Individual Income Taxation After the Tax Reform Act of 1986

Louis A. Mezzullo
I. Tax Rates; Standard Deduction; Personal Exemption; Income Averaging; Capital Gains; Credits

A. Tax rates [Act § 101(a) amending § 1]

1. After 1987

   a. Rates - There will be two tax brackets, 15% and 28%, replacing the current 14 or 15 tax brackets.

   b. The 15% tax rate and the personal exemption are phased out by taxing the amounts as indicated on the table an additional 5%.

      i. This means that taxable income in these brackets is taxed at 33%.

      ii. For a married couple filing separate returns there is an additional tax of $1,933.75 in excess of what would otherwise be the amount of tax at the
28% rate once the taxable income of the individual reaches $113,300. This additional tax is never recovered. The additional tax is caused by using the tax bracket for a joint return for determining the phase-out of the 15% rate.

iii. The phase-out of the personal exemption begins after the phase-out of the 15% bracket. In 1988, the personal exemption is phased out over an income range of $10,920. In 1989, the phase-out is over an income range of $11,200 (the tax benefit of the $2,000 personal exemption is $560 ($2,000 x 28%), and this tax benefit is eliminated by adding an additional 5% tax to $11,200 of income (5% x $11,200 = $560)).

iv. The phase-out of real estate passive losses can result in a 49.5% marginal rate (33% + 16.5% - since one dollar of deduction is eliminated for each two dollars of adjusted gross income).

v. The phase-out of the deduction for contributions to an individual retirement account (IRA) can result in a 34.3% marginal rate (28% + 6.3% (22.5% x 28%) = 34.3%), since the deduction ($2,250) is reduced by 22.5% of adjusted gross income in excess of $40,000 in the case of married couples filing joint returns. If both spouses have adjusted gross incomes in excess of $2,000, the marginal rate increases to 39.2%, since 40% of the deduction is phased out (28% + 11.2% (40% x 28%) = 39.2%).

c. The bracket amounts are adjusted for cost-of-living increases beginning in 1989 based on the Consumer Price Index published by the Department of Labor, using the average as of the close of the 12-month period ending on August 31 of the preceding calendar year.
i. Increases are rounded to the next lowest multiple of $50, except in the case of married individuals filing separately, in which case the rounding is to the next lowest multiple of $25.

2. Rates for 1987

<table>
<thead>
<tr>
<th>Type of Taxpayer</th>
<th>Applicable Amounts of Taxable Income for the Following Tax Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>11%</td>
</tr>
<tr>
<td>Joint Return</td>
<td>3,000</td>
</tr>
<tr>
<td>Head of Household</td>
<td>2,500</td>
</tr>
<tr>
<td>Unmarried</td>
<td>1,800</td>
</tr>
<tr>
<td>Separate</td>
<td>1,500</td>
</tr>
<tr>
<td>Estates and Trusts</td>
<td>500</td>
</tr>
</tbody>
</table>

For example, for a taxpayer filing a joint return, the first $3,000 of taxable income is subject to an 11% tax rate, the next $25,000 is subject to a 15% tax rate, the next $17,000 is subject to a 28% tax rate, the next $45,000 is subject to a 35% tax rate, and all taxable income over $90,000 is subject to a 38.5% tax rate. There is no phase-out of the lower brackets or personal exemption in 1987.

B. Standard Deduction [Act § 102(a) amending § 63]

1. For taxable years beginning after December 31, 1986, the zero bracket amount will be replaced by the standard deduction.

<table>
<thead>
<tr>
<th>Type of Taxpayer</th>
<th>Zero Bracket Amount in 1986</th>
<th>Standard Deduction in 1987</th>
<th>Standard Deduction after 1987</th>
</tr>
</thead>
<tbody>
<tr>
<td>Joint Return</td>
<td>3,670</td>
<td>3,760</td>
<td>5,000</td>
</tr>
<tr>
<td>Head of Household</td>
<td>2,480</td>
<td>2,540</td>
<td>4,400</td>
</tr>
<tr>
<td>Unmarried</td>
<td>2,480</td>
<td>2,540</td>
<td>3,000</td>
</tr>
<tr>
<td>Separate Return</td>
<td>1,835</td>
<td>1,880</td>
<td>2,500</td>
</tr>
</tbody>
</table>
2. In the case of an individual who is eligible to be claimed as a dependent on another return, the standard deduction is limited to the greater of (a) $500 or (b) the individual's earned income up to the basic standard deduction amount.

3. An additional standard deduction amount of $600 is allowed for a married person who has either attained age 65 or is blind (whether filing jointly or separately) or a surviving spouse, replacing the extra personal exemptions available under current law.
   a. A $1,200 additional standard deduction is allowed for an individual who is both elderly and blind.
   b. An additional standard deduction amount of $750 is allowed for an unmarried individual (other than a surviving spouse) or a head of household who is elderly or blind ($1,500 if both).
   c. For elderly or blind taxpayers only, the standard deduction amounts for 1988 and the additional $600 or $750 additional standard deduction amounts are effective beginning in 1987.

4. As under current law, the following persons are not eligible for the standard deduction:
   a. A married individual filing a separate return where either spouse itemizes deductions,
   b. A non-resident alien individual,
   c. A citizen of the United States entitled to the benefits of § 931 (relating to income from sources within possessions of the United States),
   d. An individual making a return for a period of less than 12 months on account of a change in his annual account period, or
e. An estate or trust, common trust fund, or partnership.

5. The standard deduction amounts will be adjusted for cost-of-living increases in the same manner as the tax brackets.

C. Personal exemption [Act § 103 amending § 151]

1. The personal exemption will increase from the current amount of $1,080 for 1986, to $1,900 for taxable years beginning during 1987, $1,950 for taxable years beginning during 1988, and $2,000 for taxable years beginning after December 31, 1988.

2. The $2,000 amount will be adjusted for cost-of-living increases in the same manner as the tax brackets and standard deduction for taxable years after 1989.

3. There is no personal exemption amount allowable on the return of an individual who is eligible to be claimed as a dependent on another taxpayer's return.

4. The additional exemptions for taxpayers who are over age 65 or blind are eliminated.

D. Income averaging and capital gains

1. Income averaging is repealed for taxable years beginning on or after January 1, 1987. [Act § 141] Currently, income in excess of 140% of the average income over the previous 3 years may be averaged.

2. The 60% deduction for long-term capital gains (amounts realized on the sale or exchange of capital assets held for more than six months) is repealed for taxable years beginning after December 31, 1986. [Act §§ 301 and 302 repealing § 1202 and amending § 1]

a. The Conference Committee Report states that "The current statutory structure for capital gains is retained in the Code to facilitate reinstatement of a capital gains rate differential if there is a future tax rate increase." [Page II-106]
b. Losses from sales or exchanges of capital assets will be allowed only to the extent of capital gains plus $3,000 ($1,500 in the case of a married individual filing a separate return) and may be carried forward indefinitely.

c. There is a maximum 28% rate applicable to capital gains in 1987.

d. There is no relief for long-term capital gains realized under installment sales contracts entered into before 1987.

E. Credits

1. Increase in earned income credit.
   [Act § 111 amending § 32]

   a. The earned income credit is increased for taxable years beginning after December 31, 1986.

   i. The credit rate is increased from 11% to 14% and the amount subject to the credit is increased from $5,000 to $5,714 (increasing the maximum credit to $800).

   ii. The credit is phased out at the rate of 10% of adjusted gross income (or earned income if greater) in excess of $9,000, so that the credit is eliminated at an adjusted gross income of $17,000.

   iii. The dollar amounts are adjusted for cost-of-living increases in the same manner as the tax brackets, standard deduction, and personal exemption, but with rounding to the nearest multiple of $10.

   iv. In 1987 the phase-out begins at $6,500, so that the credit is eliminated at an adjusted gross income of $14,500.

b. An employer must notify an employee whose wages are not subject to withholding that
the employee may be eligible for a refund because of the earned income credit.

i. An employer does not have to notify an employee whose wages are exempt from withholding pursuant to § 3402(n), which can apply in the case of a high school or college student who has a summer job.

2. The credit for contributions to candidates for public office (equal to one-half the contribution up to $50 of credit or $100 in the case of a joint return) is repealed for taxable years beginning after December 31, 1986 [Act § 112 repealing § 24]

II. Exclusions From Income and Adjustments To Gross Income

A. Exclusions from income

1. All unemployment compensation benefits are includible in gross income, effective for amounts received after December 31, 1986, in taxable years ending after that date, eliminating the limited exclusion under current law. [Act § 121 amending § 85]

a. Under current law, unemployment benefits are excluded if the total of adjusted gross income and benefits is less than $12,000 ($18,000 for a joint return or $0 for a separate return).

b. Over the base amount, one dollar of benefit is includible in adjusted gross income for each two dollars of adjusted gross income and benefits over the base.

2. Prizes and awards [Act § 122 amending §§ 74, 102, and 274]

a. The exclusion from gross income for amounts received as prizes and awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement (such as the Pulitzer Price or Nobel Peace Prize) is repealed for prizes and awards granted after December 31, 1986, except in cases where the prize or award is transferred by the
payor to a governmental unit or tax exempt organization pursuant to a designation made by the recipient.

b. Employee achievement awards.

i. Awards of tangible personal property for length of service or safety achievement are excludable by the employee from gross income for income tax purposes, and are deductible by the employer, to the extent that during the year the aggregate cost of awards (safety and length of service) made to the same employee does not exceed $1,600 for all awards and $400 for all awards that are not qualified plan awards.

ii. To the extent that the new exclusion does not apply, all prizes or awards by employers to employees are includible in gross income other than items of low value that are excludable as a de minimis fringe benefit.

iii. The rule permitting deductible gifts up to $25.00 per employee per year is retained.

c. An employee achievement award means an item of tangible personal property which is

i. transferred by an employer to an employee for length of service achievement or safety achievement,

ii. awarded as part of a meaningful presentation, and

iii. awarded under conditions and circumstances that do not create a significant likelihood of the payment of disguised compensation.

d. An item will not be treated as having been provided for length of service achievement if the item is received during the recipient's first five years of employment or if the recipient received a length of service
achievement award other than a *de minimis* award during that year or any of the prior four years.

e. An item provided by an employer to an employee will not be treated as having been provided for safety achievement if during the taxable year, employee achievement awards other than *de minimis* items for safety achievement have previously been awarded by the employer to more than 10% of the employees of the employer, excluding managers, administrators, clerical employees, or other professional employees; or such item is awarded to a manager, administrator, clerical employee, or other professional employee.

f. A qualified plan award means an employee achievement award awarded as part of an established written plan or program of the taxpayer which does not discriminate in favor of highly compensated employees as defined for pension plans and other purposes under § 414(q) added by the Act.

i. An employee achievement award shall not be treated as a qualified plan award for any taxable year if the average cost of all employee achievement awards which are provided by the employer during the year exceeds $400.

g. In the case of an employee achievement award made by a partnership, the deduction limitation applies to the partnership as well as to each member thereof.

h. The *de minimis* fringe benefit exception, described in § 132(e), includes a pin or similar item with a $15 value awarded to an employee upon joining a business, or completing six months of employment, or in completing a probationary employment period or a traditional retirement gift (Senate Finance Committee Report).

i. The achievement award exclusion is not available for any award made by a sole-
proprietorship to a sole-proprietor (Senate Finance Committee).

3. Scholarships [Act § 123 amending § 117]

a. The exclusion from gross income for scholarships and fellowships is limited to qualified scholarships received by an individual who is a candidate for a degree at an educational organization.

i. A qualified scholarship is any amount received by an individual as a scholarship or fellowship grant to the extent the individual establishes that, in accordance with the conditions of the grant, such amount was used for qualified tuition and related expenses.

ii. Qualified tuition and related expenses means tuition fees required for the enrollment or attendance of a student at an educational organization and fees, books, supplies, and equipment used for courses of instruction at such an educational organization.

iii. This provision is effective for taxable years beginning after December 31, 1986, but only in the case of scholarships and fellowships granted after August 16, 1986.

iv. The degree candidate requirement does not affect the exclusion under an education assistance program pursuant to § 127 or a deduction under § 162 for certain expenses in connection with a trade or business.

v. Under current law, the exclusion for a nondegree candidate was limited to a maximum of $300 a month up to $10,800 for a lifetime, and the grantor of the scholarship had to be a tax-exempt or international organization or a government agency.

b. A new provision excludes qualified tuition reductions from gross income.
i. Qualified tuition reduction is the amount of any reduction in tuition provided to an employee of certain tax-exempt organizations for the education below the graduate level of the employee or certain former employees and certain members of the employee's or former employee's family.

ii. The exclusion does not apply with respect to any officer, owner, or highly compensated employee if the reduction is not available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer which does not discriminate in favor of officers, owners, or highly compensated employees.

c. The exclusion from income for scholarships and tuition reduction does not apply to that portion of any amount received which represents payment for teaching, research, or other services by the student required as a condition for receiving the qualified scholarship or qualified tuition reduction.

d. Any amount of a noncompensatory scholarship or fellowship grant includible in gross income constitutes earned income for purposes of the limitation on the use of the standard deduction of a dependent child.

4. The partial exclusion for dividends received by individual taxpayers ($200 for a joint return and $100 for a single taxpayer or a separate return) is eliminated for taxable years beginning after December 31, 1986. [Act § 612 repealing § 116]

B. Adjustments to Gross Income

1. The deduction for two-earner married couples is eliminated for taxable years beginning after December 31, 1986 [Act § 131 repealing § 221].

a. The two-earner married couple deduction was equal to 10% of the earned income of the
spouse with the lower amount of earned income, up to a maximum of $30,000. The maximum deduction, therefore, was $3,000.

b. The earned income of the spouse with the lower earned income was reduced by certain items, including pensions, annuities, contributions to individual retirement plans, deferred compensation, and amounts received for services performed by an individual in the employ of his spouse.

c. The marriage penalty for a couple each with $50,000 of taxable income will be $1,493.50, which is the difference between (i) the tax for a married couple filing a joint return with a combined taxable income of $100,000 ($25,537.50), and (ii) two times the tax for a single taxpayer with a taxable income of $50,000 ($12,022 \times 2 + $24,044).

2. The deduction for a contribution to an individual retirement account (IRA), $2,000 or $2,250 for a spousal IRA, is reduced or eliminated with respect to an individual who is an active participant or whose spouse is an active participant in a qualified plan or other tax favored savings arrangement for contributions for taxable years beginning after December 31, 1986. [Act § 1101 amending § 219].

a. The reduction is equal to 20% of adjusted gross income in excess of (i) $40,000 for married couples filing joint returns, (ii) $25,000 for single taxpayers, and (iii) zero for married couples filing separate returns.

b. The deduction is eliminated for adjusted gross income of $50,000 in the case of married individuals filing joint returns, $35,000 in the case of a single taxpayer, and $10,000 in the case of married couples filing separate returns.

c. In no event is the deductible amount reduced below $200, until the amount otherwise deductible reaches zero. For example, a married couple filing a joint return with
adjusted gross income of $49,000 would still be able to make $200 of deductible contributions to an individual retirement account.

d. To the extent that the amount of deductible contributions is limited, nondeductible contributions can be made to individual retirement accounts. The income earned on such amounts would be tax free until distributed.

e. Types of plans include:

i. Qualified pension, profit-sharing, and stock bonus plans.

ii. A qualified annuity plan under § 403(a).

iii. A simplified employee pension (SEP).

iv. A plan established for employees of the United States or any state or political subdivision or agency or instrumentality of the United States or any state or political subdivision (but not unfunded deferred compensation plans under § 457).

v. A plan described in § 501(c)(18).

vi. Tax-Sheltered Annuities under § 403(b).

f. Active participant:

i. Defined Benefit Plan - if eligible for participation, even if individual elects not to be covered by the plan (Conference Committee Report).

ii. Defined Contribution plans - generally if allocation of employer contributions or forfeitures is required or is made to a participant's account (Senate Finance Committee Report).
iii. Determination made without regard to whether participant is vested.

iv. Participant who makes voluntary or mandatory employee contributions is an active participant (Senate Finance Committee).

v. An individual is not treated as an active participant if earnings (rather than contributions or forfeitures) are allocated to his account.

vi. Reduction or elimination applies if spouse is an active participant, unless separate returns are filed.

3. Effective for taxable years beginning after December 31, 1986, the deduction for moving expenses will be an itemized deduction and not available to a taxpayer who does not itemize [Act § 132(c) amending § 62(a)].

4. The charitable deduction for non-itemizers (which was limited in 1986 only by the limitations that apply to charitable deductions for itemizers) is allowed to terminate with respect to contributions made after December 31, 1986, under the provision contained in current law. There is no specific provision in the Act.

III. Deductions

A. Two percent floor on miscellaneous itemized deductions [Act § 132 adding § 67 and amending § 52]

1. For taxable years beginning after December 31, 1986, the miscellaneous itemized deductions of an individual for any taxable year will be allowed only to the extent that the aggregate of such deductions exceed 2% of adjusted gross income.

   a. Other limitations will apply first; i.e., the 80% limitation on meals, beverages and entertainment, the sky-box limitation, etc.

2. Miscellaneous itemized deductions means all itemized deductions except:

   a. interest deductions,
   
   b. deductions for taxes,
c. deductions for casualty losses and gambling losses in excess of gambling winnings,
d. charitable deductions,
e. deductions for medical, dental and other health expenses,
f. deductions for moving expenses,
g. deductions allowable for impairment-related expenses,
h. the deduction for the estate tax in the case of income in respect of the decedent,
i. any deduction allowable in connection with personal property used in a short sale,
j. the deduction relating to the computation of tax where a taxpayer restores substantial amounts held under a claim of right,
k. the deduction where annuity payments cease before investment is recovered,
l. the deduction relating to amortizable bond premium, and
m. the deduction in connection with cooperative housing corporations.

3. Regulations are to be prescribed which will prohibit the indirect deduction through pass-thru entities, such as partnerships and S-corporations, of amounts which are not allowable as a deduction if paid or incurred directly by an individual. The regulations will also contain reporting requirements.

a. The disallowance of indirect deductions through pass-thru entities does not apply to estates, nongrantor trusts, cooperatives, and real estate investment trusts.

b. In the case of estates and trusts, deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not
held in such estate or trust will be treated as allowable in arriving at adjusted gross income.

4. Impairment-related work expenses means expenses of a handicapped individual for attendant care services at the individual's place of employment and other expenses in connection with such place of employment which are necessary for the individual to be able to work and which are allowable as a deduction under § 162.

5. The expenses of a performing artist are treated as adjustments to gross income and not subject to the 2% floor if the expenses are paid or incurred by a qualified performing artist in connection with the performance by him of services in the performing arts as an employee.

a. A qualified performing artist means an individual who performs services in the performing arts as an employee during the taxable year for at least two employers and whose expenses allowable as a deduction in connection with performance of such services exceeds 10% of his gross income attributable to the performance of the services and whose adjusted gross income (or in the case of a married couple, their combined adjusted gross income) does not exceed $16,000.

b. An individual is not treated as performing services for an employer during any taxable year unless the amount received from the employer exceeds $200.

c. A married couple who have lived together at any time during the taxable year must file a joint return to take advantage of this provision.

6. Reimbursed expenses of an employee remain adjustments to gross income and are not subject to the 2% floor, but only to the extent of the reimbursement.

7. Miscellaneous expenses include all other employer expenses, including outside salesman expenses, travel expenses, and home office expenses, expenses under § 212 relating to investment
property, hobby losses, union dues, noncapitalized tools, professional dues and journals, fees for tax advice and tax-preparation, and carryover losses from estates and trusts.

B. **Limitations on deductions for meals, travel and entertainment** [Act § 142 amending § 274]

1. There will be no deduction for the expense of any food or beverages unless:
   a. The expense is not lavish or extravagant under the circumstances (applied before the 80% limitation),
   b. The taxpayer or an employee of the taxpayer is present at the furnishing of such food or beverages,
   c. The expense is directly related to or associated with the active conduct of the taxpayer's trade or business, and
   d. The § 274(d) substantiation requirements are met.
      i. The Treasury is directly to develop more stringent requirements while retaining the $25 rules that does not require a receipt for certain expenditures under $25.
      ii. The Internal Revenue Service is directed not to rely on the Cohan rule allowing substantiation by approximation.

2. The directly related to or associated with requirement means that a business discussion must take place before, during, or after the meal; the meal cannot be for "good will." However, a specific transaction need not be discussed, nor does this rule apply to a meal for the employee while traveling on business.

3. The amount allowable as a deduction for entertainment tickets cannot exceed the face amount of the ticket.
a. The limitation will not apply to any ticket for a sports event which is organized for the primary purpose of benefiting a charitable organization if all of the net proceeds are contributed to such organization and volunteers are used for substantially all of the work performed in carrying out such event.

4. The amount allowable as a deduction for a sky box or other private luxury box leased for more than one event cannot exceed the sum of the face value of non-luxury box seat tickets for the seats in such box covered by the lease.

a. The amount disallowed in 1987 is one-third of the amount which would be disallowed under the new rule, and the amount disallowed in 1988 will be two-thirds of the amount which would be disallowed under the new rule.

b. Under a literal reading of the statute, the rule may not apply to the cost of a sky box for only one event.

5. The deduction for expenses incurred for transportation by water will be allowed only to the extent of twice the per diem amounts for each day of travel.

a. The per diem amount is the amount generally allowable with respect to a day for employees of the executive branch of the Federal Government for expenses incurred while away from home but serving in the United State, which was $126 as of July 1, 1986 (establishing a $252 limitation).

b. The limitation does not apply to expenses allocable to a convention, seminar, or other meeting which is held on any cruise ship, which are covered under §274(h)(2).

6. No deduction will be allowable for expenses for travel as a form of education, overruling Treas. Reg. §1.162-5(d).

a. A professor of French traveling in France to maintain a familiarity with the customs
of the French people could not deduct his travel expenses. However, if he traveled to Paris to do specific research, he could deduct his travel expenses.

7. The deduction for any expense for food or beverages and any entertainment expense will be limited to 80% of the amount of the expense or item.

a. There is a limited exception for expenses for food or beverages which are part of a qualified meeting for taxable years beginning in 1987 and 1988.

b. A qualified meeting is any convention, seminar, annual meeting or similar business program with respect to which:
   i. an expense for food or beverages is not separately stated,
   ii. more than 50% of the participants are away from home,
   iii. at least 40 individuals attend, and
   iv. such food and beverages are part of a program which includes a speaker.

8. These provisions dealing with deductions for meals, travel and entertainment do not apply to the following expenses:

a. Expenses for goods, services, and facilities to the extent that the expenses are treated by the taxpayer, with respect to the recipient of the entertainment, amusement, or recreation, as compensation to an employee on the taxpayer's return of tax and as wages to such employee for purposes of withholding of income taxes;

b. Expenses paid or incurred by the taxpayer, in connection with the performance by him of services for another person (whether or not such other person is his employer), under a reimbursement or other expense allowance arrangement with such other person;
i. The Conference Committee report indicates that the payor will be subject to the 80% limit. Query: What about tax-exempt organizations?

c. Expenses for recreational, social, or similar activities primarily for the benefit of rank-and-file employees;

d. Expenses for goods, services, and facilities made available by the taxpayer to the general public, such as food samples and door prizes;

e. Expenses for goods or services (including the use of facilities) which are sold by the taxpayer in a bona fide transaction for an adequate and full consideration in money or money's worth;

f. Expenses for goods, services and facilities provided to nonemployees as compensation or as prizes or awards to the extent such expenses are includible in such nonemployee's income; and

g. De minimis fringes under § 132(e) are also excludable.

9. There will be no deduction allowed for conventions, seminars or similar meetings under § 212 relating to expenses for the production of income, such as investment advice and financial planning.

10. The Conference Committee Report also makes clear that deductions will not be allowed for seminars where the attendees are given video taped lectures and do not otherwise participate.

11. There will be no charitable deduction for travel related expenses unless there is no significant element of personal pleasure, recreation, or vacation in such travel. [Act § 142(d) amending § 170]

a. The rule does not apply to employees of the organization or to a participant in the activity.
12. All of such expenses are itemized deductions subject to the 2% floor on miscellaneous itemized deductions.

13. These provisions are effective for taxable years beginning after December 31, 1986.

C. Limitation on deductions for nonbusiness interest
   [Act § 511 amending § 163]

1. Investment interest.
   a. The amount allowed as a deduction for investment interest for any taxable year beginning after December 31, 1986 cannot exceed the net investment income of the taxpayer for the taxable year.
      i. The amount not allowed as a deduction will be treated as investment interest paid or accrued by the taxpayer in the succeeding taxable year.
   b. Investment interest means any interest allowable as a deduction which is paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment.
      i. The term investment interest does not include qualified residence interest or interest taken into account in computing income or loss from a passive activity of the taxpayer.
      ii. Investment interest includes any amount allowable as a deduction in connection with personal property used in a short sale.
   c. Net investment income is the excess of investment income over investment expenses.
      i. Investment income is the sum of:
         a. gross income (other than gains) from property held for investment, and
b. Any net gain attributable to the disposition of property held for investment, but only to the extent such amounts are not derived from the conduct of a trade or business.

ii. Investment expenses are the deductions allowed, other than for interest, which are directly connected with the production of investment income.

iii. Investment income and investment expenses do not include any income or expenses taken into account in computing income or loss from a passive activity, as described in §469 as added by the Act.

e. Phase-in of disallowance

i. The amount of interest disallowed that would have been deductible under current law is phased in in the following manner:

<table>
<thead>
<tr>
<th>In the case of Taxable Years Beginning in</th>
<th>Percentage of Interest Disallowed under The Act</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>35</td>
</tr>
<tr>
<td>1988</td>
<td>60</td>
</tr>
<tr>
<td>1989</td>
<td>80</td>
</tr>
<tr>
<td>1990</td>
<td>90</td>
</tr>
</tbody>
</table>

ii. The amount that would otherwise have been deductible would generally be $10,000 ($5,000 in the case of a married taxpayer filing a separate return).

iii. The amount of net investment income is reduced by the amount of losses from passive activities that is allowed as a deduction by virtue of
the phase-in of the passive loss rule.

iv. Any amount of investment interest that is disallowed under the investment interest limitation during the period that the investment interest limitation is phased in (that is, taxable years beginning on or after January 1, 1987 and before January 1, 1991) is not allowed as a deduction in a subsequent year except to the extent the taxpayer has net investment income in excess of net investment interest in the subsequent year.

2. Personal interest

a. No deduction will be allowed for personal interest paid or accrued for taxable years beginning after December 31, 1986.

b. Personal interest is any interest allowable as a deduction other than

i. interest paid or accrued on indebtedness incurred or continued in connection with the conduct of a trade or business (other than the trade or business of performing services as an employee),

ii. any investment interest,

iii. any interest which is taken into account under the passive loss rules in computing income or loss from a passive activity of the taxpayer,

iv. any qualified residence interest, and

v. any interest payable on the unpaid portion of the estate tax for the period during which an extension of time for payment of such taxes is in effect under § 6163 (relating to a reversionary or remainder interests) or 6166 (relating to closely held businesses). Interest on payments
subject to extensions for hardship under § 6161 is personal interest.

c. Personal interest does include interest on tax deficiencies (but not on installment payments under § 6163 or 6166).

d. Qualified residence interest is interest paid or accrued during a taxable year on indebtedness which is secured by a qualified residence of the taxpayer.

i. Qualified residence interest is limited to interest paid or accrued on indebtedness secured by a qualified residence which is allocable to that portion of the principal amount of such indebtedness which, when added to the outstanding aggregate principal amount of all other indebtedness previously incurred and secured by such qualified residence, does not exceed the lesser of

a. the fair market value of such qualified residence, or

b. the sum of the taxpayer's cost basis in such qualified residence (adjusted only by the cost of any improvements to such residence), plus the aggregate amount of qualified indebtedness of the taxpayer with respect to such qualified residence.

ii. No adjustment to cost is made for depreciation, rollover of gain under § 1034, or basis adjustments due to involuntary conversions under § 1033.

iii. The cost basis of a residence acquired from a decedent is determined under § 1014, providing for a step-up (or step-down) in basis at death.

iv. If the amount of any debt incurred on or before August 16, 1986, and secured by the residence on August 16, 1986 (reduced by any principal payments thereon) exceeds the taxpayer's
cost basis for the residence, then such amount is substituted for the taxpayer's cost basis in applying the limitations.

e. Qualified indebtedness is indebtedness secured by a qualified residence of the taxpayer which is incurred after August 16, 1986, to pay for qualified medical expenses or qualified educational expenses, which are paid or incurred within a reasonable period of time before or after such indebtedness is incurred.

i. Qualified medical expenses are amounts, not compensated for by insurance or otherwise, incurred for medical care for the taxpayer, his spouse, or dependent, but medical expenses do not include premiums on health insurance.

ii. Qualified educational expenses are qualified tuition and related expenses of the taxpayer, his spouse, or dependent for attendance at an educational institution, and includes reasonable living expenses while away from home.

f. A qualified residence is the principal residence of the taxpayer, as defined under § 1034 relating to the rollover of gain, and one other residence of the taxpayer which is selected by the taxpayer.

i. A residence for purposes of the second residence means a residence as defined under § 280A (d)(1). Generally, the taxpayer must use the dwelling for personal use for the greater of 14 days or 10% of the number of days rented.

ii. If a married couple does not file a joint return, each individual is entitled to take into account one residence unless both individuals consent to one individual taking into account the principal residence and one other residence.
iii. For purposes of determining whether the residence is used by a taxpayer, if the taxpayer does not rent or use a dwelling unit at any time during a taxable year, the unit may be treated as a residence for the taxable year.

iv. Any indebtedness secured by stock held by the taxpayer as a tenant-stockholder in a cooperative housing corporation will be treated as secured by the house or apartment which the taxpayer is entitled to occupy as such a tenant-stockholder.

a. If such stock may not be used to secure indebtedness, indebtedness will be treated as so secured if the taxpayer establishes that the debt was incurred to acquire such stock.

g. The amount of interest with respect to which a deduction is disallowed under these rules is phased in over four years, so that in 1987, 65% of personal interest will be deductible; in 1988, 40% will be deductible, in 1989, 20% will be deductible, and in 1990, 10% will be deductible. There is no carryover of nondeductible amounts.

D. Other deductions

1. The floor for deductibility of medical expenses is increased from 5% to 7.5% [Act § 133 amending § 213]

a. The Conference Committee Report affirms that the full costs of expenditures to accommodate the personal needs of a physically handicapped individual, such as entrance ramps and widening of doors, are fully deductible regardless of whether the value of the residence is increased.

2. The deduction for state and local sales taxes is repealed [Act § 134 amending §164]

a. Such taxes may be added to the basis of property used in a trade or business or for the production of income.
b. State and local income and real and personal property taxes are still deductible.

3. The current deduction for certain adoption expenses (up to $1,500 for children with special needs) is repealed [Act § 135 repealing § 222]

4. The deduction for casualty losses is reduced by the amount covered by insurance unless the individual files a timely insurance claim with respect to such loss, overruling H. L. Hills, USTC #84-1 ¶ 9669, 691 F2d 997 (11th Cir. 1984). [Act § 1004 amending § 165(h)(4)]

5. Hobby loss rules.
   a. In determining whether an activity is not engaged in for profit, the number of years in which the gross income derived from such activity must exceed the deductions attributable to such activity is increased from 2 to 3 in the period of 5 consecutive years for purposes of the presumption that the property has been an activity engaged in for profit. [Act § 143(a) amending § 183(d)]
   b. In the case of an activity which consists of a major part of breeding, training, showing or racing of horses, the applicable period remains 2 out of 7 consecutive years.

6. The rental of a dwelling unit or any portion thereof by the taxpayer to his employer during any period in which the taxpayer uses the dwelling unit or a portion in performing services as an employee of the employer will subject the expenses associated with the dwelling unit or portion to the restrictions that apply to the use of one's home as an office overruling I.S. Feldman 84 TC 1 (1985). [Act § 143(b) amending § 280A(c)] These rules require that in order for expenses in connection with an office in the home to be deductible:
   a. The use must be for the convenience of the employer,
   b. The home office must be used regularly and exclusively either as the taxpayer's
principal place of business or to meet patients, clients or customers, and

c. The deduction cannot exceed the taxpayer's gross income from the business.

7. The amount of any otherwise allowable home office deduction is limited to the taxpayer's net income from the business. [Act § 142(c) amending § 280A (c)]

a. This change overrules C. A. Scott, 84 TC 683 (1985), which held that only the deductions allocable to the use of the residence are limited by the net income from the business.

b. Disallowed losses may be carried over indefinitely.

8. A deduction is allowable for mortgage interest and real property taxes where parsonage allowance or military allowance is received. [Act § 144 amending § 265]

9. These provisions are effective for taxable years beginning after December 31, 1986, except the provisions with respect to parsonage and military housing, which are effective for all taxable years.

E. Alimony and Separate Maintenance Payments

1. The Act repeals the requirement that the divorce or separation instrument expressly state that payments terminate upon the death of the payee-spouse.

2. The recapture rules are completely revised.

a. The Tax Reform Act of 1984 contained a six-year recapture provision to prevent the deduction of disguised property settlement payments.

b. The Act changes the six-year period to a three-year period.

c. The recapture amount must be recaptured in the third post-separation year.
d. The recapture amount is the excess payments in the first and second post-separation years.

i. The excess payment in the first year is the excess of the total alimony paid in the first year over the sum of $15,000 plus the average of the alimony paid in the second and third years.

ii. The excess payment in the second year is the excess of the total alimony paid in the second year over the sum of the alimony paid in the third year plus $15,000.

e. Recapture is not required if payments terminate because either party dies.

f. The revised rules are effective for instruments executed after 1986 and to instruments modified after 1986 that expressly provide that the three-year recapture rules apply.

g. A transition rule reduces the current six-year rule to a three-year rule for pre-1987 instruments that are not modified to make the new rules apply.

IV. Planning Tips

A. Steps to be taken before 1987


2. Accelerate deductions.

3. Incur state and local sales taxes in 1986 if possible.

4. Non-itemizers should accelerate contributions to charitable organizations.

5. Persons affected by the alternative minimum tax should consider accelerating gifts of appreciated property to charitable organizations in 1986.
6. Interest that would otherwise be disallowed should be paid in 1986, especially interest on tax deficiencies.

7. Miscellaneous itemized deductions should be accelerated into 1986 to avoid the 2% floor.

8. Recognize long-term capital gains in 1986 while maximum tax rate is 20%.

9. Defer recognition of long-term capital losses until after 1986 so they offset all gain and ordinary income (up to $3,000 per year) dollar for dollar.

10. Dispose of installment obligations to recognize capital gain in 1986.


12. Accelerate medical expenses to avoid 7.5% floor.

B. Steps to be Taken After 1986

1. Employer reimbursement of employee expenses will avoid the 2% floor on miscellaneous deductions.

2. Charge business expenses and pay personal expenses in cash.

3. Secure indebtedness with primary or second residence.

4. Use nonrecognition provisions of § 1031 and § 1034 to avoid capital gains.

5. Use tax-deferred investments (Series EE bonds, growth stock) or tax-exempt interest for children under 14.