

10-1-1982

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Recommended Citation

Sanford, James (1982) "Business Tax Planning and the New Law," *West Michigan Management Memo*: Vol. 3: Iss. 1, Article 7.
Available at: <http://scholarworks.gvsu.edu/wmbm/vol3/iss1/7>

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Business Tax Planning and the New Law

By James Sanford

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) was enacted in response to concerns about projected budget deficits. It is estimated that TEFRA will raise an additional \$98.3 billion in tax revenues over a three-year period.

Approximately one-third of the expected additional revenue will be derived from compliance provisions. Examples would include withholding requirements on dividends and interest, and the withholding on restaurant employees' tips. In theory, this does not represent an actual tax increase but represents the government's desire to collect revenue which often goes unreported.

The remaining expected revenue will be derived from the elimination of certain tax breaks contained within ERTA (the Economic Recovery Tax Act of 1981), from the accelerated payment of certain business taxes, and from certain tax increases.

The following is a general description of the major changes brought about by TEFRA which will affect business tax planning.

1. Cost Recovery Reduction

ERTA allowed generous cost-recovery (depreciation) allowances. The purpose of these rapid write-off provisions was to stimulate investment and capital formation. TEFRA has slightly reduced these cost-recovery allowances by enactment of the following new rules:

- a. The basis of depreciable assets placed in service after December 31, 1982, must be reduced by one-half of the amount of the regular investment tax credit (ITC), energy credit, and credit for rehabilitation of certified historic structures allowed. Thus, a lower basis will be used for determining the cost-recovery allowance.
- b. If there is an early disposition of the property, triggering ITC recapture, the basis will be adjusted upward by one-half of the recaptured credit. As a result, the gain on the sale will be reduced by the amount of the upward adjustment. However, if the sale does not trigger ITC recapture, then the original downward basis adjustment is treated as part of the ordinary income recapture portion of the overall gain on sale. (Note that the business

owner can avoid the basis adjustments by electing a 2% reduction in the tax credit otherwise available.)

- c. The more liberal cost-recovery allowances which were to take effect in 1985 have been eliminated. Thus, the cost-recovery allowances under ACRS (Accelerated Cost Recovery System) will remain at a maximum of 150% of the amount allowed by the straight-line method.

2. Limitation on Investment Tax Credit

The percentage of tax liability, exceeding \$25,000, against which ITC may be utilized is reduced from 90% to 85%. This provision will apply to taxable years after December 31, 1982.

3. Safe-Harbor Leasing Rules

ERTA 1981 enacted the controversial safe-harbor leasing rules. Those rules established standards which, if adhered to in a third-party financing lease (and not a purchase) for tax purposes, allowed the tax benefits of ITC and cost recovery to remain with a nominal lessor. The economic objective of being able to treat the transaction as a lease is to provide struggling businesses which couldn't utilize the tax benefits of ITC and depreciation (such as Chrysler) a means of lowering equipment costs.

Under TEFRA, the safe-harbor incentives have been drastically reduced by modification of the rules, which are then completely repealed for tax years after 1983.

4. Finance Leases

While safe-harbor leasing has been effectively eliminated by TEFRA, traditional leasing will be liberalized beginning in 1984. Currently, a transaction is considered a sale for tax purposes if the "lessee" has a purchase option that is less than fair market value at the exercise date or if the property can only be used by the "lessee." The new Act permits a transaction to qualify as a lease if the fixed option price is at least 10% of the original cost.

5. Capitalization of Construction Period Interest and Taxes Required

Previously, corporations (other than Sub-S and personal holding companies) were exempt from having to capitalize construction period interest and taxes. Under TEFRA, corporations must now capitalize those costs incurred for con-

struction of nonresidential real property (office buildings). The costs are to be amortized over ten years, beginning with 10% deduction in the year in which the costs are paid or accrued and the remaining cost is deductible over nine years beginning in the year in which the construction is completed.

6. Completed Contract Method of Accounting

Previously, some businesses did not report income from a project which took more than one year to complete until the project was completed. TEFRA directs the Internal Revenue Service to issue new regulations to restrict this deferral of recognition of income on contracts taking longer than 24 months to complete.

7. Corporate Tax Payments Accelerated

For taxable years after December 31, 1982, the amount of estimated tax a corporation is required to pay in order to avoid underpayment penalties will be increased from 80% to 90%. Corporations with taxable income of less than one million dollars, however, will still be able to avoid underpayment penalties if they meet any one of the underpayment exceptions.

The penalty on underpayment of estimated taxes is limited to 75% of the full rate for underpayment, if the underpayment is between 80% and 90% of the actual tax due. The full penalty rate is still imposed if the estimated payments are below 80%.

The returning tax owed must be paid in full on the due date of the return (present law allows one-half to be paid on the due date and one-half three months later).

8. Pension Provisions

TEFRA attempts to alleviate the disparity between the deductible contributions allowed to corporate plans and those allowed to Keogh plans. In general, this is to be accomplished by reducing the corporate plan contribution limits while increasing the Keogh Plan contribution limits.

9. Summary

The foregoing material is a general summary of the new tax provisions which will affect business tax planning. See your CPA or other tax advisor for specific

advice since each taxpayer's situation is unique.

10. Future Tax Legislation

The following appeared in the *Grand Rapids Press* on September 29, 1982, reported by the UPI wire service:

WASHINGTON (UPI)—The Senate Finance Committee, acting just hours after exploring ways to simplify the tax structure, approved

more than a dozen special interest tax breaks for businesses.

The ink on the latest tax bill hasn't even dried and already new tax legislation is in the process of being passed.

11. Role of the M.S.T. Program

The Master of Science in Taxation Program (M.S.T.) offers 15 different tax courses. This program was implemented to meet the demand by the professional

tax community for quality tax education. As Congress passes new tax legislation each year, enrollment in the M.S.T. programs increases as CPA's, attorneys, and other tax advisors seek to enhance their tax knowledge.

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Evaluating Employee Performance in Grand Rapids: Some Selected Observations

By Mary Ellen Duffy and R. Bryant Mills

Note: This survey is the result of an independent study by Ms. Duffy during the summer of 1982. Dr. Mills was the faculty advisor.

According to a study conducted in the mid-1970's by the Bureau of National Affairs, formal employee evaluation systems received wide support by personnel executives in both profit-oriented and non-profit organizations in the United States. Ninety-three percent of all organizations surveyed had a formal evaluation program. However, when personnel executives—those most often responsible for designing and administering evaluation programs—of these same firms were questioned as to their attitudes about the employee evaluation, only ten percent said they believed their programs were effective in providing management with the necessary information for personnel decision making.¹ Similarly, a recent Conference Board report of a survey of 293 private firms concludes: "However necessary some formal appraisal system appears to be, current systems are still widely regarded as a nuisance at best and a dangerous evil at worst."²

This negative attitude toward appraisal systems is not shared by personnel executives in private firms and non-profit agencies in the greater Grand Rapids area. Based on our summer, 1982, survey of 35 manufacturing firms and 52 non-profit agencies in our area, formal personnel evaluation programs receive wide support. Approximately eighty-eight percent of personnel executives in both the private and non-profit organizations believed their appraisal programs to be valid in that they measured what they were designed to mea-

sure and provided useful information to management.

Data from the survey provided a useful profile of employee evaluation programs now being used in Grand Rapids area organizations. For example, about 74 percent of the non-profit organizations and 53 percent of the private firms evaluated their employees once each year; the person most responsible for the evaluation was the employee's immediate supervisor; and the supervisor's evaluation was reviewed with the next highest level of management.

Since the enactment of the Civil Rights Act of 1964, the Federal government has become increasingly involved with personnel practices, including the evaluation of employee performance. Personnel decisions involving protected groups (women, minorities) generally must be shown to be nondiscriminatory. In the case of *Mistretta v. Sandia Corporation*, the court ruled that performance appraisal systems must reflect "definite identifiable criteria based on quality or quantity of specific work performed."³ As a result, many experts in employee appraisal recommend that private and public organizations adopt a personnel appraisal system based on Management by Objective (MBO) criteria. Such a system requires that employee duties and expectations regarding quality and quantity of work be clearly identified and discussed with the job holder. After a specified period of time—usually six months or one year—the employee's performance is evaluated based on whether or not the employee completed the tasks assigned.

In our survey we asked personnel executives to indicate the type of evaluation system used. In only six percent of the non-profit agencies and eight per-

cent of the private firms were MBO-type evaluations being used. By far the most common type of evaluation system in use in both the non-profit and private organizations was a variation of the traditional personal trait instrument. That is, employees were being evaluated on subjective traits and characteristics such as "creativity," "loyalty," "intelligence," and others. We believe this should be a matter of concern since personal trait evaluation systems are becoming more difficult to defend because of recent court decisions that require evaluation criteria to be nondiscriminatory and job-related. We do not mean to say that such trait evaluation systems are automatically invalid, only that they are suspect when used exclusively. In fact, in a recent court case (*Rogers v. International Paper Company*) the court upheld a subjective trait evaluation program but warned that such evaluations need to be combined with more objective, job-related evaluations of actual job task performance.⁴

Regardless of the type of evaluation system being used, certain criteria must be followed. One is that employees should have a formal avenue of appeal if they believe their evaluation was unfairly or wrongfully performed. Our survey of practices in Grand Rapids area firms and non-profit agencies indicates that most do not provide a formal internal appeal process. Only 56 percent of the non-profit agencies and 19 percent of the private firms provided a written appeal procedure. Again, this should be of concern since the courts have slowly extended the legal concept of "due process" to apply to the treatment of employees on the job.⁵ An important part of "due process" is the right to formally appeal a decision one believes to be unfair or discriminatory.

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