

INVESTMENT STRATEGIES AFTER THE NEW TAX ACT

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DISCLAIMER

In the preparation of this book, effort has been made to offer current, correct, and clearly expressed information. Nonetheless, inadvertent errors can occur, and tax rules and regulations often change.

Further, the information in the text is intended to afford general guidelines on matters of interest to taxpayers. The application and impact of tax laws can vary widely from case to case, however, based on the specific or unique facts involved. Accordingly, the information in this book is not intended to serve as legal, accounting, or tax advice. Readers are encouraged to consult with professional advisers concerning specific matters before making any decision, and the author and publisher disclaim any responsibility for positions taken by taxpayers in their individual cases or for any misunderstanding on the part of readers. The information in this book is based on the Omnibus Budget Reconciliation Act of 1993 (Public Law 103-66), signed into law August 10, 1993. It was completed prior to the issuance of any regulations, rulings, or notices interpreting the new tax act. Therefore, current tax advice must be obtained prior to taking any actions based on the discussions herein.

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CONTENTS

PART ONE

INTRODUCTION

1

1 A PERSPECTIVE ON THE CLINTON TAX ACT

3

The Clinton Tax Act, 3

What Happened to “Tax Simplification?,” 4

Themes That Affected Tax Act, 4

How to Begin Planning, 5

What the Government Should Really Be Doing, 6

Conclusion, 6

PART TWO

CHANGES AFFECTING ALL INVESTORS

9

2 HIGHER TAX RATES TAKE A BIGGER BITE

11

Overview of How Individual Taxpayers Are Taxed, 11

Higher Tax Rates, 16

What the New Rates Mean to Investors, 18

Marriage Penalty: More Costly to Tie the Knot, 22

Energy Tax, 23

Conclusion, 23

3 CAPITAL GAINS TAX BENEFITS ARE BACK

24

Capital Gains Taxed at Favorable Rate under New Rules, 24

Basic Rules for Capital Gains, 25

Capital Gains and Losses, 27

Capital Gains Effect on an Investment and Business

Transactions, 29

Special Rules Limiting Ability to Realize Capital Gains on

Sales of Partnership Interests, 39

New Rules to Prevent Improper Conversion of Ordinary

Income into Capital Gains, 39

Conclusion, 40

4 THE ALTERNATIVE MINIMUM TAX TOUGHER AND MORE COMPLEX THAN EVER

41

What Is the AMT and How Did the Clinton Tax Act

Change It?, 41

How the AMT Is Calculated, 42
Preference Items and Adjustments That Increase Your
AMT Income, 42
Exemption Amount, 46
AMT Credit, 47
Planning for the AMT, 48
Conclusion, 50

**5 ESTATE AND GIFT TAXES: IT'S HARDER TO
GIVE YOUR CHILDREN WHAT YOU'VE
MANAGED TO KEEP 51**

Estate Tax, 51
Gift Tax, 53
Generation Skipping Transfer Tax, 55
Changes Affecting Estate, Gift, and Generation Skipping
Transfer Taxes, 58
Estate Planning Following the Clinton Tax Act, 60
Changes Affecting How Trusts and Estates Are Taxed for
Income Tax Purposes, 68
Conclusion, 74

**6 CHARITABLE GIVING IT'S HARDER TO
BE NICE! 75**

General Rules for Charitable Deductions, 75
Determining the Income Tax Deduction for Your
Contribution, 76
Alternative Minimum Tax Considerations, 77
How Charitable Contributions Must Be Reported to
the IRS, 78
Strict Requirements for Documenting
Contributions, 79
Valuations Report by IRS, 80
Conclusion, 81

**7 MISCELLANEOUS CHANGES AFFECTING
INVESTORS 82**

Investment Interest Limitation, 82
Permanent Phaseout of Itemized Deductions, 88
Permanent Phaseout of Personal Exemptions, 89
Estimated Tax Filing, 89
Installment Payment Rules Affecting When You Pay
Your Taxes, 91
Penalty for Substantial Understatement of Taxes, 92
Interest on Tax Refunds, 92
Refunds Resulting from Retroactive Changes, 93
Conclusion, 94

PART THREE**RESIDENTIAL REAL ESTATE INVESTMENTS 95****8 HOW RESIDENTIAL REAL ESTATE INVESTMENTS ARE AFFECTED 97**

Tax Rates and Capital Gains Affecting Your Investment, 97
 Tax Advantages of Larger Mortgages, 98
 Other Tax Changes Affecting Home Ownership, 100
 Moving Expenses Restricted, 100
 Conclusion, 104

9 DISASTER RELIEF: TAX HELP FOR FLOOD, HURRICANE, AND OTHER DAMAGE 105

Overview of Tax Rules Affecting Casualty Losses, 105
 Defining a Casualty Loss for Tax Purposes, 105
 Determining the Tax Year in Which to Take Your Deduction, 106
 Limitations and Restrictions on Deducting Casualty Losses, 107
 How the Taxable Loss Is Calculated, 109
 How to Prove Your Loss to the IRS, 109
 How to Avoid Tax on Insurance Proceeds Received as a Result of a Disaster, 110
 Conclusion, 111

10 LOW-INCOME HOUSING CREDIT: TAX BENEFIT FOR INVESTING IN RESIDENTIAL REAL ESTATE 112

Set-Aside Requirement, 112
 Miscellaneous Requirements, 113
 Determining the Eligible Basis in a Low-Income Housing Project, 113
 The Portion of the Eligible Basis Determining the Credit, 115
 Two-Tier Credit Structure, 115
 State Limitations Affecting the Credit, 116
 How to Determine the Credit, 116
 Limitations Affecting the Claimable Credit, 116
 Recapture of the Credit, 117
 Conclusion, 118

PART FOUR**COMMERCIAL REAL ESTATE INVESTMENTS 119****11 HOW COMMERCIAL REAL ESTATE INVESTMENTS ARE AFFECTED 121**

The Effect of Lower Tax Rates and Capital Gains on Real Estate Investments, 121

Payments to Partners That Affect Real Estate Partnerships, 122	
Avoidance of Debt Discharge Income on Some Real Estate Debt, 122	
Expansion of Reporting Requirements for Discharge of Debt, 127	
Real Estate Investments by Tax-Exempt Organizations, 127	
Special Rules Affecting Real Estate Rental Activities within Empowerment Zones and Enterprise Communities, 127	
Conclusion, 127	

12 PASSIVE LOSS RULES—EASIER FOR SOME BUT NOT ALL 128

Overview of the Passive Loss Rules, 128	
Treatment of Tax Losses That Cannot Be Deducted Currently, 129	
Types of Taxpayers Subject to the Passive Loss Limitation Rules, 131	
What Is an Activity?, 132	
Categorizing Income, Losses, and Business Activities, 133	
Conclusion, 144	

13 DEPRECIATION PLANNING FOR COMMERCIAL REAL ESTATE 145

Expensing Deduction, 145	
Longer Depreciation Period for Commercial Real Estate, 145	
Leasehold Improvements Are Subject to Absurd Depreciation Results, 147	
Ancillary Tax Changes That Affect Depreciation Planning, 151	
Planning Ideas to Maximize Depreciation Tax Benefits, 152	
Conclusion, 156	

PART FIVE CLOSELY HELD BUSINESS INVESTMENTS 157

14 HOW THE CLINTON TAX LAW AFFECTS BUSINESS 159

C Corporations, 160	
S Corporations, 173	
Limited Liability Companies, 179	
Partnerships, 180	
Miscellaneous Changes Affecting Business, 188	
Conclusion, 193	

15 SPECIAL TAX BENEFITS FOR QUALIFYING BUSINESSES	194
Investments in Qualified Specialized Small Business Investment Companies (SSBICs), 194	
Capital Gains Exclusions for Qualifying Small Business Stock, 195	
Business Owners in Targeted Development Areas: Empowerment Zones and Enterprise Communities, 198	
Special Tax-Exempt Financing for Businesses in Qualifying Zones, 200	
Community Development Corporations, 200	
Special Incentives to Promote Investment in Indian Reservations, 201	
Investment Tax Credit, 201	
Conclusion, 202	
16 EMPLOYEES AND HEALTH CARE COSTS	203
Social Security Taxes, 203	
Pension Limitations That Make Retirement Saving Harder, 204	
Health Insurance Deductions for the Self-Employed, 206	
Increased Withholding on Bonuses, 207	
Social Security Taxes on Tips, 207	
Tax Credits to Hire New Employees, 208	
New Rules for Employer Reimbursement of Moving Expenses, 209	
Limitation on Deducting Compensation over \$1 Million, 210	
Educational Assistance for Employees, 210	
Conclusion, 211	
17 BUSINESS DEPRECIATION DEDUCTIONS AND TAX CREDITS	212
Elective Expensing Increased, 212	
Real Estate Affected by Longer Write-Offs, 214	
New Rules for Amortizing (Deducting) Intangibles, 214	
AMT Depreciation Rules Changed, 221	
Research Tax Credit Reinstated and Extended, 222	
Conclusion, 225	
PART SIX	
OTHER TYPES OF INVESTORS	227
18 SENIOR CITIZENS AND RETIRED INVESTORS	229
Social Security, 229	
Planning for the New Social Security Rules, 232	
Rental Real Estate Losses Affected by Social Security Changes, 234	

Medicaid Planning Opportunities Limited, 235
Conclusion, 236

19 STOCK, BOND, AND OTHER INVESTORS AND DEALERS **237**

Tax Rates and Other Changes Affecting Investment Strategies, 237
Small Issue Bonds, 244
Qualified Mortgage Bonds and Mortgage Credit Certified Programs, 244
Private Activity Bonds, 244
Discounts on Tax-Exempt Bonds, 244
Stripped Preferred Stock Subject to Original Issue Discount Rules, 245
Investment Interest Limitation Rules, 246
Anticonversion Rules That Prevent Turning Ordinary Income into Capital Gains, 246
Securities Dealers Required to Use Mark-to-Market Accounting, 249
Conclusion, 251

20 DIVORCED INVESTORS **252**

Should You File a Joint or Separate Return?, 252
Medical Care Payments for Children, 253
Relative Advantage of Capital Gains Can Affect Strategy in Negotiating Property Settlements, 253
Estate and Gift Changes, 254
Moving Expense Deduction Changed, 255
Passive Loss Limitation Rules, 255
Expensing Deduction, 256
Higher Corporate Tax Rates, 256
Repeal of Luxury Tax
Conclusion, 257

21 TAX-EXEMPT INVESTORS **258**

Tax-Exempt Investors and UBTI, 258
Partnerships with Tax-Exempt and Non-Tax-Exempt Partners, 259
Exceptions to UBTI Rules, 260
Title Holding Companies, 263
Tax-Exempt Organizations' Investments in REITs, 263
Tax-Exempt Organizations' Investments in MLPs, 265
Conclusion, 266

GLOSSARY **267**

INDEX **279**

PART ONE

INTRODUCTION

I A Perspective on the Clinton Tax Act

THE CLINTON TAX ACT

Few investors will escape the effects of the Revenue Reconciliation Act of 1993, Title XIII of the Omnibus Budget Reconciliation Act (OBRA) 1993, passed by Congress on August 6, 1993 (the Clinton Tax Act). President Clinton's February 17, 1993, speech promised the most sweeping tax bill since the Tax Reform Act of 1986. The changes finally enacted in fact affect large corporations, closely held or smaller businesses, wealthy taxpayers, middle-income and low-income taxpayers, employees, investors of all types, retired persons, and other taxpayers.

The nature of the changes represent a dramatic departure from the Tax Reform Act of 1986 philosophy of simplification (maybe only by comparison with the Clinton Tax Act), lower rates (those are gone), and the goal of removing tax considerations from investment planning (only at your own peril). Tax rates are higher, incentives for certain types of investments will affect investment strategies, and complexity is back. With such dramatic changes, affecting almost every taxpayer, the 1993 tax bill is important for every investor to understand. The effects can be substantial. The changes in tax planning as compared with the years after the Tax Reform Act of 1986 and before 1993 are substantial. Great caution and diligence should be exercised.

This book explains how every investor will be affected by the Clinton Tax Act. It provides practical advice about revising your investments to profit from opportunities created and to minimize the cost of rate increases and other changes. Tips and traps are highlighted to help guide you through post-Clinton investing. Examples and other materials that you can use in your tax planning are included to help illustrate the new rules. A glossary will help you through the maze.

WHAT HAPPENED TO “TAX SIMPLIFICATION?”

The death knell has been sounded for the principles underlying the Tax Reform Act of 1986. Taxes will again assume their common historic role of stimulating investment; tax rate disparities will encourage tax-oriented investment strategies (although tax shelters may still be a dirty word, many investors will be looking for them); and the progressive tax rates have been enhanced so the more you make, the more you pay. Any thought of a flat tax or tax simplification is gone.

THEMES THAT AFFECTED TAX ACT

President Clinton stressed several principles underlying his tax package. Whether or not the Clinton Tax Act achieves the stated goals, these principles can help you anticipate and understand many of the tax changes described in later chapters.

Investment and Not Consumption

A major theme was to promote investment. Therefore, numerous consumption-oriented spending deductions have been further limited. For example, business entertainment deductions, club dues, and travel expenses for spouses have all been severely restricted. These changes highlight a trend that will have a much harsher effect on investors than many realize. The Clinton Tax Act, like several tax acts before it, has severely restricted a broad range of deductions. These restrictions often affect legitimate business and investment deductions that you have incurred and have paid for. The result is that the top tax rates you read about are really much worse than they sound because the deductions you can claim before applying those tax rates are so limited. Thus, not only have rates increased, but the income that will be taxed has increased as well. The result is a much higher actual tax bite.

The objective of stimulating investment utilizes job incentives, various tax deductions to encourage investment in hard assets (equipment and fixtures), and credits to encourage investment in special areas. Tax implications of investments have reassumed their historically important role.

Small Business

Several investment incentives have been targeted for small businesses where, historically, the most jobs have been created. President Clinton stated that the changes will contain the most significant benefits for small business in history. Whether they are that significant is doubtful, but every investor in a small business should pay careful attention since proper planning will be necessary to take the most advantage of the new benefits. For example, certain tax incentives are available to businesses investing in other qualified small businesses. The deduction for investments in equipment has been increased. But, as you will see in this book, not only are the incentives extremely complicated, they are often not nearly as generous as they may have sounded initially.

Commitment to Children and Strengthening of Families

The President promised several broad programs to benefit children and families. Increases in the earned income credit to help lower income workers is an example of the changes made to achieve this objective. Since these incentives generally do not affect investors, they are not discussed in any detail.

Job Creation

The President made job creation incentives an important part of the Tax Act. Job tax credits for creating new jobs as well as the various investment incentives should encourage job creation.

Closing Loopholes

The President has promised to further close tax “loopholes.” Many of these relate to business entertainment and travel deductions. This has long been a favorite loophole to attack.

HOW TO BEGIN PLANNING

The first step in planning your investments following the Clinton Tax Act is to begin to understand the changes that were made. This process cannot stop, however, with this book. For many years to come,

the Internal Revenue Service (IRS) will be issuing rulings and regulations that interpret and apply the Clinton Tax Act changes. You must then assess how the changes are likely to affect your personal investment strategies so that you can plan the steps you will take to achieve your goals. The Tips highlighted throughout this book should give you ideas for beginning this process. Where your income is sizable, or your situation complex, your next step should be to discuss your plan with your tax adviser. Like all major tax acts, the Clinton Tax Act is full of complex rules, exceptions, and special provisions, so professional help is always advisable.

WHAT THE GOVERNMENT SHOULD REALLY BE DOING

The approach taken in the Clinton Tax Act is wrong. What is most needed to achieve growth is consistency, savings incentives, and simplicity. Even in an unfavorable tax environment, business can grow if it knows the rules of the game. Unfortunately, Congress has changed the tax rules so often that the only certainty is that the rules will change again. When evaluating an investment, a common step is to project the net of tax return over the life of the investment, discount it back to present dollars, and evaluate the merits of the investment compared with its cost. Since the tax rules change significantly every few years, business must discount projected returns at a higher rate to reflect the increased risk. This does not bode well for investment. The Clinton Tax Act, with its about-face from many of the principles of the 1986 Tax Reform Act, will only exacerbate this problem.

Savings and investment incentives are critical to the rebuilding of the economy. But the Clinton Tax Act, with increased tax rates and more restrictions on pensions and other similar changes, really does not promote savings to the extent that it should.

Finally, as the rest of this book will demonstrate, simplicity is not a word to use to describe the Clinton Tax Act.

CONCLUSION

The Clinton Tax Act has affected hundreds of provisions in the Internal Revenue Code. This chapter has highlighted several miscellaneous changes that will affect a broad cross section of investors. The key

point is that the changes are numerous and complex, and can have costly results. Caution must be exercised in any tax planning.

Like all too many tax acts, the Omnibus Budget Reconciliation Act of 1993 means that you must face the daunting tasks of understanding the new rules, adjusting your investment, business, and financial plans accordingly, and bearing additional tax costs and professional fees. About the only solace is that those who are diligent will reap the benefits of lower tax costs and better net of tax investment returns. Be cautious, however; as is true of any tax legislation, the interpretation of these new laws will require future rulings, regulations, and court cases. Be certain to consult with your tax, investment, legal, pension, insurance, and other advisers before making any decision. Good luck.