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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MARTIN M. SHENKMAN

Teaneck, New Jersey
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INTRODUCTION

1 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.