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FINDING YOUR WAY OUT OF THE NEW TAX BILL MAZE

A Speech for CPAs to Deliver to General Audiences
For Use Until April 15, 1994

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If the passage of the new tax bill has left you feeling confused, don’t worry, you are not alone. After months of speculation and political debates, the facts seem to have gotten lost somewhere.

I am here to direct you out of the rather convoluted maze the recent changes have created. Today, I will provide an overview of the tax changes that are most likely to affect you and let you know when they will, or did, become effective. Then I will provide some hints to lower your tax liability.

Please keep in mind that I have tailored this presentation to a general audience. If you have questions on topics I don’t cover, I will be happy to answer them when I am finished. And don’t worry about taking detailed notes. Later on, I will distribute a brochure that sums up my remarks.

First, we have two new tax rates. In addition to the 15-, 28- and 31-percent brackets that have been in place for the last several years, there is a new rate of 36 percent, which applies to single taxpayers.
with taxable incomes over $115,000 and married couples with taxable incomes over $140,000. In addition, there is a surtax of 10 percent on all taxable incomes over $250,000 -- whether married or single -- which gives us a fifth rate of 39.6 percent.

Keep in mind, though, that these new rates are effective as of January 1, 1993. Fortunately, you will not be assessed any tax penalties if you underpaid your 1993 taxes solely due to the increased rates. In addition, any extra tax liabilities caused by the rate increase can be paid in equal installments over three years, interest-free. If you elect this option, your first payment would be due by the due date for your 1993 return and subsequent payments would be due on the same dates in 1995 and 1996. But be careful: if any of your payments are late, you’ll automatically forfeit this option and owe interest from the original due date on any payments made after that date.

In addition to the increase in rates, two provisions that were scheduled to expire in 1996 were made permanent under the new law, both of which can effectively raise the rates for high-income taxpayers. The
first is the exemption phaseout. This rule requires taxpayers to reduce the value of their exemptions by two percent for every $2,500 by which their adjusted gross incomes surpass certain limits. The limits for 1993 tax returns are as follows: $108,450 for single filers; $162,700 for joint filers; $135,600 for heads of household; and $81,350 for married couples filing separately. These income limits will be adjusted annually for inflation.

Likewise, the provision which requires high-income taxpayers to phaseout their itemized deductions was made a permanent part of tax law. For 1993, this rule affects taxpayers with adjusted gross incomes over $108,450, or half that amount if married, filing separately. If you fit into this category, you must reduce your itemized deductions by three percent of the amount by which your income exceeds the limit. Medical expenses, investment interest and gambling, casualty and theft losses are excluded from the reduction and the maximum loss of deductions is 80 percent.
High-income taxpayers also will feel the impact of a change in the way the Medicare payroll tax is calculated. Previously, the 1.45-percent tax on employees applied only to the first $135,000 of earned income. This ceiling was eliminated, however. Effective January 1, 1994, all wages are subject to the Medicare tax. For the self-employed, this change hits twice as hard since they pay both halves of the Medicare tax, or 2.9 percent.

Congress also increased the Alternative Minimum Tax, or AMT. The AMT is triggered when extensive deductions or credits drastically reduce tax liability. The rate was increased from 24 percent to 26 percent on alternative minimum taxable income up to $175,000 and 28 percent on income above that level. Since you must figure your taxes under the regular method and the AMT and pay whichever amount is higher, you may be in for a bigger tax bite than you expect.

Some Social Security recipients will also see a tax increase, effective January 1, 1994. Single individuals with incomes over $34,000 and married couples with incomes over $44,000 will have up to 85 percent
of their benefits taxed by the federal government, up from a maximum of 50 percent.

So far, all the tax increases I have mentioned target high-income individuals. But there is one increase that it is sure to affect just about everyone -- the 4.3 cents per gallon tax on gasoline and diesel fuel. This increase is effective as of October 1, 1993. To give you an idea how much extra you might pay due to the gas tax, consider this: If you drive 15,000 miles a year and get about 20 miles to the gallon, you will shell out an extra $32.00 at the pump in the first year.

I’d like to turn to deductions right now. Changes in this area were less extensive than those in tax rates. Primarily, Congress took aim at reducing business deductions rather than those deductions that affect individuals.

For example, the deduction for business meals and entertainment has been limited to 50 percent of expenses incurred in tax years beginning after 1993.
Restrictions were also placed on the deductibility of certain travel expenses. As of January 1, 1994, travel expenses for a spouse or dependent that accompanies you on a business trip will not be deductible unless that person is an employee with a legitimate business reason for making the trip.

The deduction for job-related moving expenses has also become limited. Non-transportation related expenses that were deductible in the past, such as meals while traveling, temporary living expenses, and closing costs of buying or selling a home, are now non-deductible items.

In addition, Congress made it a little more difficult to deduct the expenses that do qualify by increasing the 35-mile test to 50 miles. In the past, your new job had to be 35 miles farther from your former home that your old job was. Now, your new job has to be 50 miles farther. These limitations on moving expenses are also effective as of January 1, 1994.
And finally, one business deduction has been totally eliminated -- and that’s dues to social, athletic or country clubs. Again, January 1, 1994 is the effective date for this.

Okay, now that I have filled you in on the more negative aspects of our new tax law, I would like to tell you about some of the more favorable provisions. One is the increase in the earned income tax credit. Beginning in 1994, the maximum credit available to a low-income individual caring for one child is $2,038, that’s up about $600. The maximum credit for someone caring for two or more children is $2,527. In addition, for the first time ever, this credit is available to certain low-income workers without children.

Congress also extended or repealed several valuable tax breaks that had expired on June 30, 1992. First, the self-employed can deduct 25 percent of the amount they paid for health insurance from July 1, 1992 to December 31, 1993.

Second, employees can continue to exclude from taxable incomes up to $5,250 a year in employer-provided educational assistance. This
provision was extended through December 31, 1994.

And third, the AMT preference for appreciated property has been repealed. This means that you can donate appreciated property to charity without triggering the AMT. This tax break is retroactive to gifts of tangible personal property made after June 30, 1992, and gifts of other property made after December 31, 1993. Just make sure that the charity uses the gift for its express charitable purpose.

While I am on the subject of charitable donations, keep in mind that the IRS now requires a receipt for donations of $250 or more. A cancelled check is no longer considered adequate documentation of a donation.

One of the best things to come out of the tax bill was something that Congress left untouched -- the long-term capital gains tax rate which remains at 28 percent. Long-term capital gains result from the sale of appreciated property -- such as stocks -- held over one year. For taxpayers in the 31-, 36- or 39.6-percent tax brackets, capital gains
income is taxed at a lower rate than dividend or interest income. If you fall into this category, you may want to look into making some changes in your portfolio to take advantage of the lower capital gains rate.

Of course, Congress did foresee the advantages that capital gains income would have, as well. So, to discourage people from trying to convert regular income into capital gains income, restrictions were placed on what is considered part of this category. Be sure to seek professional investment advice before making any big moves.

And here’s more good news for investors. Congress passed two new provisions to encourage investment in small companies. First, profits from qualified small companies will be taxed at half the regular capital gains rate, or 14 percent, if the stock was held for at least five years. Other restrictions apply, so you should check with a tax adviser about this.
The second provision allows the gain on the sale of publicly traded securities to be rolled over tax-free within 60 days to a specialized small business investment company, which includes certain partnerships and corporations licensed by the Small Business Administration. However, keep in mind that the most gain you can roll over each year is $50,000.

Congress has provided some relief to those of you who must make estimated tax payments. Individuals with adjusted gross incomes below $150,000 in the previous year can base their estimated tax payments on 100 percent of their prior year’s tax liability. Those with AGIs above $150,000 in the previous year can base their payments on 110 percent of the prior year’s tax liability. This should help eliminate the guesswork involved in estimating current year tax liability.

The final piece of good news I have for you is that the 10-percent luxury excise tax on furs, boats, jewelry and aircraft has been repealed. This is effective for purchases made after 1992. If you bought any of these items in 1993, before the new law was passed, you should seek
a refund from the seller. Unfortunately, the excise tax on high-priced cars remains on the books.

Okay, now you should know whether -- or how much -- the new laws affect you. Right now I am going to give you some general tax-saving tips that can help lower your tax bill every year, no matter what your income may be.

One very important tax-saving tip is to shelter as much income as you can in retirement plans. One of the best is a 401(k). If you have not enrolled in your company’s plan, I recommend you do so as soon as possible. There are three reasons for the 401(k)’s attractiveness: One, the amount you contribute comes from your pretax salary; two, your money grows tax-deferred until you withdraw it at retirement; and three, many employers match all or part of your contribution.

An Individual Retirement Account, or IRA, is another valuable tax-saver that many people overlook. An IRA contribution lowers your taxable income and the money in your account grows tax-deferred. There is a
drawback, however. Not everyone is eligible to deduct their contributions.

Let me go over the IRA deduction rules briefly. If you, and your spouse if married, are not active participants in an employer’s pension plan, you can deduct an IRA contribution. The contribution limits are $2,000 if single, $4,000 if you are married and both spouses work, and $2,250 if you are married and only one spouse works.

If you are covered by a pension plan, you may still be able to deduct an IRA contribution, depending on how much you earn. Singles with incomes under $25,000 and married couples with incomes under $40,000 can take a full deduction. Singles with incomes between $25,000 and $35,000 and married couples with incomes between $40,000 and $50,000 are eligible for partial deductions.

For the self-employed, a Keogh plan may be the best retirement option. If you have any self-employment income, you can generally contribute and deduct up to 25 percent of your net self-employment income, or
up to $30,000, to a Keogh plan.

All three of the retirement plans I mentioned can help lower your taxable income, thus lowering your tax liability. But there are other methods for lowering the amount on which you are taxed.

One is the way you allocate your investment dollars. For example, you may want to consider purchasing tax-free municipal bonds, instead of corporate bonds. Income from municipal bonds is not included in your adjusted gross income and is free from federal tax. In some cases, interest may even be free from state and local taxes as well.

To illustrate the power of tax-free investments, consider this example: A municipal bond returning 6 percent is the equivalent of a taxable bond returning 8.7 percent in the 31-percent tax bracket. In the potential new 39.6-percent bracket, that 6-percent bond would be worth as much as a taxable bond yielding 9.9 percent.
For those planning future educational costs, Series EE bonds can be a valuable tax-saving investment. Income from bonds issued after December 31, 1989, may be totally free from federal taxes if the proceeds are used to pay educational expenses for you or your dependents and you meet certain income limits.

Be sure to keep in mind that there is a lot more than taxes to consider when investing, and always seek professional advice before jumping in.

Another way to reduce the amount of income on which you are taxed is to shift income-producing assets to your children. If your children are age 14 or over, they can receive up to $600 in dividend and interest income tax-free, with any additional income taxed at their own rate, usually 15 percent.

You have to be a little more careful if your children are under age 14, however. Children under that age can also receive up to $600 tax-free, with the next $600 taxed at their own rate. But any investment income over $1,200 will be taxed at your highest marginal tax rate.
Another caution here: If you transfer more than $10,000 to any one individual in the same year, you could be liable for gift tax.

Of course, one of the best ways to reduce your taxable income is to claim every deduction to which you are entitled. With higher tax rates, each deduction you claim may become more valuable. For example, if your tax rate rises from 31 to 36 percent, each deductible dollar will rise in value from 31 to 36 cents. Right now, I am going to point out a few ways in which you can maximize your deductions.

I’ll begin with miscellaneous expenses. Keep in mind that miscellaneous expenses are only deductible to the extent that they surpass two percent of your adjusted gross income.

To help you surpass that limit, let me give you a brief list of qualifying expenses. Miscellaneous expenses generally fall into three categories — business, investment and tax. Qualifying business expenses include union dues, uniforms, subscriptions to trade magazines, business meals, and travel and job-hunting expenses.
Eligible investment expenses include professional advice and rental fees for safe-deposit boxes in which you keep stocks and bonds.

Finally, and this is not a plug for CPAs, but fees for tax return preparation and advice are also considered miscellaneous expenses.

Medical expenses face a similar percentage-of-income limit. But in this case, your expenses must surpass 7.5 percent of adjusted gross income before they become deductible. While this is a high threshold, don’t assume you can’t surpass it without tallying your expenses. Besides unreimbursed doctor and hospital bills, a number of expenses are eligible. For example, the cost of eyeglasses, contact lenses, health insurance premiums, orthopedic shoes and even acupuncture may be deductible. The list of eligible expenses is extensive, so be sure to do your homework.

Fortunately, the restrictions on deducting charitable donations are nowhere near as stringent as those for medical and miscellaneous expenses. If you itemize, you can generally deduct 100 percent of
your charitable deductions, as long as the total does not surpass 50 percent of your adjusted gross income.

And finally, another big tax-saver for many people is the deductibility of costs associated with owning a home. Mortgage interest on first or second homes and real estate taxes are deductible. Points paid to acquire a primary residence are also deductible. However, keep in mind that if you refinanced your mortgage in 1993, the points you paid are generally not fully deductible on your 1993 return. Instead, you must deduct the points over the life of the loan.

Interest on home equity loans up to $100,000 also remains tax-deductible. If you have extensive credit card or consumer debt, you may want to consider a home equity loan to turn that non-deductible debt into a tax write-off.

Before I take your questions, I would like to stress that my goal today was not to give an all-inclusive list of tax changes and tax-saving tips. I wanted to give you some basic facts and make you realize how much
is involved in tax planning. It takes a year-round commitment on your part to become an effective tax planner. I hope I have provided you with enough information to make that first step today.

Thank you. I will be happy to answer your questions now.

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Radio and Television Interview Guide to
Commonly Asked Questions on the New Tax Laws

1. What are the new tax rates for individuals?

For many people, tax rates will remain at 15, 28 and 31 percent. However, individuals with taxable incomes over $115,000, and married couples with taxable incomes over $140,000, are subject to a new rate of 36 percent. In addition, anyone -- married or single -- with a taxable income over $250,000 is subject to a surtax of 10 percent which is equivalent to a 39.6-percent bracket. The new rates are retroactive to January 1, 1993.

2. Will I be subject to penalties if I underpaid my 1993 taxes due to the increase in rates?

No penalties will result from underpaying taxes for 1993 due solely to the increased rates. In addition, you can pay the additional tax liability in three equal installments over three years without interest. The first payment would be due on the filing deadline for your 1993 return. The two subsequent payments would be due on the same date in 1995 and 1996.

3. Did the long-term capital gains tax rate increase?

No. The maximum long-term capital gains tax rate remains at 28 percent.

4. What is the AMT and how do I know whether it affects me?

The Alternative Minimum Tax (AMT) is a separate tax that is triggered when extensive deductions or credits drastically reduce your tax liability. The only way to know for sure if it affects you is to figure your tax under the regular system and under the AMT system. You then must pay the amount that is higher.

5. Was there a change in the AMT rates?

The Alternative Minimum Tax (AMT) rates rose from 24 percent to 26 percent on the first $175,000 of alternative minimum taxable income and to 28 percent on any amount above that. This increase is retroactive to January 1, 1993.
6. **Was there any federal tax increase for Social Security recipients?**

Certain Social Security recipients will see a tax increase, beginning January 1, 1994. Singles with incomes over $34,000 and married couples with incomes over $44,000 will have up to 85 percent of their benefits taxed, up from the old maximum of 50 percent.

7. **How much did the Medicare payroll tax increase?**

The Medicare payroll tax of 1.45 percent for employees, or 2.9 percent for the self-employed applies to all earned income, effective January 1, 1994. Previously there was an income ceiling of $135,000.

8. **Was the earned income tax credit increased?**

Yes, the maximum earned income tax credit was increased to $2,038 for taxpayers caring for one dependent and $2,527 for taxpayers caring for two or more. In addition, the credit has been expanded to include certain low-income workers without children.

9. **I am subject to the new higher tax rates. How can I lower my taxable income to avoid becoming subject to a higher rate?**

Retirement plans are often an effective way to lower income. Consider joining your employer’s 401(k) plan. The amount you contribute directly reduces your taxable income. If you are not covered by a employer-sponsored pension plan, you could make a tax-deductible Individual Retirement Account contribution. In addition, you may want to consider transferring some of your investments from taxable vehicles to tax-free municipal bonds.

10. **Did the new tax bill place any limits on the deductibility of mortgage interest, points or property taxes?**

No. Mortgage interest, points, and property taxes remain deductible. Interest on home equity loans also remains deductible.

11. **Can self-employed taxpayers deduct their health insurance premiums?**

The provision which allowed self-employed individuals to deduct their health insurance premiums was extended retroactively from June 30, 1992 through 1993. To claim your deduction from the second half of 1992, you must file an amended 1992 return.
12. Have there been any changes in the miscellaneous expenses that qualify for a deduction?

The deductibility of dues to certain social, athletic or country clubs has been eliminated as of January 1, 1994. In addition, the deduction for business meals was reduced from 80 percent to 50 percent for tax years beginning after 1993.

13. Can I still deduct job-related moving expenses?

Several restrictions have been placed on this deduction. First, non-transportation related expenses such as meals, temporary living expenses and closing costs from selling or buying a home are no longer deductible. Second, the distance test has been increased from 35 miles to 50 miles. In other words, in order for your expenses to qualify, your new job must be 50 miles farther from your former home than your old job was.

14. Can I still take a full deduction for charitable contributions?

Yes. However, if you make one donation of $250 or more at one time, be sure to get a receipt. This documentation is required under a new tax law.

15. Will itemized deductions continue to be phased out for high-income taxpayers?

Yes. This provision has become a permanent part of the tax law. On 1993 returns, taxpayers with adjusted gross incomes over $108,450 ($54,225 if married, filing separately) must reduce their itemized deductions by 3 percent of the amount by which their incomes surpass the limit. Medical expenses, investment interest, and gambling, theft and casualty losses are excluded from this reduction and the maximum loss of deductions may never be more than 80 percent.

16. Was the exemption phaseout also made permanent?

Yes. This provision requires taxpayers to reduce their exemptions by 2 percent for every $2,500 (or fraction thereof) by which their adjusted gross incomes exceed certain limits. For 1993, the limits are $108,450 for singles filers; $162,700 for joint filers; $135,600 for heads of household; and $81,350 for married couples filing separately.

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