The 1984 Deficit Reduction Act Deserves Scrutiny
Because Its Intent is to Raise $50 Billion Revenues—
While Cutting Spending

By William I. Knopf, Jr.

The 1984 Deficit Reduction Act, signed into law by President Reagan on July 18, is historic—not because of its length, although it comes close, but rather it is the first tax act in history to be driven specifically by the ever-increasing federal budget deficit.

The act is designed to raise $50 billion in deficit-reducing revenues through 1987, and will “cut spending” by an estimated $11 billion over the same period.

As a spokesman for the “big eight” accounting firm of Touche-Ross says, “a model for tax simplification this act is not”. The final version signed by President Reagan is 770 pages long, and has 329 separate provisions. The act is a patchwork of election year compromises from the original 1,000 page House bill and 1,300 page Senate bill. Touche-Ross claims that the legislation “contains more words per dollar of revenue raised than any other act in the nation’s history”.

Most tax analysts are suggesting that as far as the construction industry goes, the pros and cons of the act balance out to have little immediate impact on aggregate industry margins, although certain provisions may hurt individual sectors. In other words, the additional restrictions on sale-leaseback agreements and the more restrictive caps on industrial development bonds will hurt those AWCI members engaged in commercial and industrial work, while provisions like the extension of mortgage revenue bond programs will benefit residential contractors. According to the National Association of Realtors, over 200,000 houses were purchased under these plans in 1983 alone.

Conversely, AWCI members engaged in building rental housing might be hurt by a provision that increases the write-off period from 15 to 18 years, taking away what IRS gave us in 1981’s tax act. This will reduce the return on investments for investors and discourage building, in addition to making all real property in the country worth a little bit less than it was previously.

Look deeper into the act and you are bound to find another provision which offsets the one before it. For instance, although the write-off period has been lengthened, the act eliminated withholding tax levied on foreign investors’ securities. The Federal National Mortgage Association was in favor of this provision, assuming it would expand the market for mortgage-backed securities. For AWCI members involved in homebuilding, this provision should help offset the depreciation changes.

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Diminished Markets

Those AWCI members engaged in industrial and heavy commercial work might find their markets diminished somewhat by the new $200 million cap on state industrial development bonds (exceptions including multifamily rentals, convention centers, airports and docks) and the new restrictions on sale-leaseback agreements for public property, such as solid-waste and water treatment plants.

One benefit to many AWCI members of the tax act is a liberalized
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test your customers can use for claiming rehabilitation credits. Previously, 75% of the external walls of a structure had to remain in place after the rehabilitation. Now, the credit will be available if (1) at least 50% of the external walls are retained as external walls, or (2) at least 75% of the external walls remain as external or internal walk, or (3) at least 75% of the building’s internal structure remains in place. This is effective for all rehabilitation work begun after 1983.

On the other side of the coin, your corporate customers will now be required to capitalize and amortize over 10 years construction-period interest and taxes on residential property (other than low-income housing) in tax years beginning after this year on all construction projects begun after March 15, 1984. This will tend to discourage this type of building activity.

One area of the tax act that will affect many contractors is the new restrictions on luxury cars used for business purposes. Regardless of the cost of the automobile, a taxpayer can take a maximum of only $16,000 in depreciation deductions in the first three years of ownership, with $4,000 in the first year and $6,000 annually thereafter. Any unrecovered basis after three years can be deducted at a maximum of $6,000 per year. At this rate, it will take six years to write off a $30,000 car that previously could be depreciated in just three years. The previous 6% investment tax credit is also now limited to a maximum of $1,000 per vehicle. These numbers will be indexed to take inflation into account. Rental deductions for leased vehicles are also similarly affected.

If an auto is not used entirely for business purposes, these amounts will be reduced to reflect the percentage of business use. If it isn’t used at least 50% for business, no investment credit will be allowed and depreciation for the business portion will be placed on a straight-line basis for five years.

**Employment Condition**

An employee will not be eligible for investment credit or depreciation deductions on personal autos used in business unless the use of the car (or truck in our case) is a condition of employment. However, taxpayers are still entitled to take the standard mileage deduction of 20.5 cents per mile for business use up to 15,000 miles per year, not very liberal when most studies indicate the average operating cost for a domestic compact is closer to 45 cents per mile. Accurate documentation is mandatory; you must now certify in writing to your tax preparer that records exist before claiming tax benefits on returns. No more recreating last year’s mileage on April 14; negligence penalties can be imposed if you get caught in addition to disallowing the deduction.

While on the subject of business autos, you probably won’t have to worry about the new 6¢ increase in the diesel fuel tax for your car or company
trucks—a one-time rebate for vehicles of less than five tons was approved as a compromise measure.

Unfortunately, maximum IRA contributions have not been increased, and you can no longer get more time to make your current year contribution by filing for an automatic four-month extension. Deposits in IRA accounts must be made by April 15 following each taxable year.

The act includes several revisions to the “top-heavy” pension plan rules added in 1982. In general, an employee retirement plan is considered top heavy if more than 60% of the benefits are for key employees, who are defined as those earning over $45,000. The act noted that the popular 401(k) salary reduction plans will not be disqualified if the plan satisfies the general anti-discrimination rules and “average deferral percentages”. For plan years beginning after 1984, in testing whether the employer is providing each non-key employee the required minimum contribution, elective employee deferrals under a 401(k) plan are treated as employer contributions.

The whole question of top heavy plans can be eliminated by a new concept being introduced in several areas called employee leasing. Essentially, under this program, which was developed in response to the last tax reform legislation, an employer fires his office staff and leases them back from a central pool. He then remains the only “employee” of the corporation, free to design a pension program to his specifications, not to the government’s. This program and others like it would only prove viable for open shop contractors in AWCI.

Getting back to the Deficit Reduction Act, Employee Stock Ownership Plans’ (ESOPs) tax credit for contributions remain at 0.5% of the participants’ compensation (it was due to rise to .75%) until expiration in 1987. However, the tax bill does allow for tax-free rollovers of stock sold to ESOPs, exchanges of employer stock in return for assuming estate tax liability and deductions for dividends paid out to employees.

Turning to what the act means to you as an individual taxpayer, the good news is that the period that assets (such as stocks, bonds, gold and real estate bought after June 22, 1984) must be held to qualify for preferential capital gains treatment has been reduced from 12 to 6 months. Long-term capital gains are taxed at 40% of your federal bracket, while short-term gains are taxed at regular rates. Unfortunately, the holding period reverts back to one year in 1988.

Estate and gift taxes under the new act will drop to a maximum of 55% through 1987. In 1988 and subsequent years, the rate drops again to 50%.

**Generosity Expensive**

Unfortunately, the bill also makes some interest-free loans subject to income tax, gift tax, or both, based on imputed rates of return set by current interest rates. Loans at below market rates will be considered as two transactions: a loan to the borrower bearing deductible interest with income to the lender, and as a payment by the lender to the borrower of the amount of interest foregone as a gift, dividend, or compensation. Both individuals making interest-free loans to relatives and corporations making them to key employees will have to reassess their practices. Essentially, it will cost you much more to be generous. These rules apply to loans made after June 6, 1984.

Other portions of the tax act affecting your personal finances include the requirement of independent appraisals for charitable contributions of property valued in excess of $5,000, more stringent regulation of tax shelters which allow taxpayers to deduct write-offs exceeding their investments, the
elimination of “crown loans” for shifting investment income to a child in a lower bracket, and more restrictive rules for income averaging.

We are not philosophers or economists. We are contractors trying to make payroll Friday. As we have seen, the net effect on our industry is debatable at this time; some provisions will tend to divert capital away from the industry while other provisions will attract it. The residential sector appears to have emerged from the legislation somewhat stronger than the commercial, even with the new depreciation schedules. The provisions passed which affect commercial construction markets will likely not be felt by AWCI contractors for several years at the earliest. Other provisions will affect your individual finances and it will take the tax attorneys several months to find new loopholes to replace those that have been closed. The bottom line is that IRS, under the banner of reducing the deficit, has managed to increase tax revenues by $50 billion without incurring a tax increase, per se, in an election year.

And you have to applaud a job well done, even if it’s been done to you.