CHAPTER 6

THE IMPACT OF THE 1986 TAX LAW CHANGES ON SOLO PRACTITIONERS

I.

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The words "tax reform" are code words. What they mean is tax complication; they change the tilt of the playing field from one direction to another. As a matter of fact, the Internal Revenue Code (which consists of two volumes) is now thicker by far than it was before the 1986 Tax Reform Act, and many believe that, by the time the necessary Technical Corrections Act is passed, it will be even thicker.

Let us look at the 1986 Tax Reform Act in some respects that should particularly affect you.

Income

All of you know the income tax rate structure for 1987: There is a maximum of 38½ percent for individuals. In 1988, it is supposed to drop to 28 percent, with an extra 5 percent surcharge for income between $77,000 and $149,000, which is to make up for a lower bracket below that. Whether it will, in fact, drop to 28 percent is an interesting question. The latest information is that Senator Lloyd Bentsen is now on record as saying that he is not opposed to its dropping. Representative Dan Rostenkowski has said some things that fall on both sides of the fence, and no one really knows what is going to happen.

For corporations there is a split year in 1987 in that corporations whose tax year begins before July 1, 1987, are taxed at rates which go up to 46 percent, while corporations which have

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tax years beginning after June 30, 1987, are taxed at rates which go up to 34 percent plus a small additional amount. Obviously, those of you who are incorporated know that you are going to have to change your fiscal year to a calendar year in all likelihood.

One of the things that you may want to do, whether you are involved in a corporation or not, is to defer income until the next fiscal year and take advantage of the lower brackets. You may do this in several ways: restructuring employee compensation and moving year-end bonuses to the beginning of the next fiscal year; buying T-bills, E-bonds, CDs, or annuity contracts that defer income, but avoiding money market funds (where the income is reportable immediately).

Each of you has probably been approached by someone in the insurance industry presenting the so-called tax deferred annuity arrangement where the inside buildup is not subject to tax. This type of investment is in peril precisely because it is, at the moment, the only really good game in town. The inside word seems to be that, if the hammer comes down on that, it may well come down retroactively to a date many months ago, perhaps January 1987. There is no guarantee that this is going to happen, but the great press of insurance agents to get people to invest in tax-deferred annuities may come to naught; on the other hand, "reform" may be grandfathered to some later date.

Personal service corporations have to change to a calendar year by the end of 1987 unless they meet a so-called 25 percent of gross receipts test—that is, that 25 percent of gross receipts is received in the last two months and that such has been the case for each of the last three consecutive 12-month periods. The general explanation of the Tax Reform Act (which is usually known as the Blue Book) states that the U.S. Treasury Department may prescribe other tests which corporations may meet instead of 25 percent in the last two months, but do not hold your breath for that.

In regard to the calendar-year requirement, any personal service corporation that is not an S corporation does not get the four-year period of time which an S corporation is given in order to pick up the excess income that is caused by switching to a calendar year this year. A personal service corporation which is not an S corporation has to have its income annualized under Section 443, the regular system of annualization.

Since several of you are in Subchapter S corporations, you should know that if you elected S status before 1987, you remain liable for a special tax under the old law, which applied to capital gains in excess of $25,000 in any of the first three years after you made the election; however, you will avoid a new built-in gain tax that I will describe in a minute. If you failed to make an S election before 1987, this election may still be made by a qualifying small corporation in 1987, 1988, or 1989. But if the first S year begins after 1989, then if any item held at the time of the election (whether an inventory item, an account receivable, or a physical asset of the corporation) of a qualifying small corporation is sold or distributed within ten years thereafter, it will be subject to a tax on the excess of its fair-market value over its basis at the beginning of the first S election year (its "built-in gain").

Interest Deductions

Having spoken a little about income, I now turn to deductions. Under the 1986 Act there are four kinds of interest expenses: trade or business interest, investment interest, qualified housing interest, and personal interest. Trade or business interest is deductible, subject only to what is known as the passive loss rules that are designed to prevent people from going into passive business activities, such as tax shelters, and receiving losses from those activities which they then take against their ordinary income from their own services or against their investment income.

Housing interest is going to be deductible if it is interest on a loan secured by a mortgage on your first or second home. You have probably all read about the question of whether a boat or trailer can be a second home. That seems to be up in the air, although originally it was thought it would be, and it may still be. However, the amount of the loan on which the interest is deductible is limited to the cost of the home, plus the improvements. And improvements is a rather tricky concept, because many of you may not keep accurate records of every payment that you put into a home, boat, or trailer. Most people, in the past at least, have not kept accurate records and therefore would not readily be able to determine the total amount of the improvements they have made, particularly since there is a distinction between what is known as improvements and what is known as maintenance items.

In the business setting in the past, people have been trying to maximize the maintenance items, as opposed to the improvements, because you could deduct the maintenance items. In the home, most people did not pay much attention because nothing was deductible; but if the matter ever comes to litigation (which it probably will in a few years), the Internal Revenue Service may argue contrary to the way it has argued in the past in the business area; namely, that what you thought were improvements (which therefore should increase the amount of the mortgage loan, the interest on which is deductible) really were nothing but maintenance items and therefore did not increase the amount of the mortgage loan on which you can deduct the interest (and were not themselves deductible).

Consumer interest is nondeductible, except that in 1987 the nondeductibility will extend only to 35 percent. In 1988, it will extend to 60 percent; in 1989, to 80 percent; and in 1990, to 90 percent. Thereafter, it will be 100 percent nondeductible, and that includes interest on personal income tax underpayments but not on corporate tax underpayments. (When I speak of corporate, I am talking about non-S corporations.) Therefore, while regular C corporations may still deduct interest on their income tax underpayments, individuals may not.

Investment interest is limited to net investment income, and any excess investment interest is subject to the same phase-in rules as consumer interest. But any excess investment interest may be carried over to offset future years' net investment income.

Losses

Passive losses, mentioned before, are not useful against earned income, business income, or portfolio income, which is surprising because the most passive type of income would seem to be dividends and interest. However, dividends and interest are considered investment income and not passive income. Therefore, you may not deduct your individual or your personal service corporation's passive losses against that kind of income. Nonetheless, the passive losses that are not deductible in a particular year are deductible when you sell your entire interest in the passive activity, if that ever occurs. I believe that for each of you any arbitration business losses are not subject to the passive loss limitations.

Miscellaneous Deductions

Miscellaneous itemized deductions have a floor, or a "haircut," as the in-word seems to be, of 2 percent of adjusted gross income. This means that expense items, such as unreimbursed employee travel, investment advisory fees, and tax planning or tax preparation fees for an individual or an S corporation, are not deductible except to the extent that they exceed 2 percent of adjusted gross income.

Alternative Minimum Tax

In addition, there is the alternative minimum tax, which we have been living with, but which has been greatly strengthened and is now a 21 percent tax with additional preference items in its base. The alternative minimum tax will have to be computed in virtually every situation as a second computation.

Estimated Tax Payments

Income averaging is now kaput. There are new rules as to estimated tax payments: 100 percent of the previous year's tax liability as before; or 90 percent, not 80 percent, of the current year's liability.

Investment Tax Credit

Investment tax credit, which probably did not apply to you very much except for typewriters and things of that nature, is kaput.

Kiddie Tax

One other thing before getting into the 80 percent limitation is the so-called kiddie tax. If you have children under 14 years of age, the kiddie tax will tax their unearned income of more than $1,000 at your top bracket. That creates havoc if you happen to be divorced or separated and not on friendly terms with your spouse, whose top bracket may be involved. Who gets the information? Who represents the child? These are tremendous problems. We are hoping to get this changed so that it will be similar to the income taxation of trusts and estates. Instead of having to go to somebody else's tax bracket, there would simply be a compressed rate structure with the tax higher earlier, so that children would not have the same benefit of the exemptions and run up the brackets as to their unearned income. As of now, the kiddie tax is a terrible problem.

Business Expenses

Business travel remains fully deductible. However, meals and entertainment are only 80 percent deductible. But in 1987 and 1988 you may get a full deduction for attending "qualified banquets" of at least 40 people at a business convention, where there is no separate cost charged for the banquet, where there is a speaker, and where more than 50 percent of the audience is away from home.

Substantiation requirements have been tightened very much. In order to have any deduction, a meal expense has to be directly related to or associated with the active conduct of your trade or business. This means that meals for investment purposes will not be deductible. So if you take your broker to lunch, you will not get a deduction. In addition, the meal must have a clear business purpose currently related to the active conduct of your trade or business. Although it is not necessary to discuss a specific transaction at the meal, the meal cannot be lavish or extravagant. (For example, I noticed the other day a discussion of an $80 meal being considered $20 extravagant; who is to make such a determination, and how much is one expected to know about it all?) In addition, the meal must be provided in the presence of the taxpayer or an employee of the taxpayer. It is going to be extremely difficult to meet these tests. The old rule under which you could have a "quiet business meal" following a business discussion is out.

If you are in a partnership or an S corporation with a fiscal year, the Internal Revenue Service has come out with the position that the 80 percent disallowance started January 1, 1987, no matter what your fiscal year is.

Conclusion

Some of these "reforms" were driven by the quest for revenue, but they do not make common sense and are very discouraging. Yet we have to live with them, at least until Congress changes the unlevel of the playing field in some new direction.

(*Editor's Note:* During his presentation, Mr. Benjamin answered the following questions asked by Academy members)

Q. My general question is with respect to your comments on interest deductions. Are they applicable to both those in corporate form as well as those in sole proprietorship?

A. They are generally applicable to both sole practitioners and to personal service corporations.

Q. You mentioned a 2 percent cap on certain deductions. I missed that.

A. For example, suppose you have $100,000 worth of ordinary adjusted gross income. The first $2,000 of your miscellaneous itemized deductions are not going to be deductible. For an individual, miscellaneous itemized deductions are those which are not directly related to your profession but which you undertake as an individual investor and have been deducting in the past, such as bank boxes.

Q. Professional insurance?

A. No. I think professional insurance would be part of your business expense.

Q. Health insurance?

A. Yes, things of that nature.

Q. To put it in terms we all may relate to, if we file Schedule C, as I think most of us do who are not incorporated, and we belong to the Academy, those professional expenses are deductible without meeting the 2 percent rule, are they not?

A. If they are directly related to your profession, yes. But if they are not, if they are incidental or miscellaneous, like bank boxes, investment advisory or tax planning fees, those kinds of things are subject to the "haircut."

Q. I think all of us, because of what we do, need to know about the effect of the rule on travel expenses.

A. Expenses directly related to your profession are not subject to the "haircut." It is the miscellaneous itemized deductions, which are not directly related to your professional activities (the investment-type, personal-type deductions, and those related to investments) that are subject to the "haircut."

Q. Is the last part of your answer also applicable to the professional service corporation?

A. Yes, if the personal service corporation is an S corporation; no, otherwise.

Q. You mentioned the 80 percent rule for business expenses. As arbitrators, most of us travel constantly, maybe on a daily basis, flying, that sort of thing. We are reimbursed by the parties, our clients. How is the 80 percent rule applicable there?

A. First, let me mention how the 20 percent disallowance of meals and entertainment expenses works: only 80 percent is going to be deductible by someone, that is to say, 20 percent of a client's payment to you is not going to be deductible either by the client or by you, depending upon your arrangements.

Q. Does this mean that, if you somehow couch it as a fee instead of an expense, you avoid that rule? That is, a fee is totally reportable as income but, because it is a direct business expense, it is 100 percent deductible to the client.

A. I don't know how you arbitrators bill. We lawyers bill for fees and expenses separately, the client reimbursing for the expenses. The disadvantage of the suggestion you make is that expenses are fully deductible by us and then fully reimbursable to us later. So it is a wash to us, with the client deducting only 80 percent. If you were to convert your expenses into part of your fee, rather than itemizing them to your client, then the deductibility of your expenses would automatically be limited to 80 percent instead of your client's deductibility being so limited.

Q. But if it is a nonreimbursable expense and directly related to my business, does not that fall outside the 80 percent limitation?

A. No, all your business meals and entertainment are indeed subject to the 20 percent disallowance.

Q. Who has the option of determining who may deduct only 80 percent, the client or me?

A. You have the option, depending on whether you bill the client separately for meal and entertainment expenses. If you bill separately, you should keep your own expense records very carefully, and for a long time. You should keep receipts or invoices for all charges greater than $25, evidence of the purpose of the expenditures, their time, place and purposes, and who was present and why.

Q. When you talk about business expenses and traveling, are you separating out food expenses from other travel expenses? My understanding is that the food is deductible only as to 80 percent but airline tickets are 100 percent deductible.

A. That is correct.

Q. If I have an arbitration case and I bill the parties $200 to fly someplace, and they pay me the $200, they may deduct $160 (80 percent), but I may deduct the entire $200. Is that correct?

A. No, the client may take the full deduction for your travel.

Q. What is trade or business interest? If I take a loan to fund my KEOGH, is that trade or business interest and thus 100 percent deductible?

A. Yes, it is not subject to the 2 percent "haircut."

Q. What is trade or business interest in the arbitration business?

A. It may not be applicable in your case. If you had to borrow money in order to support your travel, or if you needed to borrow to buy a depreciable library or typewriter, that would be trade or business interest.

Q. Would it make a difference whether I was incorporated or not incorporated?

A. It would make a difference only if you are not in an S corporation.

Q. Last year my travel expenses were way, way up there. If we assume that they were $50,000 or $60,000, directly attributable solely to arbitration services and are all reimbursed, next year both the client and I will be able to deduct 100 percent. Is that right?

A. That's right; the business travel itself is 100 percent deductible. Only the business meals and entertainment, not the business travel or room rent, are 80 percent deductible. However, travel and lodging expenses for a convention other than for a business purpose, such as for investment purposes, will be nondeductible.

Q. Our attendance here this week is unique for most of us, that is to say, it is a once-a-year business convention. Conventions in general have always had strange rules applied to them, and I understand that. What is more the norm is that we will check into a hotel on an arbitration call (because we almost never do business in our own home town), and we charge for the travel, hotel, meals, and everything else. Now, is there a distinction between this and the business convention situation?

A. There is no distinction. At a business convention the meals and entertainment are also only deductible to the extent of 80 percent—that is, unless you have a "qualified banquet" in 1987 or 1988. However, remember that expenses for attending a nonbusiness convention are not deductible at all.

Q. But the distinction, as I understand it, is that, when we are on an arbitration case and for no other reason, hotel and meal expenses as well as travel are fully deductible.

A. No. The travel and hotel room are fully deductible, but the meals are subject to the 20 percent disallowance.

Q. Is it true that one of us, that is, the arbitrator or the parties, is subject to the 20 percent disallowance, but not both?

A. That is correct.

Q. So it is conceivable that the arbitrator will say to the parties: You should know that I am billing you for the meals, and you should not deduct 20 percent of those expenses. Is that correct?

A. Yes.

Q. Where one of the parties to the arbitration is tax exempt, such as a public body, for example, then you have a further problem, don't you?

A. The public body does not have the same problem. It presumably does not have taxable income against which to take deductions. Therefore, it is not in the same realm as a private party.

Q. Then, if I have to deduct the 20 percent, it means 10 percent really, does it not?

A. No, because if you work it out that your public-body client takes the 20 percent disallowance rather than you, then the public body would not be subject to that disallowance because—assuming it has no unrelated business taxable income—it has no taxable income and hence no deductions.

Q. That is right, but suppose I have to take the disallowance for both parties—the private entity and the public body?

A. If you take the disallowance, it is still 20 percent to you, but if you worked out the arrangements with both clients, so that you are going to take the 100 percent deduction and they are going to take only the 80 percent, it affects only one.

Q. Yes, I understand that, but that seems a little peculiar, doesn't it?

A. No, because the public body presumably has no income and therefore no deductions.

Q. Regarding the issue you have been discussing where the parties do not have an understanding as to what will happen, in the absence of such an agreement, the payor in your law firm would be the person who takes the hit. Is that correct?

A. That is correct only if we chose not to itemize meals and entertainment separately.

Q. Has there been any change in the new law in the way that debts are collected, receivables are treated?

A. There is a new rule about the reserve for bad debts. You may not have a reserve for bad debts any more. Bad debts must be charged off on a specific item basis. Is that what you had in mind?

Q. I had in mind a fee that remains outstanding over a period of time and one is unable to collect it. May one take a deduction?

A. Aren't you on a cash basis?

Q. No, as it happens, I am on an accrual basis.

A. Are you a corporation?

Q. Yes. Is the accrual basis being discontinued, with all corporations required to go on a cash basis?

A. No. Congress was going to require all partnerships and professional service organizations to be on the accrual basis, but that was defeated as to professional partnerships and as to qualified personal service corporations. So it is not in effect as to your small corporation. Therefore, if you are not on the accrual basis, you need not take into income the fees that have not yet been collected. If you are on the accrual basis, however, you do have to, at the end of your fiscal year. If it turns out to be uncollectible, you get a deduction.

Q. And that is the same as it was before?

A. Yes, with one exception: Because your corporation renders service, it can escape taking into income any accrued fees that on the basis of experience it does not expect to collect, provided that it charges no interest or penalty on these accrued fees.

Q. I use a detailed fee statement that I send to both clients at the time of my appointment. Assuming that the 20 percent disallowance applies to meals and certain other business expenses, would you see any problem in my including in that detailed fee statement a note to the effect that I will not assume any disallowance and that this will have to be agreed to by the clients at the time of my appointment? If I send that out to the clients, do you see any problem in the fact that my appointment would be contingent on their accepting that condition?

A. No, I see no problem with that, provided that you follow it up with a detailed accounting for each meal, and so on. Where they have to get arbitration, they should be willing to accept that.

Q. I have a question with regard to billing by my corporation. If the corporation bills the parties for meals, telephone calls, whatever the expenses are, and the parties pay the corporation, what is the impact there? Isn't that 100 percent deductible both ways?

A. Who incurs the actual expense? Are we talking about a meal cost that is incurred by the individual corporate owner? Or does the professional corporation itself pay for the meal?

Q. The professional corporation sends the bill and collects what is billable against the arbitration case. When this includes a meal, the corporation bills the clients.

A. So, in effect, the corporation takes this as its own expense and bills the clients and may then reimburse its employee, and the question is: Will there be a 20 percent disallowance and, if so, at what level? If the employee gives the corporation an accounting of the meal cost and is fully reimbursed for it, there should be a 100 percent deduction to offset the income received when repayment is made. If the corporation itemizes the meals in billing the clients, it likewise should get a 100 percent deduction to offset income received under repayments. The clients stand the 20 percent disallowance.

Q. In terms of our own record-keeping responsibilities, and looking down the road toward an audit, if you have several thousand dollars of meal expenses over the year and the IRS sees that you have deducted these all 100 percent, where does it go from there? What is your responsibility to be sure that the clients have not also taken the 100 percent deduction? How do you administer that to protect yourself?

A. An advance agreement, as was mentioned before, is the best way to do that.

Q. Is it conceivable that the IRS is going to place the burden on me as a taxpayer to show that the other people have not deducted the full amount?

A. What will constitute your "reporting" is still somewhat up in the air. I feel that itemizing the meals to your client should be sufficient to discharge your burden. The presumption should be that your deduction is not limited to 80 percent, without your having to prove that the 20 percent disallowance was taken by the clients. All this area is somewhat confused since the IRS has not issued regulations as yet. The so-called Blue Book has just come out. In it, the staff of the Joint Committee on Taxation is taking some positions which are supported by the statute, while others are not. No one knows exactly what regulations will result in many of these areas. When they do come out, they will be sufficiently complex to cause record-keeping problems. We will be spending a great deal of time, money, and effort pursuing something which I feel could better be handled in some other way.

II.

EDWARD F. MARTIN*

Mr. Benjamin and I have divided the subject matter, and it's my turn to spend some time on employee benefits, particularly qualified plans since this is an important part of your tax planning and the reason why you incorporated, if you did incorporate. First of all, my impression is that you are all either sole proprietors or one-person corporations, and that you do not have other employees except maybe a secretary.

Qualified plans have been a superb tax shelter, and they continue to be a pretty good idea. As you know, you get a deduction for the money going in and you have the tax-free buildup in the value of the trust. The benefits when distributed in a lump sum may be eligible for special tax averaging. There are drawbacks if you have employees since there are some discrimination rules with which you have to comply.

An initial question is: Are qualified plans still a good deal, considering the lower tax brackets? With the different tax scene that we're living with now and the calculations I have seen, the answer is yes, it still makes sense, considering the benefits from getting deductions now and the tax-free buildup you end up with. Even if you have to pay taxes at ordinary rates when you receive the benefits, you'll end up with more money when you retire than if you don't have the plan. However, the 1986 Act has tightened the screws in a lot of ways to limit excessive use of qualified plans for the tax benefits that I have described.

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