What Tax Reform Means to You

It’s Finally Here, and It’s Time You Understood It

By Joseph Arkin, C.P.A., M.B.A.

By now every taxpayer is sick and tired of the outpouring of news and political maneuvers concerning President Reagan’s proposals for changing the Internal Revenue Code of 1954, as amended.

There is a new tax law—the Tax Reform Act of 1986—and whether you agree or disagree with the new law’s provisions, you had better understand how it affects your business enterprise.

Presented here are salient provisions of the newly enacted Internal Revenue Code of 1986 as the new Act will be known.

**Investment Credit:** The present investment credit for both vehicles and capital equipment is eliminated, retroactively to January 1, 1986.

For those with carry-over credits the bad news is that the transition rules provide for a reduction of 35% for 1987 and 17½% for 1988.

**Depreciation:** Under existing law you can deduct 25% of an automobile’s cost the first year, 38% the second year, and 37% in the third year. There is a special rule for “luxury” autos. Prior to April 3, 1985 an auto costing $16,000 or more could be depreciated $4,000 the first year, $6,000 the second year, $6,000 in the third year, and the balance in following years, until the entire cost was recovered. An auto purchased after April 3, 1985 is considered in the luxury class if its cost was $12,800 or more. First year depreciation was $3,200, second year $4,800, third year $4,800, and the balance depreciated until entire cost was recovered.

If you are using the automobile in your business (and we’ll assume that it is 100% for business) you can continue to deduct depreciation as outlined above for 1986 and for all subsequent tax returns.

Fixtures, machinery and related business fixed assets subject to depreciation used 15% the first year, 22% the second year, and 21% for the third, fourth, and fifth years.

Here again for any assets placed in service prior to December 31, 1986, you can continue to take depreciation as heretofore. (Note: under ACRS rules taxpayers could elect not to use accelerated depreciation and could elect special straight line method.)

Automobiles, light trucks, special technological equipment and other items now fall into a new five year class.

Depreciation for such items placed into service after December 31, 1986 will be depreciated over the five year period on a 200% declining balance method, i.e., $10,000 assets depreciation will be 40% or $4,000 the first year, $2,400 the second year, $1,440 in year three, $864 in year four and $522 in year five.

Luxury autos will be depreciated $2,133 in the first year and $4,210 each year thereafter until entire cost is recovered.

**How To Prepare For Tax Reform**

Accountants generally agree that most small companies will have a difficult time adjusting to the new tax law because it involves so many changes in so many areas of the tax code.

Here are some hints they offer business owners:

- Carefully weigh any purchase of equipment and personal property, because the law eliminates the investment tax credit. A main concern is what the equipment’s ultimate contribution to your business’ profitability will be.
- Review pension plans. The law’s changes will make it necessary to rewrite them by 1989.
- Calculate what your income and deductions will be for 1986, 1987 and 1988 under the new bill. The aim is to determine what expenses to take and how much income to defer.
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Similar adjustments with new yearly lives are established for assets placed into service after December 31, 1986.

Home Office: The present rules of who can deduct for a home office are retained with one big refinement. The home office deduction if premises are rented by an employee to his employer are limited to the net income from the business. This will preclude showing a loss as a result of including home office expenses as part of total expenses. Any amount not currently deductible because of this rule may be carried forward. The effective date of this rule is January 1, 1987.

Real Estate: Where real estate is used in a trade or business it can continue to be depreciated under old rules (and use of lives) if placed into service prior to January 1, 1987.

Non-residential real estate placed into service after December 31, 1986 will now have to be depreciated on a straight line basis of a 31½ year life span.

On disposition of real estate there will be no recapture of depreciation.

Expensing of Equipment: Under present law you can elect to expense the first $5,000 of equipment purchased in 1986. The new law raises this to $10,000 for purchases made after December 31, 1986 if the firm has less than $200,000 of tangible personal property.

Business Meals and Entertainment: The cost of qualifying meals can only be deducted to the extent of 80%, even for meals furnished to employees. This is going to cause one big headache in record keeping. The unallowable 20% for corporations will probably get charged to retained earnings, while proprietorships and partnerships will probably charge the 20% to drawing or capital accounts.

The excess cost of tickets over face value is no longer deductible (in 1987), but a special rule allows the surcharge to be deductible if for a charity-sponsored sporting event.

Business Travel: Deductions after December 31, 1986 are curtailed for educational travel, and cruise ship and other luxury water travel is limited to two times the Federal per diem rate. There will be certain exceptions.

Net Operating Losses: Years ago the IRS attacked the outright selling of net operating losses. Now if there is a 50% change in ownership there will be
restrictions placed on NOL being carried forward.

**Dividend Income Credit:** Present law allows a corporation to reduce its dividends received from domestic corporation by 85%. This figure after Dec. 31, 1986 will be reduced to 80%.

**Corporation Tax Rate:** Through June 30, 1987 the top rate will be 46%, thereafter it drops to 34%, giving a yearly average of 40%.

**Solar Energy:** Install devices in your business premises qualifying for the credit will entitle you to 15% cash credit in 1986, 12% in 1987 and 10% in 1988.

**Capital Gains:** The corporate capital gain rate is set at 34% for tax years beginning after December 31, 1986.

**Accounting Methods:** Where inventory is a material factor in determining a taxpayer’s taxable income, the accrual method of accounting must be used. Others had an option of using the cash method or the accrual method.

The new law provides that corporations or partnerships with a C corporation as a partner must be on the accrual basis (picking up income and expenses when incurred, not when paid).

Exceptions to this rule are farms, qualified personal service corporations and entities with average annual gross receipts of less than $5 million.

**LIFO Inventory:** Firms doing less than $5 million in average annual sales can use the simplified dollar value LIFO method. Check with your accountant to see if the simplified method can help you.

**Tax Year:** Partnerships, S corporations and personal service corporations must have the same year as partners owning a majority interest. Rule effective January 1, 1987 will hurt those firms who must change from a fiscal to calendar year and report more than twelve months income in a single year.

**New Medical Expense Deduction:** A self-employed person, one who usually loses out on most fringe benefits, now finally picks up one. The self-employed taxpayer can deduct 25% of the cost of medical insurance, limited to the net earnings of the business. This means that the inclusion of this new expense cannot give rise to a loss. Catch: The taxpayer cannot be covered by a plan of other employment, nor of a spousal plan. Note that a partner is considered to be self-employed.

**Deferred Compensation Plans:** Employers operating in the corporate form can have both stockholders and other employees participating in a 401K Plan. The new maximum contribution for years after December 31, 1986 is set at $7,000. Those who participate in SEPS are likewise limited to $7,000 and they cannot make contributions to an IRA if they have contributed $7,000.

**IRA Investments:** Years ago a prohibition was enacted into law stating that IRA funds could not be invested in collectibles. Beginning January 1, 1987 an IRA can be invested in gold and silver coins minted by the U.S. Government.
**Reporting Rules:** Your employees must give you a new Form W-4 before January 1, 1988 or you'll have to take withholding based on only one allowance for a single person, two allowances for a married person.

**Targeted Jobs Credit:** You can deduct 40% of the first year’s wages as a credit, with no credit for subsequent years. The credit will expire in 1989.

**Compliance Rules:** There is a penalty of $50 (up to $100,000) for each category where you don’t furnish W-2 or forms 1099. Also, new penalty of $5 (up to $20,000) for failure to file correct information or for making omissions.

The present 1/4% per month penalty for failure to pay taxes when due is raised to 1% per month. (25% maximum), after notification by IRS of a threat to levy. Effective date is December 31, 1986.

**Real Estate Depreciation:** Own residential property? You should continue to deduct depreciation under old rules. But for property placed into service after December 31, 1986 the write-off is based on 27 1/2 year life, computed on straight line basis. Up to now we have concentrated on those rules and changes specifically relating to business enterprises.

Sweeping changes in rates, handling of certain types of income, and deductibility of specific disbursements have great impact on individual tax liability.
- The two-wage earner credit (Schedule W) to eliminate some portion of marriage penalty is eliminated after Dec. 31, 1986.
- Income averaging over a four year period is likewise eliminated after Dec. 31, 1986.
- The 10-year income averaging for lump-sum distributions from pension plans is replaced in 1987 by a 5-year average. But distributions can still be rolled into an IRA to defer taxes.
- Earned income credit has new 14% of first $5,000, with maximum credit of $800.
- Unemployment insurance is now fully taxable after Dec. 31, 1986.
- There are no longer deductions allowed for state or local sales taxes, after Dec. 31, 1986.
- The medical expense disallowance is raised to 7 1/2% of the amount of adjusted gross income for years after Dec. 31, 1986.
- Moving expenses no longer deducted from adjusted gross income on page 1. They now must be taken on Schedule A, itemized deductions. (Not subject to new 2% rule.) This too for 1987, not 1986.
- The costs of attending investment seminars are not deductible after Dec. 31, 1986.
- Employees business expenses will no longer be deducted on Form 2106. They now must be taken as itemized deductions and will be subject to 2% disallowance of adjusted gross income figure. This too for 1987, not 1986.
- Other deductions such as investment data expenses, tax preparation, safe deposit box, union and professional dues, work clothes, etc. will likewise to shown on Schedule A as heretofore, but now will be reduced by

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2% of adjusted gross income figure. For 1987.

- Political contributions after Dec. 31, 1986 will no longer be deductible.
- The $100 dividend exclusion for singles, $200 for marrieds filing jointly will be eliminated after Dec. 31, 1986.
- IRAs now have new rules. Those who are covered by a qualified pension or profit sharing plan, or a Keogh, or a 401 K, who earn over $25,000 if single, $40,000 if married, face restrictions. For each $5 of taxable income over the threshold, $1 of the IRA contribution will not be deductible. Those with income over $35,000 if single, $50,000 on joint return will get no deduction at all. If married, your spouse being in a plan will affect your right to the deduction.
- Interest deductions for consumer interest loans will be phased out. 65% deductible in 1987, 40% in 1988, and 20% in 1990.
- Losses from rental property, unlike under present law, arising out of depreciation, interest, rental expenses, etc. can only be deducted to the extent of gross rental income. Thus no loss is allowed, unless offset against profitable property.
  Exceptions were written into this provision — those with losses under $25,000 who “actively manage” their property, and who also earn less than $100,000 are in position to still deduct losses.
- Have children over 5 years of age? Claim them as a dependent? You need to get them a social security number as you’ll need to show this on returns filed in 1988 and thereafter.
- Start now to get into habit of keeping record of all non-taxable or exempt income. Beginning in 1988 this will have to be shown.
- Capital gains taxable will be taxable on full amount in 1987, not 60/40 split as now. But rate for 1987 will be set at 28% even if taxpayer is in higher bracket. Losses in excess of profits in 1987 will be deductible without cutting them in half. $3,000 rule stays.

About the author: Joseph Arkin has a BBA degree from St. John’s University in accounting, an MBA degree from Pace University in taxes. He is licensed by the States of New York and Florida as a Certified Public Accountant. He has written extensively for trade and professional magazines.