



JOINT ECONOMIC COMMITTEE

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THE TAX REFORM ACT OF 1986: A PRIMER

As perhaps the broadest overhaul of the tax code in recent memory, the *Tax Reform Act of 1986* (TRA86) often stands as a reference point in discussions of future tax reforms. Although this reform looms large in the imagination of many policymakers, tax reform discussions are often hampered by a limited understanding of what changes to the tax code actually took place in 1986. This primer outlines the major changes of TRA86, as well as the current state of the code, in order to promote a better understanding of that often-cited legislation.

Lower individual and corporate tax rates

The *Tax Reform Act of 1986* lowered the top individual tax rate from 50 percent to 28 percent and lowered the top corporate tax rate from 46 percent to 28 percent. Especially for individual tax rates, which stood as high as 91 percent in 1964, this rate reduction represented the culmination of a long-term trend toward lower tax rates. High tax rates impose a drag on the economy by reducing the reward for productive activities such as work, saving, and investment. In the decade following 1986, however, Congress raised individual rates several times, leading to a current top rate of 35 percent.

Increased tax bias against saving and investment

TRA86 temporarily reversed a previous trend toward relieving the double taxation of saving and investment. Prior to 1986, Congress designed certain features of the tax code to encourage personal saving by individuals and investment by businesses. One such provision, the Individual Retirement Account (IRA), allows individuals to save without being penalized by the double taxation that occurs when earnings from investments made with already-taxed wages are again taxed. TRA86 placed new restrictions on the use of these accounts. The Act also repealed a partial exclusion for capital gains, thereby increasing the tax rate on investments that increase in value.

At the corporate level, the investment tax credit was repealed, and the value of tax deductions for the cost of investment was reduced by rules that forced businesses to stretch those depreciation deductions out over a longer period of time. Post-1986 amendments to the code moved again toward more tax-neutral savings treatment through expanded saving incentives like IRAs and reductions in tax rates on capital gains and dividend income.

Tax simplification: one step forward and one step back

The *Tax Reform Act of 1986* struck some gains for simplicity in the tax code, reducing the number of individual tax brackets from fourteen to two (currently, there are six brackets). Both the personal exemption and standard deduction were increased and inflation-indexed, relieving many low-income individuals of the need to itemize or even file taxes at all. Complexities such as income averaging and deductions for consumer interest and sales taxes were eliminated. Unfortunately, these individual-level simplicity improvements were overshadowed by a revision and expansion of the complicated business and individual Alternative Minimum Tax (AMT). Additionally, new rules about inventory, and especially new international taxation rules, grossly complicated business tax compliance. Since 1986, tax code complexity has steadily increased at both the individual and business levels.

The following table highlights certain characteristics of the tax system that were altered by the Tax Reform Act of 1986:

**Selected Tax System Characteristics:
Before and After the Tax Reform Act of 1986**

	Before TRA86 Enactment (Tax Year 1985)	After TRA86 Enactment (Tax Year 1986)	Current Law
Individuals			
Number of income brackets	14	2	5
Top tax rate	46	28	35
Treatment of saving	60 percent of capital gains excluded from tax	Capital gains exclusion repealed	15 percent capital gains rate
	IRAs for all workers	Income limits on IRAs for workers with pensions	Income limits on IRAs
Percent of tax filers claiming credits	20.7	16.4	29.2
Percent of filers claiming deductions	39.2	39.5	32.9
Corporations			
Top tax rate	50	34	35
Treatment of investment	Accelerated depreciation of investments	Less favorable investment depreciation	TRA86 depreciation system in place
	Investment tax credit	Investment tax credit repealed	No investment tax credit; Temporary bonus depreciation
Percent of filers subject to Alternative Minimum Tax	0.24	0.45	0.26

The **JEC Tax Simplification and Reform** series, to which this report contributes, addresses the growing bipartisan belief that the current tax code is broken and that opportunities exist for wholesale improvements. Future papers will explore topics including the difference between income and consumption taxes and issues in evaluating tax system fairness.