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The Corporate Minimum Tax: Rationale, Effects, and Issues

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THE CORPORATE MINIMUM TAX: RATIONALE, EFFECTS, AND ISSUES

SUMMARY

During the mid-1980s, reports began to appear that highlighted the falling level of corporate taxes. Among the more eye-catching of the studies were those that detailed the significant number of firms that paid little or no taxes, despite earning large book profits. Policymakers in both Congress and the executive branch became concerned about the impact of tax-free corporations on the equity of the tax system.

The Tax Reform Act of 1986 curtailed or eliminated a number of the tax benefits that enabled some firms to avoid taxes. Its Alternative Minimum Tax (AMT) on corporations, however, was explicitly designed to substantially eliminate cases where profitable firms paid no taxes. Under the AMT, a firm calculates a tentative minimum tax liability based on a lower rate and a broader tax base than the regular corporate tax. Each corporation then pays the greater of its minimum tax or regular tax. Because the base of the AMT approximates book income, most profitable corporations -- at least theoretically -- should pay a minimum portion of their accounting profits in taxes every year.

According to early analyses, the minimum tax will be substantially successful in its goal of eliminating the existence of profitable firms with no tax liabilities. One study, for example, has calculated that with the AMT as part of the tax code, only 3 percent of corporations with book income over $100 million are able to avoid paying taxes. Assessments of its economic effects, however, are mixed. Some studies indicate the AMT improves economic efficiency while others conclude that the tax introduces additional distortions into the tax system.

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THE CORPORATE MINIMUM TAX: RATIONALE, EFFECTS, AND ISSUES

Of the sweeping changes in business taxation made by the Tax Reform Act of 1986 (Public Law 99-514), one of the most important was the adoption of an alternative minimum tax (AMT) for corporations. A minimum tax for corporations had been on the books prior to the Act, but was of the "add on" variety -- a tax that was paid in addition to a firm's regular tax and which applied only to certain types of income. Even with the add-on minimum tax, however, numerous firms were able to avoid paying any taxes at all, despite reporting substantial profits to their stockholders.

The Tax Reform Act's alternative minimum tax was designed to stop the spectacle of profitable firms paying no taxes at all by requiring, in effect, that most firms pay at least a minimum portion of each year's accounting profits in taxes. With the AMT, each firm is required to calculate two different tax liabilities each year: its regular tax liability, and its AMT liability, which is imposed at a lower rate on a broader base. Each corporation then pays whichever of the two tax liabilities is higher.

Early studies of the AMT indicate that the tax is successful in its primary goal: it probably does reduce the number of profitable corporations that are free of taxes. Its impact on economic efficiency, however, is less clear: some analyses have concluded that the AMT encourages undesirable levels of mergers and leasing, while other studies have found that it improves economic efficiency by evening out tax burdens on different types of investment.

This report begins by taking a closer look at the rationale for AMT and at criticisms that have been directed against the tax. It continues with a description of the actual provisions of the AMT, discusses the AMT's effects, and concludes with a description of current minimum tax issues.

RATIONALE FOR THE CORPORATE AMT

Perhaps the single most influential factor in the enactment of the AMT was the publication, beginning in the mid-1980s, of a series of reports detailing the falling level of the Federal corporate income tax. For example, following the enactment of safe-harbor leasing in 1981, stories began to appear in the press of corporations that were able to use the new leasing laws to buy and sell tax benefits. Safe-harbor leasing was repealed in 1982, but beginning in 1984, a "public interest" group called Citizens for Tax Justice (CTJ) began to publish studies that detailed how numerous profitable corporations were able to use provisions such as the investment tax credit and accelerated depreciation

to reduce their Federal taxes drastically and, in some cases, eliminate them altogether. CTJ's reports surveyed the tax payments of 250 large, profitable corporations over the period 1981-85. The reports found that a full 52 percent of the firms paid no Federal taxes in at least one of the years surveyed.[1]

The CTJ reports emphasized that corporations were able to reduce or eliminate their taxes using means that were entirely legal. This was indeed the case. Prior to the Tax Reform Act of 1986, the Federal tax code contained a wide variety of special exemptions, deductions, and tax credits that were initially placed in the tax code to encourage activities and investments thought to be socially or economically desirable. As a consequence of these tax incentives, taxable income, as defined in the tax code, was significantly narrower than the accounting concept of income firms use to report profits to stockholders. Thus, it was not unusual at all for a corporation to report large profits to its stockholders, but to report only small amounts of taxable income to the Internal Revenue Service.

The reports of the falling level of the corporate income tax led to concerns about the equity of the tax system. Commentators made the comparison between average individual taxpayers and large corporations that paid little or no taxes. One organization, for example, printed a poster that purported to represent the sentiments of an average individual taxpayer. The poster read "I pay more taxes than GE and WR Grace & Co. and General Dynamics and Boeing and Dow Chemical and Lockheed, all put together."[2]

As we shall see, some argue that the straightforward comparison of taxes paid by corporations on the one hand and individual taxpayers on the other may be an inappropriate way to assess the equity of the tax system. Many policymakers, however, were as much concerned about the perceived equity of the tax system as about the actual impact of corporations not paying taxes. Decision makers in both Congress and the executive branch were concerned that "the prospect of high-income corporations paying little or no tax threatens public confidence in the tax system."[3] A minimum tax on corporate income

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[1]Three reports were published by Citizens for Tax Justice prior to tax reform: *Corporate Income Taxes in the Reagan Years* (Washington, 1984); *Corporate Taxpayers and Corporate Freeloaders* (Washington, 1985); and *130 Reasons Why We Need Tax Reform* (Washington, 1986).

[2]Bilik, Al. Spokesperson, Citizens Organized to Restore an Effective Corporate Tax. Testimony before the Committee on Ways and Means. in U.S. Congress. House. Committee on Ways and Means. *Comprehensive Tax Reform.* Hearings before the Committee on Ways and Means. 99th Cong., 1st. Sess. Washington, U.S. Govt. Print. Off. 1985. Vol. 1, p. 370.

[3]U.S. President. Reagan (1981-89). *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity.* Washington. U.S. Govt. Print. Off. 1985. p. 334.

was thus included in the Administration's 1985 tax reform plan, as well as the House, Senate, and Conference Committee versions of the Tax Reform Act of 1986. A corporate AMT became law, effective with tax years beginning in 1987.

The general policy embodied by the corporate AMT can be viewed as a compromise between two broad policy goals that are occasionally in conflict. Under one policy, Congress has provided tax incentives that are designed to promote social and economic goals that it has determined are desirable. Under the other policy, however, Congress has determined that for the tax system to be equitable, no profitable firm should be able to escape paying some minimum share of its earnings in taxes. The conflict between the two policies arises because even after tax reform, the tax incentives mandated by the Internal Revenue Code are sufficiently numerous and large so that, if other provision were not made, some corporations might avoid paying taxes altogether. The minimum tax compromises; it is designed to ensure that every profitable firm pays at least some taxes. At the same time, it does not abolish the tax incentives contained in the regular tax; and as long as a firm pays a minimum portion of its income in taxes, the firm can still use tax incentives to reduce its tax liability.

CRITICISMS OF THE CORPORATE MINIMUM TAX

A number of objections to the AMT can and have been made. Perhaps the most serious criticism questions the very concept of equity on which the tax is based. According to the traditional "conduit" view of the firm, a corporation has no income of its own; its earnings are merely the income of its stockholders. Further, a firm's managers exercise little or no independence, functioning only to maximize the wealth of the stockholders. The entire burden of the corporate income tax is thus borne by stockholders in the short run and is diffused among all owners of capital in the long run. According to this view of the firm, then, the benefit that occurs when a particular corporation does not pay taxes is shared among a broad range of economic actors. It is thus deemed inappropriate to judge equity based on the comparison of a particular corporation with an average individual taxpayer.

Another criticism of the AMT questions the merits of the corporate income tax in general because of its economic effects. According to this view, the regular corporate income tax creates a bias against investment in the corporate sector because corporate-source income is taxed twice: once at the corporate level, and once in the hands of stockholders and creditors under the individual income tax. Because the minimum tax increases the level of tax payments at the corporate level, it is argued that the AMT exacerbates the problems posed by double-taxation of corporate-source income.

Critics of the corporate AMT have also pointed out that the minimum tax results in one part of the tax code curtailing incentives provided in other sections of the code. Accordingly, the AMT has been characterized as a policy of contradiction rather than one of compromise. Each tax incentive, it is

argued, should be judged on its own merits as an individual element of tax policy. If a tax incentive is undesirable, then it should be eliminated or curtailed under the regular corporate income tax, not through a cumbersome mechanism such as the AMT. If an incentive is judged to be appropriate, then it should not be muted in some cases by the AMT.[4]

Opponents of the corporate AMT have also pointed out that it adds a considerable degree of complexity to the tax code, and hence complicates corporate decisions about investments. With the AMT, they point out, every corporation has to maintain at least two sets of books for tax purposes -- one for the regular corporate income tax, and one for the AMT.

PROVISIONS OF THE CORPORATE MINIMUM TAX

The corporate AMT is essentially a separate income tax that parallels the regular corporate income tax. It fits into the tax structure in following way: each year, every corporation has a tentative tax liability under both the regular corporate income tax and under the corporate minimum tax. The two liabilities ordinarily differ because the minimum tax is imposed at a lower rate than the regular tax and on a broader base. Technically, each corporation then pays its regular tax plus the amount (if any) by which its minimum tax exceeds its regular tax. In effect, however, the AMT results in a firm paying either its regular tax or its minimum tax, whichever is higher.

The minimum tax is imposed at a 20 percent rate on minimum taxable income in excess of a $40,000 exemption (the statutory tax rate for most corporations under the regular tax is 34 percent). Minimum taxable income, in turn, is defined more broadly than regular taxable income in a number of respects. First, a number of cost and income items are calculated differently under the minimum tax. These "adjustments" generally result in the recognition of income sooner under the AMT than the regular tax and so result in less generous treatment for taxpayers under the AMT. Adjustment items include:

1. Depreciation
2. Cost of pollution control facilities
3. Mining exploration and development costs
4. Contributions of shipping companies to capital construction funds
5. Income from installment sales
6. Special deduction of Blue Cross/Blue Shield organizations
7. Net operating losses
8. Completed contract method of accounting

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[4]See, for example: Shapiro, Ira H. Testimony before the Senate Finance Committee. in U.S. Congress. Senate. Committee on Finance. *Tax Reform Proposals -- VIII*. Hearings before the Senate Committee on Finance. 99th Cong., 1st Sess. Washington. U.S. Govt. Print. Off. 1986. p. 151.

Second, certain items that are primarily tax exemptions and deductions (termed tax "preferences") that are permitted under the regular income tax are not permitted at all under the AMT or are substantially reduced. These include:

1. Percentage depletion
2. Intangible drilling costs related to oil, gas, and geothermal wells
3. Tax-exempt interest on private activity bonds
4. Charitable contributions of appreciated property
5. Excess bad debt reserves of financial institutions

Finally, probably the broadest item that is included in minimum taxable income is the so-called "book income" tax preference. Once a corporation has calculated minimum taxable income on the basis of the above adjustments and preferences, it must also include 50 percent of the difference between its other taxable income and its book income as reported in its financial statements to stockholders. The book income preference has been termed a "backstop" for the minimum tax. If a profitable corporation manages to avoid a tax liability despite the preferences and adjustments explicitly included in minimum taxable income, the book income preference is designed to ensure that the corporation nonetheless pays some taxes.

Beginning in 1990, the book income preference is scheduled to be replaced by a preference based on 75 percent of the difference between other minimum taxable income and "adjusted current earnings (ACE)." As with book income, ACE is a concept of income that is generally broader than taxable income for regular tax purposes. In contrast to book income, however, which depends on a firm's own financial statements and accounting methods, ACE is based on concepts of income contained in the Internal Revenue Code. As described below in the final section of this report, the impending change from book income to ACE remains controversial. As the date of the changeover gets closer, it is probable that the merits of actually carrying it out will become the focus of debate.

The possibility that a corporation may be subject to the minimum tax in some years but not in others necessitates provision for a minimum tax credit that is designed to coordinate the minimum and regular taxes. The credit reduces the possibility that a firm will be taxed twice on the same income -- once under the minimum tax and once under the regular tax.

The possibility of double-taxation arises because of the difference in timing of some items of income and deduction under the regular and minimum tax; examples of timing differences include the minimum tax "adjustments" listed above. Consider, for example, the case of a depreciable asset. Under the regular corporate income tax, depreciation deductions with respect to the asset can be claimed sooner than under the AMT. As a consequence, income from the asset is recognized sooner for AMT purposes than it is for regular

tax purposes. Without the minimum tax credit, if the corporation that owns the asset is subject to the minimum tax in the asset's early years and the regular tax in its later years, it may pay taxes on some of the asset's income under both the minimum tax and the regular tax.

Under the minimum tax credit's provisions, a corporation is permitted to credit the excess of its minimum tax over its regular tax against its regular tax in future years. The credit, however, is not permitted to offset future years' minimum tax. Further, in calculating the excess of minimum tax over regular tax, only the amount of the excess that is due to timing differences is permitted to generate credits.

EFFECTS OF THE CORPORATE AMT

As noted above, the primary purpose of the corporate AMT is to ensure that few profitable corporations escape paying taxes. While it is still too soon for an assessment of the AMT based on actual tax return data, estimates based on the pattern of corporate tax payments prior to the AMT suggest that the AMT will be successful in its goal.

A 1987 study by Dworin that used the U.S. Treasury's Corporate Tax Model to assess the effects of the minimum tax concluded that the AMT "certainly appears to go far towards ensuring that some taxes are paid by nearly all profitable firms."[5] Table 1, below, is reproduced from that study and shows the estimated percentage of profitable firms not paying taxes prior to the Tax Reform Act of 1986 and under current law. For current law, the table presents the percent of tax-free firms with the minimum tax as well as the estimated percent that would not pay taxes if there were no AMT. It is thus possible to distinguish the impact of the AMT from that of other Tax Reform Act provisions by examining the table.

The last line of the table shows that the Tax Reform Act in general greatly reduced the percentage of firms not paying taxes. Prior to the Act, 32.5 percent of corporations paid no taxes; only 13.6 percent of firms are estimated to be tax-free under current law. The table also suggests, however, that the AMT was responsible for only a small part of the reduction. With the AMT, 13.6 percent of profitable firms are estimated to avoid taxes; without the AMT an estimated 15.5 percent would not pay taxes.

The table also indicates, however, that the AMT's impact on firms with large incomes is indeed pronounced. For example, an estimated 25 percent of corporations with profits in excess of $100,000,000 would not pay taxes if the AMT were not in place; only 3 percent are estimated to be tax-free with the minimum tax. The table thus shows that the AMT substantially eliminates

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[5]Dworin, Lowell. *Impact of the Corporate Minimum Tax.* National Tax Journal. v. 40. September 1987. p. 513.

tax avoidance of the most spectacular kind that is most damaging to the perceived equity of the tax system: the lack of tax payments by highly profitable firms.

TABLE 1. Estimated Impact of the Corporate AMT on the Percent of Corporations not Paying Taxes

Book Income Class ($ thousands)	Percent of Profitable Firms Paying no Taxes		
		Current Law	
	Prior Law	Without AMT	With AMT
0 - 100	34.0%	15.6%	14.7%
100 - 1,000	16.5	13.3	2.4
1,000 - 100,000	19.2	22.2	2.8
Over 100,000	8.8	25.0	3.0
Total	32.5	15.5	13.6

Source: Dworin, Lowell. *Impact of the Corporate Minimum Tax.* National Tax Journal. v. 40. September 1987. p. 512.

The same study also suggests that a substantial number of corporations will actually be subject to the AMT. It estimates that over 20 percent of corporations with book income in excess of $100 million will pay the minimum tax.[6]

While the corporate AMT may well be successful in reducing the number of corporations that do not pay taxes, whether or not it is beneficial to economic efficiency is less clear. On the one hand, several analysts have argued that the AMT distorts corporate behavior by encouraging economically inefficient levels of activities such as mergers and leasing. For example, a corporation that has high potential for being subject to the AMT may merge with a firm that has fewer tax preferences in order to reduce its exposure to the minimum tax. Or a firm that would be thrust into minimum tax status

[6]Ibid., p. 513.

by accelerated depreciation deductions on purchased equipment may find it more profitable to lease the equipment instead.[7]

At least one other study, however, has found that the corporate AMT actually improves economic efficiency in a number of respects. A recent analysis by Bernheim found that the AMT compresses the range of effective tax rates across different asset types. Firms are thus less inclined to make investment decisions on the basis of taxes rather than on the respective pre-tax productivity of different assets. Bernheim also found that the AMT's burden falls more heavily on firms that are relatively lightly taxed under the regular tax. Accordingly, the AMT tends to even-out the dispersion of tax burdens paid by different corporations firms, thus reducing the misallocation of investment funds among firms.[8]

Bernheim also concluded that despite the fact that the AMT increases tax revenue it does not result in an appreciable increase in the tax burden on marginal (new) corporate investment. In Bernheim's analysis, the minimum tax reduces the tax burden on investment financed with either retained earnings or the issuance of new shares but increases the effective tax rate on debt-financed investment. Most firms, however, finance investment with a mixture of debt and equity and according to Bernheim the reduced tax burden on equity roughly offsets the increased burden on debt.

Bernheim's study also concluded that the AMT does not result in an increased level of either mergers or leasing.

CURRENT MINIMUM TAX ISSUES

Several issues have helped keep the corporate AMT a focus of attention. One question that has risen on several occasions is whether the minimum tax should be used as a device to raise additional tax revenue. In 1987, for example, an increase in the minimum tax rate from 20 to 21 percent was listed as an

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[7]See: Sunley, Emil M. Minimum Income Taxation: the U.S. Experience. in Canadian Tax Foundation. *Report of Proceedings of the 37th Tax Conference.* Toronto. Canadian Tax Foundation. 1985. p. 11:2; and Dildine, Larry L. *Evaluating the Impact of the Corporate Alternative Minimum Tax on Equipment Leasing.* in Stocker, Frederick D., ed. *1987 Proceedings of the 80th Annual Conference on Taxation, National Tax Association-Tax Institute of America.* Columbus, OH. NTA-TIA. 1988. p. 147.

[8]Bernheim, B. Douglas. Incentive Effects of the Corporate Alternative Minimum Tax. in Lawrence Summers, ed. *Tax Policy and the Economy.* NBER Conference Report. Washington. National Bureau of Economic Research. 1988. p. 2-42.

option the House Ways and Means Committee might consider in raising revenue; the rate increase was estimated to raise $1.3 billion over 3 yeas (Fiscl Years 1988-90).[9] The subsequent House-passed version of the Omnibus Budget Reconciliation Act of 1987 (OBRA) did contain an increase in the AMT, albeit a different one. The measure would have increased the portion of book income included in minimum taxable income from 50 percent to 100 percent. The House provision was not included, however, in the version of OBRA that was finally enacted.

Raising the minimum tax would likely increase the complexity of the tax system; any increase in the AMT's level would increase the number of firms that would have to plan for the possibility of facing the AMT. For any particular firm, the probability of exposure to the minimum increases the closer the minimum tax rate is to the regular tax rate. And, for any given corporation, the likelihood of facing the minimum tax increases as the definition of minimum taxable income is broadened. Thus, an increase in either the minimum tax rate or in the scope of minimum taxable income would mean an increase the number of firms that must reckon with the AMT.

The probable added complexity from raising the AMT weakens the rationale for using it to raise revenue rather than relying on the nearest alternative: the regular corporate income tax. While it might be argued by some that an increase in the AMT would apply more evenly among taxpayers because of the AMT's broader base, increasing revenues by broadening the regular corporate income tax base would also improve the evenness of the business tax burden.

An increase in the minimum tax might be more easily justified on the basis of its primary goal: enhancing the equity of the tax system. Some might argue, for example, that while the AMT has increased corporate tax payments, there are still profitable firms that do not pay taxes. Thus, an adjustment to the AMT's base might be warranted in order to better accomplish the AMT's equity goal.

Another minimum tax issue concerns the scheduled 1990 switch from the book income tax preference to ACE. As noted above, the book income preference links at least part of the AMT's definition of income to accounting concepts used in corporations' own financial reports. In contrast, ACE relies primarily on concepts set forth in the Internal Revenue Code itself.[10] Indeed, the reliance

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[9]U.S. Congress. Joint Committee on Taxation. *Description of Possible Options to Increase Revenue Prepared for the Committee on Ways and Means.* Joint Committee Print. 100th Cong., 1st Sess. Washington, U.S. Govt. Print. Off. 1987. p. 243.

[10]The definition of ACE relies heavily on the tax code's "earnings and profits" concept, a definition of corporate income that is used to calculate taxable dividends and for other purposes.

of book income on concepts not found in the pages of the tax code is the reason the preference is being changed.[11]

While both book income and ACE rely on definitions of income that are similarly broad, there are differences; and any particular corporation may find that its ACE preference will differ in size from its book income preference. In the aggregate, change to ACE, is estimated to be roughly revenue neutral, neither losing nor gaining tax revenue.[12]

Prominent among the differences between ACE and book income is depreciation. Industry critics of ACE contend that ACE depreciation can, in some circumstances, be considerably less generous than depreciation under the book income preference. Accordingly, it is argued that the change from book income will be detrimental to capital intensive firms that invest heavily in depreciable assets. Complexity is another issue raised by the impending change to ACE. Under ACE, a number of different tentative depreciation calculations must be made for each asset before arriving at the final depreciation deduction. This requirement adds another level of complexity to the already-complicated AMT.[13]

At the same time the Tax Reform Act scheduled the change from book income to ACE, it mandated a Treasury Department study of ACE's probable effects. The study was originally required to be submitted to Congress by January 1, 1989, but has not been completed as of this writing. It is probable that the conclusions of the Treasury study will be an important focus of any debate over whether to amend ACE or forego is implementation.

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[11]The book income preference was adopted for the first three years of the AMT because it conforms closely to the profits firms report to the public. Consequently, Congress concluded "that it was particularly appropriate to base minimum tax liability in part upon book income during the first three years after enactment of the Act, in order to ensure that the Act will succeed in restoring public confidence in the fairness of the tax system." U.S. Congress. Joint Committee on Taxation. *General Explanation of the Tax Reform Act of 1986*. Joint Committee Print. 100th Cong., 1st Sess. Washington, U.S. Govt. Print. Off. 1987. p. 434.

[12]However, 75 percent of the difference between ACE and other taxable income will be a preference after the change, while only 50 percent of book income is currently included as a tax preference. This implies that ACE's definition of income is narrower than the book profits definition.

[13]For an industry critique of ACE, see: Duxbury, Peggy, and Rick Grafmeyer. The Minimum Tax and Adjusted Current Earnings. *Tax Notes*. July 11, 1988. p. 195-9.