Tax Reform and Investment In The Dairy and Food Industry 1/

by Richard D. Duvick
Extension Economist, Farm Management
Department of Agricultural Economics and Rural Sociology
The Ohio State University, Columbus

The year 1986 resulted in a landmark piece of tax legislation. Major changes in nearly every aspect of tax law were incorporated in the Tax Reform Act of 1986 (TRA86). It is extremely complex, as well as comprehensive. In this article, I want to 1) give an overview of the intent of the bill, 2) identify and discuss some of the key provisions affecting business, and 3) discuss how they may impact various types of businesses. Since the firms in this audience are diverse, each of you will need to interpret how it may apply to your business.

Overview of TRA86

One overriding aspect of TRA86 was that it should be revenue neutral, that is tax revenues would remain equal to amounts expected under prior law. However, tax revenues would come from different sources. For example, businesses are expected to pay $120 billion more in taxes over the next 5 years, and individuals to pay that amount less. In the process, the bill reduces tax rates, wipes out some deductions and credits while limiting others, and in general, broadens the tax base.

TRA86 cuts tax rates for both individuals and corporations. But it does not necessarily cut taxes, at least not for all. A good many individuals and businesses will pay more taxes in the future. The final impact on taxpayers will differ, and can only be determined with a detailed review of their current return, combined with changes resulting from TRA86.

George Hoffman, of The Pillsbury Company, feels that most agribusiness firms should fare well under the new tax bill. Why? "Except for heavy farm machinery manufacturing, much of agribusiness is service oriented, with a relatively low proportion of costs in plant and equipment. For most businesses in food processing, food service, distribution, food retailing and restaurants, the reduction in the top tax rate from 46 to 34 percent will more than offset the loss of investment tax credits, the scaled back depreciation schedule and the loss of favorable treatment for capital gains." (Choices, p.37, 4th Quarter, 1987)

Another basic aim of TRA86 was to encourage and facilitate business decisions based largely on investment and business

---

1/ Prepared for the 54th Annual Dairy and Food Industry Conference, "Useful Information For Managing Change", The Ohio State University, Columbus, February 11-12, 1987. The comments represent my understanding of the provisions of the tax law. These remarks are intended solely to acquaint you with the new law, and not as a final basis for making tax decisions.

considerations, and less on tax considerations. Thus tax shelters and passive losses were dealt with extensively, in the hope that combined with lower tax rates persons would have less incentive to seek tax shelters. But tax management will still affect nearly all aspects of corporate, financial and business affairs.

Major Changes Affecting Business

The comprehensiveness of TRA86 means that every firm and individual taxpayer will be affected by the legislation. And it will take time to uncover all the nuances of the bill and their effect on each of your firms. But several dominant sections are basic to an understanding of the direction and intent of this bill upon business. I intend to briefly cover some of these sections and discuss some potential changes you may need to consider in your own business. The following are the sections to be discussed:

* Lower corporate (and individual) tax rates.
* A modified, less favorable system of depreciation.
* The repeal of the capital gains exclusion.
* The repeal of investment tax credit.
* Potential changes in business accounting practices.
* A corporate alternative minimum tax .
* New rules on choice of fiscal year.
* Less favorable tax treatment on corporate distributions.
* Medical expense deduction for self-employed.
* 80% rule on business meals.

LOWER TAX RATES

Tax rates for individuals in 1986 consist of 14 brackets ranging from 11 to 50%. In 1988, only 2 brackets, 15 and 28% will apply. The combined effect of the changes in tax rates, personal exemptions and standard deduction amounts will allow the tax owed by many individuals to decline over the next few years, especially those who file returns based largely on wages and having few itemized deductions.

Tax rates for corporations also decline. In 1986 5 rates apply, ranging from 15 to 46 percent, with the 46 percent rate applying to income over $100,000. In 1988, only 3 rates will be in effect, 15, 25 and 34 percent, with the top rate applying to taxable income above $75,000. Both the corporate and individual rates phase out the benefit of the lower rates for higher levels of income. For example, corporations with incomes in excess of $335,000 will pay at the 34 percent rate on all income.

MODIFIED ACRS DEPRECIATION SYSTEM

The Accelerated Cost Recovery System of depreciation is retained, but eligible personal property and some real property

are redefined into 3, 5, 7, 10, 15, and 20 year classes. Eligible real property is depreciable over 27.5 years(residential rental) or 31.5 years (non-residential real property). In addition to creating additional classes, it reclassifies assets according to their ADR midpoint life, prescribes depreciation methods for each ACRS class, provides an Alternate Depreciation System (ADS), and changes the Sec. 179 expensing rules. In the new law 200% and 150% declining balance and straight line are the only methods allowed and specific methods are assigned to each class. Again, no salvage value is used, so assets are depreciated to zero.

In all cases, the annual depreciation switches from the declining balance method to straight line in the year in which the straight line method yields a larger amount. While most assets will now be in a different class, the amount of depreciation in the first 2 years will decline only slightly, because of the switch from the 150% to the 200% declining balance method of depreciation.

Firms can elect straight line rather than the declining balance method for property in the 3,5,7,10,15 & 20 year classes. Straight line depreciation is an election in the year the property is placed in service. It applies to all property in that class, and once made, is irrevocable. Firms may also elect the Alternative Depreciation System (ADS). This alternative must be used to determine excess depreciation for AMT tax preferences, earnings and profits tests, and certain other situations. This method generally uses straight line depreciation, but with the ADR mid-point life (rather than class years) for each asset. If the ADS is elected, it must be used for all assets in that class placed in service that year. The basic impact of using the ADS is that depreciation schedules would be stretched over more years.

The modified ACRS preserves the half-year convention for the 3 to 20 year classes. Therefore, a half-year of depreciation is allowed for the year the property is placed in service and a half-year is allowed in the year of disposition. Thus it always takes 1 more year than the recovery class to fully depreciate the asset. Real property continues to use the mid-month convention.

Warning: If more than 40% of the assets are placed in service during the last quarter of the tax year, a mid-quarter convention must be applied to all assets purchased in that tax year. This requires depreciating each class of assets starting with the mid-quarter of the quarter placed in service. Real property (27 1/2 and 31 1/2 year property) are not considered in this computation, either for computing the 40% test, nor for applying the mid-quarter convention. Generally, but not always, this will result in less depreciation for the year.

Up to $10,000 of qualified assets can be expensed per year on assets placed in service after 12/31/86. But note at least 3 complications: 1) The amount eligible to be expensed is limited

to the taxable income derived from active participation in a trade or business. It can be the sum of incomes from several trade or businesses. 2) Unused Sec. 179 expense can be carried forward to the next year. 3) Conversion to personal use at any time triggers changes in prior years depreciation and generally necessitates filing amended returns. Also, no expensing is available if investment exceeds $210,000 for the year.

CAPITAL GAINS EXCLUSION REPEALED

The 60% net capital gain deduction for individuals is repealed for tax years beginning after 12/31/86. In 1986, capital gains were never taxed at more than 20 percent (if applied the top 50% rate to the 40% that was taxable). Now capital gains are taxed as ordinary income, with a maximum of 28%. Future installment sales will need additional analysis, since all gain will now be ordinary gain. Also, persons with income from prior installment sales will find that all capital gain included in payments in 1987 and later will be taxed as ordinary income.

Capital gains of corporations will now be taxed as ordinary income, but at a top rate of 34 percent.

Taxpayers must continue to characterize sales of capital gain items and file Form 4797 and Schedule D. Also, annual limits still apply to capital losses.

INVESTMENT TAX CREDIT REPEALED

The general investment tax credit was terminated for assets placed in service after 12/31/85. So most 1986 purchases were not eligible for ITC. Taxpayers will be able to use any carryover ITC on their 1986 or later year tax returns.

However, taxpayers will lose up to 35% of any carryover ITC remaining after 6/30/87 (for tax years beginning after 6/30/87). For tax years starting after 12/31/86 but before 7/1/87, use a pro rata reduction. A calender year taxpayer who has $1,000 of unused ITC on 7/1/87 will lose 6/12ths of 35% (or 17.5%) of carryover ITC. Thus, $1,000 minus $175 will leave him with $825 unused ITC available for use in the 1987 tax year. Unused amounts will be subject to reduction for the full 35%, and remaining balances available for use in 1987 or later tax years. This one time reduction in the ITC carryforwards, compensates for the lower tax rates.

CHANGES IN BUSINESS ACCOUNTING PRACTICES

Several tax accounting provisions were modified in the TRA86, but their impact will differ from firm to firm. These include limits on use of cash method accounting, LIFO inventory, long-term contracts, reserves for bad debts, discharge of indebtedness, installment sales, and capitalization of inventory, construction & development costs. Only the latter 2 will be noted here.

Installment Sales Limited- Use of the installment method of accounting has been limited in 3 ways: 1) it can no longer be used for revolving credit plan sales; 2) it can no longer be used for sales of stock or securities traded on established securities markets; and 3) taxable income may have to be reported earlier on sales of real property and certain sales of personal property. In general, the effective date is for tax years after 1986.

Uniform Capitalization Rules Certain costs that were formerly treated as deductible expenses by sole proprietor, partnership and corporate businesses will henceforth be subject to more extensive rules. These rules require that costs associated with the production or acquisition of inventory be treated as inventory costs, and that costs attributable to producing or acquiring other property be capitalized. Both direct and indirect (for example - repairs, utilities, taxes , depreciation & interest) costs that can be allocated to inventory or to the assets are subject to the uniform rules. The effect is that taxpayers will not be able to claim current deductions for those costs that have to be included in inventory or capitalized.

These rules affect manufacturers, wholesalers and retailers. The uniform capitalization rules are effective for costs and interest paid or incurred after Dec. 31,1986. However, wholesalers and retailers are excepted if annual gross receipts are $10 million or less. There are other exceptions as well.

CORPORATE ALTERNATIVE MINIMUM TAX - A TAX WITH BITE

Effective after 1986, the current add-on minimum tax is repealed and replaced with an alternative minimum tax similar to the individual alternative minimum tax (AMT). In general, AMT income is regular taxable income increased by preferences and adjusted by computing certain deductions in a special manner. The adjustments will necessitate 2 sets of books to accommodate such adjustments as slower depreciation, an alternative NOL, certain installment sale income, etc. Preferences include items related to bad debt reserves, tax exempt interest, property donated to charity and accelerated depreciation on pre-1986 property. There is a $40,000 exemption, but it is reduced when taxable income exceeds $150,000. The AMT rate is 20 percent.

SOME BUSINESSES MAY NEED TO CHANGE FROM FISCAL TO CALENDER YEAR

After 1986, all partnerships, S corporations and personal service corporations must conform their tax years to the tax years of their owners, unless such entities can establish a business purpose for having a different year. Tax deferral is not considered a legitimate reason. This provision is effective for taxable years beginning after 1986, thus requiring some entities to change their taxable year in 1987.

Partnerships generally must adopt the same taxable year as their majority interest partners, their principal partners, or the calender year. Both S and personal service corporations must use the calender year. Use of a fiscal tax year for business

purposes requires IRS approval.

CORPORATE DISSOLUTION RULES MADE LESS FAVORABLE

Under prior law, appreciation on corporate assets generally was untaxed at the corporate level if the assets were sold or distributed with the liquidation of the corporation. Thus a corporate liquidation resulted in only a single tax at the shareholder level.

But TRA86 makes asset sales and distributions to shareholders in connection with a liquidation taxable in the same way as other sales and distributions to shareholders. This will increase the cost of disincorporation for any corporation holding appreciated property. And it's compounded by the loss of the capital gains advantage. This may also affect the form of business organization chosen by individual businesses, since it will no longer be possible to allow assets to build up in a corporation and remove them on liquidation at a single favorable tax rate. Gains will be taxed at both the corporate and shareholder levels, and at the same tax rate applying to corporate dividends.

A transition rule may offer additional time to certain small, closely-held corporations. These corporations have until Jan.1, 1989, to make liquidating sales and distributions and to complete their liquidations. Eligible corporations are those valued at $5 million or less and with 10 or fewer owners.

MEDICAL INSURANCE DEDUCTION

Sole proprietor and partnership businesses will be able to deduct 25% of the cost of medical insurance in 1987 & later. This applies to insurance for the self-employed individual, including spouse and dependents. However, this deduction is not available if either spouse is eligible to participate in a subsidized plan by an employer. Further, other employees will have to be covered, and the deduction may not exceed earned income of the business.

80 PERCENT RULE ON BUSINESS MEALS

The allowable deduction for business meal and entertainment expenses will generally be limited to 80 percent of such expenses, for tax years after 1986. Certain exceptions and special rules apply. But in general, this rule illustrates two impacts of much of TRA86 - more detailed record-keeping will be needed, and taxable income is increased.

SOME IMPLICATIONS FOR BUSINESS

While the above discussion covers only a few items from TRA86, they are sufficient to emphasize several points that firms in the dairy and food industries may need to consider. The act will keep accountants and attorneys busy for years trying to sort out the impacts on each business. But several activities need quick action, or the opportunity to act will be gone.

CHOICE OF FORM OF BUSINESS

Several factors affect the choice of form of business both at start-up and later: top rates for individuals are lower than for corporations; the top rate on capital gains is now 28%, not 20%; tax free liquidations are being, or have been, repealed; the new AMT replaces the add-on tax; and new limitations are introduced on cash basis accounting. Regular or C corporations may still be the form of choice for many individuals, but it will require additional study of the nontax factors of alternative forms, especially since S corporations and limited partnerships capture much of the limited liability aspect.

Tax impact upon liquidation may play a more dominant role in businesses which aim to accumulate earnings in the corporation. And this also needs immediate review by any firm considering liquidation in the near future.

FINANCING THE BUSINESS

Methods of financing the business, including equity, debt and internally generated earnings, may need to undergo change. For example, the loss of investment tax credits means that more capital will be needed to purchase or lease equipment. The new rules on uniform capitalization requirements and installment sales may increase both taxable income and the need for working capital. These and other factors may increase or decrease the ability to finance growth with after-tax earnings.

WORKING WITH THE NEW DEPRECIATION RULES

The modified ACRS depreciation rules for future purchases will often result in only slightly smaller deductions in the first 2 years for personal property. But depreciation deductions will take more years to fully depreciate an asset, thus increasing annual income. However, the change from a 19 year to a 31 and 1/2 year recovery period on commercial real property , coupled with mandatory use of straight-line depreciation, is a significant change. There is less flexibility in the modified ACRS rules, especially for a business that cannot use all possible depreciation deductions currently. And the mid-quarter convention means additional planning must be done to make year end purchases retain the intended tax deferral.

SALES OF GOODS AND SERVICES

One conclusion has been that service and sales businesses, which are not capital intensive, may have lower tax liabilities due to the lower tax rates. Unfortunately these lower rates may be applied to a larger tax base due to changes in the timing and reporting of income. And many changes in TRA86 lead to earlier reporting of income and elimination of opportunities for income deferral.

The requirement that all partnerships, S corporations and personal service corporations must generally use a calender year, will cause many entities to lose a method of tax deferral.

However, many food industries may be able to justify a so-called natural business year, i.e. at or soon after a peak period of business, and obtain IRS approval for a fiscal year that works to their advantage.

Some businesses may want to take advantage of the LIFO inventory method. Generally this method saves taxes in a period of rising prices. But of greater import to most businesses will be whether or not they have to comply with the uniform capitalization rules for inventory and capital items. And some businesses may also have taxable income increased due to the changes in installment sale reporting.

SALES OF BUSINESSES OR PARTIAL INTERESTS

A window still exists for tax- free liquidations for certain small, closely-held businesses. This may provide the lowest cost opportunity for a retiring shareholder to get his appreciated capital out of the business, without being taxed at both the corporate and individual levels. This may be combined with a new form of business and/or transfer of control to other owners. There are still several methods available for a full or partial distribution, but careful planning is needed.

SUMMARY

The Tax Reform Act of 1986 will impact each and every one of us in 1987 and later years. The general impact seems to favor individuals over businesses. All businesses are incurring costs, simply to try and understand and comply with the massive changes. But the extent of the added cost of compliance, and more importantly the additional taxes owed, depend on each companies circumstances.

Issued in furtherance of Cooperative Extension work, Acts of May 8 and June 30, 1914, in cooperation with the U.S. Department of Agriculture, J. Michael Sprott, Director of the Ohio Cooperative Extension Service, The Ohio State University.