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A Primer on the Corporate Alternative Minimum Tax

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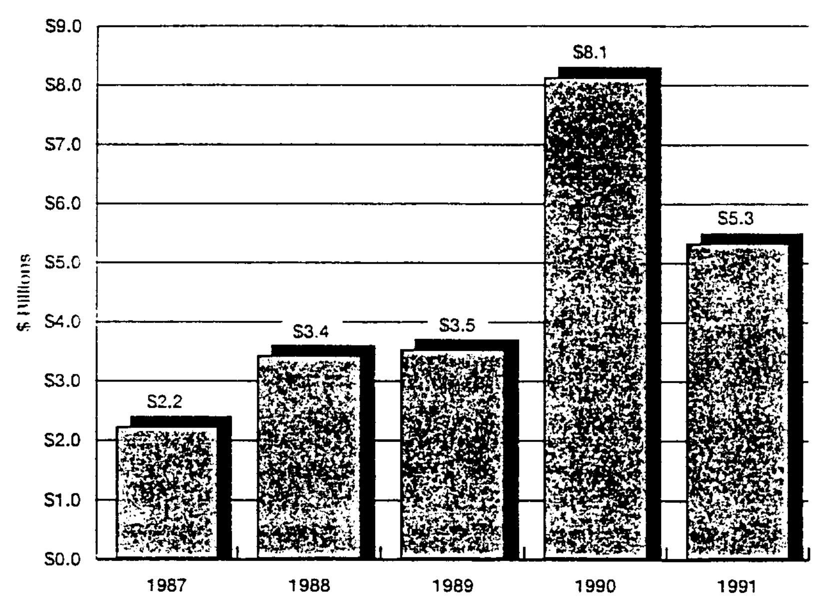
A new corporate alternative minimum tax (AMT) was enacted as part of the Tax Reform Act of 1986 (TRA86) to "serve one overriding objective," according to the House Ways and Means Committee report. That objective was to ensure that profitable corporations would not "avoid significant tax liability by using various exclusions, deductions, and credits" to which they were otherwise entitled. Thus, the AMT was consistent with the general thrust of TRA86 to broaden the base of the personal and corporate income tax systems while lowering tax rates. Unfortunately, the other main theme of TRA86, simplification, was partly sacrificed in the process.

Figure 1
Federal Corporate AMT Collections
1987-1991



Source: Tax Foundation; Internal Revenue Service.

The Economic Recovery Tax Act of 1981 (ERTA) planted the seeds for the AMT by allowing corporations to reduce current taxes paid in years with, for example, large capital investments. However, Congress began to reassess the pro-capital investment philosophy of ERTA, particularly in response to publicity focusing on some major U. S. corporations paying little tax yet reporting significant "book" income. The AMT was enacted to ensure that these corporations pay some minimum level of current taxes.

This objective of the corporate AMT has been achieved: Tax collections from many corporations have significantly increased and collections are more evenly distributed among firms and among industries. In 1991, 30,400 corporations had AMT liabilities totaling $5.3 billion. The National Association of Manufacturers claims that the AMT has become "the primary tax system" for some major industries, such as the automotive, steel, and mining industries.

Unfortunately, the effect of the AMT goes beyond simply increasing taxes on corporations. The AMT is a disincentive to investment, hits companies particularly hard during economic slowdowns when they can least afford it, and adds substantial complexity to the tax system. The Omnibus Budget Reconciliation Act of 1993 (OBRA93) contained modifications to the AMT which should alleviate some of these problems and investment disincentives. However, the tax continues to be controversial because its significant economic and compliance costs may exceed any intended policy gains.

The Corporate Income Tax

In fiscal year 1994, the federal government will collect about $131 billion from the corporate income tax, including both regular and AMT payments, representing 10.5 percent of total federal tax receipts. Corporate AMT receipts were $5.3 billion in 1991, the most recent year figures are available, down from $8.1 billion in 1990, but up from AMT payments during 1987 through 1989 (see *Figures 1* and *2*). Although 30,400 corporations paid AMT in 1991, 78 percent of that amount was paid by a few hundred large corporations with assets greater than $500 million.

A corporation's income subject to tax is equal to the corporation's gross receipts less a set of deductions, including depreciation, that reflect the cost of doing business. When a company invests in new assets, such as buildings or equipment, it allocates the costs over a number of years to match the future expected revenues from the assets. Part of that cost is deducted each year as depreciation, rather than the full cost being written off or expensed in the first year. (This paper focuses on depreciation because of its central importance to the AMT).

The tax code prescribes different rules for depreciation deductions, called capital consumption allowances, depending on such factors as when an asset was placed in service, its use, and how long before it is expected to wear out. Companies generally would prefer to depreciate new assets as quickly as possible since this will lower current taxable income and, therefore, current taxes owed. Just as individuals prefer one dollar of income today to one dollar in the future, companies tend to prefer higher depreciation deductions and the resulting lower tax burden today rather than tomorrow.

The 1981 Economic Recovery Tax Act (ERTA) implemented very favorable depreciation rules for corporations under the Accelerated Cost Recovery System (ACRS). ACRS allowed companies to depreciate assets over shorter periods with accelerated depreciation methods. Accelerated depreciation allows companies to make larger deductions in the early years of an asset's life than under straight-line depreciation. ACRS, along with a re-enacted investment tax credit, resulted in a significant tax reduction for some industries, particularly those with high levels of capital investment, including public utilities, mining, and many manufacturing industries.

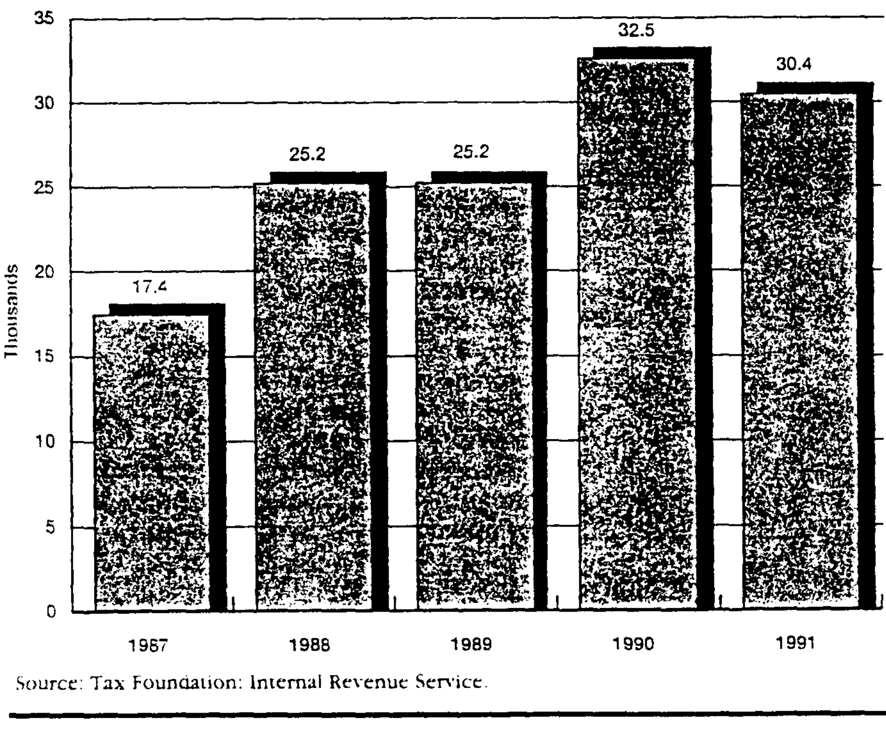
The new depreciation rules were partly in response to the high inflation of the 1970s which resulted in a heavy tax burden on the income from capital investment. Since inflation reduces the value of depreciation deductions received in future years, accelerated depreciation was considered a reasonable way to ensure that taxation on the income from new assets isn't excessive, i.e., that inflation combined with taxation doesn't produce a disincentive against new capital investment.

As the 1980s progressed and lower rates of inflation became the norm, some began to argue that ERTA had gone too far and that depreciation deductions were too generous. Some large corporations reporting significant book income were able to reduce their current tax payments to zero in some years, fueling publicity about a lack of "fairness" in the tax code. Responding to the public outcry, Congress reassessed ERTA and the House Ways and Means Committee gave the following rationale for a tough AMT in TRA86:

"The minimum tax provisions are designed to prevent taxpayers with substantial economic income from avoiding tax liability by using certain exclusions, deductions, and credits (referred to as "items of tax preference"). In applicable cases, the excess of ACRS deductions over depreciation deductions that would have been allowed had the taxpayer used the straight-line method over a prescribed recovery period is treated as an item of tax preference."

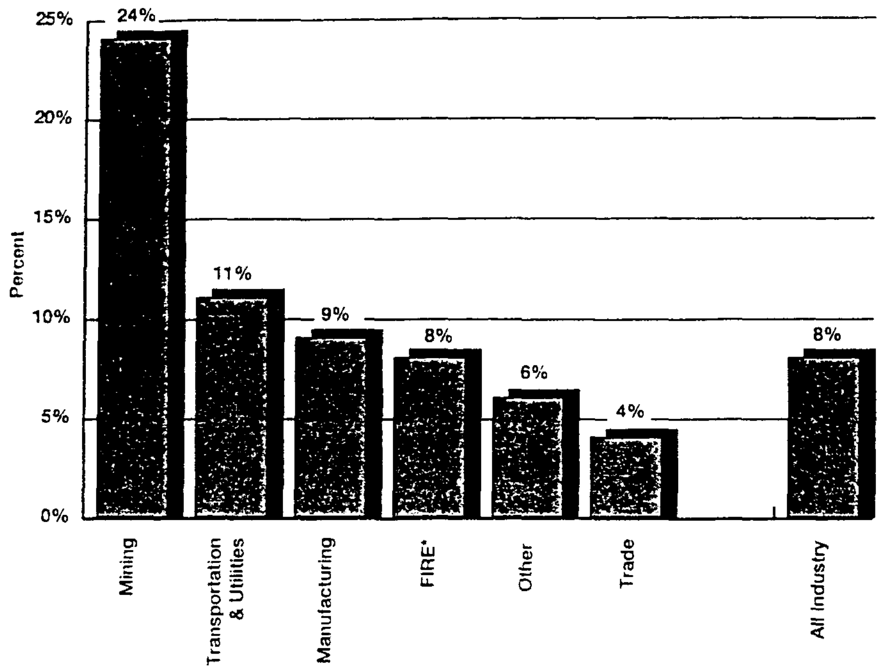
TRA86 was driven by the philosophy that eliminating special provisions in the tax code,

Figure 2
Number of Companies Paying AMT
1987-1991



Source: Tax Foundation; Internal Revenue Service.

Figure 3
AMT Paid as a Percent of Total Corporate Income Taxes, 1990



* Finance, insurance, and real estate.
Source: Tax Foundation; Internal Revenue Service.

such as accelerated depreciation, would expand the tax base sufficiently to allow for a significant reduction in tax rates. It was thought that this policy shift would both reduce disincentives to work, save, and invest caused by high tax rates and, by eliminating special provisions, make the tax code more neutral between different types of economic activity.

The AMT Structure

The AMT works like a separate corporate income tax parallel to the regular tax system and, as such, roughly doubles the record-keeping requirements for much of the corporate income tax system. All corporations must go through the AMT calculations each year to see whether they owe AMT. It is a complex method of extracting a modest additional amount of tax revenue on top of regular corporate income tax—though certain industries such as airlines and mining face a heavy added tax bill from the AMT. (See *Figure 3* and *4*).

The AMT involves adding certain preferences and adjustments to regular taxable income in order to derive alternative minimum taxable income (AMTI). Preferences and adjustments are items a corporation may take to reduce regular taxable income but are disallowed under the AMT. Accelerated depreciation is the primary adjustment accounted for in the expanded AMTI base. This adjustment requires the use of less favorable 150 percent declining balance depreciation (for personal property) under the AMT rules, compared to 200 percent declining balance depreciation under the regular rules.

A company's tentative minimum tax liability is arrived at by applying the AMT tax rate of 20 percent to calculated AMTI. Since this rate is less than the regular corporate rate of 35 percent, a company pays AMT only when its taxable income under AMT rules is significantly higher than it is under the regular tax rules. The taxpayer pays the maximum of the tentative minimum tax liability and the regular income tax liability. If the tentative minimum tax liability is greater, the excess is referred to as AMT. AMT is paid in the current year but the taxpayer may credit this amount against future regular income tax liability.

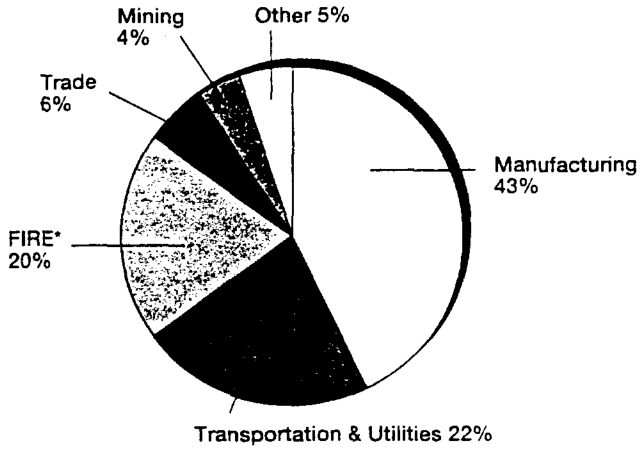
The Omnibus Budget Reconciliation Act of 1993 (OBRA93) eliminated one of the most troublesome features of the AMT, known as Adjusted Current Earnings (ACE). For investments between 1990 and 1993, firms were required to perform a third set of depreciation calculations, in addition to the regular and AMTI calculations. These calculations, using less favorable straight-line depreciation, were used to arrive at a company's ACE, which was usually higher than AMTI. If it was higher, companies were required to increase AMTI by 75 percent of the difference between the two and apply the AMT tax rate to the new, higher base. The ACE calculation was repealed by OBRA93 for new assets put in service after December 31, 1993.

The Operation of the AMT

Aside from ensuring "fairness," it has been contended that the AMT contributes to economic efficiency as well, by helping to spread the tax load more widely and evenly. This would even out pre-tax returns on different investments and allow investment to flow to the most productive companies and industries, and not just to the less tax-burdened.

However, the AMT may create this "level playing field" for investment at the cost of a lower level of total capital investment. It is true that if some industries are less tax-burdened they will attract relatively "too much" capital, compared to what may exist if the playing field were level. By imposing an AMT, taxes will be increased and capital

Figure 4
AMT Collections by Industry, 1990



* Finance, insurance, and real estate.

Source: Tax Foundation, Internal Revenue Service.

reduced in these industries. Therefore, the economic gain realized by leveling taxation across industries has been achieved at the economic cost of less total capital investment in the economy.

In addition to the economic cost of lost investment, the AMT increases resources wasted on tax compliance efforts. The AMT increases the complexity of the corporate tax system significantly because companies effectively face a dual tax system with different tax rates and deduction rules under the AMT and regular systems. Many have observed wryly that the AMT is a "jobs program" for tax accountants since, with the AMT, corporations must keep an additional set of depreciation records for tax purposes. But more importantly, business investment planning becomes more complicated because calculating the after-tax return from an investment becomes more uncertain. Companies invest when the after-tax net return of an investment over its lifetime exceeds a certain threshold. Since many firms do not know whether they will be in regular or AMT tax status in future years, they do not know what effective tax rate their investment will face and hence are uncertain about the return they can expect.

Burton Smoliar, tax counsel at Ford Motor Company, has noted, "Complexity has been a continuing complaint about the Internal Revenue Code, but the AMT depreciation rules raise complexity to new heights of absurdity. In fact, a recent Tax Foundation study conducted by Professors Joel Slemrod of the University of Michigan and Marsha Blumenthal of the University of St. Thomas found in surveying 362 large U. S. corporations that the AMT was the second most complex part of the corporate tax code.

Also, the AMT has the perverse effect of raising a firm's effective tax rate during economic slowdowns. Smoliar notes, "[t]he irony of the alternative minimum tax is that its application is usually triggered by an economic downturn during which the taxpayer experiences declining profits." In recognition of this, the 1993 commission appointed by President Clinton and the Congress to look into the ailing airline industry recommended "[a]mending the AMT so that airlines and other capital intensive industries are not forced to pay taxes at a time when they report losses." They observed that, "[f]rom 1990 to 1992, the airline industry lost $10 billion yet paid $670 million in Alternative Minimum Tax (AMT)," and that as a result, ". . . some airlines have had to borrow to pay taxes. "

Conclusion

Proponents of the tough corporate AMT enacted in TRA86 were successful in their goal of increasing tax payments by some corporations which had reduced their current tax liability by taking large depreciation and other deductions as allowed in the tax code. Whether or not this is a victory for "fairness" is debatable. Lowell Dworin, Director of the Office of Tax Analysis at the U. S. Treasury, notes that "[s]ince people, not corporations, ultimately bear the burden of all taxes, it is questionable whether the reality of fairness was harmed by large and apparently profitable corporations paying little or no tax."

Nonetheless, it is desirable that the tax code strive for neutrality and not benefit investments in some industries or types of assets more than others. Proponents of the AMT argue that by limiting allowable tax deductions and credits, the AMT contributes to such neutrality. However, if these preference items in the tax code actually create disparities, then the appropriate policy would be to reduce them, rather than to impose a complicated alternative minimum tax system to reduce disparities through the back door. That is, the goal of greater neutrality can be achieved without adding additional complexity to the tax system. This complexity places significant planning difficulties and investment disincentives on corporate business. While OBRA93 contained an important simplification of the AMT, the costs of the AMT certainly appear to outweigh the benefits.

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