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PERSONAL FINANCIAL PLANNING -- EFFECTS OF THE RECENT AND PROPOSED TAX LEGISLATION

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o A discussion of the personal financial planning process, including a discussion of the effects of any recent and proposed legislation on individuals.

MS. DEBORAH WALKER: I deal primarily with retirement planning and some personal financial planning as it impacts retirement planning. I think personal financial planning is going to have some great opportunities given the pending legislation. There's almost sure passage of this legislation. There's also almost sure passage of lower individual income tax rates in future years, so the question now becomes for financial planners and tax planners, How can we take advantage of the fact that rates are going to be high for one more year in 1986 and lower in future years? What we want to do here is go through some of those provisions that are going to change with the pending tax reform legislation, or may change, to give you some ideas as to what we think is going to happen, and how you can plan for these possible changes.

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Before I get into all of that, I want to talk a little bit about the legislative process. A lot of people are probably not aware that tax reform started way back in 1982/83. There were a number of Congressmen at that time, who were calling for much lower individual income tax rates and elimination of many of the deductions -- basically, the simplification of the tax system. In 1984, President Reagan instructed Treasury to release a study, and Treasury released the first tax reform proposal in November of 1984. If you read that proposal, it's very clear that what Treasury wanted to do was to move away from a tax system that encourages you to do things you already do. It wanted a tax system maybe to increase revenues, primarily to be fair and not give you a tax benefit, through the fall of 1985, for what you were going to do anyway. The President did not immediately endorse that tax reform proposal. Six months later, in 1985, the President's proposal came out. What the President did was take Treasury's Ivory Tower, No Political Considerations Proposal, and mesh political considerations with Treasury's proposal. Now we had the President's proposal in May of 1985.

Through the fall of 1985, Congressman Rostenkowski started the legislative process that led to tax reform. He drafted a bill, looking at the President's proposal but also understanding other things that were available. As you'll remember, that bill which came out of the House Ways and Means Committee was not well liked, and in fact, it almost did not pass the House. President Reagan had to go up to the House and promise the Republican Congressmen that he would not sign that bill if it didn't change by the time it reached his desk. He gave them his promise; they passed the bill; it went to the Senate. And now the Senate had to produce a bill that Reagan would like so that he could sign it and keep his promise to all the Republicans that passed the Bill they didn't like to begin with.

Two different proposals are now in Congress, and one or the other of the two proposals is going to work its way into the new tax reform bill. Let's start first with the House bill, which everybody first thought would never pass, and then once it passed, thought would surely die. Basically, what Congressman Rostenkowski did was not change individual income taxes too much. He broadened the individual income tax base a little bit with the minimum tax. But because he did not broaden the base significantly, he could not lower rates any further

than his 38%. Remember, the caveat of all these people drafting tax legislation is it has to be revenue neutral over five years. That's just the given, and they start from there. So Congressman Rostenkowski went in; he didn't change individual deductions too much. He couldn't lower the rate any more than 38%. He still wanted to help the poor middle income taxpayers, so he increased the exemption -- that's the $1,000 that everybody has on his tax return, $1,000 per individual in the family -- and he increased the standard deduction which helps low income taxpayers. To do all of this, it cost him $140,000,000,000. Now he had to get the $140,000,000,000 somewhere. So he went over to the corporate side. In the corporate side, he changed appreciation, he changed investment tax credit and he also lowered rates. That brought him $33,000,000,000, but he still needed $107,000,000,000 to make his plan work. Remember, his plan was not a big change except for low and middle income taxpayers where there were exemptions. He did not eliminate a lot of deductions; he didn't lower the rates below 38%. He got the revenues from a corporate minimum tax, accounting changes, more taxes on insurance companies, more taxes on banks, more foreign taxes and taxes on employee benefits. So he took a broad range and raised the $140,000,000,000 out of the corporate sector to pay for increased exemptions and increased standard deductions.

The Packwood proposal was the Senate version. What the Senate finally ended up with, after a few false starts, was a broader individual tax base. It eliminated deductions for individuals. It took out passive losses from tax shelters; it took out the deduction for consumer interest. It took out the sales tax deduction, and it took out the IRA deduction. Broadening the individual tax base so much enabled it to lower the rates 27%. But don't forget, it has to be revenue neutral. But in Senator Packwood's bill, he's broadened the individual base so much that he only has to go to the corporate side for $100,000,000,000 instead of $140,000,000,000. He hurts corporations, but not to the extent that Congressman Rostenkowski does. And where does Senator Packwood get his changes? He gets $33,000,000,000 from accounting changes and the corporate minimum tax. He also increased compliance; he's going to give more money to the IRS to train more revenue agents -- to collect $12,000,000,000 in revenues that he's convinced are there already that people aren't paying. And finally he changed insurance company taxation. These four things raised the revenue. Beyond that, he did not need to talk to special

interests, other than have them reflected by accounting changes. You'll note I didn't mention anything about depreciation or ITC, and we know the Packwood proposal does eliminate that for corporations. The reason is that depreciation adjustments and the loss of the investment tax credit are directly offset by a lower corporate tax rate. Granted, certain corporations are going to be treated more favorably than other corporations, but still Senator Packwood went to only four sources within the corporate sector to fund his 27% tax rate for individuals.

When are we going to see all of this tax legislation? The Senate is meeting right now on its tax proposal -- discussing it on the Senate floor. It's rather amusing to watch sometimes on television, but basically, the senators spend about three days talking about IRAs and how we ought to provide IRAs for everybody. They resolved that they would try to do the best they could in Conference. So the elimination of the IRA deduction for people who are already covered by qualified plans will be the version that finally goes to Conference from the Senate. The senators argued about passive losses; they argued about sales tax deductions two or three times. Most of the amendments were defeated. The sales tax amendment also has a sense of the Senate resolution where the senators will try to do the best they can in Conference. They have to talk about charitable contributions for non-itemizers today. They may vote on it today if they finish. They may vote on it Monday, although they've only set aside three hours on which they'll vote on Monday, and most people think that they'll pass it on Tuesday. A lot could happen -- people could bring up other things, but the real feeling is that if IRAs couldn't win on the Senate floor, there's nothing that's going to win on the Senate floor, and the bill will go pretty much the way it is into Conference.

When will Conference begin? The staff of the House Ways and Means Committee and Senate Finance Committee seem to think that Conference won't start until the middle of July, no matter when the Senate finishes. There's a one week vacation in there, and besides, they don't want to start Conference before the middle of July. Then, the feeling is the Conference will be long -- there are a lot of details to work out -- but it really won't be that tough in July. There are a lot of similarities in these bills. Therefore, before Congress goes out of session August 16 for its summer vacation, most people are betting

that the bill will be reported out of Conference and perhaps passed by the Floor. Alternatively, it will be reported out of Conference and passed as soon as the Congressmen come back after Labor Day.

I want to talk a little bit about what I think might happen when the tax bill gets to Conference. One of the big concerns with the Senate version is that although it's revenue neutral over five years, it loses an awful lot of revenue in 1988 and 1989. People are concerned about that loss of revenue, and they wish that the Senate version were more level revenue neutral over each year instead of having revenue increases in 1987 and losses in 1988 and 1989, and then increasing and leveling out. Let me tell you a little bit about why that bulge is in the estimations of revenue losses. The majority of it comes from individual tax rates and the reduction in individual tax rates. Included in those numbers for the reduction of individual tax rates are the proposed changes in capital gains rates. The Senate proposes to increase capital gains rates beginning January 1, 1987. The estimators have assumed that there will be a lot of people who are selling capital assets in 1986 while capital gains are still favorably treated. This fire sale of capital assets is going to raise revenues for Treasury. And it's the fire sale, combined with the fact that we don't realize these full rate reductions until July of 1987, that decreases the revenue loss for 1987. Then in 1988 and 1989 -- the estimators assume that everyone sold all their capital assets in 1986 -- they don't have anything left, but they want to sell in 1988 and 1989. In fact, if they decided to hold onto it, they're going to hold onto it even longer, because to sell it, they're going to have to pay a higher tax. And it just hasn't gotten into our system that we have to pay a higher tax, so we'll hold it a little longer. And there you have the revenue losses in 1988 and 1989.

It seems a little ironic that it's the estimators' numbers (which take into account individuals' reaction to pending law changes) that may, in fact, change the pending law. That, if it happens, will be unfortunate, but it will be a political consideration. To change because of their spoils for one or two years is, in my mind, a little bit short-sighted, because the Conference Committee is going to take a long-run solution, and it's going to hurt us five or six years from now.

There is a rumor that's running around Washington that in order to stop this fire sale, the Conference Committee is going to have an effective date of whatever day it is that it's working on the capital gain changes. So, if you sold a capital asset before July 20, it would be taxed at 20%; after July 20, the new rates would apply. I guess the planning that comes with that is if you're sitting on a capital asset that you think you're going to sell anyway in 1986, maybe you want to go ahead and sell out before Conference meets. In my mind, Conference won't adopt a date of July or August for selling capital assets, but you can't tell.

The other issues that we expect will be discussed in Conference include raising revenues through an increase of rates beyond 27%. President Reagan will be happy with anything 35% or below, so that's a fairly easy thing to do except to people who are used to the 27% rate. There's a big push to change the effective date of those rate changes to January 1, 1987. The rate changes are now effective July 1, 1987. The reason for that is that everybody is going to be filing the 1987 tax returns in the spring of 1988, and 1988 is election year. And Congressmen want to be able to say to everybody, "Remember that when you filed your tax returns, you really saved a lot of money because the rates were so much lower throughout the entire year, instead of just the partial year." The other thing that everybody says is that since there was no IRA change on the Senate floor, there will be no IRA change in the Conference Committee either -- that IRAs will very likely be disallowed for people who are already covered by other corporate plans. At best, IRAs are going to help the very low income people. They're going to have a tax credit or a loss at a 15% rate instead of a 27% rate or something of that nature.

The budget prospects kind of work their way into tax reform. Although tax reform looks very, very good, the budget prospects and the budget arguments don't seem to be going very well at all, and haven't for a year, or a year and a half. The balanced budget seems to be a problem that no one can solve. I think that means that no matter what happens with this bill, we're going to have another tax bill in 1988/89, and you will hear some people say, "I don't want tax reform at a 27% rate, because to get the 27%, they made me give up all my deductions. I know they are going to come right back in next year after

they took away all my deductions and raise my rate, and I'm going to be worse off."

I think there are three things that are going to bring about a tax increase in, say, 1988/89. One of them has to do with that bulge I was talking about in the individual rates. The bulge is going to impact the deficit, people are going to go crazy, and they're going to try to raise some revenues to decrease that bulge.

Next, remember that I said Senator Packwood raises $12,000,000,000 worth of revenue by increased compliance. If you look at the budget bills, the budget bills also raise revenues by increased compliance, which means training more agents and having them out in the field, examining books and bringing in more dollars. First of all, there's a question as to whether the IRS can in fact take all this additional revenue that it is going to get to train agents and effectively train good enough agents that there'll be a return on the money. The IRS will tell you that on every ten cents it spends, it earns a dollar. The Office of Management and Budget will say it's more like for every quarter the IRS spends it earns a dollar. Whatever, it's fairly large. But at some point, those numbers are going to change and the IRS has got the numbers both in tax reform and in the budget. They're aware it's there, but we think that maybe in 1988/89, that's going to come home to roost, and there are just not going to be any more revenues that they can collect through the IRS system.

Finally, Defense spending will also bring about the tax increase. By 1988 Defense spending will have been frozen for three years, with $295,000,000,000 in 1985 to 1986 and 1987. Everyone agrees that Defense spending cannot remain frozen much more than three years. There's going to have to be an increase in Defense spending, and all of this is going to come together in 1988/89 and will generate the tax increase. Where is Congress going to get the revenues for the tax increase? Some people are concerned that they'll raise the individual rates. I personally don't think that anyone would have the nerve to come back and raise individual rates in such a short period of time. However, don't forget that Congressman Rostenkowski raised $140,000,000,000 in the corporate sector, and Senator Packwood only raised the $100,000,000,000. There's a lot of revenue back in some of the proposals that Rostenkowski was talking about --

$40,000,000,000, to be exact. Those revenue raisers can be brought up again in 1987/88/89, and, in fact, they may slide through because they affect special interest -- they may slide through relatively unnoticed. I think that's much more likely than an increase in rates. And I think by 1991/92, we may begin seeing an increase in rates, depending on how the rest of the economy is doing, and the budget itself. If they can get the budget down, then we won't need it.

I'm going to talk about the individual changes, and how you can plan for them. Then, since I spend all my time working with qualified retirement plans and fringe benefits, I would be remiss if I didn't tell you some of the things that are in the bill that are going to affect actuaries and their practice. I'm going to start with, the tax reform proposals, their whole purpose. Now these are the tax reform objectives I've been using since 1984 in giving these speeches. They're the objectives that the Treasury came up with when it verbalized its pie-in-the-sky, academic version of what would be the ideal tax system for this country: We want to have a fair tax system, we don't want any loopholes, we want it simplified, we want to promote economic growth, and we want to stay revenue neutral. I think everybody who's working for tax reform is working for these five goals. It's just a question of how you get to these five objectives. As far as individuals are concerned, the goals are to reduce tax rates, eliminate deductions, and repeal credits.

Let's take a look now at the individual income tax rates. In the Senate version of the bill, there's a 15% rate for incomes less than $29,300. That's more favorable than the rates as they exist for the 1986 law or in the House version of the bill. Currently, income of $29,300 would be taxed at 29%, and under the House version, at 25%. The Senate version then has an increase to 27%. The House has a three-step increase: 15%, 25%, and 35%. And, of course, there's something like 14 steps in the current law, ranging from 11% to 50%. And it goes above 40% somewhere around $50,000/$60,000. The effective date for the rate changes is July 1, 1987. If that stays the way it is, then your rates for 1987 on a joint return are not quite as favorable as they'll finally be when the new rates are fully phased in. The rates for 1987 end up with a 38.5% bracket at the top, 13 to 20% bracket up to $30,000.

To fully understand the way the rates work in the Packwood proposal, you have to realize that he takes away the 15% tax rate for certain higher income tax payers. Again, what he's saying is, "We want higher income." What he's trying to do is raise revenue, and he wants higher income tax payers to pay a higher fair share. He can still call it a 27% tax rate, but in fact, for higher income taxpayers, it moves as high as 32% in certain instances. What he said is when the income on your joint return exceeds $75,000, you start losing the 15%, rate, so you don't tax your first $30,000 or $29,300 of income at 15%, or rather you tax a portion of that at a higher rate. Eventually, when you get to $145,320, everything across the board stacks at 27%. There's no 15% rate for those individuals.

Senator Packwood does a similar thing with the personal exemption. The personal exemption is the $1,000 exemption that every taxpayer gets. You get one for taxpayer, spouse, and any dependents. Both the Senate and the House versions raise that exemption to $2,000 apiece. Right now it's $1,080, with cost-of-living adjustments. The Senate version phases out that exemption. Remember, the exemption is really for low income taxpayers, because it comes right off the top of their income -- in fact, brings them down to perhaps where they don't have to pay any tax. The Senate version phases out this exemption from $145,000 to $185,000. So, in the Senate version, after you're above $185,000 worth of income, you're no longer entitled to the personal exemptions. The House version does somewhat the same thing, only is geared to itemizers. It says, "We don't care how high your income is. If you itemize your deductions, you can't itemize quite as much as you would otherwise, because you've taken this $2,000 exemption." So, the House version reduces your itemized deductions by $500 for each exemption irrespective of what your income level is. The Senate version says, "We won't touch your exemptions until you make $145,000, and after you make $185,000, there's no exemption left for you."

People in our office who have two-income families thought, "I can't believe they won't adjust it," but so far it is not adjusted. However, if you're married filing separately, the Act does decrease the rates, and it decreases the point at which these exemptions phase in. In other words, under married filing separately, you start losing the 15% bracket at $37,500, as opposed to $75,000. Still, if you can get somebody in that family to have income below

the $37,500, then you never lose the phase out for that person. Then, of course, only the individual with income of $75,000 is going to lose the 15% bracket. If you add those two incomes together, the $30,000 spouse loses the 15% bracket too, because they just went from $75,000 up to $105,000. If you keep the two individuals separate, the $30,000 person can still use the 15% bracket, and the $75,000 does lose some of it. You would have to project your income to see if it's better, but there will be more and more people who can file separately, unless the Act adjusts it, and I tend to think that it will be adjusted.

The Senate and the House both increase the standard deduction -- the Senate to $5,000 on a joint return and the House to $4,800. This is the amount that you must have in itemized deductions before it's worthwhile for you to itemize. So basically, this helps people who can't itemize right now. Under current law they get $3,400 adjusted for cost of living to $3,600; everybody gets that much in a deduction. Now they've raised that number to $5,000. It also prevents a lot of people who would otherwise have to itemize from having to itemize. If you had $4,000 of itemized deductions under current law you would file a tax return and itemize your deductions. Under this law, either version, you won't have to itemize your deductions. You're just going to be given $4,800 or $5,000.

Now let me turn to the deductions and what an individual loses under the Senate version. As under the House version, there's almost no loss in deductions. Medical expenses, right now, are deductible in excess of 5% of adjusted gross income; Senator Packwood changes that to 10%. And here's the deduction for interest which has received a lot of press. Your principal residence mortgage interest is deductible under current law and will be deductible under the new law. Mortgage interest on a second home is deductible in full right now.

Credit card interest, deductible in full right now, is disallowed under the Packwood proposal. And auto loans, student loans, and any consumer interest is disallowed under the Packwood proposal, but is deductible today. That's caused a little bit of controversy as being unfair to all of those of us who are locked into consumer loans, so there is a phase in of this rule. In 1987, 65%

of your consumer interest is going to be deductible. In 1988, 40% will be deductible. In 1989, 20% will be deductible. By 1990, 10%; and in 1991, it won't be deductible anymore. This would work fine if it were 65% of what I had on my 1986 return. This really doesn't help you even if you try to pay off 35% of your loans by 1987. You only get 65% of whatever interest you incur. Obviously, the tax planning with respect to the interest deductions, is to get rid of consumer interest. There's a lot of talk: "I can get rid of consumer interest because I own a lot of equity in my home, and I'll just put it into my mortgage." It's very politically difficult, especially in a time period when half the country is refinancing homes and pulling cash out, to somehow figure out what really is mortgage interest and what's just an equity loan out of your house. I have a feeling that the Committee really will have a hard time zeroing in on that. So, in fact, as long as you have a loan secured by a mortgage on your home, it's going to be deductible interest, which then says perhaps you can renegotiate long-term outstanding credit lines or whatever so that they will be deductible, assuming you have some equity in your house.

The taxes are pretty simple; the only disallowed tax deduction is sales tax. It's not really a big deal on anybody's return. I'm surprised they're making such a big deal over it in Congress.

This next one takes a bit more, and this will probably impact everybody's tax return. Basically, Senator Packwood disallows tax preparation fees, investment expenses, safe deposit rental, uniforms, union dues, publications, magazines, whatever you buy for your business. He still allows employee travel and transportation expenses. Under employee travel or self-employed, if you're unreimbursed for that travel, you only are entitled to deduct the expenses, under Senator Packwood's version, to the extent they exceed 1% of your adjusted gross income. The House version has a similar 1% floor with respect to all of these items. The point of the 1% floor really sounds unfair. It seems if you spend any of this money, you ought to be able to deduct it, but what they're saying is you have to spend at least 1% of your income, and then they'll let you deduct everything. What they're trying to do is simplify preparation of your tax return. If you know your medical expenses are way below 5%, you don't go and figure out what you've spent on medical expenses. If you know your subscriptions and tax return preparation fees are way below 1%, then you don't

have to figure it out. It's easier for you to do your taxes, and besides, it wasn't many dollars anyway. That's the theory. How it will come out in Conference, I have no idea, although it would not surprise me to see all these miscellaneous deductions gone.

The one other thing that sort of fits in here is meals and entertainment expenses. Both the House and the Senate versions say that only 80% of a business meal or business entertainment is deductible. The theory behind the 80% is that you have to eat anyway, and there's some kind of a personal element in a business meal; therefore, business meals are only 80% deductible.

The biggest tax planning idea, of course, for this pending tax reform proposal with respect to individuals would be to defer your income. And how do you defer your income? The IRS will agree that if you enter into an agreement to receive income in the future for services you render tomorrow, as long as you enter into that agreement prior to the period for which services are rendered, then you won't be taxed on the income when you render the services. Those are standard, nonqualified, deferred compensation plans that a lot of corporate employers have for middle and high income people. Basically, they sign an agreement in December of every year and say, "Next year my salary will be $50,000; pay me $45,000 and $5,000 on my retirement or $5,000 when I leave the company."

The rules on those, even the IRS will agree, are that if you start a new plan during the year, or if you just become one of those employees eligible for that plan, and your company has always had a plan, you can defer future salary. So your company could agree to pay you in 1987 or 1988 or at retirement for the income that you would otherwise receive at the end of 1986, provided that you haven't rendered the services for that income. The IRS would also say that if you get a bonus, your bonus is calculated based on performance throughout the calendar year; you have rendered services, and they won't let you take the 30-day rule on the bonuses.

The downside to why your employer wouldn't say, "Of course I'll pay in January of 1987," is it doesn't get a deduction until you pick it up in income. Don't forget corporate rates are dropping too. So on the corporate side, the employer has to agree that it's going to take a deduction at 33% while you pick

it up in income at 27%. That's a numbers game as to whether you want to negotiate with your employer and whether it will even negotiate with you.

There is one aggressive position that you can take -- I only mention it because so many people are talking about it. If a corporate employer pays somebody within two and a half months following the end of the year, it can argue that it's not deferred compensation, but that it was accruable in December and therefore deductible in December. When you read the regulations, it certainly looks like that's what the regulations say. We think the regulations may be changed in their final form, mainly because it's not the intent to have you enter an agreement to say, "Pay me my November and December salary in January," let the employer not suffer any loss, and have you, in fact, get a tax break, even if the rates go to 38%. But I think that without a doubt people need to back off and look at where they're going to get their income for the rest of the year and see if there's any way that that income can be deferred and what the consequences of doing it are. You also might want to pay your charitable contributions in 1986. You might want to pay your subscriptions and your union dues. Do all that in 1986, when you get a 50% or 40% or 37% tax break, as opposed to when they'll be worth less on a tax rate -- perhaps none at all.

Fringe benefits and retirement plan changes kind of rode along. For a long time people thought that maybe we ought to pull this out and discuss it separately, since it's such a big issue. I think these provisions are here to stay. I think Senator Packwood's provisions, which are even more far reaching than the House version's, are here to stay. Don't forget we've talked about this legislation actively for two years, and there have been a few Congressmen who have talked about it for a lot longer than that. People have had a lot of time to talk about it and complain, and Congressmen have had time to understand what they're doing. It seems pretty clear that this is what they want to do, albeit there are a lot of people who don't like it because pension plans will no longer be tax shelters. Basically, the changes are trying to increase the benefits for rank and file. The idea is that we're going to give you a tax break, but we're only going to give you a tax break if you're doing what we want you to do, which is help the rank and file; not save in an IRA account if your money is going to be in a savings account anyway. Simplifying the system

now has fallen by the wayside; it's no more simple than it ever was. In fact, it's probably worse.

Now let's discuss retirement. Retirement plans are not designed for accumulating money and then pulling it out at age 45 and taking ten year averaging out so you can go to Florida and buy a boat or start a business or whatever. They are designed to provide you annuity income at retirement age, and therefore, no more ten year averaging below 59%. Basically, here are the changes that are incorporated. The bills limit deductible savings. They say there's no reason why we would give you tax deductions to save $30,000 a year in a 401(k) when a rank and file person can't even dream about saving $30,000. Seven is enough. Again, the same idea: Why are we going to give you a tax break for providing yourself health insurance, when you don't give your employees good health insurance? You get tax breaks only if you're giving them to your employees, and then that's fine. And then emphasizing retirement on distributions.

I mentioned the new nondiscrimination rules for welfare plans. Health insurance is going to have to be available on a nondiscriminatory basis. The biggest problem in this is compliance with the new rule. Some major corporations just tell the House that they don't discriminate, and in fact they don't, and it's going to be way too much money to comply. But somehow that's going to have to be worked out, and somehow I feel certain nondiscrimination rules on all types of benefits are going to play.

As for new employee stock ownership rules, Senator Long loves employee stock ownership plans. He's retiring, and the general feeling is that he'll get whatever he wants for employee stock ownership plans.

Under Senator Packwood's proposal, you can only have an IRA if you are not covered by another plan. 401(k), the part you reduce your salary for, is limited to $7,000 on the theory that the average person can't reduce more than $7,000 of his salary.

Now, the biggest fringe benefits changes are in pension benefit, and what I mean by that is the $95,000 annual limit on pension benefits. They've done

some fairly sneaky things with this, but basically what they've done is say that the $90,000 limit applies at the retirement age of social security, which right now is 65 and eventually creeps up to 67. So the $95,000 benefit begins at ages 65, 66, 67. But under current law, there's a floor of $75,000 of benefit at age 55. That's not going to be there anymore. You're going to have to have actuarial deductions decreasing that $90,000 to the extent that you have retirement before the social security retirement age. I'm not an actuary, but I've heard that for age 55 retirement, the benefit is somewhere like $37,500/$38,000. That's much less than individuals can get today at $75,000.

In addition, I don't know how many of you might have set up pension plans for people age 60 who never had a retirement plan in their lives and had worked for ten years and, made a lot of money. You gave them a benefit of $90,000 right off the bat, started the plan at the retirement age of 65, just put piles of money in that plan for two or three years and took huge tax deductions, sometimes in excess of what they were earning. No more. This $95,000 limit, already reduced if taken before social security retirement age, is now reduced for every new plan to the extent you have not participated in the plan for ten years. So the individual who sets a retirement plan up at age 60, even though he's been in business, is only going to get one-tenth of the benefit in that first year, two-tenths for the next year, and three-tenths for the next year. That is considered to be unfair for the individual who couldn't save for retirement any earlier than age 60. What the Congressmen see is all of these people who were just looking for tax shelters and found that plans worked well.

The annual addition limits (currently $30,000) stay the same. Cost of living has slowed down a bit; the House version lowers that to $25,000, not a big change. The worst change is in the annual addditions. Under the annual additions, you can put in, using after-tax money, up to 6% of your salary. A lot of people take after-tax income, put it into their pension plans, and are income tax free up to 6% of their salary. No more. They're changing the definition of annual addition. Everything that goes into that pension plan before or after tax contribution is going to go into this annual addition limitation. So no more 6% buried by people who can afford to save.

From our perspective, we tell everybody to wait on a plan distribution, if they possibly can, until September, October, or November. By then we'll know what the legislation is, and we can plan. The only risk is that they'll say no ten-year averaging after some date in Conference; I think that's highly unlikely. Also, for retirement plans, there won't be any more ten year averaging; there will be five year averaging. There will be some transitional rules. Until a law is passed, the best thing to do is wait. The plans are going to require that you retire by age 70 -- you have to start getting a distribution at age 70 1/2, no matter whether you stop working or not. The plan is supposed to be a retirement plan and not just an accumulation plan. And, finally, the basis recovery rules will change so that you can no longer get an annuity tax free for the first three years.

The Senate has tightened the nondiscrimination rules. This is not in the House version, but I think it is very likely to pass. Right now you have to cover 70% of all employees or a fair cross-section. The Senate has changed that to say that you must cover 80% of all employees or a reasonable cross-section, and the reasonable test is a little tougher than today's cross-section test. There is a minimum participation test, and this is kind of a sleeper. The minimum participation test says for each plan, there can be no aggregation within an employer. For each plan, the employer has to cover the lesser of 50 employees or 40% of your employee workforce. That goes directly to law firms where each lawyer has his own separate plan and then all employees have one plan. It's perfectly legal under today's system. You set up comparable plans under the definition of what is comparable; in fact it's not very comparable. They're going to shut it down now.

Vesting is accelerated: five year vesting or at best, seven year vesting, 20% a year.

Social security integration will change. There's a rule that says if you provide social security benefits for somebody, you can assume it comes out of the retirement plan and not provide a retirement benefit for him. In fact, under existing law, we can integrate people out of a plan completely, so they get all their benefits from social security. That will not happen any more.

Under the new rule, if you've got a plan with social security integration, you can never get rid of somebody completely.

The one ray of hope which actuaries will probably appreciate is that, these rules are effective for plan years beginning after 1988, so we all have time to understand them. IRS has time to write some regulations that we can understand. The regulations, in fact, have to be written by February of 1988, giving us almost two years to draft language after that under the new regulations. So the delayed effective date is primarily to take care of the problem of "you're making too many changes too quickly." There is also hope that, with those administrative details, the Senate version instructs the IRS to draft a 401K plan so that everyone can adopt 401K plans without going to their attorney or pension consultant to get a 401K.

MR. THOMAS POPPENHOUSE: I'm from the Dallas Tax Department of Peat Marwick Mitchell. I deal with personal financial planning for clients in the Dallas region. I'm going to speak to you on capital gains and income shifting devices and the passive loss limitations. I'd like to emphasize that this is still proposed tax law, and it could be changed in the Conference Committee; it appears that there will not be that many more changes to the legislation, but no one really knows.

For capital gains, the effective date is January 1, 1987. What Congress is going to do is repeal the capital gains deduction, which is 60% of the net long-term capital gain. In addition to that, they're going to tax capital gains at your regular 27% tax bracket. However, for some individuals, it will be higher than a 27% tax bracket. It will be, for some, a 32% tax bracket for capital gains. I'd like to go through an example. Let's assume an individual is making $85,000 in salary, and he pays about $10,000 of housing interest on his home. Further, about five or ten years ago, he purchased some undeveloped real estate from his brother-in-law for $1,000. This land is now worth $11,000. This individual would have a $10,000 capital gain locked in on that undeveloped real estate. If he sells it under current law, of the $10,000 gain, $6,000 would be excluded from tax, and he would only be taxed on $4,000. If the individual has $75,000 of taxable income, his tax bracket is only 42%. So, on that gain, he would only pay $1,680 in taxes. Under the Packwood

proposal, that same gain would be taxed at a 32% tax bracket. Because he is in the range where his income is taxed at 32% rather than 27%, he would pay $1,520 more in taxes than he would have paid under the old laws.

This is the fire sale that Debbie was referring to earlier. People will recognize the impact of Packwood and go out and sell all of their capital assets so that they do not have to pay these additional taxes. One question which arises is whether they'll still be able to sell them and avoid Packwood.

There is a possibility that the effective date will be retroactive through maybe July 15, 1986, March 1, 1986, or January 1, 1986. We'll only know that when the legislation is finally passed, but it's something to consider in your deliberations on whether to buy or sell those capital assets. One thing you might consider doing is selling the capital assets and then buying them the day after you sold them. That way you've locked the gain in at a maximum 20% capital gain rate. Now the downside of that is that if there is a drop in the stock market, then you may have a loss -- which may not give you a tax benefit other than $3,000 per year. So, if you have a capital asset with a basis of $1,000, the current market value is $11,000, and you sell it now, you'd only be taxed the maximum of 20% on that $10,000 of gain.

Another thing you want to consider, when you do consider your capital gains or losses for this year is the impact of any alternative minimum tax on that strategy. Currently, the 60% capital gains deduction is added back as a tax preference item for alternative minimum tax.

Another idea which may come to application concerns your tax planning with your long-term capital losses. Right now, if you have a long-term capital loss, you lose the benefit of that long-term capital loss $2 for $1. For example, if you have a $6,000 long-term capital loss, you only get a $3,000 tax deduction on your tax return. Under Packwood, they're going to eliminate the distinction between long-term and short-term, so you will be entitled to get a direct offset for long-term capital losses. Thus, at the end of 1986, if you are in a position where you have $6,000 capital losses, you may want to wait until 1987 to realize and recognize that long-term capital loss and get the

benefit of a $3,000 loss in 1987 and a $3,000 loss in 1988, as opposed to just a $3,000 loss in 1986.

It is important to note that the capital gain tax is now not just a 27% tax -- that it can be in fact a 32% tax on those capital gains. Also remember they're not totally throwing out the characterization of assets as capital assets. There will still be the characterization of capital gains in the tax law.

Another thing an individual will have to be concerned with is estimated tax payments. Under current law, you can avoid any underpayment penalties if you pay in 100% of your prior year's tax liability or 80% of your current year's tax liability, or you can use certain annualization methods. The Packwood proposal would require you to pay 90% of your current year's tax liability. You would still be able to rely on the prior year's tax exception, and presumably, you'd also be entitled to rely on the annualization methods.

Now I'd like to get into some of the income shifting devices that we've used and which are effectively killed under the Packwood proposal. The first group of income shifting devices are those in which you actually give property away and you're going to get the property back. While that property is away from you, the income generated from that property is taxed to the beneficiary of that property. One of these devices was the use of interest-free loans. In this situation, Father would give a $100,000 loan to son, and son would take that $100,000, put the money into a money market account, earn $10,000 worth of interest on it and pay a tax on that $10,000 at maybe a 20% tax bracket. If Dad had kept that money in his own money market account, he would have earned $10,000 and paid 50% tax on it, for $5,000. The family, as a total unit, rather than paying $5,000, only payed $2,000 in tax on the income of that $100,000. This device was effectively eliminated by the Tax Reform Act in 1984.

Another device was the Clifford trust. Under the Clifford trust you would give the money away into a trust for ten years and a day to your child. The income of that trust is taxed to the child, and then, after the ten year period, the property comes back to the parent. The new legislation effectively kills Clifford trusts. The Clifford trusts that were not created by property

transfers to the trust prior to March 1, 1986, will not be respected. So if you don't have a Clifford trust now, there's no reason to establish one -- it won't be respected. Another device, a refinement of the Clifford trust, which has recently become popular is a spousal remainder trust. A lot of clients would just begin to accumulate income when their kids were 15, 16 and 17 years old. These people wanted a fund for the child's college education, and they realized that if they put the money in trust for 10 years, they'd be paying income to the child when he became 25, 26 and 27. They didn't want to give the income to the child after he had gone through college. To limit the number of years you had to give the income away, the spousal remainder trust was developed. Under a spousal remainder trust you would put the money into the trust, and the income would go to your son for a period of maybe four years, and then the property would revert back to your wife at the end of that four years. The spousal remainder trust was never really officially accepted by the IRS, but it appeared to be a supportable planning device. The Packwood bill would effectively eliminate the spousal remainder trust.

In summary, the new law will close down many of the tax planning opportunities. You no longer have Clifford trusts, you no longer have spousal remainder trusts, and you can no longer do interest-free loans.

The new law has a new wrinkle. They're also going to tax to you the income from property which you have given away and you never hope to get back. If your child will be under the age of 14 after 1987 and you've given him assets, although he owns those assets, you still will be taxed on that income from those assets. What you'll have to do if you do have a child under the age of 14 is make a determination of PSUI, the child's earned income, and QSA. PSUI is Parental Source Unearned Income, and QSA is Qualified Segregated Asset. If it is determined to be parental source unearned income, then it will be taxed at the parent's marginal tax bracket. If it is income from a qualified segregated asset, or it is the child's own earned income, then they'll let that income be taxed at the child's marginal tax bracket. However, all income will be treated as parental source unearned income unless it is derived from a qualified segregated asset.

There will be regulations issued which will require you to identify the qualified segregated assets on a child's tax return for the first year in which he acquired that asset or for the first year in which he determines his tax liability by reference to the parent's marginal tax bracket. So, there will be a specific identification of qualified segregated assets. A qualified segregated asset is property received from anyone other than the parent or stepparent, and property received by reason of the death of the parent. Apparently, parental suicide avoids having to do any determination of parental source unearned income and qualified segregated income and all that, but it is a little drastic measure to avoid taxes.

In addition, parental source unearned income includes income from assets transferred to a trust. So, even if you have a Clifford trust which was established prior to March 1, 1986, the income which would be taxed at the child's rates will be taxed at the parents' tax rate if the child is under age 14.

Why is there so much emphasis on income shifting if the bracket differential is only going to be 12% or 17% as opposed to 30% or 50% before the tax rate changes? The reason is that they just want to close down all the *loopholes*. You still have a 17% bracket differential, and on $10,000 worth of income, you could still have $1,700 of tax savings to the family unit.

One thing that is a concern is that this legislation taxes the income that the child owns at the parents' marginal tax bracket, and this is the first attempt to actually tax the family as a unit. Normally, if you own an asset, you'll be taxed on the income from that asset. Even if you can establish the fact that that child owns the asset, you're still going to be taxed on it. There may be some constitutional issues raised on this, but right now that is the proposed legislation. Another thing which causes some people some consternation is the question, Why are they stopping at age 14, or is this just the first step in the legislation? Is it going to be 14, and then 16, and then 18, and then 21, and then we'll tax the whole family as a unit? Everybody throws in all their income, from grandpa on down to grandson, and then we'll figure out what the income of the family is. Hopefully, it's not going to be that drastic.

So what do you do if you have a child who's under age 14? How can you avoid these rules? One technique I tell my own parents to do is to give money to my children. Because if I don't give the money to them, then it's not subject to the rules. So I urge my parents, my brothers, my sisters, my aunts and uncles to give money to my children. Usually I do this in conjunction with the annual exclusion; every year I inform them of their right to give me $10,000 and my wife $10,000. But they're slow learners.

Usually, somebody will come up with the idea of giving property to your parents and then having your parents give the money to your children. The Committee reports indicate that that's not going to work. Another thing to do is possibly give non-income producing property to your children. Assume you own property that does not produce significant income and that it will generate large capital gain down the road. If you give that property to your child now, then even if you're taxed on the income until he's age 14, if he sells it after age 14 the gain will be taxed at his bracket rather than yours. Some people have suggested that oil stock is non-income producing property.

Another idea, if you have a child with taxable income, is to invest the child's income into tax exempt funds, so there will be no tax. Another thing which you might consider is purchasing Series EE Bonds. If you do purchase these bonds, you can elect not to have the income taxed to you each year or only upon the eventual redemption of the bonds. If your child purchases Series EE, bonds he will not have to include the increases in his income until redemption. Therefore, if he redeems the bonds after he attains age 14, he will be taxed on the income rather than the parent. That appears to be the ideal gift from parents to their children.

Now let's discuss some of the provisions affecting trusts and estates. There's a rate compression for trusts and estates. Under Packwood, rather than let you go all the way up to $29,300 at 15%, as you can for married people, the first $5,000 will be taxed at 15%, and then at $5,000 they start taxing you 27%. There's rate compression, and you're not going to get as much benefit from the trust's separate tax bracket. As for estates, the Packwood bill is going to let you use the regular estate tax rates for the first two years of the estate,

and after that, its going to require you to use the rate schedule for trusts, which again is a compressed rate schedule.

If you do have a trust -- if you're a beneficiary of a trust or your children are beneficiaries of trusts -- you're going to have to change the taxable year end of the trust, unless it has a calendar year end which is either October, November, or December. The Committee reports indicate that they do not want to have more than a three month deferral of income, and by making you have a taxable year ending October, November or December, you are not going to have more than a three month deferral. The effective date is for taxable years beginning after 1986. If you do have a trust with other than a year ending October, November or December, you're going to have a bunching of income. Let's say you have a trust taxable year of January 31, 1987. For 1987, you're also going to have another year end which either ends in October, November, or December. For 1987, as an individual, you would have to pick up the income through January 31 and then the income through, let's say, December 31. So you have two years of trust income coming into your tax return. To alleviate that, they've allowed you to take the trust income for the period from 1/31 - 12/31 over a four year period, so you only have to recognize one-fourth of that income.

Some additional provisions concern estimated tax payments of trust. Under current tax law trusts and estates do not have to make estimated tax payments, but now they will be required to make estimated tax payments. Also, estates before have been able to make their payments over four equal installments, and they will be required to pay their tax with the filing of the return, as do all other taxpayers. This provision is effective for taxable years beginning after December 31, 1986.

Now I'd like to move on to the estate and gift tax provisions under the new law. There aren't that many changes. They mostly would impact somebody who had a family farm and has elected a special use valuation for that family farm. The special use valuation is a method in which, if you do have a family farm, you can value it for federal estate tax purposes at its farm value rather than its best use value. This enables you to pay a lower federal estate tax on that farm than if it were valued at its fair market value. In order to do that, the

government extracts a promise that you will continue to farm that farm for a certain period of time. Under the former legislation, you had to farm that farm for 15 years. If you died in 1982 or after, your beneficiaries had to only agree to farm that farm for a ten year period. What Congress has done is said, "We'll go ahead and make it a ten year period for everyone who has died, rather than have this 15 year requirement for some and this 10 year requirement for others." It recognized that people are out there losing money on farms but need to continue to operate those farms because they don't want to have to pay this recapture tax if they fail to operate the farm as a family farm.

The other thing that they've done with special use valuations is allow you to correct your election which was improperly done originally. Here's the situation. People would complete the form 706 (the estate tax return) according to its instructions and make the special use valuation election in order to reduce the estate taxes for the value of the farm. The IRS would look at their regulations and say, "These are the additional provisions that they were supposed to follow. Even though they followed the instructions on the form we gave them, they didn't follow the regulation, so they're not going to get the estate tax break." Congress indicated that people should receive the tax break if they followed the instructions. The IRS should contact them and tell them what they've done deficiently, and they'll have a 90 day period to correct it. If they do correct it they'll get the special use valuation.

The passive business activity loss limitations are an ingenious device by Congress to limit people with tax shelter losses greater than their tax shelter incomes. What Congress has done is this: not only are there passive business activity losses, but there are a number of other hoops that you have to jump through to get a loss from a limited partnership. In essence, there are four hoops. You first have to make sure you satisfy the at-risk rules. At-risk rules have been around for a long time and usually will not be a problem in deducting your limited partnership losses. After the at-risk rules you come into the investment interest limitation rules. You have to satisfy those requirements before you can jump through the next hoop. The next hoop is the passive business activity loss hoop. You've got to satisfy those rules in order to still get the loss. If you satisfy all those three hoops, you get the loss, and then there's another gotcha. The loss that you get is subject to the

alternative minimum tax. So, if you do have passive business activity losses, it's going to be a mind bending experience to determine how many of those losses you're going to be getting in your return as far as trying to plan for 1987, 1988, and 1989.

The first hoop is the at-risk rules, which have been around for a long time. We won't discuss those further. The next hoop is the investment interest limitation rules. There are three types of interest: investment interest, consumer interest and business interest. Business interest is deductible -- no problem. Consumer interest is not deductible except for homes or a vacation home. The general rule under investment interest was you're entitled to investment interest to the extent of your net investment income plus $10,000. What they've done is essentially maintained that but have changed some of the calculations. First, they've wiped out the $10,000 that you got, and they've changed the calculation of the investment income. Under Packwood, you are now required to use actual depreciation rather than economic depreciation in the calculation of investment interest, and you will receive investment interest expense for any activity in which you do not materially participate. In essence, any limited partnership that you are now in which has interest expense in that limited partnership will flow through to you as investment interest expense and you must calculate whether you're entitled to that deduction on your return or not. Under former law, you could have a partnership which would satisfy a certain 15% test, and the loss from that real estate partnership would flow through to you as a regular loss. That's not going to happen anymore if you are a limited partner. Under Packwood a limited loss partnership will flow through to you as partly a regular loss and partly as investment interest expense, so you're going to be creating additional investment interest expense. Then you'll have to go through the calculation to see whether you're still entitled to that investment interest expense.

The third group is the passive business activity loss. Basically, we're now going to have to divide all of your income into three pools of income. The one pool is your passive business activity income. The next pool is your compensation for services income, and the third pool is your portfolio income. Your passive business activity income is income from an activity in which you do not materially participate in management. You're going to hear "material

participation in management" until you're blue in the face if you have any limited partnerships. It's going to be the buzzword of the latter part of the 1980s. By definition, almost, a limited partner will not materially participate in managing a partnership, because if he does, then he's no longer a limited partner, or he could lose his limited liability status under state law. Therefore, if you are in a limited partnership, you'll have to treat that as a passive business activity income or loss.

The legislation also indirectly states that no one materially participates in rental real estate activities. So, even if you're a general partner in rental real estate, it will be treated as a passive business activity.

The important thing to get out of this is you'll be only entitled to deduct your passive business losses against your passive business activity income. You can't take that loss against your portfolio income. You can't take that loss against your interest dividends and royalties. That's going to cause a lot of people a lot of problems. Working interest in oil and gas will not be treated as passive business income. It will be treated as compensation for services, provided the taxpayer has unlimited liability with respect to the property which is subject to the working interest. You will not be able to offset your real estate losses with your working income. We have defined what passive business activity income or losses are, and I should just briefly mention that portfolio income is basically your interest and your dividends. It also will include royalties from oil and gas. Working interest will be treated as compensation for services. Royalty income will be treated as portfolio income. Therefore, you won't be able to deduct your real estate limited partnerships against the royalty income. Also, capital gain from properties held for investment will not be treated as passive business activity income. There is relief from these provisions in the transitional rules. The transitional rules for these passive business activity losses have the same phaseout as was used for interest. In 1987, you'll get 65% of the loss; in 1988, 40%; in 1989, 20%; in 1990, 10%; and in 1991, it all goes away.

In addition, there's a $25,000 annual allowance for rental real estate. Congress decided that there are lots of people out there who own duplexes and will be generating losses from those duplexes, and so long as their income is not

too high, they should be able to deduct that loss even if it is a passive business activity loss. And so they've given this $25,000 annual allowance for rental real estate. To receive this, your AGI has to be less than $150,000. The $25,000 loss is phased out as your adjusted gross income goes from $100,000 to $150,000. In addition, you must actively participate in the rental real estate, as opposed to materially participating in the rental real estate. Active participation is supposed to be a less stringent standard. For instance, if you do own a duplex, and you're responsible for getting your tenants in there, signing the leases, and making sure the utilities are all taken care of, you will have active participation in that real estate. In addition, you must also have at least a 10% interest in that activity in order for it to be considered to be active participation.

QUESTION: Will there be IRAs in the future for rollovers?

MS. WALKER: Yes, there will be IRAs, provided you're not covered by another pension plan, and I would guess that under the portability rule, you could set up an IRA just to receive a rollover. You just can't make a deductible contribution to it. If you're not able to have a deductible IRA, you can still have a nondeductible IRA and shelter the income. The general feeling on that is if you have a nondeductible IRA, keep it separate from the deductible IRA. The reason is the taxability of distributions. That way you'll be able to decide whether you want it to be taxable or not, and if you mix them all together it will be a taxable distribution first.

QUESTION: Mr. Poppenhouse what you are recommending for individuals who are in limited partnerships and will be subject to the passive loss limitation?

MR. POPPENHOUSE: There isn't a lot you can do. You can try to generate passive business activity income. It may be possible, if you are in a real estate partnership, to have that partnership sell its asset and generate a capital gain on that asset. If it does sell the asset, that capital gain will come through to you as passive business activity income. That's one way to generate passive business activity income. There's a question whether you as a limited partner will be able to convince the general partner that the time is

now to sell that real estate or just who has the powers to determine the time of sale.

Another thing you can do is sell the limited partnership to somebody else. If you do sell it, you'll probably have some gain recognized, but you will get those suspended losses if you rid yourself of that passive business activity. You'll be entitled to deduct suspended losses on a complete disposition.

Another alternative is to die, and you'll get those suspended losses to the extent that you don't get a step up in your basis upon your death under Section 1014. One thing you probably don't want to do is gift that passive business activity to your son. Then those suspended losses become part of his basis in that partnership, so that even if it turns around and generates passive business activity income, he'll still not be entitled to use those losses, because he has those passive activity losses in his basis in the partnership. He'll only get a deduction when the partnership liquidates. Then he'll probably get a large capital loss upon liquidation of the partnership, because he's not going to get any benefit from those passive losses which are suspended. Another thing you might do is begin materially participating in the activity, which if you're a limited partner, you're not going to be able to do. But if you're a general partner and you still do not meet material participation, you may be able to become more actively involved in the organization and meet the material participation standard so that that loss will not be treated as a passive business activity loss in the future. You're not going to be able to do it with real estate, and you're not going to be able to do it if you're a limited partner. But for other activities that don't fall within those two zones, you may be able to become materially participating in management. But that's about it.

QUESTION: Are there any general strategies, looking forward over the next five to ten years -- I mean long term things, other than 1986/87 -- that an individual can follow to try to reduce taxes, or is everything gone now and it's simply that we all just pay a lot in taxes?

MR. POPPENHOUSE: The one thing Debbie talked about earlier was the nonqualified deferred compensation plans: just taking income in a later year.

We see that as the tax planning idea of 1986, more or less, but you have to do it early in 1986 so that you can defer it before you earn it. Another thing is to just not get into real estate deals unless you consider the impact on your taxes. You no longer just look at the losses and say you're going to get them. So, if there's anything to be gained, don't blindly jump into real estate partnerships.

QUESTION: I think a lot of people feel that the 27% rate is as low as it will ever go. A lot of people are tired of worrying about their partnerships and their real estate losses and everything else, so they just say, "Here's 27%, and now let me go on my way and not have to worry about this stuff anymore."

MS. WALKER: I think most practitioners would think it will never get so uncomplicated that we won't have a job. But basically, the whole thrust of it is to make economic decisions and try not to have tax consideration override those economic decisions.