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Reflections on the Tax Reform Act of 1986

by Professors

John A. Lynch, Jr. Wendy G. Shaller

Perhaps the Tax Reform Act of 1986 was an earthquake. But such earthquakes have become commonplace in taxation during the Reagan presidency. Maybe the volume of the 1986 Act was not much greater than that of 1984, 1982 or 1981. One thing is certain about the 1986 Act, how it has clearly made changes that significantly affect the lives of individual taxpayers. In these next few pages we would like to discuss a few of the changes which affect individual taxpayers.

Alimony

The 1986 Act simplified some of the alimony rules, particularly those dealing with "alimony recapture." Alimony recapture is the amount which the paying spouse must subsequently include as income because he deducted too much money in the first few years after a divorce or separation in comparison to that paid in later years. Alimony is sometimes bunched into early years in an attempt to recharacterize nondeductible property settlements as deductible alimony. Essentially, the alimony recapture rules provide a means of attack on such recharacterization without the complex analysis of pre-1984 Act law.

The 1986 Act limits the liability for recapture to three years beginning with the year in which alimony is first paid ("the first post-separation year"). The new tax act eliminated the provision of the 1984 Act which denied a deduction in excess of $10,000 per year for the payor of alimony if payments were not made in each of the first six post-separation years.

The modified rules apply to divorce or separation agreements executed after 1986 or to any earlier agreements which are specifically modified to require the application of the new law. For old agreements not so modified, the pre-1986 Act rules will continue to apply but only as to the first three post-separation years.

Recapture of alimony under the new law occurs, if at all, only in the third post-separation year, and requires the payor to include any excess alimony payments from the first two post-separation years in his income in that third year. Also, in the third year, the payee, or recipient of alimony, is allowed a corresponding deduction.

To determine the total of any excess amounts for the first two post-separation years, the taxpayer first computes any excess from the second post-separation year payments by adding $15,000 to the amount of third post-separation year payments and by then subtracting that amount from payments made in the second post-separation year. Thus, if $30,000 was paid in the second post-separation year and $10,000 in the third post-separation year, there would be $5,000 excess payment for the second post-separation year ($30,000 - ($15,000 + $10,000)). Then, the taxpayer computes excess payments for the first post-separation year by adding the second post-separation year payment ($30,000), reduced by any excess attributable to that year (in our example, $30,000 - $5,000 = $25,000), to the amount of third post-separation payments ($10,000). That amount, $35,000 ($25,000 + $10,000), must be averaged, (i.e., divided by two: here equalling $17,500), and then increased by $15,000 ($17,500 + $15,000 = $32,500). Finally, this amount ($32,500) must be subtracted from the first post-separation year's payment.

Thus, in our example, if $60,000 in alimony was paid in the first post-separation year, $27,500 would be recaptured with respect to the first post-separation year ($60,000 - $32,500). Thus, in a third post-separation year, a total of $32,500 ($27,500 + $5,000) would be included in the payor's income and $32,500 would be deductible by the payee spouse (or ex-spouse). Although the rules and calculations may still seem less than easy, they now only need to be computed in the third post-separation year and only with respect to the first three years.

The revisions to the "excess front-loading" provisions of the 1984 Act were a bit surprising because they were not included in President Reagan's May, 1985 tax reform proposal, the report of the House Ways and Means Committee or the Senate Finance Committee.
Although the change is designated as a "technical correction" of the 1984 Act by the conference report,13 the impact of the change will be more than just technical. In providing for recapture of deducted alimony in the first six post-separation years in the 1984 Act, Congress created a powerful incentive for paying spouses to make payments per order or agreement. This was because failure to make required payments, in addition to subjecting the delinquent spouse to state contempt proceedings, would potentially create disparities between the earlier and later years for de minimis fringe benefits;26 (3) meals for which the taxpayer is reimbursed (here, the reimbursing employer is subject to the percentage limitations);27 (4) traditional employer provided recreation (e.g., a Christmas party);28 (5) samples distributed to the general public;29 (6) meals sold by the taxpayer for full and adequate consideration;30 and, (7) for 1987 and 1988, meals which are integral to a "qualified" banquet meeting.31

Capital Gains and Losses
The long term capital deduction has been eliminated by the 1986 Act.32 This does not mean, that it no longer makes any difference to a taxpayer whether a transaction involves a "capital asset" or whether that asset is held for a long or a short term. Taxpayers still need to compute net capital gains (the excess of net long term capital gains over net short term capital losses) because there is a new maximum net capital gains rate of 28%.33 Although capital will be taxed like any other income for years after 1987, in 1987, where the maximum tax bracket is 38.5%, net capital gains still receive a tax break in terms of the 28% maximum bracket to be applied to them.34 Further, should Congress in future years add an additional, higher bracket, Congress has already expressed its intention to keep the maximum net capital gains rate at 28%.35

Perhaps the most significant change brought by the 1986 Act concerning the capital asset inquiry is that it will shift attention to capital losses rather than capital gains. Short term capital losses in excess of long term gains have long been deductible dollar-for-dollar up to a $3,000 maximum of other income for most taxpayers.36 Under the 1986 Act, long term capital losses in excess of long term capital gains will now receive the same treatment.37 Capital losses are still netted against capital gains and, if they exceed capital gains, may offset up to $3,000 of other income.38

Finally, a new issue may concern whether a loss is ordinary or capital (the latter being subject to the $3,000 per year maximum offset against other income). The Supreme Court's (yet to be rendered) decision in Arkansas Best39 should clarify the issue of whether transactions are in the ordinary course of business and thus eligible for ordinary, fully deductible, losses.

Income Shifting
As long as there have been federal income taxes, heads of families with substantial income from property (unearned income) have attempted to spread such income to as many individuals as possible within the family. Spreading the income around to a number of family "taxpayers" circumvented the progressive tax rate structure and gave the family a lower federal tax bill.

The "Clifford Rules"40 had restricted the ability of the "owner" of income producing property to control the disposition of the income. Despite Congressional intent those rules may be seen as creating safe harbors rather than restrictions. If a taxpayer who placed money in trust gave up the forbidden powers specified in the rules for the requisite period of time, he was able to shift the income away from himself to the trust or a beneficiary.

Trusts themselves have historically been regarded as separate taxpayers and tax avoidance through the use of trusts has been as American as apple pie.41 President Reagan's May 1985 tax reform proposal excoriated the use of trusts to avoid taxation.42 Although the new Act still treats trusts as separate taxpayers, it has imposed some significant new restrictions on income shifting.

Perhaps the most important change in this respect has nothing specifically to do with trusts. The Internal Revenue Code now provides that the unearned income of a child who has not reached age 14 during the taxable year and either of the parents...
of whom is alive shall be taxed at the rate of the parents.\textsuperscript{43} A tax, called the allocable parental tax, is calculated on all of the unearned income of children in the family under 14 years old as if it had been included in the income of the parents. This tax is then allocated to such children in proportion to the amount of unearned income each receives. The parent actually incurs no additional tax, but the total family tax bill for income from property is generally not reduced as much as has been possible in the past.

This "parental tax" applies not only to income from property owned or formerly owned by parents but also to income from property the parents have never owned, such as property from other relatives or even investments derived from the earnings of a child. Thus, the 1986 Act will remove income tax advantages from gifts under a gifts to minors act if the parents are in a higher tax bracket than the children.

The 1986 Act also restricts the tax benefits from shifting unearned income by taking away the personal exemption from an individual who may be claimed as a dependent on the tax return of another.\textsuperscript{44} The standard deduction of such an individual is limited to $500 plus the amount of his or her earned income.\textsuperscript{45}

The elimination of the tax incentive to shift income to children under 14 years of age may encourage parents to accumulate income in trusts, which are still treated as separate taxpayers, until such children reach age 14. However, the temptation to do this may be somewhat restricted by the substantial rate of increase in portions of the 1986 Act applicable to trusts in relation to other taxpayers.\textsuperscript{46}

The 1986 Act did not bring many changes to the "Clifford Rules," which restrict the ability of the grantors or transferors of income producing property to avoid taxation while maintaining control over the disposition of income from such property or retaining a power to get the property back. But, the Act eliminated the most popular tax avoidance device in this area which was popularly known as the "Clifford Trust."\textsuperscript{47}

A "Clifford Trust" was a trust which provided that the trust property would revert to the grantor only after the expiration of 10 years.\textsuperscript{48} During this period, as long as the grantor had no power to revoke and otherwise adhered to the "Clifford Rules," the tax burden was shifted away from the grantor so that the income from the trust property was taxed to the trust or to trust beneficiaries.\textsuperscript{49} Such income was, of course, generally taxable at lower rates than if the principal had been distributed to the grantor. Additionally, it could be used by beneficiaries for purposes the grantor would otherwise have provided for with after tax dollars. After 10 years and a day, the trust property could be returned to the grantor.

The Code now provides that the grantor shall be treated as the owner of any portion of a trust (hence taxable on the income of such portion) if he or she retains any reversionary interest the value of which exceeds five per cent of the value of such portion. The popular trusts in which money for education was accumulated for a minor child with a reversion to the parent grantor after a period of years would usually fail this test.\textsuperscript{50} This new rule does not apply (i.e., a safe harbor is created) if a reversion retained by the grantor takes place only upon the death of a lineal descendent before age 21 so long as such descendent holds all present interests in such portion of the trust.

These changes will clearly cause diminished interest in the use of trusts to accumulate, at lower tax rates, income for purposes such as college education expenses for one's children. They also reduce the income tax advantages of gifts to minors. It is ironic indeed, that while serious steps have been taken to preserve progressivity of income taxation within the family, the progressivity of the tax structure itself has been decreased because the pre-1987 rate structure has been reduced to two tax brackets.

**Interest**

The 1986 Act eliminates "personal" interest deductions for taxpayers other than corporations.\textsuperscript{51} Personal interest is defined as interest which is not: 1) paid or incurred in connection with a trade or business, 2) investment interest, 3) interest taken into account in computing income or loss from a passive activity,\textsuperscript{52} 4) qualified residence interest or 5) interest payable on certain estate tax payments.

Undoubtedly, the items most likely to be affected for most taxpayers by this change will be credit card interest and automobile financing. Home mortgage interest, particularly that which represents financing of the purchase price of two homes, is not as drastically affected. It will be fascinating to see whether this change will have significant effects upon consumer behavior.

As noted above, an exception from the rule of nondeductibility has been made for qualified residence interest.\textsuperscript{53} This includes interest on indebtedness secured by a qualified residence of the taxpayer. A qualified residence is the taxpayer's principal residence,\textsuperscript{54} and one other residence selected by the taxpayer for the taxable year.\textsuperscript{55} To the extent that interest is allocable to the principal of indebtedness which does not exceed the cost of a residence plus improvements, the interest is deductible regardless of what purpose the borrowed principal is used for.\textsuperscript{56}

As to any indebtedness in excess of the original cost of the residence, the interest on such indebtedness, incurred after August 16, 1986, is deductible only if loan proceeds are used for qualified medical expenses\textsuperscript{57} or qualified tuition expenses\textsuperscript{58} of the taxpayer, spouse or dependent. Only the portion of residence indebtedness representing the difference between the cost of the residence and its value is subject to the medical or educational expense limitation. To the extent a homeowner has paid down his original mortgage, he may borrow up to the home's original cost, plus improvements, and use the proceeds for any purpose. The denial of personal interest is to be phased in over a four year period.\textsuperscript{59}

**Conclusion**

All parties to the clamor for tax reform wanted to make the system simpler and fairer. The changes we have discussed herein would make one wonder whether the Code has been simplified. Is the tax law fairer? Some abuses have been greatly curbed but most tax breaks for middle and upper class individuals remain. Any increased "fairness" in reduction of such tax breaks has come at the cost of substantial erosion of the progressivity of the tax system.

### NOTES

5. Transitional rule in 1986 Act § 1843(c)(3).
I.R.C. § 71 (1)(A) and (B) (1986).


1986 Act § 1843(b); I.R.C. § 71(b)(4)(D).


1986 Act § 142(a); I.R.C. § 274(k)(1)(b) (1986).

1986 Act § 142(b); I.R.C. § 274(n)(3) (1986).


1986 Act § 142(a); I.R.C. § 274(k)(1) (1986).


Id.

1986 Act § 142(b); I.R.C. § 274(n)(2)(A) (1986).


1986 Act § 142(b); I.R.C. § 274(n)(2)(A) (1986).

1986 Act § 142(b); I.R.C. § 274(n)(2)(A) (1986).

1986 Act § 142(b); I.R.C. § 274(n)(2)(A) (1986).

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1986 Act § 142(b); I.R.C. § 274(n)(2)(A) (1986).


1986 Act § 142(b); I.R.C. § 274(n)(2)(A) (1986).


Tuition and related expenses, including reasonable living expenses while away from home at an educational institution. See I.R.C. § 163(b)(4)(C) (1986).

See I.R.C. § 163(b)(6) (1986) which refers to I.R.C. § 163(d)(6)(B) which provides the percentage of personal interest to be disallowed in tax years beginning in years 1987 through 1990.

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