TAX REFORM ACT OF 1966

The United States Congress passed the Tax Reform Act (TRA86) of 1986 to simplify the income tax code, broaden the tax base and eliminate many tax shelters and other preferences. The top tax rate was lowered from 50% to 28% while the bottom rate was raised from 11% to 15% - the only time in the history of the U.S. income tax (which dates back to the passage of the Sixteenth Amendment in 1913) that the top rate was reduced and the bottom rate increased concomitantly. In addition, capital gains faced the same tax rate as ordinary income. Moreover, interest on consumer loans and state and local sales or income taxes was no longer deductible. The law increased the personal exemption and standard deduction.

The TRA86 also increased incentives favoring investment in owner-occupied housing relative to rental housing by increasing the Home Mortgage Interest Deduction. The imputed income an owner receives from an investment in owner-occupied housing has always escaped taxation, but TRA86 changed the treatment of imputed rent, local property taxes, and mortgage interest payments to favor homeownership, while phasing out many investment incentives for rental housing. Since low-income people are more likely to live in rental housing than in owner-occupied housing, this would have decreased the new supply of housing accessible to them.

The Low-Income Housing Tax Credit (LIHTC) is a tax credit created under the Tax Reform Act of 1986 that gives incentives for the development of housing aimed at low-income Americans. The TRA86 was hastily added to the TRA86 to provide some balance and encourage investment in multifamily housing for the poor.

Significance

- The Tax Reform Act lowered the top tax rate from 50 percent to 28 percent. The lowest tax rate was raised from 11 percent to 15 percent. This was the only time in US history that income tax was lowered at the top and raised at the bottom. Capital gains taxation was also adjusted to relate to ordinary income and faced the same tax rates. Credit card debt and consumer loan interest was removed as a deductible.

Features

- The Home Mortgage Interest Deduction as well as the Low-Income Housing Tax Credit were both added to the Tax Reform Act to provide incentives for people to invest in housing. The Act removed imputed income advantages from the establishment of rental properties. To prevent a lack of housing for lower income individuals and families that required rental properties, the Low-Income Housing Tax Credit was added to provide better balance.

Considerations

- The Tax Reform Act expanded the use of the Alternative Minimum Tax. Expenses such as medical costs, bond interest, union dues, state and local taxes, and personal exemptions could now trigger the Alternative Minimum Tax. The law was originally intended to target untaxed rich investors, however, as wages rose over the years, it targeted families in high tax states.

Effects

- One of the most significant effects of the Tax Reform Act was the removal of a number of tax shelters for real estate investments. During the early portion of the 1980s, a real estate boom was spreading throughout the country. A number of investors would pool resources and establish companies to manage various properties. This was considered a tax shelter for many passive investors. The Tax Reform Act removed this as a viable option for investors, prompting many to move into different markets.

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