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The Tax Reform Act of 1986: Impact On Hospitality Industries

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Abstract

In her discussion - The Tax Reform Act Of 1986: Impact On Hospitality Industries - by Elisa S. Moncarz, Associate Professor, the School of Hospitality Management at Florida International University, Professor Moncarz initially states: "After nearly two years of considering the overhaul of the federal tax system, Congress enacted the Tax Reform Act of 1986. The impact of this legislation is expected to affect virtually all individuals and businesses associated with the hospitality industry. This article discusses some of the major provisions of the tax bill, emphasizing those relating to the hospitality service industries and contrasting relevant provisions with prior law on their positive and negative effects to the industry.

"On October 22, 1986, President Reagan signed the Tax Reform Act of 1986 (TRA 86) with changes so pervasive that a recodification of the income tax laws became necessary..." Professor Moncarz says in providing a basic history of the bill.

Two, very important paragraphs underpin TRA 86, and this article. They should not be under-estimated.

The author wants you to know: "With the passage of TRA 86, the Reagan administration achieved the most important single domestic initiative of Reagan's second term, a complete restructuring of the federal tax system in an attempt to re-establish fairness in the tax code..." an informed view, indeed. "These changes will result in an estimated shift of over \$100 billion of the tax burden from individuals to corporations over the next five years [as of this article]," Professor Moncarz enlightens.

"...TRA 86 embraces a conversion to the view that lowering tax rates and eliminating or restricting tax preferences (i.e., loopholes) "would be more economically and socially productive." Hence, economic decisions would be based on economic efficiency as opposed to tax effect," the author asserts.

"...both Congress and the administration recognized from its inception that the reform of the tax code must satisfy three basic goals," and these goals are identified for you.

Professor Moncarz outlines the positive impact TRA 86 will have on the U.S. economy in general, but also makes distinctions the 'Act will have on specific segments of the business community, with a particular eye toward the hospitality industry and food-service in particular.

Professor Moncarz also provides graphs to illustrate the comparative tax indexes of select companies, encompassing the years 1883-through-1985. Deductibility and its importance are discussed as well.

The author foresees Limited Partnerships, employment, and even new hotel construction and/or rehabilitation being affected by TRA 86. The article, as one would assume from this type of discussion, is liberally peppered with facts and figures.

Keywords

Elisa S. Moncarz, The Tax Reform Act Of 1986: Impact On Hospitality, TRA 86, Deductibility, Food-Service, Investment Tax Credit (ITC), Net Operating Loss (NOL), Targeted Jobs Tax, Credit (TJTC), FIU

The Tax Reform Act Of 1986: Impact On Hospitality Industries

by
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After nearly two years of considering the overhaul of the federal tax system, Congress enacted the Tax Reform Act of 1986. The impact of this legislation is expected to affect virtually all individuals and businesses associated with the hospitality industry. This article discusses some of the major provisions of the tax bill, emphasizing those relating to the hospitality service industries and contrasting relevant provisions with prior law on their positive and negative effects to the industry.

On October 22, 1986, President Reagan signed the Tax Reform Act of 1986 (TRA 86) with changes so pervasive that a recodification of the income tax laws became necessary, "a milestone in tax history."¹

With the passage of TRA 86, the Reagan administration achieved the most important single domestic initiative of Reagan's second term, a complete restructuring of the federal tax system in an attempt to reestablish fairness in the tax code while maintaining economic neutrality (i.e., neither increasing nor decreasing the total amount of revenue that the federal government collects from taxes). To this end, TRA 86 included a significant reduction in top statutory tax rates for both individuals and corporations as a means to bolster savings and investment in the U.S. economy. In order to reduce the revenue loss resulting from this rate cut, many tax preferences and deductions were eliminated or curtailed. These changes will result in an estimated shift of over \$100 billion of the tax burden from individuals to corporations over the next five years.

In formulating the various proposals and provisions, both Congress and the administration recognized from its inception that the reform of the tax code must satisfy three basic goals. First, the tax law should be perceived as fair in the sense that taxpayers with equal incomes must bear equal tax burdens. Second, tax reform must be neutral in terms of both revenue and economic effects. That is, reform should not be used as a tool to reduce the federal deficit, nor should it create incentives to direct resources away from their most efficient uses. Finally, tax reform should foster, or at least not impede, the long-term growth prospects of the U.S. economy. As a result of these broad objectives, the philosophy of the new tax legislation is much different from previous tax laws. Instead of being driven by tax incentives written over the years to encourage activities deemed economically or socially beneficial, TRA 86

embraces a conversion to the view that lowering tax rates and eliminating or restricting tax preferences (i.e., loopholes) "would be more economically and socially productive."² Hence, economic decisions would be based on economic efficiency as opposed to tax effect.

Generally, economists and financial analysts disagree over whether the changes in economic behavior to be brought about by the landmark tax revision legislation will be good or bad for the nation's overall economy. Murray Weidenbaum, director of the center for the study of American Business at Washington University and former chairman of the council of economic advisors, expects "the tax bill to lower growth in the gross national product in 1987 by about one percentage point and to raise the unemployment rate almost five-tenths of one percentage point."³ He expressed concern that "the combination of the negative effects of the tax reform and the Gramm-Rudman deficit reduction act could push the U.S. economy into recession."⁴ Yet, Weidenbaum concedes that the changes in the investment patterns resulting from TRA 86 will lead in the long-run to a more efficient economy.

Conversely, J. Makin, director of fiscal policy studies at the American Entrepreneurial Institute, feels that TRA 86 represents real progress toward a more stable, less intrusive tax system that should support growth by encouraging additional work efforts motivated by economic incentives instead of tax avoidance. Furthermore, Makin contends that "although the removal of the investment tax credit and the tightening of depreciation allowances would discourage some investments, other features of the bill would have the opposite effect (e.g., lowering tax rates and restricting interest deductions would reduce debt financing and lower interest rates). Thus, the net result will be little change in overall investment activity."⁵

Alan Greenspan, a former chief economic advisor, agreed "that there will be less of the type of investment which is not at all productive; yet he acknowledges that TRA 86 might raise slightly less revenue than anticipated and some short-term dislocations might occur."⁶ Similarly, an analysis of TRA 86 prepared by the international CPA firm of Coopers & Lybrand revealed that "lower tax rates with no preference for long-term capital gain and limiting deductions for investment losses and interest should encourage lower-risk, higher yielding investments while discouraging investments in tax shelters and other investments that create losses in the early years for presumed potential gains later."⁷

Generally, most analysts feel that the tax overhaul will promote stronger and healthier economic growth in the long run because of a better allocation of resources as investors focus on increasing real economic returns, thus improving the allocation of capital toward more productive investments. Nonetheless, "these desirable changes are not likely to occur with the speed and magnitude needed to offset the early negative effects of reducing and eliminating direct investment incentives."⁸ That is why TRA 86 has drawn a good deal of criticism from economists who believe it would hinder economic growth in the short run, perhaps pushing the U.S. economy into recession.

The positive impact of TRA 86 includes the following:

- Reduction in taxes for most individual taxpayers will result in “added rise in consumer disposable income and hence in consumer outlays.”⁹
- A more efficient allocation of capital by eliminating distortions in the economy will result in the economy being “more competitive.”¹⁰
- Investment and economic activities that make sense economically would be encouraged rather “than focusing in exploiting tax advantages created by the tax code.”¹¹
- Six million low-income taxpayers will be removed from the tax rolls and tax equity for all taxpayers should encourage a sense of fairness, thus “restoring taxpayer confidence in the tax system which, in turn, should promote faster economic growth.”¹²
- TRA 86 “is likely to lower interest rates and attract more foreign capital to the United States.”¹³

The negative impact of TRA 86 includes the following:

- “Increases in the cost of capital will hurt the individual base, making the U.S. less competitive with Japan and Korea and the rest of the world.”¹⁴
- Fewer jobs will be created as a result of reductions in business incentives resulting in “more unemployment compensation, bigger budget deficits and a weaker economy.”¹⁵
- Reduction of favored tax treatment given to investments in property and equipment and taxing capital gains as ordinary income “may sharply depress investment and jeopardize continued economic recovery, especially in the short-run.”¹⁶
- Promoting consumption at the expense of investment is considered “anti-growth, anti-capital formation and possibly pro-inflation.”¹⁷

Changes In The Tax Law Will Affect Hospitality Industry

TRA 86 increases the corporate tax burden by more than \$100 billion over the next five years in order to pay for tax relief for individuals. However, all businesses are not equally affected. While heavy manufacturing, oil, transportation, and other industrial firms that have benefited greatly from existing credits and deductions will see the tax burden increased, most service industries are expected to benefit the most from the overhaul of the federal tax system because of the reduction in the corporate tax rates. It becomes important, however, to understand the specific impact of major provisions of the tax bill on the hospitality service industries. Of the many important provisions of TRA 86, some are being identified to be of particular concern to the industry:

- reduction of top corporate rates to 34 percent

- limiting the deductibility of business meals, travel, and entertainment expenses
- repeal of the investment tax credit and lengthening depreciation schedules
- limiting losses from passive activities
- reduction of the rehabilitation credit
- limitations on the use of the targeted jobs credit
- repeal of the general utilities doctrine
- new net operating loss rules following acquisitions or other ownership changes
- limitations on the use of the cash basis of accounting
- new alternative minimum tax for corporations
- reduction of individual tax rates and increase of the standard deduction and personal exemption amounts

Under prior law corporations were taxed at 46 percent (except for 15 to 40 percent on the first \$100,000 of taxable income). TRA 86 reduces the top corporate tax rate to a blended rate of 40 percent in 1987 and 34 percent in 1988 and thereafter. It also simplifies the graduated rate structure, reducing the number of brackets from five to three (15 percent on taxable income of less than \$50,000, 25 percent from \$50,000 to \$75,000, and 34 percent on more than \$75,000). The benefits of graduated rates are phased out so that corporations having income of \$335,000 or more would in effect pay a tax at a flat 34 percent rate.

Since many hotel and restaurant chains had effective tax rates during the recent past well above 34 percent (especially restaurant firms), the changes in the corporate income tax rates would result in a significant reduction of income taxes. Table 1 presents the effective tax rates of selected hotel and restaurant chains during 1983, 1984, and 1985.

Conversely, reducing the corporate tax rates will have little effect on the airline industry as a whole because many carriers paid taxes significantly below TRA 86 rates during the '80s due to a number of tax incentives available under previous tax laws. Table 2 shows the effective tax rates of selected airline companies from 1983 to 1985.

Bill Limits Deductibility Of Business Meals

Under prior law, meals, travel, and entertainment expenses incurred in the pursuit of a trade or business were generally fully deductible subject to certain limitations. Business meals, for instance, were deductible as long as the meal took place in an atmosphere conducive to a business discussion. Business was not required to be discussed before, during, or after the meal.

Although "lobbyists from both the National Restaurant Association (NRA) and the American Hotel and Motel Association (AHMA) had hoped to save full deductibility of business meals and entertainment as

Table 1
Selected Hotels And Restaurant Chains
Effective Tax Rates *
1983-1985

Company Name	1985	1984	1983
Hotels			
Hilton (a)	30.1%	40.5%	40.3%
Holiday Corp.	37.0	43.0	45.0
LaQuinta Motor Inn (b)	36.5	33.7	38.5
Marriott	43.4	42.7	41.4
Ramada Inns (c)	32.4	61.7	48.9
United Inns	46.1	34.8	38.7
Restaurants			
Dunkin' Donuts	47.5	47.7	47.8
Jerrico (d)	43.0	43.0	44.0
McDonalds	44.6	45.0	45.4
Morrison's (d)	38.4	40.8	40.9
Ryan's Family Steak House	42.7	44.2	44.4
Saga	37.5	38.5	40.9
TGI Friday's	40.6	41.9	44.2
Wendy's	42.9	45.8	44.5

*As a percentage of pre-tax earnings

- a. Significant tax benefits related to the sale of the Shamrock Hilton and rehabilitation tax credits in connection with the restorations of the Waldorf-Astoria, Capitol Hilton, and Chicago Hilton and Towers.
- b. Fiscal year ended May 31.
- c. Increase in effective tax rates for 1983 and 1984 primarily caused by provision for state taxes, net.
- d. Fiscal year ended June 30.

Source: Annual Reports

the bill worked its way through Congress,"¹⁸ TBA 86 limits the deductibility of business meals and entertainment (including meals incurred while away from home) to 80 percent of cost beginning in 1987. The new law also alters the definition of "business meal" to include only those that are directly related or associated with the active conduct of the taxpayer's business and requires the presence of the taxpayer or representative. Employees will continue to get a full deduction for meal expense reimbursed by their employers; the percentage reduction rule applies to the employer. Certain traditional employer-paid recreational activities (e.g., company picnics and holiday parties) and promotional activities that are made available to the general public will remain fully deducti-

Table 2
Selected Airline Companies
Effective Tax Rates *
1983-1985

Company Name	1985	1984	1983
Delta (a) (c)	N.A. (b)	46.0%	42.7%
Eastern	6.9%	N.A. (b)	N.A. (b)
Pan Am	7.6	N.A. (b)	N.A. (b)
Piedmont	22.1	36.8	29.6
Texas Air	47.4	44.8	N.A. (b)
Transworld	4.0	13.2	.0

*As a percentage of pre-tax earnings

- a. Fiscal year ended June 30
- b. Negative provision and/or pretax losses reported.
- c. Planned contribution to payroll-based ownership plan (PAYSOP), which were recorded as additional compensation expense, were not deductible for income tax purposes and thus were excluded before computing the normal provision for income taxes.
- d. Pursuant to a tax allocation agreement Transworld was obligated to compensate TWA for certain tax benefits (e.g., net operating losses and significant investment tax credits) generated by TWA in prior years.

Source: Annual Reports

ble. Full deductibility also continues for meals taxed to employees as compensation and items sold to the public, such as the cost of food to restaurants. Furthermore, for 1987 and 1988 full deductibility is allowed for the cost of meals that are in integral part of a convention, seminar, annual meeting, or similar business programs, provided that "(1) at least there are 40 participants, half of whom are away from home, (2) the business event includes a speaker, and (3) the charge for the meal is not separately stated."¹⁹ This latter exception is seen by some tax experts as an opportunity for companies "to set up a short-lived subsidiary to furnish speakers for 1987-1988 business meetings for honorariums directly proportional to the increased tax deductions allowed during those years."²⁰

While the original Reagan tax plan placed restrictions on the deductibility of ordinary and necessary business lodging costs incurred while away from home, full deductibility was preserved for all such deductions in TRA 86. Still, deductions for educational and investment travel expenses are being disallowed in the new law. The same applies to charitable travel expenses where there is a significant element of personal, pleasure, or vacation time involved.

NRA and other industry groups have predicted that the 80 percent

limitation on the deductibility of business meals and entertainment would have "a disastrous impact on food-service."²¹ William Fisher, executive vice-president of NRA, expressed his concern in a May 9, 1986, *New York Times* article by stating that "the food-service industry would see a decline of \$32 billion in sales revenue and a loss of 1.3 million jobs over the next three years"²² as a result of the meals and entertainment deductibility limitation. Fisher further noted that "there would be a multiplier effect due to the foregone sales that will also affect other sectors of the economy, such as fisheries, vintners and federal and state governments."²³

The Food Service and Lodging Institute also expressed added concern in a *Nation's Restaurant News* article by noting that the impact of TRA 86 would be far more disastrous to the food service industry than early analyses acknowledged "because of the changes in the definition of what would qualify as a business meal and entertainment deduction under the new law, which places further restrictions on the active conduct of business by taxpayers."²⁴

By contrast, a number of companies that have been regular patrons of restaurants were not that alarmed by the business meal and entertainment deduction curtailment in spite of the fact that "the 20 percent reduction in the amount that can be written off for business meal and entertainment, together with the lower tax rates will raise the actual cost of a business meal by about 35 percent."²⁵ A \$100 meal, for instance, used to cost a company \$54 after taxes. Its after tax cost would rise to \$72.80 in 1988 when the 34 percent corporate tax rate is fully effective.

Many analysts feel that the tax changes are not expected to materially affect expense account policies, for companies always regarded business meals as good business regardless of tax considerations. Since employers are the ones that bear the burden of the reduced deduction, they are expected to reimburse employees for the full 100 percent of qualified expenses.

These analysts concede, however, "that employees that were previously expected to personally bear the cost of certain entertainment expenses may no longer be as willing to do so when the amount they can deduct on their tax returns is so sharply curtailed."²⁶

Before the final version of TRA 86 was signed into law by President Reagan, NRA lobbyists had begun laying the groundwork for new legislation in 1987 to restore the full deductibility for the business meal deduction. In this regard, the NRA was expected to monitor the impact of the new tax bill on the food service industry beginning January 1, 1987, (the day TRA 86 generally becomes effective). If the anticipated negative economic impact of the business meal deduction curtailment proves to be correct, "the NRA will launch a full-scale lobbying blitz to reverse the deduction cutback."²⁷

Repeal Of Investment Tax Credit Will Affect Industry

The repeal of the investment tax credit (ITC) for qualified property placed in service after December 31, 1985, combined with the new accelerated cost recovery system (depreciation) rules that, among other

things, extend the 19-year real estate write-off to 27.5 years for residential property and 31.5 years for commercial property (including hotels, motels, and inns) effective January 1, 1987, are expected to play a major part in future industry development.

The ITC and the accelerated cost recovery system included in the Economic Recovery Tax Act of 1981 "provided new incentives for hotel and restaurant development and renovation through shorter depreciation schedules and tax credit changes."²⁸ As a result, they have been contributing factors to the current status of the lodging industry often referred to as overbuilt by many industry analysts because of the marked imbalance between lodging supply and demand in selected market segments. The ITC allowed up to 10 percent of a company's investment in depreciable property (generally not including buildings or their structural components) as a direct reduction from its tax payment.

With the repeal of the ITC retroactive to January 1, 1986 (except for properties covered by certain binding contract transition rules), the federal government will no longer subsidize up to 10 percent of the acquisition cost of furniture and equipment purchased by hotels, restaurants, and airlines, affecting future plans for acquisitions and renovations. Accordingly, "the loss of the ITC could hurt hotels in the process of upgrading and refurbishing,"²⁹ as well as restaurants.

Ryan's Family Steakhouse, for instance, recently disclosed that "the loss of the investment tax credit in 1986 raised the company's effective tax rate for the third quarter from 44 to 49 percent as compared to the third quarter of 1985."³⁰ Ponderosa Steakhouse also announced that the loss of the ITC "led to an effective tax rate of about 58 percent in the last quarter of 1986; up from a 40 percent in the last quarter of 1985."³¹

At the same time, the airline industry will find it more expensive to replace and upgrade its transportation equipment (so vital to remain competitive and efficient) because the federal government is no longer subsidizing up to 10 percent of its cost. Table 3 presents the investment tax credits used by selected firms in the hospitality industry as a direct reduction of their tax liability for the years 1983 to 1985.

Moreover, the accelerated cost recovery system which provided write-offs under five classes of assets under previous law (i.e., 3, 5, 10, 15 and 19-year property) has been expanded to eight classes with certain assets re-categorized (e.g., new cars and light trucks from 3 to 5 years) and the 19-year commercial property extended to 31.5 years with straight-line recovery and mid-month convention. "The new recovery periods provide a substantial reduction in the value of the tax benefits from depreciation of real estate property."³²

Because of the reduced tax benefits from depreciation and the repeal of the ITC, TRA 86 has, in effect, eliminated some of the major tax incentives that have encouraged lodging growth during the '80s. This is expected to reduce new hotel construction and thus is perceived as a positive impact on the overbuilt status of the hotel industry, producing a better balance of hotel supply-demand. Ed Tavlin, an analyst with Prescott, Ball and Turbin, contends that a dramatic reduction in new hotel construction will represent a long-term benefit for the hotel industry

Table 3
Selected Hospitality Firms
Investment Tax Credits
(In Thousands Of Dollars)
1983-1985

Company Name	1985		1984		1983	
	Amount	Percent	Amount	Percent	Amount	Percent
Delta Airlines (a)	25,717	N.A.	52,597	12.9%	41,471	17.3%
Hilton (b)	14,598	10.0%	6,810	3.6	3,496	1.9
Holiday Corp.	4,934	2.2	11,489	5.0	8,143	3.6
La Quinta Motor Inns (c)	1,631	18.0	1,292	9.5	980	4.9
Marriott	13,500	4.6	10,100	4.3	11,000	5.9
McDonald's	19,500	2.5	16,800	2.4	16,800	2.7
Morrison's	1,565	5.4	986	2.8	1,274	4.3
Piedmont Aviation	23,370	27.0	10,487	11.0	6,565	18.0
Ramada Inns	1,508	7.4	-	N.A.	-	N.A.
Ryan's Steakhouse	636	6.7	251	4.1	170	4.3
Wendy's	6,351	4.8	4,792	3.8	2,483	2.5

*Percent of pre-tax earnings

a. Fiscal year ended June 30

b. Includes investment and other tax credits

c. Fiscal year ended May 31.

Source: Annual Reports

“by helping to put a better balance some time around the end of the decade to the oversupply of hotel rooms.”³³ On the darker side, Tavlin sees “a significant cash flow reduction since new projects and all existing hotels sold to new owners will be subject to the longer depreciation schedules,³⁴ thereby increasing the income tax payment to the federal government.

Passive Losses Rules Will Change

With limited exceptions and subject to a five-year phase-in, passive losses generated by investments in limited partnerships will no longer be of use in sheltering income from other sources (e.g., salaries, interest, dividends). Consequently, the traditional type of limited partnership syndication (privately offered, highly leveraged, and designed to reduce taxes) that have produced tax shelters for investors while raising huge amounts of equity capital for hotel and restaurant projects have lost most of their attractiveness under TRA 86.

Since a large number of new hotels and major renovations had been structured as tax shelters, many industry analysts predict a slowdown in new hotel construction. As noted earlier, this slowdown should eventually have an overall healthy impact on the industry “by reducing overbuilding and other factors that have negatively affected occupancy levels.”³⁵ Restrictions on tax shelters represent perhaps the most fun-

damental changes in the investment sphere. Sponsors of limited partnerships will have to change their focus on generating taxable income rather than tax losses. Indeed, a likely effect of TRA 86 would be to change the nature of existing limited partnerships by transforming deals that generate tax losses into income-oriented investments.

Another development that is likely to affect the future growth of creative forms of limited partnerships is the recommendation of tax experts to current investors in limited partnerships generating losses to seek ways to use those passive losses by finding limited partnerships and other passive investments that generate taxable income. In so doing, "the tax losses from the first tax shelter could be gainfully used to shelter profits from the second tax shelter"³⁶ since passive losses can still offset passive income.

Master Limited Partnerships Have Gained Popularity

One financing tool that is expected to benefit from TRA 86 is the Master Limited Partnership (MLP). Unlike traditional limited partnerships, the MLP is generally publicly traded, offering investors more protection and a relatively secure cash flow. A major appeal of the MLP is its high liquidity since it can be publicly traded. Yet they allow tax benefits to flow through to the investors while avoiding the double taxation faced by corporations and their shareholders. More importantly, income from MLP has been considered passive income.

The sponsor corporation of a MLP is typically the general partner of the organization. "Instead of dividends, limited partners receive a percentage of cash flow, which is distributed based on the number of partnership units owned."³⁷ Some of the MLP offerings in the hospitality industry during 1986 are:

- Pillsbury Company's \$92.7 million offering of 128 Burger King units is being traded on the New York Stock Exchange. QSV Properties was organized as a Pillsbury subsidiary to serve as a managing general partner.
- Perkins Restaurant registered a \$66 million syndication of 5.04 million partnership units to be used to retire debt and expand operations.
- "Prime Motor Inns, La Quinta Motor Inns, and Days Inn have been structuring similar deals in the lodging industry."³⁸

In spite of the apparent favored tax treatment of MLPs, experts have expressed concern concerning the continuation of a positive environment in the future. At this writing, "Congress is holding hearings looking at whether or not to continue partnership status for MLPs. This might lead to future legislation on the tax status of those partnerships, which could result in taxing them as corporations,"³⁹ thereby losing most of their current allure.

Some analysts have identified other investment opportunities in the hospitality industry that appear to have favored tax treatment following TRA 86:

- Condo hotels in which unit owners have legal title to their piece of property plus a share in common elements and the hotel is operated by a professional management company. "Since the condo hotel is not considered a passive investment, as long as condo unit owners meet certain requirements, investors are able to write-off unit losses without passive loss limitations."⁴⁰
- Real estate investment trusts, in which a newly formed real estate corporation makes a public offering of stock and uses the proceeds to acquire and hold the leases for a particular firm's property. During the '70s real estate investment trusts experienced a massive shakeout as a result of the high amount of debt used. They have made a comeback offering hospitality companies the opportunity to raise expansion funds while providing shareholders with an attractive investment. Their main appeal to investors is high dividends (95 percent of the real estate investment trust income is paid out as dividends) and liquidity.

Benefits For Preserving Older Properties Reduced

Under previous law, costs incurred in rehabilitating certain older commercial and industrial buildings qualified for a tax credit ranging from 15 to 25 percent, based upon the age of the building and the type of rehabilitation. The credit was available only for a substantial rehabilitation that satisfied a number of criteria, including an external walls requirement (e.g., Waldorf-Astoria hotel in New York).

TRA 86 significantly modifies the rehabilitation credit "to 20 percent for certified historic structures and 10 percent for nonresidential buildings placed in service before 1936."⁴¹ The new law continues to require that there be a substantial rehabilitation. Further, to qualify for the credit, buildings other than certified historic structures must "retain at least 75 percent of the existing external walls and at least 75 percent of the building's internal structural framework."⁴²

Although the above changes in rehabilitation credits are generally applicable to buildings placed in service after 1986, exceptions are provided for buildings placed in service before 1994 if the rehabilitation is completed under a binding contract signed before March 1, 1986. There are also special transition rules for specific projects, including the Bellevue Stratford Hotel in Philadelphia.

Jobs Credit Restored, Restricted

The Targeted Jobs Tax Credit (TJTC) is a federal program that promotes jobs for the disadvantaged by subsidizing their wages. It is aimed at hiring the handicapped, the unskilled, the veteran, the minority youth, and others economically disadvantaged or unemployable by providing incentives to companies to help create positions for them. Since its enactment by Congress in 1978, many food service chains have used this program successfully, including McDonald's, Kentucky Fried Chicken, Morrison's, and Shoney's.

Under prior law, "the credit was generally equal to 50 percent and 25 percent, respectively, of the first \$6,000 of first-year and second-year wages, for a maximum credit of \$4,500. The credit for economically disad-

vantaged summer youth employees was 85 percent of the first \$3,000 of wages, for a maximum credit of \$2,550."⁴³ The credit expired for employees beginning work after December 31, 1985.

The TJTC has been criticized as ineffective by many, including the Reagan administration which opposed it. A Brookings study in 1985 contended that "the targeted Jobs Tax Credit hurt job seekers by tainting them as hard-core unemployables."⁴⁴ Other opponents of the credit were critical for the jobs credit promoting what food service chains should have done anyway, hire disadvantaged employees.

Conversely, the NRA contended that without the TJTC program "some 563,000 people, otherwise unemployable, would not have had jobs in 1984."⁴⁵ They further note that "of the total TJTC certifications...25 to 35 percent were generated by food-service and its cousins, hotels, motels and clubs."⁴⁶

Despite heavy opposition, TRA 86 reactivated the TJTC by extending it for three years retroactive to wages paid to qualifying individuals who began work on January 1, 1986. But there will be no credit for second-year wages, and credit of only 40 percent, rather than 50 percent, for the first \$6,000 of first year wages. No credit will be allowed for certain short-term employees (i.e., qualifying individuals must be employed for at least 90 days or complete at least 120 hours of work for the employer).

In order to use the TJTC to reduce the tax payment for workers hired between January 1, 1986, and October 22, 1986 (the date the tax bill was signed into law by President Reagan), qualified individuals had to be certified by state agencies by hiring date. Since most states halted special certification programs after the original expiration date of December 31, 1985, some analysts noted that "1986 credits will only be claimed by workers hired after the reenactment date of October 22, 1986,"⁴⁷ thereby placing an added restriction on the new credit.

Reform Expected To Affect Future Mergers, Acquisitions

Some provisions of TRA 86 are expected to have significant economic effect on the structuring of future mergers and acquisitions, perhaps reversing the boom in mergers, restructurings, and takeovers that has taken place in the recent past.

Previously under the Supreme Court's General Utilities doctrine, "a corporation generally recognized no gain or loss on a distribution of assets to shareholders in liquidation or on a liquidation sale of its assets."⁴⁸ This doctrine provided generous write-offs for acquirers by boosting the depreciable value of acquired assets to their market values and allowing the write-offs of that amount over the asset's life. TRA 86 repeals the General Utilities rule "by requiring the recognition of all gains (or losses) on liquidations or deemed liquidations."⁴⁹ As a result, the new law would require full taxation of gains upon a step-up basis of acquired assets, significantly reducing the premium paid to shareholders of companies in leveraged buyouts and takeovers.

Additionally, TRA 86 substantially modifies the restrictions imposed on net operating loss (NOL) carryforwards following corporate acquisitions in several respects. Instead of reducing the amount of NOL carryforwards, as under prior law, TRA 86 limits the annual use of these

losses in the acquisition of a loss corporation to the fair market value of the acquired company on the date of change in ownership times the long-term federal exempt rate (published monthly by the Treasury Department). This approach is generally intended "to allow a loss corporation's NOL to be used no faster than a modest return on investment valued at the time the ownership change occurs."⁵⁰ The NOL is completely disallowed if the loss corporation fails to meet a continuity of business enterprise test in the two years following the shift in ownership.

Other effects of TRA 86 that will have a negative impact on future merger and acquisition activity include:

- The elimination of capital gains preferential treatment for selling shareholders.
- Divestitures and write-offs will be less valuable because of the reduction of top corporate tax rates from 46 percent in 1986 to 40 percent in 1987 and 34 percent in 1988 and beyond.
- The elimination or curtailment of some key tax breaks for acquiring companies might result in decreased market values for those firms.

Accordingly, fewer mergers, takeovers, and corporate raids may result from the aforementioned tax changes intended to discourage merger and acquisition activity. One significant side effect of TRA 86, however, was the acceleration of merger and acquisition trends before the end of 1986 in order for companies to take advantage of disappearing tax breaks (most of the provisions are effective on January 1, 1987). That is one reason why Texas Air attempted to complete its acquisition of Eastern Airlines in 1986.

Notwithstanding the likely decline in merger and acquisition activity, several experts contend "that low interest rates and a natural evolution that is occurring in many mature industries would allow the quickened pace of company restructuring to continue for some time."⁵¹ A survey released by Conference Board economists, a New York-based research institution, in September 1986 indicated that "for airlines the tax bill was likely to accelerate consolidations in the industry through mergers, acquisitions and bankruptcies."⁵²

Individual Rate Deductions Should Spur Demand For Services

The 1986 tax reform dramatically lowers the maximum tax rates for individuals from 50 to 28 percent when fully effective in 1988. It also increases the standard deduction and personal exemption amounts. Additionally, about six million lower-income taxpayers will be dropped from the tax rolls entirely while more than half of all individual taxpayers are expected to pay no higher than a 15 percent rate.

As a result of the above changes, federal income taxes paid by individual taxpayers are expected to decrease by over \$100 billion over the next five years. This tax reduction should trigger a corresponding increase in discretionary income. Although the outlook for the hospitality industry is too uncertain to quantify, some analysts have speculated

that the increased disposable income “may translate into \$15 billion for the food service industry over the next five years.”⁵³

Richard Simon, an industry analyst at Goldman, Sachs and Co. in New York, figured “that companies like MacDonald’s and Luby’s would gain the most since a major portion of the tax cuts will go to lower-income taxpayers.”⁵⁴ Similarly, George W. James, president of Airlines Economics, Inc., noted that “a reduction in personal and corporate rates will probably increase spending in air travel.”⁵⁵ This should, in turn, have a positive impact on all segments of the hospitality industry.

A New Corporate Alternative Minimum Tax Adopted

One of TRA 86’s more controversial corporate provisions involves the replacement of the old add-on minimum tax with an alternative minimum tax. Because of the public’s perception that highly profitable corporations employed tax preferences to eliminate their tax liabilities, this new tax was designed to ensure that no corporation with substantial economic income avoids payment of an equivalent amount in income taxes.

The alternative minimum tax is a very complex concept that comes into play when a large economic income produces very little or no federal income tax payment. In addition to computing the tax liability under the regular tax system, an alternative calculation is made—the alternative minimum tax—based on the addition of certain preference items (e.g., accelerated depreciation) to the regular taxable income. The corporation will then pay the greater of both amounts.

The new corporate alternative minimum tax rate is 20 percent and is subject to an exemption of \$40,000 that is phased out for higher income levels. In a political perception that too many profitable companies pay little or no tax, TRA 86 created a tax preference for 50 percent of the excess of book income (as reported on the financial statements) over alternative minimum tax income (before net operating losses). “This book-profit preference, though aiming at relatively few corporations, is expected to raise about \$20-\$25 million over five years.”⁵⁶

Moreover, the new alternative minimum tax is expected to affect many hospitality corporations because “its rate is close to the regular tax rate and due to the disallowance or limitations on the use of tax credits against the alternative minimum tax.”⁵⁷ Potentially hard hit by this new alternative tax are companies reporting book income in excess of taxable income and capital-intensive companies.

There are several provisions of TRA 86 that appear to be detrimental to small hotels, restaurants, and travel agencies, especially to those organized as regular corporations. Hence, these small corporations should fare worse than larger corporations under the new tax bill.

As noted earlier, a top corporate tax rate of 46 percent was reduced to 34 percent under TRA 86. But rates at the lower tax brackets will not drop as much, resulting in a reduced benefit for smaller corporations. That is, the tax rate for taxable income between \$25,000 and \$50,000 went down from 18 to 15 percent while the rate for income under \$25,000 remains at 15 percent.

Small hospitality firms have benefited to a greater degree from the investment tax credit, the targeted jobs tax credit, and the rehabilitation tax credit because of the relative values of credits versus deductions. In other words, a dollar of credit is always worth a full dollar, whereas a dollar of a deduction depends on the firm's tax bracket and thus worth only a percentage of a dollar. Eliminating the investment tax credit and limiting the targeted jobs credit (though extending it) and the rehabilitation tax credit "would have a disproportionately severe impact on smaller companies."⁵⁸

Under prior law, corporations could generally adopt either the cash receipts and disbursements method or the accrual method (i.e., income is recognized when services are performed regardless of when cash is received) for reporting purposes in calculating tax liability. With limited exceptions, TRA 86 requires the use of the accrual method for most corporations for years beginning after December 31, 1986. As a result, many small hospitality firms that had previously used the cash basis will now have to change to the accrual basis, imposing a particular burden for such companies. The adjustment attributable to the change in accounting methods will generally be included in income over a period not to exceed four years."⁵⁹

Other items of concern to small hospitality firms include:

- lengthening depreciation schedules
- abolishing the lower capital gains rate
- modifications in pension and executive compensation rules which are less beneficial to owners of closely held businesses
- more costly alternative minimum tax treatment where preference items are, in effect, added to regular taxable income

Structure For Small Enterprises Needs Re-Examination

The most crucial factor in weighing the impact of tax changes on small companies is the organizational structure of the firm. As outlined above, small corporate businesses could face a negative impact based on certain provisions of TRA 86. As a result, tax experts have been stressing the need to reexamine a firm's form of legal organization "to see if another form is more attractive from a tax vantage point."⁶⁰ S corporations, for instance, are seen as having special advantages for smaller enterprises. That is why "several lawyers and CPAs advised their clients who own small businesses to convert to an S corporation status before December 31, 1986."⁶¹

The S corporation (also known as Subchapter S corporation) is an organizational form in which the corporation itself is not taxed. Instead, all income, deductions, and credits flow through and are reported by the individual owners/shareholders. In this manner, the S corporation combines the tax advantage of partnerships for tax purposes with the limited liability features of corporations for legal purposes. Since corporate tax rates are higher than individual tax rates under TRA 86, it becomes more desirable to be taxed under the lower individual tax rates. In addition,

the new alternative corporate minimum tax would not apply to S corporations.

Many analysts believe that in future years S corporations will be "the rule for many small businesses, rather than the exception."⁶² However, S corporation election (or conversion) is not applicable or available in every case; for instance, a corporation must have 35 or fewer shareholders. Furthermore, not every business owner will find the S corporation an attractive alternative "since tax-favored fringed benefits that can be offered to S corporations are more limited than allowed for regular corporations."⁶³

Future Perspectives Leave Questions

The 1986 tax reform act represents a major attempt to eliminate tax inequities and interference with economic activity by removing tax consequences from economic decision-making. Accordingly, TRA 86 should help to promote efficiency and growth. In spite of that, the new law has received a good deal of criticism from economists who are concerned that the bill would depress the economy in the short run due to the early negative effects of reducing or eliminating direct investment incentives. Moreover, the growing prospect of new tax reform bills in the future, as the pressure builds to reduce the huge United States deficit, enhances uncertainty and thus may itself inhibit economic activity.

Overall, the reform act of 1986 is likely to have a positive impact in the hospitality industry, though it tends to penalize industrial firms. With the exception of small corporate businesses, the reduction in top corporate tax rates combined with the rise in travel and entertainment (triggered by the increase in personal discretionary income) should more than offset the negative impact that will result from the elimination of the investment tax credit and the limitation on depreciation write-offs and other tax incentives. In the lodging segment, the projected slowdown in new hotel construction resulting from TRA 86 may help to solve the current overbuilding problem. For airlines, the bill is expected to enhance the status of well positioned carriers and lower excess capacity in the industry, thereby strengthening prices over time.

It is too early to assess, however, how the revolutionary tax reform changes will interact with each other and what the final impact will be for the United States economy as a whole, or for the hospitality industry in particular. Further research will be needed to get final answers. For now, it is important to recognize and make efforts to understand the emerging trends. This will require the hospitality industry to develop new investment strategies and effective planning techniques in order to adapt to TRA 86's changes.

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