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The Economic and Policy Implications of Repealing the Corporate Alternative Minimum Tax

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Executive Summary

The corporate alternative minimum tax (AMT) was enacted in its current form in 1986 in response to claims that many large corporations were making excessive use of deductions and other tax preferences to significantly reduce or eliminate their corporate income tax liability. Meant to ensure that profitable corporations pay some income tax, the corporate AMT instead raises little revenue, distorts investment incentives and imposes heavy compliance costs.

Over the last fifteen years, there have been many calls for the repeal of the corporate AMT, but until last year, none ever resulted in legislation that passed either house of Congress. On October 24, 2001, the House of Representatives passed, as part of a broad economic stimulus package, a provision that would repeal the corporate AMT. The Senate did not follow suit when it considered its own version of the stimulus bill, and in December the President removed corporate AMT repeal from the agenda in an ultimately unsuccessful attempt to get other provisions of the bill through Congress. Current economic stimulus proposals would significantly reform, but not repeal, the corporate AMT.

In 1998, the most recent year for which official data are available, 18,360 firms paid an additional $3.4 billion in tax because of the AMT. Future corporate AMT collections are likely to be lower, around $1 billion per year, due to significant changes enacted in 1997 that took full effect in 1999. In comparison, the regular corporate income tax raises about $200 billion annually.

The corporate AMT is a parallel tax structure, meaning that any firm that may be affected must keep separate records specific to the intricacies of the corporate AMT in addition to its regular tax and regular accounting records. This requirement and the inherent complexity of the corporate AMT make compliance inordiately expensive. In fact, compliance costs associated with the corporate AMT are likely to exceed net tax receipts.

The corporate AMT has significant economic effects beyond the high associated compliance costs. Due to its special rules governing depreciation, foreign tax credits, and net operating losses—all intended to capture more corporate income in the taxable base—the corporate AMT actually discourages investment and misallocates scarce resources. These distortions ultimately result in fewer jobs, lower wages, higher prices, and slower economic growth.

The corporate AMT does not increase efficiency or improve fairness in any meaningful way. It nets little money for the government, imposes compliance costs that in some years are actually larger than collections, and encourages firms to cut back or shift their investments. The Congress's bipartisan Joint Committee on Taxation was undoubtedly correct in recommending that it be repealed.

Proponents of the corporate AMT, whether they recognize these distortions and costs or not, argue that the tax improves fairness, discourages investment in tax preferred assets, and is necessary to prevent corporations from using tax shelters to eliminate their income tax liability. It is not clear, however, that the AMT does improve fairness or limit the ability of corporations to avoid taxes. In any case, the corporate AMT is an extremely inefficient method of addressing these perceived problems. Much better would be to address policy concerns through the regular corporate income tax code and eliminate the complexity and inefficiencies associated with the corporate AMT.

The corporate AMT does not advance any legitimate purpose; that is, it does not increase efficiency or improve fairness in any meaningful way. It nets little money for the government—roughly $1 billion a year going forward. It imposes heavy compliance costs that in some years are actually larger than collections, and it encourages firms to cut back or shift their investments. The Congress's bipartisan Joint Committee on Taxation was undoubtedly correct in recommending that it be repealed.

Introduction

The corporate alternative minimum tax (AMT) was first enacted in response to stories in the media about profitable corporations paying little or no federal income tax. Meant to ensure that profitable corporations pay some income tax, the corporate AMT instead raises little revenue, distorts investment incentives, and imposes heavy compliance costs.

The corporate AMT was enacted in its current form in 1986 in response to claims that many large corporations were making excessive use of deductions and other tax preferences to significantly reduce or eliminate their corporate income tax liability. Over the last fifteen years, there have been many calls for the repeal of the corporate AMT.[1] Until last year, however, none of these calls ever resulted in a piece of legislation that passed either house of Congress. On October 24, 2001, the House of Representatives passed, as part of a broad economic stimulus package, a provision that would repeal the corporate AMT. The Senate did not follow suit when it considered its own version of the stimulus bill, and in December the President removed repeal of the corporate AMT from the agenda in an ultimately unsuccessful attempt to get other provisions of the bill through Congress. Because the corporate AMT continues to be an item for debate, now is a good time to examine its economic consequences.

Background

In 1998, the most recent year for which official data are available, 18,360 firms paid additional tax because of the AMT. In that year, the Treasury collected $3.4 billion in taxes from the corporate AMT.[2] This figure, however, does not reflect the likely level of current and future collections for two reasons. First, significant changes enacted in 1997 were not fully implemented until 1999. These changes are expected to reduce corporate

AMT collections by over $2 billion per year.[3] Second, corporations are able to claim a credit against their regular income tax for alternative minimum tax payments made in previous years. In some years, such as 1997 and 1998, total credits claimed exceed total collections. In these years, net corporate AMT receipts are negative. Taking these two factors into account, going forward, net corporate AMT collections are expected to average about $1 billion per year.

In comparison, the regular corporate income tax raises about $200 billion annually.[4] Thus, the corporate AMT accounts for only about one half of one percent of total corporate income tax collections. Although taxes raised by the corporate AMT have been and will continue to be small, the economic activity affected by the tax is not.

One way to measure the relative economic impact of the corporate AMT is to look at the percentage of total assets held by affected firms. The Department of the Treasury recently reported, "Over one-quarter of all corporate assets were held by companies paying higher taxes [in 1998] due to the AMT." The Treasury report also noted that the manufacturing sector is particularly hard hit by the corporate AMT. "Over one-half of all manufacturing assets were held by companies paying higher taxes under the AMT."[5]

These latest data are in line with past years. According to a 1995 General Accounting Office study, during the first five years that the current form of the corporate AMT was in effect (from 1987 through 1991), 49 percent of corporations with more than $50 million in assets had their tax payments increased in at least one year. The corporations that paid the AMT in at least one year between 1987 and 1991 accounted for 66.2 percent of all assets held in corporate form.[6]

The History of the Corporate AMT

In 1969, Congress adopted a minimum tax for both individuals and corporations. The corporate minimum tax, which was known as an "add-on" minimum tax, was separate from the regular corporate income tax and was paid in addition to it. The base for this tax was so-called "tax preferences" enjoyed by the taxpayer rather than the taxpayer's income. Selected tax preferences in excess of the $30,000 exemption amount were subject to a 10 percent tax.[7] Other than an increase in the tax rate to 15 percent in 1976, this early form of the minimum tax was largely unchanged until the Tax Reform Act of 1986 (TRA'86).

The corporate AMT raises little revenue, distorts investment incentives, and imposes heavy compliance costs. Moreover, it does not further its purported goal of improving the fairness of the tax system.

In 1986, Congress adopted the corporate AMT in its current form, responding to policy analyses and press reports that claimed many large and seemingly profitable corporations paid very little or no income tax.[8] According to the Senate Finance Committee's report on TRA'86, the principal objective in enacting the corporate AMT was to ensure that profitable corporations would not "avoid significant tax liability by using various exclusions, deductions and credits," to which they are entitled under the regular tax but which may result in taxable income that is not viewed as accurately reflecting profitability.[9]

Interestingly, other provisions of TRA'86 itself reduced the need for a corporate AMT by altering many of the preferences that enabled corporations to reduce their tax liability. Chief among these changes was a modification to depreciation rules. Under previous law, the Accelerated Cost Recovery System (ACRS) had greatly accelerated the depreciation deductions that firms could use on their tax returns as compared with the straight-line depreciation that they typically reported to their investors. As a result, many otherwise profitable corporations were able to report positive income on their financial reports while reporting little or no taxable income on their corporate returns.

The new tax depreciation system introduced by TRA'86, which applies to all property placed in service after 1987, is often referred to as modified ACRS (MACRS). Depreciation under MACRS is faster than straight-line depreciation, but it is significantly slower than the depreciation available between 1981 and 1986 under ACRS. Therefore, MACRS would have solved part of the perceived problem of financially profitable corporations paying too little tax by directly attacking the problem that the corporate AMT addressed indirectly.

Because of various problems with the corporate AMT, Congress enacted some significant changes to the tax in 1997.

Almost all credits against regular corporate tax, such as the research and development credit, are disallowed against the AMT.

That is when Congress altered the depreciation rules under the AMT to bring them more in line with the depreciation rules for regular taxable income. This significantly altered the size of total AMT collections. Prior to 1997, corporate AMT collections were approximately $4 billion per year. The Joint Committee on Taxation estimated that the 1997 changes would reduce AMT payments by approximately $2 billion per year.

The Structure of the Corporate AMT and Calculation of AMT Liability

The corporate AMT operates as a separate corporate income tax parallel to the regular corporate income tax. Unlike the earlier add-on minimum tax that it replaced, the current corporate AMT requires affected corporations to calculate their tax liability under two parallel tax systems. First, a corporation calculates its income tax liability under the regular corporate income tax; then it must calculate its tax liability under the corporate AMT. As the phrase "alternative minimum tax" implies, the corporation pays the greater of its regular tax liability or its liability under the AMT. Accordingly, if a corporation's regular tax liability exceeds its liability under the AMT, it pays its regular tax liability. If, however, its liability under the AMT is greater than its liability under the regular tax, it must pay its regular tax and an additional payment of the difference.[10] The additional payment of the difference between the tax liability calculated under the regular corporate tax rules and the corporate AMT rules is referred to as the AMT liability.[11]

In two principal ways the corporate AMT differs from the regular corporate income tax. First, the corporate AMT rate of 20 percent is substantially below the regular corporate income tax rate of 35 percent.[12] Second, the tax base for the corporate AMT, alternative minimum taxable income (AMTI), is broader than the regular corporate income tax base.[13]

AMTI is calculated by adding certain preferences and adjustments to regular taxable income. Preferences and adjustments are items a corporation may take to reduce regular taxable income but which are disallowed under the AMT. The slower depreciation allowed under AMT rules is the primary adjustment accounted for in the expanded AMTI base. In addition, the AMT imposes restrictions on the use of net operating losses and the foreign tax credit and requires a so-called "adjustment for current earnings."

The starting point for determining a taxpayer's AMT is its regular taxable income. In general, all rules that apply in determining taxable income apply in determining AMTI as well. A taxpayer's regular income tax liability after the foreign tax credit, but before other tax credits is referred to as its regular tax liability. The taxpayer then adds back various "preferences" and adjustments. AMTI is then reduced by an exemption amount. The taxpayer's tentative AMT liability (often called the tentative tax) is determined by applying the AMT tax rate to the taxpayer's AMTI, less any exemption amount.

The AMT permits deductions for operating losses (NOLs) from prior years. However, the amount of this deduction cannot exceed 90 percent of AMTI before the NOL is taken into account. Almost all credits against regular corporate tax, such as the research and development credit, are disallowed against the AMT. The only credit that is allowed is the foreign tax credit, which must be computed separately for regular and AMT tax purposes.[14]

The corporation is allowed a credit against its regular tax liability for prior years' minimum taxes paid. If a taxpayer starts paying the corporate AMT and never returns to paying the regular tax, then the AMT liabilities it pays over the years are permanent increases in its tax liability. Alternatively, if the taxpayer sometimes pays AMT but thereafter pays the regular tax often enough and in large enough amounts so that it exhausts its AMT credits, then the effect of the AMT is to accelerate the taxpayer's tax payments, not to increase them. In fact, in both 1997 and 1998 the amount of taxes collected by the AMT was less than the amount of AMT credit claimed against regular corporate tax payments. In 1997, the AMT resulted in $3.9 billion in taxes while the regular corporate income tax was reduced by $4.1 billion due to AMT credits claimed. In 1998, the AMT resulted in $3.3 billion in collections, while $3.4 billion in AMT credits were claimed.[15] For those corporations that will eventually fully utilize their AMT credits, the direct cost to the taxpayer (and value to the government) of the corporate AMT is the time value of money associated with the prepayment of the regular tax. The calculation of a corporation's AMT liability is summarized in Table 1.

Table 1: Computing the Corporate AMT

Step 1.	Compute taxable income (TI) as determined under regular tax rules.
Step 2.	Add to this amount any NOL deduction carried forward from another tax year claimed in computing TI for the current year.
Step 3.	Add or subtract the adjustments other than the alternative minimum tax NOL (AMT NOL) deduction and ACE adjustment.
Step 4.	Add "preference items."
	The result is pre-adjustment AMTI.
Step 5.	Add or subtract the adjusted current earnings (ACE) adjustment.
Step 6.	Subtract the AMT NOL deduction.
	The result is AMTI.
Step 7.	Subtract the exemption amount, if any.
	The result is the AMT tax base.
Step 8.	Apply to this base the AMT rate of 20 percent.
	The result is pre-foreign tax credit tentative minimum tax.
Step 9.	Subtract from this the AMT foreign tax credit.
	The result is the tentative minimum tax.
Step 10.	Compare the corporation's regular tax liability with its tentative minimum tax.[17] If a corporation's regular tax liability is larger than its tentative minimum tax, then its AMT liability is zero. If the tentative minimum tax is larger, its AMT liability is the excess of its tentative minimum tax liability over its regular tax liability.

The corporate AMT applies to all corporations other than: (1) those in their first year of existence (i.e., the tentative minimum tax of a corporation in its first year of existence is $0), and (2) corporations that are considered small (i.e., if the corporation has annual gross receipts of $7.5 million or less for all consecutive three-year periods beginning after 1993 and ending before the tax year in question).[16]

The seven most important "preference" items and other differences between the regular income tax and the AMT definition of income are depreciation, net operating losses (NOL), foreign tax credits, adjusted current earnings, completion methods, excess of depletion, and intangible drilling costs.

Depreciation

The largest difference between AMTI and regular taxable income results from the depreciation methods used under the two systems. Under the AMT, the method of depreciation for property, other than real property, is the 150 percent declining balance method. Under the regular tax system, taxpayers will generally use the 200 percent (double) declining balance method.[18] Property placed in service before 1999 has a longer depreciable life under the AMT rules than under regular tax rules. For property placed in service in 1999 or later, the depreciable lives under the corporate AMT and the regular tax rules are the same. Conforming the depreciable lives cuts AMT tax collections almost in half.

One of the most administratively burdensome differences between calculating regular tax liability and AMT liability results from the rules dealing with adjusted current earnings (ACE).

Net Operating Losses

AMTI is computed using the AMT NOL deduction rather than the regular tax NOL deduction. The amount of the AMT NOL that may be deducted from AMTI cannot exceed 90 percent of AMTI before the AMT NOL is taken into account. Under the regular tax, if a corporation has sufficient NOLs from prior years, it can reduce its taxable income for the current year down to zero. This allows the corporation to average out taxable income over several years, which is viewed as more accurately reflecting the company's total taxable income.

Foreign Tax Credits

The AMT foreign tax credit is calculated in much the same way as the foreign tax credit allowed under the regular tax, except that the foreign tax credit limit is calculated using AMTI instead of taxable income. The foreign tax credit limit is equal to the total U.S. tax (calculated before the foreign tax credit) multiplied by a fraction of foreign source income in the numerator and total worldwide income in the denominator. For AMT purposes, the foreign tax credit limit, the amount of worldwide income, and amount of foreign source income are recalculated using AMT rules. The amount of U.S. tax is also recalculated using AMT liability. When calculating the foreign tax credit limit for AMT purposes, the amount of the credit taken cannot exceed 90 percent of the AMT (calculated without taking into account the credit and the AMT net operating loss).

Adjusted Current Earnings

One of the most administratively burdensome of the differences between the two taxes results from the rules dealing with "adjusted current earnings" (ACE). A corporation's AMTI for any tax year is increased by 75 percent of the excess of the corporation's ACE over its AMTI determined without regard to the ACE adjustment and the AMT NOL.[19]

ACE is determined by statutory rules used for calculating "earnings and profits." This is a separate definition from either AMTI or regular taxable income, although it too, like AMTI, is calculated by starting with regular taxable income and then making various adjustments. Specifically, tax-exempt interest is included, the last-in, first-out method of accounting cannot be fully used, the installment sale method is disallowed, and the 70 percent dividends received deduction is disallowed. The ACE adjustment requires that a corporation keep at least three sets of books to calculate its taxes: one for regular tax, one for "normal" AMTI and a third for the ACE adjustments.

Completion Methods

AMTI is computed using the percentage-of-completion method of accounting for long-term contracts other than home-construction contracts. This method requires a corporation to "book" income associated with work in progress rather than waiting until the full contract has been completed. In contrast, the completed contract method, which is often allowed for regular tax purposes, allows the taxpayer to defer income until a contract is complete rather than having to include portions in gross income as the work proceeds.

Excess of Depletion

The excess of any percentage depletion deductions over the year-end adjusted AMT basis of the property on which the deduction is claimed is considered a preference and so must be added back to AMTI.

Intangible Drilling Costs

With respect to oil, gas and geothermal properties, intangible drilling costs (IDCs) are a preference to the extent that the excess IDCs for the tax year exceed 65 percent of the net income from the properties for the year, unless the corporation elects to amortize them over a 60-month period.

How the Corporate AMT Affects Firms' Behavior

Proponents of the corporate AMT frequently justify it as an attempt to prevent profitable corporations from using so many deductions, credits and other legal preferences that they do not have to pay any tax or pay only a token amount. Although the corporate AMT can increase tax collections from profitable firms that would otherwise pay little or no federal income tax, it does more than just increase corporate income tax collections. The AMT affects a wide range of behavior.

The corporate AMT affects decisions made and actions taken by firms because it changes the tax consequences of these choices. Corporations that pay the AMT have their depreciation schedules stretched out, their depletion allowances reduced, and their use of NOLs and foreign tax credits curtailed. These changes, which increase their tax bills, are at least partially offset by AMT credits they receive for the additional tax they pay as a result of the corporate AMT. These credits can be used in future years to offset their regular tax liability. However, because these credits cannot be used to reduce taxes below what they would be with the corporate AMT, many companies carry AMT credits on their books for years. Companies with excess credits

Corporations that pay the AMT have their depreciation schedules stretched out, their depletion allowances reduced, and their use of NOLs and foreign tax credits curtailed.

have their taxes increased by the AMT and have their incentives altered by it the same as corporations that currently pay the AMT. This is one reason why the corporate AMT can have effects that are disproportionate to total taxes collected.

There are four basic classes of argument against the corporate AMT. First, it discourages investment. Second, it misallocates resources. Third, it is administratively burdensome. Fourth, it makes for poor fiscal policy.

The Corporate AMT Discourages Investment

The corporate AMT discourages affected firms from investing in plant, equipment and other productive activities. There are two reasons for this. First and most obviously, "loopholes" that the AMT curtails are the same incentives that Congress bestowed to encourage such investment. The corporate AMT preferences and adjustments reduce the value of these incentives, thereby discouraging affected firms from making such investments.

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Second and less obviously, the reduced corporate AMT rate, coupled with corporate AMT credits that can be used against the corporation's regular tax liability in the future, reduce the effective marginal tax rate for firms affected by the corporate AMT. Such a reduction in the firm's effective marginal tax rate will make tax-advantaged investments less attractive. Thus, not only are AMT firms discouraged from investing in plant and equipment, they are also discouraged from such activities as advertising and research because these are expenditures that can be immediately expensed. On the other hand, the reduction in tax rate experienced by AMT firms will encourage them to invest in activities that are not tax advantaged, such as increasing cash reserves.

The most frequently reported adjustments and preferences on regular corporate tax returns are for depreciation and the ACE adjustment.[20] The rationale for providing such incentives is that the investments have beneficial effects on the economy that go beyond the private return earned by the investor. If the existence of so-called positive externalities can justify the special tax benefits, then it makes no sense to provide these benefits through one provision of the tax code (the regular corporate income tax) and to take them away with another (the corporation AMT). Alternatively, if they are not justified, they should not be provided in the tax code at all.

The Corporate AMT Misallocates Resources

The corporate AMT not only discourages investment, but also misallocates resources because it changes who makes specific investments, the legal form these investments take, how they are financed, and when they occur. These changes are all costly, and economically wasteful.

One of the keys to understanding the consequences of the corporate AMT comes from recognizing that it does not directly affect all firms. The corporate AMT does not prevent all firms from using typical tax preferences including deductions. It only affects a firm whose tax liability is increased or would be increased by the corporate AMT if the firm claimed all deductions, credits and other preferences permitted under the regular tax.[21] The investment incentives of firms that have not had their tax liabilities affected by the corporate AMT are not changed. The corporate AMT, thus, introduces an unlevel playing field between AMT and regular firms because the tax paid on the same investment varies depending upon whether a firm is paying the regular tax or the AMT.

Moreover, it is not surprising that firms in specific industries (such as manufacturing, mining and public utilities) are more likely to be affected by the corporate AMT than those in other industries. This is because the AMT decreases the expected value of any deductions taken in years in which the corporation will generate a loss by reducing the amount of deductions and restricting the use of NOLs. This reduces the incentive to invest in depreciable property, engage in research and development, or incur any other deductible expenses, including salaries of new hires. This change in investment incentives is not tied in any rational way to any legitimate governmental purpose (e.g., improving the efficiency of the economy or the provision of public goods).

The AMT also influences the form certain investments take. One of the largest and most important differences between the corporate AMT and the regular corporate income tax is the treatment of depreciation. For tax purposes, the lessor of leased property is generally considered the owner and therefore is able to depreciate the leased property. The lessee cannot depreciate the property but can deduct lease payments from its regular taxable income. Because lease expenses are not an adjustment or preference item, an AMT firm that leases property does not suffer the same disadvantage as a firm that owns property. Moreover, many of the benefits of accelerated depreciation can be passed through to the lessee in the form of reduced lease payments.[22] Thus, to the extent that the AMT causes firms to lease instead of own property, the effect is to impose additional costs of writing leases and the agency costs from separating the user from the residual claimant.

The AMT also discourages firms from using debt relative to equity to finance capital investments. Because dividends and retained earnings are not deductible from corporate income but interest payments are, a firm with more debt in its capital structure will (other things being equal) report smaller taxable income and pay a smaller tax liability. This smaller liability makes it more likely that the debt-financed firm will have to pay corporate AMT than an equity-financed corporation. Thus, the corporate AMT encourages firms to use less debt than they otherwise would.

The tax compliance costs of firms subject to the corporate AMT are 18 to 26 percent higher than firms that are not subject to the corporate AMT.

The AMT can also influence the timing of investment. Because AMT firms have higher hurdle rates for investment in depreciable property than other firms, they have a greater incentive to invest before they are subject to the AMT or after they come out of it. This encourages firms to shift the timing of their investments, an especially undesirable result from a general economic perspective because of the cyclical effects of the AMT.

Finally, because AMT liability is calculated on a consolidated basis, firms that expect to find themselves subject to the AMT have an incentive to merge with other firms. If the combined entity would not be subject to the AMT, but one of the two entities individually would, then the corporations have reduced their joint tax liability through the merger.[23] This incentive is likely to be especially strong in the case of conglomerate mergers because the incomes of the various businesses are likely to be uncorrelated. As a result, the constituent firms of a conglomerate can probably offset one another's tentative AMT liability. The investigation of the many tax planning costs associated with mergers and the preparation for mergers is outside the scope of this paper. Suffice it to say that the costs are considerable, and like all the other costs described in this section, they arise because of the corporate AMT and not for an economically beneficial reason.

The Corporate AMT Increases Tax Planning and Compliance Costs

The corporate AMT complicates the tax system and makes compliance more costly. According to a 1995 survey of large corporations conducted by Joel Slemrod and Marsha Blumenthal, the tax compliance costs of firms subject to the corporate AMT are 18 to 26 percent higher than firms that are not subject to the corporate AMT.[24] Most of the additional cost is derived from supplementary planning, record keeping, and form completion required by the corporate AMT rules. For example, instead of calculating the amount of tax owed once, the corporate AMT requires that each corporation that might potentially have to pay the tax keep at least three sets of general accounting records: one for regular tax compliance purposes, one for AMTI calculations, and a third for the ACE adjustments. Within these three sets of books, each firm must keep as many as five sets of depreciation records.

Because more firms are subject to the AMT during economic downturns than during periods of growth, the corporate AMT increases collections during recessions and decreases them during booms. This artificially accentuates natural market cycles and thereby tends to destabilize the economy.

For two reasons, the Slemrod and Blumenthal estimates of AMT compliance costs cannot be directly translated into an estimate of the aggregate cost of all businesses complying with the corporate AMT. First, firms that are subject to the corporate AMT are likely to have more complicated tax returns and more complex tax situations. For example, they are likely to use more depreciable property in their businesses and have the additional cost of dealing with those rules. This would suggest that the Slemrod and Blumenthal numbers overestimate the increased cost of complying with the corporate AMT.

Second, many companies that do not have their tax liabilities increased by the corporate AMT still must make AMT calculations and maintain the necessary records. Of the 365 respondents in the survey, 198 firms were not currently subject to the corporate AMT, yet 184 of the 198 kept the necessary records and made the relevant corporate AMT calculations. That non-AMT firms must keep the records necessary to calculate the corporate AMT suggests that Slemrod and Blumenthal's estimate of the additional compliance costs incurred by AMT firms could underestimate the total cost of complying with the corporate AMT.

Another detail of the methodology implies that their findings may substantially underestimate aggregate compliance costs. Specifically, to quantify AMT compliance costs, Slemrod and Blumenthal compared the compliance costs of firms currently paying the AMT with those who are not, but they did not exclude the AMT-related compliance costs of the firms in the latter group. Instead, these AMT-related compliance costs are incorporated into the firm's overall compliance costs and assumed to be associated with the company's regular tax liability. This assumption minimizes the difference between the compliance costs faced by AMT firms and compliance costs faced by regular tax firms.

The Slemrod and Blumenthal survey provides further support for the claim that costs of complying with the corporate AMT are very high. Three hundred and fifteen of the 365 tax officers who responded to the survey provided a response to the question, "What aspect of the current federal tax code was most responsible for the cost of complying with the tax system?" The two most frequently mentioned provisions were depreciation (118 responses) and the corporate AMT (115 responses). The third most frequently mentioned provision was the uniform capitalization (UNICAP) rules (85 responses) and the fourth was compliance with international or foreign taxes (44 responses).

The survey also asked, "What features of the Tax Reform Act of 1986 most contributed to complexity?" The answer most often given was the corporate AMT, which was mentioned by more than half of the responders. Specifically, of the 311 firms responding to the question, 189 mentioned the corporate AMT. The next most common response, with 138 mentions, was the UNICAP rules.

Finally, Slemrod and Blumenthal asked respondents to suggest reforms that would simplify compliance. Of the 256 respondents answering this question, 75 recommended greater uniformity between federal and state tax systems and 42 recommended greater uniformity between taxable income and financial accounting income. However, the current tax provision that drew the most criticism was the corporate AMT. Sixty-two respondents singled it out: 38 called for its elimination, 11 recommended it be simplified, and 13 proposed that the ACE adjustment be eliminated. In contrast, only 19 surveys mentioned the UNICAP rules and only 13 surveys mentioned the foreign tax credit.

Another indication of the high compliance costs associated with the corporate AMT is the amount of money that corporations spend each year just filling out IRS paperwork. A previous Tax Foundation paper included an estimate based on IRS paperwork calculations that corporations spend some 17.3 million hours just filling out AMT-related tax forms. At a very conservative cost of $34.66 per hour, this totals $600.1 million per year.[25]

The Corporate AMT is Poor Fiscal Policy

As a matter of fiscal policy, policy makers frequently wish to reduce taxes when the economy is in a slump and to increase taxes when the economy is in danger of overheating. The idea is that putting money into private hands can stimulate spending that will bring the economy out of a recession or possibly prevent one from occurring. Similarly, removing money from the private sector when the economy is in danger of overheating can help stave off an inflationary spiral.

Putting aside arguments for or against this general policy, the problem with using taxes as an instrument of fiscal policy is that it takes time to enact tax policy changes and additional time for those changes to have a real economic impact.

The most common arguments advanced in favor of the corporate AMT take the broad form that a corporate AMT will make the tax system fairer.

Because of the delay in seeing an effect from tax changes, economists are skeptical of the use of targeted tax policy as an instrument of fiscal policy.

However, tax polices that automatically decrease revenues when the economy is turning down and increase collections in booms are viewed by many economists as having a stabilizing effect on the economy. Thus, income tax systems, whether flat or progressive, are often viewed as more fiscally prudent than head taxes because collections decrease during recessions and increase during booms. The corporate AMT, however, works in exactly the opposite direction. Because more firms are subject to the AMT during economic downturns than during periods of growth, the corporate AMT increases collections during recessions and decreases them during booms. This artificially accentuates natural market cycles and thereby tends to destabilize the economy.

As an instrument of fiscal policy, the corporate AMT does more than take money out of private hands during recessions. It also tends to discourage corporations from investing in new plant and equipment.

Corporations are pushed into the AMT during recessions because their incomes fall. Because firms subject to the AMT have higher hurdle rates for investment than firms subject to the regular income tax, the AMT discourages firms from investing during recessions. Because increased investment is one road out of recession, the corporate AMT has the undesirable effect of making such increased investment and economic recovery less likely. The ultimate effect is typically the artificial prolongation of economic downturns.

The Response to Arguments in Favor of a Corporate AMT

Having described the arguments against the corporate AMT — that it discourages investment, misallocates resources, creates excess compliance costs, and is contrary to sound fiscal policy — we turn to the proponents. The most common arguments are that it improves the fairness of the tax system; that it discourages investment in tax preferred assets; and that it is necessary to prevent corporations from using tax shelters to eliminate their income tax liability.

Claim: The Corporate AMT Improves "Fairness"

The most common arguments advanced in favor of the corporate AMT take the broad form that a corporate AMT will make the tax system fairer. This argument usually takes one of two different forms: corporations should pay more in taxes; and a corporate AMT promotes vertical fairness. In its simplest form, the argument that corporations should pay higher taxes can be summarized by the often-cited quotation of Robert S. McIntyre, the director of Citizens for Tax Justice, "It's a scandal when members of the Fortune 500 pay less in taxes than the people who wipe their floors or type their letters."[26] At some level, this observation has an obvious emotional appeal. The balance sheets and income statements of many corporations show large cash flows and assets, including sometimes large amounts of cash on hand. It seems obvious that they can pay taxes. There are, however, two problems with this line of argument.

First, even assuming that corporations should pay more taxes, the corporate AMT is an especially poor way of seeing that they do. Because of its high compliance costs, low yield, and the misallocations it causes, the corporate AMT is a very inefficient way to collect taxes from corporations.[27] Far more effective would be to eliminate the corporate AMT and either raise the corporate tax rate (less than one percent) or reduce across the board the preferences that reduce firms' taxable income relative to their economic or book income. Indeed, either change could easily replace the taxes collected by the corporate AMT while at the same time practically eliminating the full cost of complying with the corporate AMT.

Second, it is important to remember that corporations do not pay taxes, people pay taxes. Ultimately, the economic burden of the corporate income tax, including the AMT, must be borne by individual workers, customers, and shareholders.[28] While the specific incidence of the corporate income tax has been a particularly contentious issue, the fact remains that people pay taxes and the fairness of the corporate AMT should be evaluated based on its consequences for individuals.

Many proponents of the corporate AMT justify the corporate AMT by arguing that it extracts tax dollars from wealthier people, increasing tax progressivity, or as economists would say, improving vertical equity.[29] There is a long-standing and extensive debate over whether the tax system should be progressive and if so, how progressive.[30] We do not intend to join in that debate in this paper, but what can be said here is that eliminating the corporate AMT would have little if any effect on the overall progressivity of the corporate income tax or taxes in general.

If proponents argue that the corporate AMT increases progressivity because wealthier people invest in AMT-susceptible corporations, then they are probably incorrect. There is probably no difference in the wealth of the shareholders in firms that are affected by the AMT and those that are not.

Alternatively, if proponents argue that the corporate AMT increases progressivity by taxing capital, which is more often owned by the wealthy, the argument has some merit. However, any increase in corporate taxes would have the same effect. Accordingly, if a general increase in corporate taxes is desirable, Congress should increase corporate tax collections directly either by raising tax rates or cutting back on the preferential treatment provided within the code, such as accelerated depreciation. Either would raise corporate taxes without incurring the compliance and other inefficiency costs associated with the corporate AMT.

Claim: The Corporate AMT Is Necessary to Discourage Investment in Tax Preferred Assets

Another argument that is sometimes made in support of the corporate AMT is that it discourages investment in tax preferred assets. As described above, much of the impact of the AMT is to change the form of the investment rather than to prevent it. Of course, to some extent the corporate AMT does discourage investment in tax preferred assets. However, it does so in a manner that is much more costly than simply reducing preferences. A better policy would be to reduce preferences across the board. If lawmakers think depreciation is too rapid or the depletion allowance for oil or natural gas is too high, they should change it directly.

The current compromise—large preferences and a corporate AMT—is a poor solution. It is the worst of both alternatives, akin to giving with the left hand and taking with the right. It does not generally discourage firms from making the tax favored investments. It only discourages those firms that are subject to the AMT from doing so.

Claim: The Corporate AMT is Necessary to Restrain Corporations' Use of Tax Shelters

Another argument that is sometimes made by proponents of the corporate AMT, or is at least implied by their comments, is that the corporate AMT is necessary to prevent corporations from using abusive tax shelters to eliminate their taxes. In the last five years or so, the media has focused a bright light on corporate tax shelters. As a result, there is a concern that corporations are making widespread use of abusive tax shelters. The proponents of the corporate AMT are concerned that its repeal would unleash the tax shelter market.

There are several facts that run counter to this claim. First, there are legal and nonlegal constraints on tax shelter activity. Admittedly, these constraints are imperfect, but they do operate. Second, and more to the point, the corporate AMT does little to constrain such activity because a corporation's managers can still eliminate their firm's tax liability through tax shelters. The corporate AMT simply requires them to use more shelters. The cost of this additional sheltering activity is probably minimal (because the documents are already drawn up and shelters are often priced as a percentage of the tax saved), but any extra time spent creating or finding additional shelters is time not spent in economically productive activity.

Conclusion

For the first time since its enactment fifteen years ago, Congress had before it a real opportunity to repeal the corporate AMT. Repeal would have had significant positive economic effects without substantially reducing the federal government's corporate income tax collections. The corporate AMT does not advance any legitimate purpose (it does not increase efficiency or improve fairness in any meaningful way); it nets little money for the government (roughly $1 billion a year going forward); it imposes heavy compliance costs (likely larger than net collections); and it encourages firms to cut back or shift their investments.

Notes

1 See, for examples, "Statement of Mark A. Bloomfield and Margo Thorning, American Council for Capital Formation, Before the House Committee on Ways and Means," June 6, 1991, and Andrew Lyon, *Cracking the Code: Making Sense of the Corporate Alternative Minimum Tax* (1997) pp. 129–137.

2 Patrice Treubert and William P. Jauquet, "Corporate Income Tax Returns–1998" *SOI Bulletin,* Summer 2001, Volume 21, No. 1, pp. 66–99.

3 Joint Committee on Taxation, Estimated Budget Effects of the Conference Agreement on the Revenue Provisions of H.R. 2014, the "Taxpayer Relief Act of 1997," JCX-39-97, July 30, 1997, p. 3.

4 John S. Barry, "The Corporate Tax Burden," *Tax Foundation Special Report* No. 107, October 2001, Tax Foundation, Washington, DC.

5 "Treasury Releases Data on the Corporate Alternative Minimum Tax," *Treasury News,* The Department of the Treasury, PO-762, November 6, 2001.

6 "Experience with the Corporate Alternative Minimum Tax," (Washington, DC: General Accounting Office), GAO/GGD-95-88, April 1995.

7 Unlike the current corporate AMT, tax credits were not restricted.

8 For example, Citizens for Tax Justice issued a report stating that more than 100 of the Fortune 500 corporations had not paid any federal income tax in at least one year during the early 1980s. Robert S. McIntyre and David Wilhem, "Corporate Taxpayers and Corporate Freeloaders: Four Years of Continuing, Legalized Tax Avoidance by America's Largest Corporations 1981-1984," (1985). Many similar studies had been issued for a number of years. See e.g., Thomas Edsall, "Study Says Some Firms Paid No U.S. Taxes," *The Washington Post,* December 15, 1981.

9 Senate Committee on Finance, "Report on the Tax Reform Act of 1986," Report No. 99-313, May 29, 1986, Title XI — Minimum Tax Provisions.

10 For purposes of determining whether a corporation's AMT liability or its regular tax liability is larger, the regular tax does not include the accumulated earnings tax, the personal holding company tax, the built-in gains tax, the tax on excess passive income of S corporations and additional taxes due to an investment credit recapture or low-income housing recapture.

11 This definition of a corporation's AMT tax liability ensures that the additional revenue raised by the corporate AMT equals the corporate AMT liability.

12 For large corporations, the regular corporate income tax is 35 percent. It is progressive at lower income levels and provides for recapture of the benefit of lower rates at higher incomes as described in the following table:

Taxable Income	Tax Rate
$50,000 or less	15%
$50,000 to $75,000	25%
$75,000 to $100,000	34%
$100,000 to $335,000	39%
$335,000 to $10,000,000	34%
$10,000,000 to $15,000,000	35%
$15,000,000 to $18,333,333	38%
over $18,333,333	35%

The extra 5 percent tax on income between $100,000 and $335,000 and the extra 3 percent tax on income between $15,000,000 and $18,333,333 are intended to "catch up" on the lower rates applied under $75,000 and under $10,000,000. The net effect is that if a corporation's taxable income is above $335,000, but less than $10,000,000, the average tax rate on all income is 34 percent; if corporate income is above $18,333,333, the average tax rate on all income is 35%.

13 The corporate AMT provides that tax is assessed on AMTI less an exemption amount. The maximum exemption amount for corporations is $40,000. It is phased out at the rate of 25 cents for every dollar of AMTI in excess of $150,000. Thus, the exemption amount is $0 for corporations having AMTI of $310,000 or more. For most corporations, the exemption amount will be zero, so they are effectively taxed at a 20 percent flat rate.

14 The credit is equal to the foreign income taxes paid, however it is subject to a limit equal to the amount of U.S. income tax owed (before taking the foreign tax credit into account) multiplied by the foreign source income of the taxpayer divided by the worldwide income of the taxpayer. This must be calculated separately for AMT purposes because both the amount of U.S. tax owed and the definition of income are different for AMT purposes that for regular tax purposes.

15 Treubert and Jauquet, ibid., p. 66.

16 Regulated investment companies (RICs) and real estate investment trusts (REITs), which are exempt from the regular tax, are not subject to AMT. Organizations that operate in these forms have to apportion items among their shareholders who will include them in their own individual AMT calculations. The character as preference items is determined at the entity level, which is then passed through to shareholders. The AMT applies on a consolidated basis and the AMT liability must be computed on a consolidated basis. Foreign corporations are also subject to the AMT, but only on their income and deductions that are effective-

ly connected with the conduct of a U.S. trade or business.

[17] For the purpose of this calculation, the regular tax liability is calculated without AMT credits.

[18] With both the 150 and 200 percent declining balance methods, the taxpayer switches to the straight-line method for the first tax year for which the straight-line method (using the adjusted basis as of the beginning of the year) yields a higher allowance. If, however, the taxpayer uses the straight-line depreciation for regular tax purposes, it also will use that method for AMT purposes. For purposes of both the AMT and the regular tax, real property is depreciated on a straight-line basis.

[19] Likewise, a corporation's AMTI is reduced by 75 percent of the excess of the corporation's pre-adjustment AMTI over its ACE. The reduction cannot exceed the excess of the total positive adjustments for all prior years over the total negative adjustments for all prior years.

[20] Lyon, ibid., pp. 40-41.

[21] A corporation's tax liability is increased by the corporate AMT if it pays the tax, has AMT credits that it cannot currently use because that would drive its AMT liability below its regular liability, or is paying the regular tax and has declined to make investments that would have put it into the corporate AMT. At the margin, such firms are all under the AMT. The Department of the Treasury recently reported that in 1998, 30,226 companies had increased tax liabilities due to the corporate AMT. 18,352 companies actually paid the AMT and 11,874 companies "had their use of tax credits limited by AMT rules." "Treasury Releases Data on the Corporate Alternative Minimum Tax," *Treasury News,* The Department of the Treasury, PO-762, November 6, 2001.

[22] The Department of the Treasury estimated that 84 percent of the benefits went to the lessees. "Preliminary Report on Safe-Harbor Leasing Activity in 1981," 15 *Tax Notes* 85 (1982).

[23] This benefit exists whether the AMT firm eventually uses its credits or not, but the benefit of a merger is greater if it does not exhaust them because there is a permanent reduction in tax from the merger if it does not exhaust the credits, but only a timing benefit if it eventually would use its credits.

[24] Joel B. Slemrod and Marsha Blumenthal, "The Income Tax Compliance Cost of Big Business," *Public Finance Quarterly,* Vol.24, No. 4, October 1996, pp. 411-438.

[25] J. Scott Moody, "The Cost of Complying with the U.S. Federal Income Tax," *Tax Foundation Background Paper,* No. 35, November 2000, Tax Foundation.

[26] As reported in Jeffrey H. Birnbaum and Alan S. Murray, *Showdown at Gucci Gulch: Lawmakers, Lobbyists and the Unlikely Triumph of Tax Reform* (New York, NY: Random House) 1987, p. 12.

[27] Some economists advocate replacing the corporate income tax with a value added tax (VAT) on the grounds that the corporate income tax is a particularly inefficient tax. See Harvey Rosen, *Public Finance,* 5th ed. (Columbus, OH: McGraw-Hill Higher Education) 1999, p. 449

[28] Michael L. Marlow, Ph.D., "A Primer on the Corporate Income Tax: Incidence, Efficiency, and Equity Issues," *Tax Foundation Background Paper,* No. 38, November 2001, Tax Foundation, Washington, DC.

[29] A tax system is progressive if the ratio of the tax paid by an individual to his income tends to increase with his income. That is to say, a progressive tax system is one in which the average tax rate is an increasing function of income.

[30] Joseph Bankman and Thomas Griffith, "Social Welfare and the Rate Structure: A New Look at Progressive Taxation," 75 California Law Review, December 1987, pp. 1905–1967.

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