITCs. Under the new law, 100% of the unused tax credits can still be carried back for 3 years. However, the new law will only allow 82.5% of the carry-forward to be used in 1987 and only 65% of unused credits can be carried forward up to 15 years thereafter.[22] Many small business owners have criticized this repeal, especially since it is retroactive to Jan. 1, 1986. They complain that government has changed the rules in the middle of the game. The result is that capital-intensive companies may be paying more taxes than before. On the other hand, the new law will have a negligible effect on companies that spend little on depreciable assets such as retailer, wholesalers, and other service industries.[23]

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[20] Ibid, 13 - 24.

[21] David O. Kreuter, "Here's a Look at the Key Changes in the Tax Reform Act of 1986," Oil and Gas Journal (5 January 1987): 16 - 17.

[22] Wakefield, "Tax Reform Act," 18 - 25.

[23] Robert W. McGee, "How the New Tax Law Affects Business," Management Accounting (October 1986): 54 - 57.

Changes in Other Tax Credits

The Research and Development Tax Credit, which expired at the end of 1985, has been extended through Dec. 31, 1988. However, the previous tax credit of 25% is reduced to a rate of 20%.[24] The definition of eligible expenditures has been modified to encourage research for the purpose of discovering technological information which is intended to result in a new item for sale or use in the taxpayer's business. Also, the charitable deduction for the donation of newly manufactured scientific equipment to a college has been extended to certain tax-exempt scientific research organizations.[25]

The General Business Tax Credit had included the ITC and the Targeted Jobs Tax Credit. Under prior law, these credits could not exceed the sum of the first $25,000 of net tax liability plus 85% of the net tax liability over $25,000. The TRA adds the R&D credit to this limitation and reduces the 85% allowance to 75%.[26] Although the ITC is repealed, the TRA extends the business solar energy, ocean thermal energy, and geothermal energy credits through 1988 at reduced rates. The targeted jobs credit is also extended through the end of 1988, but TRA reduces the credit on first-year wages from 50% to 40% and repeals credit for second-year wages.[27]

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[24] "The Tax Reform Act," 18 - 25.

[25] Strech, "The 1986 Tax Reform Act," 50 - 70.

[26] Ibid, 50 - 70.

[27] Robert W. McGee, "How the New Tax Law Affects Business," _Management Accounting_ (October 1986): 54 - 57.

Corporate Rate Reductions

Before the TRA, a corporation's income was taxed at rates from 15% to 46%. The new law has changed these rates and becomes effective for the tax year beginning on or after July 1, 1987. A comparison of the old corporate rates with the new rates is shown below according to taxable income brackets.[28]

TAXABLE INCOME	PRIOR LAW	NEW LAW
Not over $25,000	15%	15%
$25,001-$50,000	18%	15%
$50,001-$75,000	30%	25%
$75,001-$100,000	40%	34%
over $100,000	46%	34%

In addition, the act provides for an additional tax of 5% on corporations with taxable income between $100,000 and $335,000. The additional tax cannot exceed a maximum level of $11,750. This additional tax, in effect, creates a marginal tax rate of 39% for corporations in this income range. Corporations with taxable incomes of $335,000 or more will be taxed at the 34% rate.[29] Lastly, a corporation with a tax year that includes the effective date of July 1, 1987 will have to calculate its tax under both the old and new tax rates. Then, it will prorate the old and new taxes to that part of the year that precedes or follows the effective date. Therefore, the rates for 1987 are blended and the top rate in 1987 will be 40%.[30]

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[28] Wakefield, "The Tax Reform Act," 18 - 25.

[29] Ibid, 18 - 25.

[30] McGee, "How the New Tax Law Affects Business," 54 - 57.

Organizational Status Conversion

For the first time in U.S. history, the maximum corporate tax rate will now exceed the maximum individual tax rate (34% versus 28%). Because of the rate differential, shareholders in a closely held corporation are expected to consider electing the S-corporation status. This will enable the business to shift the tax burden on corporate earnings to the lower individual rate and still retain some of the limited liability protection of the corporate form. However, this benefit must be balanced against the effect caused by the repeal of the General Utilities doctrine.[31] The following tax table compares the 1988 income taxes when operating as an S-corporation as opposed to operating as a C-corporation.[32]

Taxable Income	Tax as C-Corporation	Tax as S-Corporation
$25,000.00	$3,750.00	$3,750.00
50,000.00	7,500.00	10,132.50
100,000.00	22,250.00	25,537.50
1,000,000.00	340,000.00	281,092.00
2,000,000.00	680,000.00	561,092.00

The S-corporation taxes assume that earnings are passed through to a sole shareholder who is filing a joint return with two personal exemptions. The tax savings from electing the S-status increases as taxable income rises beyond the break-even point of $154,790.[33] The S-form also eliminates double taxation

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[31] Bullen, "Small Business," 13 - 24.

[32] Michael Schlesinger, "Closely Held Businesses Should Consider S-Status Under the New Tax Law," _The Practical Accountant_ (December 1986): 43 - 44.

[33] Ibid, 43 - 44.

of profits distributed as dividends and double taxation of capital gains should the business be sold.[34]

To qualify for S-corporation status, certain requirements must be met. For example, only one class of stock can be used, no more than 35 shareholders may own stock, and no corporation or partnership can be a shareholder. In addition, nonresident aliens may not own stock, only certain trusts may own stock, and the corporation cannot be a member of an affiliated group.[35]

Another form of business organization to consider when forming a new business is the limited partnership. In a limited partnership, an unlimited number of investors can participate in the profits, cash flow, or tax losses without much personal legal liability. In addition, the partnership can be set up like the S-corporation which will protect key executives from personal liability while allowing them to take advantage of the lower individual tax rate.[36]

Capital Gains Repeal

Capital gains lost its preferential treatment with the passage of the Tax Reform Act. The new law taxes both long-term and short-term capital gains at the same rate as ordinary income. In effect, this raises the corporate rate to the maximum rate of 34%. Therefore, it is no longer particularly advantageous to

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[34] Peter Faber and Arthur Rosenbloom, "Managing Under the New Tax Law," INC. (November 1986): 89 - 92.

[35] Joseph R. Oliver, "The Aftermath of Tax Reform," The CPA Journal (February 1987): 64 - 69.

[36] Faber, "Managing Under the New Tax Law," 89 - 92.

have profits "capitalized" since capital gains are no longer preferentially treated.[37] Capital losses are still deductible, but only against capital gains. Previously, corporations were taxed at a maximum long-term capital gains rate of 28%. The effective date for LTCGs to be included and taxed at the same rate as ordinary income begins with income earned after 1986.[38]

General Utilities Doctrine Repeal

The General Utilities doctrine was named for the 1935 Supreme Court decision in "General Utilities vs. Helvering". The Act of 1986 continues the process of repealing the doctrine begun in the Acts of 1982 and 1984.[39] Before the 1986 TRA, sales and distributions of property in a liquidation generally did not trigger a realized gain or loss to the liquidating corporation. Small business owners could liquidate a company with minimal tax consequences. For example, when a company was sold, the proceeds went to the shareholders who were then responsible for paying taxes on the realized gain. The company itself paid no tax.[40]

However, the 1986 TRA repeals the doctrine by requiring the recognition of both sales and distributions under liquidation

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[37] Ibid, 89 - 92.

[38] Bullen, "Small Business," 13 - 24.

[39] Robert Willens, "General Utilities Is Dead: The TRA of '86 Ends an Era," The Journal of Accountancy (November 1986): 102 - 113.

[40] Joan C. Szabo, "Welcome to Tax Reform," Nation's Business (November 1986): 20 - 28.

plans and forces double taxation of appreciated corporate property. The Act generally requires corporate liquidations to be taxed at both the corporate and shareholder levels.[41] A liquidating corporation must recognize gains or losses on distributions of property as if the property has been sold at its fair market value. The new law also requires recognition of gain or loss from sales of property through a liquidation. This includes the "deemed" sale of its assets if an election is made to step up the basis of its assets following the purchase of its stock.[42]

The effective dates of repeal are a critical part of the new law. To obtain the previous General Utilities benefits of nonrecognition, generally, a liquidation must be completed by December 31, 1986. However, if a liquidation plan was adopted on or before July 31, 1986, the taxpayer has until December 31, 1987 to complete the liquidation.[43]

The provision does not, in general, apply to the liquidation of "small, closely held corporations" if the liquidation is completed by January 1, 1989. Small, closely held corporations are those that do not exceed $5 million in value and are more than 50% owned by ten or fewer individuals who have owned their shares for five years or longer. In addition, there is a phased-out decrease in the transitional protection for corporations

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[41] Diss, "Small Business," 164 - 171.

[42] Stretch, "The 1986 Tax Reform Act," 50 - 70.

[43] Willens, "General Utilities is Dead," 102 - 113.

whose stock is valued between $5 million and $10 million.[44]

The repeal of the General Utilities Doctrine will have significant economic effect on the structuring of future taxable acquisitions and liquidations. For example, it may be advantageous for certain corporations to evaluate liquidating during the two-year transition period in order to continue operations in a more favorable, noncorporate form. This is particularly worthy of consideration after taking into account the combination of lower individual tax rates, stiffer corporate alternative minimum tax, and the repeal of the General Utilities Doctrine.[45] As a result of these changes, the tax cost will usually make asset acquisition impractical unless the acquisition can qualify under the tax-free reorganization provisions of the Code. As a comparison, the total tax on a liquidation under prior law would have been the 20% individual tax on the capital gains plus any corporate level recapture tax. Under the Act, the total tax will be 52.5% which includes 34% at the corporate level plus 18.5% (28% of 66%) at the individual level.[46]

Sales Between Related Parties

Prior to the 1986 TRA, ordinary income was recognized and installment reporting was denied on certain sales of property between related taxpayers. This included a person and a corporation or partnership at least 80% owned by the person.

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[44] Diss, "Small Business," 164 - 171

[45] Bullen, "Small Business," 13 - 24.

[46] Stretch, "The 1986 Tax Reform Act," 50 - 70.

Under the TRA, the definition of related taxpayer is expanded to conform generally to the definitions used in disallowing losses between related taxpayers. Hence, related taxpayers now include a person and a corporation or partnership that is more than 50% owned by the person. Related taxpayers also refer to corporations that are members of the same controlled group, or corporations and partnerships that are more than 50% owned by the same people. This change is in effect for sales made after the date of enactment unless made under a binding contract which was in effect before August 14, 1986.[47]

Also, the Act does not allow the recognition of a loss on non-prorata distributions of property to related persons if the property was acquired as a contribution to capital within five years of the liquidation. In addition, a built-in loss prior to contribution may not be recognized on property being liquidated. This rule applies to property that was a contribution to capital within two years of the adoption of the liquidating plan, unless no tax avoidance motive can be shown for the contribution.[48]

Alternative Minimum Tax

The minimum tax was established to prevent profitable companies from escaping taxes. Often, they take advantage of too many tax incentives to pay at least some tax.[49] Before the TRA, corporations generally paid a minimum tax equal to 15% of the

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[47] Bullen, "Small Business," 13 - 24.

[48] Stretch, "The 1986 Tax Reform Act," 50 - 70.

[49] McGee, "How the New Tax Law Affect Business," 54 - 57.

amount by which total preferences exceeded the greater of $10,000 or the regular tax paid. This tax was then added to the regular tax paid on taxable income.[50] Preference items are deductions that must be added back to income or otherwise recomputed in determining an alternative minimum tax income. The preference items included: 1) excess accelerated depreciation on real property, 2) excess amortization of certified pollution control facilities, 3) excess percentage depletion, and 4) expensing of mining exploration and development costs.[51] Another preference item was 18/46 percent of net long-term capital gains. Also, excess bad debt reserve deduction was a preference for certain financial institutions.[52]

The 1986 TRA replaces the current add-on minimum tax with a tougher, more complex alternative minimum tax (AMT). It requires corporations to pay a minimum tax equalling at least 20% of its alternative minimum taxable income (AMTI).[53] The AMTI is computed by adding the dollar amount of tax preferences to the taxpayer's AGI and then reducing that total by the amount of allowable deductions.[54] The new corporate alternative minimum tax provides for a $40,000 exemption which is phased out for

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[50] Bullen, "Small Business," 13 - 24.

[51] Stretch, "The 1986 Tax Reform Act, " 50 - 70.

[52] Bullen, "Small Business," 13 - 24.

[53] Stretch, "The 1986 Tax Reform Act, " 50 - 70.

[54] G. Timothy Haight, "Passive Losses and the Alternative Minimum Tax Under Tax Reform," The CPA Journal (August 1987): 64 - 67.

companies whose minimum taxable income is more than \$150,000. The exemption amount is reduced by 25% when AMTI exceeds \$150,000.[55] The TRA includes an expanded list of preference items. These items include excess intangible drilling and development costs, the use of the completed contract method, and deferred gain on certain installment sales.[56] The changes in TRA regarding each of these new preferences will be discussed in sections to follow.

A new feature of the revised AMT is the use of reported "book income" as a separate test of taxability. For the period between 1987 and 1989, a book income adjustment must be made. More specifically, a corporation must compare the AMTI with book income reported to stockholders. If the book income is more than the AMTI, one-half of the difference is added to the minimum taxable income. The minimum tax is then calculated on the total at a tax rate of 20% as stated above.[57] The book income adjustment provision may unfairly target many corporations that already pay their fair share of taxes and has been one of the most controversial provisions on the 1986 Tax Reform Act. For taxable years after 1989, the book income adjustment will no longer apply; it will be replaced by a minimum tax on a corporation's adjusted current earnings.[58]

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[55] McGee, "How the New Tax Law Affects Business," 54 - 57.

[56] Willens, "General Utilities is Dead," 102 - 113.

[57] Wakefield, "The Tax Reform Act of 1986," 18 - 25.

[58] Ibid, 18 - 25.

Dividends Received Deduction

Under prior law, a corporation was usually allowed to deduct 85% of the dividends it received from unrelated domestic corporations and from certain foreign corporations engaged in business within the United States. In addition, dividends received from small business investment companies and from certain corporate affiliates were eligible for a 100% deduction. The purpose of this rule is to reduce the extent of double taxation that would otherwise result since the dividends are paid out of previously taxed income.[59] Under the new law, the 85% dividends received deduction is reduced to 80%. However, the 100% provision related to small business investment companies remains unchanged. This is still a significant return considering the yield differences between taxable and nontaxable investments. This deduction favors high-dividend paying stocks such as utilities and preferred stocks.[60]

Net Operating Loss Carry-Forward

Under prior law, the net operating loss (NOL) carry-forwards of a "loss corporation" could be reduced in a tax-free reorganization based on substantial changes in shareholder's interest. The NOL carry-forward could also be eliminated in a taxable acquisition where there was a change in both shareholders and a business.[61] After 1986, instead of reducing or eliminating

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[59] Wakefield, "The Tax Reform Act of 1986," 18 - 25.

[60] Susan Jayson, "Corporations Making Estimated Tax Payments," Magnagement Accounting (March 1987): 7.

[61] Bullen, "Small Business," 13 - 24.

NOLs in the case of ownership changes, the TRA imposes an annual limit on the use of NOLs if there is greater than 50% change of ownership in a loss corporation within a three-year period. The amount of a NOL that may be used to offset earnings is limited to the value of the loss corporation at the date of ownership change. This amount is then multiplied by the highest federal tax-exempt long term bond rate.[62] In addition, NOL carryovers are disallowed following taxable purchases and tax-free reorganizations unless the loss corporation substantially continues the same business for a two-year period following a change in ownership. As a result of the new rules, many loss carryovers will be far less valuable on a present value basis. Instead, losses can generally be utilized over a substantially longer period of years than under prior law.[63]

The amount of available NOLs will also be affected by the following additional rules. A loss corporation's annual limitation may be increased if there is a substantial amount of untaxed appreciation in its assets on the date of ownership change. These unrealized gains must be recognized within the next five years. NOL usage is restricted when more than one-third of a loss corporations assets are classified as "nonbusiness". NOL is also restricted if the corporation received a value-increasing capital contribution in the two years preceding the date of ownership change. Lastly, the new rules

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[62] Stretch, "The 1986 Tax Reform Act," 50 - 70.

[63] Haight, "Passive Losses and the Alternative Minimum Tax Under Tax Reform," 64 - 67.

won't be imposed on an ownership change resulting from bankruptcy proceedings if more than 50% of the corporation's stock is obtained by its shareholders and creditors.[64]

Golden Parachutes Rule

Compensation payments, otherwise known as Golden Parachutes, are terms written into the corporate bylaws to make an acquisition of the company more difficult or more expensive. Golden parachutes award large termination payments to existing management if control of the firm is changed and management is terminated.[65] Under the Tax Reform Act of 1984, no deduction was allowed for certain compensation payments made as a result of a change in ownership, control of a corporation, or of a substantial portion of its assets. In addition, a 20% nondeductible excise tax was imposed on the recipient. Modifications were made in the new Tax Act of 1986 including an exemption of these rules for corporations that meet the S-corporation qualification requirements. The new Act also made provisions so that qualified pension, profit-sharing, and annuity plans are not included as parachute payments. The new exceptions are effective back to the original provisions enacted in 1984.[66]

Cash Method of Accounting

Under prior law, many taxpayers could compute taxable income

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[64] Willens, "General Utilities is Dead," 102 - 113.

[65] J. Fred Weston and Thomas E. Copeland, Managerial Finance (New York, N.Y.: CBS College Press, 1986), 906.

[66] Bullen, "Small Business," 13 - 24.

using either the cash or accrual method of accounting. The cash method generally recognizes income when it is received and expenses when they are paid. Therefore, the cash method is considered to more accurately reflect the economic ability of small businesses to pay their taxes. With the accrual method, income is recognized when services are rendered even though payment may not be received for several months. Therefore, small businesses often pay taxes on income they haven't yet received, which makes it harder for them to run their business.[67]

Under the new TRA, a regular corporation can no longer use the cash method of accounting if it has gross receipts in excess of $5 million. Regular corporations that are affected include C-corporations, partnerships that have C-corporations as a partner, tax-exempt trusts with unrelated business income, and tax shelters.[68] The cash method of accounting is retained for S-corporations, farming and timber business, qualified personal service corporations, and corporations with $5 million or less in average annual gross receipts for the prior three taxable years. In general, the cash method is preferred over the accrual method when uncollected receivables for services rendered exceed unpaid accounts payable and accrued expenses. Also, most small businesses favor the cash method because it involves less costly accounting than required by the accrual method.[69]

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[67] Szabo, "Welcome to Tax Reform," 20 - 28.

[68] Stretch, "The 1986 Tax Reform Act," 50 - 70.

[69] Diss, "Small Business," 164 - 171.

Bad Debt Deduction Repeal

Before the 1986 TRA, accrual method taxpayers could use either the direct write-off method or the reserve method to determine the amount of the deduction for bad debt.[70] Using the reserve method, taxpayers were allowed to take a deduction for bad debts that were expected to become worthless. The TRA repeals the use of the reserve method for deducting bad debts. An exception is provided for commercial banks with less than $500 million in assets and for all thrift institutions.[71] Taxpayers affected by this change will be required to switch to the direct write-off method currently allowed. The switch to the direct write-off method is an accounting change whereby any balance in the reserve account will be taken into income over four taxable years. Under the direct write-off method, a deduction for a partially worthless debt can be taken only in the year the debt is written-off on the books. No deduction is allowed for fully worthless debts. These rules become effective for tax years beginning after 1986.[72]

The "No Fiscal Year" Rule

The TRA eliminates the 3-month deferral option which means that partnerships, personal service corporations, and S-corporations will generally be required to be on a calendar year. Previously, these corporations were able to defer taxes for up to

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70 Bullen, "Small Business," 13 - 24.

71 McGee, "How the New Tax Law Affects Business," 54 - 57.

72 Stretch, "The 1986 Tax Reform Act," 13 - 24.

three months by using a fiscal year while the owners used the calendar year. This allowed owners to use profits for awhile before they were taxed.[73] The Act requires a partnership to use the same year-end as the partners owning the majority interest in the profits and capital. If such a majority does not have the same taxable year, the partnership is then required to adopt the taxable year of all of its principal partners. If neither of these situations applies, the partnership must adopt the calendar year. S-corporations and personal service corporations do not have the same flexibility as partnerships do, and must use a calendar year-end.[74]

A corporation may continue to use a fiscal year if they can establish, to the satisfaction of the IRS, that they have a substantial business purpose for a fiscal year. However, the Act makes it clear that deferral of income to partners will not be treated as a business purpose. In addition, the following are not sufficient to establish a business purpose for retaining a fiscal year: 1) a business that usually hires staff during a certain time of the year; 2) using a fiscal year for accounting, regulatory, or administrative purposes; and 3) using a price list, models, or other items that change on a yearly basis. The tax preparers are as upset as taxpayers over the new rules because there will be a much more concentrated calendar year-end

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[73] Szabo, "Welcome to Tax Reform," 20 - 28.

[74] Stretch, "The 1986 Tax Reform Act," 50 - 70.

workload for accountants and tax lawyers.[75]

The changes take effect for taxable years after December 31, 1986. Entities with taxable years ending in 1987 will still file their returns as usual for their fiscal year. However, the next return must be for the year ending December 31, 1987, which creates a short year for tax purposes. The TRA provides that the excess of income over expenses for the short taxable year to be taken into account ratably over four taxable years. More specifically, the net income realized in the short year will be spread over the years 1987 through 1990. Lastly, partners and shareholders can elect to include all the income from the short year in their calendar-year 1987 returns.[76]

Accrual of Vacation Pay

Under prior law, businesses electing to accrue vacation pay expense were allowed a deduction for vacation pay earned by employees during the taxable year. The vacation pay expense could be paid during the taxable year or within 12 months following the close of the taxable year.[77] However, the new tax code requires that the total expense accrued must be paid within 8 1/2 months following the close of that year, in order to be

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[75] William Margulies, "Coping With the 1986 Tax Reform Act's 'No Fiscal Year' Rule," The Practical Accountant (January 1987): 43 - 46.

[76] Donald C. Weise, "The Fiscal Year: An Endangered Species Under Tax Reform," Journal of Accountancy (January 1987): 78 - 85.

[77] Bullen, "Small Business," 13 - 24.

deductible in the year earned by the employee. This provision is effective for taxable years beginning after 1986.[78]

Installment Sales Restrictions

The TRA generally disallows the benefit of the installment method for sales under a revolving credit plan and for sales of certain publicly traded property. It also disallows the benefit on a portion of most other installment sales equal to the ratio of outstanding debt to basis of the assets. Exceptions exist for sales of real property used in a trade or business, or held for rental, where the selling price is less than $150,000 and for casual sales of personal property.[79] Taxpayers who will no longer be able to use the installment method for sales made under a revolving credit plan, may make an income adjustment. The adjustment in income may be used over a period not exceeding four years which takes 15% into account in the first year, 25% in the second year and 30% in the next two taxable years. This provision is effective for sales of property after 1986.[80]

An installment sale will limit the amount of gain reported in any year to a percentage of the payments received in that year. Therefore, if a long-term capital gain is expected from the sale of investment property, and the resulting "preference" would require calculating the AMT, then an installment sale of the property should be considered. The payment schedule can be

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[78] Stretch, "The 1986 Tax Reform Act," 50 - 70.

[79] Bullen, "Small Business," 13 - 24.

[80] Stretch, "The 1986 Tax Reform Act," 50 - 70.

structured so that just enough gain is recognized to reach the break-even point. However, in some cases, use of an installment sale may not be desirable. For example, if the taxpayer is already using AMT and is seeking additional income to absorb excess interest, then it would be advisable not to use installment sale treatment.[81]

Simplified Dollar-Value LIFO

Under prior law, a small business (one with average annual gross receipts of $2 million or less for the three preceding years) could elect to use one pool for its entire inventory. A pool represents the dollar value for a group of similar inventory items and can be used to measure changes in inventory values.[82] The TRA improves the simplified dollar-value LIFO inventory method and makes it available to taxpayers with average annual gross receipt of $5 million or less for the three preceding years. The pre-TRA method was unpopular because it required computations of weighted-average price indexes for each component of the published price indexes. Under the new method, inventory values will be computed in separate pools based on the 11 Consumer Price Index pools (for retailers) or the 15 Producer Price Index pools (for other taxpayers).[83] A small business using the single pool method may continue to use it, as long as

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[81] Theodore B. Stone, "Planning Techniques for This Year's Alternative Minimum Tax on Industries," The Practical Accountant (December 1986): 17 - 40.

[82] Bullen, "Small Business," 13 - 24.

[83] Diss, "Small Business," 164 - 171.

the qualifications are met. The effective date is for tax years beginning after 1986. This provision will allow many small businesses to benefit from the LIFO inventory method who previously didn't use LIFO because of complexity or compliance costs.[84]

Uniform Capitalization of Indirect Expenses

The TRA of 1986 requires manufacturers, retailer, and wholesalers to capitalize both direct and indirect inventory, construction, and development costs (including interest) under comprehensive, uniform capitalization rules.[85] More specifically these rules require certain costs to be allocated to and capitalized as part of the cost incurred in manufacturing property, constructing property, or purchasing and storing inventories for resale. These costs include all tax depreciation and "financial conformity" costs; employee retirement, welfare, and fringe benefit costs; and a portion of general and administrative expenses. Wholesalers and retailers with average annual gross receipts of $10 million or less are excluded.[86] In addition, the new capitalization rules do not apply to research and experimental costs, to property produced under a long-term contract, or to property produced in a farming business.[87]

A relaxation of the new capitalization rules is provided for

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[84] Bullen, "Small Business," 13 - 24.

[85] Ibid, 13 - 24.

[86] Diss, "Small Business," 164 - 171.

[87] Stretch, "The 1986 Tax Reform Act," 50 - 70.

small long-term contracts. However, the contract must be expected to be completed within two years after the beginning date. The contracted work must be performed by a taxpayer with average annual gross receipts of $10 million or less for the three taxable years preceeding the year the contract was signed.[88] The new requirements will mean considerable increased record-keeping for companies with gross receipts of more than $10 million. Smaller companies will benefit since they are exempted from many of the requirements.[89]

Completed Contract Method

Previously, taxpayers could report income from long-term contracts on the completed contract method of accounting. The TRA substantially reduces the benefits of the method. All long term contracts are subject to the uniform capitalization rules. Amounts that must be capitalized include certain interest expenses incurred and cost that are attributable to the contract as identified by the taxpayer. For example, all general and administrative costs attributable to cost-plus contracts or attributable to federal government contracts which require certification of costs are treated as contract costs.[90] These costs must be capitalized regardless of whether such costs may be treated as period costs under existing regulations. However, independent research and development costs are generally not

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[88] Diss, "Small Business," 164 - 171.

[89] Bullen, "Small Business," 13 - 24.

[90] Ibid, 13 - 24.

capitalized.[91]

The current completed contract method has been replaced by a new "percentage of completion/capitalized cost method". This method applies to any long-term contracts except certain real property construction contracts. Under the new method, the taxpayer must use the "percentage of completion" method to take into account 40% of the items with respect to the contract. The remaining 60% of the items will be taken into account under the taxpayer's normal method of accounting. These rules are effective for contracts entered into on or after March 1, 1986.[92]

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[91] Stretch, "The 1986 Tax Reform Act," 50 - 70.

[92] Ibid, 50 - 70.

CHAPTER III

IMPLICATIONS OF TAX REFORM ACT '86 ON INDIVIDUALS

Many taxpayers are seeking the expert help of CPAs and financial planners in their attempt to file their income tax returns. Tax reform has created mass confusion for many taxpayers. The real problem is that the system is almost entirely new, not necessarily any harder. For example, taxpayers who itemize are encountering extra forms, new vesting schedules, and some rather complicated arithmetic.

Taxpayers being hit the hardest by tax reform are the 40 million long-form filers. This group includes those who take the mortgage-interest deduction, deduct state and local income taxes, or are self-employed. However, even those filing simple returns will be affected by some of the reform's changes. For example, some old deductions taxpayers once relied on have disappeared. These include the deductions for sales tax and working married couples.[93]

Probably the most publicized features of the new tax law are the tax cuts and closing of loopholes. However, it also contains the biggest set of reforms concerning the treatment of retirement benefits since the passage of ERISA. The provisions relating to

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[93] Miller, "The Tax Nightmare," 40 - 47.

pensions and other benefits comprised a quarter of the bill, making changes to almost every kind of retirement plan that was preferentially treated for tax purposes.[94] The following sections will discuss the major features of the new tax law as it pertains to the individual taxpayer.

Standard Deduction Increases

The standard deduction replaces the zero tax bracket amount. In 1987, the standard deduction is $3,760 for joint returns and surviving spouses, $2,540 for heads of households and singles, and $1,880 for separate returns. In 1988, for joint returns and surviving spouses, the standard deduction will be increased to $5,000. Additionally, the standard deduction will be $4,400 for heads of households, $3,000 for singles, and $2,500 for married couples filing separately. These amounts will be adjusted for inflation starting in 1989. An additional deduction of $600 is allowed for a married individual who is elderly or blind; $1,200 is allowed if the individual is both elderly and blind. Singles are allowed $750 and $1500, respectively, for being elderly or blind, or both. These rules take effect in 1987. The $600 and $750 deductions will also be adjusted for inflation starting in 1989.[95]

More people will probably use the standard deduction because so many itemized deductions have been cut or eliminated under tax

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[94] Diane H. Graper, "Is There Life After Tax Reform?" Institutional Investor (December 1986): 142 - 155.

[95] Robert W. McGee, "How the New Tax Law Affects Individuals," Management Accounting (December 1986): 22 - 26.

reform. However, a taxpayer may find it cheaper to itemize if he is a homeowner with a mortgage, lives in a high-tax state or has other big deductions. For example, a $70,000 mortgage at 10% interest can yield a write-off twice the size of the standard deduction.[96] Another increase that benefits the taxpayer is the personal exemption allowed for each dependent. In 1986, personal exemptions were worth $1,080. The law increases personal exemptions to $1,900 in 1987, $1,950 in 1988 and $2,000 in 1989. After 1989, exemptions will be adjusted for inflation.[97]

Adjustments to Income

Adjustments are subtracted directly from taxable income, and therefore reduce the amount from which you're taxed. The following changes affect adjustments to income. The "working-couple" deduction is repealed beginning in 1987. Formerly, working couples could deduct 10% of the lower-paid spouse's net earnings, up to a maximum of $3,000. In addition, the tax credit for political contributions and the benefit of income averaging are no longer available.[98] On the positive side, the "earned income credit" for low-income parents has been increased to 14% of the first $5,714 of earned income. Previously, it was 11% of the first $5,000 of earned income. The amount of credit is reduced as income rises, and beginning in 1988, the credit will

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[96] Jane Bryant Quinn, "How To Survive April 15," Newsweek, 29 February 1988, 42 - 46.

[97] Szabo, "Roses Among the Tax Thorns," 45 - 47.

[98] Jane Bryant Quinn, "Coping With Your 1987 Tax Return," Readers Digest, February 1988, 2 - 15.

be phased out at $17,000 instead of at $11,000 under prior law.[99]

TRA has added a temporary new adjustment for the self-employed. Up to 25% of the health insurance premium that covers the self-employed person, their spouse, and dependents can be deducted if they give the same insurance to anyone who works for them. This provision is effective for years 1987 through 1989. However, the deduction is not allowed if 1) the health insurance payments exceed the self-employed person's earned income for the tax year, or 2) if he is eligible to participate in a health plan offered by an organization that employs him or his spouse.[100]

Job related moving expenses and unreimbursed employee business expenses are no longer included as income adjustments; they are now itemized deductions. Some adjustments that will continue to be allowed under TRA include: 1) the deduction for regular payments of alimony, 2) deducting the penalty for early withdrawal from a certificate of deposit, and 3) the deductions for Keogh or Simplified Employee Pension plans for the self-employed. The special credit for child care expenses remains unchanged. Working parents in all tax brackets can take up to 30% of child care expenses as a tax credit. The maximum tax credit allowed is $720 for one child and $1440 for two or more children.[101]

Itemized Deduction Changes

Many deductions which were heavily relied upon under prior

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[99] Mcgee, "How the New Tax Law Affects Individuals," 22 - 26.

[100] Szabo, "Roses Among the Tax Thorns," 45 - 47.

[101] Quinn, "Coping With Your 1987 Tax Form," 2 - 15.

law have been reduced or eliminated, so taxpayers should take advantage of the ones that still exist. After 1986, state and local sales taxes can no longer be taken as an itemized deduction and the itemized deduction for certain adoption expenses has been repealed. However, deductions can still be taken for personal property taxes, state and local income taxes, real estate taxes, and mortgage points paid when buying a home. Taxpayers who do not itemize will no longer be able to take a deduction for charitable contributions.[102] In addition, the deduction for medical expenses can still be taken for itemizers, but only if the expenses exceed 7.5% of adjusted gross income. This has been increased from 5%. Also, certain personal residence expenses for the care of handicapped individuals, that were previously nondeductible, will become eligible for the medical expense deduction.[103]

Deductions are being phased out for consumer interest on credit cards; the interest on personal loans, such as auto, student, and insurance-policy loans; and the interest on overdue taxes. Only 65% of the interest is deductible in 1987, 40% in 1988, 20% in 1989, 10% in 1990, and zero thereafter. However, interest incurred on a principal or second residence will still be deductible. The new rules pertaining to home mortgages will be discusses in the next section.[104]

Several miscellaneous expenses are now only deductible to

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[102] Quinn, "How To Survive April 15," 42 - 46.

[103] Mcgee, "How the New Tax Law Affects Individuals," 22-26.

[104] Quinn, "Coping With Your 1987 Tax Form," 2 - 15.

the extend that, all together, they exceed 2% of the adjusted gross income. These expenses include union dues, professional or society fees, investment counsel, IRA fees, unreimbursed business expenses, job-hunting expenses, subscription to investment and professional publications, and tax preparation fees. In addition, the daily write-off allowed on a business trip is now limited. This amount cannot exceed two times the highest per-diem payment available to government employees traveling in the United States. Hence, the amount is limited to $252 a day since the current highest government per diem is $126.[105]

Home Mortgages

Almost all homeowners can still deduct all their mortgage interest. Also, most taxpayers will not have to file the complex new Home Mortgage Interest Form. This includes homeowners who fall into one of the following three categories: 1) the only debt against their home is the mortgage they took to buy it, 2) all the mortgages against their house were taken before August 17, 1986 or, 3) they refinanced or took a home-equity loan before the cutoff date and used all the money for home improvements.[106]

Homeowners still have a means of borrowing for consumer purchases and deducting the interest. The law allows, within limits, the deduction of interest on loans secured by a "qualified residence". This can be a principal residence and one

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[105] Quinn, "How To Survive April 15," 42 - 46.

[106] Ibid, 42 - 46.

secondary home used as a personal residence, such as a vacation home. However, mortgage interest from a third residence is not deductible at all. Also, interest deductions can be claimed when an individual refinances a first mortgage, takes out a second mortgage, or obtains a line of credit that is secured by equity in eligible property. The interest is deductible on loans obtained for any purpose, up to an amount equal to the original purchase price of the property plus the cost of improvements. Beyond that level, interest is only deductible on money borrowed for educational or medical expenses.[107]

Home Office Expenses

According to financial strategist, Charles Givens, "one of the best tax strategies is to start your own business whether you work full or part time or are retired". Taxpayers who do establish a home-based business will join the growing number of small business owners filing as individuals on Form 1040.[108] But, tax reform has closed some loopholes on home offices and certain requirements must be met before a tax deduction can be taken. For example, the owner must run his own business, the home office space must be used exclusively for work, and it must be where you spend most of your work time. If these requirements are met, the owner may then deduct office expenses. However, the amount that can be deducted is limited to the owner's net income from the business. The net effect is that home office deductions

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[107] Mark Moktarian, "The Ten Most Asked Tax Reform Questions," Nation's Business (August 1987): 28 - 31.

[108] Szabo, "Roses Among the Tax Thorns," 45 - 47.

cannot be used to create or increase a net loss from the business.[109]

Expenses that can be written off include "direct costs" such as phone bills, salaries and supplies. These direct costs may be written off even if they exceed the owner's net income. The office expenses that may be deductible include depreciation of work space, mortgage, utilities, taxes, and maintenance. Unused expenses deductions that exceed net income can be carried forward to later years. In the past, unused expenses could not be carried forward.[110] No deduction is permitted by an employee for expenses incurred when leasing a portion of his home to his employer. If the individual works for someone else, he must prove that the office is kept for the employer's convenience. In cases where the deduction is allowed, it is no longer deductible in full. It is now considered a miscellaneous deduction and is subject to the two-percent rule (i.e. the total amount of miscellaneous expenses must exceed two percent of the adjusted gross income).[111]

There are several incentives for employed people to start a home-based business. These incentives include benefits from lower tax rates on the extra income, the carry-forward of disallowed expenses to future years, and the temporary 25%

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[109] C. Clinton Stretch, "The 1986 Tax Reform Act: The New Rule For Individual Taxpayers," _The Practical Accountant_ (November 1986): 21 - 31.

[110] Quinn, "Coping With Your 1987 Tax Form," 2 - 15.

[111] Ibid, 2 - 15.

deduction for their self-paid health insurance, including payments for a spouse and dependents. In addition, the new "expensing" provision will work to benefit the home-based business owner. This provision allows some self-employed people and small companies to take an immediate deduction for equipment purchases, instead of depreciating these items. Under tax reform, up to $10,000 can be expensed which is twice the expense deduction previously allowed.[112]

Business Meals, Entertainment, and Travel Expenses

The deduction for business meals, travel and entertainment expenses has been reduced from 100% to 80% of the amount incurred. Tax reform tightens the requirements for the definition of a business meal. Business must be discussed before, during or after the meal, except for individual eating alone. The meal must have a clear business purpose directly related to the active conduct of the taxpayer's trade or business.[113] Exceptions are made for the following cases: 1) business banquets connected with qualifying business programs, 2) employer-paid recreational expenses, 3) items made available to the general public, and 4) items taxed as compensation to the recipient. Additionally, if the taxpayer receives reimbursment, the 80% deduction is applied only to the party reimbursing the taxpayer, in this case, the employer.[114]

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[112] Szabo, "Roses Among the Tax Thorns," 45 - 47.

[113] McGee, "How the New Tax Law affects Business," 54 - 57.

[114] Stretch, "The 1986 Tax Reform Act," 21 - 31.

Reducing the deduction for business meals and entertainment to 80% of their value will hit small business people particularly hard, according to Stephen Corrick of Arthur Anderson & Co. He describes entertainment as a form of advertising for the small business community. Many business owners will continue to do business over meals, but now they will have to absorb the difference between the cost and the amount that can be deducted.[115] In addition, the TRA phases out deductions for luxury sports skyboxes and limits deductions for travel on luxury boats. The deduction is limited to twice the highest federal per-diem expense for U.S. travel, times the number of days in transit. The Act also eliminates deductions for expenses incurred for 1) travel as a form of education, 2) charitable travel that serves personal, recreational or vacation purposes, or 3) the expense of attending an investment seminar or meeting.[116]

Tax Rate Structure

The Tax Reform Act replaces the previous rate structure in which rates ranged from 11% to 50% and contained 14 tax brackets. In 1987, the new rate structure will consist of 5 brackets. This will be changed again to a 2-bracket structure in 1988 and the years to follow. The following tables show the marginal tax rates on joint returns and single returns for 1987 and 1988.[117]

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[115] "Tax Reform's Varied Impact," 14.

[116] Stretch, "The 1986 Tax Reform Act," 21 - 31.

[117] Ibid, 21-31.

Taxable Income-Joint	Marginal Rate-1987	Taxable Income-Single
$0 - 3,000	11%	$0 - 1,800
3,000-28,000	15%	1,800-16,800
28,000-45,000	28%	16,800-27,000
45,000-90,000	35%	27,000-54,000
90,000 and up	38.5%	54,000 and up

Taxable Income-Joint	Marginal Rate-1988	Taxable Income-Single
$0 - 29,750	15%	$0 - 17,850
29,750 and up	28%	17,850 and up

In 1988 and later years, a 5% surcharge will be imposed on taxable income between $71,900 and $149,250 for joint returns, and between $43,150 and $89,560 for singles. The surcharge has the effect of increasing the highest marginal tax rate to 33%. Generally, the new lower rates mean that income should be deferred until 1987 or later.[118] However, the "working couple" deduction and "income averaging" are eliminated after 1986, so these effects should be considered. There are several ways to reduce taxable income which include: defer year-end bonuses, delay the closing of certain sales, delay collecting receivables, and invest in Treasury bills, certificates of deposit, or Series EE bonds that mature in a later year.[119] Lastly, the penalty for underpayment of taxes has been increased. Beginning in 1987,

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[118] Ibid, 21 - 31.

[119] Janice M. Johnson and William R. Stromsen, "The TRA and Individuals: A Year-End Rx," Journal of Accountancy (December 1986): 172 - 177.

taxpayers who must pay estimated taxes are required to pay at least 90% of their tax liability by the end of the tax year. The old law only required an 80% payment to avoid a penalty.[120]

Limitations on Passive Losses

The most far-reaching impact on real estate investors is the provision which limits the benefits of passive losses and credits. The limitations apply to all taxpayers other than widely held corporations. Passive income refers to income from limited partnership interests, from all rental activities, and from any trade or business the person doesn't materially participate in managing.[121] Tax shelters are investments designed to create "paper losses". Prior to tax reform, these losses were deducted from taxable income, thus lowering one's tax. Tax shelters have usually been structured as limited partnerships, which make an investor liable only for the amount of money he puts into the deal. Acquiring limited partnership interests allowed individuals to either postpone, reduce, or escape taxation.[122]

Under TRA, the tax losses from shelter-oriented limited partnerships and other passive activities can no longer be used to offset salary, professional earnings, or portfolio income. According to the new code, "portfolio income" includes interest,

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[120] Szabo, "Roses Among the Tax Thorns," 45 - 47.

[121] Philip J. Weisner, "Real Estate Syndications: Is There Life After Tax Reform," Journal of Accountancy (November 1986): 116 - 127.

[122] Edward C. Baig, "Whatever Became of tax Shelters?" Fortune, 1988 Investors Guide, 101 - 108.

dividends, and royalties; gains or losses attributable to the sale of investment property; and income from real estate investment trusts (REITs).[123] Instead, losses from passive activities generally can only be used to offset gains from other passive activities. Congress' purpose for this new provision was to restrict taxpayers from using passive losses for the purpose of avoiding taxes. The passive-loss rules apply to all passive losses and credits generated after December 31, 1986.[124] However, the passive-loss rules will be phased in over a period of 4 years for investors who purchased limited partnerships prior to the law's enactment. More specifically, only 65% of passive activities will be allowed against non-passive income in 1987, 40% in 1988, 20% in 1989, 10% in 1990, and 0% thereafter.[125]

A couple of exceptions exist concerning the passive-loss limitation. The rules do not apply to a "working interest" in oil and gas property if the taxpayer's liability is not limited. Therefore, losses and credits from this activity can be offset against other income. If the taxpayer is burdened with the cost of development and operation of the property, he is considered to have a "working interest" in the property. Also, an individual is allowed to offset up to $25,000 of non-passive income annually with losses and credits from rental real estate activities in which the individual actively participates. This allowance is

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[123] Wiesner, "Real Estate Syndications," 116 - 127.

[124] Haight, "Passive Losses," 64 - 67.

[125] C. Clinton Stretch, "The 1986 Tax Reform Act: The New Rules for Investors," The Practical Accountant (November 1986): 37 - 48.

reduced by 50% if the taxpayer's adjusted gross income exceeds $100,000 and is eliminated at $150,000 or greater.[126]

Net Capital Gains

Investors should consider re-examining their portfolios in light of the new tax laws. Beginning in 1987, TRA requires capital gains to be treated the same as ordinary income. Therefore, taxes must be paid on all net income from capital gains. Capital gains include profits from the sale of stocks, bonds, mutual funds, real estate, and other investments, after subtracting commissions. Previously, 60% of long-term capital gains went untaxed. "Long-term" refers to assets held for more than 6 months.[127] In addition, net capital gains are defined as the excess of net long-term capital gains for the year over net short-term capital losses for the year.[128]

According to TRA, the maximum rate that capital gains may be taxed at has been increased from 20% to 28% beginning in 1987. The maximum rate goes up to 33% in 1988 for upper-middle-income people. Because of this rate differential, it would have been advantageous for an investor with a highly appreciated portfolio to sell stocks before year-end. However, if an investor incurred long-term capital losses, it would have been advantageous to sell after 1986. Excess capital losses will be fully deductible

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[126] Stretch, "The 1986 Tax Reform Act," 37 - 48.

[127] Quinn, "Coping With Your 1987 Tax Form," 2 - 15.

[128] Stephen H. Collins, "Tax Planning For Closely Held Businesses," <u>Journal of Accountancy</u> (December 1986): 120 - 122.

against ordinary income, dollar-for-dollar, up to $3,000 a year. Losses over $3,000 can be carried ahead and written off in future years. Under the old law, only half of the long-term capital losses were deductible.[129] Although net capital gains have been capped at a maximum tax rate of 28%, net short-term capital gains will continue to be taxed at whatever the individual's maximum rate is. This rate could be as high as 38.5% in 1987, but it was 50% in 1986.[130] In view of these changes, planning for year-end securities transactions is extremely important.

Investors may want to develop a new investment strategy as part of their tax planning process. For example, TRA's elimination of the distinction between capital gains from investments and ordinary income may make dividend-paying stocks relatively more attractive than growth stocks. However, the dividend exclusion has also been eliminated after 1986.[131] Taxpayers may no longer exclude the first $100 of dividends received ($200 for joint returns). Instead, all dividend income is now taxable. In addition, tax-exempt bonds may become more popular to investors for reducing taxes under the new legislation.[132]

Another investment decision involves borrowing money to make investments (i.e. buying stock on margin). Beginning in 1987, the interest deduction write-off cannot exceed the amount the

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[129] Quinn, "Coping With Your 1987 Tax Form," 2 - 15.

[130] Collins, "Tax Planning," 120 - 122.

[131] Ibid, 120 - 122.

[132] McGee, "How the New Tax Law Affects Individuals," 22-26.

investment earns, plus 65% of anything over that amount. This extra deduction is capped at $6,500. By 1991, the interest deduction on borrowed money will not be allowed to exceed net investment income. The new law also requires reporting all tax-exempt interest. As before, this income is still not taxed, but the IRS needs this information to determine if the filer's tax on social-security income is being figured correctly. The filer may incorrectly be deducting interest on loans used to buy municipal bonds. However, the IRS won't know whether or not this sum is reported correctly because institutions that pay tax-exempt interest don't send a summary Form 1099 to the IRS.[133]

Alternative Minimum Tax

The alternative minimum tax (AMT) was originally designed by Congress in 1969 for those individuals whose tax liabilities have been significantly reduced by the use of "tax preference items". In essence, many of the tax advantages created by Congress were not only stimulating investments, but were also allowing many wealthy individuals to avoid paying taxes. Under tax reform, individuals who would otherwise greatly reduce their tax liability through the use of tax preference must recalculate their tax liability using the alternative minimum tax method.[134]

As under prior law, a person is subject to an AMT only if it exceeds their regular tax liability. However, the Tax Reform Act increases the AMT rate from 20% to 21% and also increases the

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133 Bill Powell and Rich Thomas, "Don't Roll Back Tax Reform," Newsweek, 29 February 1988, 47.

134 Haight, "Passive Losses," 64 - 67.

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[133] Bill Powell and Rich Thomas, "Don't Roll Back Tax Reform," Newsweek, 29 February 1988, 47.

[134] Haight, "Passive Losses," 64 - 67.

number of tax preference items. New tax preference items include: 1) tax-exempt interest on industrial development bonds issued after August 7, 1986, 2) net losses from passive activities, 3) all depreciation exceeding 40-year straight line for post-1986 real property, 4) and excess depreciation over the amount allowable on the 150% declining balance method for post-1986 personal property.[135]

The AMT rate of 21% is imposed on the alternative minimum taxable income (AMTI). AMTI is computed by adding the amount of tax preferences to the taxpayer's adjusted gross income, then reducing that total by the amount of alternative tax itemized deductions (ATID). There are only six ATIDs and they include the nonbusiness casualty and theft deduction, gambling losses, charitable contributions, medical and dental expenses, qualified interest, and the deduction for estate tax attributable to income in respect of a decedent.[136] Once the AMTI is determined, it is then reduced by an exemption amount to arrive at the "excess alternative minimum taxable income". This exemption amount is $40,000 for a married couple filing jointly, $30,000 for a single person, and $20,000 for married filing separately. The exemption is reduced by 25% of the amount that AMTI exceeds $150,000 for joint returns or $112,500 for single filers. Lastly, the excess AMTI is taxed at the rate of 21% to arrive at the alternative minimum tax.[137]

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[135] Weisner, "Real Estate Syndications," 116 - 127.

[136] Stone, "Planning Techniques," 17 - 40.

[137] Johnson, "The TRA and Individuals," 172 - 177.

IRAs and Retirement Plans

The Economic Recovery Tax Act (ERTA) of 1981 provided all taxpayers with a true incentive for individual retirement saving. The ERTA allowed individuals to contribute to an IRA and deduct either $2,000 or 100% of earned income, whichever was smaller. This investment can grow, year to year, with no tax obligation until the individual reaches retirement age, beginning as early as age 59 1/2. The Tax Reform Act has either reduced or eliminated this deduction for many taxpayers who are presently covered by employer-sponsored or Keogh retirement plans. For taxable years beginning after Jan. 1, 1987, individuals may no longer make tax-deductible contribution to an IRA if they are covered by a retirement plan at work or if their adjusted gross income (AGI) is greater than $35,000 for singles or $50,000 if filing jointly. Individuals with AGI between $25,000 and $35,000 ($40,000-$50,000 if filing jointly) may take only a partial pro-rata deduction. The full $2,000 deduction is allowed for individual whose AGI is less than $25,000 ($40,000 if filing jointly). In addition, the Act increases the penalty from 10% to 15% for early withdrawal from an IRA (before age 59 1/2).[138]

Individuals who do not participate in employer-sponsored retirement plans may continue to take the IRA deduction regardless of their income. An employer-sponsored retirement plan includes the following: 1) "401(k)" plans including pension, profit-sharing or stock bonus plans, and Keogh plans;

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[138] Gary D. Stadtmauer and Leonard J. Whittman, "401(k) Plans: The Pro's and Con's," The Practical Accountant (July 1987): 21 - 26.

2) a qualified annuity or tax-sheltered annuity plan; 3) a Simplified Employee Pension plan (SEP); and 4) a plan sponsored for employees of the federal, state, or local government.[139] The purpose of the new legislation was to prevent taxpayers from building up both IRA and retirement plans to the maximum limits for each. Therefore, the Act reduces the $2,000 IRA contribution by the amount of the employee's salary deferral through a retirement plan.[140]

Previously, an employee could defer up to $30,000 of salary annually through a retirement plan such as the 401(k). However, after Dec. 31, 1986, the deferral is limited to $7,000 a year. This limit will be adjusted to inflation beginning in 1988. In addition, there is a 10% penalty tax on early withdrawal from a 401(k) plan, as well as, payment of income tax on the sum. Under prior law, an individual could take out the employee's portion of the contributions, the account's earnings, and sometimes, even the employer's contributions. This was allowed if the individual retired, left the company, became disabled, or could prove hardship. However, an employee can borrow on the amounts that build up in a 401(k) account without paying the 10% penalty tax.[141]

Pensions and Employee Benefits

It has been estimated that about $9 million will be raised

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[139] Ibid, 21 - 26.

[140] Joe Wiltsee, "How New Tax Laws Will Affect You," Business Week Careers, March 1986, 54 - 57.

[141] Denise M. Topolnicki, Company Benefits Reel From the Zeel," Money, October 1986, 54 - 57.

for the Treasury by changes in the tax treatment of lump-sum distributions from contributory pension and savings plans.[142] Before tax reform, a person age 59 1/2 or older, could roll over a lump sum into an IRA within 60 days after receiving it. Or, the person could take the money and pay tax on it using 10-year forward averaging. This method allows the person to pay taxes as if the cash had been received over 10 years instead of all at once. Under tax reform, Congress has retained the rollover provision, but has reduced 10-year averaging to 5 years for a lump sum received after age 59 1/2. However, the new law allows a person who is age 50 by Jan. 1, 1986 to use either 5-year averaging with the new rates or 10-year averaging with the old rates to calculate tax on a lump-sum distribution.[143]

Another $5 billion will be generated from tax changes that restrict the size of benefits that can be funded and paid out annually from retirement plans.[144] Previously, the maximum pension benefit that could be collected was $90,000 a year if an individual stopped working at age 62. If the individual retired between ages 55 and 61, the maximum was gradually reduced to $75,000 a year. The new tax law retains the $90,000 maximum pension benefit, but a person must retire at age 65 instead of 62. In addition, only a maximum of $40,000 is allowed for those who retire at age 55. However, benefits that have accrued prior to 1987 are exempt from the new limits. Therefore, highly paid

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[142] Groper, "Is There Life After Tax Reform?" 142 - 145.

[143] Topolnicki, "Company Benefits Reel," 109 - 116,

[144] Groper, "Is There Life After Tax Reform?" 142 - 145.

executives with long tenure at their companies won't have to be pressured to retire this year.[145]

The new tax law requires corporate pension plans to fully vest employees after 5 years of service instead of the previous requirement of 10 years. As an alternative, an employer can provide 20% vesting after completing 3 years of service followed by a 20% increase in vesting for each subsequent year until 100% is reached after 7 years. This rule doesn't go into effect until 1989, but the years already served with a company by then will still count.[146] Beginning in 1987, the amount of annual pay that a company can use to determine an employee's pension will drop to $200,000, but will rise thereafter with the cost of living. Before tax reform, there was no limit. However, benefits that have built up in an employee's account before 1987 will not be affected.[147]

In addition, another new tax penalty will be levied if a pension is too big. The reform imposes a 15% tax on total distributions from qualified plans in excess of $112,500 a year. If an employee chooses to take the money in a lump sum, a 15% tax will be imposed on amounts exceeding $562,500. The tax does not apply to benefits accrued before Aug. 1, 1986. Lastly, tax reform repeals the current income tax exclusions for car pooling. It does extend the tax exclusion for employee educational

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[145] Topolnicki, "Company Benefits Reel," 109 - 116.

[146] Szabo, "Welcome To Tax Reform," 20 - 28.

[147] Donna DiBlase, "Tax Measure Contains Many Pension Changes," Business Insurance (27 October 1987): 35 - 36.

assistance benefits and group legal benefits through 1987. Also, it is recommended to take advantage of the company car benefit instead of using a personal car for company business. This is because only business-related expenses that exceed 2% of adjusted gross income can be deducted.[148]

Children and Tax Reform

Tax reform will impact children and the tax they owe in more ways than one. For the first time, a taxpayer who claims an exemption for a dependent who is at least five years old must include that person's social security number on the return. The new rule was aimed at reducing the number of taxpayers who claim their dog or cat as a dependent. Also, the IRS wants to use it as an identifier to catch divorced parents who both claim the same child on their separate tax returns. This rule becomes effective in 1987, and a $5 fine will be charged for not reporting a social security number in 1988.[149]

Another impact of tax reform on children reguards students on scholarship. Under new legislation, scholarship money used to pay for tuition, books, course fees, and supplies is considered tax-free. However, students must now report as taxable income any grants that cover room, board, travel, and incidental expenses. Tuition reductions granted in exchange for teaching or other services must also be reported. In addition, students not getting credits toward a degree, including many of those who

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[148] Ibid, 35 - 36.

[149] Quinn, "How To Survive April 15," 42 - 46.

attend summer school, must pay taxes on their entire scholarship. Generally, only the largest scholarships will fall into the taxable territory.[150]

In general, children with income from employment, trust funds, or savings accounts will probably pay more tax this year. Previously, the family unit was able to reduce its total tax by transferring interest and dividend producing assets to minor children. For example, the arrangements provided by a "Clifford Trust" allowed such a transfer. This transfer allowed the income to be taxed at the child's lower rate. Beginning in 1987, TRA requires that "unearned income" exceeding $1,000, of a child under age 14, to be taxed at the parent's top marginal rate.[151] There is a personal exemption of $500, and the first $500 of the child's unearned income will be taxed at the child's lower rate. Thus, a child may have up to $1,000 of unearned income before tax is imposed at the parent's rate.[152]

This rule applies reguardless of the source of the assets creating the child's net unearned income. It doesn't matter when the transfer of income producing assets occurred. For example, "unearned income" from a trust established as a gift at birth will be taxable at the parent's rate until the child reaches age 14, if it exceeds $1,000. However, the child's "earned income" is taxed to the child at the child's marginal tax rate.

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150 Miller, "The Tax Nightmare," 40 - 41.

151 McGee, "How the New Tax Law Affect Individuals," 22 - 26.

152 Anthony Billings and Ted D. Englebrecht, "Impact of TRA '86 On Trusts, Estates and Gifts," The CPA Journal (February 1987): 50 - 57.

The overall impact of the new rules reveals that intra-family gifts and income-shifting trusts generally won't be as useful in family tax planning in the future. Emphasis should now be placed on appreciation rather than income-producing investments and on deferring income until the child is 14 years old.[153]

As previously mentioned, the "Clifford Trust" was commonly used by parents as a means of shifting income to a child's lower bracket. Originally, the arrangements of a Clifford Trust provided that the grantor would not be taxed if he would not be receiving the principal back within ten years. The new law deletes the ten-year rule, thus eliminating the tax advantage of a Clifford Trust. Instead, a grantor is taxed on any portion of a trust in which the grantor has a reversionary interest that exceeds 5%. Therefore, income from the trust will be taxed to the grantor if greater than 5% of the the trust's principal will be reverting back to the grantor or the grantor's spouse at any time. The key to taxability has shifted from the time of the reversion to the value of the reversion. Additionally, all trusts, other than charitable trusts, must use the calendar year as their taxable year. Thus, the tax deferral that would otherwise result when the recipient's tax year is different from the trust, has been eliminated.[154]

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[153] Johnson, The TRA and Individuals," 172 - 177.

[154] Billings, "Impact of TRA '86," 50 - 57.

CHAPTER IV

SUMMARY AND CONCLUSIONS

Evaluating the Tax Reform Act of 1986 requires a comparison between the losses made from reducing tax rates and the gains sustained by the broader tax base. Overall, the new individual tax system is fairer than the former one. For example, millions of poor families have been removed from the tax rolls, and many tax loopholes have been closed. The change in rules governing tax shelters is especially helpful for the economy because it prevents the limited savings available from being invested in unprofitable projects. Previously, losses were desirable because of the tax breaks they offered. Tax shelter reform makes it much more difficult for affluent people to avoid paying taxes.

It is unclear whether the 1986 individual reforms will increase economic efficiency. One evaluation estimates that the rate reductions in the TRA will raise labor supply by only .9% for the average person in the economy. Also, eliminating IRA deductions for many taxpayers will probably reduce personal saving even below its current low level. Eliminating preferential tax treatment for capital gains may simplify the tax code and prevent some tax shelter activity, but it may also discourage investors from holding corporate equities. This could make capital markets less efficient if individuals forego recognizing large capital gains in order to avoid paying taxes on them. In general, the reforms affecting individuals improve tax

fairness at a large revenue cost, but according to its critics, does little to stimulate incentives to work, save, and invest.[155]

Overall, tax reform will raise corporate tax revenues by a projected $120 billion over the next five years. A closer look at this figure reveals that investments already in place actually receive tax "benefits" totaling $68 billion, whereas the "burden" on new corporate capital rises by $188 billion. The net result is a $120 billion increase in corporate tax revenues. This shift in tax burden is biased in favor of capital already in place, which helps companies that have previously invested heavily. Therefore, it will remove the incentive for capital investments which is required for economic growth. According to a recent study by Don Fullerton, deputy assistant secretary for tax policy, the tax reform changes made in 1986 will raise GNP by less than 1%.[156] Since the Act is suppose to be revenue neutral in comparison with the old law, the projected $120 billion increase in corporate taxes means that individuals will be paying about $120 billion less. However, it is more likely that the new law will raise more taxes than the old law, rather than being revenue neutral.[157]

Although the 1986 Tax Act will probably reduce capital investment, it may actually increase the competitiveness of U.S. industry in the short run. The reduced investment incentives

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[155] Summers, "A Fair Tax Act," 53 - 59.

[156] Ibid, 53 - 59.

[157] McGee, "How the New Tax Law Affects Business," 54 - 57.

will make investing in the U.S. less attractive to foreigners and will reduce the amount of capital flowing in. Therefore, the dollar will continue to decline, making exports cheaper and imports more expensive. This will improve the trade balance, at least for the time being. However, a reduction in capital investments will require U.S. workers to use less modern equipment and will result in lower productivity. Hence, improving competitiveness by reducing capital investment is shortsighted. In order to simultaneously raise investment and international competitiveness, national savings must be increased. Ironically, the low level of national savings is a leading economic problem. The Tax Reform Act of 1986 made the tax system fairer and eliminated a number of significant abuses, but according to its critics, did not address the national savings problem. In addition, they believe it may compromise future economic growth by scaling back investment incentives.[158]

Reducing the federal deficit is another major concern for Congress and increasing tax rates seems to be the easiest way to accomplish this, according to many politicians. This would involve revising the basic tax rate structure of tax reform, the 2-bracket structure. However, other options do exist for reducing the deficit. For example, Congress could remove more loopholes, and at the same time improve simplicity and fairness. If Congress eliminated interest exemptions on municipal bonds, an additional $2.5 billion could be raised. Also, taxing social security as ordinary income would generate $15 billion. Congress

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[158] Summers, "A Fair Tax Act," 53 - 59.

could even double the tax on cigarettes to 32 cents which would raise an extra $3 billion. Taken together, these adjustments could significantly reduce the deficit without revising the basic tax structure.[159]

Another possible method to reduce the federal deficit, as well as, restore investment incentives would be to impose new federal taxes on consumption. This could be accomplished through value-added taxes, sales taxes, or business transfer taxes. Each of these options taxes consumption in the same way, they differ only with respect to where the tax is collected in the distribution channel. The intentions of consumption taxes are to encourage personal savings and help increase American competitiveness, instead of reducing investment incentives. Consumption taxes would burden people based on what they withdraw from the economy, not on what they contribute.[160]

As discussed above, critics of TRA 1986 expected the economy to be damaged and capital investing to be significantly reduced. Contrary to their opinion, the economy has continued growing slowly but steadily, and investment spending has been increasing at a reasonable rate. Many economists believe investment spending is now going toward more productive assets, like plant and equipment, instead of wasteful office-buildings that was previously encouraged by the benefits of tax loopholes.[161] With the lower tax rates, individuals and businesses can make

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159 Powell,"Don't Roll Back Tax Reform," 47.

160 Summers, "A Fair Tax Act," 53 - 59.

161 Powell,"Don't Roll Back Tax Reform," 47.

decisions that are based primarily on economic factors, rather than on tax factors. Supporters of TRA believe the lower rates will increase the incentive to earn, and will decrease the incentive to invest in tax shelter. In the long run, they expect the new tax system to encourage businesses and individuals to allocate their resources more efficiently.[162] This in turn will create more wealth and employment, and therefore will benefit the economy.

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[162] McGee, "How the New Tax Law Affects Business," 54 - 57.

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