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TAX REFORM ACT OF 1986: PUBLIC LAW 99-514
IP267T

On October 22, 1986, President Reagan signed into law H.R. 3838, the Tax Reform Act of 1986, P.L. 99-514. This tax revision measure establishes two tax rate brackets of 15 and 28 percent for individuals and a corporate income tax rate of 34 percent, to take effect in tax year 1988. For tax year 1987 there will be a blend of old and new rates. This Info Pack includes a summary of the new law and provides information on the following topics:

General provisions affecting individuals.....p.	1
Treatment of real estate and second homes.....p.	10
Retirement savings provisions and pensions (includes IRAs, 401(k)s, vesting, and distribution).....p.	14
Corporate tax change overview.....p.	25

The enclosed CRS report on the effects of the new tax law (IB87010) lists other reports on special topics.

Please note that the IRS will be issuing new regulations on many of the law's provisions. We cannot answer in detail specific questions regarding an individual's tax liability; one may need to consult with a nearby IRS office, or seek the advice of an attorney or accountant.

CRS does not have copies of P.L. 99-514 for distribution. Many Federal depository libraries and other libraries with collections of legal material have copies of the law available for reference use. The full text of the law may be purchased from:

Superintendent of Documents
U.S. Government Printing Office
Washington, D.C. 20402

Tax Reform Act of 1986: P.L. 99-514
Stock no.: 822-009-00274-6
Price: \$24 (prepaid)

Additional information on the effects of the new tax law, primarily in newspapers and periodicals, can be found in many local libraries through the use of indexes such as the Readers' Guide to Periodical Literature and the Wall Street Journal Index.

Members of Congress desiring additional information may call CRS at 287-5700.

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COMPARISON OF CURRENT LAW AND TAX REFORM ACT OF 1986

Individual Taxes

Provision	Current Law	New Law
Individual Tax Rates	15 rate brackets from 11 percent to 50 percent, indexed	Two rate brackets set at 15 and 28 percent, indexed, effective 1988; 15-percent bracket phased out for high income taxpayers creating top marginal rate of 33 percent; five rate brackets in 1987 set at 11 percent, 15 percent, 28 percent, 35 percent, and 38.5 percent
Capital Gains Rate	60-percent exclusion, 20-percent effective rate	Exclusion repealed, effective for taxable years after Dec. 31, 1986; the maximum rate on long-term gains is 28 percent in 1987
Personal Exemptions	\$1,080, indexed	\$1,900 in 1987, \$1,950 in 1988, \$2,000 in 1989, indexed thereafter, phased out for upper income taxpayers
Zero Bracket Amount <i>Single</i> <i>Joint</i> <i>Heads of household</i>	\$2,480 \$3,670 \$2,480	New standard deduction \$3,000 (\$3,750 if blind or elderly; \$4,500 if blind and elderly) \$5,000 (\$5,600 if blind or elderly; \$6,200 if blind and elderly) \$4,400 (\$5,150 if blind or elderly; \$5,900 if blind and elderly)
Dividend Exclusion	\$100/\$200 exclusion	Exclusion repealed
Income Averaging	Lower marginal rate of 40 percent of the excess over the average of the prior 3 years	Repealed
Two-Earner Deduction	Allowed (\$3,000 maximum)	Repealed
Earned Income Credit	Allowed (\$550 maximum)	Increased (\$800 maximum)
Fringe Benefits <i>Health</i> <i>Group-term life insurance, legal services, dependent care, education assistance, van pooling</i>	Not taxed Not taxed	Not taxed, with 25-percent deduction for self-employed \$50,000 exclusion for life continued; legal services, education assistance extended through 1987; \$5,000 cap on dependent care; van pooling not extended
Wage Replacement <i>Unemployment</i> <i>Workers' compensation</i>	Taxed if AGI over \$12,000 (\$18,000 if married) Not taxed	Taxed Not taxed

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COMPARISON OF CURRENT LAW AND TAX REFORM ACT OF 1986

Individual Taxes

Provision	Current Law	New Law
Itemized Deductions		
<i>State and local income, property, and sales taxes</i>	No overall cap Deductible	No overall cap Sales tax deduction repealed
<i>Charitable contributions</i>	Deductible (non-itemizer deduction expires after 1986)	Deductible for itemizers. Deduction for non-itemizers allowed to expire
<i>Mortgage interest</i>	Deductible	Deductible for principal residences, second homes, with anti-abuse provision limiting deduction to the basis of the property plus improvements, student loans, and medical expenses
<i>Other interest</i>	Personal interest deductible; investment interest limited to \$10,000 over investment	No deduction, except for net investment interest
<i>Medical Expenses</i>	Deductible above 5 percent of AGI	Increase floor to 7.5 percent of AGI
<i>Meals and entertainment expenses</i>	Deductible	Deductible up to 80 percent
<i>Passive, tax shelter losses</i>	Generally, no limit to use of deductions	Deductions disallowed against income other than passive income, with exceptions for rental real estate and oil and gas ventures: phased in over five years, with special exceptions for real estate tax credits
<i>Misc. Expenses</i>	Hobby/gambling, employee home office, union dues, etc., no floor	Floor of 2 percent of AGI, with full deduction for certain other expenses
Retirement Savings		
<i>IRA limit</i>	\$2,000	\$2,000 deduction for taxpayers without employer retirement plans, and for joint filers with AGIs up to \$50,000 and singles up to \$35,000
<i>Spousal IRA</i>	\$250	\$250, allow for spouses with no compensation
<i>401(k) plans</i>	\$30,000 annual deferred limit	\$7,000 limit, indexed beginning in 1988; no IRA offset
Minimum Tax	Alternative tax set at 20 percent	21 percent rate, adding preferences, including passive losses, tax-exempt interest on newly issued public purpose bonds, untaxed appreciated property contributed to charities
At-Risk Rules	Generally not applicable for real estate	Extend to real estate, with third-party financing exemption
Generation-Skipping Taxes	Tax on trusts and similar arrangements having beneficiaries in more than one generation below donor	Flat tax of 55 percent, dropping to 50 percent in 1988. Direct transfers would be taxed, with exception for some grandchildren
Unearned Income of Minor	Generally taxed at child's marginal rate	Generally taxed at parent's marginal rate for child under 14 with exception for first \$1,000 of income

How the Bill Would Simplify 1988 Tax Brackets

Married Couple Filing Jointly

INCOME BRACKET PAY BASE TAX OF PLUS THIS PERCENTAGE OF AMOUNT OVER LOWER BRACKET

Conference Bill

\$ 0	\$ 0	15%
29,750	4,463	28

Current Law*

\$ 0	\$ 0	0%
3,860	0	11
6,250	263	12
8,640	550	14
13,520	1,233	16
18,180	1,979	18
22,960	2,839	22
27,960	3,939	25
33,980	5,444	28
40,000	7,130	33
52,050	11,106	38
68,190	17,239	42
97,280	29,457	45
124,330	41,630	49
184,570	71,147	50

Single Filer

INCOME BRACKET PAY BASE TAX OF PLUS THIS PERCENTAGE OF AMOUNT OVER LOWER BRACKET

Conference Bill

\$ 0	\$ 0	15%
17,850	2,678	28

Current Law*

\$ 0	\$ 0	0%
2,610	0	11
3,860	138	12
5,000	274	14
7,390	609	15
9,660	949	16
12,270	1,367	18
14,660	1,797	20
17,050	2,275	23
20,680	3,110	26
26,710	4,678	30
32,730	6,484	34
38,750	8,531	38
47,160	11,727	42
62,850	18,316	48
92,970	32,774	50

NOTE: Inflation adjustments are calculated using the Congressional Budget Office's economic projections, which show inflation of about 5.8% over the next two years.

*The current-law includes standard deductions. Under the conference plan, the standard deduction is subtracted from taxable income before taxes are computed.

Source: *Coopers and Lybrand*

How Rich and Poor Fare Under Tax Bill

Proposed percentage tax cuts, by income group

INCOME CLASS (In thousands)	CONFERENCE BILL 1987	1988
Less than \$10	-55.2	-65.7
\$10 to \$20	-16.4	-22.3
\$20 to \$30	-10.7	-9.8
\$30 to \$40	-9.4	-7.7
\$40 to \$50	-9.7	-9.1
\$50 to \$75	-0.7	-1.7
\$75 to \$100	+5.2	-1.0
\$100 to \$200	+5.6	-2.4
\$200 and above	+11.4	-2.3
TOTAL	-1.6	-6.1

Source: *Joint Taxation Committee*

Tax Overhaul Milestones

Aug. 5, 1982 Sen. Bradley and Rep. Gephardt introduce their tax overhaul plan.

Jan. 25, 1984 President Reagan orders the Treasury to study tax overhaul.

April 26, 1984 Rep. Kemp and Sen. Kasten introduce their version of tax overhaul.

Nov. 27, 1984 Treasury Secretary Donald Regan unveils Treasury I.

May 29, 1985 President Reagan endorses a new plan, Treasury II, devised by Treasury Secretary James Baker and Deputy Treasury Secretary Richard Darman.

Nov. 23, 1985 The Ways and Means Committee passes its tax-overhaul bill, which has a top individual tax rate of 38% and takes a bigger whack at business than does the president's plan.

Dec. 17, 1985 After first being blocked by House Republicans, the Ways and Means bill is passed by the House by voice vote.

April 29, 1986 Forced to withdraw his own package because it is laden with special-interest amendments, Chairman Packwood of the Senate Finance Committee unveils another plan with a top individual tax rate of 27%.

May 7, 1986 Senate Finance Committee unanimously approves 27%-rate tax bill. It would kill most tax shelters, curtail individual retirement accounts, and raise business taxes less than the House bill. Top corporate rate would be 33%.

June 24, 1986 By a vote of 97-3, the Senate passes the Finance Committee's bill with only minor changes.

Aug. 16, 1986 House-Senate Conference Committee approves compromise bill that sets top individual rate at 28%, corporate top rate at 34%.

The Tax Bill of 1986: Progressive System Is Kept

Tax System to Remain Progressive, Experts Say

By ROBERT PEAR

Special to The New York Times

WASHINGTON, Aug. 17 — For people with low and moderate incomes, the tax bill represents the most important advance in Federal policy in more than a decade, according to both liberals and conservatives.

Moreover, the bill reflects a historic consensus in Congress that there should be less use of the tax code as an instrument of social policy.

At first blush, the new system, with two tax-rate brackets for individuals, appears less progressive than the current law, which sets 14 rates for people at different income levels. But this assessment is superficial and probably wrong, according to tax experts, who say the new system will be just about as progressive as the present one.

The supposed progressivity of the current system is a complete sham," said Eugene Steuerle, an economist at the American Enterprise Institute who formerly worked in the Treasury's Office of Tax Analysis. "The high statutory rates create a mirage. The new tax code will not be significantly less progressive."

To be sure, the current rates are finely graduated and appear highly progressive. But so many types of income are excluded from taxation that the effective rates people actually pay are much less progressive than the tax rate schedule would suggest.

What People Actually Pay

Census Bureau data show that households with pre-tax incomes of \$50,000 or more actually paid, on the average, 18.3 percent of their incomes in Federal income taxes in 1984, while those making \$15,000 to \$17,500 paid 6.9 percent. Under current law the rate for married couples with incomes of \$50,000 or more ranges from 38 percent to 50 percent on the last dollar of income.

Under one commonly used definition, a tax is said to be progressive if taxpayer

ers at higher income levels pay larger proportions of their incomes in taxes than people at lower levels.

The bill shifts part of the individual income tax burden to corporations. The corporate income tax is generally believed to be progressively distributed because, according to many economists, it is indirectly paid by higher-income individuals (whose dividends and capital gains are smaller than they would otherwise be). The rise in corporate taxes may thus enhance the overall progressivity of the tax structure.

Harvey Galper, an economist at the Brookings Institution, said: "You can't just look at the statutory rates. You have to look at the effective rates people actually pay on their income. The current effective rates are not so progressive we can't match them with lower tax rates and a broader base."

One of the most significant achievements of the new tax bill is to remove about six million low-income households from the tax rolls. This was an essential component of the political bargain that produced a bill cutting tax rates for people at all income levels.

Bill's Changes for the Poor

The bill would eliminate Federal income taxes for most working people below the poverty level and for a significant number just above the poverty line. A family of four was classified as poor in 1985 if it had cash income of less than \$10,989.

Robert L. Greenstein, director of the Center on Budget and Policy Priorities, a research and advocacy group, noted that "Federal tax burdens on working poor families have increased dramatically in recent years." A family of four at the poverty level had to pay 10 percent of its income in payroll and income taxes last year, as against 4 percent in 1978.

The main reason for the increase in these burdens, Mr. Greenstein said, is that three key features of the tax code

affecting lower-income working families — the personal exemption, the standard deduction and the earned income tax credit — "have all been severely eroded by inflation."

However, he said, the new tax bill "does not so much extend the safety net as repair a hole that has developed since 1978." The bill, he said, "only compensates for tax increases on the working poor in recent years and returns tax burdens on low-income families to the levels of the late 1970's."

The bill, he said, does little or nothing for families so poor that they currently have no income tax liabilities.

Families With One Parent

Single-parent households, a group of great concern to social policy experts, fare well under the bill. Under present law, such households must pay more in taxes than two-parent families with the same income because their standard deduction is considerably less (\$2,390 for single heads of households, as against \$3,540 for married individuals filing joint returns).

By raising the standard deduction for single heads of households closer to that for married couples, the new bill significantly reduces the difference in tax treatment of the two types of families. Forty-eight percent of all poor families are headed by women with no husband present, according to the Census Bureau.

Single heads of households, like two-parent families, will also benefit from the bill's increase in the personal exemption for dependents.

Alicia H. Munnell, senior vice president of the Federal Reserve Bank of Boston, said people would probably consider the tax system fairer after the bill becomes law. If so, she said, "there would be less incentive to evade taxes and perhaps more acceptance of the civic duty to pay taxes."

There would still be winners and losers at every level. People with incomes above \$200,000 a year who are involved in limited partnerships and other tax shelters may experience large increases in their tax bills — \$50,000 a year. But some people with similar income from interest and dividends can look forward to tax cuts of similar magnitude.

Analysis of the 28% Rate

Despite the fact that families with taxable incomes of \$50,000 would be subject to the same 28 percent marginal rate as families with \$2 million of income, tax experts said the new system would be at least as progressive as present law. Tax breaks used almost exclusively by the wealthiest taxpayers would be curtailed under the bill, they said. The broadening of the tax base will generally be greatest for people at the highest income levels because they have taken most advantage of opportunities to avoid taxes under current law. So they will experience the greatest increases in tax liabilities, the experts said.

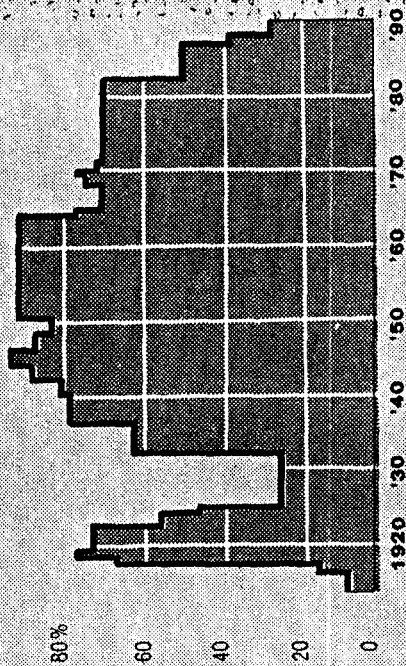
The bill appears to reduce incentives for construction and rehabilitation of housing for low-income families, and some people are concerned that this may reduce rent increases that offset the tax cuts for these families.

Douglas B. Diamond, an economist at the National Association of Home Builders, said that "we expect rent increases averaging well over 10 percent" for lower-income families. Even increases of 5 percent would fully offset the tax savings that the typical low-income renter will receive, he said.

Mr. Steuerle, the economic staff coordinator for the Treasury's 1984 tax proposal, said the legislation may also alter the behavior of homeowners. "There will be less tendency to mortgage your house to the hilt," he said.

The Top Rate for Individuals

The maximum income tax rate for individuals since 1913, in percent



Source: Joint Committee on Taxation.

"It may once again become profitable for families to build up equity in homes rather than borrow against them, because the effective tax subsidy given to borrowing will be reduced."

Economic Emphasis Seen

This, he said, is part of a larger pattern. Under the bill "there will be more of a tendency for individuals as well as businesses to look at the economic effects of their actions, rather than just the tax effects," he explained.

The bill does not tax employers' contributions to employee health plans. The Treasury and the Reagan Administration have proposed such levies several times in the last few years.

But the bill does tighten the rules for pensions and other retirement savings plans to make sure that people use the money for the intended purposes and do not withdraw it early. People who

withdraw savings for personal consumption, purchase of a home or other purposes would be subject to larger penalties than under current law.

Frank B. McArdle, a spokesman for the Employee Benefit Research Institute, a nonpartisan organization, said: "Congress provided tax benefits for these programs to insure that people would have retirement income. If the programs are not used for that purpose, Congress concluded, the tax incentives are not working properly."

In addition, he said, the tax bill reflects Congress's conclusion that "there need to be tighter rules to insure that pension, health, life insurance and other employee benefit programs do not unduly favor higher-paid workers." If a benefit plan unduly favors the best paid workers, he said, the extra benefits would be subject to taxation.

AFTER REFORM: **Borrowing**

The New Math of Managing Your Personal Debts

You may lose some prized interest deductions, but the rules will still leave you plenty of borrowing room.

BY DEBRA WISHIK
ENGLANDER

If you are a credit junkie, watch out. The tax reform bill of 1986 has eyes for you—the eyes of a narc staring down a crack dealer. Several of the most important changes:

- ▶ A gradual elimination for itemizers of tax write-offs for interest payments on personal loans and consumer debt, including credit-card finance charges and loans for cars, vacations and school bills.
- ▶ A limitation on the number of houses—two—for which you can claim a deduction for mortgage interest.
- ▶ A cap on the amount of interest you can deduct for most home-equity loans.
- ▶ A strict limit on how much you can deduct for interest charges on loans from your broker.
- ▶ And, most of all, a cut, because of lower tax rates, in the value of interest deductions. This will raise the after-tax cost of all borrowing, including that for buying a house. Take, for example, an interest deduction of \$1,000. Under current law, it reduces a top-bracket taxpayer's IRS bill by \$500. Next year, with the top rate at 38.5%, his savings will be \$385; in



"I pay for almost everything by credit cards. After reform, I'll cut back. I may start carrying cash when I go shopping."

—KAREN ROBINSON OF VOORHEES, N.J.

MONEY, OCTOBER 1986, P. 91, 92, AND 96.

Borrowing

1988, with him in the 28% bracket, he will save only \$280.

As a result of the new math, you will have to pay closer attention to the after-tax cost of debt. The basic post-reform principle, according to Timothy Kochis, national director of personal financial planning at Deloitte Haskins & Sells in San Francisco, is that most taxpayers "must change from assuming all interest is deductible to realizing that almost no interest, except for a loan secured for a house, is deductible."

What follows are details on how the new tax law will bash borrowers—and how borrowers can bounce back:

Consumer interest. Starting on Jan. 1, deductions for interest payments on consumer debt will be phased out. The schedule specifies that next year, 65% of your consumer interest payments will be deductible; in 1988, 40%; in 1989, 20%; in 1990, 10%; and in 1991, the write-off will vanish altogether.

The change will turn smart shoppers into amateur accountants as they try to determine whether paying cash is better for them than buying on credit. If you are considering buying a new car, for example, you may still be able to come out ahead by borrowing despite the loss of the interest write-off. Say you are in the 28% tax bracket after reform fully takes effect and borrow \$10,000 at 6.9% interest. Over the customary four-year period for such a loan, you would pay \$1,380 in nondeductible interest. But, by not paying cash, you could theoretically invest that \$10,000. If you put the money in Treasury bills paying 7%, you would earn \$2,170 after tax over four years, more than compensating you for the interest payments on the loan.

You can get ready for the new math on consumer credit by paying off, or at least paying down, any credit-card balances. If you must carry balances on plastic, you can get a list of banks offering cards with finance charges as low as 12% for \$1 from Bankcard Holders of America, a non-profit consumer group, 333 Pennsylvania Ave. S.W., Washington, D.C. 20003.


Home-equity loans. If you own your house, you will still be able to use it as a versatile financing tool, despite tax reform's new limits on home-equity loans. As of Jan. 1, only mortgage interest on

Borrowing

Tax reform will let you borrow against your house, for example, to buy a car or consolidate your other consumer loans.

loans up to the purchase price of your house, plus the cost of improvements, may be deducted. Also still deductible: interest charges on home-equity loans used to pay for medical expenses or a child's education.

The reform rules, though crimping the deductibility of interest on home-equity loans, which can be as large as 80% of the appraised value of your house, still leave you plenty of borrowing room. For example, if you bought a house for \$100,000 five years ago, financed \$80,000 of it and have since made \$10,000 worth of improvements and paid down, say, \$1,000 of principal, you could deduct the interest payments on a home-equity loan of up to \$31,000. The tax bill would then let you use that line of credit, say, to buy a car or consolidate debts on which interest payments will lose their tax deductibility.

Margin loans. Under the bill, if you borrow on margin from a broker or use a brokerage-house line of credit to make an investment, the interest you pay will be deductible only to the extent that it is offset by investment income from such sources as dividends, capital gains and limited partnerships. If you want to deduct \$1,000 worth of interest on margin debt, for example, you must report at least \$1,000 of investment income on your 1040. What is more, you will no longer be able to write off interest on such debt if you use the money for something other than investments. Currently, you can borrow on margin or use a brokerage line of credit for any purpose, and the interest you pay is deductible up to the amount of investment income you report plus \$10,000. In the future, you may have to provide the IRS with documentation that you actually used the money to make an investment. 

AFTER REFORM: **Saving**

Creative Ways to Save for College

Some excellent tax-advantaged options will survive, but you will have to be agile to benefit from them.

BY ROBIN MICHELI

First the bad news. The challenge of building savings to pay for your children's education—which was never easy—will be even tougher after the revised tax law takes effect. Items:

- ▶ Unless you use home-equity loans (see the story on page 91), you will no longer be able to deduct the interest on money you borrow for college.
- ▶ Your son or daughter will have to pay tax on any scholarship money that doesn't go for tuition and fees.
- ▶ And your ability to cut taxes by shifting your savings to your child through gifts and trusts will be restricted severely.

Some superb tax-advantaged ways to save will remain. But Bruce Scharf, a partner in the Circle Consulting Group, a financial planning firm in New York City, warns: "Parents are going to have to be more creative now."

Under the old law, you could transfer investments to your offspring through two principal means: Clifford trusts, in which assets are held in your child's name for 10 years before reverting to you, and custodial accounts established under the Uniform Gifts to Minors Act (UGMA), in which assets are owned by your child outright. In both cases, earnings on those assets were taxed at your child's rate, no matter what his age, rather than at your presumably higher rate, making it easier for you to build funds for school bills.

No more. The not-so-pleasant details:

Clifford trusts. Under the new law, all income from newly created Cliffords will be taxable to whoever sets up the trust, whether they be parents, relatives or friends. If you have already established a Clifford, its tax treatment will depend on when you did so. Income from trusts created before March 1, 1986 will be taxed at your rate until your child reaches age 14.

Then his tax rate will apply. But if you set up the trust after that date, the income will be taxed at your rate even after your child hits 14. Best advice: You probably won't be able to dissolve an existing Clifford, so if yours beats the March 1 cutoff, load it with tax-deferred investments such as U.S. Savings Bonds. If it is newer than that, your best option is tax-exempt municipal bonds. ➡



"We'll probably buy municipal zeros in our own name. Why use trusts anymore?"

—JOHN DILLOW AND HIS FAMILY OF SEATTLE

MONEY. OCTOBER 1986. PGS. 101, 102, AND 106.

Saving

Custodial accounts. You can still put as much as \$10,000 a year (\$20,000 if you give jointly with your spouse) in an UGMA account for each child. But only the first \$1,000 of income from new and existing accounts will be taxed at your child's rate if he is under 14. On anything above that, your rate applies. Once your child turns 14, however, all the account's earnings will be taxed at his rate. Best advice: make as heavy use of UGMA accounts as you can, bearing in mind your child's age so that you can invest the money in ways to keep taxes low. For example, if your child is under 14 and his account now consists of income-oriented stocks, such as utility shares that have risen since you bought them, sell the stocks before the end of the year while the capital gains will still be taxed at your child's rate. Then reinvest the money in fast-growing companies. When your child reaches 14, you can sell the shares and any gain will be taxed at his rate.

Put the proceeds in the safest high-yielding investment you can find, since the interest will no longer be taxed at your rate. Current examples of such investments include high-grade corporate bonds (currently yielding around 9.5%) and risk-free one-year Treasury bonds, paying 5.4%. You should avoid risky investments at this point because with college only a few years away, you may not have enough time to recoup losses.

Another way to postpone taxes while you build savings in a young child's account is to buy supersafe Series EE U.S. Savings Bonds with maturities that fall after the child's 14th birthday. The bonds currently pay at least 7½% annually if held for a minimum of five years. The interest won't be taxed until the bonds mature.

An alternative tax-deferred investment is life insurance. The policy's cash value will increase over the years with no taxes due on the earnings until withdrawal. Eventually your child could borrow at low rates from the policy to pay school bills without owing any tax at all. For example, you might pay annual premiums of \$5,100 for a \$250,000 universal life policy that nets, at present, 7¼% a year. If current rates of return hold, after

Please note:
The interest rate
was reduced to 6%
as of 11/3/86.

Saving

After reform, all earnings on gifts made to children by grandparents will be taxed at the child's rate.

18 years a child born this year would have up to \$178,000 to borrow against for college at below prevailing bank rates.

Don't overlook tax-exempt securities. Yields on them have been extraordinarily high lately, with 30-year municipals paying about 7½%, compared with 7¼% for taxable Treasuries of similar maturities. Zero-coupon municipal bonds are especially well suited to college savings plans. They pay no interest. Instead you buy them at a deep discount from face value and receive the full amount when the bonds mature. Thus you can count on accumulating a specified sum of money by the time you need it. But make sure that any zeros you buy can't be redeemed before their maturity date by the issuer. Recently you could buy a 10-year, \$1,000 zero municipal yielding 7% for \$400.

One apparent loophole in the new rules on custodial accounts offers an unbeatable option if you can take advantage of it. Under the revised law as now written, all earnings on gifts made to children by grandparents, other relatives or even friends are taxed at the child's rate, no matter what his age. Such a benefactor can give as much as \$10,000 a year tax-free to each of your children.

But don't be hasty about transferring money to your folks or Aunt Nellie for them to deposit in your kids' college kitty. The IRS is expected to be on the lookout for such fancy footwork. Barry Salzberg, a partner in the accounting firm of Deloitte Haskins & Sells, advises: "The two gifts, from parent to grandparent and grandparent to child, cannot be remotely simultaneous." If they are, you could have to pay the IRS the difference between the taxes owed at your rate and at your child's as well as interest and penalties. □

SELECTED PROVISIONS AFFECTING REAL ESTATE AND HOUSING

(Excerpts): Understanding the 1986 Tax Changes, Touche, Ross & Co.

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Low-Income Housing Credits

The 1986 act allows three new tax credits for investors in low-income housing: for construction, acquisition, and rehabilitation of low-income housing. These new credits replace a number of incentives for investment in low-income housing.

1. *New construction or rehabilitation of existing housing.* A maximum tax credit of 9 percent per year for 10 years for expenditures on new construction or rehabilitation of qualifying low-income housing units not financed with tax-exempt bonds or other federal subsidies.

2. *New construction or rehabilitation financed by federal subsidies.* A credit of 4 percent a year for 10 years on expenditures for construction or rehabilitation of low-income units financed by tax-exempt bonds or other federal subsidies.

3. *Acquisition costs of existing housing.* A credit of 4 percent a year for 10 years on the acquisition costs of low-income units.

For the first two credits, expenditures must exceed \$2,000 per low-income unit. Also, the first two credits can be applied in addition to the third. In other words, if existing housing is acquired for low-income use and it is rehabilitated without federal subsidies, the total annual credit would be 9 percent of the rehabilitation expenditures plus 4 percent of the acquisition costs. These credit percentages will be adjusted to reflect changes in interest rates.

Residential rental projects are eligible for the credit if at least 20 percent of the units are occupied by individuals with incomes of 50 percent or less of the area's median income, or if 40 percent of the units are occupied by people with incomes of 60 percent or less of the area median. The rent that can be charged must also be limited.

The depreciable basis of property subject to these credits is *not* reduced by the amount of low-income housing credit claimed.

The amount of credit given is limited by a state volume cap. In general, each state is granted rental housing tax credits of \$1.25 per state resident.

Use of the low-income housing credit is subject to the passive-loss rules described above. Thus the credit may not be available to offset tax other than tax generated by passive income. However, the credit will be available to offset tax on up to \$25,000 of ordinary income as long as the taxpayer's AGI is not over \$200,000. This treatment phases out for AGI between \$200,000 and \$250,000.

Effective date: Generally, property placed in service after 1986 and before 1990.

Source: Understanding the 1986 Tax Changes; An Executive Summary

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Rehabilitation Credit

Previous law allowed a tax credit for the costs of rehabilitating older buildings. The credit rates were 25 percent for certified historic buildings, 20 percent for buildings more than 40 years old, and 15 percent for buildings more than 30 years old.

The 1986 act significantly modifies the rehabilitation credit—to 20 percent for certified historic structures and 10 percent for other buildings placed in service

before 1936. As under previous law, certified historic structures can be residential or nonresidential, but other buildings must be nonresidential.

The definition has also been revised for those parts of the original building that must be retained in the rehabilitation. To qualify for the credit, buildings other than certified historic structures must retain at least 75 percent of the existing external walls (50 percent as external walls), and at least 75 percent of the building's internal framework must also be kept.

The basis for depreciation of any rehabilitated building is reduced by the full amount of any rehabilitation credit claimed.

Effective date: The modifications in the new law generally apply to buildings placed in service after 1986. Transition rules apply to buildings for which there was a binding contract for rehabilitation or in which rehabilitation had begun before March 1, 1986. Provided the transition requirements are satisfied, credits will be available if the property is placed in service before 1994. There are also special transition rules for many specified buildings and projects. The new law has transition rules for specified buildings and for buildings under certain rehabilitation contracts on March 1, 1986, that reduce the 20 percent credit to 13 percent and the 15 percent credit to 10 percent.

Real Estate Investment Trusts

A real estate investment trust (REIT) is an entity that receives most of its income from passive real estate investments and distributes most of its income annually to shareholders. If numerous conditions are satisfied, the REIT will not be taxed on income distributed to shareholders. The REIT will generally be taxed only on retained and undistributed income.

The 1986 act changes the following REIT provisions, which make it easier for entities to qualify for and benefit from that status and imposes a new excise tax for insufficient distributions. To the extent that the actual REIT distribution to shareholders is less than a required amount, a nondeductible 4 percent excise tax is imposed.

Election as a REIT. An entity is not precluded from electing REIT status solely because it is closely held in its first year. An automatic change of accounting period is granted with the initial election of REIT status. Established corporations that have accumulated earnings and profits must distribute them to elect REIT status.

REITs are permitted to hold assets in wholly owned subsidiaries. Income to a REIT from newly invested capital is treated as qualifying income for one year for the REIT qualification tests. REITs may receive rents based on the tenants' net income. Also, REITs can furnish certain services in connection with renting real property without triggering unrelated business income.

REIT distributions. Certain income a REIT accrues but does not receive is not subject to the general REIT distribution requirements if that amount exceeds 5 percent of the REIT's taxable income. The amount of a REIT's current earnings

and profits cannot be less than the REIT's taxable income. REITs can compute their net capital gains without an offset for net operating losses. REITs can also send capital-gain notices to their shareholders with their annual reports instead of separately within 30 days of year-end.

The number of sales that a REIT can make without falling under the prohibited-transaction rules has been raised, and REITs will be allowed to make more substantial improvements to buildings than previously.

Effective date: Generally, for tax years beginning after 1986.

Mortgage-Backed Securities

The 1986 act creates a new tax entity called a real estate mortgage investment conduit (REMIC). A REMIC is an entity formed to hold a fixed pool of mortgages secured by interests in real property. REMICs were created to clarify the treatment of entities that invest in multiple-class, mortgage-backed securities, and it is intended that REMICs will be the only entities to hold this type of investment.

A REMIC receives a deduction for all amounts included as income by holders of "regular interests" in the REMIC; it also gets a deduction for amounts distributed to holders of "residual interests" up to the amount of a deemed return. A REMIC may be created in the form of a corporation, a partnership, or a trust.

All interests in a REMIC are treated as either "regular" or "residual." Regular interests are treated as debt instruments; residual interests are generally treated as stock.

If property is transferred to a REMIC in exchange for either regular or residual interests, gain is recognized by the transferor, but loss will not be recognized until the disposition of the interests.

Effective date: Tax years beginning after 1986.

Extension of At-Risk Rules to Real Estate

Since 1976, the tax law has limited the deductions for a loss in certain activities to the amounts for which the taxpayer is at risk. Generally, that amount has been the sum of the cash invested, the value of property contributed, and the debt for which the taxpayer is personally liable. All real estate activities were exempt from the at-risk rules until now. Real property is still a major exception to the rules. A taxpayer is treated as at risk in a real estate activity to the extent of qualified third-party nonrecourse financing secured by real property used in the activity. In other words, a taxpayer can still be considered at risk in a real estate activity financed with nonrecourse debt, provided the lender is a person or business regularly engaged in the trade or business of lending money. The taxpayer will not be considered at risk if the lender is the person from whom the taxpayer bought the property or a person who receives a fee with respect to the taxpayer's investment in the property. All loans from related parties, however, must be on commercially reasonable terms.

Effective date: Losses attributable to property acquired after 1986.

FAMILY FINANCE ■ A loophole that survives

What Congress giveth: Home-equity loans

■ It wasn't planned that way, but Congress's massive tax-reform plan is about to encourage you to put your home deeper in hock.

Homeowners by the millions are expected to turn to home-equity loans—a form of second mortgage—to circumvent tax reform's taboos on deductions for interest paid on credit-card purchases and all other kinds of consumer debt.

Under the reform plan expected to be voted into law later this month, deductions for consumer interest will gradually disappear over the next five years. But the mortgage-interest deduction will stay alive. As a result, many homeowners may trim taxes by financing vacations, new cars and fur coats with a home-equity loan. If they decide to take the loan in the form of a revolving-credit line—and tap the line only when needed—they pay interest only on the portion of the credit used.

"Home-equity loans will be the only game in town," predicts Bob Trinz, a specialist at Prentice-Hall, which publishes tax guides. "They could be the primary loan product of the future," agrees Carl Harris, a vice president at People's Bank in Bridgeport, Conn.

Under the new rules, however, the length to which you can go to mortgage your house for other purposes will shrink considerably from what it is now. Mortgage interest will be deductible on first and second homes only to the extent that the loan does not exceed the original purchase price of the home—not its market value—plus the cost of improvements you've made. You can deduct more only if the loan's proceeds are used to pay for education, medical expenses or further home improvements.

Room to maneuver

Even when restricted that way, the provision leaves owners who have had time to build up equity plenty of room to maneuver, says Gary Blum, a tax partner with the accounting firm Seidman & Seidman. Suppose you bought your home for \$100,000 and have since added an air-conditioning system and a new driveway for \$15,000. If your mortgage is paid down to \$50,000, you could borrow \$65,000 for whatever reason and deduct the interest.

Banks limit what they will lend against a home, of course.

Generally, the maximum loan is equal to 75 or 80 percent of the home's appraised value, minus whatever is owed on the first mortgage. So the person in Blum's example might in fact qualify for a home-equity loan of \$36,250 if the house were valued at \$115,000.

As it stands, these provisions will

apply even to home-equity loans that have already been taken out. If you have borrowed more than the home cost, plus improvements, your excess deductions will be phased out by 1991.

To compete for customers seeking home-equity credit lines over the next few months, many banks will offer low-interest rates and low fees on such loans. Buffalo, N.Y.-based Goldome Federal Savings Bank, with \$60 million outstanding in Home Equity Line of Credit balances, expects its current direct-mail and advertising campaign to increase home-equity lending by \$225 million over the next six months. Goldome is charging new customers interest 2 percentage points above the bank's prime rate, with an application fee of \$250 (\$350 in the New York metropolitan area). Closing costs, which run 2 to 2½ percent of the amount of the credit line, will be picked up by the bank.

First National Bank of Chicago charges rates ranging from 2 percent over prime for small loans to prime plus ½ percent for amounts in excess of \$25,000. Customers pay a \$100 application fee and the cost of title insurance and appraisal but no other closing costs.

Lure of the loan

Tax considerations aside, home-equity credit lines are attractive to borrowers for many reasons. Once established, they remain in place for years and can be tapped at any time by check and sometimes by credit card. While the rates are almost always variable, they

tend to be lower than for other kinds of consumer loans. Payback is often flexible. Generally, you can pay off the loan early without penalty, and since the term of the loan may stretch as long as 15 years, monthly payments can be kept quite low.

But such home-secured credit can be dangerous. New York City financial adviser Lewis Altfest warns against

Here's how the tax-reform bill's limits on the deduction of interest would affect John and Jane Smith, who want to borrow against the value of their home, now worth \$160,000—

Price the Smiths paid for home	\$100,000
Cost of improvements they made	+ \$10,000
Total invested	\$110,000
Amount owed on present mortgage	— \$80,000
Remaining unrestricted borrowing power for tax purposes	\$30,000

The Smiths CAN DEDUCT interest on a home-equity loan of—

- Up to \$30,000 for any purpose
- Up to \$80,000 for tuition
- Up to \$80,000 for medical expenses
- Whatever it costs to add a room to the house

They CANNOT DEDUCT interest on loans of—

- More than \$30,000 to buy cars or boats
- More than \$30,000 for vacations, furniture and other major consumer expenses
- More than \$30,000 for cash for living costs

dipping into it just to save on taxes. "It's very easy to write a loan against your home," he says. "But it should be reserved for strategic purchases. Go too far and you may find yourself overextended. Before you know it, you've jeopardized your home."

Because home-equity credit lines can vary significantly from bank to bank, it is important to understand all available features before signing up. How much will you have to pay in closing costs? How is the interest rate figured, and when are adjustments passed on to you? Remember, if the rate is tied to the prime, it will probably change every time the prime does, no matter how high.

Ask how paybacks are handled, and be sure you will not be charged a penalty for early repayment. Each time you write a new check against your credit line at United Jersey Bank, N.A., in Princeton, for example, your entire balance owed is spread over a new 15-year term. At First Chicago, you can pay what you like each month as long as you keep up with the interest. The whole amount comes due after seven years.

As attractive as the terms and the tax deductions may be, experts say to keep in mind that loans make sense only if they are used wisely. ■

by Anne McGrath

Tax Proposal Trims IRA, 401(k) Benefits

Pensions Improve for Low-Paid Workers

By Spencer Rich
Washington Post Staff Writer

The tax bill approved by House-Senate conferees after weeks of intense negotiations would curtail tax breaks for two forms of savings plans thought to benefit mainly middle- and upper-income taxpayers: the individual retirement account and the tax-deferred 401(k) on-the-job savings plan—but would compel employers to provide better benefits and wider coverage for low-income and short-term workers.

Although congressional staff and government officials cautioned yesterday that some provisions may be changed as they work out final details, the following were said to be the major pension provisions:

- Starting in 1987, an individual would be able to deduct the full \$2,000 a year for a contribution to an IRA only if neither the taxpayer nor his or her spouse is covered by a qualified employer-retirement plan, such as a regular pension, a 401(k) plan, a Keogh plan or a tax-sheltered annuity.

If either spouse did have such a plan, then an income test would apply. Couples with adjusted gross income of under \$40,000 would be able to deduct the full \$2,000, (plus \$250 for a nonworking spouse) but the amount they could deduct would be reduced for income above that and would be totally phased out at \$50,000. A single person with income under \$25,000 could deduct the full \$2,000, but this would be reduced above that and would phase out completely at \$35,000.

However, all interest earned on IRA accounts would still be fully tax-deferred, and a person ineligible to deduct all or part of his initial \$2,000 contribution (plus the spousal \$250) still could make the contribution on a nondeductible basis and pay no tax on the interest until retirement. For a younger employee, the long-term growth of the tax-deferred interest is actually a larger benefit over his lifetime than the savings on deduction of the contribution.

- The amount of money an employee could put into a tax-deferred 401(k) on-the-job savings plan would be limited to \$7,000 a year (starting in 1987) and later increased to keep pace with inflation; at present up to \$30,000 is possible in some cases. These 401(k) plans for state and local government employees would not be allowed unless the plan started before May 6, 1986. Such plans could remain in effect and enroll new workers, if they started before that date.

- A \$9,500 annual limit would be imposed on employee contributions to tax-sheltered annuities permitted for certain teachers and employees of hospitals and other tax-exempt organizations. In general, such workers would be permitted to continue putting 20 percent of their pay into an annuity, but the dollar amount would be limited to \$9,500.

- Workers in firms with "simplified employee pension plans"—often small businesses—would be able to contribute part of their salaries to it voluntarily under terms generally similar to those for 401(k)s. At present only the employer can make contributions.

- In single-employer pension plans (about 30 million workers are in such plans), the face value of the final pension could not be reduced by more than 50 percent in cases where a so-called Social Security offset provision is in effect.

An offset-type integrated plan is one in which part of the value of a worker's Social Security benefit is deducted from the pension entitlement earned on the job. In some cases, involving low-paid workers, plans have been set up in such a way that all or virtually all of the earned pension was wiped out by the offset, leaving the worker with Social Security only, even though he or she had worked for many years in the expectation of receiving a pension from the employer as well as Social Security.

This change in the offset provision was hailed by the Pension Rights Center, National Council of Senior Citizens and others as one of the major improvements in the bill.

The new rules would not apply to so-called multi-employer plans (about 7 million participants), which, in any event, are rarely integrated.

- Single-employer plans, including pensions, profit-sharing and stock bonus plans, would be required to vest all participants after five years of service; most employees are in plans using a 10-year vesting rule. This provision would mean vesting and, therefore, pensions for millions who now don't get them because they shift jobs frequently or spend a relatively short time in the labor force, and is expected to be particularly helpful to women, but it will add to the overall costs of pensions.

- Rules governing coverage for pension and retirement plans of various types would be tightened so that employers could not use them easily to finance benefits to top employees while excluding large groups of lower-paid.

- Income-averaging rules in various retirement plans for lump-sum distributions received by persons leaving the job before age 59½ would be tightened to reduce the tax benefit: The 10-year income-averaging provision would be reduced

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- Income-averaging rules in various retirement plans for lump-sum distributions received by persons leaving the job before age 59½ would be tightened to reduce the tax benefit: The 10-year income-averaging provision would be reduced to five.

- In certain types of pensions, the early-retirement benefits would be lower than at present for most high-paid employees.

- The elderly, who now get a double personal exemption (an elderly couple gets four exemptions worth \$1,080 per exemption, instead of only two) would be abolished. However, for the elderly as for all other groups, the personal exemption would rise to \$2,000 a person by 1989 and, in addition, elderly non-itemizers would get an increase in the standard deduction of \$750 a person (or \$600 a person for a couple) above what the non-elderly would obtain.

(pp. 1-2)

IRA TIPS

A NEWSLETTER FOR INDIVIDUAL RETIREMENT ACCOUNT PARTICIPANTS

FALL 1986

TAX REFORM CONFEREES REACH FINAL AGREEMENT ON IRA PROVISIONS

On August 16, House and Senate conferees resolved legislative differences and agreed upon the Tax Reform Bill of 1986. The Bill must now be approved by both Houses of Congress and must be signed by the President. As we go to press, neither the House nor Senate has voted on this legislation.

The Bill contains provisions which will probably affect your IRA. Anyone under 70-1/2 can still put up to \$2000 of earned income in an IRA each year and earn tax-deferred income. But for millions, the right to deduct contributions ends.

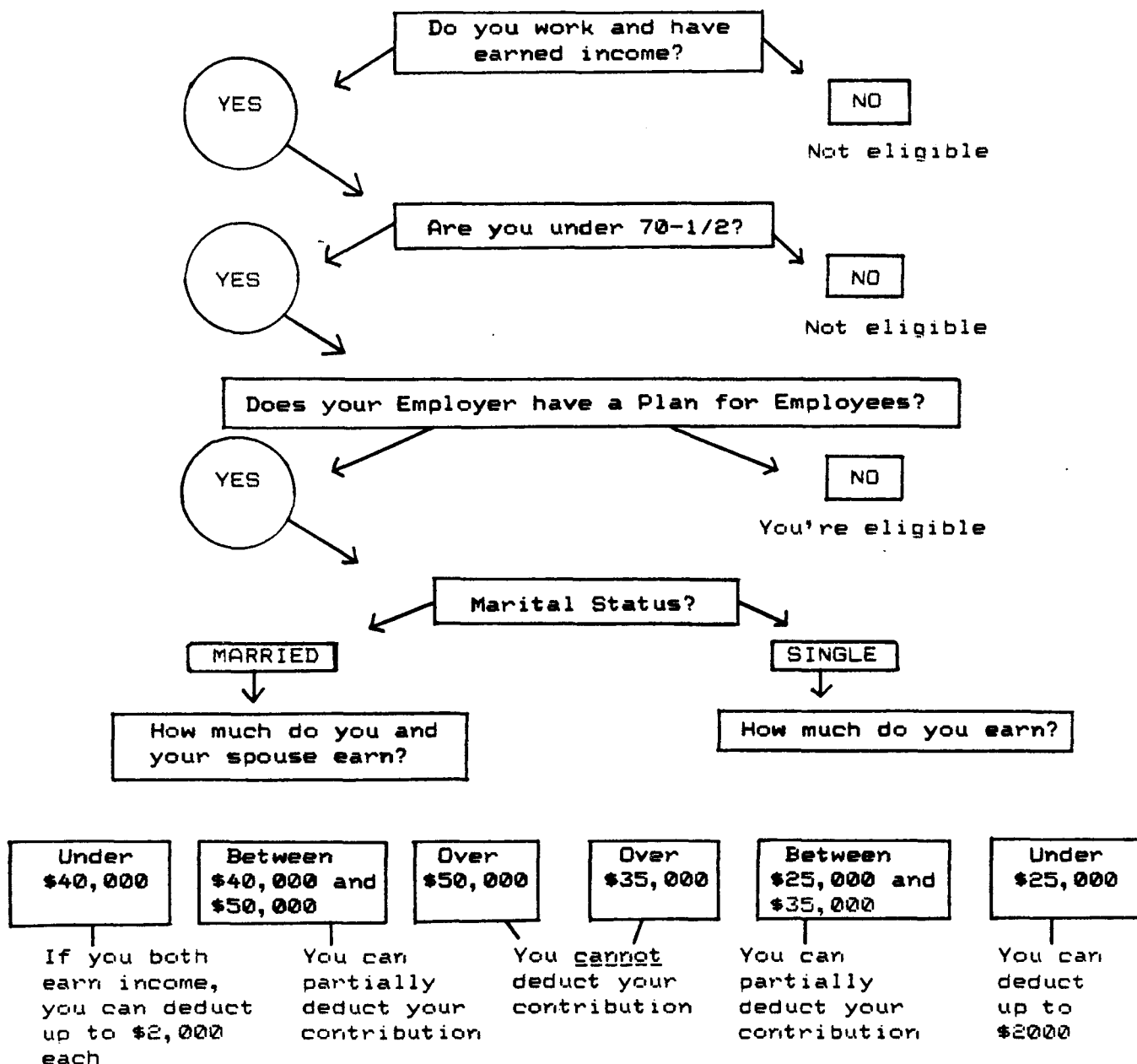
Who will be eligible for IRA deductions for the 1987 tax year? Taxpayers not covered by a retirement plan at work will still be able to deduct IRA contributions. IRA deductibility will be based on the following criteria for taxpayers who are covered by employer-maintained plans:

- o Fully deductible, if adjusted gross income is below \$40,000 for joint taxpayers and below \$25,000 for single taxpayers.
- o Partially deductible, if adjusted gross income is between \$40,000 and \$50,000 for married couples and between \$25,000 and \$30,000 for singles.
- o Not deductible, for taxpayers with adjusted gross income over \$50,000 on a joint return and over \$35,000 on a single return. However, these taxpayers will be able to make non-deductible contributions up to \$2,000 a year where interest can grow tax-deferred.

A greater emphasis needs to be placed on the major benefit of an IRA - tax-deferred earnings. If you invest \$2,000 a year in a taxable account, earning 8% and pay taxes on the earnings at the 28% tax rate, at the end of 20 years you'll have \$75,831. Put those \$2,000 deposits in a non-deductible but tax-deferred IRA and at the end of that time you'll have \$98,846. If you withdrew it all and paid the deferred tax bill on the earnings, you wind up with \$82,370. The longer you contribute to an IRA - deductible or not - the greater the advantage of tax-deferred earnings. And remember, since non-deductible contributions are made with after-tax dollars there is no tax liability on your principal investment when withdrawn and you can make IRS penalty-free withdrawals prior to 59-1/2.

To help you better visualize the proposed IRA eligibility requirements, a "decision tree" is provided for your reference.

ELIGIBILITY REQUIREMENTS TO DEDUCT IRA CONTRIBUTIONS



AFTER REFORM: **Benefits**

Company Benefits Reel from the Zeal of Reform

It will be more costly to take money out of company savings plans before you retire, and easier to qualify for a pension.

BY DENISE M. TOPOLNICKI

As anyone who pays taxes knows, Congress giveth deductions with one hand and taketh them away with the other. Unfortunately, lawmakers were not in a giving mood when they rewrote the sections of the tax code that deal with corporate benefits. Highly paid employees who receive the most generous retirement packages will be hit hardest, but every wage earner will feel reform's lash.

Among the many negatives, you won't be able to stash as much cash as you can today in profit-sharing, 401(k) salary-reduction and other tax-deferred savings plans, nor will you be allowed to tap those savings before retirement as readily as you can now. The major plus: the law that will take effect Jan. 1 will trim the time it takes to be fully vested in a pension plan from 10 years to five.

Here's a rundown on how to cope with the new taxes:

COMPANY-SPONSORED SAVINGS PLANS

The basic rules remain the same: Money that you and your employer contribute to profit-sharing, stock-ownership, 401(k) and other investment accounts grows tax-free until it is with-



"Judy and I are happy about five-year pension vesting. If I decided to change jobs or retire, I'd be able to do it sooner."

—GORDON CAMPBELL AND HIS WIFE JUDITH OF WYNDMOOR, PA.

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Benefits

Since it will cost you a 10% tax penalty to withdraw from a 401(k), the money that you put in should be for your retirement.

drawn. You put after-tax dollars in these plans except for 401(k)s, which you fund with pretax earnings.

Under both the new and the old rules, your annual contributions to all these accounts, plus the money your employer kicks in, may not exceed 25% of your pay or \$30,000, whichever is less. Currently, only a small portion of your after-tax contributions are counted against that limit. Starting in 1987, however, all after-tax dollars that you put in will count toward the \$30,000 ceiling, and you won't be able to sock away more than \$7,000 a year in a 401(k). For middle-income taxpayers, however, these ceilings are rather high.

Perhaps more worrisome, the new law will more tightly restrict withdrawals from a company plan before you retire. The most stringent provisions apply to 401(k)s. You are now allowed to take out your own contributions, your account's earnings and, in some cases, even your employer's contributions, if you retire, leave the company, become disabled or can prove hardship. And hardship has been loosely interpreted to include buying a house or paying college tuition.

After tax reform, however, if you plead hardship you will be permitted to withdraw only your own money from a 401(k), and you will have to pay a 10% tax penalty as well as income tax on the sum. The penalty is waived if you use the money to pay medical expenses that exceed 7½% of your adjusted gross income. The new law will also impose a 10% tax penalty on early withdrawals from profit-sharing and other company-sponsored plans to which you contribute after-tax earnings unless you are using the money to pay tax-deductible medical bills.

While restrictions on early withdrawal and the \$7,000 cap will make 401(k)s less

appealing, they will remain attractive long-term, tax-deferred investments, particularly for people who can't deduct IRA contributions (see the story on page 63). Says Chris Parsons, a tax partner with the accounting firm of Deloitte Haskins & Sells in Houston: "Since 401(k)s are no longer very liquid, the money you're putting into them had better be for long-term retirement purposes. If it is, put in as much as you can before the \$7,000 limit takes effect on Jan. 1." Conversely, if you anticipate some hardship in the near future, get your money out of your 401(k) before 1987.

The new law also changes the income tax treatment of withdrawals from tax-deferred savings plans. You will not be able to pull out just your own contributions, which are not taxed. Next year, each withdrawal must consist of contributions made by you and your employer, as well as some of the account's earnings. Say that 10%, or \$3,000, of your \$30,000 profit-sharing account came from your own after-tax contributions. If you withdrew \$3,000 under the old rules, you would owe no tax because the money would be a return of your principal. But under the new regulations, only 10% of the withdrawal, or \$300, would be considered a return of principal and escape tax, while \$2,700 would be subject to tax as well as the 10% early-withdrawal penalty. Assuming you were in the top bracket next year, you would wind up with only \$1,390.50 after taxes.

But don't rush to raid profit-sharing and other accounts that you have been funding with after-tax dollars. The provision will not apply to balances you have built up through the end of 1986. They also will escape the tax penalty no matter when you withdraw the money.

In the end, under tax reform, the least painful way to get cash out of company-sponsored savings plans will be to borrow it. Says Allen Steinberg of Hewitt Associates, a benefits consulting firm in Lincolnshire, Ill.: "Congress has stacked the deck in favor of borrowing because there's no 10% tax penalty on loans."

Taking out a loan will become less appealing, however, because the deduction for consumer-loan interest will be phased out (see page 91). Moreover, the legislators have reduced the maximum amount

Benefits

Your pension could be less than you expect because the annual salary used in the formula to figure your benefit will drop.

that you can borrow from a company plan at any one time from \$50,000 to \$50,000 minus your highest outstanding loan balance from the company plan over the past 12 months—even if you have already paid off that loan. Your company must charge you a market rate of interest. You will also have to repay your new loan within five years, making payments at least quarterly. There is an exception to the five-year repayment rule: borrowing to buy a principal residence for yourself. But you can sidestep the new repayment rules and loan limits by borrowing before the end of this year.

PENSIONS

The tax bill requires corporate pension plans either to vest employees fully after five years of service or stretch the process out to seven years by vesting them with 20% of their pension benefits after three years, plus 20% in each of the next four years. The rule goes into effect in 1989, but the years that you will have logged with your employer by then count. So if you joined a company with five-year vesting in January 1986, you will be fully vested in January 1991.

If you are a big earner, there's bad news: your pension may be smaller than you have been counting on. Next year, the amount of annual compensation that your company can use to determine your pension will drop to \$200,000 and rise thereafter with the cost of living. Currently, there's no limit. If you earn, say, \$300,000 a year and your pension equals 3% of your pay multiplied by your years of service, you now would accrue \$9,000 a year in benefits. But under the new rule, only \$200,000 of your salary will be counted, and you will accrue \$6,000 a year. Benefits that have built up in your

Benefits

name prior to 1987 will not be affected.

In addition, the legislators have slashed the maximum pension benefit that you can collect if you retire early. You may now receive up to \$90,000 a year if you stop working at 62. If you call it quits between 61 and 55, the maximum is gradually reduced to \$75,000. The new rules set a maximum of \$90,000 for people who retire at 65 and \$40,000 for those who bow out at 55. Benefits you have accrued prior to 1987 are exempt from the new limits, so highly paid executives with long tenure at their companies don't have to hustle to retire this year.

Congress has also changed the rules on lump-sum distributions of pension benefits for those who retire next year. If you are 59½ or older, you may now roll over a lump sum into an IRA within 60 days after you receive it or take the money and pay tax on it using 10-year forward averaging, which allows you to pay tax as if you had received the cash over 10 years instead of all at once. Congress has retained the rollover provision but chopped 10-year averaging to five years for a lump sum you receive after age 59½.

But if you reached age 50 by Jan. 1, 1986, the law will let you use either five-year averaging under the new rates or 10-year averaging under the old ones to calculate your tax on a lump-sum distribution. According to Chris Parsons of Deloitte Haskins & Sells, you will likely pay lower taxes if you average over 10 years rather than five in 1987 because blended tax rates will be in effect that year. But in 1988 and thereafter, the best method depends upon the size of your lump sum. Five-year averaging under the two-bracket system will usually result in lower taxes for amounts over \$350,000, but 10-year averaging will be best for smaller sums. Assume that you will receive \$200,000. You would pay \$44,000 in taxes under five-year averaging but only \$36,900 using 10-year averaging.

It hardly seems fair, but you will get socked with yet another new tax penalty if your nest egg is too big. The reform law levies a 15% tax on taxable distributions in excess of \$112,500 a year from your pension, company-sponsored savings plans, tax-sheltered annuities and even your IRAs. If you take money in a lump sum, you will have to pay a

Benefits

Ask for a company car. You will owe tax when you use it personally, but you will avoid financing charges and sales tax.


15% tax on amounts exceeding \$562,500.

Fortunately, there is a way to dodge this bullet: roll over the lump sum into an IRA and then withdraw no more than \$112,500 a year. Benefits accrued before Aug. 1, 1986 may not be counted against these limits, but Congress has yet to clarify the issue.

FRINGE BENEFITS

If you use your own car on your employer's business, ask the boss for a company car instead, because under the new rules you will be able to deduct only business-related expenses that exceed 2% of your adjusted gross income. You will pay income tax on the value of the auto to the extent that you use it personally, but the tax will be less than the financing charges and sales tax on a car you bought yourself. Moreover, you won't be able to deduct state sales tax on the purchase of a car after this year, and the deduction for auto loan interest is being phased out.

DEFERRED COMPENSATION

With the top tax rate due to drop from 50% to 28% in 1988—actually 33% for married couples with taxable incomes between \$71,900 and \$171,090—you will have less incentive to defer salary and bonuses until retirement, when you might be in a lower tax bracket. You should, however, postpone as much compensation as you can until 1988, when the lower tax rates take effect. But you may not want to delay taking your pay beyond 1988. Says Mark Edwards, San Francisco office manager for Sibson & Co., a compensation consulting firm: "Taxpayers are very distrustful of the changes. After seeing how Congress gutted IRAs, for example, they don't believe that the low tax rates will be here for eternity." 

[EXCERPT]

TAX REFORM ACT OF 1986—Conference Report to Accompany H.R. 3838
(House Report 99-841, 99th Congress, 2d Session, Sept. 18, 1986)

pp. 424-427, vol. II

4. Vesting Standards

Present Law

In general

To ensure that employees with substantial periods of service with the employer do not lose plan benefits upon separation from employment, the Code generally requires that under a qualified plan (1) a participant's benefits be fully vested upon attainment of normal retirement age under the plan; (2) a participant be fully vested at all times in the benefit derived from employee contributions; and (3) employer-provided benefits vest at least as rapidly as under one of three alternative minimum vesting schedules (Code sec. 411(a)). Under these schedules, an employee's right to benefits derived from employer contributions becomes nonforfeitable (vested) to varying degrees upon completion of specified periods of service with an employer.

Under one of the schedules, full vesting is required upon completion of 10 years of service (no vesting is required before the end of the 10th year). Under a second schedule, vesting begins at 25 percent after completion of 5 years of service and increases gradually to 100 percent after completion of 15 years of service. The third schedule takes both age and service into account, but, in any event, requires 50-percent vesting after 10 years of service, and an additional 10-percent vesting for each additional year of service until 100-percent vesting is attained after 15 years of service.

Patterns of discrimination

Vesting more rapid than under the 3 schedules described above may be required under a qualified plan to prevent discrimination if (1) there has been a pattern of abuse under the plan tending to discriminate in favor of employees who are officers, shareholders, or highly compensated, or (2) there has been, or there is reason to believe there will be, an accrual of benefits or forfeitures tending to discriminate in favor of employees who are officers, shareholders, or highly compensated (sec. 411(d)(1)).

Top-heavy plans

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) required that for any plan year for which a qualified plan is top heavy, an employee's right to accrued benefits must become nonforfeitable under one of two alternative schedules. Under the first top-heavy schedule, a participant who has completed at least 3 years of service with the employer maintaining the plan must have a nonforfeitable right to 100 percent of the accrued benefit derived from employer contributions.

A plan satisfies the second alternative (6-year graded vesting) if a participant has a nonforfeitable right to at least 20 percent of the accrued benefit derived from employer contributions at the end of 2 years of service, 40 percent at the end of 3 years of service, 60 percent at the end of 4 years of service, 80 percent at the end of 5 years of service, and 100 percent at the end of 6 years of service with the employer.

Class year plans

Special vesting rules also apply to "class year plans." A class year plan is a profit-sharing, money purchase, or stock bonus plan that provides for the separate vesting of employee rights to employer contributions on a year-by-year basis. The minimum vesting requirements are satisfied if the plan provides that a participant's right to amounts derived from employer contributions with respect to any plan year are nonforfeitable not later than the close of the fifth plan year following the plan year for which the contribution was made.

Changes in vesting schedule

Under present law, if a plan's vesting schedule is modified by plan amendment, the plan will not be qualified unless each participant with no less than 5 years of service is permitted to elect within a reasonable period after the adoption of the amendment to have the nonforfeitable percentage of the participant's accrued benefit computed under the plan without regard to the amendment.

House Bill

No provision.

Senate Amendment

In general

The Senate amendment provides that a plan is not a qualified plan (except in the case of a multiemployer plan), unless a participant's employer-provided benefit vests at least as rapidly as under one of 2 alternative minimum vesting schedules.

A plan satisfies the first schedule if a participant has a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions upon the participant's completion of 5 years of service. A plan satisfies the second alternative schedule if a participant has a nonforfeitable right to at least 20 percent of the participant's accrued benefit derived from employer contributions after 3 years of service, 40 percent at the end of 4 years of service, 60 percent at the end of 5 years of service, 80 percent at the end of 6 years of service, and 100 percent at the end of 7 years of service.

Top-heavy plans

The provisions of the Senate amendment relating to vesting do not alter the requirements applicable to plans that become top heavy. Thus, a plan that becomes top heavy is required to satisfy one of the two alternative vesting schedules applicable under present law to top-heavy plans.

Class-year plans

A plan with class year vesting will not meet the qualification standards of the Code unless, under the plan's vesting schedule, a participant's total accrued benefit derived from employer contributions becomes nonforfeitable at least as rapidly as under one of the two alternative vesting schedules specified in the bill.

Changes in vesting schedule

If a plan's vesting schedule is modified by a plan amendment, the plan will not be qualified unless each participant with at least 3 years of service is permitted to elect, within a reasonable period after the adoption of the amendment, to have the nonforfeitable percentage of the participant's accrued benefit computed without regard to the amendment.

Multiemployer plans

As an exception to the general vesting requirements, the bill requires that, in the case of a multiemployer plan, a participant's accrued benefit derived from employer contributions be 100 percent vested no later than upon the participant's completion of 10 years of service.

Effective date

The provisions of the Senate amendment are generally applicable for plan years beginning after December 31, 1988, to participants who perform at least one hour of service in a plan year to which the new provision applies.

A special effective date applies to plans maintained pursuant to a collective bargaining agreement. Under this special rule, in the case of a plan maintained pursuant to a collective bargaining agreement between employee representatives and one or more employers ratified before March 1, 1986, the amendments are not effective for plan years beginning before the earlier of (1) the later of (i) January 1, 1989, or (ii) the date on which the last of the collective bargaining agreements terminates, or (2) January 1, 1991. Extensions or renegotiations of the collective bargaining agreement, if ratified after February 28, 1986, are disregarded.

Conference Agreement

The conference agreement follows the Senate amendment. In addition, the conference agreement modifies the rule permitting an employer to condition participation in a plan on 3 years of service. Under the conference agreement a plan may require, as a condition of participation, that an employee complete a period of service with the employer of no more than two years. A plan that requires that an employee complete more than one year of service as a condition of participation must also provide that each participant in the plan has a nonforfeitable right to 100 percent of the accrued benefit under the plan when the benefit is accrued.

In addition, the conference agreement limits the special rule for multiemployer plans to employees covered by a collective bargaining agreement.

Also, benefits that become vested due to these provisions are to be immediately guaranteed by the PBGC (without regard to the phase-in rule).

The conference agreement also modifies the effective date so that the provision applies to all employees who have one hour of service after the effective date. This revised effective date also applies to the conference agreement modification regarding years of service required for participation.

In addition, the conference agreement limits the delayed effective date for plans maintained pursuant to a collective bargaining agreement to employees covered by such agreements.

Variable Annuities, Life Insurance: Tax-Favored Investing—At a Price

YOUR MONEY MATTERS

By KAREN SLATER

Staff Reporter of THE WALL STREET JOURNAL

With tax overhaul a virtual certainty, brokers and other financial advisers are scrambling to find investments that will have the most allure in the new environment. Among the items getting their attention: variable annuities and variable life insurance.

These products, which combine mutual-fund investing with the tax deferral of insurance, are among the big winners under the proposed changes, brokerage and insurance executives say.

The bill approved by House and Senate conferees preserves the tax advantages of insurance while virtually eliminating tax shelters and curtailing deductions for individual retirement accounts. It also eliminates the preferential rate for capital gains, making it more attractive to buy securities through a tax-sheltered vehicle.

"I fully expect variable annuities and variable life to become one of the hottest products in the financial-services industry over the next few years," says Arthur H. Goldberg, president of Integrated Resources Inc., a New York securities and real estate firm.

Unadvertised Drawbacks

As with any other hot product, however, the advantages are tempered by drawbacks that sellers aren't advertising. In the case of variable annuities and variable life, these include reduced flexibility and fees that lower investment return.

"It's not wise to be blinded by the tax-deferral aspect," says Glenn Daily, insurance-product analyst for the financial planning affiliate of accountants Seidman & Seidman/BDO in New York.

The variable annuity, simpler of the two products, is essentially a tax-deferred retirement-savings plan. It is similar to what the IRA will be like after tax overhaul for people who no longer qualify to make a tax-deductible contribution.

With an annuity, however, there isn't a maximum annual contribution. And if the annuity holder dies during the accumulation period, the beneficiary is guaranteed no less than the amount invested.

The annuity buyer makes one or more investments into the contract. The term "variable" refers to the fact that the buyer can select and periodically change how the money is allocated among a handful of stock, bond and money-market funds. Interest, dividends and capital gains accumulate without any current tax.

As with an IRA, money withdrawn in a lump sum or in annuity payments after re-

tirement age is subject to ordinary income tax on the amount attributable to earnings. Withdrawals before age 59½ are generally subject to both ordinary income tax and a penalty, which would rise to 10% from 5% under the tax package.

The tax treatment is the key to the investment. "It's a way to accumulate your dollars without current taxes coming out, which translates into a higher return," says Joseph W. Jordan, insurance-product manager with PaineWebber Inc.

Indeed, over a 20-year holding period, the after-tax return on a variable annuity can be more than one percentage point higher than the return on a mutual fund with the same gross earnings and fees.

Mr. Daily of Seidman Financial notes, however, that the advantage slips to only

Variable Annuities Vs. Mutual Funds

Assumes 20-year holding period,
30% tax rate and 11% annual yield
before expenses.

	TYPICAL ANNUAL EXPENSES	EFFECTIVE AFTER-TAX ANNUAL RETURN
Variable annuity	2%	7.5%
No-commission mutual fund	1	7.0
Commissioned mutual fund	2	6.3

Source: Seidman Financial Services, New York

half a percentage point a year if the annuity is compared with a mutual fund that doesn't have a sales commission. Annuities usually are sold with sales commissions—although, as with the latest wave of mutual funds sold through brokers and other commissioned salespeople, the sales charges are paid out of higher annual fees rather than as an up-front charge.

"I really don't think the numbers (on the variable annuity) work out to be as spectacular as the salespeople would like you to believe," Mr. Daily says.

Meanwhile, the potentially higher return on the variable annuity needs to be weighed against other factors. Both the tax burden and surrender charges for canceling the contract in the first several years make variable annuities strictly a long-term investment. Accordingly, variable annuities are most often marketed to, and are most suitable for, people over 50.

Further, variable annuities usually offer only a handful of mutual-fund choices, and their performance isn't listed in daily newspapers. Investors who like to move among funds should also note that they may be limited to as few as four switches a year.

"For the most part, I'm inclined to keep my clients in mutual funds because of the liquidity and the flexibility," says Linda J. Jepson of Financial Planners Equity Corp. in Erie, Pa.

Like variable annuities, variable-life insurance policies allow holders to invest in mutual funds without paying current taxes on the income. But sellers of variable life insurance say that the product addresses one of the big drawbacks of variable annuities: the tax bite on withdrawals before retirement. Variable-life policyholders have tax-free access to their funds by borrowing, often at an interest rate of no more than 1% or 2% a year.

Variable-life policies also include life-insurance coverage that can be two or more times the size of the original investment. (When marketed principally as investments, these policies are typically sold on a single-premium basis, rather than with annual premiums.) If an insurance policy is in force at death, the proceeds pass to beneficiaries free of income tax.

Compared with a variable annuity, "it is the more flexible product," says Jerome S. Golden, president of Monarch Resources Inc., which sells its variable-life policies primarily through Merrill Lynch & Co.

Higher Annual Charges

The insurance coverage and the related borrowing ability of variable life don't come free, however. Variable-life policies have higher annual charges than variable annuities, and thus are a somewhat different product.

Variable life "is a combination of attractive investments and attractive insurance protection," says Donald G. Southwell, president of Prudential Life Insurance Co. of America's variable-products subsidiary. "It certainly is a better deal if buyers value the insurance protection."

Investors who expect to use the policyholder-loan option as a tax-free source of cash also face a hidden problem, says John H. Cammack, a financial planner with Alexandria Armstrong Advisors Inc. in Washington, D.C. If they borrow heavily and their investments perform poorly, they may need to pay additional premiums to continue the policy and, hence, preserve the tax-free status of their investments and loans.

Finally, in buying either a variable annuity or a variable-life policy, investors should pay attention to the financial strength of the insurance company backing the products. The investment dollars are segregated in accounts that are not available to pay the insurance company's other liabilities. But Michael Chesman, a vice president and attorney at Prudential Insurance, points out that the buyer is still relying on the insurer to pay a death benefit that exceeds the account balance.

Tax Bill Would Change the Rules For Executive Compensation Plans

By AMANDA BENNETT

Staff Reporter of THE WALL STREET JOURNAL

In the past, some of the most popular compensation and benefits programs for executives have enabled them to keep a larger share of their earnings out of the hands of the Internal Revenue Service.

But the proposed new tax law promises to change the rules for such maneuvers.

The revised code, which was completed last weekend by a House-Senate conference committee and is expected to become law by early fall, won't necessarily kill off the programs. But compensation specialists say it will reduce the appeal of many of them, especially for higher-paid executives.

For example, the new bill places significant restrictions on the use of so-called 401(k) plans for sheltering retirement income, and sets income ceilings for the deductibility of contributions to individual retirement accounts. It also sharply limits the maximum pension benefit a company can pay out of a funded pension plan to an employee who retires before age 65.

What's more, the proposed elimination of special tax treatment for capital gains will probably curtail the use of a common form of stock option. And the lower maximum rate for personal income taxes is likely to make deferred-compensation plans, along with benefits granted in lieu of salary, less advantageous.

"For higher-paid people, the attractiveness of benefits as tax-effective compensation is going to lessen," says Michael Carter, a senior vice president of Hay/Huggins Co., a benefits-consulting group based in Philadelphia. "We see more executives saying, 'Don't bother with the benefits—just give me the cash.'"

The following are some of the areas in compensation and benefits that are most affected by the tax bill.

Deferred Compensation

Many high-paid executives have found it beneficial, under current tax laws, to defer a portion of their income into the future. With the maximum personal tax rate at 50%, deferral has meant the ability to postpone payment of taxes until after retirement—at which time, presumably, the executive would be in a far lower tax bracket. Of 916 U.S. companies polled by Hay/Huggins in an annual survey, about one-third indicated that they had some form of deferred-compensation plan for their executives.

The new tax rates will change this. For most individuals, the maximum rate will be 28% (a 33% rate will apply to taxpayers in a certain high-income bracket). As a result, the gap between the taxes that would be paid immediately and those that might be paid later will be narrowed, if not eliminated entirely. Moreover, consultants say,

many executives won't be willing to risk the possibility that rates may be raised again under future administrations, or under the pressure of budget deficits.

"Some people—especially the highest-paid people—may be looking at their lowest tax rates ever," says Richard Raskin, a consulting actuary with Wyatt Co., a New York-based compensation and benefits consulting company.

Over the next two years, income deferral is expected to become briefly more popular as the lower rates are phased in and taxpayers seek to move as much income as possible from today's 50% rates into the future. However, Jane Romweber, a consultant with Hewitt Associates in Lincolnshire, Ill., cautions that the IRS may be considering taking steps to reduce such short-term income deferral.

Pension Plans

Under current tax laws, companies can pay out a maximum of \$75,000 a year from funded pension plans to executives who retire at age 55. The maximum rises to \$90,

'SOME people—especially the highest-paid people—may be looking at their lowest tax rates ever,' says one compensation consultant.

000 a year for those who wait until age 65.

The new law, however, sets the maximum allowable payout from such plans at \$72,000 for 62-year-old retirees; \$60,200 for 60-year-olds; and \$40,000 for 55-year-olds. The limit would remain at \$90,000 for 65-year-olds.

Most executive-compensation specialists expect companies to try to make up the difference for early retirees with payments from unfunded pension plans, which aren't subject to those restrictions. For companies, however, the disadvantage with unfunded plans is that, while provisions for future pension payments must be charged to income immediately, those amounts aren't tax deductible until payments are actually made.

With unfunded plans used as backup, the payouts would presumably remain the same. But such plans are less secure: Unlike funded pension plans, unfunded ones aren't guaranteed by the government.

"With mergers, acquisitions and bankruptcies, unfunded liabilities place the potential recipient in the position of being a creditor of the corporation," notes Philip Henderson, senior vice president of A.S. Hansen Inc., a consulting company based

in Chicago. "If the benefit is unfunded and the new owner decides not to pay, then the employee is in a very tough position."

Increased cash or bonus payments, which executives could invest for retirement as they like, may thus become a more attractive option, consultants say.

Savings Plans

About two-thirds of the companies in the Hay/Huggins survey offer 401(k) plans, through which employees can set aside income in a tax-deferred account against retirement. But under the proposed tax bill, the maximum allowable contribution drops to \$7,000 a year from \$30,000, most seriously affecting executives earning \$100,000 or more annually.

Furthermore, the bill makes withdrawals from such funds before retirement more difficult—for example, by imposing a 10% penalty, on top of any income tax owed, for early withdrawals. "All the [proposed] restrictions on 401(k) plans make them relatively unattractive," says Everett Allen, a vice president of Towers, Perrin, Forster & Crosby, a New York-based consulting firm.

For those participating in qualified employer pension plans, tax deductions on contributions to IRAs will begin phasing out at \$25,000 annual income for individuals and \$40,000 for couples. At \$35,000 annual income for individuals and \$50,000 for couples, no deductions at all are permitted. For those without qualified employer pension plans, however, IRA deductions are still allowed. In either case, interest can accumulate in the account tax free.

Stock Options

Use of incentive stock options, one of the two main forms of stock options, would be greatly reduced under the proposed tax bill, compensation specialists say. One of the major attractions of such benefits—that the proceeds have been taxed at capital-gains rates—fades with the elimination of capital-gains-tax treatment.

The status of non-qualified stock options, whose proceeds are taxed as ordinary income when the option is exercised, will remain the same. However, their use is coming under fire as a result of separate changes in Financial Accounting Standards Board regulations, which will require companies to charge some value for the options against the company's earnings statement. Currently, stock options are listed only as shares outstanding.

As a result of both the tax changes and the FASB regulation, "I think we'll see a lot of companies move away from stock options," says Jude Rich, president of Sibson & Co., a compensation consulting company based in Princeton, N.J.

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Source: BNA Daily Report for Executives, Oct. 23, 1986, pp. G9-11

COMPARISON OF CURRENT LAW AND TAX REFORM ACT OF 1986

Corporate Taxes

Provision	Current Law	New Law
Corporate Tax Rate	Graduated up to 46 percent	34 percent top rate, effective July 1, 1987; graduated rates for small business
Dividends Paid Deduction	No deduction allowed	No provision
Dividends Received Deduction	85 percent	Drop from 85 percent to 80 percent over 10 years
Depreciation <i>ACRS</i>	Five asset classes, ranging from 3 to 19 years, using accelerated depreciation schedules	Current law with 8 asset classes ranging from 3 to 31.5 years; 200 percent declining balance for classes 3, 5, 7, and 10; 150 percent declining balance for most other property, real estate in 27.5 and 31.5 year classes with straight-line method; no indexing
Expensing	Up to \$5,000	Deduction for up to \$10,000 annually, unavailable for taxpayers with more than \$200,000 in equipment purchases annually, with addition of anti-abuse rules
Investment Tax Credit	6-10 percent	Repealed; 65 percent of carry forwards allowed
Other tax credits <i>Rehabilitation credits</i> <i>Energy credits</i> <i>Targeted jobs credit</i> <i>R&D tax credit</i> <i>Low-income housing</i>	15 and 20 percent credits for non-historic structures and 25 percent credit for certified historic structures Alternative energy, production, alcohol fuels, and residential credits Up to \$3,000 first year, \$1,500 second year for hiring targeted workers 25 percent credit for qualified costs (Sunset 12/31/85) No credit, tax-exempt bond funding and accelerated amortization election	10 percent for non-historic structures; 20 percent for historic Residential credits expired; business credits for solar, geothermal, oceanthermal extended through 1988 Extended through 1988 for up to \$2,400 first year wages, credit unavailable for second year 20-percent credit; tighten definition of qualified costs; new 20-percent credit for corporate donations to university basic research; extended through 1988 Three new credits for new and old units, projects using federal subsidies including tax-exempt bonds, and for acquiring units; sunset after 1989

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COMPARISON OF CURRENT LAW AND TAX REFORM ACT OF 1986

Corporate Taxes

Provision	Current Law	New Law
<i>Possessions tax credit</i> <i>Foreign tax credit limits</i> <i>Orphan drugs credit</i>	Credit for U.S. tax on U.S. possession source income is permanent Overall method applies 50 percent of qualified clinical testing expenses; expires after 1987	Retain credit; tighten active trade or business test and cost-sharing rules No separate limits for passive, financial, shipping income, and currency gains; impose comparability rules for in lieu of taxes on cross-border loans; with 5 year transition rule for cross-border loans to lesser developed countries Extended through 1990
Capital Gains	28 percent preferential rate	Preferential rate repealed
Accounting <i>Cash method</i> <i>Production cost</i> <i>Completed contract</i> <i>Installment sales</i>	Allowed No uniform rules for multi-year activities Allowed for long-term contracts Deferral of gain allowed	Generally disallow for taxpayers with over \$5 million in gross receipts, but exempt professionals Uniform rules requiring capitalization of most costs created for manufacturers and for wholesalers and retailers with more than \$10 million in gross receipts Taxpayers must compute 40 percent of contract items under percentage of completion method; the 60 percent of items under the completed contract method covered by new capitalization rules Repealed for publicly traded securities, revolving credit plans; limited for other gains based on debt-to-equity ratio of taxpayer
Oil Industry <i>Percentage depletion</i> <i>Intangible drilling costs</i>	Allowed Expense	Current law 30 percent of integrated producers IDCs amortized over 5 years
Timber	Special capital gains treatment; amortization of preproduction costs; special rules, including credit for reforestation	Special capital gains rates repealed, but other preferential rules generally retained
Financial Institutions <i>Reserve bad debt deduction</i> <i>Deduction for interest to carry tax-exempts</i> <i>Net Operating Losses</i>	Experience method and percentage Allowed Special 10-year carryback, 5-year carryforward	Repeal only for banks with over \$500 million in assets, tighten for thrift institutions, with special exception for troubled banks Repealed Repealed except for NOLs attributed to bad debts for losses incurred before 1994; NOLs incurred 1981-1985 get eight year carryforward

COMPARISON OF CURRENT LAW AND TAX REFORM ACT OF 1986

Corporate Taxes

Provision	Current Law	New Law
Insurance Companies		
<i>Deferral for life insurance and annuity income</i>	Allowed	Retained
<i>Life insurance reserve deduction</i>	Allowed	Retained
<i>Special life insurance deductions</i>	Allowed	Repealed
<i>Tax-exempt status of Blue-Cross, Blue-Shield; TIAA-CREF</i>	Allowed	Repealed for Blue Cross and Blue Shield only
<i>P&C reserve deductions</i>	Not discounted	Discount reserves; include 20-percent of un-earned premiums as well as a portion of tax-exempt bond interest in income
<i>Deduction for additions to protection against loss account</i>	Allowed	Repeal, with current law recapture rules
Industrial Development Bonds		
<i>Volume Cap</i>	\$150 per capita or \$200 million, dropping to \$100 per capita after 1986	\$75 per capita or \$250 million effective Aug. 15, dropping to \$50 per capita and \$150 million in 1988
<i>Bonds not subject to volume cap</i>	501(c)(3) bonds, multi-family housing, airports, docks, and wharves, mass commuting facilities, convention centers, and trade show facilities	501(c)(3) bonds, but subject to \$150 million institutional cap for non-hospitals, airports, docks and wharves, and governmentally owned solid waste disposal facilities
<i>Mortgage Revenue Bonds</i>	Separate volume cap, program expires after 1987	Included in IDB cap, extended through 1988
<i>Arbitrage restrictions</i>	3-year exception	Tighten restrictions
Minimum Tax	Add-on	New alternative tax with 20-percent rate; add preferences, including tax-exempt bond interest, FSC income, dealer installment reporting, capital construction funds, 50 percent of book income (switches to earnings and profits in 1990)
Net Operating Losses	1976 rules have never taken effect	Replace 1976 rules with provision for stock purchases, tax-free reorganizations; allow parent firm to absorb NOLs at rate based on long-term tax-exempt bond rate
General Utilities Doctrine	No gain recognized at corporate level on liquidating sales and distributions of appreciated property	Repealed for distributions and sales completed after Jan. 1, 1987; grandfather transactions that received transition relief under House bill as long as completed before Jan. 1, 1988

-- End of Section G --

How the New Law Affects Corporations

- The maximum corporate tax rate goes down from 46 percent to 34 percent.
- A corporation's ability to carry forward net operating losses and tax credits is limited when more than 50 percent of the stock changes hands.
- The deduction for dividends received by one corporation from another corporation is reduced from 85 percent to 80 percent.
- The basis of stock held by a corporation for less than two years is reduced by the untaxed portion of any extraordinary dividends.
- Gain will be recognized both at the corporate and the shareholder level on distributions under plans of complete liquidations and on stock sales treated as asset sales pursuant to plans of complete liquidation.
- The technical corrections in the new law are highly technical, but they are *not* mere corrections.
- By electing S corporation status, you can take advantage of the lower individual tax rates, avoid two levels of tax on the sale or disposition of the corporation's assets, and avoid application of the alternative minimum tax.

Rates

The new law reduces marginal tax rates for corporations. It also simplifies the graduated rate structure, reducing the number of brackets from five to three. Here are the new brackets and rates.

<u>Taxable Income</u>	<u>Tax Rate</u>
\$50,000 or less	15%
\$50,000–\$75,000	25
More than \$75,000	34

An additional 5 percent tax is imposed on income between \$100,000 and \$335,000, which in effect creates a flat tax rate of 34 percent for corporations with taxable income of \$335,000 or more, and a 39 percent effective rate on taxable income in the \$100,000 to \$335,000 phaseout range. *Effective date:* July 1, 1987. Income in any taxable year that includes July 1, 1987, is subject to blended rates (40 percent maximum for a calendar-year corporation).

The alternative 28 percent tax rate on corporate net capital gains is repealed. Capital gains will be taxed at regular corporate rates. For taxable years subject to the blended rate, the maximum tax on capital gains is 34 percent. The capital-loss provisions remain unchanged. *Effective date:* Tax years beginning after 1986.

Source: Understanding the 1986 Tax Changes; An Executive Summary
Touche, Ross & Co., pp.6-14

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Dividends and Redemptions

Dividends-received deduction. The 85 percent dividends-received deduction drops to 80 percent, and 80 percent is substituted wherever the 85 percent test was previously used. However, the tax on dividends received by a corporation drops from the current 6.9 percent (15 percent times the top 46 percent rate) to 6.8 percent (20 percent \times 34 percent). However, dividends received by calendar-year corporations in 1987 will be subject to an 8 percent tax (20 percent times the 40 percent blended rate); and fiscal-year corporations could pay as much as 9.2 percent if their years end no later than June 30, 1987, and they receive dividend income between January 1 and the end of their year. *Effective date:* Dividends received after 1986.

Extraordinary dividends. A corporation must now hold stock for at least two years or its basis will be decreased at disposition by the untaxed portion of extraordinary dividends. *Effective date:* For dividends declared after July 18, 1986.

An extraordinary dividend is a dividend that is 5 percent or more of the taxpayer's adjusted basis in the stock on preferred stock or 10 percent or more on common stock. The taxpayer may elect to determine whether the dividend is extraordinary by reference to fair market value (FMV) rather than to adjusted basis, if the FMV can be established to the Treasury Department's satisfaction. *Effective date:* For dividends declared after enactment.

Stock-redemption expenses. No deduction is allowed for any amount paid or incurred by a corporation in connection with the redemption of its stock. This applies to any corporate redemption and is not limited to hostile takeovers. However, it does not apply to deductible interest, to the dividends-paid deduction, or to other items currently deductible by mutual funds. *Effective date:* Amounts paid after February 28, 1986.

Limitation on NOLs

If over a three-year period more than 50 percent of a corporation's stock changes hands, an annual limitation is imposed on the use of the corporation's net-operating-loss (NOL) carryovers. The limitation is calculated by multiplying the loss corporation's value at the time of the ownership change by the long-term federal tax-exempt rate, which will be published monthly by the Treasury Department. The NOLs are eliminated if the loss corporation fails to meet the present continuity-of-business-enterprise requirements in the two-year period following the shift in ownership. The restrictions on NOLs apply to built-in losses, exclud-

ing built-in depreciation deductions; but relief is provided to the extent of built-in gains recognized during the first five years following the ownership change. A de minimis rule applies when net built-in losses do not exceed 25 percent of the loss corporation's value immediately before the ownership change.

Example. Assume that the shareholders of XYZ Corporation sell 51 percent of the corporation's stock in 1987. At the time of the sale, the corporation has \$5 million of NOL carryovers, but the corporation itself is worth only \$1 million. At the time of the sale, the long-term federal tax-exempt rate is 6 percent.

Under the new limitations, only \$60,000 (6 percent \times \$1 million) may be used each year. Since the maximum carryover period for an NOL is 15 years, no more than a total of \$900,000 (15 \times \$60,000) can be used. Consequently, at least \$4,100,000 of NOLs will be lost.

Furthermore, this loss of NOLs does not take into account the time value of NOLs not available until future years, despite the presence of substantial ongoing income.

Creditors are treated as continuing shareholders under this rule if they receive their shares as part of a bankruptcy proceeding and if they have held their debt for at least 18 months before the bankruptcy filing. Interest on the debt of these creditors is eliminated from the NOL if it was deducted in the three years preceding the bankruptcy filing. The NOLs are further cut back by 50 percent of the excess of the discharged debt over the value of the stock received.

If one-third or more of a loss corporation's assets consists of passive assets, then the income to which the NOLs can apply is subject to reduction, except for regulated investment companies and real estate investment trusts.

The value of a loss corporation is diminished by capital contributions made within two years of the acquisition date if the motive of these contributions was to avoid taxes.

The special 10-year carryback rule for financial institutions is repealed after 1986, except for the portion of commercial bank losses attributable to pre-1994 bad debts. An additional three-year carryforward is allowed for thrift institutions for losses incurred after 1981 and before 1986. Thereafter, they will be subject to normal carryback and carryforward rules.

Caveat: While the above discussion is framed in the context of NOLs, it applies equally to limiting or eliminating any other carryovers (capital losses, foreign tax, investment tax credits, and so forth) from the loss company.

Effective date: For purchases after 1986 and reorganizations with plans adopted after 1986. Connoisseurs of this subject will be happy to know that the NOL rules that were to be effective in 1986 are repealed retroactively to January 1, 1986. Thus, the 1985 rules continue in effect through 1986, with certain exceptions.

General Utilities Doctrine Repealed

After over half a century, the 1986 act repeals the Supreme Court's *General Utilities* doctrine. The new rules require a corporation to recognize a gain or loss on a liquidating distribution as if the corporation had sold its assets to the distributee shareholders at fair market value. Gain or loss will also be recognized by a corporation on liquidating sales. This change affects complete liquidations, one-month liquidations, liquidating sales of property within 12 months, and stock purchases treated as asset purchases; or in other words, Section 331, 333, 336, 337, and 338 transactions. A further change affects the conversion of C corporations into S corporations after 1986. Previously, a corporate-level tax was imposed on gain from sales or distributions within three years after the date on which the S conversion took effect. The act extends from three years to 10 years the period during which a corporate-level tax is imposed on gains accrued before the conversion. *Effective date:* For S elections after 1986.

Nonrecognition will still be available in complete liquidations of subsidiaries into their 80 percent or more corporate parents (but distributions to minority interests will trigger gain unless the liquidation is part of a merger). Nonrecognition will also be available in actual and deemed liquidations if more than 50 percent of the corporation's stock has been held by 10 or fewer individual shareholders (using attribution rules) for a substantial time, and if the FMV of the corporation's assets is \$5 million or less. Relief for small, closely held corporations phases out if their FMVs are between \$5 million and \$10 million, and this relief is available only through December 31, 1988. In addition, closely held corporations under \$10 million in value may avoid the 10-year S corporation rule if they elect S corporation status before 1989. Prior law contained exceptions to gain-recognition by corporations making certain nonliquidating distributions. The act repeals all of these exceptions with a transition rule for small closely held corporations.

The recapture, tax-benefit, and other statutory and judicial rules continue to apply to these excepted transactions. In addition, gain will be recognized on ordinary income and short-term capital-gain property for liquidating distributions.

Effective date: Liquidating distributions or sales and exchanges of stock completed after 1986.

Example. Several investors form a corporation to buy properties that have the potential for long-term appreciation. For simplicity, assume that these are nondepreciable properties, such as land, stocks, stamps, rare coins, or diamonds. After several years, the assets appreciate by \$1 million, and the investors decide to sell everything and liquidate the corporation.

Under the old law, the corporation would not recognize any gain on the appreciation, regardless of whether the properties were distributed to the shareholders and sold by them, or the corporation sold the properties and distributed the proceeds in liquidation. But if the shareholders were in the highest marginal tax bracket, they would pay capital-gains tax of \$200,000 (20 percent \times \$1 million).

Under the new law, the *General Utilities* doctrine is repealed, the corporate capital-gains rate goes up to 34 percent, and the individual capital-gains rate goes up to 28 percent. Liquidation of the corporation will trigger a corporate-level tax of \$340,000 on the \$1 million gain. When the remaining after-tax gain of \$660,000 is distributed to the shareholders, they will pay a 28 percent capital-gains tax of \$184,800. Thus, the total tax paid on the liquidation will be \$524,800, and the shareholders' after-tax proceeds will only be \$475,200, rather than the \$800,000 under the old law.

Example. XYZ Corporation, a calendar-year taxpayer, has been planning a complete liquidation for the past eight months. The liquidation is to be completed in February 1987. In August 1986, XYZ entered into a letter of intent to sell all its assets to PQR Corporation for \$17 million in cash and \$12 million in notes. The proposed sale and plan of liquidation must be approved by XYZ's shareholders. If at all possible, XYZ should complete the liquidation in 1986 to obtain the benefits of the *General Utilities* doctrine before its repeal.

**XYZ Corporation
Balance Sheet
August 31, 1986**

	000s Omitted			
	Basis	FMV	Recapture Income	Gain
<i>Assets:</i>				
Cash	\$1,000	\$ 1,000		
Accounts receivable	1,000	1,000		
Property, plant, and equipment	2,000 ^a	15,000	\$ 8,000	\$5,000
Inventory:	2,000 ^b	12,000	8,000	2,000
Total	<u>\$6,000</u>	<u>\$29,000</u>	<u>\$16,000</u>	<u>\$7,000</u>
<i>Liabilities and Shareholder Equity:</i>				
Current liabilities	\$ 500			
Long-term debt	2,000			
Paid-in capital	2,000			
Retained earnings	1,500			
Total	<u>\$6,000</u>			

^a\$10,000 less depreciation of \$8,000.

^b\$10,000 less LIFO reserve of \$8,000.

In comparing the results of liquidating XYZ in 1986, 1987, or 1988, we assume the shareholders will elect out of the installment method.

	(000s omitted)		
<i>Corporation</i>	1986	1987	1988
Recapture income	\$16,000	\$16,000	\$16,000
Recognized gain on sale		7,000	7,000
Total	\$16,000	\$23,000	\$23,000
Tax rate	46%	40%	34%
Tax to corporation	\$ 7,360	\$ 9,200	\$ 7,820
Payment of debts	2,500	2,500	2,500
Cash used for debts and taxes	\$ 9,860	\$11,700	\$10,320
Cash to shareholders (from \$17 million available)	\$ 7,140	\$ 5,300	\$ 6,680
<i>Shareholders</i>			
Taxable distribution: cash (from above) plus \$12 million in notes	\$19,140	\$17,300	\$18,680
Tax rate	20%	28%	33%*
Tax	\$ 3,828	\$ 4,844	\$ 6,164
Net cash (cash distribution less tax)	\$ 3,312	\$ 456	\$ 516
Notes	12,000	12,000	12,000
Net distribution	\$15,312	\$12,456	\$12,516

*At the 28 percent rate, the tax would be \$5,230 and the net distribution \$13,450.

Thus, the shareholders would gain \$2.856 million (\$15,312 – \$12,456) by having XYZ liquidate in 1986 rather than in 1987 (an additional 23 percent). The 1988 result does not differ significantly from 1987.

Transition rules. In addition to the rule for small, closely held companies noted above, and to liquidations, sales, and exchanges completed before 1987, two other transactions will be grandfathered. One is a distribution pursuant to either a plan of liquidation or a sale or exchange under a binding contract or letter of intent adopted or entered into before November 20, 1985. But the distribution or sale must be completed before 1988. The other grandfathered transaction is an actual or deemed liquidation under a plan of liquidation or binding contract that was adopted or entered into before August 1, 1986. Again, the liquidation must be completed before 1988.

Technical Corrections

The technical corrections in the 1986 act are highly technical, but they are *not* mere corrections. Here are some of the major changes.

Tax-free liquidations of subsidiaries. The stock ownership requirements for the tax-free liquidation of an 80 percent-or-more-owned subsidiary into its parent corporation are changed to conform with the consolidated return, affiliated-group stock ownership requirements of 80 percent of both voting power and value. The requirement that the parent own 80 percent of each class of nonvoting stock is eliminated. *Effective date:* Plans of liquidation adopted after March 28, 1985.

Reorganization changes. The transferor corporation in a tax-free reorganization will no longer recognize gain or loss on the receipt of nonqualifying consideration, regardless of whether the properties received are distributed under the reorganization plan. However, gain will be recognized on such nonqualifying distribution of appreciated property under a reorganization plan by the appropriate corporation that is a party to the reorganization. The gain is determined under the same provision that applies to gain on dividends and other distributions.

The act also provides that any property, qualifying or nonqualifying, received by the transferor corporation will have a basis equal to its fair market value. In the case of a solely-for-voting-stock asset acquisition, the sale or other disposition of the stock of the acquiring corporation (or its parent corporation) in the reorganization will not produce gain or loss; and the distribution requirement will be satisfied when distributions are made to creditors, as well as shareholders, of the transferor corporation.

The act strengthens the IRS's ability to attack liquidation-reincorporation cases by extending the "drop-down" of the stock-or-asset provision to acquisitive reorganizations. So a sale or transfer of assets from the shareholders or from the liquidating corporation to a first- or second-tier subsidiary of a corporation in which the shareholders of a liquidating corporation own 50 percent or more of the stock could be treated as a liquidation-reincorporation. As a result, the shareholders of the liquidating corporation, instead of receiving capital-gain treatment, would be treated as exchanging shares in a reorganization, and any boot (nonqualifying consideration) received would be taxed as a dividend.

Effective date: Reorganization plans adopted on or after date of enactment.

Other Changes

Discharge of indebtedness. The election allowing solvent taxpayers to reduce the basis of depreciable property rather than currently recognizing income from discharge of indebtedness is repealed. *Effective date:* Discharge of indebtedness occurring after 1986.

Extension of the residual allocation method to the purchase of assets. The 1986 act extends the residual method of allocating the purchase price in stock acquisitions treated as asset acquisitions to asset purchases generally. Under this method, both buyer and seller must first allocate the purchase price to the specific assets, up to each asset's FMV. Any remaining, unallocated purchase price is then assigned to goodwill and going-concern value.

Effective date: For transactions after May 6, 1986, unless a binding contract is in effect on that date and at all times after.

Personal holding companies (PHCs). Under the 1986 act, certain royalties relating to computer software will not be considered as PHC income. To qualify for this treatment, the recipient of the royalties must (1) be actively engaged in the business of developing computer software, (2) have the royalties make up at least 50 percent of its gross income, (3) incur substantial research or business expenses, and (4) distribute most of its passive income other than software royalties. *Effective date:* Retroactive to royalties received while the statute of limitations is still open.

Regulated investment companies (mutual funds). While not requiring regulated investment companies (RICs) to adopt a calendar year, the act imposes a 4 percent nondeductible excise tax on the excess of the required distribution over the dividends paid for the calendar year ending within the RIC's taxable year.

Effective date: The excise tax applies to dividends paid in calendar years beginning after 1986.

The definition of permitted income for RICs is expanded to include income from foreign currencies, and options to futures contracts, derived from the RIC's business of investing.

Further, if a RIC has a series of funds, each fund is treated as a separate corporation. In this instance, each fund will be considered to have been incorporated tax-free.

Effective date: These two changes apply to tax years beginning after 1986.

Planning Ideas

1. Where possible, postpone receiving income until taxable years beginning after June 30, 1987, to take advantage of the lower corporate rates.
 2. Take advantage of the alternative 28 percent capital-gains tax rate before its repeal after 1986 by selling appreciated assets before 1987.
 3. Complete all stock purchases and reorganizations involving corporations that have NOL carryforwards before 1987 to benefit from the reinstatement of the old law through 1986.
 4. Complete liquidations and sales or exchanges before 1987 before the repeal of the *General Utilities* doctrine takes effect.
 5. Consider electing S corporation status in 1986 for next year to avoid the 10-year rule (discussed above under *General Utilities*) or, alternatively, for years beginning in 1986. This way, you can take advantage of the lower individual tax rates, avoid two levels of tax on the sale or disposition of the corporation's assets, and avoid application of the corporate alternative minimum tax (see Chapter 4).
 6. Merge a C corporation into an existing S corporation by December 31, 1986, having the S corporation survive.
-
7. Complete all planned redemptions during 1986, so that shareholders can benefit from the 20 percent maximum capital-gains tax rate.
 8. Individuals holding installment notes received in previous redemptions, liquidations, or other capital-gain transactions should consider disposing of these notes in 1986 to accelerate the gain so that it will be taxed at the 20 percent capital-gains rate. Corporations that issued installment notes at high interest rates should consider refinancing or prepaying them so the noteholders can accelerate the income.

Small-Business Conferees Voice Worries About Impact of Overhaul

By SANFORD L. JACOBS

Staff Reporter of THE WALL STREET JOURNAL

WASHINGTON—The tax-overhaul bill isn't popular with small-business people assembled in the capital this week for the White House Conference on Small Business.

The bill would eliminate a number of business tax benefits and would add some accounting requirements that many small-company owners believe will be a heavier burden for them than for big corporations. "The increases are going to hit small business harder," said Steve Sellers, a delegate to the conference and owner of Sellers Advertising Co., Dallas.

"There's no way we can pass on the added tax because our business is so competitive," said Stuart Grossman, owner of Spot Distributing Co., a candy and tobacco wholesaler in Louisville, Ky., and a conference delegate.

Tax Relief

Despite the generally negative remarks heard about the bill at the conference here, tax specialists note that it contains some relief for some small companies.

Those that don't invest much in depreciable assets won't be hurt by the loss of the investment tax credit or the less-generous depreciation schedules, and will gain from the rate reduction, said Abe Schneider, tax counsel at the National Federation of Independent Business. "The rate cut is a big plus," Mr. Schneider said. About 65% of NFIB's more than 500,000 members report earnings of less than \$25,000 a year.

Along with cutting the top corporate rate to 34%, the tax bill would continue to allow even lower rates for small businesses. Income of as much as \$50,000 would be taxed at 15%, and income between \$50,000 and \$75,000 would be taxed at a 25% rate. The top corporate rate would apply to incomes above \$75,000.

Small companies with relatively higher revenues would get hit by several provisions in the bill. New inventory-accounting rules, applied to companies with more than \$10 million of annual receipts, would require keeping track of inventory-related costs such as payroll expenses for employees who order, stock and maintain inventoried items, and other expenses that businesses have been deducting as they were paid.

Under the proposed law, such costs would have to be capitalized and written off as inventory is sold. "It's a whole new ball game if you are a retailer or wholesaler," said Stephen R. Corrick, a partner in the Washington office of the accounting firm of Arthur Andersen & Co. But the new rules would apply only to businesses with annual gross receipts exceeding \$10 million a year.

That won't exempt Mr. Grossman's distribution firm. "It will mean a lot more paperwork and expense," said his wife, Phyllis.

Simplified Rules

A benefit for small companies with inventories will come from simplified rules for using last-in, first-out inventory reporting. LIFO tends to keep taxes lower in inflationary periods than the first-in, first-out, or FIFO, method. Many small companies, however, use FIFO because the accounting methods that the tax code required for LIFO were too costly. "We think this will help small retailers and wholesalers," Mr. Schneider said.

The bill ends the tax benefits a business owner could gain by also owning the firm's buildings and then leasing the property to the company. The new restrictions on so-called "passive losses" will bar writing off the paper losses from such an arrangement against the owner's salary. The new bill would allow losses from passive investments such as real estate to be written off only against passive income, which doesn't include income from portfolio investments such as stocks and bonds.

Impact on Small Business

Here's what hurts:

- Elimination of investment tax credit
- Less generous depreciation
- Elimination of tax benefits of owning property and leasing it to the business
- Requiring certain inventory-related costs to be deducted only as inventory is sold (affects businesses with more than \$10 million of annual gross receipts)
- Elimination of "General Utilities" doctrine, which allowed a firm to be liquidated with minimal tax consequences
- Requiring greater participation and faster vesting in retirement plans

Here's what helps:

- Maximum corporate tax rate lowered to 34%
- Simplified LIFO inventory accounting

Still there would be financial reasons and some tax benefits for the business owner and his family to own the company's real estate, said Robert Milburn, a tax partner at the accounting firm of Laventhol & Horwath. He said one advantage "is that you can dispose of it without having to pay corporate tax."

Benefit for Family Members

A common practice in closely held retail chains is for family members to own real estate partnerships that own stores and lease them to the corporation. C. Clinton Stretch, tax director of Washington office of Deloitte, Haskins & Sells, accountants, said it is a way to provide benefits for family members who aren't employed in the business. The partners will lose the tax advantages—mainly deducting paper losses from depreciating the properties—in the new law.

Tougher rules on sharing pension benefits more quickly and with more employees will force many small companies to rewrite retirement plans to qualify under the new rules. Mr. Grossman said he recently paid \$5,000 to have his company's retirement plan rewritten. "In a small firm, \$5,000 here and \$5,000 there can be the difference between profit and loss," he said. Mr. Stretch noted there is concern that "the way some small companies will handle the required modification is to junk the plan."

Partnerships, proprietorships and Subchapter S corporations, whose profits and losses are taxed to the owners as partners are taxed, would be forced onto calendar-year accounting for tax purposes under the new law. Often, businesses use a fiscal year while the owners report income on a calendar year, and thus have the use of the profits for a time before they are taxed.

Capital Gains

Next year, capital gains would be taxed at 28%, making it advantageous to take gains this year while the rate is 20%. And in some states there will be significantly greater state tax due on capital gains next year because of the interplay between state tax schedules and the change in the federal rules, Mr. Milburn said. "You can end up owing state tax on 100% of the profit," he said. Under current law, as much as 60% of a capital gain is free of tax in a number of states.

Cashing out of a small business with a minimal tax bite has been possible if the liquidation complied with rules following the so-called General Utilities doctrine. The proposed law would phase out this advantageous procedure.

Overall, the tax bill "is no great news for small business," said Gerald G. Portney, a partner in the Washington tax office of Peat, Marwick, Mitchell & Co.

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Tax Overhaul Would Kill Popular Tactic, Mean Higher Bill for Many Professionals

YOUR MONEY MATTERS

By MARTHA BRANNIGAN

Staff Reporter of THE WALL STREET JOURNAL

A favorite tax-deferral device of doctors, lawyers and other professionals is being wiped out by the new tax bill.

"This is the grinch that stole Christmas," says Harold I. Apolinsky, a Birmingham, Ala., tax lawyer and vice president of the Small Business Council of America, a trade group. "Congress just ruined Christmas" for professionals.

The change affects professionals who structure their practices as partnerships, S corporations or regular personal-service corporations—the most popular vehicles for professional practices. Under current law, these people can postpone taxes on some of their income by putting the business entity on a fiscal year different from the calendar year they use to figure their personal taxes; the income they realize between the end of the fiscal year and the end of the calendar year isn't taxed for another year.

But under the plan approved by congressional tax conferees, both the business and the individual will, in most cases, have to use the same tax year. Although there is an exception for professionals who can demonstrate sound business reasons for not having the years coincide, few are expected to qualify. The change takes effect in fiscal years beginning after Dec. 31.

Raising \$1.7 Billion

Congress estimates that the switch, along with a separate, minor deferral-killing provision, will raise roughly \$1.7 billion over the next five years. In the short run, the vast majority of professionals are expected to face higher tax bills.

"It all boils down to timing," says Stuart Becker, president of Stuart Becker & Co., a New York tax-accounting firm. "The government is going to get the money sooner."

The maneuvers that the tax bill eliminates are complicated, but the principle is simple: deferring taxes by exploiting the gap between fiscal and calendar years.

For instance, if a professional partnership's fiscal year ended Sept. 30, 1985, the partner's personal tax return for calendar 1985 didn't have to show income earned by the partnership after Sept. 30; that would be included in the return for 1986. The same applies for an S corporation, a "pass-through" entity that, like a partnership, doesn't pay tax at the firm's level.

With personal-service corporations, employee-owners have been able to defer income by paying themselves a bonus, equal

to the corporation's undistributed net profit, at the corporation's fiscal year-end—after the end of the calendar year on which their personal taxes are based.

Individuals with personal-service corporations will be hit hardest by the elimination of such maneuvers, says Stanley L. Blend, a San Antonio, Texas, tax lawyer. That's because partners and employee-owners of S corporations will be able to spread the extra taxable income over four years. But those with regular corporations will have to recognize all of it in one year and will thus wind up paying at a higher rate.

Mr. Blend gives the example of a lawyer with a corporation that uses a fiscal year ending on Jan. 31. The lawyer pays himself a salary of \$7,000 a month plus a fiscal year-end bonus of \$174,000, for a total gross income of \$258,000.

Under the pending legislation, Mr. Blend continues, the lawyer would have to include an additional 11 months of per-

'IT ALL boils down to timing,' says the president of a tax-accounting firm. 'The government is going to get the money sooner.'

sonal-service corporation income—\$152,500—in his gross income. At the 38.5% transitional top tax rate provided in the bill, that would mean an added tax of \$58,712. But if the lawyer had a partnership instead of a regular corporation, the additional tax—paid over four years at rates declining from 38.5% to 28%—would total \$48,304, Mr. Blend says.

'A Horrible Nightmare'

No one is more peeved about the change than accountants and tax lawyers. They not only have to pay extra taxes, but also face highly concentrated workloads as many of their clients are forced onto a calendar year. "It will be a horrible nightmare," says Morton Harris, chairman of the Small Business Council's legislative committee. "This will concentrate work for accountants, tax attorneys, anybody meeting with clients at the end of their fiscal year."

Many accountants predict the switch will be just as painful for the Internal Revenue Service, which also faces a more concentrated workload. These accountants expect a lot of requests for extensions.

That "won't help us much," however, says Thomas P. Ochsenchlager, a partner in the Washington office of the accounting firm Grant Thornton. "We've got to do the

computations and estimate the tax in order to file for the extension."

The bill does provide an exception for firms that can show a convincing "business purpose" for a different tax year. IRS regulations say that a highly seasonal business may have "a natural business year," ending after business hits its high point. A retailer, for example, who makes most of his sales over Christmas and New Year's could seek a year ending just after then.

One acid test the agency uses to determine a "natural business year" for an S corporation is that if a company gets 25% of its gross receipts within two months, its year ends after that.

Gary W. Dix, a Miami accountant, says some of his clients—doctors and other professionals—can make a case for a non-calendar year, because of southern Florida's tourist season. "We're certainly going to try for it where we think it applies," he says. Some other accountants and lawyers say, however, that they doubt the IRS will be sympathetic.

Some accounting firms assert that because most of their work is bunched into the first few months of the year, they deserve to pick a year ending sometime after April 15, when workloads peak.

"I can't think of a more unnatural business year end for us than Dec. 31," says Gerald W. Padwe, national director of tax practice for Touche Ross & Co., whose year ends Aug. 31. "We don't want to be closing our books and worrying about internal things then. That's our heavy client time."

Waiting to Bill

As firms switch to a calendar year, owners must decide how to handle the "short year" or "stub year" as part of their overall tax planning. They may want to accelerate or defer income or expenses during that period. Firms using cash-basis accounting, for example, can reduce their income by not billing clients until the next tax year.

"It will depend on individual circumstances," says Mr. Becker. "If you're over-sheltered or have too many deductions, you may want to accelerate income into that short year." Alternately, an individual may wish to accelerate deductions and postpone income "to push it off until the rates are lower," he says.

Those with regular personal-service corporations may want to make them S corporations to spread the extra taxable income over four years, says Jerald D. August, a Palm Beach, Fla., tax attorney.

"The tax bill is creating a lot of good reasons for wanting to go S corporation during 1987," Mr. August says, noting maximum individual tax rates will be lower than the maximum corporate rates. "This is one more."

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