The Complexities of a NEW TAX ACT

The Tax Laws Have Become Much More Complex in Certain Areas With the 1984 Tax Reform Act — And Contractors Should Study the Situation Carefully

The 1984 Tax Reform Act made wide-ranging changes in the existing tax law. The result is basically a much more complex law than before, requiring careful attention by taxpayers and CPAs alike. Some of these changes are pertinent to nearly all businesspeople.

- The holding period for long-term capital gains has been temporarily cut to six months. The reduced holding period applies to assets purchased between June 22, 1984, and January 1, 1988. Beginning on January 1, 1988, the holding period will once again become one year. Because only 40% of a long-term gain is taxed at ordinary income rates and the maximum tax bracket is 50%, the maximum tax rate on a long-term gain is 20%.

- There are new restrictions on business tax breaks for automobiles, computers, and other equipment also used for personal purposes. You must have documentation that the car or equipment is used more than 50% of the time for business reasons before you can take advantage of any investment credits or accelerated depreciation allowances.

Under the old rule, the allowable Investment Tax Credit was 6% of the purchase price with no ceiling imposed on the price. The new law states that luxury cars costing more than $16,666 are allowed a maximum credit of $1,000, while those cars costing $16,666 or less are allowed an ITC of 6% of the purchase price. The accelerated depreciation schedule has also been changed. Now depreciation is limited to $4,000 for the first year and $6,000 for each succeeding year until the entire cost less 50% of the ITC is written off. As under the old law, the ITC and depreciation are reduced proportionately for the time the car is driven for non-business purposes.

- Laws governing income averaging have been changed. Basically, fewer taxpayers will be eligible to take advantage of income averaging. Under the old law, you were eligible to average your income on your return if your income for the current year was more than $3,000 higher than 120% of your average taxable income for the previous four years. In other words, if your average income in the previous three years was $30,000, you would have to earn $45,000 in the current year to take advantage of income averaging ($30,000 x 140% = $42,000. $42,000 + $3,000 = $45,000). Not only has the new law raised the basis for income averaging, it has also shortened the time over which income can be averaged.

- When property is transferred as part of a property settlement in a divorce proceeding, the old law treated the transfer as if the property had been sold by the transferring spouse, thereby incurring taxable income. The new law basically treats property transfer pursuant to a divorce as nontaxable event. The property is transferred at book value, and the basis for the property transfers over to the recipient spouse. The new rules apply to transfers that take place after July 18,
1984, unless the parties elect to have the new law apply to transfers that have taken place since December 31, 1983.

• Corporations with taxable income of over one million dollars will lose the benefit of the graduated tax rates that currently apply over the first $100,000 of income. Because of the graduated rates, a savings of $20,250 is presently possible. The new law states that once taxable income has reached one million dollars, a tax of 5% is levied on the excess over the one million dollars up to the $20,250 threshold. A corporation with taxable income of over $1,400,000 will find that they have lost the benefit of any savings and are taxed at a flat rate of 46%. These revised rules do not affect 1983-1984 fiscal year operations.

• Stringent restrictions have been placed on that controversial but favorite tax-planning device, the interest-free loan. Loans with a fixed maturity date made on or before June 6, 1984, are safe from the new tax law. Demand loans that can be called at any time by the lender will be hit by the new law unless the loans are paid back by September 15, 1984. The new law is complicated, but it may result in tax liabilities for both the lender and the borrower. Be sure to consult an expert before entering into an interest-free loan agreement.