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CPA Client Bulletin

January 1990

Section 89, Medicare Surtax Are Both Repealed; Capital Gains Change to Be Debated Further

The infamous Revenue Code Section 89, with its highly convoluted antidiscrimination rules for company accident, health and benefit programs, has been withdrawn at last.

The act repealing this controversial provision of the Tax Reform Act of 1986 is retroactive, so it is as though Section 89 never existed, although thousands of business people who went to great trouble and expense getting ready for it can tell you otherwise.

The much simpler rules barring discrimination in employee benefit programs that prevailed previously have been reinstated. These apply especially to self-insured medical reimbursement plans, group-term life insurance and so-called cafeteria plans. If a company has adjusted its programs to conform to Section 89, those plans will be considered to be in compliance.

Another widely discussed legislative proposal, the restoration of preferential treatment for capital gains, after delaying other legislation for weeks, was finally put on hold. But it is expected to generate further debate during the 1990 congressional term.

Catastrophic Coverage And Surtax Killed

As its last act before adjournment until January 23, Congress repealed the Catastrophic Coverage Act and its surtax on senior citizens. This means that those subject to the surtax who in 1989 adjusted their withholding or estimated tax payments to cover it are in most cases overwithheld. They can now look forward to a larger-than-usual tax refund—as much as $1,600 larger for joint filers.

In addition, recipients of Social Security benefits will enjoy larger monthly checks because the Medicare premiums deducted from those checks also revert to what they were before the Catastrophic Coverage took effect. This, of course, is in addition to the 4.7 percent cost-of-living increase that began the first of the year.

Minor Increases To Ease Budget Pinch

In an effort to bring the budget at least a little closer to balance, a number of minor tax increases were approved in the closing hours of the final 1989 congressional session. These included:

- Increasing the Social Security tax wage base, which had been scheduled to rise January 1 to $50,400, to $51,300 instead. This will result in a wage earner at or above the upper limit paying $320 more in Social Security taxes in 1990 than in 1989, with the employer paying the same added amount.
- Increasing the Social Security tax wage base to include deferred income, such as that contributed to pension funds.
- Discontinuing the deductibility as a net operating loss carryover of interest paid on debt used for leveraged buyouts (retroactive to last August 2).
- Speeding up the collection of payroll taxes for companies with large payrolls, making them payable within one day after they reach $100,000 (effective next August 1).
- Repealing most of the tax exemptions that banks enjoy on 50 percent of the interest received from loans used to buy securities for Employee Stock Ownership Plans (retroactive to loans made after November 17, 1989).
- Abolishing what is left of completed-contract accounting for tax purposes.
- Generally requiring S corporations that have tax liabilities for the current year to make advance tax payments (effective for years beginning after 1989).
- Discontinuing the tax subsidy given to banks making loans to developing countries unless the bank sets up substantial loss reserves to cover the loans.
- Restricting or deferring the deductibility of interest on zero-coupon bonds, when the securities are of the junk-bond category (retroactive to July 11, 1989).
- Delaying for a year the scheduled reduction in airport and airline taxes.
- Doubling the departure tax for international air passengers to $6 and imposing a similar $3 tax on departing ship passengers.
- Ending the deductibility of cellular telephones not used at least 50 percent for business.
- Taxing domestic crude oil 5 cents a barrel, to pay for oil-spill cleanups.

Expiring and Expired Tax Breaks Renewed

Not all the last-minute changes in tax law were revenue *raisers*. A laundry list of credits, exemptions and other tax breaks that either were to have expired January 1 or had expired earlier were renewed through next September 30. (Why would they run through only part of the year? Reportedly, so they can be used as playing chips in the 1990 tax-writing poker game.)

The revenue-reducing actions included tax credits for

- Hiring certain disadvantaged young people (the targeted jobs credit).
- Increasing corporate spending on research and development.
- Constructing low-income housing.
- Subsidizing bonds that make available low-cost mortgages for middle-income families.
- Renewing the 25 percent deduction of health insurance costs for the self-employed.
- Continuing credits for businesses utilizing geothermal energy.
- Excluding from taxes educational assistance up to $5,250 per year provided by employers (retroactive to 1988, when the provision expired).
- A similar exclusion for employer-provided group legal aid programs, also retroactive to 1988. ■

Older Employees Taxed More on Group Insurance

The rate at which workers 65 or over are taxed on group life insurance coverage over $50,000 provided by their employers has gone up—retroactive to January 1 a year ago. For employees 60 to 65, the cost of coverage imputed to the individual as taxable income has been, and remains, $1.17 per month for each $1,000 of coverage over $50,000. That's the amount added to the employee's taxable income reported on Form W-2.

But active workers 65 to 69, who had been taxed at the same rate, now are considered to receive $2.10 per $1,000 of coverage over $50,000, and after age 70 the cost of the coverage is taken to be $3.76 per $1,000.

Lesser increases may soon be made in the imputed incomes of insured employees *under* age 65; the IRS is still studying the pertinent statistics. ■

Numbers Pertinent to 1989 Tax Returns

As we enter the income tax season, leading up to the filing of 1989 returns, here are some numbers that will bear on the taxes you will owe:

- Personal interest expense deduction: 20 percent for 1989, 10 percent for 1990, then nothing.
- Age above which dependents' Social Security numbers must be reported on the tax return: 2 years.
- Personal exemption deduction: $2,000 per dependent (up $50 from last year).
- Standard deduction, for those who don't itemize: up from last year by $100 to $200, depending on filing status. For single taxpayers, $3,100; joint filers, $5,200; marrieds filing separately, $2,600; and heads of households, $4,550.
- Age limit above which children no longer qualify a parent for the child-care credit: 13th birthday.
- Portion of 1989 taxes that must be prepaid, through withholding, estimated returns or otherwise, to avoid penalty: 90 percent (or 100 percent of 1988 liability).
- Interest rate charged by the IRS on tax underpayments in the first quarter of 1990: 11 percent. Interest *paid* by the IRS on overpayments: 10 percent.
- Maximum contribution to a 401(k) plan in 1989: $7,627.
- Standard business-driving deduction allowance for 1989 (for those who don't itemize driving costs): 25½ cents.
- When a child under 14 must pay income taxes at his or her parents' rate: when unearned income exceeds $1,000. (The first $500 of unearned income is tax free, and the next $500 is taxed at his or her rate—in most cases, 15 percent.)
- Maximum amount of home-equity borrowing (loan proceeds not used to acquire or improve the home) on which interest is fully deductible: $100,000.
- Self-employment tax, if self-employed income is over $48,000: $6,249.60. If under $48,000, multiply it by .1302.
- Thresholds certain expenses must exceed to be deductible: Casualty losses, 10 percent of adjusted gross income plus $100 per casualty; medical expenses, 7½ percent of AGI; miscellaneous deductions, 2 percent of AGI.
- Maximum period one can have rented out a primary or second home in 1989 without having to report the income on one's tax return: 14 days.
- When 1989 tax rates change from 15 to 28 percent: at $18,550 of taxable income for singles; $30,950 for joint filers; $15,475 for marrieds filing separately; and $24,850 for heads of households. ■

New Minimum Wage Takes Effect April 3

On April 3, 1990, the federal minimum wage rises from $3.35 to $3.80 per hour. Additional scheduled increases will raise the minimum to $4.25 an hour by April 1991.

Under the present minimum wage law, some retail or service businesses with sales under $362,500 a year are exempt from the minimum, as are auto service stations with annual sales under $250,000.

Also laundries, dry cleaners, fabric-care businesses and construction companies are exempt, regardless of sales.

The new law permits payment of less than the minimum wage for a training period of no more than six months to workers under age 20, but this is likely to be of only academic interest to employers in areas other than those with high unemployment rates. In most places, where there is virtually full employment for youngsters willing to work, competing employers have pushed prevailing rates well above the sub-minimum level.

In areas where labor is not in such short supply, the increased payroll expense created by the rise in minimum pay may prompt small companies to adopt work-saving devices long favored by larger companies but shunned by the not-so-large because they were considered too costly.

The big worry at smaller firms is not so much over what will happen to their own payroll as it is over what the effects might be on their other costs, as suppliers boost prices. ■

Moonlighters Not Prepared for It Might Find Good News and Bad on 1989 Tax Returns

Did you do some moonlighting in 1989? A record number of Americans—more than 7 million—did, and of course it makes a difference in their income taxes.

If the second employer did not withhold taxes, the employee naturally must come up with the full amount owed, possibly subject to a penalty for inadequate withholding under our pay-as-you-go system. More likely, the second employer *did* withhold, which could mean that Social Security taxes were *over*withheld. One can claim credit for such excess payments—amounts over $3,604.80 in 1989—on the 1989 tax return.

If you expect to hold two or more jobs in 1990, you can arrange for correct withholding by filing with each employer a revised form W-4.

Don't overlook the fact that additional earned income from the second job can reduce the amounts you are eligible to contribute to IRAs.

Driving Between Jobs

Also, although the costs of driving between one's home and workplace cannot be deducted, those of driving from one job to another can. A five-times-a-week 10-mile trip from one job to another adds up to 500 miles a year, which, using the standard allowance of 25½ cents per mile, means a deduction of $127.50. Unfortunately, this is subject, along with other "miscellaneous" deductions, to an exclusion of 2 percent of adjusted gross income.

If your after-hours work is self-employment rather than for another employer, this opens another tax planning opportunity: You may qualify for an investment in a Keogh deferred-compensation plan. The income thus invested, along with the interest it earns, is not subject to income or payroll taxes until withdrawn, perhaps years hence. The limits on the amounts that can be put into such a plan are higher than those on Individual Retirement Accounts (IRAs) or on 401(k) plans.

Different Deadlines

Unfortunately, unlike an IRA, which can be opened now and still be used to defer 1989 income, it's too late to open a Keogh for 1989. If you have a Keogh that

was opened before the end of last year, you can make contributions now and avoid 1989 taxes on that income.

In fact, the 1989 Keogh contributions can be made right up until tax-filing time, including extensions. IRA contributions, on the other hand, can be made only to April 16.

More details about those 7 million moonlighters: They comprise more than 6 percent of the working population—the highest percentage since the 1950s. Almost 8 percent of them are managers or professionals, according to the Bureau of Labor Statistics.

Five to ten years ago this trend would have been blamed on inflation. ■

EE Bonds for Education Are Now Available

Tax-protected Series EE U.S. savings bonds earmarked for the buyers' or their children's education are now available. Interest earned by the bonds until they are cashed to pay for tuition and fees goes untaxed.

This method of funding a future education is lost as adjusted gross income rises, phasing out, for joint-filers, between $60,000 and $90,000 of modified adjusted gross income. (Modified AGI adds back to income the portion of Social Security benefits not subject to income tax, as well as amounts deducted for IRA contributions and some other, similar, "preferences.")

It should be emphasized, however, that the phasing out as income rises applies to the years in which the bonds are redeemed—not to the years when they are purchased.

Another requirement is that the EE bonds to which the tax protection is given must have been purchased by an individual who was at least 24 years of age before the date of issuance. This means a child's savings cannot be used to buy them. However, there is nothing to prevent the child from investing in EE bonds as in the past and reporting the interest therefrom as it accrues. If the child's other income is low, this could result in little or no tax being paid on the bonds.

One can't roll over bonds already owned into the new ones, nor do bonds acquired from someone else qualify for the tax exclusion. This is to limit the tax break to those who will be paying educational costs only for themselves or their children. ■

Still Awaiting '88 Refund? Have You Recently Moved?

Are you still waiting for a refund of overpaid 1988 income taxes? If so, you could be one of the 72,000 taxpayers whose refund checks (averaging $555 each) were returned to the Treasury Department as undeliverable. If you have moved since last year's filing there's a good chance the IRS has lost track of you.

Call the IRS tax assistance office listed in the phone directory and tell them where you now live.

Many taxpayers when they move don't bother to notify the IRS, figuring that their next return will give the tax collector the new address, and counting on the post office at their former address to forward any mail.

Problems can arise from the fact that any return the IRS may be questioning is likely to be two or three years old—sent from your former location. Although the service is now required to check the address on a taxpayer's latest return, if they fail to do so, what can you do—sue?

Better to notify them of the change when it happens, as you do all the other people with whom you have business.

If your returns have been the sort that are likely to prompt IRS queries, you could make doubly sure they learn of your address change by sending the notification certified—return receipt requested. ■

Recruiters Must Emphasize Own Special Attractions

The late Walter Hovey, for many years the head of Tiffany's, the renowned Fifth Avenue retail establishment, had a policy of denying credit to any customer who was rude to a member of his staff. Few small-business owners/managers will go that far in trying to keep employees contented, but human resources experts warn that they'll have to do more than they have in the past to locate, hire and retain good people in the years ahead.

The supply of labor is dwindling as the baby-boom generation ages and birth rates flatten out. Large companies, with skilled recruiters to help them, compete vigorously for the reduced supply of workers—even signing up employees in places as remote as Ireland, the Philippines and mainland China.

Few small companies can hope to play in that league. Their only alternative, say personnel specialists, will be to play up their own unique attractions, offering nonmonetary but very real inducements, such as a sense of participation or involvement—of playing a significant role in the company's operations.

Also, according to a panel of labor experts assembled by The Conference Board, an industry-supported research group, small companies will have to look, as large ones do, at sources of labor until now not fully utilized, such as minorities and women.

Some panelists suggested that many testing systems used in weighing the merits of job applicants are way out of date; the job specifications are filled with irrelevancies. Skills that can be imparted by on-the-job training should be removed from the list of "requirements." Said Madelyn Jennings, head of personnel for the Gannet Company, "Training will probably be one of the big growth industries of the 1990s."

The area in which small firms enjoy an edge over large ones in attracting workers, as mentioned by personnel authorities interviewed by the *Wall Street Journal*, is that they are able to fill openings through word of mouth. Employees tell friends and relatives that their employers are good people to work for. This sort of recommendation is encouraged at some companies by bonuses paid for every new hire an employee recommends who remains with the company for a minimum period, such as six months.

In this way, a feeling of "family" can be engendered in a company, which itself can be appealing, for example, to workers laid off as a result of a big corporate merger. ■

Sole Proprietors Doing Quite Well, Thanks, in Part, to Tax Treatment

We have commented in the past on the relative advantages of the various forms a business might take: sole proprietorship, partnership, C corporation and S corporation. Generally, the sole proprietorship—the unincorporated company with only one owner—has suffered by comparison with C corporations.

Changing conditions, especially in the tax picture, have made going it alone somewhat more attractive than it had been. The big tax change is in the rates, which for now are lower for individuals than for corporations. This, together with the fact that income taken out of a sole proprietorship is *pre-tax* income—not a dividend subject to double taxation—has left sole proprietors relatively favored to that extent.

There are, of course, many other elements to be taken into consideration. For example, a big danger frequently cited in opposition to sole proprietorships is that they make the owner liable for obligations of the company, thus putting everything he or she owns at risk.

One shouldn't make a major decision such as selecting a form of organization without looking at *all* aspects of the matter and discussing the ramifications with one's CPA and one's attorney.

Recent Record Good

How have sole proprietorships been doing lately? Not bad at all, to judge from the most recent IRS compilation of the *Statistics of Income* (SOI), which includes analyses of sole-proprietorship tax returns for 1987 and previous years.

The study finds that sole enterprises as a group did well *every year* from 1982 to 1987, with net income rising substantially in each of those five years:

1982 - $50.6 billion
1983 - 60.4 billion
1984 - 70.8 billion
1985 - 78.8 billion
1986 - 90.4 billion
1987 - 105.5 billion

Even those who *lost* money tended on the average to lose less than previously; total net losses in 1987 were down nearly 9 percent from 1986. Also, the number of sole proprietors continued to increase: More than 13 million of them filed tax returns in 1987— up about 6 percent over 1986.

All this makes interesting reading, but what good are three-year-old data? Not much, except as a historic base against which to compare the present. The same goes for data that are very general, as these are, covering all sole proprietorships in the country. Generally, it is useful to an individual company for comparison only.

This reemphasizes the need for good, specific, up-to-date information about one's own company, assembled and analyzed regularly. With computerization, of course, it's now possible to know where you stand on a continuous basis. ■

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