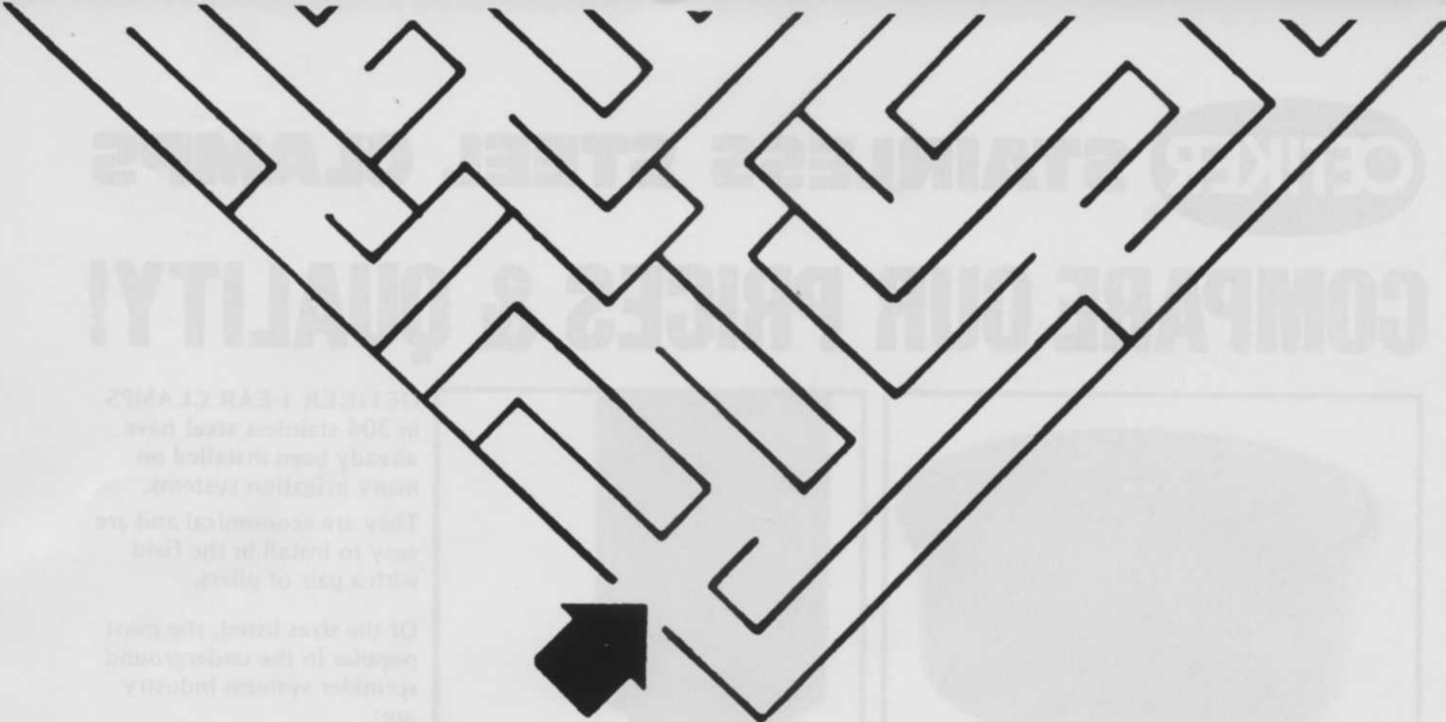

Living in 1977 with the Tax Reform Act of 1976

by Joseph Arkin CPA, MBA

The Tax Reform Act of 1976 is the most comprehensive, complex and massive overhaul of our tax system that has ever been attempted. It affects you both as an individual and as a Green Industry businessman.

Some of the provisions enacted into law have proven to be unduly harsh and there are hearings being held at the time of this writing to enact legislation to mitigate some of the provisions of the 1976 Act.

Listed below are some of the more important features affecting the filing of your 1977 tax return:

Corporate rates

The reduced corporate rates have been extended through December 31, 1977. Corporations will pay 20% on the first $25,000 of taxable income, 22% on the next $25,000 and 48% on taxable income in excess of $50,000.

Capital gains and losses

As an individual you'll be entitled to deduct $2000 in capital losses against other ordinary income (interest, dividends, salaries, business profits, etc.) in 1977 and $3000 in 1978.

As in the prior tax act (Tax Reform Act of 1969) you'll need to use $2 of long-term loss to offset $1 of ordinary income. The holding period for long-term gains and losses will be nine months in 1977 and twelve months in 1978 and thereafter instead of the six-month period we've been accustomed to during these many past years.

Individual rates

There hasn't been any change in the tax rates but all taxpayers having a taxable income of $20,000 or less must use a new set of tax tables. These new tables are based on taxable income as opposed to adjusted gross income as in years 1975 and prior. In 1977 there will continue to be a credit of $35 per exemption (exemptions for blindness or being over 65 not being counted), or 2% of the first $900 of taxable income, whichever is greater.

The standard deduction minimum is $1700 for singles and $2100 for a joint return. Maximum standard deduction is 16% of adjusted gross income with a ceiling of $2400 for singles and $2800 for a joint return.

Investment credit

The purchase of equipment qualifying for the investment credit will give rise to a 10% credit as a reduction against tax liability — this applies both to individuals and corporations.

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And until December 31, 1980 the ceiling on investments in used property will remain at $100,000.

Corporations with ESOPS (employee stock option plans) can get an extra 1% if they meet certain requirements — and the credit can go as high as 11½% if both employer and employees agree and contribute the extra ½% to the plan.

Foreign conventions

To halt the abuse of conventions being held outside the U.S. (to make them more sightseeing than business and a drain on the balance of payments) the law now provides that you can only deduct for the costs of attending two foreign conventions in any year. If more than two are attended, the option is left to the taxpayer to claim deductions for the two of his choice. There are also limits to the amounts that can be spent for transportation and subsistence.

The per diem limit for subsistence expense for any one day can't exceed the per diem rate applying to U.S. civil servants serving in that area of the world during the calendar month in which the convention begins.

Transportation expenses are limited to coach or economy fares only, no first class fares. The transportation costs will not be allowed in full if half or more of the total days of the trip are spent on non-business related activities.

It would be prudent to attend at least two-thirds of the business activities (seminars, converences, lectures, etc.) scheduled during the convention. Make sure you sign in and keep a detailed log or diary and proof of attendance. In fact you're going to need a statement from the sponsoring organization verifying the amount of time you spent at business-related activities and functions.

Qualified stock options

Both as an employee and stockholder-employee the new law spells bad news. Stock options granted under plans adopted after May 20, 1976 give rise to immediate tax liability as *ordinary* income.

Plans adopted prior to May 20, 1976 qualifying under Sections 423 and 424 will still qualify. Restricted options must be exercised by May 21, 1981 to retain special treatment.

Child care expenses

This section is mislabled as the law also applies to persons (other than children under 15) who are physically disabled.

Does your spouse help in your business and you incur expenses to take care of your children or a disabled dependent?

The child care deduction has been abolished and a new non-refundable credit equal to 20% of the employment related expenses is available. This reduces your tax liability, not just your taxable income and is a decided advantage.

There are a lot if "ifs and buts" — payments to relatives now qualify if the person isn't your dependent and you pay social security taxes on the wages paid; (b) if your spouse works part time the earned income limit applies to the spouse with the lower income; (c) if the spouse has no earned income there is an assumed income of $166 per month if you have one dependent and $333 per month if you have two or more dependents; (d) marrieds can only claim the credit if a joint return is filed; (e) allowable expenses no longer need be reduced by the dependent's disability income.

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The new credits are $2000 for one individual (child under 15 or spouse or dependent incapable of self-care) giving rise to a cash credit of $400 or $4000 for 2 or more with an $800 credit.

Another important change here is that this actual reduction of tax liability can be taken and the standard deduction can still be used.

Sick-pay exclusion

The old sick-pay rules are thrown out and only a group of under 65-year-old disability retirees are eligible for the new disability exclusion.

According to many tax practitioners and publishers of tax periodicals there is a transition rule to protect those who qualified by retiring before January 1, 1976. ALSO, there is a little-known Public Law 94-455 which seemingly conflicts with the instructions on form 2440 and the instructions in current IRS tax booklets issued to the public.

Home office expenses

A taxpayer, employed or self-employed, must show that the deduction for a home office expense meets the stringent set of rules: (a) the area used must be exclusively used on a regular basis (cannot be part of a den or another room used for person pursuits) as a principal place of business, or as a place for meeting patients, clients, or customers in the normal course of business; (b) employees have to prove that the exclusive use is for the convenience of the employer. If you operate a business (retail or wholesale (out of your home as a selling operation and regularly use it for storage, you can still get a home-office deduction. Also, if you have a separate structure, not attached to your home, used exclusively for your business operation you can still get the deduction.

Keogh plans

The provision that you were able to contribute up to $750 without regard to percentage limit came into conflict with the rule limiting deductions to 25% of income. The new law removes the ceilings of 25% for

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self-employed taxpayers earning less than $15,000.

The ceiling on yearly contributions is still $7500 and limits of 15% of that contribution still apply.

Moving expenses

The 50-mile rule has been reduced to 25 miles, and the maximum deduction for pre-move house hunting and temporary living expenses has been increased from $1000 to $1500 while the maximum deduction for qualified expenses relating to sale, purchase and lease of a new principal residence has been increased from $2500 to $3000.

Non-business guarantees

Starting in 1976 the differences between guarantees and direct loans will end. If an individual taxpayer has a loss arising from a loan guaranty, he or she will get the same treatment as if the loss were from a direct loan. So, a loss on a guaranty connected with the taxpayer's trade or business will be treated as an ordinary loss. While a loss on a guaranty that's entered into for profit, but not connected with taxpayer's trade or business, will be treated as a short-term capital loss.

Prepaid interest

Cash basis taxpayers as well as accrual basis taxpayers will now have to spread the prepaid interest cost of a loan over the life of the loan. Points, other than those paid on home mortgages, must likewise be spread over the life of the loan.

Interest limitations

Where interest is deducted for investment purposes a limit of $10,000 is imposed, plus the amount of th investment income. Long-term capital gains are no longer counted as net investment income. Where interest in incurred in making an investment in a 50 percent owned corporation or partnership there is a special rule. Here the figure goes up to the lesser of $15,000 or the amount of the interest on the debt used to acquire the corporation or partnership.

Confusion abounds. All taxpayers are subject now to pre-'70, pre-'76 and post-'75 interest deduction rules. A special allocation rule applies to determine how much current investment interest is deductible on investments subject to the prior year rules. And, there are carry-over rules for currently disallowable interest to be carried forward indefinitely, subject only to the post-'75 limitations.

First-year depreciation

Under the old law $2000 limit ($4000 on joint return) of additional first year depreciation allowance applied to the partnership level. Thus five married partners could deduct $4000 each if the partnership purchased an asset for $100,000. Now the law makes the limit apply both at the partnership and partner level, so in effect the partnership will only be able to flow through to its partners their allocable shares of the $2000 limit.

There are many liberalizations regarding firing and layoff, because of lack of business.

Organization fees of partnerships

Corporations have had to amortize their organization expenses over 60 months, and now partnerships can make the same election of amortizaiton and can no longer deduct fees in the first year of operation.

Subchapter S corporations

Under existing laws only 10 stockholders were permissible. Now after 5 years of existence a Subchapter S corporation can have up to 15 shareholders. There are also new rules about joint ownership of stock, transfers to estates and trusts.

Prior law required new stockholders to file consent for Subchapter S election or the election was lost. Now the new stockholders needn't file a consent and the status of Subchapter S will remain unless the new stockholder files an election to terminate.

IRA benefits to homemakers

An employee can now set aside retirement savings for the benefit of a spouse who doesn't work outside the home. A qualifying individual can contribute up to $1750 to a single IRA that has subaccount for the spouse. Or he or she can make contributions to his or her own account up to $875 and up to $875 to a separate account for the spouse. In either case the total deduction does have an overall limit of 15 percent of compensation.

WIN benefits

The old law providing that an employer hiring a qualified person (the hard-core unemployed) and following all of the required rules could claim a cash credit against taxes of $25,000 plus half of the employer's taxes above $25,000. Now the ceilings are raised for a credit up to $50,000 plus half the taxes above $50,000 — and there are many liberalizations regarding firing, and lay-offs, because of lack of business.

Joseph Arkin holds a BBA degree in accounting from St. John's University, an MBA degree in taxation from Pace University, is licensed by the States of New York and Florida as a Certified Public Accountant and is enrolled to practice before the Treasury Department.