S. HRG. 104-80

# ALTERNATIVE MINIMUM TAX

## HEARING

BEFORE THE

## COMMITTEE ON FINANCE
## UNITED STATES SENATE

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

MAY 3, 1995

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# ALTERNATIVE MINIMUM TAX

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**WEDNESDAY, MAY 3, 1995**

U.S. SENATE,
COMMITTEE ON FINANCE,
*Washington, DC.*

The hearing was convened, pursuant to notice, at 9:30 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Bob Packwood (chairman of the committee) presiding.

Also present: Senators Chafee, Hatch, D'Amato, Nickles, Moynihan, Breaux, and Graham.

## OPENING STATEMENT OF HON. BOB PACKWOOD, A U.S. SENATOR FROM OREGON, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will come to order, please. We are going to face stacked votes. I think, Mr. Secretary, you will get through your testimony all right. We are going to face stacked votes starting at 11:15, unless they are called off. I would hope we could get through the entire hearing by that time, because it is five votes and I do not want to have to make the witnesses wait an hour and a half for us to come back.

This is our first hearing on the minimum tax. This is an issue with which I am very familiar. I was familiar with it when we passed it in 1986, familiar with the debate in the House and the Senate between book income and ACE, and I know why we passed it.

Of course, those were in the days when you had at least two major corporations—well-known major corporations—that succeeded in some years in paying no taxes at all. You cannot go home, and you cannot go to a mill where somebody is making $20,000 a year and attempt to explain to them why a major American corporation can have over $1 billion in profits and pay no taxes, or why a millionaire can have income of that size and pay no taxes.

And it makes no difference that you go home and say, you have to understand, they are buying municipal bonds and school bonds, and because they do that it keeps your property tax rate lower. That just does not work in terms of explanation. Or that they gave a tremendous painting to the Metropolitan Museum of Art. That does not work either.

So, in considering the minimum tax we just cannot return to the days where, regardless of the legality of deductions, it just must not be allowed to lead to corporations and people of immense wealth paying no tax, or it destroys the faith in the tax system by 90 percent of the taxpayers in this country.

I know the flaws in the minimum tax, I know the unfairness. I realize how long a company can be in it, and perhaps be in it forever. I understand the investment that it discourages.

So, I would hope that those who are testifying today who want us to change it, at least, can remember that we have got to have a goal that you cannot be in a situation where individuals and corporations of immense wealth or profits pay no taxes at all.

Mr. Secretary?

## STATEMENT OF HON. LESLIE B. SAMUELS, ASSISTANT SECRETARY, TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Secretary SAMUELS. Thank you, Mr. Chairman. I would ask that my written statement be placed in the record, and I would like to summarize it this morning.

The CHAIRMAN. Without objection.

[The prepared statement of Secretary Samuels appears in the appendix.]

Secretary SAMUELS. I welcome the opportunity today to discuss the administration's views on the alternative minimum tax. Since their inception, both the individual and corporate AMT have served one over-arching purpose: to ensure that taxpayers with economic income pay at least some tax.

In 1985, President Reagan proposed major changes in the corporate AMT. His proposals recognized that the prospect of high-income corporations paying little or no tax threatens public confidence in the tax system.

Congress agreed, and, in the Tax Reform Act of 1986, enacted major reforms to both the corporate and individual AMT. The report of this committee explained that, although tax incentives may serve worthy goals, they become counterproductive when taxpayers are allowed to use them to avoid all, or most, tax liability.

The committee noted that this undermines respect for the tax system. The committee stated, "It is inherently unfair for high-income individuals and profitable corporations to pay little or no tax."

The administration believes that these principles remain valid. We recognize that the AMT is not a perfect system. The perceived flaws fade, however, when measured against the potential damage to our tax system if wealthy individuals and profitable corporations are able to pay little or no tax.

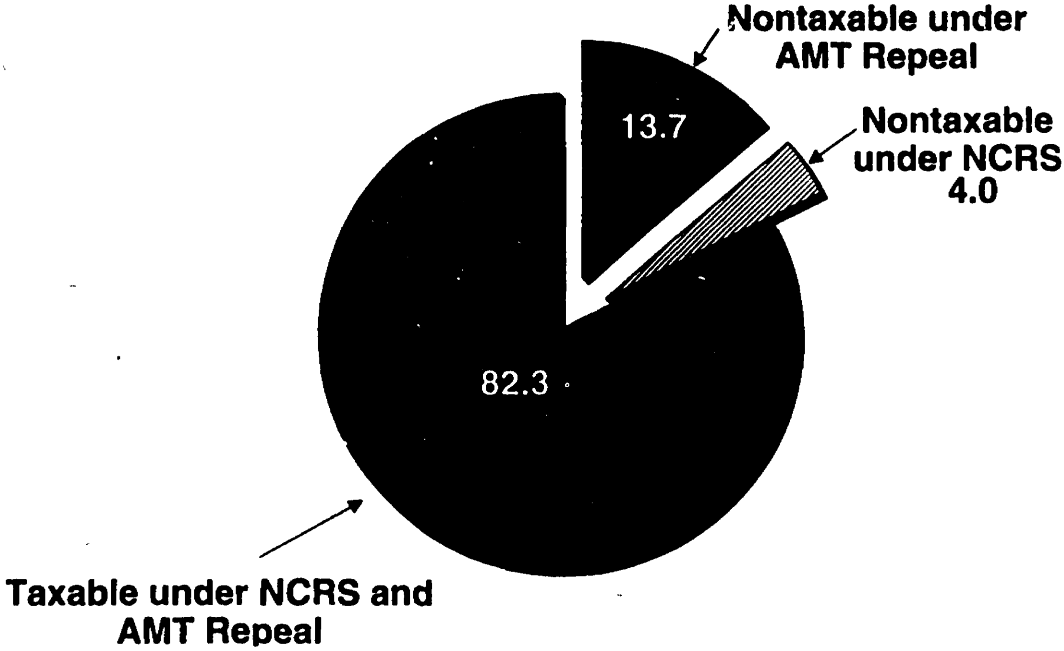
For instance, the House passed tax legislation, H.R. 1215, which eventually would repeal the corporate AMT, while weakening the individual AMT. It would also provide significant additional benefits to individual and corporate taxpayers, notably the so called Neutral Cost Recovery System.

If this legislation were enacted, we estimate that approximately 76,000 corporations that otherwise would have paid tax in the year 2005 would avoid paying any tax. The chart that I have here illustrates the share of the assets of currently taxpaying corporations represented by these 76,000 companies.

[The chart referred to above follows:]

**Impact of Neutral Cost Recovery System and Repeal of Corporate Alternative Minimum Tax**

Share of Assets of Currently Taxable Corporations




The CHAIRMAN. I am a little confused. Explain this a little slower, will you?

Secretary SAMUELS. Sure. On the chart, the one slice represents 2.1 trillion, or 13.7 percent, of the assets——

The CHAIRMAN. Right.

Secretary SAMUELS [continuing]. And reflects the impact of AMT repeal alone. So these are the corporations, the assets of corporations, that would have paid tax, which would not pay tax if AMT were repealed.

The CHAIRMAN. Thirteen percent of the corporations, 13 percent of the taxable——

Secretary SAMUELS. Thirteen percent of taxable corporations.

The CHAIRMAN. All right.

Secretary SAMUELS. Of assets.

The CHAIRMAN. Of assets. All right.

These are the ones that would pay taxes now and would not pay it under the AMT repeal.

Secretary SAMUELS. Right. Correct.

The CHAIRMAN. All right. Now, what are the other two?

Secretary SAMUELS. The large slice are the people who would not be affected by the repeal of AMT, and the other reflects the additional corporations that would not pay tax because of NCRS.

The CHAIRMAN. All right.

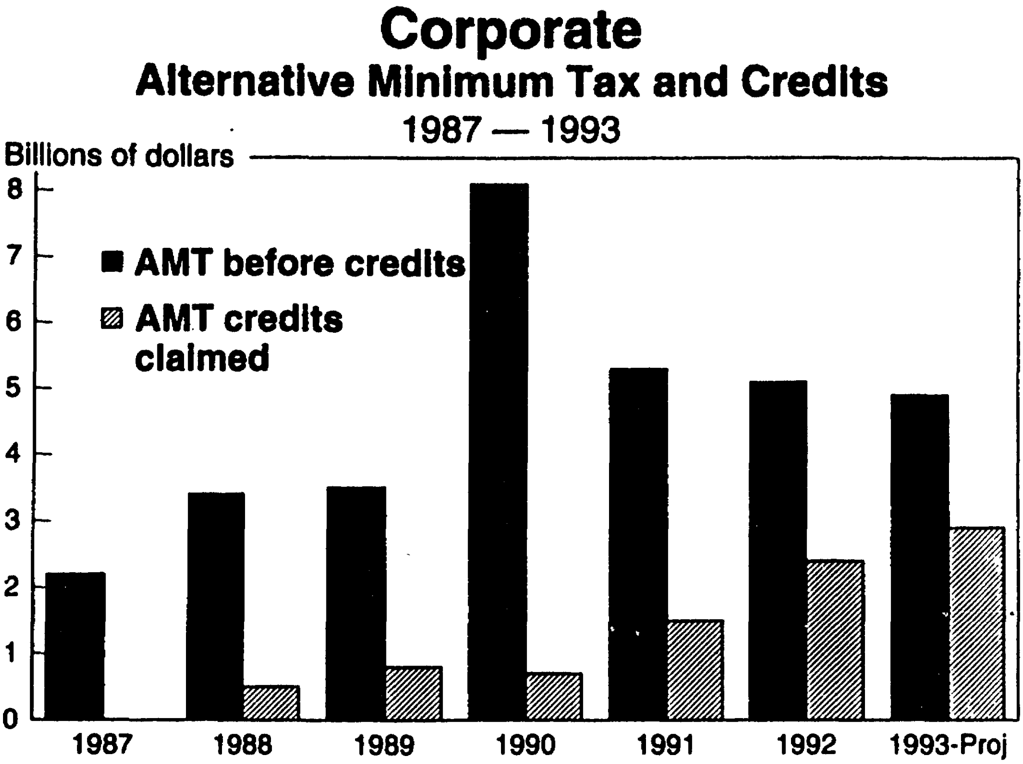
Secretary SAMUELS. When you look at the combination of NCRS and the red slice, the non-taxable corporations under AMT repeal, you see that corporations with $2.7 trillion, or 18 percent, of all the assets of currently taxpaying corporations would avoid paying any tax. Thus, income on $2.7 trillion of corporate assets would not be subject to tax under the House-passed legislation.

We believe that recent efforts to improve the AMT have already addressed some of the most significant problems of the AMT system. In its 1993 budget, for instance, the administration proposed significant AMT relief for capital investment by corporations.

As enacted in modified form in OBRA '93, this relief removed depreciation from the so called ACE adjustment. Because depreciation is by far the largest source of AMT revenue, these changes are expected to make fewer corporations subject to the AMT, ease compliance costs, and contribute to a downward trend in corporate AMT liabilities.

We have a chart which shows the historical revenue pattern from the corporate AMT. As you can see, corporate AMT liabilities increased after 1986, peaked in 1990 as a result of the switch in AMT calculations—that was a switch from book income to ACE—and are now declining.

[The chart referred to above follows:]




1993 data are projections.

Secretary SAMUELS. In addition to the relief enacted in OBRA '93, several factors have contributed to the downward trend. One major factor is the depreciation adjustments, by far the largest source of AMT revenues, which affect only the timing, rather than the total amount, of depreciation deductions. In time, these depreciation adjustments reverse. We have now reached the period where this reversal is occurring for post-1986 investment.

Another factor in the decline in net corporate AMT revenues relates to the use of AMT credits. AMT liability in 1 year may be credited against regular tax liability in future years.

The chart shows how AMT credits have steadily increased since 1986. As AMT liabilities declined, corporations use an increasing amount of AMT credits to reduce the regular tax liability.

The economic recovery will likely contribute to this trend, although the overall stock of AMT credits is not expected to decrease in coming years.

It should be noted that large firms pay most of the corporate AMT. Table III* on page 15 of my written testimony shows that corporations with assets over $500 million generally pay 75 percent

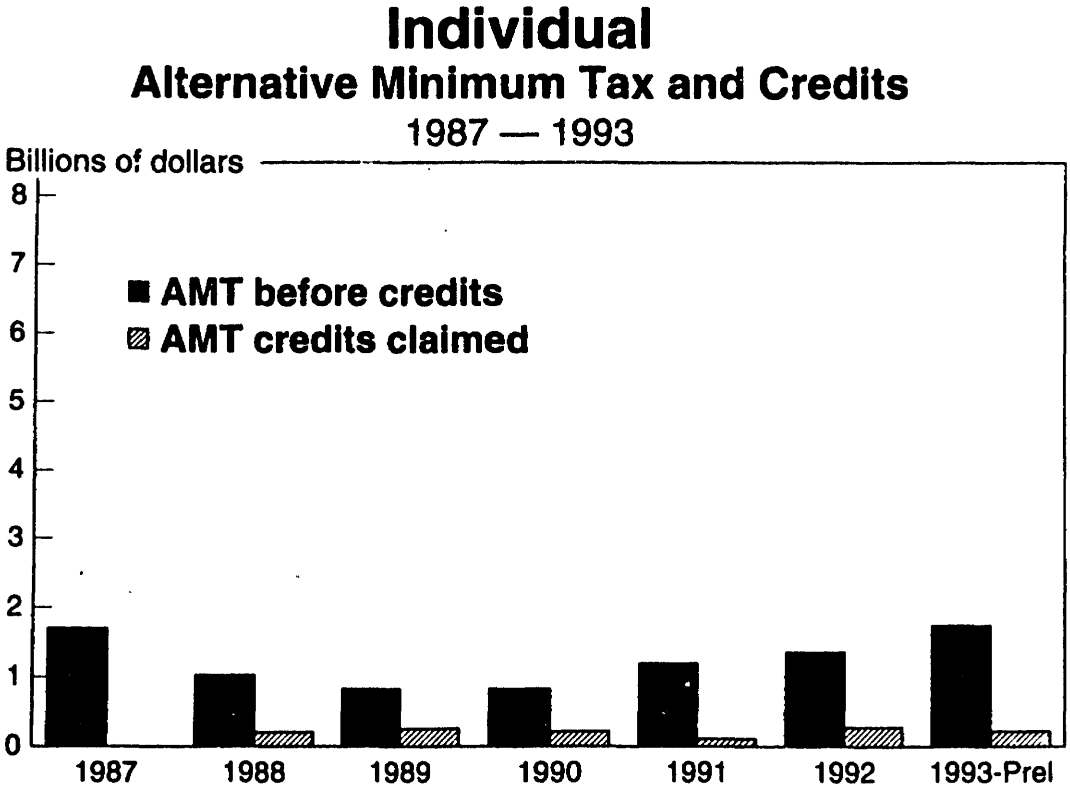
*The table referred to appears in Secretary Samuels' prepared statement in the appendix:]

of the corporate AMT. Smaller corporations are largely eliminated from the corporate AMT by the $40,000 per year exclusion.

Table IV in my written testimony shows that most corporations that pay AMT do not pay it for more than one or 2 years. The tax liability generated by the individual minimum tax has fluctuated substantially.

We have a chart showing individual AMT and credits claimed since 1987.

[The chart referred to above follows:]




1993 data are preliminary.

Secretary SAMUELS. As you can see, in this period individual AMT collections declined until 1990, and have now increased, approximately, to their 1987 levels.

Like corporations, individuals seemed to pay AMT only infrequently. In recent years, only a tiny percentage of individuals have been subject to the AMT in successive years. We believe that the AMT has accomplished its goals of ensuring that taxpayers with significant economic income pay some income tax.

My written testimony details the evidence that, as a result of the individual AMT, very few high-income individuals have been able to escape all tax liability. The evidence also indicates that most of the non-taxpaying corporations are relatively small, and many probably quality for the AMT exemption.

The corporate AMT has been criticized for adversely affecting economic growth. It has been argued that the corporate AMT reduces incentives to invest, creates differing incentives for different corporations, and may encourage mergers and acquisitions to avoid the AMT or better utilized AMT credits.

While there is some validity to these concerns, they may easily be overstated. In fact, the lower AMT rate can increase the incentive to invest if the corporation were to remain subject to the lower AMT rate over the life of the asset.

Likewise, it may increase the incentive to invest for a firm not currently subject to the AMT. If the firm anticipates that it will be subject to the AMT after a few years, such a firm will be able to claim regular tax depreciation now while a portion of the returns will be taxed at the lower 20 percent AMT rate in later years.

Moreover, by design the AMT reduces the incentive to invest in tax-favored assets. Thus, the overall efficiency of investment may be enhanced by the AMT's propensity to create a more neutral tax system.

Any potential adverse effect of the AMT on investment is mitigated by the fact that few corporations are subject to the corporate AMT. In 1992, for instance, only about one percent of non-subchapter S corporations were subject to the AMT.

Moreover, most corporations that pay AMT do so only temporarily. In addition, firms subject to the AMT do not permanently lose their tax benefits because AMT liability generates credits that can be used in future years.

Concern has also been voiced about compliance costs of the AMT. We share this concern about complexity. This concern was addressed, in part, in OBRA 1993 by the repeal of the ACE depreciation adjustment. This provision will significantly reduce the application of AMT to taxpayers, as well as ease the compliance costs for those likely to be subject to the AMT. It will also increase the pace at which AMT credits may be used.

The administration welcomes the opportunity to work with the Congress to develop measures that would simplify the AMT on a revenue-neutral basis, either within the AMT, or by identifying other acceptable revenue offsets.

In addition, the administration is committed to simplifying the AMT through administrative measures, where possible. For instance, last November the Treasury Department issued regulations that greatly simplified adjustment gross income calculations for AMT purposes.

Finally, the administration is very concerned about the potential effects of the House-passed tax legislation. As I have noted, we believe that by repealing the corporate AMT and weakening the individual AMT this legislation would seriously undermine the objective of ensuring that taxpayers with economic income pay at least some tax.

The administration is also very concerned about the potential effects of the House-passed tax legislation on the Federal deficit. The tax provisions are estimated to lose about $178 billion over the 5-year budget window. By the year 2005, the annual cost of these provisions is estimated to be almost $100 billion.

The revenue losses anticipated for the proposed changes to the AMT alone are about $19 billion over the 5-year window, and $36 billion over the 10-year window. These estimated tax losses, which make the commitment to fiscal responsibility more difficult, reflect only one dimension of the impact of the House-passed legislation on the AMT. These provisions would facilitate tax avoidance and reduced the perceived and actual fairness of the income tax.

In conclusion, although net AMT revenues have declined, the administration believes that the AMT system has not diminished in importance. While the administration opposes proposals that would seriously weaken the objectives of the AMT, we welcome the opportunity to work with the Congress to simplify the AMT on a revenue-neutral basis, either within the AMT or by identifying other acceptable revenue offsets.

Mr. Chairman, that concludes my oral remarks, and I would be happy to answer any questions that you or other members may have.

The CHAIRMAN. What did you say, 1 percent of the corporations are in the AMT, pay AMT?

Secretary SAMUELS. About 1 percent of the corporations are paying AMT.

The CHAIRMAN. Do you have any idea what percent of the corporate assets in this country that 1 percent may represent? My hunch is, it is bigger than 1 percent.

Secretary SAMUELS. Yes, because the larger corporations, those with more than $500 million, a larger percentage of those pay the AMT.

The CHAIRMAN. That is why I think it is a little bit unfair to use the 1 percent. It is like the Republicans saying, do you realize that 75 percent of the people that pay capital gains taxes make less than $50,000 a year, to which you would say, yes, but 80 percent of the capital gains go to people who make over $100,000. So it is a question of how you want to use the percentages.

Mr. Secretary, there are some corporations to which this is unfair. In my mind, there is no question about it. They are normally big, they are normally capital-intensive and invest lots of money.

The difference between the depreciation on AMT and the depreciation on regular taxes is unfair to them. Yet, I do not want to go back to having to explain why they pay no taxes at all, and we are not going to go back to that.

Is there a fairer way? Would we be better off to go to book income? I have no idea, if we went to it, where we would have to be on percent to raise the money we raise. But is there a fair way to treat those corporations that, in my mind, are unfairly treated now?

Secretary SAMUELS. Mr. Chairman, we have been reviewing that issue because we believe that the AMT should be simpler and we should try to eliminate some of the complexity.

In OBRA '93 we repealed the ACE depreciation adjustment. We think that will go a long way to reducing some of the perceived unfairness on corporations with significant investments.

With respect to moving back to the book income adjustment, I think we would consider the following factors. First, the book income adjustment is only easily applied by publicly-traded companies that regularly report their book income to shareholders, so there were some questions about the determination of book income.

The CHAIRMAN. That would be, however, most of the corporations that are paying the AMT, I would wager.

Secretary SAMUELS. However, most importantly, I think we would agree, one of the most difficult problems for taxpayers, is when we keep changing the rules. Right now they are in the ACE system. They have their books and records organized to keep track of that, although it is not an insignificant burden, and we think that it is better to stick now with what we have got than to move back to the book income proposal. So, at this point in time, we should look to see the effects of the 1993 changes and try to stick to the basic structure.

The CHAIRMAN. So, at the moment the administration has no suggested further changes from what we adopted in 1993.

Secretary SAMUELS. Mr. Chairman, the types of changes that we would consider are ones that are targeted to reducing the complexity of the AMT. So, for example, I think what we would suggest is, that we would work with the committee, look at the list of AMT preferences.

When you look at the list, for both individuals and corporations, you will find some that are either deadwood or near deadwood and represent very small amounts of AMT preferences, and one might be able to simplify the AMT by reducing some of the preferences in a way that would not affect the basic structure of the AMT.

In addition, we are looking at ways of reducing some of the recordkeeping burdens. For example, for individuals, we find that about 10 times the number of individuals that are subject to AMT have to file the form. So approximately 3 million individual taxpayers that have to file the form, even though a little over 300,000 are actually subject to the AMT.

We are looking at ways of trying to reduce the burden on those who are not subject to AMT and see whether we can simplify or streamline the system so not as many taxpayers who are not subject to AMT would have to file the form.

So, those are the kinds of things that we are thinking about, and we should move along in trying to decide whether we can make some simplification proposals.

The CHAIRMAN. Mr. Secretary, thank you. I have no more questions.

Bob, do you want to ask any?

Senator GRAHAM. Mr. Secretary, it has been suggested that the real reason that many companies with economic income paid no taxes had to do with factors that surrounded their tax status, such as their use of safe harbor leasing or investment tax credits. To test that hypothesis, if the AMT were repealed, how many companies would report profits for book purposes, but no tax liability, today?

Secretary SAMUELS. Senator Graham, I do not have the figure for book income. However, we had estimated that if AMT were repealed and the House-passed NCRS legislation were enacted, that almost 18 percent of the assets of taxable corporations would not be subject to tax.

In other words, corporations with about 18 percent of the assets would not be subject to tax, and that represents assets of about $2.7 trillion. So, we believe it would be a significant change, and would increase the problem of public perception regarding whether the tax system is fair.

Senator GRAHAM. Do those 18 percent of the corporations fall into any particular economic sectors?

Secretary SAMUELS. Well, the major preferences that place companies into the AMT are depreciation and the so-called ACE adjustment for corporate AMT. Those are the two major items. So, it is those two items that are basically——

The CHAIRMAN. And on depreciation it would have to be companies, therefore, that are heavily capital-intensive and invested in machinery.

Secretary SAMUELS. That is correct. I think the idea of the AMT, though, is to basically say that there is a limit on the use of tax incentives that any particular taxpayer will be able to enjoy. That is the purpose of the AMT. It is a break on the use, and over-use, of tax incentives.

I would say, an important factor on the corporate AMT, unlike the individual AMT where we have special rules to deal with tax shelter type activity, the so called passive loss rules, those generally do not apply to corporations, so our backstop, in terms of trying to make sure that people perceive the tax system as fair for corporations, is the AMT. We believe that that objective is important.

And, when you take into account the 1993 OBRA changes and the decline in the expected revenues from AMT, I think you can conclude that, (1) the AMT is important, and, (2) its burden on capital-intensive industry is being reduced.

We project that the net AMT in 1993—this is after credits have been utilized—was about 1.2 percent of regular corporate tax receipts. In 1995, we expect that to be reduced to about one-half of 1 percent. So, it is going from 1.2 percent to one-half of 1 percent, and then it will actually decrease to be a little below a half a percent in the next several years.

So the overall burden of the AMT, I think, on capital-intensive industries has been, and will continue to be, reduced. We think that, in balancing the factors, we need to take that into account. But it is also very important to make sure that we have an AMT system in place so that we do not have the problems of public perception that very large corporations are not paying any tax.

The CHAIPMAN. Thank you, Mr. Secretary. I have no more questions. I appreciate you coming this morning.

We will conclude with our panel of Dr. Andrew Lyon, from the Brookings Institution; Robert McIntyre, from Citizens for Tax Justice, who has appeared before this committee frequently; Dr. George Plesko, from Northeastern University; and Thomas Usher, the president and CEO of USX Corporation.

As I indicated, we have stacked votes at 11:15 and I am hoping we can finish this panel so they do not have to wait for us for an hour and a half.

Senator GRAHAM. Mr. Chairman, I am afraid I am going to have to leave at 10:00 o'clock for a markup.

The CHAIRMAN. All right.

Dr. Lyon, we will start with you.

## STATEMENT OF ANDREW B. LYON, PH.D., VISITING FELLOW, BROOKINGS INSTITUTION, WASHINGTON, DC

Dr. LYON. Thank you for inviting me to testify on the AMT. Nine years ago, as a staff member of the Joint Committee on Taxation, I watched this committee put together historical legislation that fundamentally improved our tax system.

I understand why the AMT was put into the 1986, but, with the benefit of hindsight, I urge you to consider modifications to the AMT that would reduce, if not totally eliminate, the discrepancies between the AMT and the regular tax.

I should make clear that my concerns with the AMT are not over the effects of the AMT on overall corporate tax revenues. A tax system can be structured with or without an AMT to raise a wide range of tax revenues.

A true debate over the minimum tax should ask whether the AMT is the best way to augment revenues collected by the corporate taxes. Are the consequences of the AMT more beneficial, or at least less harmful, than alternative means of raising comparable amounts of corporate tax revenue?

I feel so strongly about this point that I would urge that, if this committee recommends changes to the corporate AMT, that they be made on a revenue-neutral basis with respect to corporate tax revenues or taxes on capital income, more generally.

Let me explain my main concerns with AMT. First, legitimate concerns over the fairness of the corporate tax system are not well-addressed by the AMT. One argument that special tax preferences violate principles of fairness is that they are believed to result in above-average rates of return for the benefitting corporation.

But the belief that the after-tax return to an activity is simply increased by the value of any tax preference is incorrect. Any activity offering tax benefits will attract investment, and this new investment will drive down the pre-tax return. If anyone is free to participate in this activity, its after-tax return will be about the same as for any fully taxable activity.

But let us suppose that in some cases the after-tax return earned by an investor receiving the tax preference is higher than that generally prevailing. If one could use a minimum tax to tax only those cases where super-normal returns were earned at the expense of a government tax subsidy, this would seem to be a desirable outcome, but this is not what the AMT does.

The more profitable a firm is per dollar of tax expenditure, the less likely it is the firm will pay AMT. A firm with $10 million in income and $1 million in tax preferences will pay taxes under the regular tax because its regular tax liability exceeds tentative AMT, but the firm with $2 million in income and $1 million in tax preferences will pay AMT.

If it is the desire to limit above-average returns that are the result of tax preferences, the most effective way to accomplish this is to directly limit each specific tax preference.

The CHAIRMAN. Let me ask you something as you are going along, because you were there. You know what our desire was, it was to make sure that we could not have—and General Electric was one—corporations with immense profits pay no taxes and be unable to explain that to an average taxpayer. There is no way you can explain it to an average taxpayer.

Dr. LYON. If the perceptions of firms paying low rates of tax are all that matters, presumably we could have a law that requires every low-rate tax firm to merge with a high-rate tax firm. Clearly, if this soothed public perceptions, then the well-foundedness of the fairness objection in the first place is ridiculous.

I would argue that appropriately understood, the concern over fairness is not over whether firms pay rates of tax above some minimum, but that each activity performed by a corporation is taxed at or above some minimum rate.

The way to achieve that objective, again, is to remove the tax preferences for that specific activity, as opposed to attaching it to the firm. If the preference is removed from that activity, all taxpayers undertaking that activity will pay a rate of tax above that minimum rate. Again, I would target the particular activity as opposed to the collection of activities undertaken by a particular firm.

As for efficiency, does the AMT improve efficiency? As a first approximation, I would argue that the output of the economy is likely to be maximized by eliminating all tax preferences and allowing investment to be allocated by market-oriented forces rather than tax-oriented forces.

This is not to say that tax preferences for certain activities are not well-deserved. Of course, everyone in this room believes that one of their favorite tax preferences ~~is to~~ target an activity which generates above average social returns, but I argue this leads to the Lake Wobegon effect where, as you will recall, all the children are above-average. Not all potential investment can have above-average social returns.

The Tax Reform Act of 1986 generally followed this logic by reducing or eliminating tax preferences and using the revenues to lower tax rates. Further opportunities for such base broadening and rate reduction remain by reducing, for all corporations, the value of tax preferences already identified under the AMT, as well as additional preferences omitted from the AMT.

Short of such base broadening, does an AMT improve efficiency? The answer is not clear. While the reduction in the value of tax incentives for AMT firms is likely to reduce their incentives in such activities, the value of such preferences remain for other firms. It is quite possible that the total amount of tax-preferred activity is unchanged, but it has merely shifted from one firm to another firm.

I would argue that a minimum tax is, therefore, very poorly designed to improve efficiency. I do not believe it directly addresses appropriate fairness concerns. I think across the board reductions in tax preferences would be an improvement. A model for this type of across-the-board reduction is already found in Section 291 of the Internal Revenue Code.

I would be happy to respond to any questions you might have on these points, or on more technical concerns. Thank you.

The CHAIRMAN. Thank you.

[The prepared statement of Dr. Lyon appears in the appendix.]

The CHAIRMAN. Mr. McIntyre.

## STATEMENT OF ROBERT S. McINTYRE, DIRECTOR, CITIZENS FOR TAX JUSTICE, WASHINGTON, DC

Mr. McINTYRE. Thank you, Mr. Chairman. It is great to be back. So today we are revisiting the alternative minimum tax. As you so eloquently pointed out, it was adopted in the 1986 Tax Reform Act because we had discovered that half of the biggest companies in America were not paying taxes year-in and year-out.

The House has decided, in its wisdom, that it should offer a slap in the face to the designers of the 1986 Tax Reform Act; to you, Senator Bradley, President Reagan, all the others of us who worked on it. They make no bones about the fact that they want to return to the bad old days of widespread corporate freeloading.

Well, we think that is a bad idea. In fact, we urge the committee to not only reject the House proposals, but to strengthen the minimum tax so it does better the job it was designed to do.

Since the 1986 reforms were adopted, including the corporate minimum tax, we have seen most of the worst corporate tax avoidance problems go away. I think that is a very good thing. We did surveys after the tax bill was adopted and, instead of finding half the companies paying no tax, we found only a handful at most. That was partially due to the AMT, and you can see it directly in the annual reports.

As Treasury has pointed out, the AMT is not paid by very many companies directly. It is a low percentage of corporate taxes, it is a low percentage of corporations. Even when you look at the biggest companies, it is a very low percentage of them.

So why all this corporate concern about the AMT? why when the House went to the business community and asked them to write the House tax bill, was that the issue the business lobbyists wanted to have on the table?

Why do they care so much if it affects so few? Well, first of all, it affects a lot more than shows up in Treasury statistics. There are a lot of companies that are not engaging in tax avoidance activities because of the alternative minimum tax; insurance companies are not investing in so much tax-free debt; oil companies are not using such fast write-offs; other companies are not getting involving in becoming lessors of equipment. That is why the estimates the staff gives you on the revenue losses on this bill are ludicrously low.

I think it was suggested by Mr. Samuels at the end of his testimony that, in fact, we would see a much higher level of corporate tax avoidance activity, and the revenue losses, I would say, are at least three times as large as the numbers that have been put out by the Joint Tax Committee.

Now, besides the fact that it keeps them out of tax avoidance, companies have suggested that the AMT has caused all of these other dire problems for them: raised their cost of capital, hurt their competitiveness, a good content-free word, and so forth. The argument is almost silly. The companies who care most about the AMT are in the AMT for the duration. That means they are in a 20 percent tax bracket, at most. That is a lower tax rate than any country in the world imposes on its corporations. If that is too high a tax rate to compete internationally, well, my goodness. Mobil has been running advertorials in Time Magazine about the minimum tax and how awful it is; certainly a predictable position for an oil company to take, since they took the position before the Tax Reform Act that it was un-American for an oil company to pay taxes.

One of the examples Mobil gives is that, golly, under the regular tax you can write off a steel mill in 7 years, but under the minimum tax it takes 15 years to write off a steel mill. Well, I will tell you, I thought that was kind of funny. I mean, how long does Mobil think a steel mill lasts? 7 years? Gosh, they must be making them out of papier mache these days.

Now, the argument you just heard here from Dr. Lyon is that what we really ought to do is fix the regular tax. Fine. I am in favor of tax reforms to fix the regular tax. That is not the issue here on the table, unfortunately. So the issue is not, should we fix the regular tax or the minimum tax, the question is whether the minimum tax should be repealed or not. So, yes, fix the regular tax. There are some loopholes that have crept back in since 1986. The lawyers and accountants have figured out ways around some of our 1986 rules. Fix it.

But, even if you do, do not think that you do not need the AMT as a backstop. One size does not fit all out there. Companies that are heavily leveraged are in negative tax rate situations under almost any conceivable set of depreciation rules under the regular tax and we need a minimum tax to back that up because we cannot have one set of depreciation rules that work with all companies.

Now, finally—and it is detailed in our testimony—the purpose of these AMT proposals in the House, as Chairman Archer has cheerfully admitted, is to allow some highly profitable companies "to pay no tax." Treasury says, 76,000 companies would go off the tax rolls if this provision is adopted. There is no doubt it would be large numbers. And, at the end of our testimony, we detail who some of those companies are. Not surprisingly, they are the ones who are lobbying for repeal of the AMT.

So, if you think that CSX, and Champion International, and Dow Chemical, and FINA, Mitchell Energy, Phillips Petroleum—we have a long list—should not pay any tax, by all means adopt the Gingrich-Armey-Archer plan.

Otherwise, we suggest you not only reject their AMT proposals, not only reject the rest of their egregious tax bill, but, in fact, strengthen the alternative minimum tax—as outlined in the list of reforms we have at the end of our testimony—so that it better does the job it is supposed to do.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. McIntyre, thank you.

[The prepared statement of Mr. McIntyre appears in the appendix.]

The CHAIRMAN. Dr. Plesko.

**STATEMENT OF GEORGE A. PLESKO, PH.D., ASSISTANT PROFESSOR, DEPARTMENT OF ECONOMICS, NORTHEASTERN UNIVERSITY, BOSTON, MA**

Dr. PLESKO. Thank you, Mr. Chairman. Thank you for the opportunity to testify before this committee again.

The current individual and corporate AMT, as we all know, was enacted as part of tax reform to ensure that no taxpayer with substantial economic income would avoid significant tax liability.

Many have taken the existence of an AMT as evidence of failures within the underlying tax system; were the underlying system designed properly, no AMT would be necessary. But, given the existence of some sort of minimum tax since 1969, this would not appear to be a recent concern.

If this concern were so significant, it seems odd that the 1986 Act, the design and debate of which provided an enormous opportunity for self-study, had, as such an important part of its structure, this broader and more significant AMT.

I find it difficult to believe that those who endorsed tax reform viewed the AMT as a failure in the tax reform process, but rather as a means to obtain other goals. To many, the minimum tax is necessary in a system in which tax policy is designed and enacted in a world of trade-offs between differing, and sometimes competing, objectives.

The existence of an AMT to address these compromises should not draw our attention away from the underlying issues of how income should be taxed. If anything, the AMT should serve as a reminder that our current tax system is not yet ideal. To the extent that the underlying system of taxation is reformed, the importance of the AMT and the revenue generated from it should diminish. In this way, the AMT may serve a role as a way to measure the progress of these changes.

As for the corporate AMT, we know much about the affected firms. The majority of the firms that actually pay the AMT are relatively small, with less than $10 million in assets. However, the bulk of the AMT payments are made by larger firms, with about 20 percent of firms with assets in excess of $1 billion being on the AMT in any given year.

Among corporations with assets in excess of $50 million, about half have been on the AMT at least once since 1987, and more firms are required to file to maintain AMT-related records than are actually on the AMT. The GAO recently reported 400,000 corporations filed the AMT form in 1990.

Within the narrow goal of decreasing the likelihood that firms with positive financial statement earnings pay little or no tax, the AMT appears to have had quick success. Since 1986, there has been a sharp decline in the number of firms with positive book income that paid no tax. In addition, 90 percent of the remaining firms are not supposed to be subject to the AMT, by design.

Other goals of the AMT, such as the perception of fairness, are more difficult to evaluate. Too much attention can, and, I believe, may have been paid, to differences between taxable and financial statement income. Given that we have a tax system based on a separate set of accounting rules than used for financial purposes, we need to accept a certain degree of divergence between the two measures of income. However, the perception of fairness has been shown to be an important part of the tax system and cannot be rejected out of hand. As a result, the book income and ACE adjustments may be more important in addressing fairness than the other aspects of the current AMT.

As for the costs of the AMT, the most obvious is the increase in taxes paid. The AMT has proven to be a significant source of revenue, ranging from $2.2–8.1 billion per year; 3–9 percent of overall corporate tax liabilities.

It also should be remembered that these figures are a lower bound on the amount of revenue collected due to the AMT since they do not include any increase of regular tax paid by firms which may do that in order to avoid being on the AMT. These AMT liabilities, however, should ultimately be paid back to these firms as they become subject to the regular tax.

A second cost of the AMT is compliance. While compliance costs themselves are difficult to measure, compliance-related activities impose real costs on firms, as well as on the government, as it monitors and enforces these tax provisions.

Finally, as mentioned by others, the AMT has been suggested as increasing the cost of investment. It is worth noting, however, that, to the extent the AMT does increase the cost of investment, it is doing so relative to the cost of that investment under the regular tax.

As for simplification, an obvious concern should be any revenue loss. Outright repeal of the AMT would cost nearly $17 billion over the short-term budget horizon, and more than twice that over the next 10 years.

By itself, this amount of revenue loss is significant, but this revenue loss should also be viewed in the context of tax reform, which was designed to be revenue-neutral, by shifting some tax liabilities from individuals to corporations. Any modification or outright repeal of the AMT could affect this balance. Five years ago to the day, this committee held a hearing because of concerns over a shortfall in corporate revenues after tax reform.

I concur with Professor Lyon's opinion that any change that might be made to the AMT should be revenue-neutral within the confines of the corporate tax system, or at least within the confines of taxes on capital.

There are, however, some obvious ways that the AMT could be simplified which may also mitigate the effects on investment. First, changes could be made to the underlying non-AMT tax base to provide a more consistent measure of income between the two tax systems.

Second, the use of AMT credits could be liberalized. Current limits on the use of AMT credits make it more difficult for firms to recover their tax payments and increase the likelihood that the AMT will be a permanent tax rather than a temporary one, which was not a goal of the underlying legislation. While the current credit restrictions make sense in terms of preserving a goal that some level of tax be paid, they do so at the expense of further increasing the present value of the tax on firms.

Third, the threshold for the AMT could be increased to reduce the burden on the smallest firms. As stated above, the GAO found approximately 400,000 firms filed an AMT form, even though only 28,000 had an AMT liability. Many more firms have to keep records in order to calculate their AMT liability in order to know whether they are subject to the tax.

The threshold could be raised, either through an increase in the exemption level or in reference to some other aspect of the Tax

Code, such as limits borrowed from form 1120A requirements, or through the Section 179 limits on expensing.

Thank you.

The CHAIRMAN. Thank you.

[The prepared statement of Dr. Plesko appears in the appendix.]

The CHAIRMAN. Mr. Usher, how long does a papier mache steel plant last? [Laughter.]

Mr. USHER. I have never built one. I do not know. But I can tell you this, if you are still in the business with 15-year-old equipment, you are not competitive on a world basis. It is not the wearing out of the equipment, it is the technology, which really drives it.

**STATEMENT OF THOMAS J. USHER, PRESIDENT AND CHIEF OPERATING OFFICER, USX CORPORATION, PITTSBURGH, PA, ON BEHALF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS**

Mr. USHER. Thank you, Mr. Chairman. As you mentioned, my name is Tom Usher. I am the president and chief operating officer of USX Corporation.

I am here today on behalf of the National Association of Manufacturers and its broad-based coalition of companies and associations who support repeal of the corporate alternative minimum tax.

I am pleased to be here today to discuss why changes are needed in AMT, not from a theoretical viewpoint, but from the viewpoint of an American businessman.

Let me begin by stating that NAM members understand the budgetary challenges you are confronting. We support your efforts to lower the deficit and reduce the tax burden on new savings and investment; we believe it is imperative and possible to do both.

Congress should have as a priority repeal, or at least substantial reform, of the penalty imposed on investment under the AMT. The AMT increases the cost of capital for a typical manufacturer by about 10 percent over what it would be under the regular tax system.

The AMT's penalty on investment reduces cash flow and hinders economic growth and job creation. AMT repeal would go a long way toward making American businesses more competitive internationally and will level the playing field between AMT and regular taxpayers.

The AMT is not working as we believe Congress and this committee intended. The AMT was supposed to prevent companies with substantial economic income from paying little or no tax. Instead, the AMT has become the primary tax for many capital-intensive companies.

My own company's experience, USX, provides a striking example of the unintended impact of the AMT. During the 5-year period 1990–1994, we reported over $1.3 billion in financial losses to our shareholders, yet during that same period we paid over $200 million in taxes due to the AMT.

So, instead of paying a minimum tax when reporting book profits, we are paying a large amount of tax when we are reporting losses and can least afford them. I do not think this is what was intended when the AMT was conceived.

There is a tremendous national opportunity cost to the AMT expressed in terms of less investment, lower productivity, lower economic growth, and, consequently, fewer good jobs and lower wage growth for U.S. workers. The AMT penalizes job-creating investment by the very firms that are at the forefront of international competition.

As I stated at the outset, NAM favors complete repeal of the AMT. We believe the United States should have a single, reasonably understandable, tax system that applies equally to all corporate taxpayers.

If complete repeal cannot be accomplished, however, there are at least two reforms short of repeal that should be enacted. First, depreciation should be calculated under AMT in the same way as it is for regular taxpayers. Some profitable firms recover their cost of investment through tax depreciation more than twice as fast than less profitable firms subject to the AMT.

As mentioned, the steel assets are depreciated over a 7-year period under the regular tax, but over a 15-year period using the slower depreciation method under the AMT. It makes no economic sense to continue to treat investment differently and to penalize AMT taxpayers in this way.

Second, accumulated AMT credits and other business credits should be allowed to partially offset AMT liabilities. Because the AMT was never intended to permanently tax investment at a higher rate than under the regular tax, a credit against future regular taxes is given for the amount of AMT paid in excess of regular tax liability.

Since many manufacturers find themselves in a near-permanent AMT position, they may never be able to use the credits, or may not be able to use them in a meaningful time frame. For these taxpayers, the AMT becomes a permanent tax increase relative to the regular taxpayer.

Additionally, since several business credits, including R&D, targeted jobs, and alternative fuels, as well as net operating losses and foreign tax credits, are not allowed or are of limited use against the AMT, many of the broad policy objectives instituted through the Tax Code do not work as intended. A mechanism should be established to permit partial utilization of AMT and other credits against AMT liability.

Manufacturing remains the backbone of the U.S. economy. The steel industry, for example, is recognized as being world-class; low-cost, high-quality. However, we are the only major economy in the world which is required to import a significant amount of steel due to a lack of domestic capacity. We are also the only country in the industrialized world that penalizes investment through an AMT system. I think there is a clear relationship between the two.

If we invested more, the trade deficit would be lower and America would have more good paying manufacturing jobs. These are the jobs that make the American factory worker the envy of workers around the world. These are jobs with good health care benefits and wages that enable a person to own a house, own a car, and educate their children. In short, quality jobs with a quality of life. Americans need these jobs, and Americans want these jobs.

Sure, we have created new jobs, but many of them are minimum wage jobs or low-paying jobs. Two or more of these jobs is needed to provide a family with a standard of living associated with one manufacturing job.

In conclusion, the NAM urges you to repeal the AMT penalty against investment, or to at least enact meaningful AMT reform, and, thus, help stimulate economic growth to preserve and create quality manufacturing jobs for Americans.

Thank you. This concludes my remarks.

[The prepared statement of Mr. Usher appears in the appendix.]

The CHAIRMAN. Mr. Usher, tell me what you said again about imported steel because we do not have the capacity here?

Mr. USHER. Really, if you look around the world, any other industrialized country has an excess of steel capacity. In this country, we do not have enough steel capacity to take care of the steel needs for the United States, so, in fact, we need to import steel.

And part of the problem has been that this industry, which is a capital-intensive, very cyclical industry has not been able to invest in facilities in a way to maintain a world competitiveness, and also to take care of the demands of this country.

If, in fact, they were treated more fairly under the tax system, this would create funds that would be available for investment so that steel companies in this country could invest and take care of the needs of this country rather than importing, not only steel, but importing the jobs.

The CHAIRMAN. Well, I am fascinated by the fact, and I guess I have not followed it. For almost as many years I have been on this committee, the argument was the other way around, we had an excess of capacity and it was that subsidized foreign steel unfairly traded that you needed protection against.

Mr. USHER. Well, there are two arguments here. One, the first fact, we did have an excess of steel back through the 1980's. But during the 1980's, as I think many of you know, the steel industry went through an awful lot of transformation, hundreds of thousands of jobs were lost, and about 40 percent of the capacity in this country was shut down. What emerged from this was capacity that was competitive, competitive from a cost standpoint, a productivity standpoint, and a quality standpoint. So what was left was very world-competitive, but it was not enough to satisfy the demand from foreign countries.

The CHAIRMAN. Can you compete pretty much in the world now?

Mr. USHER. We can compete anywhere on a cost basis.

The CHAIRMAN. Are you exporting steel?

Mr. USHER. We are exporting steel.

The CHAIRMAN. So part of our inability to fill our domestic needs is, you are selling part of it overseas.

Mr. USHER. No. The export has dried up as this market has gotten stronger, and we export specialty kinds of steel, high value-added steel. Some products, such as tubulars, tend to be more of a world market. We are exporting—I am talking for U.S. steel, now—probably 2–3 percent, and a fair amount of that into Mexico.

The CHAIRMAN. I did not mean it to be critical.

Mr. USHER. No.

The CHAIRMAN. By and large, American manufacturing has done pretty well over the last decade at modernizing. I think what happened is, for 20 years after World War II it did not have any competition anyplace and we could sell anything we wanted anyplace, and people had to buy it; it did not matter if it was good or bad. Then we had 20 years of tough competition and we had to get good, and we have in most manufacturing areas.

Mr. USHER. As it relates to steel, I think that is a fair assessment.

The CHAIRMAN. Question. Assuming we must not go back to the situation where profitable corporations can pay no taxes—because of legitimate deductions, I understand that—how should we structure a minimum tax to avoid that from happening?

Mr. USHER. Well, I am not a tax expert, but I know back at the time that this was occurring there were a number of other issues that were there. The Investment Tax Credit was there.

The CHAIRMAN. We had Safe Harbor Leasing.

Mr. USHER. Safe Harbor Leasing was another one. If these had been eliminated, I think a lot of this problem would go away. So, in effect, these were exacerbating the problem at that time.

There is also, I am sure, something that can be done that, as companies make a lot of money or are paying no taxes, it can be more directed. What I think is bad about this is, you have a whole host of companies, they tend to be very capital-intensive companies, they tend to be companies that have a cyclical business, and they are being penalized by what was an attempt to catch some people that were falling through, primarily, I think, because of some of these other features. Now we have a lot of companies that have become permanent AMT payors.

The CHAIRMAN. I want to ask again, I know you are not a tax expert, but we cannot go back to profitable companies paying nothing. I am telling you, that will come home to haunt you in subsequent Congresses when the public says, how can USX make $500 million in profit and pay no taxes.

So, we have got to have something. I understand what I think is the unfairness on capital-intensive corporations, not particularly service corporations, but capital-intensive, and there we need some help in structuring something.

Mr. USHER. Well, again, looking at it from our perspective, even if we return to where we were making money, we would then shift into the regular tax. So, you are going to pay one or the other and you are going to pay the higher of the two, so right there I think you have that.

The elimination of the ITC and the Safe Harbor Leasing take away a lot of these credits that, in the past, allowed these situations to be created, which I do not think they would be created in the future.

The CHAIRMAN. Well, maybe not. I am fascinated with the ingenuity of tax lawyers to find something, some way, something you would not even be thinking of, it is not your forte, it is not mine, but there are creative minds in this world that will find things that we did not intend, never thought of.

Mr. McIntyre, let me ask you. You and I worked on this in 1986. On the individual side, it was easy enough to avoid taxes because you had the passive loss provision, which was the biggest loophole, no enforceable minimum tax and capital gains. You could combine those three and anybody, along with some charitable contributions, probably could easily escape tax. We are not going to go back to that.

And I am not talking about individuals out here, but on the corporate side I think we have unduly hit capital-intensive corporations, yet we have got to make sure they pay some tax. Do you have any suggestions?

Mr. MCINTYRE. Well, first of all, I just want to argue with your characterization about it being unfair. It is true that capital-intensive companies get very large subsidies through the Tax Code. Those who get the largest may find themselves in the minimum tax because we say, enough is enough. But to say it is unfair that you cannot take the whole trough while you are gorging yourself there, does not seem to me to be a very good argument.

If you want to slow down depreciation for steel mills, I am with you. That will take some of them out of the minimum tax and put them in the regular tax, and then they will not be complaining about the minimum tax as much, they will be complaining about the regular tax instead, and we can have another hearing on that. But to say that it is unfair that these guys are so heavily subsidized they have to pay the minimum tax, I just do not understand the argument.

The CHAIRMAN. How long have you been at this business, 15 years?

Mr. MCINTYRE. It seems like half my life, but it is only since 1976.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Well, thank you, Mr. Chairman.

Mr. McIntyre, I do not think Mr. Usher is going to invite you out for lunch. [Laughter.]

Mr. USHER. No, but I will invite him to a steel mill if he wants to see what one looks like. [Laughter.]

Senator CHAFEE. I have known Mr. McIntyre's family for many, many years. His dad was very active up in our area and very esteemed, appreciated, and respected. I have had fine associations with Mr. McIntyre going back, I guess we really got to know him best in 1986. While I look on that effect as a triumph of Bob Packwood, it also, I think, was a triumph of Bob McIntyre.

I read over the testimony—and I apologize for being a little late—of Mr. Samuels. And in it he said something that gets to the heart of the alternative minimum tax. We had situations where people, corporations and individuals, with very big incomes who were paying no tax. That presents a big problem. I guess that, on the individual side, it still can be true. It always seems to be a rich woman—I do not know why the men escape—who is totally invested in municipal bonds.

Mr. McIntyre, if an individual, is invested in municipal bonds totally, not the so called private activity bonds, he or she would not pay a nickel of tax. Is that true?

Mr. MCINTYRE. Yes.

Senator CHAFEE. So we do have a situation with the current tax code that allows individuals to completely avoid paying income tax.

Such a situation is probably very rare, and if we attempted to change it we would have every mayor in the Nation in this room. But, nonetheless, it bothers us. I sympathize and really agree with what Mr. Usher was saying. We have heard from a number of constituents about problems in connection with contributions to charitable organizations and individuals being hit by alternative minimum tax, and we corrected that, I think. Have we not, Mr. Chairman, pretty well straightened that out? I think so, anyway.

Mr. MCINTYRE. From one point of view.

Senator CHAFEE. So I would like to follow-up on what the Chairman was saying to you, Mr. Usher, and we are not expecting you to be a tax expert or write the Code for us, although I suppose you would not mind doing that in some instances. [Laughter.]

Senator CHAFEE. But I think that, somehow, we ought to be able to resolve these issues.

Another concern I have with the alternative minimum tax, I might say, is that an individual—and they do not have to be particularly wealthy—or a corporation has to, in effect, go through two tax computations. Now, that may be great for the CPAs, but it is an expense that must be substantial for somebody like USX, I suppose.

Mr. USHER. It is. We certainly would favor simplification. I think what we are really addressing, though, more than that, while we would favor simplification, is this idea that you should be treated different than a regular taxpayer, you should have your depreciation life stretched out, you should not have the availability of some of these credits.

And, for companies that find themselves, as I say, mainly for cyclical, high-investment intensity companies, you just never get out of this rut and you continue on, you continue on. And I agree with you, it seems there ought to be a way to do this and ensure that companies that are making money do pay some taxes, but this, in my opinion, has not worked as intended.

Senator CHAFEE. Mr. McIntyre, you heard the discussion about the Safe Harbor Leasing and the passive losses, and the other credits that we eliminated in 1986. Do you still think there is a big problem?

Mr. MCINTYRE. Well, we have looked at corporate annual reports, and we have looked especially at the companies who were lobbying the hardest on this bill to repeal the minimum tax. The answer is, without it many of them would pay no tax on large profits. So the answer is, yes, we still do have a problem.

In particular, the depreciation rules under the regular tax law for any company with any significant amount of leveraging produce outright negative tax rates that will take those companies off the tax rolls in the absence of an AMT.

Senator CHAFEE. Let me try something. I am not as shocked by that as you are. Our tax instructor at law school was Dean Griswald, and he offered a proposal once that was rather fascinating. He said, let anybody depreciate at any rate they want to, and the hogs will be caught pretty quickly, their deductions will all be gone in 3 years, and then they will not be there. I am not sure Dean Griswald used the word hog, but the avaricious ones.

So, in a heavily capital-intensive business like steel, they make big investment and they depreciate, and you say, in too short a time. But when the short time is up, they have no more depreciation, except if they continue to invest.

Mr. MCINTYRE. Which they do. That is why they are called a capital-intensive industry and that is why expensing investments would be so costly to the Treasury.

Senator CHAFEE. But is that all bad?

Mr. MCINTYRE. Well, if they do exactly what they would do without the tax breaks, they will not pay taxes if you let them write it off immediately, as you suggested.

That is why the House quasi-expensing proposal on the "neutral cost recovery" does not have just an enormous, one-shot revenue loss and then not cost any money afterwards; instead, it grows, and grows, and grows, up to about $30 billion or more a year. It is the time value of money, is one way to look at it.

Another way to look at it is, if you let everybody write off future expenses, they won't pay much in taxes. Let us suppose I am a service industry company and I can write off the wages of my employees for 5 years in the future right now. That is going to let me pay very little in taxes for a very long time.

Senator CHAFEE. I do not think that is a fair comparison.

Mr. MCINTYRE. Well, it is right, because what they are doing with accelerated depreciation is writing off future expenses now.

Senator CHAFEE. Can I just follow-up one minute? Let me just follow this one minute, if I could. Let us stick with the steel company, making a heavy capital investment. And let us say they can write it off in 4 years.

Mr. MCINTYRE. Let us say it lasts 30, just so we will have the concept.

Senator CHAFEE. Sure. All right. So they write it off in 4 years. At the end of the 4 years the deductions are gone, and presumably they then get hit with some pretty heavy taxes, except if they have made other big investments. Am I right so far?

Mr. MCINTYRE. If this steel company made one investment and that is it, and lived on it, and then went out of business when it was done, then the only value of the fast write-off would be the time value of money.

So, let us say they invested $10 million, it might be worth something on the order of $1.5 million to them in tax savings in present value terms. That is what the subsidy would be on that investment. That is what it would cost the government. But you are right, in the future they would pay higher taxes; in the current year, they would pay lower taxes.

Senator CHAFEE. All right. So then you are saying, but what they do is, they invest in more equipment.

Mr. MCINTYRE. That is what they do.

Senator CHAFEE. Is that bad?

Mr. MCINTYRE. Not at all. We want them to do it. In fact, one of the reasons we passed the Tax Reform Act was to encourage them to invest——

Senator CHAFEE. That is right.

Mr. MCINTYRE [continuing]. More in steel, less in empty office buildings. And that is exactly what happened.

Senator CHAFEE. All right. So USX, at the end of the 4 years, puts a ton more money into capital investment, which I presume makes them more competitive and makes them more——

Mr. MCINTYRE. Oh, no. Wait a minute. Do not think, Senator, that productive investment happens because this committee thinks some investment is a good idea. We want companies to invest because it makes economic sense. If they invest in, say, too many steel mills because this committee starts subsidizing them too heavily, we will have the situation we had in the 1980's with overcapacity, and laying off workers, and all other kinds of problems. No. We want them to respond to markets, not to signals that you or I might think are right, because we do not know a doggone thing about it.

Senator CHAFEE. Well, my time is up. I do have a little trouble with the use of the word subsidization.

Mr. MCINTYRE. Really?

Senator CHAFEE. Yes, I really do. I am with you on many things, Mr. McIntyre. All right. Thank you.

Mr. MCINTYRE. Well, the oil companies think their tax breaks are subsidies, even if the people that give them do not.

Senator CHAFEE. All right. Thank you.

The CHAIRMAN. I might indicate to the committee, we are going to try to finish by 11:15 if we can. We have a bunch of back-to-back votes, about an hour's worth, and I do not want to have the witnesses to have to come back.

If I can find it, Mr. McIntyre, I will send it to you. You mentioned the empty office buildings. I was speaking to, I think it was the American Hotel Association, in about 1989 or 1990, and their executive director spoke ahead of me and he said, the hotel business used to be a wonderful business and people would invest in it for tax reasons. Now they will not invest unless they think they can make money. [Laughter.]

The CHAIRMAN. That is exactly what we intended.

Senator Hatch.

Senator HATCH. Thank you, Mr. Chairman. Mr. McIntyre, in your written statement you indicate that the estimate produced by the Joint Committee on Taxation on the House-passed repeal of AMT is, to use your terms, "ridiculously low," and that if the repeal were enacted the actual revenue loss would be at least three times as large as the Joint Committee estimate.

Can you tell us what you base that assertion on?

Mr. MCINTYRE. Well, I am not the only witness to say that today, by the way, Senator.

Senator HATCH. No. But I am asking you.

Mr. MCINTYRE. But what do I base it on? Looking at the level of corporate concern about it is one basis. Looking at annual reports and looking at what companies have done in changing their behavior in terms of the kinds of write-offs they are taking, the kinds of investments they are engaged in, are others. Is that a scientific estimate when it is all done? No. The answer could be five times as much, it could be only 2.5 times as much. It is clearly much bigger. I think everybody at this table would agree with that.

Senator HATCH. All right. But you do not have a scientific estimate or an economic analysis of it——

Mr. MCINTYRE. No.

Senator HATCH [continuing]. Other than generally.

Mr. MCINTYRE. Right.

Senator HATCH. All right.

In your testimony you discount the negative effect of the AMT by stating that "the AMT rate is only 20 percent, and this rate is below the regular tax rate for corporations. It is not to be a major concern."

Is it not true that when you compare the AMT rate to taxable income, or to book income, that the rate can easily exceed 100 percent?

Mr. MCINTYRE. Typically it turns art to be closer to eight or nine percent.

Senator HATCH. But it is true that it can.

Mr. MCINTYRE. Compared to taxable income? I mean, the whole point is that taxable income is the wrong answer, so I do not understand that question. Compared to book income, generally not. Generally, for the companies we have looked at—and we have looked at a lot of them—the AMT, when they pay it, gets them into a rate of somewhere between 3–10 percent.

Senator HATCH. You see, I think what brings this to my mind was David Hogue, the head of the LTV Corporation, who testified back in 1992, I believe, that the corporation paid a 500 percent AMT rate in a low-profit year. I just wondered if that is just an exception.

Mr. MCINTYRE. I am sure it is an exception. And what it might reflect is LTV taking some kind of book write-off, probably writing off some future costs that it decided to book now, and we do not allow that for tax purposes. In fact, when they book it on their books they put a big note on it saying, this is a future cost that we are booking now. So, no, not in any real sense.

Senator HATCH. You do not know of any other illustrations like that one?

Mr. MCINTYRE. I am sure you could find some companies taking special write-offs for future costs where you could get what appeared to be that, but I would not consider it a real case, no.

Senator HATCH. All right.

Mr. Usher, in the GAO report on the AMT, there is a significant disparity between economic depreciation and the depreciation allowed under both a regular tax system and the AMT.

Now, in your experience and in the experience of other manufacturing firms—for instance, you are representing the NAM here today—are these depreciation schedules severely out of touch with the true depreciation of the capital assets across the board?

Mr. USHER. I would say, in general, yes, Senator. The technology in most businesses keeps changing and, as Senator Chafee said, you have to keep reinvesting in the business if you are going to be competitive, especially those that try and compete in the world. Certainly in steel, equipment that used to last 15 years and technology would still be good for 15 years, it is turning over much more quickly.

Senator HATCH. Yes.

Mr. USHER. So I think that the depreciation lives that are recognized, especially in the AMT, are much longer than their technological lives are.

Senator HATCH. I notice in our former USX plant in Utah, the Geneva Steel Company, they invested in cube-ops and all kinds of other environmentally-sensitive equipment.

Mr. USHER. If Geneva had not invested, they would not be in business today. They have invested an awful lot of money over the last several years and they are a competitive force today.

Senator HATCH. But the are still just one single company with one single product.

Mr. USHER. Right.

Senator HATCH. And if they are not treated fairly in the Tax Code, they are going to be in real trouble.

Mr. USHER. Agreed. They are in the AMT basis. Five years from now, if Geneva does not continue to invest, they are going to fall behind.

Senator HATCH. Now, you have indicated to us here today some of these matters, but I would like you to just tell us a little bit more, if you can, how the AMT has, over the past years, hurt investment plans and the cost for capital of manufacturing plants.

Mr. USHER. Well, I would say that over the last several years that many of these companies have been in a loss position, have not had cash, and have still had to remit taxes to Washington. This is money that could have been invested into plant and equipment.

It is our view, I think, in the long-run, we would all be a lot better off, rather than this money coming down here, if it had been put into plant and equipment, jobs would have been created, taxes would have been paid, and that manufacturing base would have remained.

So it certainly affects your decision making. You need money to invest in equipment. I would say most companies, one of their biggest needs is to continue to have capital to maintain competitiveness.

Senator HATCH. My time is up. Thank you. Thank you, both.

The CHAIRMAN. Senator Breaux.

Senator BREAUX. Thank you, Mr. Chairman. I thank the panel. I apologize for missing a great deal of the presentations, but I have seem some summaries of what you have said and I appreciate your testimony.

I think we are facing in the Senate, an Alice in Wonderland type of scenario. That is why we are struggling with all of these individual questions. We have a House bill pending in our committee that essentially eliminates the AMT completely for corporations, substantially reduces the capital gains tax, cuts other taxes by $188 billion, increases defense spending. This bill promises not to touch Social Security, it does not cut Medicare for deficit reduction purposes, but we will still balance the budget in 7 years.

That scenario makes Alice look rational and sane. I do not think it is possible, when you start really crunching the numbers like this committee is going to have to have to do here in the Senate.

I would just say, and ask you to comment, I do not think the AMT, with due respect to one of the principal authors of it, makes a lot of sense. The reason I say that is, we give certain things to companies to encourage activities.

We give tax deductions, tax credits, and other incentives to businesses to encourage certain types of activities in this country, because the Tax Code is more than just a revenue raiser, it is, also, used to encourage certain types of activities in this country.

I do not really understand why we give these tax incentives on the one hand, and take them away with the other. Why do we not just reduce the amount of deductions, credit exclusions, and incentives we give up front and not have an AMT at all?

So my question is, why do we not just reduce the amount of exclusions and deductions in order to make sure everybody pays their fair share?

Mr. McINTYRE. Senator, I am with you. I think we should make the AMT the regular tax. I am with you 100 percent. Let us do it.

Senator BREAUX. Mr. Usher?

Mr. USHER. Well, again, I think the real culprit here in the AMT is the depreciation schedule. If you are looking for a rather simple fix, I think if you could make the depreciation life and the AMT the same as it would be in the regular taxpayer Code, you would solve a lot of the problem. I do not think it would have any impact on those people who are regular taxpayers.

Senator BREAUX. Anybody else?

Dr. LYON. Senator Breaux, I would agree with you. In my testimony I recommended exactly what you recommend, that the preferences be reduced on the regular tax system.

I would like to say, while the AMT in many cases singles out items which result in tax rates below the economic tax rates, I think, in depreciation, it goes too far.

For example, on the regular tax, income generated from equipment investment, I calculate, given rates of inflation on the order of 3–4 percent; that income generated from equipment is taxed at about a 27 percent rate at the corporate level relative to the 34 percent, which would be taxed if depreciation for the regular tax was economic depreciation.

On the other hand, for the AMT, if depreciation was provided at economic rates, the effective tax rate for equipment would be 20 percent on the AMT, given the 20 percent tax rate.

I calculate that depreciation under the AMT is much slower than economic. For a firm that is on the AMT for about 5 years, it is paying an effective tax rate on the order of 33 percent.

So, this is a case where 20 percent is actually more than 34 percent. The 20 percent corporate tax rate on the AMT is more than the 34–35 percent tax rate presently for the regular tax.

There are other items. For example, under the AMT, inventories which are accounted for using the last-in-first-out method, which is used under the regular tax, it is what economists would call economic accounting for inventories, under the AMT they are required to use a different method of accounting, first in, first out, which taxes inflationary gain every year on inventory.

Senator BREAUX. Well, we struggle with this so much. If the Tax Code is going to be used to encourage certain types of activities on the one hand, whether it is in investment in energy activities, municipal bond purchases, or any types of things that we use the Tax

Code to encourage which is good, and then on the other hand we turn around and take it away, what are we doing?

We are encouraging the activity, and after the pages do that activity we come back and penalize them for doing the activity that we were trying to encourage in the first place. We struggled with this on public securities and municipal bonds where the tax, for AMT purposes, was 50 percent. We came back and increased that to, 75 percent, thereby discouraging the purchasing of municipal bonds.

Mr. MCINTYRE. Well, Senator, one thing to understand, though, is that the subsidies are much larger for some companies than others because of leveraging.

So, the examples there that Dr. Lyon gave were for companies that did no borrowing, which is not a real-world example. When you get a significant amount of leveraging, these effective tax rates on capital investment go negative very quickly.

So what we say is, if you are a company with mainly equity investment, the regular tax works reasonably well. If you are a company with a lot of leveraging, the regular tax does not work, the subsidies are much too large for you, and that is why we need the minimum tax.

Senator BREAUX. Or change the subsidies.

Dr. PLESKO. But, Senator, when you talk about those underlying changes, again, the AMT being there can be used as a guide to what it is you have done in terms of the underlying system. If there is a concern about debt, then you can address debt again directly in the regular Tax Code. Treasury and this committee have dealt with the issues of how we should treat leverage and whether or not we should have even a corporate tax system overall.

I think the problem with the AMT, however, is that, even if you solved all of the underlying problems with the AMT and made everything conform, you would still have complaints that are fundamentally based on the fact that book income is different than taxable income. I do not have a problem with that. They are very different.

But the perception problem and the notion of equity is often based on an evaluation of numbers in an accounting system which is not the tax accounting system, and that raises an issue of perception which the Chairman addressed in his opening statement.

Senator BREAUX. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Nickles.

Senator NICKLES. Mr. Chairman, thank you very much. I will be very brief; I have to leave. But I am intrigued by some of the comments, most of all by my colleague, Senator Chafee, and his law professor, Dean Griswald. In my business, had I subscribed to that theory, I thought you should be able to expense items over a rapid period of time.

Mr. McIntyre, I did not consider that a subsidy. I thought, if you wrote a check, you should be able to expense it over a shorter period of time. I was in manufacturing. It is dissimilar to steel, but technology was moving very rapidly.

So, if you are depreciating an asset over 15 years, quite often you would find technology moving, and maybe that machinery, which still had some productivity capability, would still be somewhat obsolete by the end of that cycle, and the need for investment to stay competitive was very much there. AMT, I think, serves as a disservice to making those investments.

Mr. Lyon, I did not quite stay up with you, and I am going to have to read your statement. But a lot of the thrust of it was, the depreciation schedule, the life of the assets, the expensing of it, is more expensive, I guess, for AMT firms.

A lot of firms seem to get stuck into this cycle, capital-intensive type firms, putting them somewhat at a disadvantage vis-a-vis other firms that are able to expense these items or depreciate the items over a shorter cycle, so it may be kind of a circle or whirlpool that they are not able to extricate themselves from. I do not think that was the intention of the authors. Maybe that could be worked out.

Now, Mr. Usher, I think your comment was, going to an economic depreciation cycle instead of the longer depreciation cycle.

Mr. USHER. I mean, probably one major thing that could be done, if you just took the depreciable life and treated the AMT taxpayer with the same life of that asset as you do for the regular taxpayer, that would solve a lot of the problems right there.

Senator NICKLES. Because it would eliminate a lot of the preference items?

Mr. USHER. Yes. In effect, on the calculation you would be able to recover the cost of that investment in the same time period of the regular taxpayer.

Senator NICKLES. Now, Mr. McIntyre called that a subsidy. But, Mr. McIntyre, you were calling a subsidy any depreciation. If you take the entire life of an asset and you write a check for it, but if you are able to expense it before the life of that asset totally expired, you were considering that as a subsidy?

Mr. MCINTYRE. Yes. The accelerated depreciation subsidy is one that lets you write off your future expenses. Most businesses are not allowed to do that, capital-intensive companies are. That is intended, by the people that wrote the Tax Code, as a subsidy for capital investment.

Senator NICKLES. Mr. McIntyre, let me just ask you a question. You mentioned, for future expenses. Let us just assume that one had some capital. Say they did not have to borrow. If you had $1 million and you are going to spend it buying a piece of machinery, for example, you said, for future expenses, you write the check for that $1 million, most people would like to recoup that investment over a short period of time because that expense was made. You are saying, no, if that asset has a life of 20 years you should only be able to deduct 5 percent of that per year?

Mr. MCINTYRE. If that is the rate it wears out, yes, Senator. Just as if you put that $1 million in a savings account we would not give you a deduction for it because it did not have any decline in value.

Senator NICKLES. I am not sure I would concur with your theory. I think if we did that we would have very little investment and we would not be very competitive in this.

Mr. MCINTYRE. Well, Senator, after 1986 when we closed down the investment tax credit and a host of other investment subsidies, investment took off and has been so much stronger since we got rid of the subsidies than before, that any theory that tax incentives are good for business investment would seem to be hard to prove. In case you have not noticed, manufacturing investment has been leading the economy of the last couple of years.

Senator NICKLES. Do not misinterpret my comments. I would consider an investment tax credit a subsidy.

Mr. MCINTYRE. Oh.

Senator NICKLES. So I see a big difference in allowing a corporation or a company that makes an investment in plant and equipment to be able to expense that investment. That does not have anything to do with investment tax credit.

I do see investment tax credit as a subsidy, but that is a different issue. I think there is a real disincentive. AMT has served as a disincentive for an investment penalizing capital-intensive companies.

I happen to share some of the thoughts, though. I do not think that profitable companies should have the possibility of being able to escape tax liability. I know the House changes, which I am reviewing right now——

AMT is much more confusing. The more I look at it, the more I have to learn. That is they reason why, Mr. Lyon, I was trying to stay with your statement. I am going to read it again and maybe call you, because I think you have a couple of good suggestions.

Mr. Chairman, I have to run. So, thank you very much.

The CHAIRMAN. Thank you.

Senator D'Amato.

Senator D'AMATO. I have no questions.

The CHAIRMAN. Mr. McIntyre, let me ask you this. Some companies are capital-intensive, some companies are people-intensive. You would regard expensing of equipment as a subsidy?

Mr. MCINTYRE. Yes, absolutely.

The CHAIRMAN. Which we allow small business to do, to a certain extent.

Mr. MCINTYRE. Right. It is a subsidy.

The CHAIRMAN. Well, big business, too, to, what, $25,000?

Mr. MCINTYRE. Yes. That is phased out for them. It is listed in the official book of tax subsidies that is prepared every year.

The CHAIRMAN. I know where it is listed.

Mr. MCINTYRE. And the people who get it think of it is as a subsidy, economists think of it as a subsidy.

The CHAIRMAN. Apart from the time value of money, why is it a subsidy?

Mr. MCINTYRE. If money had no time value, then we probably would not have an economy. I mean, that is obviously central to why it is a subsidy.

The CHAIRMAN. And you would, therefore, almost try to make us go back to, projected out, what is the expected useful life of this tool, and base your depreciation on trying to figure out, now, how long is this tool going to be worthwhile.

Mr. MCINTYRE. That is what I would like to do, yes.

The CHAIRMAN. How long is this tool going to be worthwhile? And, in what we are discovering in most businesses, it is a shorter and shorter—I do not want to say financial life—but useful life, from the standpoint of, how long can you stay in competition and keep this tool than it used to be?

Mr. MCINTYRE. Maybe for some, sure. That is what we ought to do, put the Treasury to work analyzing that, updating that every few years. It is not a big job for them.

The CHAIRMAN. And perpetually guessing.

Mr. MCINTYRE. It is better to guess close to the right answer than just enact a law you know is wrong.

The CHAIRMAN. I am more inclined, I think, to agree with Senator Chafee. I am not sure I find expensing morally wrong, to the extent that you have expensed it.

I realize the tremendous revenue lost to the government. Right now it is an immense loss which we then begin to pick up very rapidly in years two, three, and four. But I will not pursue it.

Senator Chafee?

Senator CHAFEE. I appreciate that the investment tax credit and some of the things we got rid of in 1986 were the right steps to take. And, as you will recall, no one knows better than you, Mr. McIntyre, in 1986 what we were trying to do is to get people to make business decisions, not decisions based on taxation. But I do have a little trouble with your view.

Or maybe I do not have trouble, if I understand what you were saying, the last part there. You said that if Mr. Usher has bought a new rolling mill and the period currently for depreciation of that rolling mill is 15 years, but Mr. Usher will come and tell the government that, the way things are going now, that thing has a technological age, to keep up with the competition, of 10 years.

Now, do I understand you, Mr. McIntyre? In that case you would say, all right, Mr. Usher can depreciate that over 10 years.

Mr. MCINTYRE. Well, I might not just take his word for it, but if he made a good case, yes.

Senator CHAFEE. Well, all right. You get some expert in there of some type, as they call them now, faceless bureaucrats. Why are all bureaucrats faceless? I don't know.

So, anyway, you would be willing to do that?

Mr. MCINTYRE. Absolutely.

Senator CHAFEE. What about the alternative minimum tax?

Mr. MCINTYRE. Well, if you had depreciation rules in the regular tax that reflected economic reality you certainly would not need different ones in the minimum tax except, insofar as you decided to build any subsidies into the regular tax rules. If they were economic reality and you did not try to jigger them to try to deal with inflation or something, then you raise debt issues.

Senator CHAFEE. All right. Let us assume we do not have any of that. Take my case.

Mr. MCINTYRE. Sure.

Senator CHAFEE. Under those illustrations that I gave you, do you think we could get rid of the alternative minimum tax? Mr. Usher and USX would not have to do another double——

Mr. MCINTYRE. You would not have a depreciation preference, Senator, under your hypothesis, which would get rid of almost all of it. Yes. On the other hand, he will not take this.

Senator CHAFEE. Well, I do not know. Let us try it. What do you say to that, Mr. Usher?

Mr. USHER. I would love to be able to depreciate over the technical life of an asset. I think it would be very helpful to us.

Senator CHAFEE. And obviously there would be contention over, what is the technical life of the asset, but somehow we would arrive at it. Well, maybe that is a solution. I must say, the alternative minimum tax bothers me.

At the same time, I recognize the points that the Chairman, I guess, made in his opening statement, and Mr. Samuels also made, that it really makes us look so bad when some companies are rolling in money and pay no tax.

Mr. USHER. Senator, I agree. I would add that, when you look at the tax on capital investment for regular taxpayers in this country and you compare them across the world in all the countries we compete with, they are about in the middle of the pack, but, for the AMT taxpayer, they are dead last.

Senator CHAFEE. Dead last being the heaviest.

Mr. USHER. The heaviest, by far. The tax on capital investment for AMT taxpayers, which tend to be heavy capital investment people, were dead last in the world, where, for regular taxpayers, it is in the middle of the pack.

Senator CHAFEE. Do you end up paying an AMT at times?

Mr. USHER. Yes.

Senator CHAFEE. USX does?

Mr. USHER. Yes.

Senator CHAFEE. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Breaux?

Senator BREAUX. No questions.

The CHAIRMAN. Senator D'Amato?

Senator D'AMATO. I have no questions, Mr. Chairman.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. Mr. Chairman, we all went through this in 1986 and here we are back. I guess the question I would like to ask, and it has, perhaps, been asked. I will excuse myself; I had a "dental emergency," which used to be called a toothache.

Our problem seems to be that, if this system works well enough for the rather large corporations for which it was intended, or at least which gave rise to the concern, there are about 400,000 corporations who have to maintain these two sets of tax calculations, as I understand it, to no consequence. I mean, they do not, indeed, owe an AMT after all the calculations, they pay a regular tax. That is a dead weight economic loss to us all, is it not? Well, not to the people who make out the tax returns.

Dr. Plesko?

Dr. PLESKO. Well, it is actually probably more. There are 400,000 AMT forms filed. That does not actually include everybody who fills it out and then does not send it in. So what that means is, some of those are there because of the environmental tax.

The environmental tax is piggy-backed off of the AMT. They have 28,000 AMT taxpayers; presumably the rest of them are there either to establish or not establish that they actually are AMT taxpayers or that they are or are not liable for the environmental tax. But I have no idea. There is no way, really, of knowing how many additional firms out there do the calculation.

Senator MOYNIHAN. We know we have a bottom line which is fairly consistent.

Dr. PLESKO. Yes. That is a lower bound on the number of firms that might actually calculate the AMT, because that is the number of forms filed. Many firms may still fill out the form to find out that they are not subject to it, and, therefore, not file it, and that would put us over the 400,000.

Those probably, I would assume, although the data is not publicly available, tend to be much smaller firms. I mean, there are a lot of AMT taxpayers who file the 1120A, the short, simplified form. It seems anomalous that the short form simplified taxpayer has to fill out and calculate an AMT.

Senator MOYNIHAN. What you call an opportunity cost.

Dr. PLESKO. Well, it is certainly an opportunity cost. It is a resource cost. In my testimony I think I point out, there is about $600,000 raised from 1120A taxpayers. That is the amount of minimum tax that all of the 1120A taxpayers pay.

So, there are a lot of people calculating this. There are a lot of people paying what might end up being nominal amounts of the AMT or no AMT, in the left-hand tail, smaller firms, for which I have a feeling that the calculation of what the costs of the recordkeeping and the compliance, compared to what the government gets out of them, may not be very beneficial.

Dr. LYON. I would agree with what Professor Plesko stated. But it is also intriguing, Professor Slemrod, from the University of Michigan, did a survey of essentially Fortune 500 companies, and they, too, singled out the AMT as the most complex feature of the Tax Code for them.

So it is not only the small guy, it is also the people who hire the big six accounting firms, and they have a hard time figuring out their taxes.

I have heard other accountants say that they cannot actually undertake all the computations that are technically required under the AMT, but they make a good pass at it and hope that it will pass the audit.

Dr. PLESKO. I do not know directly, but would be curious to know, exactly how much time the IRS spends, try to find out how many resources are devoted to auditing or understanding the AMT, again, by firm size.

Again, it is a difficult area. A lot of times on IRS audits you do not actually make line-by-line calculations at the end. You sum everything up at the end and you come up with a settlement as opposed to figuring out what the particular line item should or should not be.

Mr. MCINTYRE. A rule of thumb, Senator, is that there probably is no tax provision simple enough if it raises the affected taxpayers' taxes, and nothing too complicated if it cuts them.

Mr. USHER. I would say, Senator, a simple change, make the depreciation schedule for the AMT taxpayer the same as the regular taxpayer.

Mr. MCINTYRE. Which means, repeal the minimum tax. It is the same proposal he came in with.

Dr. PLESKO. But it is not clear that that is the case, though. If you look at the recent GAO report—you could spend as much or as little time with the GAO report—for but while getting rid of even all of the post-1986 depreciation would take, obviously, a good chunk of the adjustments out, the book income and ACE get at depreciation as well. The fact that there are differences between tax depreciation and book depreciation means that part of these depreciation differences show up in another place on the form. If you look at the data provided by the GAO, in a number of years the book income or ACE adjustments are much larger than any of the adjustments made directly just for the depreciation.

Mr. McINTYRE. Yes. But ACE is a depreciation adjustment.

Dr. PLESKO. Excuse me. But if I can, the notion of the book income of the ACE adjustments, I think those, in particular, go to the equity issues which the committee has always been concerned about, because that is where you get a public company showing something in their financial statements that may be different than what their tax return shows, whereas the depreciation changes are not something that the public sees directly.

So, while there may be an efficiency argument and there may be concerns over revenue, the equity argument, I think, tends to be shown and demonstrated through what is showing up in financial statements.

Those certainly, again, looking through what Mr. McIntyre produces, are calculations based on financial statements which may or may not at all be representative of the underlying tax situation of the firm.

Senator MOYNIHAN. Mr. Chairman, you chose to return to this subject, so we shall look to you for guidance.

The CHAIRMAN. I appreciate that. Sometimes I wish I had not returned to it.

Senator Breaux, any more?

Senator BREAUX. No more.

The CHAIRMAN. Gentlemen, thank you very much. We are adjourned.

[Whereupon, at 11:09 a.m., the hearing was concluded.]

# APPENDIX

## ADDITIONAL MATERIAL SUBMITTED

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### PREPARED STATEMENT OF ALFONSE D'AMATO

Mr. Chairman, I am pleased to participate in today's hearing to discuss the alternative minimum tax and its impact on individual and corporate taxpayers.

It is important to take a closer look at the alternative minimum tax, to determine its effects on economic growth and whether it has, in fact, discouraged capital investment, especially in the manufacturing and finance industries. A number of my constituents have informed me that the AMT has caused their marginal tax rates to soar—in one case as high as 68 percent. That it is crippling their ability to invest and create jobs.

Mr. Chairman, available data indicates that the AMT has accomplished its goal of ensuring that all taxpayers pay their fair share of income taxes. However, it is imperative that we carefully consider its effects on equity and investment incentives. I look forward to hearing from our distinguished panel of witnesses.

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### PREPARED STATEMENT OF SENATOR ORRIN G. HATCH

Mr. Chairman, thank you for holding this important hearing this morning to discuss the Alternative Minimum Tax.

As you know, the minimum tax dates back to President Johnson's Treasury Department and that Administration's efforts to shore up tax laws that were allowing individuals with large economic incomes to pay little or no tax. Since that time, both the tax code and the AMT have undergone numerous changes and modifications, most notably in the Tax Reform Act of 1986.

This Committee, in its report accompanying the 1986 Act, stated:

> "The Committee believes that the minimum tax should serve one overriding objective: to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits."

I believe the minimum tax was set up with a worthy purpose in mind. Our goal should be a tax system that is fair. The perception of unfairness within the tax system damages the credibility of the system, the Congress, and the entire federal government.

At the same time, Mr. Chairman, we must not, in the name of fairness, place a counterproductive burden on American enterprise that chokes initiative, punishes expansion, and limits growth and job creation. I am afraid that in 1986 we created a monster that goes way beyond reason.

The time has come to reevaluate the alternative minimum tax, along with the regular tax system. By definition, the AMT acknowledges the limitations of the regular tax system with regard to fairness and is an effort to correct these limitations.

At a minimum, I believe the AMT needs to be modified. Perhaps we should even repeal it, as the House did. Individuals, corporations, and the government are all burdened with this second tier tax system. Decisions for investment and capital expenditures are oftentimes overshadowed by the impediments in the AMT. This discourages investment and stifles the growth of those who have found themselves trapped within its walls. Millions of taxpayers, corporate and individual, who are not alternative minimum taxpayers, are burdened not only with the opportunity costs of this tax, but also by the high compliance cost of this exceptionally complex tax system.

I am eager today to hear the testimony about the specific problems with and the need for the AMT. Significant questions have arisen since the House took the bold initiative to repeal the tax. I believe we must assess the feasibility of repeal and examine other alternatives that would lessen the counterproductive nature of the current alternative minimum tax.

Thank you, Mr. Chairman.

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# PRESENT LAW AND ISSUES RELATING TO THE CORPORATE AND INDIVIDUAL ALTERNATIVE MINIMUM TAX (AMT)

Scheduled for a Hearing

Before the

SENATE COMMITTEE ON FINANCE

on May 3, 1995

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

May 2, 1995

JCX-22-95

## CONTENTS

## INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on May 3, 1995, on issues relating to the alternative minimum tax ("AMT") on individuals and corporations and proposed changes to the AMT included in H.R. 1215 (the "Tax Fairness and Deficit Reduction Act of 1995") as passed by the House of Representatives on April 5, 1995. This document,[1] prepared by the staff of the Joint Committee on Taxation, describes present-law AMT rules and the provisions in H.R. 1215, and discusses issues relating to the present-law AMT.

Part I of the document is an overview of present-law AMT and the provisions in H.R. 1215. Part II describes the present-law AMT rules and the legislative background of the AMT. Part III is an analysis of the present-law AMT rules, including data on individual and corporate AMT taxpayers. Part IV is a description of the AMT provisions in H.R. 1215 as passed by the House.

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[1] This document may be cited as follows: Joint Committee on Taxation, Present Law and Issues Relating to the Corporate and Individual Alternative Minimum Tax (AMT) (JCX-22-95), May 2, 1995.

# I. OVERVIEW

## Present law and background

Present law imposes a minimum tax, known as the alternative minimum tax ("AMT"), on an individual or a corporation to the extent the taxpayer's minimum tax liability exceeds its regular tax liability. The individual AMT is imposed at rates of 26 and 28 percent on alternative minimum taxable income in excess of a phased-out exemption amount. The corporate AMT is imposed at a rate of 20 percent on alternative minimum taxable income in excess of a $40,000 exemption amount.

Alternative minimum taxable income is the taxpayer's taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items. In the case of a corporation, in addition to the regular set of adjustments and preferences, there is a second set of adjustments known as the "adjusted current earnings" adjustment. The adjusted current earnings adjustment replaced the "book income" adjustment for taxable years beginning after 1989. Thus, for many taxpayers, when compared to the regular tax, the AMT generally imposes a lower marginal rate of tax on a broader base of income.

If a corporation is subject to AMT in any year, such amount of tax is allowed as a credit in any subsequent taxable year to the extent the corporation's regular tax liability exceeds its tentative minimum tax in such subsequent year. For an individual, this credit is allowed to the extent the taxpayer's AMT liability is a result of adjustments that are timing in nature.

The corporate AMT was enacted as part of the Tax Reform Act of 1986. Prior to 1987, corporations were subject to an "add-on" minimum tax. The Tax Reform Act of 1986 also expanded the pre-existing individual alternative minimum tax. Various changes have been made to the AMT since 1986, including the repeal of certain preferences and adjustments and increases to the individual AMT rate.

## Analysis of issues

Relatively few individuals are subject to the AMT. Those that are so subject tend to be individuals with higher adjusted gross incomes. Similarly, relatively few corporations are subject to the AMT. However, large corporations are more likely to be subject to the AMT than are small corporations. This is generally true because large corporations tend to be more capital intensive and many of the preferences and adjustments of the corporate AMT relate to the cost recovery of capital items, such as depreciation.

As a separate system within the regular tax system, the AMT should be analyzed in terms of equity, efficiency, growth, and simplicity. The individual AMT may act to increase the progressivity of the income tax system. The effects of the AMT on the cost of capital and aggregate investment is uncertain. The AMT creates additional compliance burdens and is viewed as complex by taxpayers.

<u>**H.R. 1215 as passed by the House**</u>

H.R. 1215 (the "Tax Fairness and Deficit Reduction Act of 1995"), as passed by the U.S. House of Representatives on April 5, 1995, would repeal the corporate AMT for taxable years beginning after December 31, 2000. In addition, the bill generally would repeal the various adjustments and preferences that relate to business activities of individuals and corporations for transactions entered into after December 31, 1995. The depreciation adjustment would be repealed for property placed in service after March 13, 1995. The individual AMT, as amended by the bill, would remain in existence. For taxable years beginning after December 31, 1995, a taxpayer with AMT credit carryovers would be allowed to use these credits to offset 90 percent (rather than 100 percent) of its regular tax liability (determined after the application of other credits as under present law).

## II. PRESENT LAW AND LEGISLATIVE BACKGROUND

### A. Present-Law Rules

In general

Present law imposes a minimum tax (known as the alternative minimum tax ("AMT")) on an individual or a corporation to the extent the taxpayer's minimum tax liability exceeds its regular tax liability. The individual minimum tax is imposed at rates of 26 and 28 percent on alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount. The 26 percent rate is applied to the extent that an individual's AMTI in excess of an exemption amount does not exceed $175,000 ($87,500 in the case of a married individual filing a separate return). The 28 percent rate is applied to the amount in excess of $175,000. The exemption amounts are: (1) $45,000 in the case of married individuals filing a joint return or a surviving spouse, (2) $33,750 in the case of a single individual; and (3) $22,500 in the case of a married individual filing a separate return or an estate or a trust. The exemption amounts are not indexed for inflation and are phased-out by an amount equal to 25 percent of the amount by which the taxpayer's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return or a surviving spouse, (2) $112,500 in the case of a single individual, and (3) $75,000 in the case of a married individual filing a separate return or an estate or a trust. The corporate AMT is imposed at a rate of 20 percent on AMTI in excess of a $40,000 exemption amount.[2] The corporate exemption amount is not indexed for inflation and is phased-out by an amount equal to 25 percent of the amount by which the corporation's AMTI exceeds $150,000.

Alternative minimum taxable income is the taxpayer's taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items. In the case of a corporation, in addition to the regular set of adjustments and preferences, there is a second set of adjustments known as the "adjusted current earnings" adjustment.

Preference items in computing AMTI

The minimum tax preference items are:

(1) The excess of the deduction for percentage depletion over the adjusted basis of the property at the end of the taxable year. For taxable years beginning after 1992, this preference does not apply to percentage depletion allowed with respect to oil and gas properties.

[2] In addition, in the case of a corporation, section 59A imposes an environmental tax at a rate of 0.12 percent on modified AMTI in excess of a $2,000,000 exemption amount. Environmental tax collections are dedicated to the Hazardous Substance Superfund. This tax is scheduled to expire for taxable years beginning after December 31, 1995.

(2) The amount by which excess intangible drilling costs arising in the taxable year exceed 65 percent of the net income from oil, gas, and geothermal properties. "Excess intangible drilling costs" is the amount by which the regular tax deduction for intangible drilling costs exceeds the amount that would have been deducted had such costs been capitalized and amortized over a 120-month period. For taxable years beginning after 1992, this preference does not apply to independent producers to the extent the producer's AMTI is reduced by 40 percent (30 percent in 1993) or less by ignoring the preference.

(3) The amount that a financial institution's bad debt deduction determined under section 593 (the percentage of taxable income method generally available to savings and loan associations) exceeds the amount that would have determined based on the institution's actual experience.

(4) Tax-exempt interest income on private activity bonds (other than qualified 501(c)(3) bonds) issued after August 7, 1986.

(5) Accelerated depreciation or amortization on certain property placed in service before January 1, 1987.

(6) One-half of the amount excluded from income under section 1202 (relating to gains on the sale of certain small business stock).

In addition, losses from any tax shelter farm or passive activities are denied.[3]

<u>Adjustments in computing AMTI</u>

The adjustments that all taxpayers must make are:

(1) Depreciation on property placed in service after 1986 must be computed by using the generally longer class lives prescribed by the alternative depreciation system of section 168(g) and either (a) the straight-line method in the case of property subject to the straight-line method under the regular tax or (b) the 150-percent declining balance method in the case of other property.[4]

(2) Mining exploration and development costs expensed under the regular tax must be capitalized and amortized over a 10-year period.

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[3] Given the full applicability of section 469 (relating to the deductibility of losses from passive activities) following a phase-in period after the passage of the Tax Reform Act of 1986, these provisions are largely deadwood.

[4] Generally, under the regular tax, the 200-percent declining balance method applies to tangible personal property with a class life of less than 20 years, the 150-percent declining balance method applies to tangible personal property with a class life between 20 and 25 years, and the straight-line method applies to all other property.

(3) Taxable income from a long-term contract (other than a home construction contract) must be computed using the percentage of completion method of accounting.[5]

(4) The amortization deduction allowed for pollution control facilities (generally determined using 60-month amortization for a portion of the cost of the facility under the regular tax) must be calculated under the alternative depreciation system.

(5) Dealers in property (other than certain dealers of timeshares and residential lots) may not use the installment method of accounting.[6]

The adjustments applicable to individuals are:

(1) The miscellaneous itemized deductions (generally those that are allowable against the regular tax if they are in excess of two percent of the taxpayer's adjusted gross income) are not allowed.

(2) State, local, and foreign real property taxes; state and local personal property taxes; and state, local, and foreign income, war profits, and excess profits taxes are not allowed as itemized deductions.

(3) Medical expenses, except to the extent in excess of ten percent of the taxpayer's adjusted gross income, are not allowed as itemized deductions.

(4) Certain restrictions are placed on home mortgage interest that is otherwise deductible for regular tax purposes.

(5) Standard deductions and personal exemptions are not allowed.

(6) The amount allowed to be expensed and deducted under the regular tax for circulation expenditures must be capitalized and amortized over a three-year period.

(7) The amount allowed to be expensed and deducted under the regular tax for research and

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[5] Pursuant to a provision in the Omnibus Budget Reconciliation Act of 1989, most taxpayers producing property pursuant to a long-term contract must use the percentage of completion method for regular tax purposes. Under prior law, contractors could use the completed contract method to report income from a portion of the contract.

[6] Pursuant to a provision in the Revenue Act of 1987, most dealers in property are denied the use of the installment method. Under prior law, dealers were allowed to report income under the installment method.

experimental expenditures must be capitalized and amortized over a 10-year period;[7] and

(8) The special rules relating to incentive stock options do not apply.[8]

The adjustments applicable to corporations are:

(1) The special rules applicable to Merchant Marine capital construction funds do not apply.[9]

(2) The special deduction under section 833(b) (relating to Blue Cross and Blue Shield organizations) is not allowed; and

(3) The adjusted current earnings adjustment, as described below, applies.

<u>Adjusted current earnings and book income adjustments</u>

The adjusted current earnings adjustment increases a corporation's AMTI by an amount equal to 75 percent of the amount by which the adjusted current earnings ("ACE") of the corporation exceeds its AMTI (determined without the ACE adjustment and the alternative tax net operating loss deduction).[10] In determining ACE, the following rules apply:

(1) For property placed in service before 1994, depreciation generally is determined using the straight-line method and the class life determined under the alternative depreciation system.[11]

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[7] No adjustment is required if the taxpayer materially participates in the activity that relates to the research and experimental expenditures.

[8] Under the regular tax, no income results at the time of the qualified transfer of any share of stock pursuant to the exercise of an incentive stock option.

[9] Generally under the regular tax, amounts contributed to a Merchant Marine capital construction fund may be expensed, earnings on investments within the fund are not subject to tax, and withdrawals from the fund are not subject to tax to the extent the amount of the withdrawal is used to reduce the adjusted basis of a qualified vessel.

[10] If ACE is less than AMTI, the ACE adjustment may reduce AMTI to the extent of prior-year ACE inclusions.

[11] Pursuant to a provision in the Omnibus Budget Reconciliation Act of 1993, the ACE depreciation adjustments is not required for property placed in service after 1993. See the discussion in Part II.B. below, for changes made to the corporate depreciation adjustment.

(2) Any amount that is excluded from gross income under the regular tax, but is included for purposes of determining earnings and profits, is included in determining ACE.[12] Thus, for example, interest income on State and local bonds that is tax-exempt under section 103 is included in ACE.

(3) The inside build-up of a life insurance contract is includible in ACE (and the related premiums are deductible).[13]

(4) Intangible drilling costs (other than those incurred by an independent producer after 1992) must be capitalized and amortized over a 60-month period, rather than expensed and deducted.

(5) The regular tax rules of sections 173 (allowing circulation expenditures to be expensed) and 248 (allowing organizational expenditures to be amortized over a 60-month period) do not apply.

(6) Inventory must be calculated using the FIFO, rather than LIFO, method.

(7) The installment sales method generally may not be used.

(8) No loss may be recognized on the exchange of any pool of debt obligations for another pool of debt obligations having substantially the same effective interest rates and maturities.

(9) Depletion (other than oil and gas depletion claimed by an independent producer or a royalty owner after 1992) must be calculated using the cost, rather than the percentage, method; and

(10) In certain cases, the adjusted bases of the assets of a corporation that has undergone an ownership change must be stepped-down to their fair market values.[14]

The ACE adjustment applies to taxable years beginning after 1989. For taxable years beginning after 1986 and before 1990, the AMTI of a corporation was increased by the "book income adjustment," as described in detail in Part II.B. below.

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[12] Exceptions and special rules are provided for related expenses that are not deductible for regular tax purposes but reduce earnings and profits, the dividends received deduction relating to certain dividends, taxes on dividends from 936 companies, and certain dividends received by certain cooperatives.

[13] Under the regular tax, the inside build-up of a life insurance contract is not subject to tax and the related premiums are not deductible.

[14] Under the regular tax, the usage of built-in losses with respect to assets acquired after a corporate change of ownership may be limited by section 382. The effect of the ACE provision is to eliminate such losses for ACE purposes.

Other rules

The combination of the taxpayer's net operating loss carryover and foreign tax credits generally cannot reduce the taxpayer's AMT by more than 90 percent of the amount determined without these items.

The various credits allowed under the regular tax generally are not allowed against the AMT.

If a taxpayer is subject to AMT in any year, such amount of tax is allowed as a credit in any subsequent taxable year to the extent the taxpayer's regular tax liability exceeds its tentative minimum tax in such subsequent year. If the taxpayer is an individual, this credit is allowed to the extent the taxpayer's AMT liability is a result of adjustments that are timing in nature.

## B. Legislative Background

Minimum taxes prior to the Tax Reform Act of 1986

Immediately prior to the Tax Reform Act of 1986 ("1986 Act"), corporations were subject to an "add-on" minimum tax (first introduced in 1969 and applied to both individuals and corporations) and individuals were subject to an alternative minimum tax similar to the AMT of present law. This individual alternative minimum tax was first introduced in 1978.

A corporation was subject to the "add-on" minimum tax in addition to its regular tax liability. The amount of the tax was 15 percent of the corporation's tax preferences, to the extent the aggregate amount of these preferences exceeded the greater of the regular income tax paid or $10,000. The corporate tax preferences were: (1) the excess of accelerated over straight-line depreciation in the case of real property; (2) the excess of 60-month amortization over the amount of depreciation otherwise allowable in the case of certified pollution control facilities; (3) the excess of bad debt deductions over the amount of those deductions computed on the basis of actual experience in the case of a financial institution; (4) percentage depletion to the extent in excess of the adjusted basis of the depletable property; and (5) 18/46 of the corporation's net capital gain.[15] Special rules also applied to corporations with net operating losses.[16]

Prior to the 1986 Act, individuals were subject to an alternative minimum tax that resembled the AMT of present law. The tax was payable in addition to all other tax liabilities to the extent it exceeded the individual's regular tax liability. The tax was imposed at flat rate of 20 percent on

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[15] Prior to the 1986 Act, corporations were subject to a maximum rate of tax of 28 percent on net capital gains and a maximum rate of tax of 46 percent on ordinary income.

[16] In addition, section 291 provided a reduction in the use of certain preferences by corporations in computing taxable income. Section 291, as amended by the 1986 Act, remains in present law.

alternative minimum taxable income in excess of an exemption amount. A taxpayer's alternative minimum tax liability could be reduced by foreign tax credits and refundable credits. An individual's alternative minimum taxable income was his or her adjusted gross income, increased by certain preferences and reduced by alternative tax itemized deductions.

The tax preference items were: (1) dividends excluded from taxable income under prior-law section 116 (prior law allowed an individual to exclude up to $100 of dividends annually); (2) the excess of accelerated over straight-line depreciation in the case of real property; (3) the excess of accelerated over straight-line depreciation (the latter using lengthened recovery periods) in the case of leased personal property; (4) the excess of 60-month amortization over the amount of depreciation otherwise allowable in the case of certified pollution control facilities; (5) the excess of the deduction for expensed mining exploration and development costs over the amount that would be allowable if the costs were capitalized and amortized over a 10-year period; (6) the excess of the deduction for expensed circulation expenditures over the amount that would be allowable if the costs were capitalized and amortized over a 3-year period; (7) the excess of the deduction for expensed research and development expenditures over the amount that would be allowable if the costs were capitalized and amortized over a 10-year period; (8) percentage depletion to the extent in excess of the adjusted basis of the depletable property; (9) that portion of net capital gains that were deductible from gross income (unless the gain related to the sale or exchange of a principal residence);[17] (10) the excess of the fair market value received through the exercise of an incentive stock option over the exercise price; and (11) the amount by which excess intangible drilling costs deducted in the taxable year exceeded the net income from oil, gas, and geothermal properties. An individual could avoid some of the preferences listed above by electing to defer regular tax deductions for circulation expenditures, research and experimental expenditures, intangible drilling costs, mining exploration and developments costs, and depreciation. An individual may have had an incentive to make such an election even though it increased his or her regular taxable income in the year of the election in order to reduce his or her alternative minimum tax liability in future years. The election may have been attractive because the prior-law alternative minimum tax was, in many respects, an "add-on" system (i.e., minimum tax paid with respect to timing preferences did not give rise to a credit to be used in subsequent years).

The itemized deductions that an individual could deduct for minimum tax purposes were casualty or theft losses, gambling losses to the extent of gambling gains, charitable deductions, medical deductions to the extent in excess of 10 percent of the taxpayer's adjusted gross income, interest expense on qualified home indebtedness, other interest expense not in excess of qualified net investment income, and deductions for estate tax attributable to income in respect of a decedent.

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[17] Prior to the 1986 Act, individuals could deduct from income up to 60 percent of net capital gains.

<u>Changes made by the Tax Reform Act of 1986</u>

The 1986 Act replaced the corporate "add-on" minimum tax with the present-law corporate AMT. The 1986 Act also broadened the base of the pre-existing individual alternative minimum tax. In addition, the 1986 Act increased the individual AMT rate to 21 percent, phased-out the exemption amounts, provided the AMT credit, and changed the individual AMT from essentially an add-on system of preferences to a separate tax system of preferences and adjustments, the latter of which were deferral items that could "turn-around" (i.e., decrease AMTI) over the life of the related property.

The 1986 Act provided that the ACE adjustment described in Part II.A., above, was to apply to taxable years beginning after 1989 and the "book income adjustment" was to apply to taxable years beginning in 1987, 1988, and 1989. The book income adjustment was the amount equal to 50 percent of the amount by which the adjusted net book income of a corporation exceeded its AMTI (determined without the book income adjustment and the alternative tax net operating loss deduction). The "adjusted net book income" of a corporation meant the net income or loss of the corporation as set forth in the corporation's applicable financial statement, with the following adjustments:

(1) Adjusted net book income did not include any Federal income taxes, or income, war profits, or excess profits taxes imposed by any foreign country or possession of the United States, unless such foreign taxes were deducted rather than claimed as a credit on the taxpayer's return. In addition, adjusted book earnings could be reduced by the corporation's environmental tax liability under section 59A.

(2) If the corporation filed a consolidated return with other corporations, adjusted net book income took into account items of the corporation's applicable financial statement that were properly allocable to the members of the group that were included in the return, with appropriate adjustments for dividends received from affiliated corporations that were not included in such return.

(3) Appropriate adjustments were required to the extent the applicable financial statement covered a period other than the corporation's taxable year.

(4) In the case of a cooperative to which section 1381 applies, adjusted net book income did not include patronage dividends and per-unit retain allocations to the extent such amounts were not otherwise taken into account in determining adjusted net book income.

(5) Subject to certain limitations, for purposes of determining the alternative minimum tax foreign tax credit, 50 percent of any taxes withheld or tax paid to any possession of the United States with respect to dividends received from a section 936 corporation were treated as a tax paid to a foreign government.

(6) In the case of an Alaskan Native Corporation, adjusted net book income would be appropriately adjusted to allow cost recovery and depletion deductions attributable to property

received pursuant to the Alaskan Native Claims Settlements Act and for certain payments made pursuant to such Act.

(7) In the case of a mutual life insurance company, adjusted net book income was reduced by policyholder dividends to the extent such payments exceeded the differential earnings amount determined under section 809.

(8) In the case of a corporation in title 11, or to the extent the corporation is insolvent, adjusted net book income did not include any income resulting from the transfer of stock of the corporation in the discharge of its indebtedness.

(9) The Secretary of the Treasury had the authority to properly adjust adjusted net book income to prevent the omission or duplication of any item.

For this purpose, the applicable financial statement of a corporation was an statement covering the taxable year which was (1) required to be filed with the Securities and Exchange Commission; (2) a certified audited income statement to be used for purposes of a statement or report for credit purposes, to shareholders, or for any other substantial nontax purposes; (3) an income statement for a substantial nontax purpose required to be provided to the Federal government, a State government, a political subdivision of a State, or any agency of any of the above; or (4) an income statement to be used for purposes of a statement or report for credit purposes, to shareholders, or for any other substantial nontax purposes. If a corporation did not have an applicable financial statement, the earnings and profits of the corporation was considered to be the net income or loss of the corporation as set forth in an applicable financial statement. In addition, if a corporation had only a statement described in (4) above, the corporation could elect to use its earnings and profits in lieu of net income or loss on such statement. If a corporation had more than one statement described above, the corporation generally was to take into account the first statement delineated above.

## Changes made since the Tax Reform Act of 1986

Certain amendments have been made to the individual and corporate AMT bases and rates since the 1986 Act. The principal changes are described below.

### Tax rates

The individual AMT rate was raised from a flat 21 percent to a flat 24 percent by the Omnibus Budget Reconciliation Act of 1990 ("1990 Act"). The Omnibus Budget Reconciliation Act of 1993 ("1993 Act") instituted the two-tier individual rate system (at 26 and 28 percent) of present law and increased the individual exemption amounts. Both the 1990 and 1993 Acts increased the top marginal individual rates for purposes of the regular income tax. The corporate AMT rate has remained at 20 percent since the 1986 Act.

Depreciation

Several changes have been made to the corporate depreciation adjustment. For taxable years beginning in 1987, 1988, and 1989, corporations were subject to the book income adjustment. Thus, for AMT purposes, the allowable deduction for the cost of depreciable property placed in service in those years generally was effectively bifurcated--one-half of the deduction was determined using the 150-percent declining balance method over the alternative depreciation system class life for the property and the other half was determined pursuant to whatever method the taxpayer used for book purposes. For property placed in service prior to 1987, the deduction was also bifurcated--one-half of the deduction was determined using the regular tax allowance and the other half was determined under the taxpayer's book method.

The corporate ACE adjustment (applicable to taxable years beginning after 1989) generally required the cost of depreciable property to be recovered using the straight-line method over the alternative depreciation system life of the property. Thus, for AMT purposes, the allowable deduction for the cost of depreciable property placed in service after 1989 and before 1994 generally was bifurcated as follows--25 percent of the deduction was determined using the 150-percent declining balance method over the alternative depreciation system class life for the property (the AMT depreciation adjustment applicable to all taxpayers) and 75 percent was determined using the straight-line method over the same alternative depreciation system class life (the ACE depreciation adjustment). The combination of the two systems results in depreciation allowances that are roughly equivalent to the allowances that would have been obtained had the corporation used the 120-percent declining balance method over the alternative depreciation system class life for the applicable property. The ACE depreciation adjustment also had transition rules for property placed in service before 1990. For property placed in service prior to 1990, corporations were required to recover the remaining basis of property over the remaining class life under the alternative depreciation system and using the straight-line method for ACE purposes. For property placed in service prior to 1987, remaining basis means adjusted basis under the regular tax. For property placed in service prior after 1986 and before 1990, remaining basis means adjusted basis under the AMT depreciation adjustment applicable to all taxpayers (i.e., using the 150-percent declining balance method over the alternative deprecation system class life for personal property). In addition, as originally enacted, ACE contained a provision that provided that the ACE depreciation deduction could not exceed the depreciation expense the corporation claimed for book purposes. Similar rules applied with respect to intangible drilling costs, depletion and mining expenses. These "book-backstop" rules were repealed by the Omnibus Budget Reconciliation Act of 1989.

The ACE depreciation adjustment was repealed by the 1993 Act for property placed in service after December 31, 1993. The ACE depreciation adjustment remains applicable to property placed in service before that date.

Oil and gas provisions

The 1986 Act version of the AMT contained several provisions that related to oil and gas exploration and production.[18] Preferences included (1) the deduction for percentage depletion to the extent the deduction exceeded the adjusted basis of the property and (2) the amount by which excess intangible drilling costs ("IDCs") arising in the taxable year exceeded 65 percent of the net income from oil and gas properties. "Excess IDCs" was the amount by which the regular tax deduction for IDCs exceeded the amount that would have been deducted had such costs been capitalized and amortized over a 120-month period. In addition, under ACE, percentage depletion could not be used and the cost of IDCs had to be capitalized and amortized over a 60-month period.

The 1990 Act provided a special energy deduction for purposes of reducing AMTI. The deduction was based on a specific portion of the various oil and gas related preference and ACE adjustment items. Specifically, the special energy deduction was initially determined by determining the taxpayer's IDC preference and marginal production depletion preference. The amount of these preferences was the amount that the taxpayer's AMTI would have been reduced had the AMT rules relating to IDCs and percentage depletion on marginal properties not applied. The IDC preference was divided between qualified exploratory costs and other costs and each portion, and the marginal production depletion preference, were multiplied by specified percentages. These three products were added together to comprise the special energy deduction. The special energy deduction was not allowed to the extent it exceeded 40 percent of the taxpayer's AMTI (determined without this deduction and net operating losses). In addition, the special energy deduction was phased-out if the average price of crude oil exceeded $28 a barrel in the prior year.

The special energy deduction was repealed in the Energy Policy Act of 1992. The 1992 Act also repealed the preferences and ACE adjustments for the deductions of IDCs and percentage depletion of oil and gas producers other than integrated oil companies. The repeal of the IDC preference and ACE adjustment could not reduce a taxpayer's AMTI by more than 40 percent (30 percent in 1993) of the amount that the taxpayer's AMTI would have been had the preference and adjustment ACE not been repealed.

Charitable contributions of appreciated property

Under the regular tax, a taxpayer generally is allowed to deduct the fair market value of appreciated property contributed to a charity. The 1986 Act included a preference that limited a taxpayer's deduction for the charitable contribution of appreciated property to the taxpayer's adjusted basis in the property. The 1990 Act repealed this preference for tangible personal property contributed in taxable years beginning in 1991 and contributions made before July 1, 1992, in taxable years beginning in 1992. The 1993 Act repealed the preference for tangible personal property contributed after June 30, 1992, and other appreciated property contributed after December 31, 1992.

[18] As discussed above, the corporate and individual minimum taxes in effect before the 1986 Act also contained preferences with respect to oil and gas exploration and production.

Miscellaneous changes

The Omnibus Budget Reconciliation Act of 1989 made miscellaneous changes to the AMT. These changes: (1) allowed additional dividends to qualify for the dividends-received deduction under ACE, (2) excluded discharge of indebtedness income from ACE to the extent the income was excluded under the regular tax, (3) repealed certain ACE capitalization rules, (4) conformed the effective date of the ACE change of ownership provision with the general effective date of ACE, (5) conformed certain ACE and regular tax rules with respect to IDCs, (6) repealed ACE rules with respect to annuities, (7) excepted small home construction contracts from the AMT long-term contract rule, (8) repealed the AMT adjustment for research and development expenditures for individuals who actively participate in the underlying business, (10) provided an exception to the 90-percent limitation on the use of foreign tax credits, (11) increased the minimum tax credit by the amount of the orphan drug credit not allowed solely by reason of the tentative minimum tax limitation, and (12) allowed corporations to use the entire amount of their AMT liability as a minimum tax credit (under prior law, corporations were only allowed the credit with respect to deferral items; this rule currently applies to individuals).

Moreover, certain changes have been made to the regular income tax to more closely conform its base to the AMT base. For example, many of the preferences contained in the pre-1986 individual alternative minimum tax were enacted, in part, because of a concern with individuals investing in tax shelter activities. The 1986 Act directly addressed this concern with the enactment of the passive activity rules of section 469. Similarly, the present-law AMT adjustments relating to installment sales by dealers and long-term contracts apply to relatively few taxpayers because since 1986, Congress has, with some exceptions, adopted the AMT treatment for these items for regular tax purposes. Finally, the depreciable recovery period for nonresidential real estate under the regular tax (39 years) now approximates the period used for AMT purposes (40 years).

# III. ANALYSIS OF ISSUES

## A. Data on AMT Taxpayers

Individual AMT taxpayers

Relatively few taxpayers, either individual or corporate, are subject to the AMT. In 1992, of the 86.7 million individual income tax returns with positive tax liability, approximately 287,000, or 0.33 percent, paid tax arising from an individual AMT liability.[19] Table 1 presents individual AMT data for the 1987-92 tax years.

**Table 1.--Individual Income Tax Returns With Tax Liability Under the Individual Alternative Minimum Tax, 1987-1992**

| Year | Number of returns (thousands) with positive tax liability | Number of returns (thousands) paying AMT | Percentage of returns paying AMT | Excess of AMT liability over regular liability $ (millions) |
|---|---|---|---|---|
| 1987 | 86,723 | 139.8 | 0.16 | 1,674.9 |
| 1988 | 87,135 | 113.6 | 0.13 | 1,027.9 |
| 1989 | 89,178 | 117.5 | 0.13 | 831.0 |
| 1990 | 89,862 | 132.1 | 0.15 | 830.3 |
| 1991 | 88,734 | 243.7 | 0.27 | 1,213.4 |
| 1992 | 86,731 | 287.2 | 0.33 | 1,357.1 |

Source: Internal Revenue Service, *Statistics of Income*, various years.

In 1992, the approximately 287,000 individual AMT taxpayers had a total tax liability of $1.36 billion arising from the excess of their AMT over their regular tax, or 0.28 percent of $476.2 billion in total individual income tax liabilities. Table 2 below reports how individual AMT taxpayers were distributed across various income classes in 1991 when those classes are demarcated by adjusted gross income ("AGI") as defined under the regular individual income tax.

[19] Joint Committee on Taxation tabulations from Internal Revenue Service, Statistics of Income, Individual Income Tax Returns, 1992.

**Table 2.-- Distribution of Individual AMT Taxpayers and Liabilities by Adjusted Gross Income, 1991**

| AGI | Number of Returns | Tax Liability (Thousands $) |
|---|---|---|
| No AGI | 4,261 | 53,720 |
| $1 to less than $5,000 | 14,164 | 3,501 |
| $5,000 to less than $10,000 | 8,431 | 4,941 |
| $10,000 to less than $25,000 | 3,402 | 7,607 |
| $25,000 to less than $50,000 | 18,537 | 37,246 |
| $50,000 to less than $75,000 | 39,955 | 84,250 |
| $75,000 to less than $100,000 | 35,783 | 87,982 |
| $100,000 to less than $200,000 | 69,309 | 249,880 |
| $200,000 to less than $500,000 | 39,344 | 322,047 |
| $500,000 to less than $1 million | 7,275 | 143,776 |
| $1 million and over | 3,211 | 218,475 |
| Total | 243,672 | 1,213,426 |

Source: Internal Revenue Service, *Statistics of Income*, 1991

Table 2 reveals two features that would be expected from the design of the AMT.[20] First, as explained in Part II.A. above, the AMT broadens the base of regular income tax by adding back into income some exclusions from income, tax preferences, the standard and certain itemized deductions, and personal exemptions. Hence, some taxpayers with low or no incomes under the regular tax may have relatively high AMTI. For example, in 1991, 4,261 returns that showed no adjusted gross income and thereby would have had no income tax liability under the regular tax paid over $53 million income taxes under the AMT.[21] Second, many of the AMT preferences and adjustments relate to investment and business income and itemized deductions. Investment and business income and itemizing deductions are more prevalent among taxpayers with higher income. Table 2 shows that almost 80 percent of all AMT taxpayers have adjusted gross incomes of $50,000 or greater. Only 20 percent of all individual taxpayers with positive tax liabilities in 1991 had adjusted gross incomes of $50,000 or greater.

[20] Also in 1991, 32,154 individual returns claimed $169.3 million in tax credits for AMT paid in prior years.

[21] There were 926,020 returns filed in 1991 reporting no adjusted gross income.

**Corporate AMT taxpayers**

The corporate AMT is paid by relatively few corporations. For example, in 1990, approximately 32,000 of 2.1 million corporate income tax returns included an AMT liability. Table 3 reports corporate AMT taxpayers as a percentage of all corporate income tax returns between 1987 and 1992.

**Table 3.--Corporate AMT Taxpayers as a Percentage of All Corporate Returns, 1987-1992**

| Year | Percentage of Corporate AMT Taxpayers |
|---|---|
| 1987 | 0.7 |
| 1988 | 1.1 |
| 1989 | 1.1 |
| 1990 | 1.5 |
| 1991 | 1.5 |
| 1992 | 1.3 |

Source: U.S. General Accounting Office, *Experience With the Corporate Alternative Minimum Tax*, (GAO/GGD-95-88), April 1995, Table II.2, p. 34.

Tax payments under the corporate AMT constitute a larger percentage of all corporate income tax payments than is the case of the individual AMT. In 1992, total corporate income tax revenue was $96.8 billion. Of this amount, AMT payments contributed $4.9 billion, and $2.3 billion in credits for prior AMT paid were claimed. The net, $2.6 billion, comprised 2.6 percent of all corporate income tax payments.[22]

Larger corporations are more likely to be AMT taxpayers than are smaller corporations. A recent General Accounting Office (GAO) study calculates that less than half of one percent of corporations with less than $1 million in assets were paying AMT, while more than 20 percent of corporations with more than $1 billion in assets were paying AMT.[23] This outcome would be expected

[22] The Omnibus Budget Reconciliation Act of 1993 eliminated the ACE depreciation adjustment for property placed in service after 1993. Over time, this should reduce the number of corporate and individual AMT taxpayers and the AMT liabilities relative to the data reported here for 1992 and earlier.

[23] U.S. General Accounting Office, *Experience With the Corporate Alternative Minimum Tax*, (GAO/GGD-95-88), April 1995, p. 35.

by the design of the AMT. The AMT includes as an adjustment the difference between accelerated depreciation claimed under the regular tax system and depreciation calculated under the AMT's less generous allowance schedules. As described in Part II.A. of this document, other AMT preferences and adjustments defer the recovery of other capital costs that are deductible under the regular tax. Thus, the greater a corporation's capital assets, the greater its total value of accelerated depreciation and other capital-related preferences and adjustments, and the greater the likelihood the corporation will be an AMT taxpayer. For the same reason, a capital-intensive business is more likely to be subject to the AMT than would a less capital-intensive business with equal gross revenues. The GAO estimated 25 percent of all corporate assets are owned by corporations subject to the AMT.[24] Recognizing the importance of the treatment of depreciation and other capital costs under the AMT may also explain the apparent counter-cyclic pattern of Table 3, where the percentage of corporate AMT taxpayers increased as the economy experienced recession and declined with recovery. Fixed capital assets produce a schedule of depreciation deductions that is invariant to economic conditions. As the economy enters a recession, business receipts fall. Consequently, corporate income as measured under the regular tax declines, but depreciation deductions generally remain the same.[25] Because, in simple terms, a taxpayer becomes subject to the AMT when its AMT tax preferences and adjustments become large relative to its regular taxable income,[26] a recession increases the likelihood that a business will become an AMT taxpayer.[27]

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[24] GAO, *Experience With the Corporate Alternative Minimum Tax*, p. 36.

[25] A business may reduce its purchases of capital equipment during a recession, thereby reducing deductions for depreciation over time.

[26] A taxpayer pays the AMT if its AMT tax liability exceeds its regular tax liability. Let Y represent a corporation's regular taxable income. Let P represent AMT preferences. Then alternative minimum taxable income is (Y+P), and ignoring graduated marginal tax rates under the regular tax, a taxpayer is subject to the AMT when:

$$(.20)(Y+P) > (.35)Y.$$

Simplifying, this is equivalent to:

$$(.20)\,P > (.15)Y$$

$$\text{or} \quad P/Y > .75.$$

As preferences become large relative to income, the taxpayer is more likely to be subject to the AMT.

[27] The counter-cyclical nature of the corporate AMT is increased by the rules relating to the AMT credit. Under present law, a corporation that pays AMT in one year may carry forward such amount of AMT as a credit to reduce the corporation's regular, but not AMT, tax liability in a subsequent year. As discussed above, a corporation is more likely to be subject to the regular

The preponderance of firms being subject to the AMT being large firms may be explained by other factors as well. First, the corporate AMT contains an $40,000 exemption amount that phases-out as AMTI increases. Second, many smaller firms are closely-held and a closely-held firm has greater control of its corporate income tax liability by entering into transactions with owner-operators of the firm. Finally, it may be expected that because larger firms are more likely to be audited by the Internal Revenue Service than are smaller firms, larger firms are more likely to comply with the AMT rules.

## B. Issues

Overview

In general, the AMT applies a lower marginal rate of tax to a broader tax base. Thus, the AMT may simultaneously lower the taxpayer's marginal tax rate (the amount of tax liability arising from an additional, or marginal, dollar of income) while increasing the taxpayer's average rate of tax (total tax divided by total income). In the case of income from capital investment, the AMT may increase or decrease the effective marginal tax rate because the tax rate on the income from investment depends upon the capital recovery permitted, for which the AMT generally lengthens recovery period, as well as the statutory rate of tax applied to that income.

Some maintain that the base of the AMT provides a better measure of economic income than does the base of the regular income taxes.[28] Although it is generally true that the base of the corporate AMT more closely adheres to economic income principles than does the regular tax, there are some deficiencies in income measurement in the individual AMT. First, the individual AMT does not contain all the business-related adjustments and preferences contained in the corporate AMT. Second, miscellaneous itemized deductions are preferences under the individual AMT, even though some of these deductions, such as employee business expenses and investment expenses, relate to the production of income and should be deductible in determining economic income.

Strictly speaking, the corporate AMT (and to some extent the individual AMT) is not a separate tax but is a calculation that assesses a larger income tax liability today in return for a reduced income tax liability in the future. Each dollar of AMT paid today generates credits that may be applied against future regular income tax liabilities.[29] However, because AMT credits accrue in nominal dollars, the time value of money erodes the future value of such credits. As a consequence, the AMT increases the

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tax when its gross income rises.

[28] See, for example, Senate Finance Committee, *Report on H.R. 3838, the "Tax Reform Act of 1986,"* at p. 518: "The committee believes that the minimum tax should serve one overriding objective: to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits."

[29] Under the individual AMT, only that portion of the taxpayer's AMT liability that relates to adjustments and preferences that are timing in nature give rise to an AMT credit.

real tax liability of AMT taxpayers.

As a pre-payment of tax rather than a separate tax, the AMT should be assessed as part of the individual and corporate income taxes. Analysts usually evaluate taxes in terms of: (1) equity--the fairness of the tax; (2) efficiency--the extent to which the tax distorts economic decisions; (3) growth--the extent to which the tax system encourages or discourages economic growth; and (4) simplicity--the ease of compliance and administration by affected taxpayers and the IRS.

## Equity

In practice, the AMT has the effect of requiring more taxpayers to pay over some funds to the Federal Treasury every year, than would be the case if only the regular income taxes applied (see the discussion relating to Table 2 above). To the extent that taxpayers who outwardly appear to have the ability to pay taxes indeed do pay taxes, some observers conclude that the AMT increases the perceived fairness of the income tax system. The Senate Finance Committee noted that this was one of the rationales for the enactment of the corporate AMT.

> In particular, both the perception and the reality of fairness have been harmed by instances in which major companies have no taxes in years in which they reported substantial earnings, and may even have paid substantial dividends to shareholders. Even to the extent that theses instances may reflect deferral, rather than permanent avoidance, of corporate tax liability, the committee believes that they demonstrated a need for change.[30]

To assess whether the AMT promotes the overall equity of the individual and corporate income tax systems, it is necessary to look beyond who remits tax payments to the Federal Treasury to who bears the burden of the individual and corporate income taxes. Regarding the corporate income taxes, economists argue that corporations do not bear the burden of the corporate income tax, but rather individuals bear the burden of the corporate income tax and all other taxes. There is disagreement, however, over which individuals bear the burden of corporate income tax, whether it is customers in the form of higher prices, workers in the form of reduced wages, owners of all capital in the form of lower after-tax returns on investment, or some combination of these individuals.[31] Regarding the individual income tax, while economists generally believe that income taxes on wages are borne by taxpayers who supply labor, there is disagreement concerning the incidence of taxes that affect the returns earned by capital such as the taxation of interest, dividends, capital gains, and business income from pass-through entities.

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[30] Senate Finance Committee, *Report on H.R. 3838, the "Tax Reform Act of 1986,"* at p. 519.

[31] For a discussion of incidence of the corporate income tax and taxes on the return to capital, see, Joint Committee on Taxation, *Methodology and Issues in Measuring Changes in the Distribution of Tax Burdens* (JCS-7-93), June 14, 1993, pp. 44-51.

The uncertainty regarding the incidence of income taxes on the returns to capital make it difficult to assess the effect the AMT has on the equity of the burden of the income tax system. As noted above, the AMT raises effective average tax rates for affected taxpayers. At the individual level, the data above suggested that higher-income taxpayers are more likely to be AMT taxpayers than are lower-income taxpayers. If the burden of the taxes were to rest with the affected taxpayers, the individual AMT might increase the overall progressivity of the income tax system.

Some analysts argue that the AMT promotes horizontal equity by taxing more equally taxpayers who have the same economic capacity but choose to engage in different patterns of tax-favored activities. Other analysts note that in a market economy, investment by individuals and corporations would be expected to equilibrate risk-adjusted, after-tax returns. As a consequence, the prices of tax-favored investments would be bid up (or their quantity increase) and the prices of tax-disfavored investments would fall (or their quantity decrease). In equilibrium, the pre-tax returns of tax-favored and tax-disfavored investments would differ, but their after-tax returns would be the same.[32] For example, tax-exempt bonds trade at interest rates lower than otherwise comparable taxable bonds. This is because the tax-exempt borrower does not have to offer as great an interest rate to the lender to provide the lender with a competitive after-tax return. If after-tax returns equilibrate, analysts may questions whether a horizontal inequity existed prior to the enactment of the AMT.

Other analysts note that because, as explained above, the business cycle may move taxpayers onto and off the AMT that the AMT may create its own horizontal inequities by taxing different businesses differently based on the variability of their profits during the course of a business cycle.[33]

Efficiency and growth

A tax system is efficient if it does not distort the choices that would be made in the absence of the tax system. No tax system can be fully efficient. Whether the AMT contributes to the efficiency of the United States tax system depends on the extent to which it reduces other inefficiencies in the tax system and the extent to which it creates new inefficiencies. By discouraging some individuals and corporations from undertaking what are otherwise tax-favored investments, efficiency may be increased. However, the AMT generally does not eliminate tax-favored treatment of certain activities or investments, but rather limits which taxpayers may take full advantage of the tax-favored treatment provided by the regular income tax. Some analysts have noted that on efficiency grounds, "no one should care if ten companies each invest a little in a tax-preferred activity or one company invests a lot"

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[32] Andrew B. Lyon, "The Alternative Minimum Tax: Equity, Efficiency, and Incentive Effects," in *Economic Effects of the Corporate Alternative Minimum Tax*, (Washington, D.C.: American Council for Capital Formation Center for Policy Research), 1991, pp. 51-82.

[33] Charles R. Hulten, "Commentary," in *Economic Effects of the Corporate Alternative Minimum Tax*, (Washington, D.C.: American Council for Capital Formation Center for Policy Research), 1991, pp. 84-88.

in such an activity.[34] However, under present law, the ten firms described above could each avoid the AMT while the one firm with the aggregated investment could be subject to the AMT. In addition, limiting which individuals or corporations can profitably undertake tax-favored activities could lead to more efficient investors finding the activity unprofitable, while less efficient investors find the activity profitable. Moreover, some tax-favored activities may be permitted as part of the regular income tax as a way reduce some other inefficiency in the economy. These arguments might suggest that efficiency could be better improved by changes in the regular income taxes.[35]

The effect of the corporate AMT also may lead to increased merger and acquisition activity. As discussed above, a capital-intensive firm (such as a leasing company) is more likely to be subject to the AMT than is a labor-intensive firm (such as a service provider). This may lead to the merger of capital-intensive and less capital-intensive firms so that their combine taxable incomes is not subject to the AMT.

In the mid-1980s there was concern that the regular income tax system created different effective tax rates on capital investment depending upon the source of finance and type of equipment being purchased by the investor. It has been argued that such differentials in effective tax rates reduce the efficiency of investment in the United States. For example, the regular income tax has been criticized as favoring debt-financed investments at the expense of equity-financed investments. One analyst calculated that the AMT would lower the cost of capital for equity-financed investment and increase the cost of capital for debt-financed investment, thereby reducing the regular tax's preference for debt finance.[36] The benefit of debt finance derives from the deductibility of interest expense. An AMT taxpayer deducts such expenses at a 20-percent tax rate rather than a 35-percent tax rate. This increases the after-tax cost of borrowing. At the same time, the returns to equity under the AMT are taxed at a 20-percent marginal tax rate rather than a 35-percent marginal tax rate, increasing the after-tax return to equity. The increased returns to equity investments are mitigated to the extent that, by lengthening depreciation lives and the lowering of the marginal tax rate, the AMT reduces the value of depreciation deductions. If the effect of a lower rate of tax on returns offsets the smaller value of depreciation deductions, equity-financed investments face a lower cost of capital under the AMT. More generally,, that study concluded that "the AMT compresses the range of effective tax rates on alternative classes of investments and sources of financing, thereby reducing the distortionary impact of taxation on

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[34] Michael J. Graetz and Emil M. Sunley, "Minimum Taxes and Comprehensive Tax Reform," in Henry J. Aaron, Harvey Galper, and Joseph A. Pechman (eds.) *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax*, (Washington, D.C.: The Brookings Institution), 1988, p. 406.

[35] As described in Part II.B. above, Congress has, in certain instances, conformed the regular tax base to the AMT base.

[36] B. Douglas Bernheim, "Incentive Effects of the Corporate Alternative Minimum Tax," in Lawrence H. Summers (ed.), *Tax Policy and the Economy, 3*, (Cambridge: The MIT Press), 1989.

decisions taken by individual firms. ... Furthermore, the AMT tends to move effective tax rates for atypical firms toward the mean, thereby reducing the distortionary impact of taxation on the allocation of capital across firms."[37] Subsequent research has questioned the extent of such efficiency gains, noting that the effective tax rates of firms temporarily on the AMT may show greater variance than those of firms that are routinely, or permanently, AMT taxpayers, or of firms that are regular income tax taxpayers.[38]

In addition, the AMT may affect the level of investment in the United States and thereby affect economic growth. By increasing average tax rates (the total tax paid by certain taxpayers), the AMT may reduce the cash flow of potential investors. If as some analysts believe, investors' cash flows are important to the investment decision, the AMT may reduce aggregate investment.

Finally, the effect of the AMT on effective tax rates, and thereby on the cost of capital, may change the incentive to undertake marginal investment projects and thereby affect the level of aggregate investment. As noted above, one cannot generalize about the effects of the AMT on the cost of capital because the effect varies with the type of investment, the means of finance, and the extent to which the investor is subject to the AMT both currently and in the future. The cost of capital may increase or decrease.[39] Understanding the potential incentive effects also is complicated by the lack of understanding of the magnitude that any such incentive effects may have on aggregate investment.[40] Others note that the uncertainty of knowing whether one will be subject to the AMT increases the uncertainty of investment decisions and may work to reduce investment.

Simplicity and compliance

The AMT requires a calculation of a second income tax base[41] and computation of a tax on that base, so the present tax system, with an AMT, is not as simple to administer or comply with as would the same system without an AMT. As detailed above, relatively few individual or corporate taxpayers are subject to the AMT. However, that observation understates the extent to which the AMT imposes a compliance burden on taxpayers. Many taxpayers must undertake the AMT calculation to determine whether, in fact, they are liable. For example, the GAO reported that while only 28,000 corporations

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[37] Bernheim, "Incentive Effects of the Corporate Alternative Minimum Tax," p. 91.

[38] Andrew B. Lyon, "Investment Incentives under the Alternative Minimum Tax," *National Tax Journal*, 43, December 1990, pp. 451-465.

[39] Lyon, "The Alternative Minimum Tax: Equity, Efficiency, and Incentive Effects."

[40] See, GAO, *Experience With the Corporate Alternative Minimum Tax*, for a more detailed review of some of the literature relating to the AMT's possible effects on aggregate investment.

[41] The ACE adjustment causes corporations to have three tax bases.



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actually paid corporate AMT in 1992, 400,000 corporations filed the AMT form.[42] The 400,000 figure would understate the number of corporations that did the necessary calculations to determine whether they had an AMT liability.

Survey evidence has suggested that the compliance cost to taxpayers required by the AMT may be large. One recent analysis of tax compliance costs of large businesses finds that being subject to the AMT adds 16.9 percent to the personnel and nonpersonnel compliance costs of complying with Federal income taxes.[43] The average total income tax compliance cost reported in the survey was approximately $1 million, implying that complying with the corporate AMT may require additional expenditures of $160,000 annually by large businesses. While a large number, compliance costs generally are larger for larger businesses which often have more complex business arrangements. The AMT is not the mostly costly aspect of tax compliance. The same study identifies approximately 40 percent of total compliance costs as arising from foreign-source income and that having an ongoing appeal or tax litigation increases compliance costs by 18 to 28 percent.

At the individual level, taxpayers subject to the individual AMT due to business-related activities will experience compliance costs similar to those experienced by corporations subject to the corporate AMT. There are no studies that specifically measure compliance costs arising from the individual AMT. Indirect evidence of the complexity imposed by the individual AMT may be the increased utilization of the services of paid tax preparers by individual taxpayers subject to the individual AMT. In 1988, 14 percent of taxpayers with AGI of $100,000 or more and no significant farming or self-employment income prepared their own tax returns. Of taxpayers with AGI of $100,000 or more and significant income from self employment or farming, nine percent and four percent of taxpayers prepared their own returns. By contrast, only one percent of all taxpayers subject to the individual AMT prepared their own returns.[44] If taxpayers subject to the AMT are more likely to have complicated financial affairs, they might use paid tax preparers in the absence of the AMT.

[42] GAO, *Experience With the Corporate Alternative Minimum Tax*, p. 3.

[43] Joel Slemrod and Marsha Blumenthal, "The Income Tax Compliance Cost of Big Business," Working Paper No. 93-11, The Office of Tax Policy Research, The School of Business Administration, The University of Michigan, July 1993, p .11.

[44] Based on tabulations of the staff of the Joint Committee on Taxation of the 1988 IRS, Taxpayer Compliance Measurement Program (TCMP).

## IV. DESCRIPTION OF AMT PROVISIONS IN H.R. 1215

### Repeal of the corporate alternative minimum tax

H.R. 1215 (the "Tax Fairness and Deficit Reduction Act of 1995"), as passed by the U.S. House of Representatives on April 5, 1995, would repeal the corporate AMT for taxable years beginning after December 31, 2000. In addition, as described below, the bill would make certain changes to the individual AMT, and to the corporate AMT for taxable years beginning before January 1, 2001.[45] The individual AMT, as amended by the bill, would remain in existence.

### Preference items in computing AMTI

The bill would make the following changes to the minimum tax preference items:

(1) The preference relating to depletion is repealed for depletion claimed in taxable years beginning after December 31, 1995.

(2) The preference relating to excess intangible drilling costs is repealed for costs incurred in taxable years beginning after December 31, 1995.

(3) The preference relating to bad debt losses of financial institutions is repealed for taxable years beginning after December 31, 1995.

(4) In the case of a corporation (other than an S corporation, regulated investment company, real estate investment trust, or REMIC), the preference relating to tax-exempt interest on private activity bonds is repealed for interest accruing after December 31, 1995.

In addition, Code section 58 (relating to tax shelter farm activity and passive losses) would be repealed for taxable years beginning after December 31, 1995. An individual that has a loss from a tax shelter farm activity arising in a taxable year beginning after December 31, 1995, (or arising in prior year and being carried forward) may use such loss in computing the individual's AMTI for a taxable year beginning after December 31, 1995 (to the extent such loss is otherwise allowable after taking into account such limitations as the passive activity and at-risk rules). The bill moves the passive activity rules of present-law section 58 to section 59(h).

### Adjustments in computing AMTI

The bill would make the following changes to the adjustments used in computing AMTI:

(1) The adjustment relating to depreciation is repealed for property placed in service after March

[45] These changes made to the corporate AMT would also apply for purposes of section 59A.

13, 1995. Under another provision of the bill, property to which the proposed neutral cost recovery system applies is not subject to the AMT depreciation adjustment. The neutral cost recovery system generally applies to qualified property placed in service after December 31, 1994, unless the taxpayer irrevocably elects, on a property-by-property basis, to not have the system apply.

(2) The adjustment relating to mining exploration and development costs is repealed for costs paid or incurred after December 31, 1995.

(3) The adjustment relating to long-term contracts is repealed for contracts entered into after December 31, 1995.

(4) The adjustment relating to pollution control facilities is repealed for property placed in service after December 31, 1995.

(5) The adjustment relating to installment sales is repealed for dispositions after December 31, 1995.

(6) The adjustments relating to circulation and research and experimental expenditures of individuals is repealed for costs paid or incurred after December 31, 1995.

(7) The adjustment relating to Merchant Marine capital construction funds of corporations is repealed for deposits made to a fund after December 31, 1995, and to earnings received or accrued after December 31, 1995, on amounts in such funds. Withdrawals of deposits and earnings from a fund after December 31, 1995, will be treated as allocable: (a) first to deposits (and earnings received or accrued) before January 1, 1987; (b) then, to deposits (and earnings received or accrued) after December 31, 1986, and before January 1, 1996; and (c) then, to deposits (and earnings received or accrued) after December 31, 1995.

(8) The denial of the special deduction allowed under section 833(b) is repealed for taxable years beginning after December 31, 1995.

Adjusted current earnings (ACE) adjustment

The bill would make the following changes to the ACE adjustment of the corporate AMT:

(1) The ACE rules relating to the inclusion (or deduction) of items included (or excluded) from the calculation of earnings and profits are repealed for taxable years beginning after December 31, 1995.

(2) The ACE adjustment relating to intangible drilling costs is repealed for amounts paid or incurred after December 31, 1995.

(3) The ACE adjustments relating to section 173 and section 248 costs are repealed for amounts paid or incurred after December 31, 1995.

(4) The ACE adjustment relating to LIFO inventory is repealed for LIFO adjustments arising in taxable years beginning after December 31, 1995.

(5) The ACE adjustment relating to installment sales is repealed for sales after December 31, 1995.

(6) The ACE adjustment relating to the exchange of debt pools is repealed for exchanges after December 31, 1995.

(7) The ACE adjustment relating to built-in losses with respect to certain changes of ownership is repealed for ownership changes after December 31, 1995.

(8) The ACE adjustment relating to depletion is repealed for depletion allowed in taxable years beginning after December 31, 1995.

Use of credits

The special rules relating to the use of net operating losses and foreign tax credits would be repealed for net operating losses and foreign tax credits used in taxable years beginning after December 31, 1995. Carrybacks of losses and credits to taxable years beginning before January 1, 1996, would continue to be subject to the 90-percent limitations.

The bill would not change the rules regarding the availability of other credits against the AMT.

For taxable years beginning after December 31, 1995, a taxpayer with alternative minimum tax credit carryovers would be allowed to use these credits to offset 90 percent of its regular tax liability (determined after the application of other credits as under present law). As under present law, in no event may alternative minimum tax credit carryovers be used to reduce the taxpayer's tax liability below its tentative minimum tax, if any.

## PREPARED STATEMENT OF ANDREW B. LYON [1]

Mr. Chairman: Thank you for inviting me to testify on the role of the Alternative Minimum Tax in our tax system and its economic effects. Due to the necessary brevity of my remarks, I will limit my testimony today to the corporate AMT. I also intend in my opening remarks to focus on the general philosophy behind the AMT and its most general effects on corporations and economic efficiency, although I would be pleased to respond to any questions on more technical concerns of the AMT.

In my academic research I have given considerable attention to the AMT. I am no foreigner to the reasons behind this tax. During this Committee's consideration of the Tax Reform Act of 1986 I was on the staff of the Joint Committee on Taxation. I am proud to have had the opportunity to work on the bill and I have great respect for the Chairman and this Committee in developing the Act and ensuring its passage. I do, however, have reservations about the AMT. I should make clear that these reservations are not over the effects of the AMT on overall corporate tax revenues. A tax system can be structured, with or without an AMT, to raise a wide range of tax revenue. For instance, more revenue can be raised by increasing the statutory tax rate on corporate income or by providing less generous deductions for all corporations. Less revenue can be raised by the opposite actions. Changes to the AMT are only one of many alternative policies affecting corporate tax revenue. A true debate over the AMT should ask whether the AMT is the best way to augment revenues collected by the corporate tax system. Are the consequences of the AMT more beneficial or, at least, less harmful than alternative means of raising comparable amounts of corporate tax revenue? I feel so strongly about this point that I would urge that if this Committee recommends changes to the corporate AMT that they be made on a revenue neutral basis with respect to corporate tax revenues or taxes on capital income more generally.

Let me summarize my main conclusions:

- Legitimate concerns over the fairness of the corporate tax system are not well addressed by the AMT.
  - —Concepts of fairness among corporations—if there is such a thing—differ from those applied to people. After-tax earnings to shareholders are likely to be the same whether they invest in corporations with low effective tax rates or in corporations with high effective tax rates.
  - —Concerns over lightly taxed corporate income are more reliably addressed through changes to the regular tax system.
  - —Concerns that each corporation pay tax at or above some minimum rate are probably less meaningful than ensuring that a particular activity is taxed at or above that rate, regardless of the corporation undertaking it.
- Tax preferences are generally undesirable from an efficiency perspective.
  - —The effect of the AMT on economic efficiency is ambiguous. Firms paying AMT are likely to reduce the level of investment in tax-favored activities. Other firms, however, are likely to increase their investment in these tax-favored activities. The AMT, by making investment decisions more dependent on the particular tax status of corporations, could actually decrease efficiency.
  - —Efficiency gains are more reliably achieved by limiting tax preferences under the regular tax system.
- The AMT potentially affects a significant share of economic activity.
  - —In a single year, 1990, AMT firms accounted for 40 percent of all corporate assets.
  - —In the same year, more than half of all foreign-source income was earned by U.S. multinational corporations paying AMT.
  - —Between 1987 and 1991, firms accounting for approximately two-thirds of all corporate assets have paid AMT.
- The 1993 OBRA reforms, while reducing the burden of the AMT, had relatively small effects on the cost of capital of AMT firms.

### 1. DOES THE CORPORATE AMT IMPROVE FAIRNESS?

Proponents of minimum taxes believe that they improve fairness. In a frequently cited passage from the 1986 Blue Book, the Joint Committee on Taxation wrote, "Congress concluded that both the perception and the reality of fairness have been harmed by instances in which corporations paid little or no tax in years when they

[1] Visiting Fellow, Brookings Institution and Associate Professor of Economics, University of Maryland, College Park, Maryland. The views expressed in this testimony are my own and do not necessarily represent those of any organization with which I am affiliated.

reported substantial earnings, and may even have paid substantial dividends, to shareholders."[2]

The AMT arose to solve this perceived problem. Many deductions, particularly (but not exclusively) those in excess of an economic measure of income, are scaled back or disallowed entirely under an alternative computation of tax liability. A lower, 20 percent tax rate is applied to this larger measure of taxable income. If a corporation's tax liability is larger under the alternative computation than under the regular tax system, the firm pays AMT in addition to whatever regular tax liability the firm has.

The AMT, by making it more likely that corporations pay tax, does narrowly solve the problem stated by the Joint Committee. But does this really address a correctly perceived equity problem? Is a reduction in the number of zero tax firms benefiting from tax preferences in itself a solution? Although issues of fairness are notoriously difficult for different people to reach agreement on, it is worth probing these questions further.

- Concepts of fairness among corporations—if there is such a thing—differ from those applied to people. After-tax earnings to shareholders are likely to be the same whether they invest in corporations with low effective tax rates or in corporations with high effective tax rates.

> If one is careful not to discuss corporations as though they were people, it should be clear that all proper questions of fairness relate to the individuals on whom the taxes really fall; and that at the business level, we should confine attention to influences on business behavior as to prices, outputs, investments, and as to innovation, enterprise, venturesomeness, and such behavior qualities.
>
> HENRY SIMONS, *Federal Tax Reform*, 1950.

> It is true that the tax-exempt privilege is a feature always reflected in the market price of bonds. The investor pays for it.
>
> JUSTICE LOUIS BRANDEIS, 1928.

One argument that special tax preferences violate principles of fairness is that they are believed to result in above average rates of return for the benefiting corporations. But the belief that the after-tax return to an activity is simply increased by the value of any tax preference is incorrect. As recognized by Justice Brandeis over 60 years ago, an activity offering tax benefits will attract investment and this new investment will drive down its pretax return. If anyone is free to participate in this activity, its after-tax return will be about the same as for any fully taxable activity. The lower pretax return to a tax-favored activity is referred to by some economists as an implicit tax.

While such implicit taxes are easily seen in the published yields of tax-exempt bonds, the principle operates for any activity in which there is some competition. In the case of the investment credit or accelerated depreciation, firms increase investment in equipment over time until the after-tax return is reduced to that available on comparable investments. In the case of tax subsidies for oil and gas exploration and drilling, investment is encouraged in areas with less promise or where more costly recovery techniques will be required.[3]

Whether or not there are valid public policy reasons to encourage the subsidized activities, the issue being discussed here is whether these tax incentives result in supra-normal profits for the companies that use them. To the extent the incentive is successful in encouraging the targeted activity, rates of return from undertaking the activity will fall. The lower pretax return from undertaking the targeted activity is an implicit tax. Where competition in undertaking the activity is keen, the implicit tax may represent substantially all of the value of the tax subsidy.

Our notions of ability-to-pay are usually stated in terms of ensuring that taxes bear a suitable relation to pretax incomes. Acknowledgement of implicit taxes complicates this notion. Are implicit taxes—which may represent price concessions to consumers or the adoption of more costly production processes—"equivalent" in burden as tax revenues paid to the government? To many people they may not seem philosophically equivalent.

But implicit taxes do reduce the pretax return earned by an investor relative to that on alternative activities. Of course it will not always be the case that the implicit tax is equal to the revenue foregone from a tax subsidy. In some cases, the

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[2] *General Explanation of the Tax Reform Act of 1986*, Joint Committee on Taxation, p. 433.

[3] It is unlikely that consumers benefit from lower prices for oil and gasoline because U.S. production of oil is small relative to worldwide production.

after-tax return earned by an investor receiving the tax preference will be higher than that generally prevailing. If one could use a minimum tax to tax only those cases where supra-normal returns were earned at the expense of a government tax subsidy, this would seem to be a desirable outcome.

But this is not what the AMT does. The more profitable a firm is per dollar of tax expenditure, the less likely it is that the firm will pay AMT. A firm with $10 million in income and $1 million in tax preferences will pay taxes under the regular tax (since its regular tax liability exceeds its tentative AMT), but the firm with $2 million in income and $1 million in tax preferences will pay AMT. Further, to the extent that above average returns are the result of limited competition, a minimum tax may further reduce competition in the activity by limiting the availability of the full benefit of the tax preference to a smaller group of qualified firms.

If it is the desire to limit above average returns that are the result of tax preferences, the most effective way to accomplish this is to directly limit each specific tax preference.

- Concerns over lightly taxed corporate income are more reliably addressed through changes to the regular tax system.

The AMT does increase the total tax burden of capital income, and this increase may be regarded by some as increasing tax fairness. As noted above, however, the firms singled out under the AMT are unlikely to be earning higher after-tax rates of return than any other corporation. The AMT is a very cumbersome mechanism if the only goal is to increase tax revenues; very small changes to the regular tax system can achieve the same outcome with greater predictability.

- Concerns that each corporation pay tax at or above some minimum rate are probably less meaningful than ensuring that a particular activity is taxed at or above that rate, regardless of the corporation undertaking it.

In addressing concerns over why tax preferences scaled back under the AMT were not simply eliminated under the regular tax, the Joint Committee wrote that while such preferences "may provide incentives for worthy goals, they become counterproductive when taxpayers are allowed to use them to avoid virtually all tax liability." In this view, a minimum tax is needed to allow tax preferences to offset some, but not all, tax liability. Is this goal—that no firm pay less than some minimum amount of income in tax—well founded?

Consider how effective tax rates can change as two firms with different characteristics merge. One firm, HiProfit, is a highly profitable manufacturing firm in an industry without notable tax preferences. HiProfit currently pays regular tax; its tentative minimum tax is assumed to be less than its regular tax. The other firm, TaxBreak, operates in an industry granted substantial tax preferences. It pays minimum tax, since its regular tax is smaller.

But what if TaxBreak and HiProfit had merged their operations into a single firm, TaxProfit? Suppose the combined firm could avoid paying minimum tax. Tax preferences that would have put TaxBreak on the minimum tax would instead be used to offset some of the income earned by HiProfit. The total tax payments of the combined firm would be the same as if there were no minimum tax and the firms remained independent.

If the perception of firms paying low rates of tax is all that matters, then presumably the merged firm, since it pays tax at or above the minimum rate, would not be perceived as being in violation of the stated objective. (If the reasons for the merger were tax motivated, however, perhaps attitudes toward the merged firm would differ.) But if perceptions are so easily soothed, is the original objection well founded? What if instead of a formal merger, the stockholders of the two firms happened to be identical?

For those whose concerns over tax preferences would not be satisfied by a merger of HiProfit and TaxBreak, we might ask what level of aggregation of firm activities is justifiable. For example, what if it were discovered that, pre-merger, one of HiProfit's product lines—if operated independently—would have actually been subject to the minimum tax? Should the original firm be treated for tax purposes as two separate firms in this case, one of which is subject to the minimum tax?

Perhaps use of the corporation as an entity is only a matter of convenience. What is desired is that income earned from every activity within every corporation be taxed at the same rate. This argument, however, directly questions the usefulness of tax preferences for any activity. Direct cutbacks on all tax preferences, or their repeal, might be a better response to this set of beliefs than a minimum tax. A starting point for implementing this kind of across-the-board reduction in tax preferences already can be found in Internal Revenue Code sec. 291.

These questions are meant to probe further those who argue that the public believes in the importance that a corporate entity, somehow defined, must pay tax at a certain minimum rate. The entity of a corporation is malleable. It can be made to encompass a larger number of activities through mergers or a smaller number through the reverse process. Despite these changes at the corporate level, the ultimate beneficiaries of the firm, its shareholders, can be unchanged.

For those who wish to limit the use of tax preferences, the minimum tax is an arbitrary mechanism to rely on. It is difficult to argue from a perspective of fairness that the denial of tax preferences to some firms while allowing them to continue for other firms can have a significant beneficial effect.

### 2. DOES THE AMT IMPROVE EFFICIENCY?

- The effect of the AMT on economic efficiency is ambiguous. Firms paying AMT are likely to reduce the level of investment in tax-favored activities. Other firms, however, are likely to increase their investment in these tax-favored activities. The AMT, by making investment decisions more dependent on the particular tax status of corporations, could actually decrease efficiency.

As a first approximation, the output of the economy is likely to be maximized by eliminating all tax preferences and allowing investment to be allocated by market-oriented rather than tax-oriented forces. This is not to say that tax preferences for certain activities are not well deserved. Among economists, for example, there is a recognition that investments in research and development probably confer social benefits in excess of their market returns. The inability for a firm to protect through patents all of the know-how learned through its investments in R&D leads to this divergence between social and market returns. The immediate deduction for R&D expenses and the R&D tax credit are frequently justified on these grounds.

Of course all existing tax preferences (and many more that can be proposed at a moment's notice) are believed by someone to generate social returns in excess of those available from other activities. But this leads to the Lake Wobegon effect where, you will recall, all the children are above average. Not all potential investments can have above average returns!

The Tax Reform Act of 1986 generally followed this logic by reducing or eliminating tax preferences and using the revenue to lower tax rates. Further opportunities for such base broadening and rate reduction remain by reducing for all corporations the value of tax preferences already identified under the AMT as well as additional preferences omitted from the AMT.

Short of such base-broadening of the regular tax, does an AMT that limits tax preferences improve efficiency? The answer is not clear. While the reduction in the value of tax incentives for AMT firms is likely to reduce their investment in such activities, the value of such preferences remain for other firms. It is quite possible that the total amount of tax-preferred activity is unchanged, but it is merely shifted from one firm to another. In this case there is no efficiency gain.

Even if the minimum tax results in a net reduction in the overall level of tax-preferred activities, an efficiency loss can still occur if it reallocates activities from firms most qualified to undertake them to less qualified ones. The ability for one firm to receive tax preferences for an activity may result in that firm undertaking the activity while a technically more efficient firm subject to the minimum tax may give it up.

- Efficiency gains are more reliably achieved by limiting tax preferences under the regular tax system.

A minimum tax is therefore very poorly designed to improve efficiency. It is possible that the minimum tax does not reduce the overall level of tax-preferred activity or, when it does, it may do so in an efficiency-reducing manner. A more reliable method of achieving efficiency gains by reducing the level of any tax-preferred activity would be a direct reduction in the value of the tax preference for that activity. A direct reduction, being tied to the particular activity rather than the characteristics of the taxpayer, would reduce the incentive of investing in that activity for all taxpayers. As mentioned earlier, a model for this kind of across-the-board reduction in tax preferences already can be found in Internal Revenue Code sec. 291.

### 3. AMT CORPORATIONS AND THEIR ECONOMIC ACTIVITY

In recent work, I had the opportunity to examine data on the number of firms affected by the AMT in 1990.[4] These data indicate a substantial amount of economic activity is conducted by firms subject to the AMT. In 1990, AMT payments accounted for 8.5 percent of corporate tax receipts, or $8.1 billion. Including regular taxes paid by these AMT firms, their tax payments totalled 21.4 percent of all cor-

[4] Andrew B. Lyon and Gerald Silverstein, *The Alternative Minimum Tax and the Behavior of Multinational Corporations*, National Bureau of Economic Research working paper 4783, June 1994, Cambridge, MA.

porate income tax. Approximately 25 percent of corporations with assets in excess of $50 million paid AMT. Among the largest firms, those with assets in excess of $500 million, the proportion of firms paying AMT was 30.6 percent. AMT firms accounted for 40 percent of all corporate assets. U.S. multinational firms were even more heavily concentrated on the AMT. Over half of all assets of multinationals were owned by firms paying AMT and over half of all foreign-source income was earned by firms paying AMT.[5]

These figures do not include an additional number of firms that do not directly pay AMT but whose regular taxes are increased by the inability to utilize tax credits because their regular tax liability may not be reduced below their tentative minimum tax. These firms too are negatively affected by the AMT and generally face the same incentives at the margin as AMT firms.

The number of AMT firms in 1990-1991 is likely higher due to the recession at that time. Firms are more likely to pay AMT as their receipts fall relative to their deductions, provided their receipts do not fall enough to make their AMT income negative. The increased tax payments collected at the time of a recession as well as the reduced investment incentives faced by AMT firms can reduce the automatic stabilizing property of the income tax.

These data confirm that the AMT is not taxing a narrow group of firms who make use of some obscure tax loophole. Firms undertaking a substantial share of this nation's corporate activity pay AMT. The GAO has estimated that about half of all firms with assets in excess of $50 million paid AMT in at least one year between 1987 and 1991. Such AMT firms account for just under two-thirds of corporate assets.[6]

4. THE EFFECT OF THE 1993 AMT REFORMS

The major reason firms pay AMT is the adjustment for depreciation allowances and the Adjusted Current Earnings (ACE) preference, which prior to 1994 also indirectly reduced allowable depreciation deductions. The reductions in depreciation benefits have the effect of decreasing investment incentives for firms on the AMT. Firms presently on the regular tax that can anticipate a future period of AMT liability may temporarily have increased investment incentives.

The cost of the AMT to any firm is reduced by the ability in a future year to use past AMT payments as a credit against regular tax liability. AMT credits may not be used against the AMT, nor may they reduce regular tax below tentative minimum tax, nor are they refundable for firms with losses under the regular tax. The GAO has estimated that 60 percent of firms paying AMT in 1987 have failed to fully recover their AMT payments by the end of 1991. Given common discount rates used by corporations, a deduction received in five years has about half of the value of a deduction received immediately.

In other work I have estimated how the AMT affects the cost of capital for firms temporarily paying AMT.[7] I have used this model to estimate the effects of the Omnibus Reconciliation Act of 1993, which, as proposed by the Clinton Administration, eliminated the ACE depreciation adjustment. This modification had the effect of reducing the burden of the AMT on new investment in equipment. The following figure shows, however, that the reduction in the cost of capital for AMT firms was relatively small. The cost of capital is shown for a firm financing its investment in an aggregate category of equipment half with debt and half with equity. A five percent real after-tax discount rate is assumed. Most of the disincentive for new investment remains for firms that continue to pay AMT. The relative disincentive faced by AMT firms increases with the length of time the firm is either paying AMT or is [figure goes here, p. 12] unable to fully utilize all of its AMT credits. For a firm unable to reclaim its AMT credits for 5 years, investment must earn a pretax return roughly 10 percent higher for the life of the investment to earn the same after-tax return as a regular tax firm.

The figure shows that the cost of capital under the AMT is generally increased by less than one percentage point relative to the regular tax. Over long periods of

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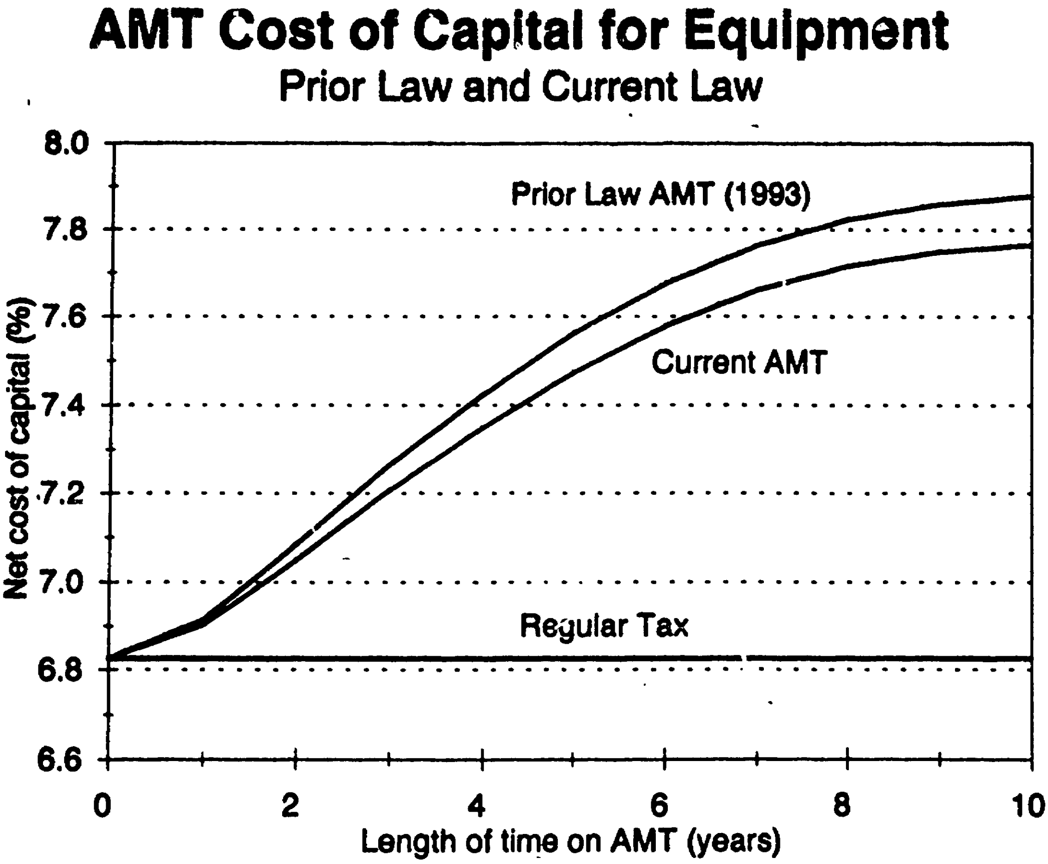
[5] Other recent data for the years 1987 to 1992 are presented in *Experience with the Corporate Alternative Minimum Tax*, General Accounting Office (GAO/GGD-95-88), April 1995. These data indicate that the percentage of firms paying AMT has declined slightly since 1990.

[6] Given these data, it might be puzzling at first to also learn that in a given year, only 1 to 2 percent of all corporations paid AMT. The reconciliation of these figures is fairly straightforward. Ninety percent of corporations account for only 1 to 2 percent of all corporate activity (measured by assets). The majority of these smaller corporations report net operating losses.

[7] Andrew B. Lyon, "Investment Incentives under the Alternative Minimum Tax," *National Tax Journal*, December 1990, pp. 451–465.




Source: Computations following methodology of Andrew B. Lyon, "Investment Incentives under the Alternative Minimum Tax," National Tax Journal, December 1990.

time, market rates of interest easily fluctuate by as much. Short-term fluctuations in the real interest rate of this magnitude are less common. Little is known on how the differential in the cost of capital faced by AMT firms relative to regular tax firms affects the quantity of investment undertaken. Firms on the AMT are likely to invest less than otherwise, but how much less is uncertain. As noted earlier, however, there does not appear to be a well-founded efficiency motivation for reducing investment by such firms.

Another AMT reform proposed by the Clinton Administration in 1993 was not adopted by Congress. Under the proposal, AMT property would be recovered over shorter periods. This reform would have further reduced the gap between the AMT cost of capital and that of the regular tax.

5. SUMMARY

I began my testimony by asking whether the consequences of the AMT are more beneficial, or less harmful, than alternative means of raising comparable revenues. I believe the best possible justification for the AMT is to limit the value of tax preferences. But the AMT operates in a far more cumbersome manner than is necessary to achieve this result. Across-the-board reductions in tax preferences offer a far simpler and generally more efficient method to accomplish this objective. Such reductions also probably better address underlying equity concerns with the corporate tax.

Because my objections to the AMT are in the manner in which tax revenues are raised, rather than the level of taxes collected, I would like to see repeal of the AMT accomplished in a manner neutral with respect to total corporate tax revenues or taxes on capital income more generally. The easiest way of accomplishing this objective (and perhaps the fairest with respect to more closely preserving the status quo of tax liabilities faced by different corporations) would be to scale down for regular tax purposes all tax preferences presently covered by the AMT. Other options would be to include additional tax expenditures listed by the Joint Committee on Taxation and deficit reduction options identified by CBO. For example, requiring a small amount of advertising expenditures to be capitalized could easily pay for prospective repeal of the corporate AMT with no other modifications.[8] Requiring a carryover of basis for capital gains of individuals held at death together with relatively small revenue raising items could similarly cover the cost of prospective repeal.

I have had the privilege of witnessing this Committee in some of its finest hours in 1986. I believe the potential exists for modifications to the AMT in that spirit.

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[8] Since advertising expenditures give rise to long-lasting goodwill, I have estimated that amortization of advertising expenditures would treat advertising investments more similarly to investments in other forms of capital. See Don Fullerton and Andrew B. Lyon, "Tax Neutrality and Intangible Capital," in Lawrence H. Summers (ed.), *Tax Policy and the Economy*, vol. 2, Cambridge: MIT Press, 1988, pp. 63-88.

**Statement of Robert S. McIntyre**
**Director, Citizens for Tax Justice**
**Concerning the Alternative Minimum Tax**
**Before the Senate Finance Committee**
**May 3, 1995**

I appreciate the opportunity to testify before the Committee on behalf of Citizens for Tax Justice. Our coalition of labor, public interest and grassroots citizens groups represents tens of millions of middle- and low-income Americans, who have a vital stake in fair, economically sound tax and budget policies.

The issue before the Committee today involves the Alternative Minimum Tax, which was adopted in 1986 to try to put an end to the spectacle of highly profitable corporations and high-income individuals paying little or nothing in federal income taxes. Recently, however, the House has passed a bill that, among many other egregious provisions, would entirely repeal the Alternative Minimum Tax on corporations and gut the AMT as it applies to individuals.

The House plan is a direct attack on the principles of the 1986 Tax Reform Act. It could reasonably be called a slap in the face to Chairman Packwood, Sen. Bradley, former President Reagan, and all the others who worked so hard to pass the 1986 reforms. The designers of the House plan make no bones about the fact that they want to return to the bad old days of widespread corporate tax freeloading. We urge the Committee to reject the House's outrageous AMT repeal proposal and instead to take measures to strengthen the minimum tax.

## Why the Corporate Minimum Tax Was Adopted

A 1986 CTJ survey of 250 of the nation's largest and most profitable corporations found that 130—more than half the total—managed to pay absolutely nothing in federal income taxes in at least one of the five years from 1981 to 1985.[1]

These 130 companies, ranging alphabetically from Aetna Life & Casualty to Xerox, earned a combined total of $72.9 billion in pretax domestic profits in the years they did not pay federal income taxes. But instead of paying $33.5 billion in income taxes, as the 46 percent statutory federal corporate tax rate purportedly required, they received $6.1 billion in tax *rebates*—fo "negative" tax rate of –8.3 percent.

- Of this group of 130 corporate tax freeloaders, 73 had at least *two* years of paying nothing in federal income taxes from 1981 to 1985.
- 42 of these companies paid nothing—or less—in total federal income taxes over the entire five years.

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[1] Citizens for Tax Justice, *130 Reasons Why We Need Tax Reform* (July 1986).

Congress rightly found this situation intolerable. "The committee believes the tax system is nearing a crisis point," said the December 1985 House Ways and Means Committee Report on what became the Tax Reform Act of 1986. "Many firms have made use of tax provisions to reduce their tax liability to zero, and, in some cases corporations with substantial book income obtain tax refunds."

Likewise, the Senate Finance Committee's May 1986 report on the same bill stated: "The committee finds it unjustifiable for some corporations to report large earnings and pay significant dividends to their shareholders, yet pay little or no taxes on that income to the government."

In response to the egregious level of corporate tax avoidance, the Tax Reform Act of 1986 closed many business loopholes and adopted the Alternative Minimum Tax. The AMT was designed to assure that all profitable corporations pay at least some reasonable amount in federal income tax. The official summary of the Tax Reform Act of 1986 states:

> "Congress concluded that the minimum tax should serve one overriding objective: to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits. . . . It is inherently unfair for high-income taxpayers to pay little or no tax due to their ability to utilize tax preferences."

## The Structure of the Alternative Minimum Tax

The "alternative" feature of the AMT works like this. Most companies pay the 35 percent regular corporate tax rate on their profits less amounts sheltered by various remaining tax preferences, such as accelerated depreciation (200%-declining-balance over short periods) and special breaks for oil, gas and mining. *Alternatively*, companies must pay the 20 percent minimum tax on profits computed without some of the loopholes—if the AMT is higher.

Minimum taxable income is usually higher than regular taxable income for several reasons. Depreciation write-offs, for example, are less accelerated under the AMT. Investments in mining exploration and development must be amortized over 10 years rather than deducted immediately. And tax "losses" (NOLs) left over from prior years that are attributable to certain tax preferences (such as accelerated depreciation and a portion of certain oil tax breaks) cannot be used to offset the AMT.

In addition, if "adjusted current earnings" exceeds minimum taxable income as otherwise defined, then the AMT applies to three-quarters of the difference. In computing adjusted current earnings, certain tax preferences are further scaled back and tax "losses" from previous years are not allowed.[2]

[2]The "adjusted current earnings" rule replaced a similar rule that tried to relate alternative minimum taxable income to a portion of the profits that companies report to their shareholders ("book income").

# How the Minimum Tax Has Worked in Practice

Since their adoption, the 1986 reforms, including the corporate Alternative Minimum Tax, have curbed many of the worst corporate tax avoidance problems. In fact, the number of no-tax giant corporations in CTJ's last comprehensive survey (in 1989) dropped sharply—to only seven in 1988.[3] Although not all firms disclose in their annual reports whether they paid the minimum tax, in our 1987 corporate tax survey we were able to identify 11 profitable companies that would have paid no tax at all without the minimum tax.[4] As a 1991 IRS paper noted, "in the case of large companies with regular deferrals of tax liability, AMT may cause them to experience a new phenomenon: paying taxes."[5]

That's not to say, however, that the Alternative Minimum Tax is paid by very many corporations. According to the IRS, from 1987 through 1991 the corporate AMT was paid by about 28,000 corporations a year —only 1.2 percent of all active corporate filers. By major industry, the percentage of corporations paying the AMT (in 1988-91) ranged from 4.3 percent in mining down to 0.7 percent in wholesale and retail trade.

**Total Corporate Income Tax Payments, 1987-92 Including Alternative Minimum Tax (AMT)**
($-billions)

| By Year | Total Taxes | AMT (net) | AMT/ Tot. Tax | % of Corps w/AMT** |
|---|---|---|---|---|
| 1987 | $ 87.0 | $ 2.2 | 2.6% | 0.7% |
| 1988 | 95.9 | 2.9 | 3.0% | 1.1% |
| 1989 | 96.1 | 2.7 | 2.8% | 1.1% |
| 1990 | 96.4 | 7.4 | 7.7% | 1.5% |
| 1991 | 92.6 | 3.8 | 4.1% | 1.5% |
| 1992 | 101.5 | 2.5 | 2.5% | na |
| **Total, 1987-92:** | **$ 569.5** | **$ 21.6** | **3.8%** | **1.2%** |

*Number of corporations reporting AMT payments as a percentage of total number of active C corporations. Total at bottom of this column is for 1987 to 1991. (Number of returns for 1992 is not available).
*Notes: Total taxes equal total federal income taxes paid after all credits. AMT (net) equals AMT payments net of credits for prior-year AMT.*
*Source: Internal Revenue Service.*

Overall from 1987 through 1992, the AMT directly increased total corporate income tax payments by a net of $21.6 billion. That's only 3.8 percent of the total amount that corporations paid in income taxes over that period. As a share of taxes paid, the biggest direct tax effects from the AMT were in the historically low-tax mining and oil & gas extraction industries, where the AMT amounted to about a fifth of total income taxes paid from 1987 to 1991.

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[3]*See* Citizens for Tax Justice, *IT'S WORKING, BUT. . ., The Resurgence of Business Investment & Corporate Income Taxes* (Oct. 1989).

[4]*See* Citizens for Tax Justice, *THE CORPORATE TAX COMEBACK* (Sept. 1988). The 11 companies were: Englehard, General Re, Harris Bancorp, Merrill Lynch, Middle South Utilities, Pennsylvania Power & Light, Philadelphia Electric Co., St. Paul Companies, Sun Company, Suntrust Banks and Xerox.

[5]Patrice Treubert & Amy Pavelko, Internal Revenue Service, "The Alternative Minimum Tax: An Analysis of Its Effect on Corporations in 1987" (1991).

Some 83 percent of the total 1987-91 net AMT was paid by corporations with assets greater than $250 million. That's noticeably more than 71 percent of total corporate income taxes (after credits) paid by these giant companies. The AMT's share of total taxes on giant companies was 4.7 percent.

**Total Corporate Income Tax Payments, 1987-91**
**Including Alternative Minimum Tax (AMT)**
**Five-Year Totals ($-millions)**

| | All corporations | | | Assets > $250 million | | |
|---|---|---|---|---|---|---|
| By Industry | Total Taxes | AMT (net) | AMT/ Tot.Tax | Total Taxes | AMT (net) | AMT/ Tot.Tax |
| All corporations | $ 468,002 | $ 19,067 | 4.1% | $ 333,032 | $ 15,761 | 4.7% |
| Mining (except oil & gas extraction) | 2,829 | 593 | 21.0% | 1,836 | 401 | 21.8% |
| Oil & gas extraction | 2,524 | 496 | 19.7% | 1,296 | 344 | 26.5% |
| Office, computing & accounting equipment | 3,936 | 682 | 17.3% | 3,471 | 665 | 19.2% |
| Motor vehicles and equipment | 7,289 | 1,168 | 16.0% | 6,814 | 1,146 | 16.8% |
| Railroads | 3,363 | 420 | 12.5% | 3,210 | 409 | 12.7% |
| Non-ferrous metals | 2,518 | 283 | 11.3% | 1,834 | 257 | 14.0% |
| Airlines | 3,338 | 290 | 8.7% | 3,057 | 262 | 8.6% |
| Paper, pulp & boards | 5,354 | 405 | 7.6% | 4,953 | 398 | 8.0% |
| Steel companies | 2,312 | 163 | 7.0% | 1,454 | 144 | 9.9% |
| Electric & gas utilities | 34,023 | 2,296 | 6.7% | 32,664 | 2,261 | 6.9% |
| Chemical, plastics, synthetics | 12,146 | 478 | 3.9% | 10,960 | 441 | 4.0% |
| All other corporations | 388,369 | 11,791 | 3.0% | 261,483 | 9,034 | 3.5% |

*Notes: Total taxes equal total federal income taxes paid over the five years after all credits.*
*AMT equals alternative minimum tax payments net of credits for prior-year AMT.*
Source: Internal Revenue Service, *Corporate Source Book*, 1987 to 1991.

## Corporate Complaints about the Minimum Tax

So if the AMT is paid by so few corporations and amounts to such a small share of total corporate income tax payments, why is there so much corporate complaining about the AMT? There are two primary reasons:

First of all, the most important effect of the AMT is not the revenues it directly produces, but the tax avoidance that it stops in the first place. In other words, without the AMT corporations would find it profitable to engage in a plethora of economically wasteful tax avoidance activities that they now eschew in favor of productive endeavors. For example, it would be easier for companies to buy and sell excess tax write-offs. Oil companies would use loopholes they now sometimes forego. Insurance companies and banks would shift into more tax-exempt debt. That's why the official Joint Tax Committee estimates of the cost of the House-passed AMT repeal—about $3 billion a year—are ridiculously low. In truth, if the House measure were enacted, the actual revenue cost would be at least three times those official estimates.

**Second, direct AMT payments *are* a big deal for the few companies that actually pay the AMT. Overall, the AMT amounted to about 45 percent of the income taxes paid by the few corporations that paid it in 1988 through 1991 (in the years that they paid the AMT). Without the AMT, those corporations that paid it would have had very low, or even zero effective tax rates, as the examples further on in this testimony illustrate.**

**Corporate Tax Returns With Alternative Minimum Tax**
**By Major Industry, 1988 to 1991 Averages**

| | 1988-91 Averages | | | |
|---|---|---|---|---|
| Industry: | Total No. of Returns | Number w/AMT | % with AMT | Returns with AMT AMT/Total Tax |
| All corporations* | 2,183,413 | 28,375 | 1.3% | 45% |
| Mining | 25,190 | 1,084 | 4.3% | 65% |
| Manufacturing | 193,425 | 5,594 | 2.9% | 48% |
| Transportation & Public Utilities | 94,410 | 2,446 | 2.6% | 36% |
| Construction | 250,042 | 4,494 | 1.8% | 57% |
| Finance, Insurance & Real Estate | 366,670 | 5,714 | 1.6% | 43% |
| Agriculture, Forestry & Fisheries | 70,933 | 854 | 1.2% | 51% |
| Services | 553,902 | 3,969 | 0.7% | 55% |
| Wholesale & Retail Trade | 615,109 | 4,215 | 0.7% | 44% |

*Active C corporations. *Source: Internal Revenue Service.*

Corporations who favor eliminating the AMT contend that it has caused dire problems for the companies affected, raising their "cost of capital" and hurting their ability to compete internationally. But this argument verges on being silly. The AMT rate is only 20 percent—far below the corporate tax rate in any other major Western nation. Indeed, the *regular* U.S. corporate tax rate of 35 percent is also below the rate in most other countries. How can paying taxes at a 20 percent rate (or a 35 percent rate, for that matter) put American companies at a disadvantage compared to foreign corporations that generally pay much higher tax rates?

The United States already has very low corporate income taxes by international standards. In fact, at only 2.3 percent of gross domestic product (from 1989 to 1991), U.S. federal and state corporate income taxes are 40 percent below the 3.8 percent of GDP weighted average for the 22 other OECD nations. Japan's corporate income taxes, for example, were 6.8 percent of GDP in 1989-91, the United Kingdom's were 3.9 percent of GDP, and Canada's were 2.6 percent.

It's very hard to believe that the AMT—a low-rate tax that directly affects only one percent of all corporations and directly raises only a few billion dollars a year—could possibly be guilty of the crimes it is alleged to perpetrate. Instead, the AMT actually works to level the business playing field, avoiding the inevitable economic distortions that result when certain industries and companies enjoy low-tax status, while others must pay significant taxes.

Notably, after the 1986 Tax Reform Act was adopted, business investment picked up markedly from its weak performance over the 1981-86 loophole era. Real business investment grew by 2.7 percent a year from 1986 to 1989, 42 percent faster than the meager 1.9 percent annual growth rate from 1981 to 1986. Leading the way was a resurgence in investment in industrial plant and equipment, which grew rapidly after actually *falling* from 1981 to 1986.

Some companies complain that the AMT can be tough on them in bad years. For example, suppose a company "normally" makes $500 million in pretax profits, and that after various special tax write-offs, its taxable income is $250 million. Such a company would "normally" pay 35 percent of that, or $88 million, in regular taxes—a 17.5% effective tax rate that would be unlikely to trigger the alternative minimum tax. But should the company's pretax profit temporarily fall to, say only $250 million (due to an short-term downturn in sales), while its special tax write-offs remained constant, then its taxable income would go to zero, and the AMT would probably be triggered.

**AMT Examples**

| Year | 1 | 2 | 3 | 4 | 4-yr Totals |
|---|---|---|---|---|---|
| **1. Unusual AMT:** | | | | | |
| **Pretax profit** | $ 500 | $ 250 | $ 625 | $ 625 | $2,000 |
| Special tax write-offs | 250 | 250 | 250 | 250 | |
| Taxable income | 250 | — | 375 | 375 | |
| Regular Tax @ 35% | $ 88 | $ — | $ 131 | $ 131 | $350 |
| **Effective tax rate, reg.:** | 17.5% | — | 21.0% | 21.0% | 17.5% |
| Special write-offs disallowed under AMT | 125 | 125 | 125 | 125 | |
| AMT Taxable income | 213 | 125 | 256 | 256 | |
| Tentative AMT (20%) | 43 | 25 | 51 | 51 | |
| Net AMT+ | $ — | $ 25 | $ — | $ — | |
| Credit for prior AMT | — | — | -25 | — | |
| Net Tax Paid: | $ 88 | $ 25 | $ 106 | $ 131 | $350 |
| **Effective Tax Rate:** | 17.5% | 10.0% | 17.0% | 21.0% | 17.5% |
| **2. AMT paid regularly:** | | | | | |
| **Pretax profit** | $ 500 | $ 500 | $ 500 | $ 500 | $2,000 |
| Special tax write-offs | 500 | 490 | 480 | 500 | |
| Taxable income | — | 10 | 20 | — | |
| Regular Tax @ 35% | $ — | $ 4 | $ 7 | $ — | $11 |
| **Effective tax rate, reg.:** | — | 0.7% | 1.4% | — | 0.5% |
| Special write-offs disallowed under AMT | 250 | 245 | 240 | 250 | |
| AMT taxable income | 250 | 249 | 247 | 250 | |
| Tentative AMT | 50 | 50 | 49 | 50 | |
| Net AMT+ | $ 50 | $ 46 | $ 42 | $ 50 | |
| Credit for prior AMT | — | — | — | — | |
| Net Tax Paid: | $ 50 | $ 50 | $ 49 | $ 50 | $199 |
| **Effective Tax Rate:** | 10.0% | 9.9% | 9.9% | 10.0% | 10.0% |

Why this is perceived to be a problem, however, is hard to understand. After all, the company in this example still earned $250 million, and the approximately 10 percent tax that it would be likely to pay under the AMT hardly seems excessive. Moreover, assuming that the company returns to its "normal" profitability in subsequent years, it will get a credit for the AMT it paid.

Thus, as the real world evidence outlined in the next section of this testimony (and appendix 1) illustrates, the primary corporate complaints about the AMT come from companies that absent the AMT would pay little or nothing in federal income taxes year in and year out. Such companies simply don't want to pay federal income taxes, hardly a sympathetic position.

The sometimes ludicrous nature of the corporate complaints about the AMT were inadvertently illustrated in a recent series of Mobil Corp. advertorials, which bemoan the fact that under the regular tax, a steel mill can be written off over 7 years, but under the AMT the write-off period is 15 years. How long does Mobil think a steel mill actually lasts?

Finally, some academic economists have argued that in a perfect world, we would not need an alternative minimum tax. It would be preferable, they say, if the regular tax were improved by closing the loopholes whose excesses the AMT is designed to curb. Maybe so, but the choice on the table today is not whether we should reform the regular tax rather than keeping the AMT. Instead, it is whether, an admittedly imperfect regular tax system needs an AMT backup to curb abuses. The AMT may be only a second-best solution to corporate tax avoidance, but that's far better than no solution at all. In addition, academic economists who argue that we should have "one set of tax rules for everyone" ignore the complicated real world we live in—where one size does not always fit all. For example, current accelerated depreciation rules may provide "only" a significant subsidy for equity-financed corporate investment. But in the case of even partially debt-financed investments, the regular depreciation rules can often lead to outright *negative* tax rates. Thus, we need a backup AMT, with (among other things) less generous depreciation allowances, to deal with those cases where even generally "reasonable" tax rules lead to subsidies that are far, far larger than anyone would want them to be.

## A Return to the Days of Corporate Tax Freeloading?

At bottom, the real purpose of various proposals to weaken the minimum tax has nothing to do with sound economics. As Ways and Means Chairman Bill Archer (R-Tex.) has happily admitted, the result of the House alternative minimum tax repeal would be to allow some highly profitable companies "to pay no tax." He's right. If Congress weakens the minimum tax by restoring tax preferences, it can be confidently predicted that the specter of large, profitable "no-tax corporate freeloaders" will return.

In particular, some of the companies that are lobbying hardest for repeal of the minimum tax paid very low—or no—federal income taxes prior to adoption of the Alternative Minimum Tax, and even today they pay low effective rates.

CTJ's previous corporate tax reports covering 1982 to 1985 include 16 of the 26 corporate members of a so-called "AMT Working Group," which was set up in 1993 to lobby for reductions in the corporate minimum tax. **Over those four pre-tax-reform years, the average effective federal income tax rate on these 16 companies was a minuscule 1.4%.** As a group, the 16 companies enjoyed a total of 22 no-tax (but profitable) years from 1982 to 1985.

- Thirteen of the 16 companies enjoyed at least one year from 1982 to 1985 in which they paid nothing (or less) in federal income taxes (despite considerable profits). Six companies enjoyed multiple profitable no-tax years.

- Six of the 16 companies paid a *total* of less than nothing in federal income taxes over the four years prior to tax reform.
- Only 4 of the 16 companies paid more than 10 percent of their profits in federal income taxes from 1982 to 1985.

More recent corporate annual reports from some of the "AMT Working Group" members show the effects of the current Alternative Minimum Tax. Many of them would pay nothing at all in federal income taxes without the corporate minimum tax. For example:

- In 1992, Texas Utilities paid a total of $19.6 million in federal income taxes on its $1 billion-plus in profits (for an effective rate of 1.9%). Without the AMT, Texas Utilities would have received a tax *rebate* of at least $18 million in 1992. The AMT also accounted for *all* the taxes paid by Texas Utilities in 1991 and 1990.
- In 1991 and 1992, FINA received tax *rebates* totaling $12.6 million on top of its $73 million in pretax profits. But without the AMT, FINA's 1990-91 tax rebates would have been at least $8.2 million larger.
- In 1991, Union Camp paid $35.8 million in federal income tax on its $185 million in profits (an effective rate of 19.4%). Without the AMT, Union Camp not only would have paid no tax, but would have received an outright tax *rebate* of at least $3.7 million in 1991. In addition, the AMT cut Union Camp's tax rebate in 1992 from $52.9 million to "only" $37.2 million.
- The AMT was the only reason why Champion International paid any federal income tax on its $346 million in 1990-91 profits. Without the AMT, Champion would have received $48.6 million in tax *rebates* over the two years. Champion paid only about 2% of its profits in federal income taxes from 1981 to 1987.

**Companies in the "AMT Working Group" (lobbying for alternative minimum tax cuts) & Their Federal Income Taxes Prior to the Tax Reform Act of 1986**

| | 1982–85 | |
|---|---|---|
| | **Effective Tax Rate** | **# of No-Tax Years** |
| Allied Signal | -16.3% | 2 |
| CSX Corp. | 2.1% | 1 |
| Champion Intern'l | 8.3% | 2 |
| Chrysler | 1.4% | 1 |
| Dow Chemical | -39.8% | 2 |
| FINA | -18.1% | 1 |
| Ford | 16.3% | – |
| Mitchell Energy | -5.5% | 4 |
| Mobil | 6.8% | 1 |
| Phillips Petroleum | 5.3% | 1 |
| Scott Paper | 6.8% | 1 |
| Shell | 19.3% | – |
| Texaco | -4.3% | 3 |
| Texas Utilities | 11.8% | – |
| UNOCAL | 15.4% | 1 |
| Union Camp | -5.3% | 4 |
| **Average/Total** | **1.4%** | **22** |

*"AMT Working Group" companies not included in CTJ reports:*

| | |
|---|---|
| American Airlines | PEPCO |
| ALCOA | PHH Corp. |
| Bethlehem Steel | Ryder System |
| Conrail | USX |
| Delta Air Lines | LTV Corp. |

*The "AMT Working Group" also includes 11 trade associations.*

*Note: Pre-tax-reform "no-tax years" include only profitable years.*
*Source: Citizens for Tax Justice corporate tax studies, based on corporate annual reports.*

*Citizens for Tax Justice, May 10, 1993.*

- From 1987 to 1991, the AMT accounted for all of the federal income taxes paid by **Mitchell Energy Corp.** Without the AMT Mitchell would have paid no federal income tax at all in each of those five years (as it did from 1982 to 1985), and would have received outright tax rebates in some years. In 1992, the AMT accounted for more than half of Mitchell's federal income tax payment.
- **LTV Corporation** paid a 14.6 percent effective federal tax rate in 1990 and only 4.1 percent in 1989, most or all of which, according to LTV's annual report, was the Alternative Minimum Tax.
- After paying no federal income taxes at all in the early 1980s, **Texaco** has been paying some tax in recent years. In 1993, however, Texaco's federal income tax bill was only $5 million on $383 million in U.S. profits—an effective tax rate of only 1.3%.

We don't need to lower taxes even further on these companies or others that pay the AMT in order to compete in world markets. On the contrary, the fact that these and other companies pay such low effect tax rates suggests that the AMT needs to be strengthened, not repealed. If the abuses that the minimum tax was designed to stop are recreated, the cost to the Treasury will be substantial, and taxpayer confidence in the integrity of the federal tax system will be damaged. It will then become even more difficult to raise the revenue the government needs to reduce the budget deficit and address our nation's other problems. And if Congress fails to deal with those issues, the damage to American business and our ability to compete internationally *will* be severe.

We urge the Congress to reject efforts to weaken the corporate Alternative Minimum Tax, and instead to take steps to *strengthen* this important feature of our tax system.

## AMT Reform Options

Although adoption of the corporate Alternative Minimum Tax was an important step in the direction of tax fairness, further reforms are still needed.

To make the Alternative Minimum Tax more effective, more loopholes and tax preferences should be disallowed in computing Alternative Minimum Taxable Income. Examples of changes that could be made to strengthen the corporate Alternative Minimum Tax include:

- Change accelerated AMT equipment depreciation to straight line over ADR lives.
- Treat all oil & gas intangible drilling cost deductions in excess of 6-year amortization as a tax preference.
- Disallow AMT deductions for business meals & entertainment.
- Disallow write-offs for "company cars" (with minor exceptions).
- Disallow interest deductions for payments to foreign lenders in tax havens. (This is a back-door compliance reform).
- Increase the corporate AMT rate from the current 20 percent rate, so that it is closer to the 28% individual AMT rate.

| APPENDIX 1: Post-1986 Corporate Alternative Minimum Tax Examples (\$-millions) | | | | | | | |
|---|---|---|---|---|---|---|---|
| Texas Utilities | 1992 | 1991 | 1990 | 1989 | 1988 | 1987 | *1982–85* |
| Pretax US profit | \$1,042.7 | \$855.7 | \$1,091.0 | \$1,031.2 | \$863.6 | \$963.7 | |
| Fed. Income Tax | 19.6 | 51.9 | 47.3 | 120.6 | 140.5 | 42.9 | *Rate* |
| Effective Rate | 1.9% | 6.1% | 4.3% | 11.7% | 16.3% | 4.5% | *11.8%* |
| AMT at least (≥) | \$37.6 | \$123.2 | \$94.8 | \$59.0 | \$13.1 | \$0.0 | *# of no-tax* |
| AMT % of tax | >all | >all | >all | 49% | 9% | — | *years* |
| Tax w/o AMT ≤ | –\$18.0 | –\$71.3 | –\$47.5 | \$61.6 | \$127.4 | \$42.9 | — |
| FINA | 1992 | 1991 | 1990 | 1989 | 1988 | 1987 | *1982–85* |
| Pretax US profit | \$19.7 | \$53.0 | \$183.7 | \$141.2 | \$202.5 | \$139.5 | |
| Fed. Income Tax | –1.9 | –10.7 | 54.0 | 26.9 | 51.6 | 6.2 | *Rate* |
| Effective Rate | –9.8% | –20.2% | 29.4% | 19.1% | 25.5% | 4.5% | *–18.1%* |
| AMT at least (≥) | \$3.6 | \$4.6 | \$13.5 | \$9.4 | \$0.0 | \$4.1 | *# of no-tax* |
| AMT % of tax | >all | >all | 25% | 35% | — | 66% | *years* |
| Tax w/o AMT ≤ | –\$5.5 | –\$15.3 | \$40.5 | \$17.5 | \$51.6 | \$2.1 | *1* |
| CSX | 1992 | 1991 | 1990 | 1989 | 1988 | 1987 | *82–85 rate* |
| Pretax US profit | \$229.0 | \$523.0 | \$375.0 | \$445.0 | \$804.0 | \$579.0 | *2.1%* |
| Fed. Income Tax | 27.0 | 102.0 | –50.0 | 110.0 | 125.0 | 24.0 | *# no-tax* |
| Effective Rate | 11.8% | 19.5% | –13.3% | 24.7% | 15.5% | 4.1% | *years* |
| | *Detailed AMT information not disclosed, but AMT was most of taxes paid in recent years.* | | | | | | *1* |
| Mitchell Energy | 1992 | 1991 | 1990 | 1989 | 1988 | 1987 | *1982–85* |
| Pretax US profit | \$49.5 | \$65.0 | \$71.6 | \$46.1 | \$7.3 | \$14.1 | |
| Fed. Income Tax | 9.5 | 9.6 | 4.2 | 1.5 | 0.8 | 0.3 | *Rate* |
| Effective Rate | 19.2% | 14.8% | 5.8% | 3.3% | 10.9% | 1.9% | *–5.5%* |
| AMT at least (≥) | \$5.4 | \$12.0 | \$5.6 | \$1.5 | \$0.8 | \$0.3 | *# of no-tax* |
| AMT % of tax | 57% | >all | >all | all | all | all | *years* |
| Tax w/o AMT ≤ | \$4.1 | \$–2.3 | \$–1.4 | \$0.0 | \$0.0 | \$0.0 | *4* |
| Union Camp | 1992 | 1991 | 1990 | 1989 | 1988 | 1987 | *1982–85* |
| Pretax US profit | \$94.8 | \$184.7 | \$334.8 | \$441.0 | \$422.0 | \$318.4 | |
| Fed. Income Tax | –37.2 | 35.8 | 105.7 | 143.4 | 102.2 | 57.6 | *Rate* |
| Effective Rate | –39.3% | 19.4% | 31.6% | 32.5% | 24.2% | 18.1% | *–5.3%* |
| AMT at least (≥) | \$15.6 | \$39.5 | \$0.0 | \$0.0 | \$0.0 | \$0.0 | *# of no-tax* |
| AMT % of tax | > all | > all | — | — | — | — | *years* |
| Tax w/o AMT ≤ | –\$52.9 | –\$3.7 | \$105.7 | \$143.4 | \$102.2 | \$57.6 | *4* |
| Champion Int'l | 1992 | 1991 | 1990 | 1989 | 1988 | 1987 | *1982–85* |
| Pretax US profit | loss | \$38.9 | \$306.6 | \$460.7 | \$489.1 | \$436.2 | |
| Fed. Income Tax | zero | 12.7 | 46.2 | 53.0 | 41.7 | 6.9 | *Rate* |
| Effective Rate | NM | 32.7% | 15.1% | 11.5% | 8.5% | 1.6% | *8.3%* |
| AMT at least (≥) | none | \$70.3 | \$37.2 | –\$2.0 | \$42.5 | \$6.6 | *# of no-tax* |
| AMT % of tax | NM | > all | 81% | –4% | > all | 95% | *years* |
| Tax w/o AMT ≤ | NM | –\$57.6 | \$9.0 | \$55.0 | –\$0.8 | \$0.3 | *- 2* |

*Note. Numbers of pre-1986 "no-tax years" include only years with profits. AMT figures shown are the minimum amount paid (due to the limited way the AMT is disclosed, the actual amounts may well have been a larger share of total tax bills). For some companies in some years, reported profits were adjusted to assign "special charges" to the years when expenses were actually incurred.*

*Source: Corporate annual reports.*

*Citizens for Tax Justice, May 10, 1993.*

# APPENDIX 2: International Comparisons

| Corporate Income Taxes as Shares of GDP in OECD Countries, 1989-91 | | | | |
|---|---|---|---|---|
| | 1991 | 1990 | 1989 | 89-91 |
| Australia | 4.2% | 4.3% | 3.9% | 4.1% |
| Austria | 1.6% | 1.5% | 1.6% | 1.6% |
| Belgium | 2.7% | 2.9% | 3.0% | 2.9% |
| Canada | 2.1% | 2.6% | 3.0% | 2.6% |
| Denmark | 1.7% | 1.6% | 2.2% | 1.8% |
| Finland | 1.4% | 2.1% | 1.6% | 1.7% |
| France | 2.0% | 2.3% | 2.4% | 2.2% |
| Germany | 1.7% | 1.8% | 2.1% | 1.9% |
| Greece | 2.0% | 2.1% | 1.6% | 1.9% |
| Iceland | 0.8% | 0.9% | 1.0% | 0.9% |
| Ireland | 2.2% | 1.8% | 1.2% | 1.7% |
| Italy | 3.8% | 3.9% | 3.8% | 3.9% |
| Japan | 6.2% | 6.8% | 7.5% | 6.8% |
| Luxembourg | 7.5% | 7.9% | 8.4% | 7.9% |
| Netherlands | 3.4% | 3.4% | 3.2% | 3.3% |
| New Zealand | 2.7% | 2.6% | 3.7% | 3.0% |
| Norway | 4.6% | 4.1% | 2.4% | 3.7% |
| Portugal | 3.2% | 2.9% | 2.1% | 2.7% |
| Spain | 2.7% | 3.0% | 3.0% | 2.9% |
| Sweden | 1.6% | 1.8% | 2.1% | 1.8% |
| Switzerland | 2.0% | 2.1% | 2.0% | 2.0% |
| Turkey | 1.8% | 1.9% | 2.4% | 2.0% |
| United Kingdom | 3.2% | 4.0% | 4.5% | 3.9% |
| **OECD Average without US:** | **3.5%** | **3.8%** | **4.1%** | **3.8%** |
| **UNITED STATES** | **2.1%** | **2.2%** | **2.5%** | **2.3%** |
| *Source: OECD. Averages are weighted by size of GDP.* | | | | |

## Corporate Tax Returns With Alternative Minimum Tax
## By Major Industry, 1988 to 1991

| Number of Returns<br>Industry: | 1991 Total No. of Returns | 1991 Number w/AMT | 1991 % with AMT | 1990 Total No. of Returns | 1990 Number w/AMT | 1990 % with AMT | 1989 Total No. of Returns | 1989 Number w/AMT | 1989 % with AMT | 1988 Total No. of Returns | 1988 Number w/AMT | 1988 % with AMT |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| All corporations* | 2,098,641 | 30,613 | 1.5% | 2,136,032 | 32,458 | 1.5% | 2,199,881 | 25,237 | 1.1% | 2,299,896 | 25,193 | 1.1% |
| Mining | 23,073 | 1,014 | 4.4% | 23,644 | 1,342 | 5.7% | 26,308 | 1,063 | 4.0% | 27,735 | 918 | 3.3% |
| Manufacturing | 184,705 | 6,906 | 3.7% | 188,380 | 6,494 | 3.4% | 195,472 | 4,489 | 2.3% | 205,143 | 4,488 | 2.2% |
| Transportation & Public Utilities | 94,971 | 2,819 | 3.0% | 96,395 | 2,758 | 2.9% | 93,807 | 2,410 | 2.6% | 92,465 | 1,795 | 1.9% |
| Construction | 239,917 | 3,882 | 1.6% | 248,829 | 4,716 | 1.9% | 252,474 | 4,714 | 1.9% | 258,948 | 4,663 | 1.8% |
| Finance, Insurance & Real Estate | 356,744 | 6,007 | 1.7% | 362,083 | 6,198 | 1.7% | 366,826 | 5,068 | 1.4% | 381,028 | 5,583 | 1.5% |
| Agriculture, Forestry & Fisheries | 71,292 | 999 | 1.4% | 71,451 | 1,023 | 1.4% | 70,846 | 546 | 0.8% | 70,141 | 848 | 1.2% |
| Services | 514,243 | 4,081 | 0.8% | 527,715 | 4,914 | 0.9% | 552,174 | 3,313 | 0.6% | 621,475 | 3,567 | 0.6% |
| Wholesale & Retail Trade | 598,743 | 4,904 | 0.8% | 603,224 | 5,012 | 0.8% | 629,208 | 3,619 | 0.6% | 629,262 | 3,323 | 0.5% |

*Active C corporations. *Source: Internal Revenue Service.*

| RETURNS WITH AMT<br>Gross AMT Paid ($-mill.)<br>(before prior year credits) | 1991 AMT Payers Total Tax | 1991 AMT Payers AMT | 1991 AMT Payers AMT/ Tot. Tax | 1990 AMT Payers Total Tax | 1990 AMT Payers AMT | 1990 AMT Payers AMT/ Tot. Tax | 1989 AMT Payers Total Tax | 1989 AMT Payers AMT | 1989 AMT Payers AMT/ Tot. Tax | 1988 AMT Payers Total Tax | 1988 AMT Payers AMT | 1988 AMT Payers AMT/ Tot. Tax |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| All corporations* | $ 13,026 | $ 5,321 | 41% | $ 20,691 | $ 8,104 | 39% | $ 7,867 | $ 3,541 | 45% | $ 6,293 | $ 3,353 | 53% |
| Mining | 451 | 299 | 66% | 466 | 330 | 71% | 448 | 268 | 60% | 339 | 211 | 62% |
| Manufacturing | 4,285 | 1,894 | 44% | 8,238 | 3,418 | 41% | 2,796 | 1,185 | 42% | 2,235 | 1,469 | 66% |
| Transportation & Public Utilities | 3,532 | 1,154 | 33% | 5,937 | 1,810 | 30% | 1,857 | 750 | 40% | 1,145 | 458 | 40% |
| Construction | 133 | 83 | 62% | 185 | 103 | 56% | 161 | 90 | 56% | 192 | 104 | 54% |
| Finance, Insurance & Real Estate | 3,121 | 1,297 | 42% | 4,111 | 1,661 | 40% | 1,794 | 811 | 45% | 1,743 | 802 | 46% |
| Agriculture, Forestry & Fisheries | 37 | 20 | 53% | 37 | 19 | 51% | 32 | 17 | 54% | 27 | 13 | 46% |
| Services | 339 | 198 | 58% | 478 | 302 | 63% | 350 | 182 | 52% | 310 | 145 | 47% |
| Wholesale & Retail Trade | 1,127 | 376 | 33% | 1,240 | 461 | 37% | 430 | 238 | 55% | 301 | 151 | 50% |

*Active C corporations. *Source: Internal Revenue Service.*

| RETURNS WITH AMT<br>Average AMT Paid ($-000)<br>(before prior year credits) | 1991 Total Tax | 1991 AMT | 1991 AMT/ Tot. Tax | 1990 Total Tax | 1990 AMT | 1990 AMT/ Tot. Tax | 1989 Total Tax | 1989 AMT | 1989 AMT/ Tot. Tax | 1988 Total Tax | 1988 AMT | 1988 AMT/ Tot. Tax |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| All corporations* | $ 426 | $ 174 | 41% | $ 637 | $ 250 | 39% | $ 312 | $ 140 | 45% | $ 250 | $ 133 | 53% |
| Mining | 445 | 294 | 66% | 347 | 246 | 71% | 421 | 252 | 60% | 370 | 229 | 62% |
| Manufacturing | 621 | 274 | 44% | 1,268 | 526 | 41% | 623 | 264 | 42% | 498 | 327 | 66% |
| Transportation & Public Utilities | 1,253 | 409 | 33% | 2,152 | 656 | 30% | 770 | 311 | 40% | 638 | 255 | 40% |
| Construction | 34 | 21 | 62% | 39 | 22 | 56% | 34 | 19 | 56% | 41 | 22 | 54% |
| Finance, Insurance & Real Estate | 520 | 216 | 42% | 663 | 268 | 40% | 354 | 160 | 45% | 312 | 144 | 46% |
| Agriculture, Forestry & Fisheries | 37 | 20 | 53% | 36 | 18 | 51% | 58 | 32 | 54% | 32 | 15 | 46% |
| Services | 83 | 49 | 58% | 97 | 62 | 63% | 106 | 55 | 52% | 87 | 41 | 47% |
| Wholesale & Retail Trade | 230 | 77 | 33% | 247 | 92 | 37% | 119 | 66 | 55% | 91 | 45 | 50% |

*Active C corporations. *Source: Internal Revenue Service*

PREPARED STATEMENT OF GEORGE A. PLESKO

Mr. Chairman and Members of the Committee:

My name is George A. Plesko. I am an Assistant Professor of Economics at Northeastern University in Boston, Massachusetts. I am very pleased to have this opportunity to testify today before this distinguished committee on the role of an alternative minimum tax within the current income tax system. I thank the Committee for inviting me to share my views on the subject.

My testimony today can be broken down into five areas. First, I present a brief description of the AMT's role in our federal tax system. The second section provides information about those affected by the AMT. Section three contains an evaluation of the AMT's effectiveness in meeting its goals. The fourth section outlines some of the direct and indirect costs of the AMT. The final section outlines some approaches that might be used to modify the AMT. Because the effects of the AMT on corporations appears to be the focus of much of the current discussion, my remarks will generally address the corporate, rather than the individual, AMT.

WHY AN AMT?

The current alternative minimum tax (AMT) structures were enacted as part of the Tax Reform Act of 1986 (TRA86). The primary reason for the change, as explained in the Report of the Committee on Finance was "to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits."[1]

Many have taken the existence of an AMT as evidence of failures within the underlying tax system: were the underlying tax system designed properly no AMT would be necessary as a back-up. Given the existence of some sort of minimum tax since 1969 this would not appear to be a recent concern. Yet if this concern were so significant, it seems odd that the 1986 tax act, the design and debate of which provided the opportunity for such a comprehensive examination of the tax code, and which yielded one of the broadest restructurings of the code in decades, would have as an important part of its structure a broader and more significant AMT. Within this context, I find it difficult to believe this Committee, and all others who endorsed TRA86, viewed the AMT as an admission of failure in the tax reform process, but rather as a means to obtain other goals. These goals include those stated above in the Committee's report, as well as broader concerns about the perception of the tax system. Others have acknowledged the existence of a minimum tax as necessary in a system in which tax policy is designed and enacted in a world of trade-offs between differing, and sometimes competing, objectives.[2]

The existence of an AMT to address these compromises should not draw our attention away from the underlying issues of how corporate income should be taxed (if at all). If anything, the AMT should serve as a reminder that our current tax system is not ideal. To the extent that the underlying system of taxation is reformed, the importance of the AMT (and the revenue generated from it) should diminish. In this way the AMT serves a role as a way to measure the progress of these changes.

WHO PAYS THE AMT?

Treasury and Internal Revenue staff, and most recently the General Accounting Office (GAO), have released a number of reports on the AMT, the characteristics of firms subject to the AMT, and the extent of firms' AMT duration.[3] These studies have found that while the majority of firms paying the AMT are relatively small (less than $10 million in assets) larger firms experience the highest probability of paying an AMT liability. Of the largest firms, those with assets in excess of $1 bil-

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[1] U.S. Senate, Committee on Finance, Tax Reform Act of 1986, Report 99-313 (Washington D.C.: U.S. GPO) May 29, 1986, p. 518.

[2] For a discussion see M.J. Graetz, and E.M. Sunley, "Minimum Taxes and Comprehensive Tax Reform," in H.J. Aaron and J.A. Pechman, eds, Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax (Washington DC: Brookings) 1988.

[3] The earliest data on the effects of the corporate AMT were reported by then Assistant Secretary of the Treasury (Tax Policy) Kenneth Gideon before the Ways and Means committee on February 7, 1990. More recent data can be found in G. Gerardi, H. Milner, and G. Silverstein, 1993, "Temporal Aspects of the Corporate Alternative Minimum Tax: Results from corporate Panel Data for 1987-1990," in Proceedings of the Eighty-Third Annual Conference 1992, (Columbus: National Tax Association—Tax Institute of America): 117-127; A. Gill, and P. Treubert, 1993, "The Corporate Alternative Minimum Tax: A Year-by-Year Analysis of Tax Return Data from 1987-1990," in Proceedings of the Eighty-Third Annual Conference 1992, (Columbus: National Tax Association—Tax Institute of America): 128-136; U.S. General Accounting Office, Experience With the Corporate Alternative Minimum Tax, (Washington D.C.: US GPo) 1995.

lion, more than 20 percent were on the AMT in each year since 1987. These seemingly contradictory results are explained by understanding the different distribution of corporate tax returns and corporate income. While there are approximately 3.8 million corporate tax returns filed each year (including S corporations) more than half of them have less than $100,000 in assets and fewer than 6,000 have assets in excess of $250 million. The group of firms in the largest asset category, however, hold the vast majority of corporate assets, and are responsible for more than 70 percent of taxable income and tax payments.

The GAO reports that no more than 1.5 percent of corporations have paid the AMT in any given year. In 1990, for example, 32,000 out of 2.1 million returns included AMT.[4] Among larger corporations, those with assets in excess of $50 million, about one-half have been on the AMT in at least one year. However, given the need to calculate the AMT to determine whether one is on it, and the use of the AMT form to levy the Environmental Tax, many more firms are required to maintain AMT-related records. The GAO reports 400,000 corporations filed the AMT form in 1990.

We also know the effects of the AMT are not uniform across industry group. Some industry groups have had a greater share of their firms subject to the AMT. As a result, the AMT has had different effects on firms' effective tax rates across industry.

DOES THE CURRENT AMT MEET ITS OBJECTIVES?

Within the narrow goal of decreasing the likelihood that firms with positive financial statement earnings would pay little or no tax the AMT appears to have had quick success. The 1990 Treasury testimony reported a 41 percent decline in the number of firms with positive book income that paid no tax, with 90 percent of those remaining firms being small with large NOL carryforwards. In its recent report the GAO also provided an explanation of why many firms with positive book income were not subject to the AMT, and reached essentially the same conclusion: these firms were either small, had net income below the exemption level of the AMT, or were RICs and REITs.

Since the AMT was designed in response to the concern that firms overutilized various provisions of the tax code it should not be surprising that it is one of the few provisions which raise, rather than reduce, the share of taxes paid by the largest corporations. While there is no public-use microdata available to analyze the tax status of firms, the IRS does publish aggregate data by asset size. If one uses these published asset categories to examine the distribution of taxes, one finds the corporate tax actually places a slightly heavier burden on smaller firms than large. The AMT and the Environmental Taxes, however, decrease the extent to which smaller firms bear the tax. The use of credits is much greater larger firms than small, reducing the burden of the corporate tax more among the larger firms. If one desires a slightly progressive corporate tax, or at least a proportional one, the AMT may be necessary to help achieve that goal.[5]

While these goals of the AMT are relatively easy to quantify, other aspects of the AMT are not. For example, in discussing the rationale for an AMT the Senate conference report also stated:

> In particular, both the perception and reality of fairness have been harmed by instances in which major companies have paid no taxes even in years when they have reported substantial earnings, and may even have paid substantial dividends to their shareholders. Even to the extent that these instances reflect deferral, rather than permanent avoidance, of corporate tax liability, the committee believes they demonstrate a need for change.

Too much attention can, and may have been, paid to differences between taxable and financial statement income. Given that we have a tax system based on a separate set of accounting rules than used for financial purposes we need to accept a certain degree of divergence between the two types of income. In particular, the AMT should be more sensitive to the cyclical nature of many businesses, and the different effects the business cycle may have on the two type of income. Nonetheless, the perception of fairness has been shown to be an important part of the tax system and cannot be rejected out of hand.[6] As a result, the book income and ACE adjust-

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[4] GAO, Experience With the Corporate Alternative Minimum Tax, p. 34.

[5] The question of who, ultimately, pays the corporate tax, including the AMT, is not addressed here. Regardless of the ultimate economic incidence of the corporate tax, the structure of the tax code implies a desire on the part of Congress a generally proportional, if not slightly progressive, statutory incidence.

[6] A discussion of the role taxpayer perceptions may play in compliance can be found in S.M. Sheffrin and R.J. Triest, "Can Brute Force Backfire? Perceptions and Attitudes in Taxpayer

ments may be more important in addressing fairness than the other adjustments in the AMT.[7]

WHAT COSTS ARE IMPOSED BY THE AMT?

The most obvious cost imposed by the AMT is the increase in taxes paid by firms on the AMT. The AMT has proven to be a significant source of revenue, ranging from $2.2 to $8.1 billion per year, or 3 to 9 percent of corporate liabilities. It must also be remembered that these figures from the GAO, and reported in IRS publications, are a lower bound on the revenue collected due to the existence of the AMT as they do not include increases in regular tax payments made by firms that increase their regular tax liability in order to avoid being on the AMT.

Since the AMT generates a credit, it should be remembered that these additional liabilities should ultimately be paid back to AMT firms as they become subject to the regular tax. The net cost of the AMT to a firm is the loss in the use of those funds until they are refunded.

A second cost of the AMT is the resources devoted to compliance. In a recent survey of large corporations, depreciation and the AMT (as well as their interaction) were the two most cited aspects of the tax code responsible for the cost of compliance.[8] While compliance costs are difficult to measure, compliance related activities do impose real costs on firms as well as on the Government as it monitors and enforces tax provisions.

Finally, the AMT has been suggested as increasing the cost of investment to firms. While this is an area I expect will be addressed in more detail by other panelists, it is worth noting that to the extent the AMT does increase the cost of investment to the firm, it does so relative to the cost of that investment under the regular tax code. As a result, any increase in the cost of investment should not, in and of itself, be surprising. Rather, it should underscore the role the AMT was designed to play, and generate discussion about the proper tax treatment of investment assets.

ARE THERE WAYS TO SIMPLIFY THE AMT?

Any evaluation of proposals to modify the AMT will include a discussion of the cost. The Joint Committee on Taxation has estimated the repeal of the AMT, as passed by the House, would cost nearly $17 billion over the short-term budget horizon, and more than twice that over ten years, with some offset from its interaction with the proposed Neutral Cost Recovery.[9]

By itself, this amount of revenue loss is significant. However this revenue loss should also be viewed in the context of TRA86. TRA86 was designed to be revenue-neutral by shifting approximately $120 billion in collections from individuals to corporations. Five years ago, to the day, this Committee held a hearing on whether TRA86 raised as much revenue from corporations as was forecast.[10] At that time, the "shortfall" was largely explained as having been caused by a divergence between the economic forecasts upon which TRA86 was based and actual economic performance. Any modification, or outright repeal, of the AMT would also affect the intended balance of corporate and individual receipts set forth in TRA86.

This is not to say that changes cannot, or should not, be made to the tax system. As outlined above, changes can be made to the underlying (non-AMT) tax base to provide a more consistent measure of income between the two systems. Changes made in OBRA89 eliminated the distinction between permanent and timing differences in determining the AMT credit. OBRA93 eliminated the ACE depreciation adjustment, and lengthened the life of non- residential real estate for regular tax purposes.

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Compliance," in J. Slemrod, ed., Why People Pay Taxes: Tax compliance and Enforcement (Ann Arbor: University of Michigan Press) 1992.

[7] A number of studies have suggested that the inclusion of book income as an adjustment in the AMT affected firms' reporting of income in their financial statements. By decreasing reported earnings firms were able to reduce the tax effects of the book income adjustment, which included one-half of the difference between book and taxable income in AMTI. See, for example, C.E. Boynton, P.S. Dobbins, and G.A. Plesko, "Earnings Management and the Corporate Alternative Minimum Tax," Journal of Accounting Research, 30, Supplement 1992.

[8] J. Slemrod and M. Blumenthal, "The Income Tax Compliance Cost of Big Business," University of Michigan, Office of Tax Policy Research, Working Paper No. 93-11.

[9] U.S. Congress, Committee on Ways and Means, Contract with America Tax Relief Act, Report 104-84 (Washington D.C.: U.S. GPO) March 21, 1995.

[10] U.S. Senate, Committee on Finance, Decline of Corporate Tax Revenues, S. Hrg. 101-1065 (Washington, D.C.: U.S. GPO) May 3, 1990.

The remainder of this sect ion describes two changes that could be made to the AMT.

AMT CREDIT: The use of AMT credits could be liberalized. Currently, firms may not use AMT credits to reduce their regular tax liability below their AMT liability. Limits on the use of AMT credits make it more difficult for firms to recover their tax payments, and increase the likelihood that differences due to the AMT will become permanent. While the current credit restrictions make sense in preserving the goal of a level of tax being paid in each year, it does so at the expense of increasing the present-value of the tax on corporations. While I would not advocate AMT credits being allowed to offset the regular tax regardless of the current year AMT liability, a more generous allowance would at least partially compensate firms for the deferral of their use.

SMALL FIRMS AND THE THRESHOLD FOR THE AMT: As stated above, the recent GAO report found approximately 400,000 firms filed an AMT form even though only 28,000 were liable for an AMT liability. Many more firms have to keep records in order to calculate their AMT liability in order to know whether they are subject to the tax. This suggests the possibility that the threshold for the AMT could be raised in order to reduce the number of affected firms.

While the AMT threshold could be raised by increasing the exemption level above its current amount, any number of alternative thresholds can be identified in the tax code. For example, the short form for corporations (1120A) is available to firms which meet a list of criteria, including gross receipts, total income, and total assets less than $500,000.[11] While it is unclear from published data how many of these firms pay the AMT, the amount of AMT revenue collected from these firms was less than $1 million in 1991.[12]

Other aspects of the regular tax which may provide an alternative threshold are the §179 limits on expensing. While the expensing provisions do not directly enter the calculation of AMTI, the reduction in regular tax liability from expensing may increase the likelihood of a smaller firms being subject to the AMT.[13]

This concludes my prepared remarks. I would be happy to answer any questions the Committee may have. Thank you.

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## PREPARED STATEMENT OF LESLIE B. SAMUELS

Mr. Chairman and Members of the Committee:

I welcome the opportunity this morning to discuss the Administration's views regarding the importance of the individual and corporate alternative minimum tax (AMT), as well as the changes to the AMT proposed by H.R. 1215.

Since the introduction in 1969 of the individual and corporate minimum tax, its primary goal has been to strengthen taxpayers' confidence in the fairness of our income tax system. This was also one of the objectives of the sweeping changes made by the Tax Reform Act of 1986 (TRA 86). Strengthening the individual and corporate minimum taxes was one of the ways that TRA 86 sought to increase both the actual and perceived fairness of the income tax by inhibiting tax shelter activities and ensuring that taxpayers with substantial economic income pay tax on that income.

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[11] They must also not be subject to the Environmental Tax.

[12] U.S. Internal Revenue Service, Statistics of Income—1991: Corporation Income Tax Returns, (Publication 16) (Washington D.C.: US GPO) 1994.

[13] While reducing the number of small firms subject to the AMT may ease the compliance cost of the AMT, any change should be viewed within the context of the large number of tax, and non-tax, benefits provided to smaller firms. for example, many smaller firms already have the option of electing to operate as a subchapter-S corporations. In addition, any changes made should not encourage individuals to operate in the corporate form solely as a tax-avoidance device.

The AMT is not a perfect mechanism, although some improvements have been made in recent years. The complexity of the AMT, especially the corporate AMT, has been eased repeatedly since 1986, most recently in the Omnibus Budget Reconciliation Act of 1993 (OBRA 93), which repealed the depreciation component of adjusted current earnings (ACE) for assets placed in service after 1993.

We are committed to simplifying the AMT where possible through administrative measures, as we had done in November, 1994, through the promulgation of a regulation allowing regular tax AGI to be used for AMT purposes where AGI acts as a constraint in limiting deductions or exclusions. Moreover, the Administration welcomes the opportunity to work with the Congress to identify areas where further simplification is possible on a revenue-neutral basis, either within the AMT or by identifying other acceptable revenue offsets.

In reviewing the AMT, it is important to note that although theoretically more attractive approaches can be imagined, the flaws of an AMT fade when measured against the potential damage to our tax system that might result if wealthy individuals and profitable corporations were able to pay little or no tax by investing in tax-favored activities or assets. This would be particularly true if the tax cuts in H.R. 1215, which reflects the House Republicans' Contract with America, were to be enacted. Moreover, in the event H.R. 1215 were enacted, we estimate that approximately 76,000 corporations that would otherwise have paid income tax in 2005 would avoid paying any tax. These companies account for approximately $1.1 trillion in sales, or 16 percent of total sales ($7.1 trillion), and $2.7 trillion in assets, or 18 percent of total assets ($15.4 trillion) of corporations currently subject to tax.

In the remainder of my testimony, I will briefly review the history of the individual and corporate AMT, summarize how the AMT is calculated, and examine the record of AMT liabilities and credits, and the reasons why taxpayers are subject to the AMT. My testimony will briefly comment on economic issues related to the AMT. I will then turn to the provisions of H.R. 1215, which would significantly weaken the AMT system over the next five years and totally repeal the corporate AMT in 2001.

## I. Legislative History of the Minimum Tax

Responding to Treasury studies that found some high-income individuals paid little or no tax, in 1969 Treasury proposed a minimum tax for individuals. The Tax Reform Act of 1969 included a minimum tax for individual and corporate taxpayers on certain tax preferences and excluded capital gains for individuals. A 10-percent tax was levied on the taxpayer's minimum tax base, which was the sum of the tax preferences less an exemption amount and the taxpayer's regular tax liability. This was an add-on rather than an alternative tax; taxpayers paid both the regular tax and the minimum tax. The Tax Reform Act of 1976 added more preferences to the base of the individual minimum tax, including one for "excess itemized deductions," and, for both the individual and corporate minimum tax, reduced the exemption amount and increased the minimum tax rate to 15 percent.

The Revenue Act of 1978 removed the excluded capital gains and excess itemized deductions preferences from the individual minimum tax, and included them as part of the base of an alternative tax with graduated rates ranging up to 25 percent, which would generate a supplemental AMT liability that applied only when the alternative tax was greater than the regular tax liability. From 1978 to 1982, individuals were subject to both the AMT and the add-on minimum tax. The Economic Recovery Tax Act of 1981 (ERTA) lowered the top AMT rate to 20 percent, so that the maximum rate on excluded capital gains would be no higher than on capital gains under the regular tax.

In the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the add-on tax for individuals was repealed, and the base of the AMT was broadened to include nearly all of the tax preferences that had been included in the add-on minimum tax. To address increasing concerns about the equity of the corporate tax system, TEFRA also contained a direct 15 percent cutback in certain corporate tax preferences.[1] Although these cutbacks operated independently of the corporate minimum tax, adjustments were made to the minimum tax to prevent the combination of that tax and the cutback provisions from unduly reducing the benefits from a preference.

The Deficit Reduction Act of 1984 increased the direct cutback of certain corporate tax preferences from 15 percent to 20 percent and again made corresponding adjustments to the corporate add-on minimum tax. Except for the cutbacks in preferences enacted in 1982 and 1984, the corporate add-on tax was essentially unchanged between 1978 and 1986. Just prior to the Tax Reform Act of 1986 (TRA 86), corporations paid an add-on minimum tax equal to 15 percent of certain tax preferences to the extent that the preferences exceeded the greater of regular tax paid or $10,000. The tax preferences in the corporate minimum tax base included the excess of accelerated depreciation over straight line, excess bad debt deductions for financial institutions, percentage depletion in excess of basis, and a portion of net capital gains.

While the corporate add-on minimum tax reduced benefits from tax preferences, it failed to ensure that corporations with book income paid tax in the year they received that income, and that all corporations with substantial economic income paid tax on that income. Groups outside the government brought attention to corporations reporting substantial earnings, while not paying corporate tax. Also, calculations of effective tax rates on economic income generally showed low or even negative effective tax rates on some forms of corporate investment. These results, in combination with publicity about tax shelters and high-income individuals without income tax liability, raised concerns about whether the high level of voluntary taxpayer compliance that had characterized our tax system could be maintained.

In response to these concerns about corporate tax avoidance, President Reagan's 1985 tax reform proposals included a provision

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[1]Section 291, as amended by TRA 86, remains in current law.

to replace the add-on minimum tax with a 20 percent alternative minimum tax (AMT) that included various tax preferences. The President's message noted that "the prospect of high-income corporations paying little or no tax threatens public confidence in the tax system"[2] and asserted that "an alternative minimum tax limited to the tax preferences applicable to corporations under [pre-TRA 86] law would be insufficient to prevent many corporations from eliminating their regular tax on economic income."[3]

In enacting TRA 86, Congress reduced tax rates and broadened the tax bases of the individual and corporate income taxes to ensure that taxpayers with substantial economic income would not escape income tax by using tax preferences. TRA 86 repealed the investment tax credit, the partial exemption of capital gains income and certain other incentives, and imposed limits on deductibility of passive losses. To ensure that remaining incentives in the tax law did not allow taxpayers to escape tax completely, TRA 86 also replaced the corporate add-on minimum tax with a new AMT similar in structure to the alternative minimum tax that had applied to individuals before 1986. TRA 86 also changed the individual AMT by increasing the AMT tax rate, effectively eliminating the AMT exemption for joint returns with AMT income over $310,000 ($232,500 for single filers), and adding new preference items.[4]

For both corporations and individuals, TRA 86 introduced credits for previously paid AMT, allowing taxpayers to use part of AMT liability incurred in one year as a credit to offset regular tax liability in future years. These AMT credits, however, could only be generated from AMT liability resulting from "timing" preferences that turned around in future years. Allowing credits for timing preferences was necessary to enable taxpayers to recover fully the amount of capital invested. Without the credits, a taxpayer could be forced, for example, to use the relatively back-loaded AMT depreciation schedule in the

[2]"The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity," May, 1985, p. 335.

[3]Ibid., p. 334.

[4]An important effect of TRA 86 on the AMT came from the elimination of the capital gains exclusion in the regular tax. Before TRA 86, the capital gains exclusion was by far the largest difference between taxable income under the regular tax and under the AMT for individuals. TRA 86 also phased out the personal interest deduction, another major AMT preference item for individuals.

early years of an asset's life and the relatively accelerated regular tax schedule in the later years.

The Senate Finance Committee's Report discussed the rationale for these changes in the AMT:

> The Committee believes that the minimum tax should serve one overriding objective: to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits. Although these provisions may provide incentives for worthy goals, they become counterproductive when taxpayers are allowed to use them to avoid virtually all tax liability. The ability of high-income individuals and highly profitable corporations to pay little or no tax undermines respect for the entire tax system and, thus, for the incentive provisions themselves. In addition, even aside from public perceptions, the committee believes that it is inherently unfair for high-income individuals and profitable corporations to pay little or no tax due to their ability to utilize various tax preferences.
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> In particular, both the perception and the reality of fairness have been harmed by instances in which major corporations have paid little or no tax in years when they reported substantial earnings, and may even have paid substantial dividends, to shareholders. Even to the extent that these instances reflect deferral, rather than permanent avoidance, of corporate tax liability, the committee believes that they demonstrate a need for change.[5]

To ensure that corporations reporting book income paid some tax, TRA 86 included for years 1987 through 1989 an AMT adjustment for 50 percent of any excess of book income over minimum taxable income after other adjustments and preferences. Negative adjustments were not allowed. Beginning in 1990, TRA 86 replaced the book income adjustment with an adjustment based on tax definitions of earnings and profits, the adjusted current earnings (ACE) adjustment. Seventy-five percent of the amount by which ACE exceeds alternative minimum taxable income (AMTI) must be added to AMTI. Unlike the book-income adjustment, these adjustments could be either positive or negative.

The Omnibus Budget Reconciliation Act of 1989 extended the corporate AMT credit to all items generating an AMT liability, even "exclusion items." Exclusion items are preferences that cause a permanent difference in taxable income, rather than a

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[5]U.S. Senate, Committee on Finance, "Tax Reform Act of 1986", Report 99-313, pp. 518-9, May 1986.

difference in the timing of income (for example, tax-exempt interest income). It also repealed a limitation on ACE writeoffs for depreciation, intangible drilling costs, depletion, and mining costs.

The Omnibus Budget and Reconciliation Act of 1990 (OBRA 90) permitted a special energy deduction against alternative minimum taxable income for oil and gas interests, which was in effect for tax years 1991 and 1992. In addition, OBRA 90 raised the individual AMT tax rate and removed as a preference item the capital gain from appreciated tangible personal property donated to charity. (Subsequent legislation applied this change to property donated through June 30, 1992, and then OBRA 93 made this change permanent.)

For years beginning in 1993, the Energy Policy Act of 1992 repealed the energy deduction enacted in OBRA 90 and eliminated excess intangible drilling costs and percentage depletion deductions as AMT and ACE preference items for independent producers, subject to certain limitations.

In its February 1993 Budget, this Administration proposed AMT tax relief. OBRA 93 incorporated one of the proposed AMT changes. The depreciation component of the ACE adjustment, which was measured by the difference between AMT depreciation (150 percent declining balance method) and depreciation based on use of the straight line method over the class life of the asset, was repealed for property placed in service after 1993. OBRA 93 also lengthened the depreciable life for non-residential structures under the regular tax, thereby reducing the AMT preference for those assets.

In addition, for individuals, OBRA 93 created a two-tier tax rate structure (26 percent on the first $175,000 of a taxpayer's AMT income subject to tax[6], and 28 percent on amounts in excess of $175,000), increased the AMT exemption to $45,000 for married individuals filing joint returns[7], and permanently removed the capital gain from charitable contributions of appreciated property as a preference item.

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[6]$87,500 for married individuals filing separately.

[7]The exemption amount for single filers was raised to $33,750, and to $22,500 for married individuals filing separately.

II. Description of the AMT under Current Law

Corporate AMT

The computation of the corporate AMT is generally a two-step process. The starting point is the corporation's regular taxable income before any net operating loss deduction. This amount is increased by tax preferences for the year and increased (or decreased) by adjustments that modify certain items of income or deductions used in the computation of regular taxable income, and reduced by the net operating loss deduction for AMT purposes. In a second step, alternative minimum taxable income ("AMTI") is adjusted further to reflect the ACE adjustments. The resulting amount of AMTI, reduced by an exemption amount of $40,000 less 25 percent of the amount by which AMTI exceeds $150,000 (which effectively eliminates the AMT exemption for AMT income over $310,000), is taxed at a 20 percent rate to compute the tentative minimum tax before credits.

The tentative minimum tax before credits may be partially offset by the AMT foreign tax credit. If the resulting tentative minimum tax exceeds the corporation's regular tax, the excess is defined as the AMT; the corporation pays its regular tax plus the AMT. The AMT paid becomes a credit that may be used to offset regular tax in any later year, but may not be used to reduce regular tax below the tentative minimum tax for the year in which the credit is claimed.

Adjustments and Preferences

The adjustments and preferences applicable in computing unadjusted AMTI are:

Adjustments--all taxpayers:

(1) Depreciation (post-1986 property)--computed using generally longer class lives prescribed by the alternative depreciation system under the Code and either the straight-line method for property subject to this method for the regular tax, or the 150-percent declining balance method for other property.

(2) Amortization of pollution control facilities (post-1986 property)--computed using the alternative depreciation system under the Code.

(3) Mining exploration and development costs--capitalized and amortized over a 10-year period.

(4) Long-term contract taxable income (other than home construction)--computed using the percentage-of-completion method of accounting.

(5) Installment sales (property other than timeshares and residential lots)--installment method of accounting not available for dealers in property.

(6) Tax shelter farm or passive activities--losses denied.

Adjustments--corporate taxpayers only:

(1) Adjusted current earnings (ACE) adjustment--described below.

(2) Merchant Marine capital construction funds--special rules apply.

(3) Blue Cross and Blue Shield organizations--special deduction not allowable.

Preferences:

(1) Percentage depletion--excess over the adjusted basis of the property at the end of the taxable year. (Post-1992, the preference is not applicable to percentage depletion allowed for oil and gas properties.)

(2) Tax-exempt interest income--interest income on private activity bonds (other than qualified 501(c)(3) bonds) issued after August 7, 1986.

(3) Intangible drilling and development costs--excess costs (over 10-year amortization) in the taxable year that exceed 65 percent of the net income from oil, gas, and geothermal properties. (Post-1992, this preference is not applicable to independent producers to the extent the producer's AMTI is reduced by 40 percent or less without the preference.)

(4) Bad debt reserves--excess deductions determined under the Code over the financial institution's actual experience.

(5) Real estate depreciation (pre-1987 property)--excess of accelerated depreciation over the straight-line method.

(6) Amortization of pollution control facilities (pre-1987 property)--excess over other methods under the Code.

(7) Gains on sale of certain small business stock--one-half of the amount excluded from income under the Code.

Operation of the Accumulated Current Earnings (ACE) Adjustment

A corporation must increase its AMTI by 75 percent of the amount by which ACE exceeds AMTI determined without regard to the

ACE adjustment and alternative tax NOLs. If unadjusted AMTI exceeds ACE, AMTI is reduced by 75 percent of the difference. This reduction, however, is limited to the aggregate amount by which AMTI has been increased by the ACE adjustment in prior years.

To calculate ACE, the following items are added to AMTI: (1) income items that are included in determining earnings and profits (E&P) but are not otherwise included in AMTI, such as tax-exempt interest (other than interest on specified private activity bonds); (2) items deductible in computing AMTI but not deductible for determining E&P, such as the dividends received deduction; and (3) certain specific adjustments, such as depreciation (other than for personal property placed in service after 1993). In addition, certain adjustments to the computation of unadjusted AMTI are required in computing ACE.

AMT NOLs

Net operating loss deductions under the AMT are determined by using a separate computation of AMT net operating losses and loss carryovers. This computation takes into account differences between the regular tax base and the AMT base. The amount of the AMT net operating loss for any taxable year is in general equal to the amount by which the deductions allowed in computing AMTI for the taxable year (other than the deduction for carryovers to the taxable year of AMT net operating losses) exceed the gross income includible in AMTI for the taxable year. In light of the parallel nature of the regular tax and AMT systems, any limitations applying for regular tax purposes to the use by a consolidated group of net operating losses or current-year losses apply for AMT purposes as well. Moreover, alternative tax NOLs cannot reduce current-year AMTI by more than 90 percent.

Foreign tax credits for AMT

The foreign tax credit (FTC) is allowed for minimum tax purposes, but the credit is calculated specially for the minimum tax. In essence, the minimum tax FTC is figured in the same manner as for the regular tax, except it includes only AMT items of income and deduction, uses AMT taxable income instead of regular taxable income, and uses AMT in place of regular tax. Foreign tax credits, in combination with NOLs, can offset no more than 90 percent of the tentative minimum tax. Excess AMT foreign tax credits can be carried forward 5 years or back 2 years.

AMT Credit

AMT paid by a corporation in one year is available as a credit against its regular tax liability in future years. This AMT credit generally compensates the corporation for the loss of a regular-tax benefit when the corporation is in an AMT position by reducing the corporation's regular tax in subsequent years.

The AMT credit cannot reduce regular tax after other credits below the tentative minimum tax. Unused AMT credits may be carried over indefinitely to subsequent tax years.

Individual AMT

The structure of the individual AMT is generally similar to that for corporations. Alternative minimum taxable income (AMTI) for individuals is taxable income (before limitations on personal exemptions) for the regular tax, and various preferences and adjustments, including an adjustment for the net operating losses allowed under the AMT. AMTI in excess of an exemption amount (described below), phased out at higher levels of AMTI, is then subjected to a two-tier tax rate structure (for married individuals filing a joint return, 26 percent for the first $175,000 of AMTI and 28 percent of AMTI in excess of $175,000). After allowance for the foreign tax credit for AMT purposes, the resulting tentative minimum tax is compared to the individual's regular tax liability, with the taxpayer owing the regular tax plus the individual AMT equal to the excess (if any) of the tentative minimum tax over the regular tax liability.

AMT NOLs

The net operating loss deduction allowed for individual minimum tax purposes is similar to that for the corporate AMT. It is calculated using AMT items of income and deduction, and cannot reduce AMT by more than 90 percent.

Preferences and Adjustments

Other than the previously listed adjustments and preferences applicable for all taxpayers, additional adjustments for individuals include the following:

(1) State, local, and foreign taxes.

(2) Miscellaneous itemized deductions (in excess of 2 percent of taxpayer's AGI).

(3) Special rules relating to incentive stock options.

(4) Standard deductions and personal exemptions.

(5) Medical deductions (between 7.5 percent and 10 percent of a taxpayer's AGI).

(6) Circulation expenditures--capitalized and amortized over a three-year period.

(7) Research and experimental expenditures--capitalized and amortized over a 10-year period (unless material participation by taxpayer).

Exemption amount for AMT

An exemption is allowed for AMTI of $45,000 for joint returns, and $33,700 for single returns. These amounts are phased out at a rate of $1 for every $4 of AMTI in excess of $150,000 for joint returns and $112,500 for single returns. This eliminates the exemption at AMTI of $310,000 for joint returns, and $232,500 for single returns.

Foreign tax credits for AMT

A foreign tax credit is allowed for minimum tax purposes, but it is calculated specially for the minimum tax (as discussed above).

AMT credits

AMT liability in one year may be credited against regular tax liability in future years. These AMT credits, however, cannot lower a taxpayer's regular tax liability for a given year below the taxpayer's tentative minimum tax for that year, and, for individuals, they can only be generated from AMT liability resulting from timing preferences. For example, AMT liability generated by accelerated depreciation can result in AMT credits, but not AMT liability resulting from state and local tax deductions. Excess credits can be carried forward indefinitely.

Pattern of Corporate AMT Liabilities and Credits

Table 1 summarizes the historical revenue pattern from corporate income taxes. Until TRA 86, the corporate minimum tax generally accounted for less than one percent of total corporate tax liabilities. TRA 86, however, substantially increased the importance of the corporate AMT as a source of revenue. From gross corporate AMT revenues averaging about $3 billion per year in 1987 though 1989, corporate AMT revenues jumped to $8.1 billion in 1990, with the replacement of the 50 percent book income adjustment by the 75 percent ACE adjustment that year. In 1991 and 1992, gross corporate AMT revenue declined to about $5 billion. At the same time, the use of AMT credits grew. From an average of less than $700 million in 1988 through 1990, corporate AMT credit use increased to $1.5 billion in 1991 and $2.4 billion in 1992, the last year for which corporate tax data are available. Thus, in 1992, the corporate AMT produced net revenue of $2.7 billion compared with net revenue of $7.4 billion in the peak year of 1990. The decline in net AMT revenue is expected to continue after 1992, with $1.4 billion estimated for 1993.

Table 1

HISTORIC PATTERN OF CORPORATE TAX REVENUE

| Year | Total Corporate Income Tax (after credits) | Minimum Tax before Credits | AMT credits | Net Minimum Tax | Net Minimum Tax as % Total Tax | Unused AMT Credits |
|---|---|---|---|---|---|---|
| | (Dollar amounts in billions) | | | | | |
| 1970 | 27.5 | 0.3 | | 0.3 | 1.0% | |
| 1971 | 30.2 | 0.3 | | 0.3 | 0.9% | |
| 1972 | 33.5 | 0.3 | | 0.3 | 0.9% | |
| 1973 | 39.1 | 0.3 | | 0.3 | 0.9% | |
| 1974 | 40.6 | 0.3 | | 0.3 | 0.9% | |
| 1975 | 39.7 | 0.2 | | 0.2 | 0.4% | |
| 1976 | 49.8 | 0.2 | | 0.2 | 0.4% | |
| 1977 | 56.7 | 0.3 | | 0.3 | 0.5% | |
| 1978 | 64.4 | 0.3 | | 0.3 | 0.5% | |
| 1979 | 65.9 | 0.4 | | 0.4 | 0.7% | |
| 1980 | 63.0 | 0.4 | | 0.4 | 0.7% | |
| 1981 | 58.4 | 0.5 | | 0.5 | 0.9% | |
| 1982 | 47.1 | 0.5 | | 0.5 | 1.0% | |
| 1983 | 51.9 | 0.6 | | 0.6 | 1.1% | |
| 1984 | 64.0 | 0.5 | | 0.5 | 0.9% | |
| 1985 | 62.4 | 0.7 | | 0.7 | 1.2% | |
| 1986 | 73.2 | 1.0 | | 1.0 | 1.4% | |
| 1987 | 87.0 | 2.2 | | 2.2 | 2.5% | 2.2 |
| 1988 | 95.9 | 3.4 | 0.5 | 2.9 | 3.0% | 5.1 |
| 1989 | 96.1 | 3.5 | 0.8 | 2.7 | 2.8% | 7.8 |
| 1990 | 96.4 | 8.1 | 0.7 | 7.4 | 7.7% | 15.2 |
| 1991 | 92.6 | 5.3 | 1.5 | 3.8 | 4.1% | 19.0 |
| 1992 | 104.6 | 5.1 | 2.4 | 2.7 | 2.6% | 21.7 |
| 1993-est. | 123.8 | 4.9 | 2.9 | 1.4 | 1.1% | 23.1 |

Source: IRS, Corporation Income Tax Returns, relevant issues, and unpublished IRS data

Note: 1993 data are estimated.

This downward trend in AMT net revenues is expected to continue for several reasons. First, depreciation adjustments, by far the largest source of AMT revenue, only affect the timing, rather than the total amount, of depreciation deductions. Most AMT revenues are initially generated from the less-accelerated depreciation allowed for AMT purposes. Subsequently, these depreciation allowances reverse and AMT revenues from depreciation adjustments decline. We have now reached the period where this reversal is occurring for post-TRA 86 investment.[8]

Second, the removal of depreciation from the ACE adjustment under OBRA 93 and the lengthening of the regular-tax depreciation lives of non-residential real property are expected to reduce future AMT liabilities (and increase the utilization of AMT credits). Third, as the number of corporations subject to the AMT and tentative minimum tax liabilities decline, corporations are able to use an increasing amount of AMT credits to reduce their regular tax liability. The economic recovery will likely contribute to this trend. For these reasons, the downward trend in net corporate AMT revenues since 1990 (when the one-time spike in revenues occurred) is expected to continue.

The relative importance of adjustments and preferences in corporate AMTI is presented in Table 2, which is derived from data presented in a recent GAO report on experience with the corporate AMT.[9] Since the depreciation adjustment was the largest adjustment and played a dominant role in the ACE adjustment, the difference between regular tax and AMT depreciation has been the most significant reason most corporations were subject to the AMT.[10]

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[8]However, net depreciation adjustments remain positive because corporate investment continues to grow.

[9]General Accounting Office, "The Experience with the Corporate Alternative Minimum Tax," GAO/GGD-95-88, April, 1995, Table II.20, p. 47 (hereinafter cited as "GAO").

[10]See also GAO (1995), Table II.21, p. 48.

Table 2.
Corporate AMT Adjustments and Preferences for 1992

| Item | Amount ($ millions) | Percent of total |
|---|---|---|
| **Adjustments** | | |
| ACE | 18,890 | 44.6 |
| Depreciation (post-1986) | 22,030 | 54.0 |
| Pollution facilities | 21 | 0.0 |
| Mining development | 108 | 0.3 |
| Basis adjustment on sale | -3,368 | -8.0 |
| Long-term contracts | 95 | 0.2 |
| Installment sales | -14 | -0.0 |
| Merchant marine construction | 31 | 0.1 |
| Section 833 deduction | 1,478 | 3.5 |
| Farm losses | 0 | 0.0 |
| Passive losses | 34 | 0.1 |
| **Preferences** | | |
| Percentage depletion | 1,620 | 3.8 |
| Tax-exempt bonds | 128 | 0.3 |
| Charitable contribution of appreciated property | 82 | 0.2 |
| Intangible drilling costs | 176 | 0.4 |
| Reserves for bad debts | 86 | 0.2 |
| Accelerated depreciation of real property | 108 | 0.3 |
| Accelerated depreciation of personal property | 4 | 0.0 |

Large firms pay most of the corporate AMT. Table 3 shows that corporations (other than pass-through entities) with assets over $500 million pay 75 percent of the corporate AMT and 69 percent of total corporate tax. Smaller corporations are largely eliminated from the corporate AMT by the $40,000 exclusion.

Table 3.
Corporate AMT Liabilities, AMT Credits, and Total Corporate Tax by Asset Size in 1992
($ millions)

| Asset size class | AMT | AMT Credit | Total Tax Including AMT |
|---|---|---|---|
| less than 1 | 58 | 26 | 3,131 |
| > 1 less than 10 | 222 | 100 | 5,710 |
| > 10 less than 100 | 473 | 166 | 10,698 |
| > 100 less than 500 | 567 | 238 | 13,356 |
| > 500 | 3,738 | 1,846 | 71,698 |
| Total | 5,058 | 2,376 | 104,593 |

Although large corporations pay most of the AMT, and many large corporations have been subject to the AMT at least once, Table 4 shows that the duration of their AMT status has been relatively short. Based upon an analysis of a panel of approximately 9,000 large corporations with assets over $50 million, we found that approximately 55 percent were subject to the AMT in at least one year between 1987 and 1992. Of those that paid the AMT at least once, 64 percent paid it for only one or two years. Only 90 firms, or 1 percent of these large firms, were subject to the AMT in all 6 years (1987 - 1992).

Table 4.
Percentage of Corporations With Assets over $50 Million Paying AMT by the Number of Years Paying AMT (1987 - 1992)

Years in AMT Status

| | Never Paid AMT | 1 | 2 | 3 | 4 | 5 | 6 |
|---|---|---|---|---|---|---|---|
| Corporations (Percent) | 44.7 | 20.5 | 15.0 | 10.3 | 5.7 | 2.8 | 1.0 |

Pattern of Individual AMT Liabilities and Credits

The tax liability generated by the individual minimum tax has fluctuated substantially since it began, generally as a result of changes in tax law. Table 5 reports the individual minimum tax liabilities and the number of returns paying minimum tax from 1970 through 1993. It also indicates the years in which significant tax changes became effective.

From producing average revenue of $160 million on about 25,000 tax returns per year in the early 1970s, the individual minimum tax jumped to $1 billion paid by nearly 250,000 taxpayers in 1976 with the Tax Reform Act of 1976. The revisions in the Revenue Act of 1978 lowered total individual minimum tax revenues and taxpayers in 1979. Changes to the regular tax in the Economic Recovery Tax Act in 1981 boosted individual minimum tax liabilities, and the expansion of the individual minimum tax in the Tax Equity and Fiscal Responsibility Act of 1982 substantially increased individual minimum tax revenues in 1983 and later years.

The Tax Reform Act of 1986 had major effects on individual AMT collections, first raising them in 1986 before the capital gains exclusion ended, and then lowering them in 1987 when the exclusion had expired. TRA 86 also instituted the credit for previously paid AMT on timing preferences. These have averaged about 20 percent of the previous year's minimum tax, consistent with the share of total preferences and adjustments made up of timing preferences. OBRA 90 and OBRA 93 both expanded the impact of the individual AMT.

Economic conditions, as well as tax laws, affect minimum tax liability. Relatively modest decreases in minimum tax liability can be attributed to recessions in 1974 and 1982.

The preferences and adjustments to income that give rise to individual minimum tax liability have also varied over time. When excluded capital gains were a preference for the individual minimum tax, they accounted for around 70 to 80 percent of total preferences and adjustments in the mid-1980s, with state and local taxes the next largest preference at about 10 percent. About equally important were accelerated depreciation, miscellaneous itemized deductions, personal interest deductions, and personal exemptions, each accounting (on average) for about 2 percent of total preferences and adjustments.

As shown in Table 6, in 1992 deductions for state and local taxes contributed nearly 40 percent of total individual AMT preferences and adjustments, followed by miscellaneous deductions in excess of the 2 percent floor at about 25 percent, and depreciation at about 10 percent. Capital gains on certain charitable contributions added about 8 percent, certain allowed

TABLE 5

HISTORIC INDIVIDUAL MINIMUM TAX DATA
AND TAX LEGISLATION 1/

| Liability Year | Total Income Tax Liability After Credits | Minimum Tax Liability: Net of Credits 2/ | Minimum Tax Liability: Gross of Credits | Minimum Tax Liability: Credits | Number of Returns with: Minimum tax Liability 2/ | Number of Returns with: AMT Credits |
|---|---|---|---|---|---|---|
| | | (in millions) | | | (in thousands) | |
| 1970 | $83,905 | $122 | | | 19 | |
| 1971 | 85,400 | 168 | | | 24 | |
| 1972 | 93,600 | 216 | | | 27 | |
| 1973 | 108,100 | 182 | | | 26 | |
| 1974 | 123,600 | 143 | | | 19 | |
| 1975 | 124,526 | 144 | | | 20 | |
| Tax Reform Act of 1976 | | | | | | |
| 1976 | 141,800 | 1,000 | | | 247 | |
| 1977 | 159,800 | 1,323 | | | 399 | |
| 1978 | 188,200 | 1,514 | | | 495 | |
| Revenue Act of 1978 | | | | | | |
| 1979 | 214,500 | 1,175 | | | 222 | |
| 1980 | 250,341 | 1,263 | | | 211 | |
| Economic Recovery Tax Act of 1981 | | | | | | |
| 1981 | 284,100 | 1,827 | | | 251 | |
| 1982 | 277,600 | 1,520 | | | 225 | |
| Tax Equity and Fiscal Responsibility Act of 1982 | | | | | | |
| 1983 | 274,200 | 2,521 | | | 265 | |
| 1984 | 301,900 | 4,490 | | | 370 | |
| 1985 | 325,710 | 3,792 | | | 428 | |
| 1986 | 367,300 | 6,713 | | | 609 | |
| Tax Reform Act of 1986 | | | | | | |
| 1987 | 369,200 | 1,675 | | | 140 | |
| 1988 | 412,900 | 825 | 1,028 | 203 | 114 | 26 |
| 1989 | 432,900 | 578 | 831 | 253 | 117 | 40 |
| 1990 | 447,126 | 616 | 830 | 214 | 132 | 34 |
| Omnibus Budget Reconciliation Act of 1990 | | | | | | |
| 1991 | 448,430 | 1,036 | 1,205 | 169 | 244 | 32 |
| 1992 | 476,239 | 1,073 | 1,357 | 274 | 287 | 63 |
| Omnibus Budget Reconciliation Act of 1993 | | | | | | |
| 1993–prel. 3/ | 509,700 | 1,534 | 1,751 | 217 | 323 | 56 |

Source: Various issues of "Individual Income Tax Returns," IRS, Statistics of Income Division; and unpublished IRS data.

1/ Legislation is listed before the year in which it became effective.

2/ For 1979 – 1982, minimum tax liability includes both add–on and alternative minimum tax. Number of returns include those paying either AMT or add–on minimum tax.

3/ 1993 minimum tax data are preliminary.

TABLE 6

ADJUSTMENTS AND PREFERENCES FOR INDIVIDUAL TAX RETURNS
REPORTING AMT LIABILITY, 1992

| | | Reported Amounts In millions | Percent | Number of Returns (in 1000s) |
|---|---|---|---|---|
| Adjustments and Preferences from Form 6251 | | | | |
| 1 | State and local tax deductions | $5,644 | 39.7% | 245 |
| 2 | Miscellaneous deductions above the 2-percent floor | 3,613 | 25.4% | 169 |
| 3 | 3/ Post-1986 depreciation | 1,441 | 10.1% | 66 |
| 4 | Charitable donations | 1,073 | 7.5% | 16 |
| 5 | 3/ Passive activity loss | 824 | 5.8% | 70 |
| 6 | Depletion | 576 | 4.0% | 19 |
| 7 | 3/ Incentive stock options | 450 | 3.2% | 4 |
| 8 | 3/ Beneficiaries of estates | 235 | 1.7% | 21 |
| 9 | 3/ Intangible drilling costs | 169 | 1.2% | 5 |
| 10 | 3/ Long-term contracts | 126 | 0.9% | 1 |
| 11 | Standard deduction | 119 | 0.8% | 38 |
| 12 | Private activity bonds interest | 116 | 0.8% | 15 |
| 13 | 3/ Loss limitations | 76 | 0.5% | 3 |
| 14 | Medical deductions | 62 | 0.4% | 30 |
| 15 | Investment interest | 50 | 0.4% | 5 |
| 16 | Home-mortgage interest | 47 | 0.3% | 6 |
| 17 | 3/ Mining costs | 28 | 0.2% | 1 |
| 18 | 3/ Circulation expenses and R&E expenses | 27 | 0.2% | 2 |
| 19 | 3/ Pre-1987 accelerated depreciation | 19 | 0.1% | 7 |
| 20 | 3/ Tax shelter farm loss | 13 | 0.1% | 1 |
| 21 | 3/ Pollution control facilities | 1/ | 0.0% | 2/ |
| 22 | 3/ Installment sales | (2) | -0.0% | 2/ |
| 23 | 3/ Adjusted gain or loss | (99) | -0.7% | 20 |
| 24 | State and local tax refunds | (379) | -2.7% | 112 |
| | Total, Adjustments and Preferences | $14,228 | 100.0% | 287 |

Source: Unpublished data from IRS Statistics of Income, Individual Income Tax Returns, 1992

Notes: 1/ Less than $500,000.
2/ Less than 500.
3/ Item is generally considered a "timing" item for purposes of calculating AMT credits.

passive losses contributed about 6 percent, and depletion allowance 4 percent. The remaining 20 preferences and adjustments each added little to total individual AMT revenues.

Like corporations, individuals tend to pay AMT only temporarily, not permanently. In recent years, on average 35 percent of individuals with AMT liability in one year have AMT liability in the following year. Of a panel of taxpayers with any AMT liability over 1989-91, only 6 percent had AMT liabilities in all years, and 80 percent had AMT liabilities in only one year.

With OBRA 93, total revenues from the individual AMT are expected to grow, as are the number of returns subject to the AMT. The relative importance of various individual preferences should not significantly differ from that reported in 1992. Incentive stock options appear to be an individual preference that is growing in importance, though for only relatively few taxpayers, while capital gains on charitable contributions has been removed as an individual AMT preference.

Has the AMT Accomplished its Goals?

As the legislative history for the TRA 86 suggests, the primary objective of the AMT is to ensure that taxpayers with significant economic income pay some income tax. Evidence indicates that the individual and corporate AMT, together with the TRA 86 changes to the regular income tax, have largely accomplished this objective. Over the 1990-92 period, the individual AMT imposed tax on about 19,000 taxpayers per year who paid no regular U.S. individual income tax. Of these, over 1,000 on average had AGI in excess of $200,000. At the same time, approximately 1,200 individuals with AGI over $200,000 paid neither AMT nor regular federal income tax.[11] This is not entirely indicative of success or failure, however, because the definition of income used in the analysis, adjusted gross income, is not the same as economic income. The possibility that some taxpayers with high economic income have been able to utilize tax-exempt bonds, and business and investment tax preferences to reduce their AGI below $200,000 is thus not reflected in this analysis. The AMT can only be as successful as the AMT definition of income is in capturing economic income.[12]

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[11]Allen Lerman, "High Income Tax Returns for 1991," IRS, SOI Bulletin, Winter 1994-95.

[12]The individual AMT does not, for example, capture tax-exempt interest on public purpose municipal bonds or "inside-buildup" on life insurance. Consequently, this possibility is significant.

The 1995 GAO report points out that in every year examined (1987 - 1992) at least 6,000 corporations with positive book income that paid no regular tax paid some corporate AMT.[13] However, it also notes that in each of those years at least 290,000 corporations with positive book income paid no income tax. Although at first glance this might suggest that the corporate AMT, unlike the individual AMT, is not very successful, the GAO report also notes that about 98 percent of the non-taxpaying corporations were relatively small, having less than $10 million in assets. About 85 percent had less than $40,000 in net income and probably qualified for the AMT exemption. The few large non-taxpaying corporations with $1 billion or more in assets were predominantly mutual funds and investment companies, which generally pass all income to shareholders, and are exempt from the book income and ACE adjustments.[14]

More important, the objective of ensuring that profitable taxpayers pay some tax is too narrow a characterization of the goal of the AMT. A large fraction of taxpayers subject to the individual and corporate AMT ("AMT payers") pay both the regular and AMT tax (about 75 percent of corporate AMT payers and 92 percent of individual AMT payers in 1992). If the AMT were to be judged only by its impact on those taxpayers who pay no regular tax (i.e., who "zero out" their regular tax liability), it would thus be measured by its effect on only a fraction of the affected taxpayers.

A more appropriate standard for the success of the AMT is whether it helps ensure that taxpayers with significant economic income pay a tax relatively commensurate with that income. By examining the average tax rate (defined as the ratio of tax liability to regular taxable income) in each of eight major industries over the 1987-1992 period, the GAO report shows that the corporate AMT helped bring the average tax rate closer to the maximum statutory rate.[15] As in the case of the individual AMT, a more compelling demonstration that the corporate AMT has

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[13]GAO (1995), Table III.7, p. 64.

[14]GAO (1995), Table III.14, p. 68. The measure of book income used in the GAO analysis (that shown on schedule M-1 of Form 1120) is reported inconsistently, because it does not affect the corporation's tax liability and is provided for informational purposes only. It is intended to reflect the income shown on the parent corporation's consolidated financial statement, which may not include the same members of the affiliated group that are included in the consolidated tax return.

[15]GAO (1995), Table II.12, p. 41.

achieved its goal would require measuring the tax paid against economic income, which is not generally possible to infer from the tax return information of non-AMT payers.

Criticisms of the AMT

The corporate AMT has been criticized for having adverse effects on economic growth. It has been argued that, by delaying the receipt of tax benefits, the AMT raises the cost of capital for many corporations, and thus reduces their incentive to invest. It has been suggested that it also creates different incentives for different corporations making identical investments, depending upon whether they are likely to be subject to the AMT, and if so, for how long. Furthermore, it has been suggested that the corporate AMT may encourage mergers and acquisitions and uneconomic leasing transactions in order to allow corporations to avoid the AMT or better utilize AMT credits.

While there is some validity to these concerns, they may easily be overstated. The lower AMT tax rate can increase the incentive to invest if the corporation were to remain subject to the AMT over the life of the asset, or if a firm not currently subject to the AMT anticipates that it will be subject to the AMT after a few years and can thus claim regular-tax depreciation allowances now, while a portion of the returns will be taxed at the lower 20 percent AMT rate in later years. Moreover, by design, the AMT reduces the incentive to invest in tax-favored assets. Thus, the overall efficiency of investment may be enhanced by the AMT's propensity to create a more neutral tax system.

Any potential adverse macroeconomic effect of the AMT on investment is also mitigated by the fact that few corporations are subject to the corporate AMT. Approximately 28,000 corporations, or about 1.3 percent of the 2.1 million non-subchapter S corporations, were subject to the AMT in 1992. Moreover, smaller corporations are less likely to be subject to the AMT. As noted in the GAO report, less than one-half of one percent of corporations with assets under $1 million, and only 7 percent of corporations with assets under $10 million, were subject to the AMT in 1992. In contrast, approximately 20 percent of corporations with assets over $1 billion were subject to the AMT in that year.[16] As noted above, however, most large corporations that paid AMT between 1987 and 1992 were AMT payers for one or two years.

[16]GAO (1995), Table II.4, p. 36.

In general, firms subject to the AMT do not permanently lose their tax benefits (except for the benefits of timing), because AMT liability generates credits that can be used against regular tax in later years. Although the relatively slow use of AMT credits has been a source of concern, the repeal of the ACE depreciation adjustment under OBRA 93 is expected to reduce future AMT liabilities and increase the use of AMT credits.

Concern also has been voiced about the compliance costs of the AMT. This concern has been addressed in part by the OBRA 93 repeal of the ACE depreciation adjustment for investment after 1993. Prior to the repeal of the ACE depreciation adjustment, taxpayers were required to make three separate depreciation computations to determine taxable income and alternative minimum taxable income. The depreciation adjustment was also the most important component of ACE. The repeal of the ACE depreciation adjustment eases the compliance costs for those likely to be subject to the AMT and will significantly reduce the application of the AMT to taxpayers. Moreover, as stated above, the Administration welcomes the opportunity to work with the Congress to identify areas where further simplification is possible on a revenue neutral basis, either within the AMT or by identifying other acceptable revenue offsets.[17]

While supporting revenue-neutral legislative changes to make the AMT more simple and rational, the Administration is also committed to simplifying the AMT through administrative measures, where possible. For instance, last November the Treasury Department issued final regulations that will eliminate substantial complexity and recordkeeping burden for all individual AMT taxpayers. The regulations allow taxpayers to use regular-tax AGI in determining items of income, exclusion, or deduction that are computed with reference to AGI (for instance, medical expenses) in computing AMTI, instead of having to make separate calculations of minimum-tax AGI for such purposes.

H.R. 1215 AMT Proposal

The tax provisions in House bill H.R. 1215, which incorporates the tax provisions in the House Republicans' Contract with America, provide significant tax benefits to individual and corporate taxpayers. The Administration is very concerned about the potential effects of H.R. 1215 on the Federal deficit, and in particular about the estimated $178 billion

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[17]The concerns with complexity and compliance costs are particularly noteworthy for the individual AMT, with fewer than 0.3 percent of individual returns owing AMT liability, but ten times as many filing AMT forms.

revenue cost of the tax provisions over the FY 1995-2000 period, and the approximately $99 billion annual revenue cost by the year 2005. Several of these provisions, such as the Neutral Cost Recovery System (NCRS) and the capital gain exemption and indexing provisions, will further complicate an already complicated tax system and provide disproportionate benefits to high-income individuals and highly profitable corporations.

H.R. 1215 weakens the regular income tax as a measure of income. While the Administration opposes NCRS and the capital gains provisions of H.R. 1215, the fact that they are not subject to AMT compounds this problem. As I have noted, the primary objective of the individual and corporate AMT system is to ensure that taxpayers earning substantial economic income pay a tax relatively commensurate with that income. The greatly expanded tax benefits in the bill significantly increase the importance of an AMT system in serving that function, particularly for corporations. Whereas for individual taxpayers, the limits on passive losses may restrict tax avoidance activity, for corporations the AMT is the principal backstop. Yet the bill includes provisions that would seriously impair the AMT system:

1. For individuals, all AMT preferences (depletion, excess intangible drilling costs, tax shelter farm activities, passive losses) are repealed after 1995;

2 Those adjustments that are business-related (depreciation, mining exploration and development costs, long-term contracts, pollution control facilities, installment sales, circulation expenditures, research and experimentation expenditures) are repealed for transactions after 1995;

3. For corporations, AMT preferences and adjustments applying generally to transactions after 1995 are repealed;

4. The 90 percent limitations on the AMT use of net operating losses (NOLs) and foreign tax credits (FTCs) are repealed for taxable years after 1995;

5. The corporate AMT is repealed for taxable years beginning after December 31, 2000; and

6. AMT credits could be used to offset up to 90 percent of the regular tax liability for tax years (after application of other credits) after 1995, but not below the tentative alternative minimum tax.

These provisions leave only preferences and adjustments attributable to investments made prior to 1996 (many of which will reverse in future years) subject to the corporate AMT before its total repeal in 2001. Even if the other tax provisions of H.R. 1215 were not enacted, we estimate that the repeal of the corporate AMT alone when fully phased in in 2001, would allow over 12,000 corporations each year to avoid paying any income tax. Those corporations account for almost $840 billion in sales, or 12 percent of total sales, and approximately $2.1 trillion in assets, or 14 percent of total assets of all corporations currently subject to tax.

If NCRS is enacted and the corporate AMT repealed, we estimate that about 76,000 corporations that would otherwise have paid an income tax in 2005 would avoid paying any tax. These corporations account for approximately 16 percent of total sales ($7.1 trillion) and 18 percent of total assets ($15.4 trillion) of all non-subchapter S corporations currently subject to tax.

More important, NCRS is estimated to cost over $32 billion in 2005. Even if NCRS allows only a limited number of corporations to "zero out," it nevertheless results in a significant reduction in corporate tax liabilities. Because these tax benefits are not subject to AMT, corporations would no longer pay a tax that is relatively commensurate with their economic income. Likewise, none of the $12 billion cost of the individual capital gains tax cuts in 2005 would be reflected in the individual AMT.

While H.R. 1215 does not repeal the individual AMT, the only adjustments that remain subject to the tax are: miscellaneous itemized deductions; state, local, and foreign taxes; medical expenses between 7.5 and ten percent of adjusted gross income; tax-exempt interest on private activity bonds; standard deductions and personal exemptions; and incentive stock options. Unlike the corporate AMT, which is essentially vitiated by the bill even prior to its total repeal in 2001, the individual AMT is weakened in comparison to current law.

The revenue losses anticipated for the proposed changes to the individual and corporate AMT under H.R. 1215 are about $19 billion over the FY 1995-2000 period and $36 billion over the FY 1995-2005 period. These losses are much greater than simply the loss of AMT liabilities which would otherwise have been generated. The tentative alternative minimum tax, which currently acts as a limit on the extent to which AMT credits can be used to reduce the regular tax, would no longer be a meaningful constraint. The bill's 10 percent floor on the residual regular tax would instead allow a greatly accelerated use of the outstanding stock of unused AMT credits ($22 billion in 1992). This speed-up in credit usage accounts for the additional revenue cost of these provisions.

These estimated revenue losses, which make the commitment to fiscal responsibility more difficult, reflect only one dimension of the impact of H.R. 1215 on the AMT. Our tax system largely relies on voluntary compliance with the tax laws. Stories about large profitable corporations or wealthy individuals who manage to avoid paying any income tax reduce the willingness of other taxpayers to comply with our tax laws.

Conclusions

The AMT system has served a very useful purpose by helping ensure that individuals and corporations earning substantial economic income pay income tax relatively commensurate with that income. Since the last major reform of the minimum tax in TRA 86, Congress has simplified the system and provided targeted relief that has been, and will continue to be, reflected in a decline in net AMT revenues. Nevertheless, despite the lower revenues, the importance of the AMT system has not diminished. Thus, a visible AMT system should continue into the future.

Indeed, if the tax cuts in H.R. 1215 (other than the AMT proposals) are enacted, an enhanced AMT system will eventually be required to prevent a reemergence of the tax reduction-type activity that characterized the years prior to enactment of TRA 86. Moreover, the provisions of H.R. 1215 that weaken the individual AMT, and weaken and then repeal the corporate AMT will, instead, facilitate tax avoidance and reduce the perceived and actual fairness of the income tax. Thus, the Administration opposes proposals in H.R. 1215 that seriously weaken the objectives of the AMT. However, the Administration would welcome the opportunity to work with the Congress to develop measures that would simplify the AMT on a revenue-neutral basis, either within the AMT or by identifying other acceptable revenue offsets.

## PREPARED STATEMENT OF THOMAS J. USHER

The National Association of Manufacturers (NAM) is a voluntary business association of more than 13,000 firms located in every state. Our members range in size from the very large to the more than 8,000 small members that have fewer than 500 employees. The NAM's member companies produce more than 80 percent of the nation's manufactured goods. In addition, the NAM coordinates the activity of a broad-based coalition interested in repeal or reform of the AMT. The coalition is comprised of small, medium, and large companies and associations from a wide range of industries including: airlines, automotive, chemicals, energy, mining, paper, steel, transportation, and utilities.

Mr. Chairman, the NAM and the members of the AMT coalition are grateful to you and this Committee for having this hearing on the Alternative Minimum Tax (AMT). We appreciate the opportunity to address what continues to be a critical problem for U.S. manufacturers—namely, the grossly inadequate capital cost recovery system in the United States, especially as it affects AMT payers.

The NAM supports a fiscal policy that recognizes the need to balance the federal budget and encourage investments aimed at job creation and economic growth. As a top tax priority, Congress should ensure that the burden of taxation is as broad based as possible, so that it does not fall disproportionately on U.S. manufacturing, the nation's key source of high wage, high skilled jobs. We support congressional study of the potential advantages of a replacement tax system because our existing business tax code is harming U.S. competitiveness.

In the short term, however, we believe immediate action is required to eliminate the penalty imposed on investment under the AMT. Getting to a balanced budget will ultimately be much easier if the economic pie continues to grow. Freeing up capital for new job-creating investment will help ensure continued economic growth. This is especially important now as many industries, including my own, have begun to see orders drop due to lower consumer demand for products like automobiles.

While we are hopeful for the future, we cannot ignore the fact that another economic downturn will come and when it does, the AMT will make it longer and deeper than would otherwise be necessary. We saw all too clearly during the recession of 1991 that AMT had a negative reinforcing effect on the economy by further constraining cash flow at a time when we could least afford it. AMT repeal, or at least substantial reform, is one of the most important things Congress can do to keep the U.S. economic recovery going.

AMT: THE NEED FOR REPEAL OR AT LEAST SUBSTANTIAL REFORM

The AMT originally was intended to ensure that all profitable U.S. corporations pay at least some tax. Mr. Chairman, that goal has been turned on its head. The enactment of the AMT in the 1986 Tax Reform Act (TRA) have had the unintended effect of placing steel and other low-profit, capital-intensive companies in a near-permanent AMT status with taxes being payable even in years where economic losses are incurred. My own company, for example, reported losses to shareholders of more than $1.3 billion over the past five years (1990-1994), yet paid more than $200 million in AMT. As a result, the AMT is having a serious, adverse impact on U.S. capital cost recovery and a highly distorted effect on U.S. investment flows.

Unfortunately, the AMT reform contained in the 1993 budget bill—the elimination of the AMT's adjusted current earnings ("ACE") adjustment—does not solve the problem for most manufacturers. Among other things, the 1993 reform still leaves intact the AMT's slower depreciation methods (150 percent declining balance) and long recovery periods (typically double regular tax lives)—periods identical to those Congress abandoned in 1981 as being outdated and inadequate due to inflation and technological advances.

The AMT's discriminatory depreciation methods and excessively slow recovery periods have had especially harmful effects on U.S. manufacturers. That's because the AMT is most damaging to (i) companies that must invest heavily and continuously in productive equipment, (ii) companies in cyclical industries, and (iii) companies whose profitability is subject to dramatic swings because their prices are set by the global market. These criteria define much of the U.S. manufacturing sector. A good way to understand why the AMT is such a problem and why repeal or substantial reform is so urgently needed is to look closely at the case of steel.

Since 1980, thanks in large part to massive self-help efforts and over $35 billion in investment in new steel plant and equipment, the United States steel industry has dramatically improved its competitive position. In spite of suffering major economic losses for a number of years, we aggressively restructured and modernized. As a result, today labor productivity in our industry exceeds that of even Germany and Japan, and we are the low-cost supplier of quality steel products to the U.S. market. That is the good news, especially since other manufacturers have also accomplished similar gains.

The bad news is that we did much of this in the face of an anti-competitive tax system and at enormous cost. We would have made even greater capital investments and competitive gains had it not been for the AMT which forced steel companies to pay effective tax rates well in excess of the regular corporate rate and raised our cost of capital by as much as 20 percent.

The main problem continues to be the AMT's extreme bias against capital investment. This anti-competitive tax treats accelerated depreciation as an adjustment (an increase in income) that must be added back into the AMT calculation—even when profits are low or non-existent and the economy is in recession. Insofar as many manufacturing companies have no choice but to invest heavily and continuously—in good times and bad—it is this "add-back" that increases taxable income, and thus forces many low-profit, capital-intensive companies into long term, if not permanent, AMT status.

Since passage of the Tax Reform Act of 1986 and its harmful AMT provisions, many companies with significant reported losses (for both financial and regular tax purposes) have been forced to pay AMT and to defer any tax benefits associated with losses until regular taxes exceed the AMT, which may be never. Adding insult to injury, as companies have remained stuck in the AMT—due to its perverse depreciation provisions—they have been unable to use their accumulated minimum tax credits ("AMT credits") which accrue in the years when the AMT exceeds regular tax liability.

AMT credits can only be used to the extent that a taxpayer's regular tax liability exceeds its AMT liability. The intent of the AMT credit was to ensure that over time no company would pay more tax than if it were in a regular tax position. Many capital intensive companies are expected to remain in the AMT indefinitely and thus will generate AMT credits that would not be usable. Therefore, the AMT in effect has become for these companies a permanent tax increase relative to what they would have paid as regular taxpayers. Many other companies are unable to use credits against regular tax within a meaningful time frame. For these companies, prepayment of tax and limited use of AMT credits result in an interest free loan to the government.

As research done for the American Council for Capital Formation (ACCF) has shown, capital-intensive companies that must continue to modernize immediately before or during an economic downturn, are penalized most, because of the depreciation adjustments. What happens, is that when an AMT firm's income declines, it must pay higher taxes which reduce cash flow at a time when cash flow is already weakened by low or non-existent profits. But, even if we were to choose to stop our capital improvement programs during periods of recession—which is not a realistic possibility—we would still pay more tax in a recession year, because the AMT's depreciation add-backs relate to prior years' capital spending.

It is this retroactive feature of the AMT that is especially pernicious. Even non-AMT firms must take into account the negative effect of the AMT when making investment decisions, because two or three years later, they may fall into the AMT due to an economic downturn. Many firms found themselves in the AMT during 1991, 1992, and 1993, because of the combination of prior year investments and current year low profits. Consequently, future investments are being made anticipating the negative tax treatment of AMT. This translates into less total investment over the business cycle, which means fewer jobs created and lower economic growth.

In addition to the negative treatment of depreciation, companies also find they pay a significant penalty due to the AMT's limitations on the use of business credits such as research and development, alternative fuels, target jobs credits, net operating losses, and foreign tax credits. Many of the broad policy objectives instituted through the tax code and reflected in these credits do not work as intended. The effect of these limitations, again, is to put the AMT firm at a competitive disadvantage against a regular tax paying firm. In the case of foreign tax credits, it is indefensible to double tax foreign-earned income by arbitrarily limiting the use of foreign tax credits to 90 percent.

With respect to the future, many manufacturing companies are likely to remain stuck in the AMT for the remainder of this century and beyond. The reason is twofold. First, although many of us expect profits in the short-term, they will not be high enough to offset all of the losses and AMT credits generated during the last recession. Second, we continue to face substantial new investment requirements to meet both global competitive pressures and new environmental rules (stemming from legislation and agency-initiated efforts).

The AMT was enacted to ensure that no corporation with substantial economic income could deliberately structure its finances to avoid tax liability. Instead, it is placing capital intensive, cyclical companies at a severe competitive disadvantage—particularly against their foreign competitors, who pay no income tax when they have no profits and whose depreciation is not subject to an AMT.

The AMT is imposing a tremendous administrative burden because it requires numerous depreciation and inventory calculations. It is inherently inequitable because it is providing vastly different tax treatment to similar investments made by similar taxpayers. It is acting as a competitive drag on U.S. manufacturing. It is penalizing in particular those companies that invest the most in relation to their profits. And by denying the use of pre-paid regular tax—i.e., AMT credits—at all, or within a meaningful time frame, the value of these credits is rendered worthless. It is time for repeal or substantial AMT reform.

## AMT REPEAL OR REFORM: WHAT CONGRESS SHOULD DO

Mr. Chairman, it is clearly our view that AMT repeal or substantial reform should be your highest job-creating tax policy priority at this time. As I stated at the outset, the NAM favors complete repeal of the AMT. We believe the United States should have a single, reasonably understandable tax system that applies equally to all corporate taxpayers. If complete repeal cannot be accomplished, however, there are several reforms short of repeal that would help minimize the anti-competitive impact of the AMT.

With respect to AMT reform, we ask you to consider the following principles—capital cost recovery provisions should promote, not impair, manufacturing investment and competitiveness; recovery lives and method under the AMT should be no longer than under the regular tax; AMT credits and other business credits should be made available to companies that find themselves in the AMT; and, foreign tax credits should not be limited.

Given these principles, we urge Congress to do the following:

- Eliminate the depreciation adjustment for plant and equipment under the AMT. Today, a company's depreciation system (method and length of asset lives) is determined less by the type of asset and more by the profitability of the company. Some profitable firms recover their cost of investment through tax depreciation more than twice as fast as less profitable firms subject to the AMT. For example, steel assets are depreciated over a 7-year period under the regular tax but over a 15 year period using a slower depreciation method under the AMT. Treating regular tax accelerated depreciation as an adjustment under the AMT violates the most basic tax policy principle that investment in similar assets should be taxed in the same manner. It makes no economic sense to continue to penalize capital investment in this way.

- Change the way the AMT credit operates to make it usable for industries that are near permanent AMT payers. The AMT was never intended to tax capital investment at a higher rate than the regular tax on a permanent basis. But this is exactly what happens when AMT payers are denied use of the credit. Since many AMT payers will not have enough regular taxable income to utilize their AMT credits fully in a meaningful time frame, a mechanism should be established to allow partial utilization of credits against AMT liability. This would monetize these credits and thus decrease the cost of capital. It would also stimulate economic growth by liberating funds for additional capital investment.
- Remove the unfair limitations on the use of business credits, NOLs, and foreign tax credits that apply only to AMT payers. Since the AMT is essentially America's second business tax system, with its own rules and limitations, many of the broad policy objectives instituted through the tax code do not work as Congress intended. This is true for many business credits including R&D, target jobs, alternative fuels (Sec. 29), etc.. Arbitrary limitations on the use of NOL deductions and foreign tax credits are equally unfair.

## CONCLUSIONS

The NAM urges the Senate to address the problems caused by the Alternative Minimum Tax in whatever job-creating, investment-stimulating tax package it considers this year. We fully support the AMT proposal included in the House-passed bill, H.R. 1215, and look forward to working with the Finance Committee, and others, to help pass an AMT repeal or reform bill in the Senate.

## COMMUNICATIONS

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### STATEMENT OF THE AMERICAN FOREST & PAPER ASSOCIATION (AF&PA)

This statement is submitted on behalf of the American Forest & Paper Association (AF&PA), a national trade association representing producers of paper, pulp, paperboard and wood products, as well as the growers and harvesters of this nation's forest resources. The industry has over $200 billion annual sales, employs 1.6 million workers, has an annual payroll of $49 billion, and is among the top ten employers in 46 states. Forest products represent more than seven percent of U.S. manufacturing output. The U.S. forest products industry is a good example of the role investment plays in creating good, high-paying manufacturing jobs.

The pulp and paper segment of the industry is one of the most capital intensive and internationally competitive industries in the world. Each employee in the pulp and paper business is supported by $123,000 of plant and equipment. Just since 1980, the industry has invested more than $130 billion in new pulp and paper production and pollution prevention equipment. This amount accounts for about ten cents of every sales dollar from paper products, the highest reinvestment rate of any U.S. manufacturing industry.

This industry is also one of the best examples of the positive effect of investment on productivity. As a result of our investment, productivity has improved dramatically, costs are down and this industry is a strong global competitor. That doesn't mean, however, that we can become complacent. Industry technology is rapidly changing, world-wide competitors are proliferating, and proposed government regulations require new environmental technologies to be adopted.

Because of the requirements of global competition, technological advances and environmental protection, the industry must continuously reinvest large amounts of capital, yet the current tax code discourages that investment in a number of ways. Compared to our international trading partners, the U.S. tax code is significantly less favorable for investment. The enactment in 1986 of the AMT, plus the loss of the investment tax credit and capital gains rate differential, and the lengthening of recovery periods under regular tax depreciation have all raised the cost of capital and reduced the funds available for investment in job creating assets. This trend of recent tax changes must be reversed to provide more favorable and predictable treatment of investment. At a minimum, we urge the members of the Finance Committee to make improvements to what we believe is one of the most detrimental aspects of the current tax law with respect to investment—the anti-capital bias of the Alternative Minimum Tax (AMT).

Much of the forest products industry is subject to AMT simply because of the amount of investment required to be competitive. In fact, some companies in this industry have been paying AMT since 1987, when it first became effective. The combination of high investment and cyclical profits found in this industry means that investment in plant and equipment undertaken by many of our companies since 1987 has been severely penalized by the AMT. In fact, the AMT directly increases the cost of capital for pulp and paper manufacturing assets by some 10 percent over what it would be under the regular tax system. This is due in large part to the extended recovery periods under AMT, which are about twice as long as that used for regular tax purposes. (Pulp and paper manufacturing assets are relatively long-lived, with recovery periods under the regular tax of seven years and 13 years under the AMT.)

The AMT is particularly pernicious because a company is hit hardest when it can least afford it. AMT increases taxes when profits decline and cash flow is constrained. Yet most capital intensive companies cannot simply stop investing because profits have temporarily fallen. The investment must be completed in order to generate income in the future. As a result, companies can pay the AMT penalty on investment even when they may actually be losing money.

When the economy improves and a company's profitability returns, its AMT problems are not necessarily over. Often, the company does not have enough regular taxable income in the short-term to fully offset the large amounts of AMT credits that have been generated in bad economic times. This is particularly the case for the forest products industry. At some point during the past five years, almost every forest products company was in an AMT position.

The U.S. House of Representatives has addressed unintended consequences of the AMT by recommending its repeal. AF&PA supported the House-passed bill. Critics argue that repeal of the AMT will result in profitable corporations paying no tax as was the case in the early 1980s. They are wrong. The underlying reasons profitable firms could legitimately pay not tax were all addressed by changes to the tax code between 1982-86. From 1982-86, Congress either repealed or substantially modified the tax provisions thought to be responsible for companies paying little or no tax. Provisions such as safe-harbor leasing and the Investment Tax Credit were repealed. The completed contract method of accounting was substantially modified, and accelerated depreciation was made less generous for most regular taxpayers.

Most tax professionals agree it was the combination of these provisions—prior to their repeal or modification—that allowed companies to legitimately pay no tax. None of these provisions would be reinstated by the current tax relief changes approved by the House.

When the law was changed in 1986, we do not believe the Congress intended for companies to incur a permanent tax increase as a result of AMT. As the Finance Committee considers proposals to encourage investment, we would recommend that priority be given to eliminating the penalty imposed on job creation and enhanced productivity by the AMT as currently written.

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## STATEMENT OF THE AMERICAN PETROLEUM INSTITUTE

This statement is submitted by the American Petroleum Institute (API) for the record of the May 3 hearing of the Senate Committee on Finance on the role of the alternative minimum tax (AMT) within the current income tax system, its impact on corporations and individuals, and proposals to modify or repeal the AMT. API represents approximately 300 companies involved in all aspects of the oil and gas industry, including exploration, production, transportation, refining and marketing.

API supports repeal of the alternative minimum tax. The AMT has been particularly damaging to capital intensive industries because it drives up the after tax cost of capital. It is of concern to API's member companies because of the capital intensive nature of oil and gas operations.

The capital intensiveness of an industry may be defined as the ratio of its percentage share of the national capital stock relative to its percentage contribution to national income. When this measure is used, as Table 1 indicates, the petroleum industry can be seen as one of the nation's most capital intensive industries, when compared to other manufacturing and service industries. Of the sectors surveyed, only electrical utilities are more capital intensive. If one simply uses an industry's percentage share of net property, plant and equipment as the measure of capital intensiveness, oil and gas production and refining are still seen to be capital intensive relative to other major manufacturing and selected service industries. Only the communication industry and electric services have larger shares.

Because the industry is so capital intensive, API members are vitally concerned with the effect of the cost of capital on their ability to find new energy resources, and develop and deliver them to the American consumer at a reasonable price. In exploration and production operations, because many promising sources of new reserves are located offshore in deep water or in operationally difficult frontier areas, huge capital investments and very long lead times are required. Typically, an oil or gas project in these areas can take over 7 years to reach the producing stage. It is only then that a company can begin to recover its capitalized costs. Onshore lower 48 reserves require increasingly sophisticated drilling and recovery techniques which are also high cost. In 1991—the latest year for which complete industry data are available—the petroleum industry invested $22 billion in exploring for and developing oil and gas reserves.

In the refining and marketing segment of the business, the industry is faced with enormous costs imposed by government environmental regulations. For example, the National Petroleum Council estimates that over the period 1991-2000, refiners will be required to expend $37 billion to comply with environmental mandates. These are unfunded mandates which are intended to be of general societal benefit. But, they also reduce a company's ability to add to the manufacturing capacity of the industry and decrease a company's income and its rate of return on investment.

Investment in new plant and equipment is quite sensitive to capital cost recovery rates. In 1981, the capital cost recovery system relevant to most investment in the United States was improved, moving toward the goals of full recovery, simplicity and economic efficiency. Succeeding tax Acts culminating with the Tax Reform Act of 1986 reversed this favorable development. While TRA '86 did provide a rate reduction for all taxpayers, it did so at the expense of capital intensive industries such as the petroleum industry by extending depreciation periods, repealing the investment tax credit, imposing complex production period capitalization requirements, and adding the Alternative Minimum Tax under which taxpayers face not only tax acceleration but possibly even double taxation because of the limitation on the use of foreign tax credits.

For petroleum companies—the vast majority of whom are subject to the AMT—the minimum tax has the perverse effect of penalizing them when prices decline and when investment in property, plant and equipment increases. Furthermore, while Congress intended the AMT as a temporary prepayment of tax, it actually represents a permanent tax increase for some petroleum companies because once a company gets into an AMT position it is very difficult to get out because continuing or expanding investment in depreciable property triggers additional AMT liability.

The overall effect of the AMT is to drive up the after tax cost of capital and to depress new investment in plant, property and equipment. A 1991 study by the American Council for Capital Formation found that the cost of capital for AMT companies making new investments was increased by a range of 10 to 22 percent over the cost of capital under the regular Modified Accelerated Cost Recovery System.

This increased cost of capital and reduced cash flow significantly depresses the level of new investment necessary to remain competitive. Typically it is these capital intensive industries that provide a large fraction of the high paying jobs in the economy. The longer lived manufacturing assets such as those used in automobile manufacturing, chemicals, oil and gas production and refining, pulp and paper, and steel are subject to the greatest increase in the cost of capital as a result of the AMT.

The complexity of the AMT also contributes to increased compliance costs for taxpayers—a fact that is directly contrary to one of the twin objectives of TRA '86—simplification and compliance cost reduction. A 1993 Tax Foundation study entitled "The Income Tax Compliance Cost of Big Business" reports that "there is near unanimity among senior corporate tax officers that TRA 1986 added complexity to the tax system, resulting in a combination of higher compliance costs and less accurate information transmission [to the IRS]." The Alternative Minimum Tax was the item most often mentioned as contributing to that complexity.

As noted, API supports repeal of the alternative minimum tax. However, if Congress determines that within the current budget constraints outright repeal is not possible, there are several specific changes to the AMT that we would recommend:

(1) making AMT credits applicable against future AMT liability; (2) conforming the AMT depreciation system to the regular tax system; (3) repealing the IDC preference and the IDC ACE adjustment for all taxpayers; (4) removing the 90% foreign tax credit limitation; and, (5) repealing the LIFO inventory adjustment.

## TABLE 1: "CAPITAL INTENSITY BY INDUSTRY"

(Corporate Net PPE/Total U.S. Corporate Net PPE x 100)

| | DEPRECIABLES (%) (1) | DEPLETABLES (%) (2) | LAND (%) (3) | PERCENT OF TOTAL U.S. CORPORATE NET PPE (4) | CONTRIBUTION TO NATIONAL INCOME (%) (5) | CAPITAL INTENSITY (4)/(5) |
|---|---|---|---|---|---|---|
| OIL AND GAS PRODUCTION AND REFINING | 6.81 | 51.58 | 4.28 | 7.89 | 1.66 | 4.78 |
| PIPLINES EXCEPT NAT. GAS | 0.07 | 0.04 | 0.01 | 0.06 | 0.12 | 0.53 |
| GAS PRODUCTION AND DISTRIBUTION | 2.29 | 2.38 | 0.23 | 2.14 | 0.58 | 3.69 |
| MOTOR VEHICLES AND EQUIPMENT | 2.54 | 0.00 | 0.74 | 2.34 | 1.12 | 2.09 |
| PAPER AND ALLIED PRODUCTS | 2.16 | 3.84 | 0.75 | 2.10 | 0.94 | 2.23 |
| CHEMICALS AND ALLIED PRODUCTS | 4.45 | 4.73 | 2.69 | 4.32 | 2.20 | 1.97 |
| ELECTRIC SERVICES | 9.97 | 1.48 | 0.86 | 9.04 | 1.87 | 4.83 |
| FOOD MANUFACTURING | 2.76 | 0.07 | 2.49 | 2.66 | 2.06 | 1.30 |
| MACHINERY, EXCEPT ELECTRICAL | 2.30 | 4.11 | 1.54 | 2.27 | 2.22 | 1.02 |
| ELECTRICAL AND ELECTRONIC EQUIPMENT | 2.76 | 0.06 | 0.02 | 2.57 | 1.84 | 1.40 |
| COMMUNICATION | 8.95 | 0.02 | 0.01 | 8.14 | 2.37 | 3.44 |

Source: "Corporation Income Tax Returns" Source Book 1991 Statistics of Income, SOI Division, Dept. of Treasury.

## STATEMENT OF THE CERIDIAN CORP.

(BY JAMES R. BURKLE, VICE PRESIDENT, CORPORATE TAX)

Ceridian Corporation supports repeal of the Alternative Minimum Tax (AMT) as a provision that has outlived its usefulness.

The limitation on the use of net operating loss (NOL) carryovers to offset AMT liability is a glaring example of how the AMT adversely affects companies in a way that was not originally intended. This provision places a limit on the deductibility of economic losses in calculating AMT liability. The NOL limitation should be repealed for the following reasons:

- *The NOL provision is fundamentally unfair.* Companies that have sustained severe economic losses and have not utilized any tax preferences still must pay an AMT. In the computer industry, for example, many companies were nearly forced out of business by industry restructuring and foreign competition. As a result, the industry experienced unprecedented declines in employment. Because of the NOL provision, losses incurred are not fully deductible against the AMT. Congress could not have anticipated the severity of such losses when it enacted the NOL limitation.
- *The NOL provision is inconsistent with section 172 of the Internal Revenue Code.* The intent of the NOL provisions of the IRC is to allow companies that have incurred severe economic losses to recover taxes previously paid and use loss carryforwards to reinvest and regain competitiveness. The AMT with the NOL limitation, because of its adverse effect on investment and the creation of new jobs, is contrary to the intent of these provisions of the Code.
- *The Alternative Minimum Tax imposes an onerous administrative burden.* Companies are required to maintain separate books, one for the AMT and one for the regular tax. At a time when Congress is considering ways to reduce government regulations, and companies are trying to reduce costs, these administrative requirements seem counterproductive.

As businesses struggle to regain competitiveness, current law hampers their ability to preserve and create jobs. Prompt repeal of the ninety percent limitation, as provided for in section 331 of H.R. 1215, reported by the Ways and Means Committee, will go a long way toward ensuring effective restructuring, new job opportunities, fundamental tax fairness and simplicity.

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## STATEMENT OF THE CHEMICAL MANUFACTURERS ASSOCIATION

The Chemical Manufacturers Association ("CMA") welcomes this opportunity to submit the views of the U.S. chemical industry on the provisions in H.R. 1215 that would initially reform and ultimately repeal the corporate alternative minimum tax ("AMT"). We applaud the Chairman and members of the Subcommittee for holding these important hearings. We look forward to working with you in developing effective tax reform proposals.

Although CMA supports the general philosophy of improved and more neutral capital cost recovery expressed in H.R. 1215, we are very concerned over the negative impact of the neutral cost recovery system ("NCRS"). Although the proposal could benefit other industries, in the short run it could place the U.S. chemical industry at a competitive disadvantage. CMA testified before the House Committee on Ways and Means that improving the AMT would be a more cost-effective means to improve capital cost recovery in the U.S.

CMA is a nonprofit trade association whose 189 member companies represent more than 90 percent of America's productive capacity for basic industrial chemicals. Since 1991 the chemical industry has been the nation's leading exporter with an estimated $50 billion in exports and a net trade surplus of $18 billion in 1994. These exports help insure 1.1 million high-wage, chemical industry jobs throughout the U.S.

While the present capital cost recovery system can be improved, the business community and the chemical industry would benefit directly from your efforts to repeal or to lessen the burden of the corporate AMT. Because these reforms would increase the cash flow available for investment in equipment and jobs when earnings are low, they are likely to have more significant impact on employment levels in our industry than would the proposed NCRS. Most importantly, neither improved capital cost recovery nor reform of AMT (which itself is largely a penalty on depreciation) should be financed by reducing 200 percent declining balance depreciation to 150 percent.

Most chemical companies are not currently in an AMT position because of the strong current domestic sales and export demand for our products. Yet, the pernicious effect of the AMT on our operations remains. The chemical industry is highly capital-intensive and industry fixed costs—principally depreciation on equipment—remain high even when income declines. In addition, the industry must also continue to make new capital expenditures to meet Congressionally mandated environmental standards regardless of current economic conditions. Should our sales and exports decline because of a downturn in the domestic economy or increased worldwide competition, many chemical companies would pay the AMT when their cash needs are greatest. In the recent recession this problem was replicated across American industry and may even have extended the duration of that recession.

As stated above, most chemical companies are not in an AMT position today. The AMT provision, however, limits the amount of previously paid AMT that may be taken as a credit against regular income taxes in subsequent years. Under present law, the AMT credit is allowed in a subsequent year only to the extent regular tax liability exceeds minimum tax liability. Effectively, this limitation requires the taxpayer to take available minimum tax credits over a period of years and thus reduces the true value of the AMT credit substantially.

There are serious misconceptions about why and under what circumstances corporate taxpayers pay the minimum tax. Most misunderstood is the effect of the AMT in an economic downturn or recession. Congress enacted the AMT in 1986 to assure that firms with substantial economic income could not avoid paying any Federal taxes. In a recession, however, the AMT becomes not the "minimum" but the "maximum" tax that corporations will pay. One principal consequence of this tax is that American manufacturers that regularly pay Federal income taxes will have to pay the AMT precisely when their cash needs to finance new investment and jobs are greatest.

CMA submits that without fundamental structural change the principal effect of the AMT will be to continue to punish America's basic heavy industries during periods of economic slowdown. These industries will find it increasingly more difficult to compete internationally during these periods. Repealing the AMT is perhaps the cleanest and simplest means to eliminate these problems. H.R. 1215 would achieve this goal over a five year period, but would implement several important AMT reforms much sooner.

We strongly support the immediate reforms to the AMT included in H.R. 1215. The chemical industry would benefit principally from the bill's provisions to reduce the AMT penalty on depreciation by changing AMT depreciation periods and methods to reflect those provided for regular income tax purposes. In addition, our industry would also benefit from the repeal of the special rules relating to the use of net operating losses and foreign tax credits in taxable years beginning after December 31, 1995.

CMA again commends the framers of H.R. 1215 for having included provisions for immediate AMT reform that we believe to be the best means at hand for improved capital cost recovery. Our nation's fundamental tax policy mission should be to achieve effective, responsible progress toward that goal. We recognize that the Federal budget imposes limits on the revenue costs of reform this committee can undertake. Nonetheless, progress toward real AMT reform is the most important progress toward a rational capital cost recovery system that this committee can make at this time.

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## STATEMENT OF THE CHICAGO COALITION FOR THE REFORM OF AMT

The Chicago Coalition for the Reform of AMT believes that the Alternative Minimum Tax ("AMT") system currently in place has a negative effect on future capital investments made by U.S. business. AMT causes project investment returns to be lower than they would be without AMT. Moreover, the prepayment of tax which AMT represents drains cash from American business which could otherwise be used for investment. As a result, American business has invested less in plant and equipment since AMT was enacted than it otherwise would have, and future investments will be similarly affected.

The AMT capital cost recovery system is among the worst available in the industrialized world. The AMT system lengthens the recovery periods and slows the rates of recovery for capital investments. Thus, AMT taxpayers are treated differently than "regular" corporate tax taxpayers, creating unfair competitive advantage for those taxpayers lucky enough not to be paying AMT. In addition, AMT tends to hit taxpayers the hardest during business downturns, creating a counter-cyclical mechanism which prolongs recessionary periods, rather than encouraging the investment which creates future growth.

The AMT system denies taxpayers use of normal business credits, full use of their foreign tax credits, and requires taxpayers to pay their tax sooner. For taxpayers which are unable to use their AMT credits, the AMT system permanently denies them the use of their tax credits and retains their cash which could be used for investment in the business.

CHICAGO COALITION RECOMMENDATION

The Chicago Coalition supports the provisions of H.R. 1215 which repeal AMT after the year 2000, and selectively repeal various provisions of the AMT system prior to the year 2000.

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## STATEMENT OF COALITION FOR JOB GROWTH AND INTERNATIONAL COMPETITIVENESS THROUGH AMT REFORM

This statement is respectfully submitted on behalf of the Coalition for Job Growth and International Competitiveness through AMT Reform. The Coalition appreciates the Committee's interest in proposals to modify or repeal the corporate alternative minimum tax ("AMT") and welcomes the opportunity to work with the Committee in the future on this issue of critical importance to the competitiveness of America's businesses and to the growth of our Nation's economy.

The Coalition consists of six companies with operations across America and customers around the world. FMC Corporation is a diversified company that manufactures a broad range of products in the machinery, chemical and other industry segments. Hutchinson Technology Incorporated produces suspension assemblies for domestic and foreign manufacturers of the rigid disk drives used in computer applications. Magma Copper Company is a fully-integrated producer of electrolytic copper that makes, among other products, high-quality copper cathodes and rods for the wire and cable industry. Occidental Petroleum Corporation is a diversified company engaged in oil and gas exploration and production, chemical manufacturing, and natural gas transmission. Sequa Corporation is a diversified industrial company that produces a broad range of products in aerospace, machinery and metal coatings, specialty chemicals, and other industry segments. Telephone and Data Systems is a diversified telecommunications company that provides cellular, telephone, paging and other communications services.

These companies obviously are different in many ways. They represent a wide range of industry segments and vary in both asset size and degree of profitability. However, they also share a number of important characteristics. They are all engaged in highly-competitive businesses in which technology is constantly changing and in which new investment and development is constantly required. They are all capital-intensive. They all pay the AMT now, and expect to continue to pay it in future years. And, they all share concerns about the effect this tax has on their continued ability to invest, to innovate, to provide quality jobs, and to compete successfully both in the United States and overseas.

<u>Background</u>

As the Committee knows, the corporate AMT was enacted as part of the comprehensive changes to tax law contained in the Tax Reform Act of 1986 (the "1986 Act"). At that time, there were concerns that certain large corporations were reporting sizable profits to their shareholders, but were paying no Federal income tax because they were taking advantage of certain tax benefits -- such as safe harbor leasing, completed contract method of accounting, and investment tax credit provisions of the Internal Revenue Code. Thus, in order to achieve the "one overriding policy objective" of ensuring that no taxpayer with "substantial economic income" avoid significant tax liability, the 1986 Act imposed the corporate AMT. S. Rep. 99-313 at p. 518.

As enacted, the corporate AMT in effect is a completely separate, but parallel, tax system. A corporation generally must compute separately its tax attributes (such as adjusted asset bases, depreciation, depletion, net operating losses, and foreign tax credits) in each system. If the corporation's "tentative minimum tax" liability is greater under the AMT system than its liability under the regular tax system, then the corporation must pay the AMT, defined as an amount equal to the excess of its tentative minimum tax liability over its regular tax liability. However, the taxpayer is allowed to use its AMT payments as credits against regular tax liability in future years to the extent its regular tax liability exceeds its tentative minimum tax liability in those years. Thus, the AMT system is designed to speed up the payment of taxes, with a corporation over time paying no more than it would under the regular tax system. (See the Joint Committee on Taxation pamphlet prepared in connection with this hearing (JCX-22-95) at p. 20.)

Problems with the Corporate AMT

As explained below, the corporate AMT system does not work in the manner anticipated by the Congress in 1986. Instead, the corporate AMT has severe and costly shortcomings: it imposes significant costs on capital investment and on other productive activities (such as mining development and exploration); it impairs competition; it makes it more difficult for AMT-paying corporations to compete in the global marketplace; and it imposes tremendous administrative costs on American businesses. Moreover, most of the reasons underlying enactment of the corporate AMT in 1986 no longer exist to justify the continued existence of the tax.

1. The Overriding Purpose of the Corporate AMT Has Been Turned on Its Head.

As explained above, the overriding objective in enacting the corporate AMT was to ensure that corporations with substantial economic income pay their fair share of tax. However, in practice, the AMT system has turned this principle completely upside down. Because of the mechanics of the AMT system, a corporation with high earnings relative to its investment in productive activities is *less* likely to pay the AMT than a corporation with lower earnings. Further, the more the corporation invests in new assets and new technologies, the more likely it will fall into the AMT. (See JCX-22-95 at p. 19.)

This concept can be illustrated by a simple example. Assume that each of two companies has an identical investment history and can take depreciation deductions in a given year of $15,000,000 for regular tax purposes and $10,000,000 for AMT purposes. One company (Company A) generates $50,000,000 of taxable income before depreciation. By contrast, the other company (Company B) generates only $18,000,000 in taxable income. Assuming for simplicity's sake that each company pays regular tax at a flat 35% rate, the regular tax and tentative minimum tax (TMT) liabilities of each would be as follows:

<u>Company A</u>

| *Regular Tax* | | *AMT* | |
|---|---|---|---|
| Taxable income (before depreciation) | $50,000,000 | Taxable income (before depreciation) | $50,000,000 |
| Depreciation | <u>$15,000,000</u> | AMT depreciation | <u>$10,000,000</u> |
| Regular taxable income | <u>$35,000,000</u> | AMT Income | <u>$40,000,000</u> |
| Tax at 35% rate | <u>$12,250,000</u> | TMT at 20% rate | <u>$ 8,000,000</u> |

<u>Company B</u>

| *Regular Tax* | | *AMT* | |
|---|---|---|---|
| Taxable income (before depreciation) | $18,000,000 | Taxable income (before depreciation) | $18,000,000 |
| Depreciation | <u>$15,000,000</u> | AMT depreciation | <u>$10,000,000</u> |
| Regular taxable income | <u>$3,000,000</u> | AMTI | <u>$8,000,000</u> |
| Tax at 35% rate | <u>$1,050,000</u> | TMT at 20% rate | <u>$1,600,000</u> |

Because Company A's tentative minimum tax liability would be less than its regular tax liability, it would not pay any additional tax under the AMT system. However, Company B would have to pay the excess of its tentative minimum tax liability over its regular tax liability ($550,000) in AMT liability on top of its regular tax liability. Stated another way, although both companies made the same investment, the company with less income incurred an AMT liability, making its effective rate 53 percent.

Thus, the image that some would paint of the typical AMT-payer as a highly-profitable corporation that reports sizable earnings to its shareholders is extremely misleading. As a practical matter, many companies -- such as start-up companies and companies engaged in emerging technologies -- fall in the AMT simply because they have a high-level of investment relative to their earnings. Other AMT-payers are companies that have experienced downswings in their businesses -- whether business-specific, industry-related, or economy wide.

Indeed, as indicated in the GAO Report, Experience with the Corporate Alternative Minimum Tax, from April 1995 (GAO/GGD-95-88 at p. 33), the revenues collected from the corporate AMT reached their high-point during the recession of 1990 and 1991. Further, the AMT even causes some corporations that report losses to their shareholders to pay AMT. GAO report at p. 64. One of the Coalition members that has booked losses for several years has had to pay AMT in some of those years.

2. The AMT Credit Mechanism Has Failed.

As explained above, the AMT credit mechanism was designed to ensure that a corporation would not pay more than its regular tax liability over a period of time. However, this mechanism has not worked in practice. Instead of being able to use AMT to reduce tax liability in future years, many corporations have been forced merely to accumulate substantial amounts of credits with the hope -- but not necessarily the expectation -- that they will be able to use the credits at some point in the future.

The reason these credits are of limited utility is simple. They cannot be used to offset AMT liability but can only be used to offset regular tax liability in a year in which the amount of that regular tax liability exceeds tentative minimum tax liability and only to the extent of that excess. However, for many corporations that in effect have become permanent payers of the AMT, such a year is not in the foreseeable future. And, to make matters worse, the more these companies invest in productive activity, the more likely they are to go even "deeper in the hole" with respect to the AMT, and the less likely they are to be able to use past AMT payments as credits against tax liability.

The GAO report indicates that more than half of AMT payments made in 1987 had not been recovered through the credit mechanism by 1991 (GAO report at p. 44). Further, even if some of these credits ultimately are recovered by some corporations, their value in real terms will have declined as a result of the loss of the time value of the money. All of the members of the Coalition have substantial unused AMT credits and most expect to be unable to use these credits in the foreseeable future.

3. The AMT Discourages Productive Activities.

As suggested above, the corporate AMT system works in such a manner that the more a corporation invests in productive assets, the more likely it is to be subject to the AMT. This has the effect of raising the average tax rates and decreasing the cash flows of companies that are engaged in capital intensive industries and in highly-competitive businesses in which investment in state-of-the-art technology is essential. In fact, according to the GAO Report, about one-quarter of corporate assets are in firms that pay the AMT. GAO Report at p. 36. Effectively penalizing companies for investing in such assets -- and in America's future -- is counter to other policies legislated by the Congress and clearly is not in America's best economic interest.

Further, the perverse effects of the AMT extend beyond the implications this tax has on investment in capital assets and in new technology. The AMT also makes it more costly for AMT-paying corporations to engage in other productive activities and removes incentives that Congress has determined are critical to ensuring an appropriate level of activities in certain areas. For example, Congress has chosen through the foreign sales corporation (FSC) provisions of the Internal Revenue Code to attempt to offset competitive disadvantages that U.S. exporters face vis-à-vis foreign trading partners that have more beneficial tax systems. The rules were enacted to encourage U.S. companies to keep manufacturing jobs in the United States, rather than moving them overseas. However, the AMT provisions carve back the benefits of the FSC provisions, making them meaningless to many AMT-payers.

Similarly, Congress has determined that providing certain general business credits is essential to ensuring that corporations engage in a sufficient level of certain desirable activities. For example, Congress enacted the research and development credit to ensure that U.S. businesses devote adequate resources to the development of future technologies, even when there may not be immediate returns on such investment. However, because the AMT system provides that a corporation cannot use this credit to reduce its total tax liability to less than its tentative minimum tax liability for a year, the AMT system effectively neutralizes the benefit of the credit for many AMT-payers. Thus, the credit does not provide these corporations with the level of incentive to engage in research and development that Congress determined is necessary.

Further, the Congress has found it essential to defray the financial risks associated with mining activities and to encourage the development of natural resources through the percentage depletion and mining exploration and development deduction provisions. However the AMT rules severely reduce the value of these provisions, making them of limited, if any, utility to AMT-paying corporations.

Thus, it makes little sense to deny these incentives to one segment of corporations -- those that are subject to the AMT -- when those corporations are engaged in precisely the activities that Congress believes are critical to encourage.

4. <u>The AMT Treats Similar Companies Very Differently.</u>

As is apparent from the above discussion, another major defect of the corporate AMT is that it causes AMT-payers to receive different tax treatment for their activities than do other corporations that are not in the AMT. Indeed, as indicated in the Joint Committee pamphlet for this hearing, the AMT does not eliminate the tax-favored treatment of activities -- it merely limits which taxpayers are able to benefit from them. JCX-22-95 at p. 22. This not only runs afoul of basic principles of sound tax policy, but is inherently unfair and can place AMT-paying companies at a serious disadvantage vis-à-vis their competitors.

For example, assume that Company A and Company B compete for the same customers in offering certain communications services. Company A and Company B invest the same amount in the technology necessary to offer state-of-the-art services. However, Company B only operates in the communications services sector; Company A also operates a vast array of other businesses that are profitable but are not capital intensive, and its communications services line represents a small portion of its diversified portfolio. In such a situation, Company A likely would not be subject to the AMT while Company B would. Thus, Company A would be able to take advantage of more favorable depreciation deduction provisions with respect to its investment in the communications services technology than would Company B.

5. The AMT Makes it More Difficult for U.S. Companies to Compete in the Global Marketplace.

The distortive effects of the corporate AMT on the cost of capital, as well the application of special AMT rules (discussed above) relating to such matters as foreign sales corporations and the research and development credit, have profound implications on the competitiveness of U.S. businesses in the global marketplace. For example, as indicated in a study prepared by Arthur Andersen for the American Council for Capital Formation, the U.S. AMT capital cost recovery system for equipment used to make various manufacturing products and pollution control equipment is significantly less favorable than that of some of our major trading partners[1]. This slower cost recovery system makes technological innovation and productivity growth more costly for U.S. businesses relative to many of their foreign competitors. Combining this with the fact that unprofitable foreign companies likely are not paying foreign taxes overseas obviously places U.S. companies at a severe competitive disadvantage in the global marketplace.

6. The AMT Unfairly Restricts Corporations from Utilizing Net Operating Losses and Foreign Tax Credits.

The AMT also unjustly precludes corporations from fully utilizing their net operating losses and foreign tax credits (as computed under the AMT system, after taking into account the different AMT rules with respect to depreciation, depletion, and other items). Instead, AMT-payers are only allowed to use their AMT net operating losses and foreign tax credits to offset 90 percent of their tentative minimum tax liability, determined without these items. However, there is no apparent justification for this restriction. If, under the AMT system, a corporation's income in a year does not cover its losses, why should the corporation not be able to utilize without limit, on a carryforward or carryback basis, the full amount of its losses in a year in which it has income under the AMT? Similarly, if the corporation has AMT foreign tax credits, why should it not be able to fully use those credits to offset its AMT? In fact, to disallow the use of the foreign tax credits results in double taxation on U.S. corporations operating in the international marketplace.

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[1] For example, the present value of depreciation deductions (as a percent of asset cost) with respect to telephone switching equipment is 78.38 percent under the U.S. AMT, compared to 91.72 percent in Singapore, 84.30 percent in Korea, and 86.17 percent in Japan. The present value of these deductions for engine blocks is 60.81 percent under the U.S. AMT, compared with 83.91 percent in Germany, 83.67 percent in Japan, 91.72 percent in Singapore, 79.6 percent in Korea, and 63.71 percent in Taiwan. The present value of these deductions for scrubbers used in electricity plants is 41.5 percent under the U.S. AMT, compared with 146.96 percent in Taiwan, 92.21 percent in Korea, 91.72 percent in Singapore, 85.25 percent in Canada, and 82.4 percent in Japan.

Net operating losses and foreign tax credits in no way are tax gimmicks used by "profitable" corporations to avoid the payment of tax. Instead, they reflect real losses and real payments of foreign taxes that corporations have incurred.

7. The AMT Is Unduly Complex and Imposes Tremendous Costs on U.S. Businesses.

On top of all its other shortcomings, the AMT system is terribly complex and imposes substantial costs on American businesses. Even corporations that ultimately do not end up owing AMT generally must keep track of their liabilities under both tax systems in order to know whether or not they owe AMT. For example, in 1992, the GAO Report indicates that, even though 28,000 corporations actually paid AMT, some 400,000 corporations filed the AMT form. Moreover, the GAO Report notes that even more than these 400,000 filers would have had to produce separate computations and records for each of the two tax systems. GAO Report at p. 3.

The additional burden to corporations is not without substantial monetary cost. Corporations must incur additional personnel and nonpersonnel costs in order to comply with the separate tax system of the AMT. The Joint Committee pamphlet prepared in connection with this hearing suggests that complying with the corporate AMT may require additional expenditures of $160,000 per company each year by large businesses. (JCX-22-95 at p. 25). Obviously, this money would be better spent on wages or in capital investment.

8. The AMT Is Not Needed Anymore.

Notwithstanding all of the problems associated with the corporate AMT, some argue that it must be retained in close to its current form in order to prevent a return to the pre-1986 world in which highly-profitable corporations paid no tax. However, on closer scrutiny, this argument holds little water.

First, the 1986 Act itself did away with many of the perceived tax "loopholes" which gave rise to the concerns surrounding the enactment of the corporate AMT. As indicated above, most of the 1986 concerns arose out of safe harbor leasing and the completed contract method of accounting. Also, taxpayers were able to reduce their tax liabilities through the investment tax credit. However, the safe harbor leasing and completed contract method provisions have been repealed and the investment tax credit has been scaled back substantially and virtually repealed. As a result, the regular tax system provides a far better base than it did in 1986 for measuring a corporation's real income.

Second, under the current AMT, the adjustment for accelerated depreciation is by far the biggest contributor to AMT liability. See the GAO Report at p. 8. However, accelerated depreciation clearly is not a "loophole" or an invitation to tax abuse. Depreciation is a result of real productive activity. Further, for some assets (particularly those with high-technology applications), there are strong arguments that even the regular tax system's accelerated depreciation understates actual economic depreciation. And, as indicated in the GAO report, if inflation is high or moderate, the depreciation deductions under the current AMT system actually can be less generous than estimates of economic depreciation would dictate. (GAO

Report at p. 52). Thus, it is inappropriate to require an adjustment for accelerated depreciation as a means of ensuring that "profitable" companies pay tax on their economic income.

Recommendations

The Coalition commends the Committee for its interest in examining the current corporate AMT system. In light of the significance of the problems associated with the AMT (including the problems associated with the inability to use AMT credits, depreciation, depletion, foreign sales corporations, general business credits, net operating losses, and foreign tax credits), the Coalition believes that the corporate AMT should be repealed completely at the earliest possible date. To this end, the Coalition strongly supports the provision in the Contract with America, as passed by the House on April 5, 1995, which would completely repeal the corporate AMT.

The Coalition looks forward to working the Committee on this critical issue.

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STATEMENT OF THE ESOP ASSOCIATION ON THE ALTERNATIVE MINIMUM TAX

Mr. Chairman, and members of the Committee on Finance, The ESOP Association submits for your consideration a recommendation to alter, a provision of the regulation interpreting the application of the Corporate Alternative Minimum Tax (AMT) to deductible dividends paid on certain stock held by an Employee Stock Ownership Plan, or ESOP.

The ESOP Association is a non-profit, 501(c)(6) entity representing nearly 1200 corporations that sponsor ESOPs and their nearly 1 million employee owners through the ESOP. It is headquartered in Washington, D.C.

GENERAL BACKGROUND: In 1984, in the tax legislation known as DEFRA, Congress enacted Internal Revenue Code Section 404(k), and expanded that provision of the Code in 1986, in the tax legislation known as the Tax Reform Act of 1986, or TRA 86.

ESOP Deductible Dividends: In essence, Section 404(k) permits the corporate sponsor of an ESOP to deduct the dividends paid on stock held by its ESOP if (1) the dividend is passed on to the employee participates in the ESOP in cash, or (2) the dividends are paid to the lender to help satisfy the "securities acquisition loan," or in other words, the loan that allowed the ESOP to acquire employer securities if stock of value equal to the dividends is allocated to the participants' accounts.

This provision of law is referred as the ESOP dividend deduction law. It has played a significant role in the creation and operation of ESOPs since it enactment in 1984 and expansion in 1986.

From the enactment of the ESOP dividend deduction until 1990, the value of corporation's ESOP dividend deduction was not subject to the corporation AMT.

Corporate AMT: The corporate AMT, in its current form, it became law as a result of provisions in TRA 86.

TRA 86 provided as a preference item the value of a tax concept known as book untaxed reported profits, or the "BURP" preference item. TRA 86 limited the BURP as a preference to the tax years 1987, 1988, and 1989. TRA 86 provided that after tax year 1989, the BURP preference item would be replaced by a preference item calculated from "adjusted current earnings," or ACE.

1989 AND BEYOND: In essence, the Omnibus Budget Reconciliation Act of 1989, or OBRA 89, followed through on TRA 86 and substituted ACE for BURP. Having said this, it is noted that the tax committees discussions about the corporate AMT in 1989 was anything but cursory, as several significant "reforms" of the AMT were put before the tax committees.

In the final conference Report on OBRA 89, Congress directed Treasury to issue regulations interpreting ACE.

Important to note that while reviewing the preference ACE, the same tax committees spent considerable time and debate in 1989 reviewing ESOP tax law, and in particular, the ESOP dividend deduction.

In other words, the tax committees, and the tax conference between the House and Senate on OBRA 89 had on their agenda both ACE as a preference and ESOP dividend deductions. It is important to note that with regard to the ESOP dividend deduction, the debate centered on whether to limit this tax deduction, and if so, to what extent, and how.

ACE Regulations: On March 15, 1990, the Department of Treasury in Proposed Regulation Section 1.56(g)-(d)(3)(iii)(E) (the Reg.) proposed, among other things, that in calculating the ACE preference, ESOP deductible dividends were to be included in the ACE calculation.

Although it is technically true that this regulation, which was made final on March 15, 1991, retroactive for tax year 1990, does not point blank make ESOP deductible dividends subject to the corporate AMT, the practicable effect is to make this ESOP tax incentive worth less for the ESOP sponsor.

A handy, although not precise, reference point, is that the Department of Treasury regulation reduces the value of the ESOP dividend deduction by 15 cents for every $1 dollar of dividends deducted.

The ESOP Association takes the position that the regulation is a wrong interpretation of law, is counter to legislative intent for ESOP dividend deduction, and is patently unfair to those ESOP sponsors who entered into transactions from 1985 until the regulation was published in final form because it is retroactive in impact.

Below these matters are discussed in greater detail:

REGULATION WRONG AS A MATTER OF LAW: The only statutory authority for disallowing the deduction for ESOP dividends in the calculation of ACE is section 56 (g)(4)(C)(i), which requires that a deduction be disallowed if such item is not also deductible for purposes of calculating E&P. Necessarily, the Service has concluded that section 404(k) dividends, while deductible in computing regular taxable income, are not deductible in determining E&P. Such a judgment, however, is clearly erroneous and involves "a serious distortion of the AMT statutory structure and of E&P concepts."

Taxable income is generally recognized as the starting point for determining E&P. Since section 404(k) dividends are deductible in computing taxable income, the initial presumption is that these payments are also deductible in determining E&P. However, taxable income is "only a (beginning) point, and certain items that are deductible in (the computation of) taxable income must be added back in computing E&P." These items are often thought of as artificially created deductions, or deductions which are allowed for purposes of computing taxable net income, but which do not represent actual expenses or outlays of cash by the corporation. " Examples of such artificially created deductions (are) the dividends received deduction" and the deduction for the excess of percentage over cost depletion, which are deductible only because of tax policy considerations, and not because they involve an actual cash outlay.

In comparison, dividends paid to an ESOP involve an actual outlay of cash by the paying corporation. It follows, then, that the expenditure for ESOP dividends cannot be characterized as an artificially created deduction, and thus there is no ground for treating ESOP dividends as non-deductible in the calculation of E&P. Moreover, the payment of ESOP dividends results in a reduction of economic income because it causes a decrease in the net assets of the corporation. Disallowing a deduction for these dividends in the computation of ACE would violate the objective of the ACE adjustment to bring AMTI closer to economic income. Thus, the fact that taxable income serves as the foundation for E&P creates a strong presumption that ESOP dividends are deductible in computing E&P. And while the code fails to provide a precise definition of E&P, "there is no statutory authority for the Service to stray too far from the generally accepted understanding of E&P in setting forth the ACE regulations. Unless Congress indicates otherwise, in clear statutory language, the ESOP dividend deduction amounts should be deductible for E&P purposes." No such contrary language can be found. Nor has Congress granted Treasury the authority to issue legislative regulations that would add to the list of adjustments, provided by statute, that must be made to taxable income in the calculation of E&P. Hence, there is no basis for disallowing a deduction for section 404(k) payments in the calculation of E&P.

In fact, section 312(a) of the Code clearly states that ESOP dividends are deductible in calculating E&P. Section 312 provides a set of rules requiring adjustment to the E&P of a corporation as a result of the occurrence of certain event. Section 312(a) states that a corporation's E&P shall be "decreased," but not below zero, by the amount of any distribution of property by the corporation with respect to its stock. Dividends paid by a corporation thus are deductible in the computation of its E&P because naturally these are distributions of property with respect to its stock. As a result, section 56(g)(4)(i), upon which the Regulation relies, is not applicable in the case of ESOP dividends. Thus, there is no statutory authority for disallowing the deduction for ESOP dividends in the calculation of ACE. (Note these comments are quoting the Virginia Tax Review Association, Spring 1991 Note, by Mark B. Wychulis, Copyrighted 1991.)

Furthermore, ESOP dividends are not the same as other dividends set forth in the Reg. as not deductible for purposes of computing ACE. Congress has characterized the ESOP dividend for deductible purposes as part of a compensatory arrangement. This Congressional characterization is clear by the placement of the ESOP dividend deduction statutory provision in Subchapter D of Chapter 1 of the Code, the subchapter which sets forth the statutory scheme pertaining to "Deferred Compensation, Etc." it is not disputed that compensation expenses are deductible for E&P calculations.

REGULATION WRONG AS A MATTER OF LEGISLATIVE INTENT: Simultaneous with the changes in the ACE calculations included in OBRA 89, the Congressional tax committees considered, debated, and amended the ESOP dividend deduction. This is particularly true in the context of the Conference Committee on OBRA 89 because, whereas the Senate version had no changes in the ESOP dividend deduction, the House version made very radical changes which, in essence, would have reduced the use of the ESOP dividend deduction drastically. The final product included a change in the ESOP dividend deduction provision, but not to any major extent.

While the Congress, in particular the Conference Committee, had before it the amendments to the ACE provisions, and the amendments to the ESOP dividend deduction, it is logical to assume that, when the Conference Committee basically sided with the Senate version of the ESOP dividend deduction, the House participants would have insisted, or at least proposed that the ESOP dividend deduction, the House ESOP dividend deduction value be reduced by the AMT provisions (up to a 44% reduction in value under certain circumstances).

There is no evidence that this is the case, and if the ESOP dividend deduction was presented as an item to be reduced in value by AMT, then clearly the Conference rejected such a proposal.

The Reg., in the explanatory materials, relies on the Conference Report explaining TRA 86, which set forth this sentence—" . . . no deduction is allowed with respect to a dividend paid." H.R. Rep. No. 841, 99th Cong. 2nd Sess. II-276 (1986).

Reliance on this outdated reference to the pre-1990 version of ACE is completely inappropriate. During the deliberations on the 1989 changes of both ACE and the ESOP dividend deduction, Congress had every opportunity to reiterate this bit of legislative history of TRA 86, but it did not do so, wither in the statute itself, or in the contemporary legislative history of OBRA 89.

It is important to note also that at the time the Conference Report on TRA 86 was drafted, the use of the ESOP dividend deduction was limited. The expansion of the original DEFRA provision that arose because of TRA 86 had not yet impacted those who create and operate ESOPs. So, it is unlikely that the drafters of the Conference Report gave any thought whatsoever to ESOP dividend deductions when they put pen to paper in drafting the report. Surely they were referring to the payment of dividends by a few publicly traded corporations that had reported considerable cash flow in financial statement while reporting little or no taxable income for Federal tax purposes. It was these reported corporations that gave rise to the Congressional enactment of the new corporate alternative minimum tax with its book income/ACE preference items, not the handful of employee-owned corporations paying dividends to employees in accord with the Congressional intent that as many citizens as possible share in the bounty of ownership of capital assets.

Having established that there is no basis in legislative history the Congress intended to deny a deduction for ESOP dividends in the calculation of ACE, the only place to review is the statue itself.

REGULATION PATENTLY UNFAIR: Finally, the Reg. is patently unfair with a retroactive impact on certain employee-owned companies. In 1987, 1988, 1989, and 1990, before publication of the Reg., several corporations established large employee ownership programs that relied on full deductibility of ESOP dividends. Now these employee-owned corporations face a very serious prospect of having only a portion of the value of the planned ESOP dividends available for ESOP debt service.

Under the Reg., these employee-owned corporations may find that some of their cash slated for ESOP debt payment may instead be used to pay AMT. Such an adjustment in their pre-1990 ESOP transaction plans may result in significant economic problems for these employee-owned corporations. Thus, regardless of interpretation, because the deduction for ESOP dividends was an important factor in future cash flow projections for these ESOP transactions, no regulatory change of the magnitude proposed under the Reg. should be applied retroactively to transactions completed before the change.

Based on all of the above, The ESOP Association would respectfully ask that the Committee consider enacting a clarification of the ACE preference item making it clear that the 1991 regulation is wrong. We call to your attention that legislation doing so was introduced in the 103rd Congress in the House of Representatives and garnered 117 co-sponsors. And in the House-passed 1995 tax bill (Contract with America), effective January 1, 1996, the entire ACE provision that led to the Reg. is repealed.

Your consideration of The ESOP Association's members' position on this matter is greatly appreciated.

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STATEMENT OF THE GEOTHERMAL ENERGY ASSOCIATION

[BY DR. PHILLIP MICHAEL WRIGHT]

Mr. Chairman and Members of the Committee, I want to thank you for the opportunity to present this statement to you supporting alternative minimum tax ("AMT") relief in general and specific legislation which would permit the renewable energy investment tax credits ("tax credits") presently available to businesses as offsets to their regular tax, to also be applied against the AMT.

Mr. Chairman and members of the Subcommittee, my name is Dr. Phillip Michael Wright, and I am President of the Geothermal Energy Association. I am presenting this statement on behalf of our Association, which is comprised of about 50 U.S. member companies that bring the benefits of clean, reliable geothermal energy to society. We focus on issues of interest to geothermal development and, of course, a major issue is the ability to utilize the tax credits for geothermal property which were, with your support and assistance, made permanent in the Energy Policy Act of 1992. It is therefore not surprising that we support legislation which would provide for application of the tax credits against the AMT, which is almost always triggered in the case of companies involved in geothermal development.

Prior to commenting with more specificity on AMT relief, however, I would like to put geothermal resources in perspective. Put succinctly, the geothermal resource has significant potential, is a secure energy source in our national energy strategy, is compatible with the environment and can enhance the tax base and create jobs through development.

The geothermal industry is comprised of more than 50, mostly small companies, headquartered in various states, including California, Colorado, Florida, Hawaii, Maryland, Nebraska, Nevada, New Jersey, New York, Oregon, Texas, and Utah. Direct employment is about 10,000 people in the U.S., and our indirect effect is a minimum of 20,000 other jobs. We generate a total of 2,280 megawatts of geothermal power, producing 17 billion kilowatt-hours/year, in four states—California, Hawaii, Nevada, and Utah. States having excellent potential for near-term development of geothermal power include Alaska, Arizona, Idaho, Oregon, New Mexico, and Washington. Geothermal energy is the second largest grid-connected renewable electricity source, after hydropower. We generate 17 times more electricity than solar energy and 7 times more than wind energy. The power we produce in the United States displaces the emissions of 22 million tons of carbon dioxide, 200,000 tons of sulfur dioxide, 80,000 tons of nitrogen oxides, and 110,000 tons of particulate emissions (whose adverse health effects are becoming more widely known) per year compared with the production of the same amount of electricity from an average U.S. coal-fired plant (coal data from DOE/EIA-0348(90)).

All of this reflects the fact that geothermal energy is environmentally benign, a fact which is of particular importance in an era of global warming stemming from excessive carbon emissions and air pollution caused by other harmful pollutants being emitted into the atmosphere. A state-of-the-art flash steam geothermal plant emits a small percentage of pollutants discharged by fossil fuel plants and emits none of the pollutants causing smog and acid rain. Binary plants such as those operating in California and Nevada produce essentially no air emissions of any kind.

As we all know, significant regulatory changes are underway in the electric utility industry as a result of the Energy Policy Act of 1992 and other factors. Utilities and their customers are becoming ever more strongly motivated solely by short-term economics. In addition, natural gas prices have been very low in recent years. Tradition, regulation, and subsidies have favored the use of fossil fuels for electric power generation in our country for decades.

All of this adds up to a stagnant domestic geothermal market. To compete in the domestic market, we need to lower our costs through enhanced technology. And there can be no greater assistance in this area than allowing companies to actually utilize the tax incentive you have granted them by permitting them to apply the tax credits against the AMT.

H.R. 1215 is an important step in reducing the negative impact of the AMT on business in general, and on the geothermal industry in particular. Under the House-passed bill, the AMT would be repealed for taxable years beginning after December 31, 2000. In the interim, the impact of the tax would be lessened, as business preference and adjustment items would generally cease to apply after December 31, 1995, the most important of which is a more favorable depreciation adjustment (effective March 13, 1995). Under H.R. 1215, changes in the computation of the AMT during the phase-out period would help move our industry toward parity with the oil and gas industries which, twice in the last five years, have received relief from the AMT in tax legislation.

Accordingly, we support the AMT provisions contained in H.R. 1215.

However, we strongly urge you to consider a small adjustment to the overall relief during the phase-out period which would permit the tax credits to be applied against not only the regular tax, but also the AMT. Such relief has been introduced, over the past five years, on a bipartisan basis and in both Houses. Currently, S.108, introduced by Senator Tom Daschle (D-S.D.), would permit these tax credits to be applied against the AMT.

Permitting the tax credits to be applied against both the regular tax and the AMT will enable renewable projects to compete with conventional fossil fuels in the bidding for new utility projects. And such successful bidding will help decrease our dependence on imported oil—the largest component of our trade deficit. Moreover, new geothermal plants will create a larger local and state tax base and more jobs; if built on federal lands such projects will generate production royalties. Finally, keeping the domestic market viable could place our industry in an excellent position to compete for foreign projects, thus keeping the United States at the forefront of power projects around the world and enhancing our balance of payments.

The tax credits can be the single-most effective federal program to promote renewable energy, stimulating investments and enabling the technology to develop and improve, provided they can be fully utilized. We urge this Committee and the Congress to permit the tax credits to be applied against the AMT.

Thank you for permitting me to present the views of the Geothermal Energy Association.

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## STATEMENT OF GOVERNMENT FINANCE OFFICERS ASSOCIATION (GFOA)

This statement is submitted on behalf of the Government Finance Officers Association (GFOA), a professional association of more than 10,000 state and local government officials whose duties include all the disciplines of public finance, including the issuance of tax-exempt bonds. GFOA urges the Senate Finance Committee to consider reform of the treatment of tax-exempt interest under the alternative minimum tax (AMT) as it reviews the role of the AMT within the federal income tax system. Under current law, tax-exempt interest is subjected to federal income taxation by including

- tax-exempt interest on private activity bonds as a tax preference item under the corporate AMT,
- tax-exempt interest on private activity bonds as a tax preference item under the individual AMT, and
- 75 percent of the tax-exempt interest earned by a corporation in the adjusted current earnings adjustment.

GFOA and numerous other national organizations representing issuers of tax-exempt securities have called for the elimination of tax-exempt interest under the individual and corporate AMT since these changes were enacted as part of the 1986 Tax Reform Act. We have taken this position because the taxation of this interest is inconsistent with the important principle of reciprocal tax immunity and the application of the AMT to tax-exempt interest has led to increased borrowing costs for state and local governments. This is due both to the increased interest premium issuers must pay to compensate for the tax status of the securities, and to the decrease in demand for private activity bonds by taxpayers who either are, or believe they may be, subject to the AMT.

Although the precise effect of the AMT is unknown, there is general agreement that private activity bonds subject to the AMT pay roughly 25 basis points ( or one-quarter of one percent) more in interest than similar bonds not subject to the tax. For a city financing a $10 million sewer facility with a private activity bond, the resulting additional cost over 20 years would be roughly $368,000. For larger financing and the market overall, it can be seen that the AMT has a significant impact on borrowing costs. The decrease in demand is particularly acute in corporate investment in state and local government tax-exempt securities. Where in the past banks and property and casualty insurance companies were the primary purchasers of state and local government securities, nearly seventy five percent of these securities are now held by individuals. The decrease in bank demand for tax-exempt securities has been particularly hard on those small communities that issue bonds that are "bank eligible." Banks may purchase the securities of certain small issuers and deduct the carrying costs of such investments as a business expense.

As you reconsider the AMT, we ask that you take into account the following points:

- State and local governments are prohibited by federal law from taxing interest earned on federal securities, including the securities issued by many government-sponsored enterprises for private activities. The federal government should not tax interest earned on state and local government securities. There should be reciprocal tax immunity.
- Studies have not identified tax-exempt interest as a major factor contributing to corporate tax avoidance.
- Investments in tax-exempt securities are not tax shelters as some claim. Tax-exempt bonds are purchased with after-tax income and the investor in these securities is taxed indirectly by the governmental issuer because the investment pays a below-market return.
- Tax-exempt interest is an efficient tax expenditure because financing is provided for desirable and economically viable projects and there is no federal bureaucracy required to manage the program.
- The taxation of private activity bond interest under the AMT affects bonds issued for governmentally owned and operated facilities because the federal income tax code provisions defining private activity bonds sweep certain governmental bonds into the private activity category.
- The taxation of private activity bond interest under the AMT results in a multi-tiered and multi-faceted market for tax-exempt securities. It includes individuals and corporations who are subject to the AMT and those who are not. Taxpayers who are subject to the AMT do not pay more tax: they change their buying pattern and only purchase bonds not subject to the tax.
- Taxpayers who know that they will never be subject to the alternative minimum tax invest in the private activity bonds that offer an interest premium and thereby receive an unjustified interest windfall. This windfall results in higher state and local government borrowing costs, but does not produce additional federal revenues.
- Data collected by the U. S. Department of Treasury from a sample of individual taxpayers have consistently shown that people who own municipal bonds are in the middle-income brackets as well as the upper-income brackets, and that virtually all taxpayers in all income categories have taxable income. Thus, taxpayers do not totally eliminate their tax liability through tax-exempt bonds.

State and local governments rely on tax-exempt financing to provide much-needed infrastructure and other facilities that are vitally important to the nation's economy. We believe that it is good public policy to enable these governments to borrow at the lowest possible cost. Repeal of the application of the AMT to tax-exempt interest would contribute significantly to lowering state and local borrowing costs at little or no cost to the federal government.

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## STATEMENT OF THE INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION (IRET)

(BY MICHAEL A. SCHUYLER, SENIOR ECONOMIST)

My name is Michael Schuyler. I am a senior economist with the Institute for Research on the Economics of Taxation (IRET). I would like to thank the Senate Finance Committee for allowing me to submit this written testimony. The subject of this hearing is the alternative minimum tax (AMT): What is its role? What problems is it creating? How can it be improved? The topic is an important one, and the committee is to be praised for convening this hearing to examine it.

The regular income tax and the AMT are essentially parallel tax systems with different tax bases and different tax rates. Each year, a taxpayer must pay whichever of the two results in a higher tax liability. Several arguments are usually presented in favor of the AMT. Without commenting initially on their validity, the arguments are:

(1) The regular tax system contains many tax subsidies; those subsidies encourage wasteful economic activities. Because the AMT limits some of those subsidies, it improves economic efficiency.

(2) If not for the AMT, some profitable companies and wealthy individuals would use various tax preferences excessively to avoid paying all or nearly all income tax.

(3) Regardless of the merits of the deductions, credits, and exemptions in the regular tax system, it looks bad if some profitable companies and wealthy individuals pay little or no income tax.

(4) Whether or not the AMT is a good tax, relaxing or repealing it would lower federal revenues, and the federal government cannot afford the revenue loss.

On the other side of the issue, several criticisms are frequently levelled against the AMT:

(1) The AMT is inefficient because it blocks some productive investments both by raising the cost of investments and by reducing the internal funds businesses have available to make the investments.

(2) The AMT increases administrative costs for taxpayers (and the IRS) because it forces affected taxpayers to prepare two sets of tax returns, in effect, one for the regular tax system and one for the parallel AMT system.

(3) The AMT is unfair because while most taxpayers can claim certain exclusions, deductions, and credits, those claims are denied or severely restricted for taxpayers falling into the AMT.

(4) The AMT is poorly targeted because low profits, rather than large amounts of preferences, often push taxpayers into the AMT.

Which of these conflicting sets of propositions is closer to the mark depends heavily, although by no means exclusively, on whether the tax "loopholes" at which the AMT system is aimed really are loopholes or are, instead, appropriate exemptions, deductions, and credits within the tax system. To make that determination, one must decide according to sound tax principles what the proper tax base should be and then whether the regular tax base or the AMT base comes closer to meeting that objective. If the regular tax system is more in line with good tax principles, there is virtually no justification for the AMT and many reasons for not having it. If the AMT better matches sound tax principles, the case for it is much stronger, although it may still have shortcomings that could be improved.

Most of the difference between the regular tax base and the AMT base lies in the differing treatment of capital cost recovery with respect to depreciable property. Determining whether the regular tax or the AMT more closely conforms with basic tax principles, therefore, depends very largely on their respective capital recovery, or depreciation, provisions. One criterion for investment neutrality is that a tax system does not increase the cost of saving-investment uses of income compared with consumption uses. A second criterion for investment neutrality is that a tax system does not alter the relative market values of different kinds of capital. If two kinds of capital have equal values before tax considerations, they should have equal values after factoring in taxes.

Both tax systems are flawed in that they are biased against investment, more so in the case of some kinds of facilities than others, but the failings of the AMT are substantially greater. Instead of the regular tax system needing a harsher backstop in the form of the AMT system, the regular tax system is already too severe with respect to capital cost recovery allowances.

## COST RECOVERY ALLOWANCES OF THE REGULAR INCOME TAX AND THE AMT COMPARED TO THOSE OF A TAX NOT BIASED AGAINST INVESTMENT

Because most of the differences between the tax bases of the regular income tax and the AMT have to do with write-offs for capital expenditures, a particularly revealing gauge of whether the AMT system plugs "loopholes" is how the capital cost recovery allowances in the regular tax and the AMT compare to those in a neutral tax. With respect to investment, one may usefully look at what might be called first-order and second-order biases. A tax will be guilty of what might be called a first-order (generalized) bias against saving and investment if it penalizes saving and investment relative to consumption. A tax will be guilty of a second-order bias if it distorts the investment mix by burdening some categories of investment more heavily than others.[1]

### *Unbiased Cost Recovery Allowances*

A tax system that fails to provide for full recovery of investment expenditures by allowing inadequate write-offs for capital costs may readily generate one or both types of anti-investment biases. A numerical example will illustrate how these biases can come about and what form of capital cost recovery allowance is needed to avoid them.

[1] By no means are these the only possible types of tax biases.

As a hypothetical example, suppose that a business pays $1,000 for a piece of equipment this year, that the equipment adds $1,210 to the business's receipts two years hence, and that the discount rate is 10%. This discount rate adjusts both for inflation, which erodes the purchasing power of $1 today compared to $1 in the future, and for the time value of money, which refers to people's tendency to prefer having something now as opposed to not having it until the future. Together, inflation and the time value of money are assumed to be 10% in the example. When the $1,210 future return is discounted at the 10% rate, its present value is found to be $1,000 ($1,210 discounted at 10% for 2 years). Because this gross return has a discounted value that repays the investment's current cost, the investment is just worth undertaking. That is, saving and investing the initial $1,000 is just as rewarding as the foregone consumption. Will this result change, however, when taxes enter the picture?

Suppose the business is subject to a 35% tax. Also suppose that the investment's cost can only be deducted when the investment yields its return, which will be two years from now.[2] In that event, the business's tax base two years in the future will be $210 ($1,210 gross return –$1,000 deduction), and the business's tax liability two years from now will be $73.50 (35% of $210). That leaves the business with an after-tax return two years hence of $1,136.50 ($1,210–$73.50). The present value of that after-tax return is only $939.26 ($1,136.50 discounted at 10% for 2 years). Because the discounted value of the investment's after-tax return is more than $60 below the investment's current cost ($939.26 vs. $1,000), this worthwhile investment has become unattractive purely for tax reasons.

The delayed write off in this example roughly corresponds to a cost recovery method known as economic depreciation. Economic depreciation gives short shrift to when a business incurs a cost. What it focuses on is the rate at which an asset wears out in terms of its remaining future returns. The numerical example indicates that gearing when the tax system recognizes an asset's cost to when the asset generates income, rather than to when the business pays for the asset, leads to a strong bias against investment. The problem is that if cost recovery is delayed until the generation of future income while being limited to the nominal cost of the asset, the discounted amount of the deductions will be less than what was actually spent for the asset.[3] This finding bears emphasis because economic depreciation is often—but wrongly—presented as the ideal for a capital cost recovery system.

In contrast, suppose the business in the example can deduct the $1,000 investment expenditure when it is made and then must pay tax on the $1,210 gross return when it is received. In that event, the expenditure reduces the business's current tax liability by $350 (35% of $1,000). The tax on the gross return two years hence is $423.50(35% of $1,210). That leaves the business with an after-tax return two years from now of $786.50 ($1,210 - $423.50), which has a present value of $650 ($786.50 discounted at 10% for 2 years). Together with the $350 tax saving from the immediate deduction, the present value of the investment's total after-tax returns is $1,000 ($650 + $350). Because the discounted returns, after tax, still repay the investment's current cost, the investment continues to be worth making. This capital cost recovery method, which permits investments to be deducted when the expenditures are made, is known as expensing.

The divergence between the two tax systems in this example is entirely attributable to their different cost recovery methods. Intuitively, what happened is that because expensing deducts costs when they occur, it measures costs accurately over time. In the example, expensing provides a $1,000 cost recovery allowance, which equals the investment's cost. As a result, income, which is revenues less costs, is also measured accurately over time. That permits the income tax to be assessed on true income. With the delayed cost recovery method, on the other hand, the present value of cost recovery is less than the amount spent to acquire the asset, and that causes true income to be overstated. In the delayed cost recovery example, the discounted cost recovery allowance is only $826.45 ($1,000 discounted at 10% for 2 years), or $173.55 less than the cost of the asset. At the 35% statutory tax rate, that

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[2] So that the analysis will be clearer, this illustrative example assumes depreciation can be claimed in a single year. Current law, of course, is more complicated. Current law spreads depreciation allowances over a multi-year period, starting when an asset is placed in service and continuing for a term that depends on how the tax code categorizes the asset and what recovery period it assigns to that category of assets. An example using current law would need to evaluate cost recovery allowances in many years, but, aside from greater complexity, the general results would be the same as those derived in this simplified example. (See Table 1 for some current-law results.)

[3] As an analogy, if the discount rate is 10%, would someone lend $1,000 in return for receiving $100 each year for 10 years? No, because although the repayments sum to $1,000, their discounted value is much less.

under depreciation increases the business's discounted tax liability by $60.74, which fully explains the drop in the discounted net return.

Tax neutrality regarding the consumption versus saving-investment choice requires expensing. Although expensing reduces the dollar amount of the net return on an investment by the same percent as the tax rate, it does not reduce the rate of return on the investment's net-of-tax cost. Thus, investments that are worthwhile relative to consumption before considering taxes remain worthwhile under an income tax with expensing. Conversely, expensing does not turn ill-conceived investments into winners. If an investment has a negative net return before taxes, it will continue to have a negative net return under an income tax with expensing. Expensing, in other words, is not an investment subsidy. As the numerical example demonstrated, however, an income tax that features delayed cost recovery allowances often transforms positive before-tax net returns into negative after-tax net returns. Thus, a tax system with delayed capital cost recovery allowances harbors an anti-investment bias.

In addition to violating the first-order neutrality condition against investment in general, delayed capital cost recovery also distorts the composition of investments that businesses make. When a capital cost recovery system forces longer-lived assets to be written off more slowly than shorter-lived assets, it biases investment decisions against the longer-lived investments.

The reason for this is that the present value of a given total amount of deductions is lower the longer the period over which the deductions must be spread. For example, the present value of, say, 4 annual deductions of $250 discounted at 10% a year is $792.47, significantly greater than the present value, $614.46, of 10 annual deductions of $100. The upshot is that delayed capital cost recovery depresses the discounted net returns on assets with longer cost recovery periods more severely than it depresses the returns on assets with shorter cost recovery periods. That discourages businesses from making longer-lived investments compared to shorter-lived ones; it contributes to an overemphasis on shorter-term investments.

Whereas delayed capital cost recovery generates a second-order bias, directed against longer-term investments, expensing is free of that bias. Because costs are written off when they occur, one dollar spent on a longer-term asset receives the same effective tax deduction as an equal dollar spent on a shorter-term asset.[4]

Of course, other provisions in the tax system also exert an anti-investment bias. For example, because returns on corporate equity are taxed at both the corporate level (by the corporate income tax) and again at the individual level (by the individual income tax on dividends and capital gains), many worthwhile corporate investments are derailed by the two successive rounds of taxation.

*Capital Cost Recovery In the Regular Income Tax Versus the AMT*

By far the largest single divergence between the tax bases of the regular income tax and the AMT is due to the AMT's slower depreciation schedules. The regular income tax generally uses the modified accelerated cost recovery system (MACRS) adopted as part of the Tax Reform Act of 1986 (TRA-86). The AMT substitutes alternative MACRS, which has more stretched out cost recovery schedules. Part of the slowdown arises because MACRS permits the 200% declining balance depreciation method for capital assets with recovery periods of 3,5,7, and 10 years while the AMT's alternative MACRS reduces that to 150% declining balance. A bigger timing difference is that alternative MACRS specifies much longer recovery periods than does MACRS.

The modified accelerated cost recovery system (MACRS) of the regular income tax is significantly slower than expensing, especially for long-lived assets. Table 1 provides some examples. It shows for a range of capital assets the discounted amount of capital cost recovery allowances on a $1,000 investment under expensing, the regular tax system's MACRS, and the AMT's alternative MACRS. The discount rate is based on assumed inflation of 3% and an assumed rate of time preference of 5%. With all assets, expensing accurately reports capital costs. Whether the property is a boat, a computer, an electric generating system, a land improvement, office furniture, or any other type of capital, the discounted amount of the cost recovery allowances equals the asset's actual cost. Expensing has no bias against capital, nor does it generate biases for or against certain types of capital.

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[4] It should be mentioned that another cost recovery method is equivalent to expensing and also maintains first-and second-order investment neutrality. The alternative technique stretches out the cost deductions but keeps their present value equal to the capital expenditure. It accomplishes this by increasing the nominal dollar amounts of write-offs in future periods to offset the time delay. This is the basis of the neutral cost recovery system included in the tax bill that the House has passed H.R. 1215).

TABLE 1.—Sum of Discounted Cost Recovery Allowances Under Alternative Cost Recovery Methods (Selected Examples Capital Asset Purchased for $1,000)

| Type of Capital Asset | Expensing | Regular Tax | AMT |
|---|---|---|---|
| Airplanes | $1,000 | $791 | $648 |
| Automobiles | 1,000 | 839 | 811 |
| Boats and ships | 1,000 | 727 | 546 |
| Computers | 1,000 | 839 | 811 |
| Construction | 1,000 | 839 | 784 |
| Industrial electric generation systems | 1,000 | 727 | 492 |
| Land improvements | 1,000 | 594 | 518 |
| Office furniture | 1,000 | 791 | 689 |
| Pulp and paper manufacturing | 1,000 | 791 | 672 |
| Steel mill products' manufacturing | 1,000 | 791 | 634 |

The inflation rate is assumed to be 3%, and the rate of time preference is assumed to be 5%. All assets are assumed to he placed in service in the middle of the first year. The half-year convention is used throughout in computing cost recovery allowances. All cost recovery allowances are discounted for a half year in the first year, for 1.5 years in the second year, etc. The discounted amounts depend on inflation and the rate of time preference. The discounted amounts would be lower (not as depressed) at higher (lower) assumed rates of inflation and time preference.

The regular tax system's MACRS is biased, however. In all instances in the table, the discounted amounts of the MACRS cost recovery allowances fall significantly short of actual capital costs. This leads to overtaxation of net returns on investments and, therefore, a bias against investments. Furthermore, because the discounted amounts of MACRS cost recovery allowances differ widely among asset types (because of differences in MACRS recovery periods among asset types), MACRS also distorts the capital mix. For instance, the discounted amount of the capital recovery allowance on a $1,000 expenditure is only $839 for automobiles and computers; that falls to $727 for boats and industrial electric generation systems; and it declines to just $594 for land improvements. Thus, capital assets with longer MACRS recovery periods are handicapped relative to capital assets with shorter MACRS recovery periods.

For the AMT, taxpayers must recalculate all cost recovery allowances using alternative MACRS. Because alternative MACRS is slower than MACRS, the AMT provides cost recovery allowances that, when discounted for time, are even further below the amounts spent to acquire the properties than those of the regular income tax. As examples, in going from the regular tax system to the AMT, the discounted amount of the cost recovery allowances falls from $791 to $648 for airplanes, from $839 to $811 for automobiles, from $727 to $546 for boats, from $727 to $492 for industrial electric generation systems, from $594 to $518 for land improvements, and from $791 to $672 for assets used in paper and pulp manufacturing. These examples indicate that while expensing allows full tax recognition of capital costs, the regular tax's MACRS falls short of full cost recognition, and the AMT's alternative MACRS is yet more inadequate.

The cost recovery system in the regular income tax discriminates against investments, especially longer-lived investments. To help correct this problem, cost recovery allowances should be speeded up. The AMT, unfortunately, goes in the wrong direction. Its cost recovery allowances are even more biased than those of the regular income tax.

A REVIEW OF THE ARGUMENTS FOR AND AGAINST THE AMT

*Does the AMT improve economic efficiency?* If the regular tax system subsidized inefficient behavior, the AMT might conceivably improve the situation. In fact, however, the regular tax system is itself too miserly, not too generous. The slower cost recovery schedules in the AMT, which comprise the main area of difference between the two levies, compound the first- and second-order biases against investment. Contrary to the claim that it promotes efficiency, the AMT contributes to distortions of the relative values of alternative investments and increases the cost of all investments relative to current consumption. Some of the regrettable consequences of the intensified anti-investment biases are lower productivity, lower wages (workers earn less because, with fewer capital tools, they are less productive), reduced international competitiveness, and weaker prospects for growth.

*Does the AMT prevent some companies and individuals from using tax preferences excessively?* Because the regular tax system does not treat capital cost favorably, it does not make sense to label as "preferences" its already too restrictive capital cost recovery allowances. The regular tax treatment of depreciation should not be identified as a preference or loophole.

In most other areas, too, the restrictions of the AMT are hardly directed against genuine loopholes. For example, companies that suffer losses cannot receive corporate income tax refunds, but they can carry those losses to other years as offsets against income in those years. This provides a truer measure of long-term profits, although the delay in claiming the losses reduces the offsets' discounted value. If such offsets were prohibited, a company with, let's say, losses of $1 million in one year, income of $1 million in the next year, and, consequently, zero net income over the two years would be hit with a large income tax bill in the second year. The regular income tax places various restrictions on loss offsets; the AMT adds another restriction. Two concerns the AMT limitation raise are, first, allowing companies to offset income with losses is hardly a "preference" and, second, since the corporate AMT is supposedly directed against hugely successful companies somehow avoiding taxes, what is it doing attacking companies trying to recover from losses?

*Should the AMT be retained for the sake of appearances?* The Conference Report explaining the Tax Reform Act of 1986 (TRA-86) bluntly defended the AMT on this ground. "In particular, Congress concluded that both the *perception* and the reality of fairness have been harmed by instances in which corporations paid little or no tax in years when they reported substantial earnings . . . "[emphasis added][5] Concern about perceptions is understandable. People often feel pressured to do what appears to be good, even if the underlying reality is different. Further, members of Congress are well aware that vocal critics will attack them stridently if the AMT is in any way softened. Two counterpoints should be made, however. One is that keeping up appearances is very costly to taxpayers and the public at large in the case of the AMT. Thanks to the AMT, the U.S. has less capital than otherwise and the mix of capital is less efficient—productive than otherwise. Also thanks to the AMT, many taxpayers bear the cost of greatly increased tax complexity. According to the General Accounting Office, 400,000 corporations had to submit corporate AMT forms in 1992 (most of which did not end up owing the AMT).[6] Many more went through all the AMT paperwork to be sure they did not need to file. Subjecting hundreds of thousands of corporations to a complex, second tax system is a very heavy and costly compliance burden to impose if it is all just for the sake of appearances.

Another counterpoint is that even in terms of appearances the primary rationale for the AMT has passed. TRA-86 removed many of the features of the old tax system that had most given the appearance of being tax shelters. Furthermore, legislation several years earlier had phased out safe harbor leasing, which had been a lightening rod for criticism. Thus, if the AMT ever seemed needed for the sake of looks, the base broadening of TRA-86 greatly weakened that rationale. Ironically, TRA-86 vastly expanded the corporate AMT.

*Even if the AMT is a bad tax, can the federal government do without the AMT's revenues?* One response to this question is that a fixation on federal revenues is only correct if private costs do not matter, that is, if the private sector exists to serve the government as opposed to vice versa. A more balanced perspective is that any problems caused by lower federal revenues due to a rollback of the AMT should be weighed against the gains in improved efficiency, tax simplicity, and fairness that might come about from AMT reform. Another response is that even if revenue neutrality is taken as a requirement, that does not preclude reducing or repealing the AMT and replacing its revenues with some other tax that is less distortionary or less complicated.

On the other side of the ledger, the AMT does cause many of the problems with which it is most often charged.

*Economic efficiency.* It was demonstrated earlier that the regular income tax has inadequate capital cost recovery allowances, which create biases against investment. The AMT's even less adequate capital cost recovery allowances worsen the biases. Thus, the AMT reduces economic efficiency.

The AMT also interferes with investment in ways that have not previously been mentioned. When companies pay the AMT, they have less cash flow with which to service their debts. That financial constriction will tend to make them more reluctant to move forward with new investments. For companies using financing, the AMT is also a drag on new investments; it reduces the internal funds the companies

[5] Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (Washington, DC: Government Printing Office, 1987), pp. 433.

[6] General Accounting Office, Experience With the Corporate Alternative Minimum Tax (Washington, DC: Government Printing Office, 1995), p. 3.

have available after paying taxes. These inhibiting effects will be felt not only by companies currently paying the AMT. Companies that think they might become liable for the AMT in some later periods may scale back their investment plans to adjust for the AMT's possible drain on their future cash flows.

*Administrative costs.* Preparing a second tax return, which many taxpayers must do because of the AMT, is a time-consuming, costly procedure. With capital assets, for instance, companies that have already calculated cost recovery allowances according to regular tax depreciation schedules must recompute each asset's basis and cost recovery allowances substituting the AMT's depreciation schedule for that type of asset. The added effort is particularly pointless for the hundreds of thousands of companies that do not owe the AMT but must, nevertheless, perform the recalculations and submit the AMT form. Taxpayers that do owe the AMT because of the timing difference between regular tax and AMT depreciation accumulate AMT credits that they may be able to use as offsets in later years if they again become liable for the regular tax, perhaps as a result of the eventual reversal in the size of the two system's cost recovery allowances. Computing those credits, however, requires yet more paperwork. Abolishing the AMT would, of course, eliminate these administrative burdens. Short of that, the extra paperwork could be drastically reduced by removing items that are not tax subsidies from the AMT, such as capital cost recovery allowances. More modestly, the current high percentage of "false alarms," in which taxpayers not ultimately owing the AMT must go through the computations, could be greatly reduced by increasing the AMT's exemption amount.

*Fairness.* Supporters of the AMT often defend it in terms of fairness, saying it is needed so that all taxpayers pay their "fair share." Ironically, the opposite is closer to the truth. For the most part the AMT takes already restrictive provisions of the tax code and saddles some taxpayers with further restrictions. The extra restrictions might improve fairness if the provisions in the regular tax system were overly favorable but the regular tax provisions are themselves unfavorable. Rather than ensuring that all taxpayers pay their "fair shares," the AMT's often arbitrary limitations result in the overtaxation of some taxpayers by denying them the lawful exemptions, deductions, and credits afforded to other taxpayers.

*Poor targeting.* A curious feature of the AMT is that it is more likely to snare low profit companies than high profit ones. To explain this by way of example, suppose a company has regular taxable income of $2 million and AMT preferences and adjustments of $1 million (making its AMT income $3 million). Its regular tax liability will exceed its AMT liability and it will, therefore, not owe the AMT. Suppose, however, that the company has a bad year and, consequently, its regular income falls to $1 million while its AMT preferences and adjustments remain $1 million (making its AMT income $2 million). Because of the decline in the company's regular income, its AMT liability now exceeds its regular tax liability, meaning that it has fallen into the AMT—not as the result of high profits but because of low profits.

With the AMT's emphasis on capital costs, another way many firms fall into the AMT is to invest heavily. That is also bizarre targeting. It tends to single out for a special penalty tax some of America's most innovative, far-sighted companies precisely because of their efforts to improve future productivity.

## CONCLUSION

The case for the AMT is remarkably weak. Instead of plugging genuine loopholes, the AMT primarily places takes restrictions that are already unfavorable to taxpayers and makes them worse. That does not promote efficiency, equity, or tax simplicity. The AMT causes a variety of problems. By replacing inadequate capital cost recovery allowances with still more inadequate capital cost recovery allowances, it discourages investment, which weakens productivity and the nation's outlook for growth. The AMT's high administrative costs are a substantial burden on taxpayers and a deadweight loss to society in that they divert time and energy from productive uses. Perversely, the corporate AMT is most likely to catch two types of companies: companies that are leaders in investment and companies that have weak current profits but are trying to maintain strong investment programs.

The AMT should be repealed. If that is not politically acceptable, a somewhat less ambitious but very helpful reform would be to bring AMT depreciation into conformity with regular tax depreciation.

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## STATEMENT OF THE NATIONAL MINING ASSOCIATION

The National Mining Association (NMA) is a business association representing most of the nation's producers of coal, metals, industrial and agricultural minerals and businesses that provide equipment, goods and services to the mining industry.

We are pleased that Chairman Packwood has held this hearing on the corporate alternative minimum tax (AMT) and to have this opportunity to submit for the record our comments supporting the repeal of the AMT.

NMA is a member of the broad-based AMT reform/repeal coalition spearheaded by the National Association of Manufacturers (NAM). We agree and concur with the testimony presented by Thomas J. Usher on behalf of the NAM on May 3, 1995.

As the Committee is well aware, the intent of the AMT was to ensure that all companies reporting profits to shareholders pay at least some tax. We believe the AMT as currently designed has overshot this mark. For many mining companies, the AMT has become their permanent tax system, not a backstop tax as it was designed to be.

Mining is enormously capital intensive and is a cyclical commodity-based industry. Mining companies must continuously invest in exploration, reserve acquisition and developmental activities in order to yield a flow of commodities over time. Companies must also make large capital investments to comply with ever changing environmental laws and regulations. The bias against capital investment created by the AMT (in mining's case, the depletion preference and adjustments for depreciation, exploration and development expenditures) makes it harder for U.S. mining companies to make needed investments. The AMT increases our cost of capital and the added tax burden we must bear diverts cash flow we would otherwise channel into our operations. The reduced cash flow is particularly pronounced during a period of declining profits and low commodity prices.

By acting as a brake on investment we become less able to compete in the fiercely competitive world-wide minerals market. This means fewer job opportunities for U.S. miners which are among, if not the, highest paid workers in the nation. We should have tax policies that encourage creation of these jobs, rather than policies that create road blocks to job creation.

We support outright repeal of the AMT. It is anti-investment, anti-growth and anti-jobs. If because of revenue or political constraints the Senate cannot repeal the AMT we will be willing to discuss other reform options to lessen the negative affect the AMT has on our industry.

We thank the Committee for allowing us to present our views.

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## STATEMENT OF WILLIAM P. MCCLURE, J. ROGER MENTZ & LINDA E. CARLISLE, WHITE & CASE

Mr. Chairman and Members of the Committee: Under the alternative minimum tax, the amount of foreign tax credit available to a U.S. taxpayer to offset against U.S. tax liability is limited to 90 percent of the taxpayer's pre-credit alternative minimum tax liability. This 90 percent limitation means that both corporate and individual U.S. taxpayers may incur substantial alternative minimum tax liability with respect to foreign source income even though the foreign tax liability on their foreign source income exceeds the rate of U.S. taxation. For example, if a U.S. corporation operating in Western Europe incurs a 50 percent foreign tax on $100 million of foreign source income, and thus realizes a net profit after foreign tax of $50 million, under current U.S. law that corporation would pay no regular tax but would have an alternative minimum tax liability of $2 million.

This result is inconsistent with the basic policy behind the foreign tax credit. The foreign tax credit is the mechanism adopted by the United States to reduce or eliminate international double taxation. Where a country imposes an income tax on income realized in its jurisdiction, it is well established that such country has the first right to tax that income. The United States has long recognized this right, and imposes tax on such foreign source income only if the U.S. tax would be greater than the foreign tax. Thus, where the foreign tax rate is at least 35 percent, in general no regular U.S. corporate tax would apply. This is the correct tax policy result.

The difficulty occurs in the case of the U.S. alternative minimum tax which is, in effect, a separate tax system. Because the alternative minimum tax foreign tax credit is limited to 90 percent of the pre-credit alternative minimum tax, in the hypothetical situation described above there would be an alternative minimum tax due, even though the foreign source income is subjected to a higher rate of tax than the U.S. rate. This is indefensible as a tax policy matter.

A provision repealing the 90 percent limitation was included in the "Contract with America Tax Relief Bill of 1995" passed by the House of Representatives. This very important provision of the House Bill should be included in the Senate Finance tax bill so that it will become part of the tax legislation enacted this year. The time has come to remedy this mistake in current law.

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STATEMENT OF THE PUBLIC SECURITIES ASSOCIATION

MAY 2, 1995

Hon. JOHN BREAUX,
*U.S. Senate,*
*516 Hart Senate Office Building,*
*Washington, DC.*

Dear Senator Breaux: As the Senate Finance Committee prepares for a hearing on the role of the alternative minimum tax (AMT) within the current tax system, we urge you to consider reform of the treatment of tax-exempt interest under the (AMT). Since 1986, the AMT has discouraged capital investment by making certain tax-exempt securities less attractive to potential purchasers. However, as representatives of banks and securities firms in the bond markets, we are cognizant that in order to avoid increasing the deficit any tax reductions need to be offset by discretionary spending cuts and entitlements reforms.

Each of the markets, represented by PSA exists primarily to serve public policy goals. The municipal bond market provides financing for state and local capital investment. The U.S. government securities market allows the federal government to finance national needs at the lowest possible cost of borrowing for taxpayers. The mortgage-backed securities market helps provide financing for home ownership. The liquidity and efficiency of these markets are their hallmarks.

The corporate AMT has reduced investment in public capital by corporations through its effects on corporate purchases of tax-exempt bonds. All private-activity bond[1] interest, and a portion of the interest on public purpose bonds and 501(c)(3) bonds, is subject to the corporate AMT. Until 1990, 50 percent of the interest on public purpose and 501(c)(3) bonds was subject to the corporate AMT. Since 1990, 75 percent of the interest on these bonds has been subject to the corporate AMT. Because the corporate AMT is 20 percent, corporations subject to the AMT now pay an effective tax rate of 15 percent on supposedly tax-exempt interest from public purpose and 501(c)(3) bonds and 20 percent on private activity bonds. The corporations are less inclined to purchase such securities because of the AMT. As a result, the municipal bond market is dependent predominantly on demand by individuals.

The application of the corporate AMT to public purpose bonds and the increase in the percentage of interest taxed have markedly discouraged demand from property and casualty insurance companies (P&Cs) and from commercial banks. In the late 1980s, P&C purchases helped temporarily mask the impact of bank disinvestment in municipal bonds due to a separate provision of the 1986 Tax Act. Recently, however, P&C municipal bond purchases have dropped in response to the higher AMT. Similarly, commercial banks are also discouraged from purchasing municipal securities by the alternative minimum tax. Since banks can purchase only those securities sold by certain "small issuers,"[2] the 1990 change that encouraged banks to abandon municipal bond purchases has been especially harmful to the nation's smaller communities.

The AMT also affects the investment behavior of individuals to the detriment of the market for certain securities. Yields on private-activity-bonds must be between 15 and 20 basis points[3] higher than yields on similar securities because private-activity bond interest is taxable under the AMT. However, investors subject to the AMT tend to avoid purchasing securities bearing AMT-taxable interest. Generally, the only investors liable for tax-exempt interest income under the AMT are those who find themselves inadvertently holding securities that bear AMT-taxable interest. This trend means that the federal Treasury collects very little interest income under the individual AMT. Nonetheless, issuers of private-activity bonds are forced to offer higher yields on AMT bonds because of their taxable status, and therefore bear higher project costs. In an environment where public-private partnerships may be the only way available to fund a needed project, this unnecessary increase in cost frustrates these efforts.

The AMT has increased borrowing costs for many state and local governments by reducing demand and liquidity for securities subject to the tax. The problem has been particularly acute for small communities. However, these increased project costs have not been accompanied by any significant gain to the federal Treasury. This is principally because good tax planning helps to ensure that taxpayers, where

[1] Private-activity bonds are issued by states or localities to fund projects where 10 percent or more of the proceeds benefit a private party, and 10 percent or more of the debt service is secured by a private party.

[2] Small-issuers are defined in the Internal Revenue Code as those that issue no more than $10 million worth of bonds annually.

[3] One basis point equals 1/100 of one percent.

possible, avoid activity that carries with it AMT consequences. Investment in municipal bonds is just such an activity. For the above reasons, the application of the AMT to interest on tax-exempt bonds should be reconsidered. As a result, PSA supports the AMT reforms contained in the House-passed tax bill, H.R. 1215. That bill would immediately address the problems created by the AMT on the municipal bond market. This would broaden the capacity of corporate entities to invest in public projects, return institutional demand to the municipal securities market and reduce borrowing costs for states and localities.

We urge you to consider the above analysis in the context of broader AMT reform. In addition, we will submit written comments for the hearing record. Please do not hesitate to contact our office if we can be of any assistance in efforts to reform the structure of the alternative minimum tax.

Sincerely,

JOHN R. VOGT
*Senior Vice President*

* * * * *

The Public Securities Association (PSA) is pleased to present our views on the alternative minimum tax as it relates to the municipal securities market. PSA represents banks and securities firms that underwrite and make markets in municipal securities, U.S. Government and federal agency securities, mortgage- and other asset-backed securities and money-market instruments. PSA's members account for approximately 95 percent of the nation's municipal securities market activity. Since its inception in 1986, the alternative minimum tax has had a significant effect on the composition of demand for municipal securities and on the cost of financing public investment. We take an active interest in proposals to address problems that have been identified with the AMT. We commend Chairman Packwood and other members of the Finance Committee for their attention to this issue, and we appreciate the opportunity to present our views.

THE MUNICIPAL SECURITIES MARKET

The municipal securities market is the principal means—virtually the only means—by which state and local governments raise capital to finance public investment. State and local governments issue bonds for a wide variety of projects, including water and sewer facilities, schools, hospitals, colleges and universities, roads and bridges, low-income housing, mass transportation, airports, solid waste facilities and a numerous other public projects that contribute to the nation's continued economic growth and efficiency.

One of the most important features of bonds issued by states and localities is that interest earned by investors is generally exempt from federal taxation. As a result, investors in tax-exempt bonds accept a lower pre-tax rate of return on their investments, and state and local governments pay a significantly lower cost of borrowing. Because of the federal tax-exemption on municipal bonds, states and localities pay capital costs that are two to three percentage points lower than what they would otherwise incur. The tax revenue foregone by the federal government as a result of the tax-exemption is essentially a form of assistance from the federal government to state and local governments. Indeed, the federal tax-exemption on municipal bond interest is the most important form of federal assistance for state and local capital investment projects.

The capital markets in general tend to be dominated by large investors, corporations and institutions such as banks, pension funds, insurance companies and foreign institutions. Individual investors play a significant role in the capital markets, but large, institutional investors make up the bulk of the demand for securities. This is not the case in the municipal securities market. Demand for municipal securities is concentrated among individual investors, who access the market either directly or through mutual funds. At the end of 1994, individuals held, directly or indirectly, $891.8 billion of municipal securities, or 74.1 percent of outstanding state and local bonds. This is largely the result of tax code provisions which effectively shut corporations, pension funds, banks (with a narrow exception) and foreign investors out of the municipal market. The only significant source of corporate demand for municipal securities is among property and casualty insurance companies, who, at the end of 1994, held $153.4 billion of municipal securities, or 12.8 percent of all state and local government bonds outstanding. A graph depicting trends in holdings of municipal securities is attached to this statement.

MUNICIPAL SECURITIES AND THE AMT

All tax-exempt bonds are subject in some way to the corporate AMT. In addition, so-called private-activity bonds[1] are subject to the individual AMT. The corporate AMT inhibits corporate investment in tax-exempt securities, especially by property and casualty insurance companies, the only remaining substantial source of corporate demand for municipals. The corporate AMT also affects what is left of commercial bank investment in municipal bonds. Eliminating the application of the AMT to municipal bond interest would expand the corporate base of demand for municipals and would make it easier for states and localities to sell their securities.

The AMT applies to otherwise tax-exempt interest in two ways. First, all the interest on tax-exempt private-activity bonds is subject to both individual and corporate AMTs. Second, a portion of interest on public purpose tax-exempt bonds and on tax-exempt bonds issued on behalf of tax-exempt 501(c)(3) organizations to the corporate AMT. Until 1990, 50 percent of the interest on public purpose and 501(c)(3) bonds was subject to the AMT. Beginning on January 1, 1990, 75 percent of the interest on these bonds is subject to the AMT. Since the corporate AMT is 20 percent, this means that corporations affected by the AMT effectively pay an AMT rate of 15 percent on tax-exempt interest on public purpose and 501(c)(3) bonds.

The application of the corporate AMT to public purpose bonds, and the increase in the percentage of interest taxed, have had a negative effect on demand from property and casualty insurance companies (P&Cs). An insurance company invests loss reserves, financed through premium payments, in a variety of instruments. Tax considerations come into play when an insurance company's revenue are such that its tax liability under the AMT approaches that under the ordinary corporate income tax. A wise insurance company structures its portfolio to maximize its after tax return on investments. A P&C whose AMT liability approaches its ordinary income tax liability will avoid investments that result in additional AMT income, such as that from municipal bonds. Thus, as a result of the AMT, P&C investment in municipal securities is less than it might otherwise be. In response to the AMT, municipal bond purchases among P&Cs has dropped recently. Over the past 15 years, P&Cs have reduced their holdings of municipal bonds from 22 percent of all bonds outstanding in 1980 to 12.8 percent today. A significant reason for the recent lack of P&C demand is the AMT. Reduced demand for municipal securities among P&Cs makes it more difficult for state and local governments to sell their securities and makes the market precariously dependent on demand among individual investors.

The AMT has also had a negative effect on commercial bank demand for municipal securities. Before 1986, banks could deduct 80 percent of their interest expense associated with carrying tax-exempt bonds, making them attractive investment instruments for commercial banks. A provision of the Tax Reform Act of 1986 prohibits banks from deducting the interest expense associated with investing in municipal securities. As a result, commercial banks have largely exited the municipal bond market as investors, reducing their holdings of municipal securities from $231.7 billion in 1985 to $97.6 billion, or 8.1 percent of bonds outstanding, in 1994. A narrow exception exists for bank purchases of municipal bonds sold by communities that issue $10 million or less per year. This provision makes it easier for small issuers, who often have a difficult time accessing the capital markets, to sell their bonds. However, the application of the corporate AMT to tax-exempt interest earned by banks tends to dampen demand for bonds issued by small communities.

The individual AMT also decreases demand for municipal securities and results in increased financing costs for public investment projects. As already mentioned, the interest on most private-activity bonds is subject to the personal and corporate AMTs. As a result, in order to compensate investors for the risk that they may be required to pay tax on their tax-exempt interest, yields on these "AMT bonds"[2] are currently between 15 and 20 basis points (0.15 to 0.20 percentage points) higher than yields on other, similar bonds. The higher costs to issuers of AMT bonds does not necessarily correspond with substantial revenue gains to the Federal govern-

[1] The Internal Revenue Code distinguishes between bonds issued for purely public uses and bonds issues for projects with significant element of private participation. The Code defines "private-activity" bonds as issues where ten percent or more of the bond proceeds are used by a private entity and ten percent or more of the debt service is secured by a private entity. In general, private-activity bonds cannot be tax-exempt. However, tax-exempt private-activity bonds are permitted for certain specific types of projects and facilities, subject to volume caps and other restrictions.

[2] Bonds where the interest is subject to the individual AMT are known as "AMT bonds."

ment. Investors subject to the AMT simply avoid such bonds, and they are instead purchased by investors not exposed to the AMT who enjoy a higher tax-free yield.

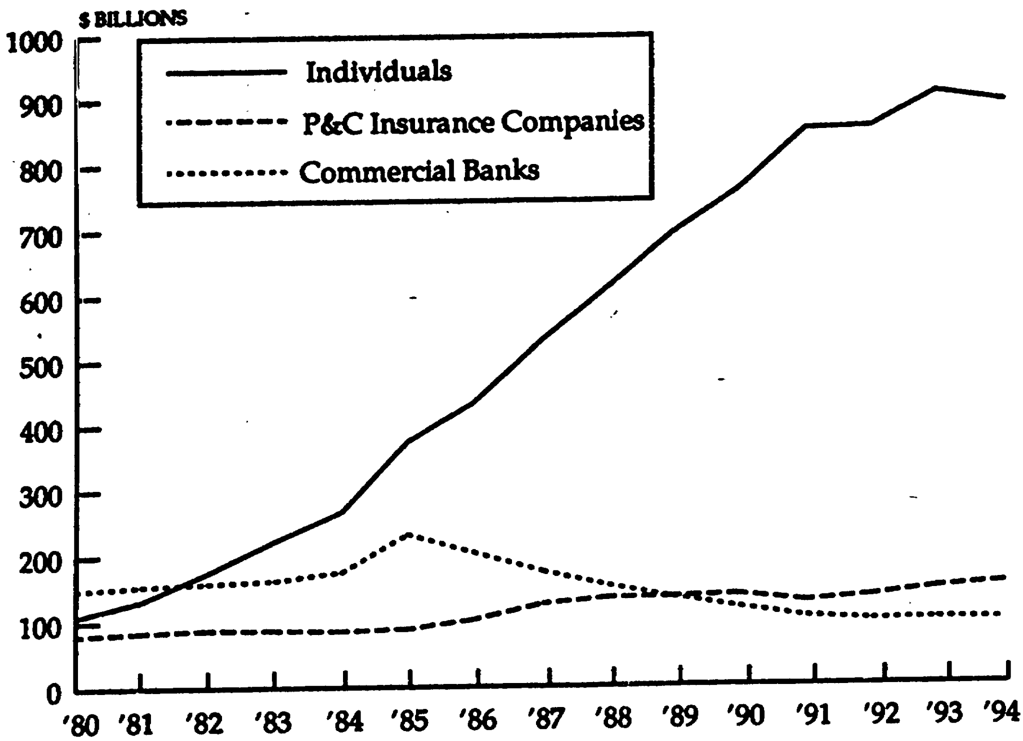
CONCLUSION

The corporate AMT and its effect on corporate demand for municipal securities has increased borrowing costs for many state and local governments. When combined with the loss of bank deductibility for municipal bond portfolios, the AMT threatens to hurt the borrowing ability of small communities especially. Moreover, the application of the individual AMT to municipal interest results solely in increased borrowing costs to public entities, an investment windfall to non-AMT payers, and little or no federal tax revenue. If P&Cs reduce their holdings of municipal securities even more as a result of the AMT—in the same way commercial banks have—it could mean that states and localities will have a harder time finding buyers for their securities. Their cost of borrowing would rise, and public investment that is vital to our economy would become more expensive. Fewer investment projects would be undertaken, and the ones that were would cost more. This is not the intent of the alternative minimum tax. -6- We are pleased that Congress is devoting attention to issues related to the AMT and how it affects economic behavior and capital investment. We are very supportive of the AMT provisions contained in H. R. 1215, the Tax Fairness and Deficit Reduction Act of 1995, passed last month by the House. We are especially encouraged by the proposal in H. R. 1215 to eliminate application of the corporate AMT to municipal bond interest beginning in 1996. We urge the Finance Committee, as it considers proposals for & 1995 tax bill, to reform both the corporate and individual AMTs by eliminating their application to municipal bond interest.

Again, we appreciate the opportunity to present our views, and we look forward to working with the Committee as the debate over tax proposals continues.

# Trends in the Holdings of Municipal Securities

**1980-1994**




**Includes mutual, money market, closed-end funds, bank personal trusts and direct holdings by individuals.*
*** A series break in 1991 distorts comparisons to prior-year figures of property & casualty insurance companies.*

Source: Federal Reserve System
All Amounts in Billions

## Statement of the Texas Utilities Company

Texas Utilities Company ("TU") submits this written statement to the Senate Finance Committee in support of proposals to reform or repeal the alternative minimum tax ("AMT").

TU is a diversified holding company. TU has a wholly-owned subsidiary, Texas Utilities Electric Company ("TU Electric"), which is engaged in the operation of an electric public utility system involving the generation, transmission, distribution and sale of electric energy in Texas.

The current AMT was originally enacted as part of the Tax Reform Act of 1986 to ensure that taxpayers having economic profit reported taxable income and paid Federal income tax. The AMT is a comprehensive, separate tax system, but parallel to the regular tax system. Under current law, AMT liability is a credit that generally may be carried forward to reduce regular tax liability, but not to reduce AMT liability.

### I. THE CORPORATE AMT SHOULD BE COMPLETELY REPEALED; IF REPEAL IS NOT POSSIBLE, THE AMT SHOULD BE REFORMED

TU strongly supports the testimony before this Committee of Thomas J. Usher on behalf of the National Association of Manufacturers ("NAM"), who urged the Committee to consider legislation to remedy some of the inequities and unfair policy inherent in the current structure of the AMT.

As noted by the NAM, the AMT has served to discriminate against taxpayers in capital-intensive industries. This discrimination results primarily because the depreciation rules used in computing the AMT are considerably less favorable than the depreciation rules used for regular tax purposes. The AMT depreciable lives are longer, and the AMT depreciation methods are less accelerated, when compared to the regular tax depreciable lives and depreciation methods. In practice, the AMT, as applied to capital-intensive taxpayers serves as depreciation "penalty."

The inequity of the current system is demonstrated by the experience of TU in recent years. TU has been in an AMT position for every taxable year since the enactment of the AMT effective for the 1987 taxable year. During 1987 through 1989, the construction of TU Electric's two-unit Comanche Peak nuclear plant (which has a tax depreciable basis of more than $8 billion) was in progress. During those years, the AMT was computed in part by making a positive adjustment for book untaxed reported profits (the "BURP adjustment"). In computing the BURP adjustment for those years, TU was required to include in income the allowance for funds used during construction ("AFUDC"). The AFUDC represents a non-cash accounting entry which reflects the capital carrying costs for regulatory purposes incurred during large construction projects. Thus, from 1987 through 1989 (the most costly construction period in TU's history), TU was required to pay enormous amounts of AMT with respect to the non-cash book income represented by the AFUDC.

Effective for the 1990 taxable year, the BURP adjustment was replaced with the ACE adjustment. The ACE adjustment required an even less favorable depreciation adjustment than that required for general AMT purposes. TU Electric placed Unit 1 of the Comanche Peak station in service in 1990 and Unit 2 in service in 1993. The total tax depreciable basis of the two units exceeds $8 billion. That substantial investment resulted in an extremely large ACE adjustment by virtue of the ACE depreciation of the $8 billion investment on a straight-line basis over 20 years and a consequent extremely large annual AMT liability.

The foregoing scenario has resulted in TU's having $450 million in accumulated AMT credit carryforwards. TU projects that, under current law, it will be unable to use these credits for at least 10 years. This represents a prepayment of taxes in the amount of $450 million, essentially an interest-free loan by TU to the government in that amount. TU, having made this interest-free loan to the government consequently has been obliged to use borrowed funds to finance its operations.

TU respectfully urges the Committee to consider the specific proposals offered by the NAM in its testimony, namely to **completely repeal the AMT**. If complete repeal cannot be accomplished, TU supports the proposals by the NAM for the Committee to do the following:

(1) Eliminate the depreciation adjustment under the AMT.

(2) Change the way the AMT operates to make AMT credits usable by companies which, like TU, have been placed in the position of being long-term AMT taxpayers as the result of their substantial capital investment, e.q., to establish a mechanism to allow partial utilization of AMT credits against AMT liability.

(3) Remove the unfair limitations on the use of business credits, net operating losses and foreign tax credits that apply only to AMT taxpayers.

The House of Representatives has recognized the need for AMT reform by including modifications to and ultimate repeal of the AMT in H.R. 1215, the Contract with America Tax Relief Act of 1995. TU supports that proposed legislation.

II. THE COMMITTEE SHOULD REJECT THE POSITION OF THE CITIZENS FOR TAX JUSTICE

The Committee should reject the position of the Citizens for Tax Justice ("CTJ"), as set forth in the testimony of Robert S. McIntyre before this Committee.

As an initial matter, most of the numerical data upon which CTJ rely in its written statement in support of its position, as that data relate to TU, are simply incorrect. For example, in appendix 1 of the CTJ, the items cited for TU include the following errors:

- The amount of "tax w/o AMTs" for 1992 cited by CTJ, $-18.0, is wrong; the correct amount is $0.
- The amount of "pretax US profit" for 1991 cited by CTJ, $855.7, is wrong; the correct amount is $-525.4.
- The amount of "Fed. Income Tax" for 1991 cited by CTJ, $51.9, is wrong; the correct amount is $45.6.
- The amount of "AMT at least" for 1991 cited by CTJ, $123.2, is wrong; the correct amount is $62.1.
- The amount of "Tax w/o AMTs" for 1991 cited by CTJ, $-71.3, is wrong; the correct amount is $0.
- The amount of "Fed. Income Tax" for 1990 cited by CTJ, $47.3, is wrong; the correct amount is $0.
- The amount of "Tax w/o AMTs"" for 1990 cited by CTJ, $-47.5, is wronq; the correct amount is $0.
- The amount of "Fed. Income Tax" for 1989 cited by CTJ, $120.6, is wrong; the correct amount is $112.9.
- The amount of "AMT at least" for 1989 cited by CTJ, $59.0, is wrong; the correct amount is $53.9.
- The amount of "Tax w/o AMTs" for 1989 cited by CTJ, $61.6, is wrong; the correct amount is $95.3.
- The amount of "Fed. Income Tax" for 1988 cited by CTJ, $140.5, is wrong; the correct amount is $145.4.
- The amount of "Tax w/o AMTs" for 1989 cited by CTJ, $127.4, is wrong; the correct amount is $111.8.
- The amount of "Fed. Income Tax" for 1987 cited by CTJ, $42.9, is wrong; the correct amount is $85.3.
- The amount of "Tax w/o AMTs" for 1989 cited by CTJ, $42.9, is wrong; the correct amount is $99.4.

CTJ's pervasive use of incorrect data in the case of TU should call into question the empirical "basis" for the position articulated by CTJ.

It should be noted, however, that one statistic that CTJ cites is correct. In the chart on page 8 of the written statement of CJS, it is noted that from 1982 through 1985 TU had no "No-tax years." In other words, during that period, the normal tax rules resulted in TU's payment of Federal income taxes. As noted above, TU had extraordinary events occurring during 1990 and 1993, namely the placement into service of unique generation assets having a tax basis in excess of $8 billion. In the absence of the AMT, those extraordinary events (which, incidentally involved the actual expenditure of a like amount of money by TU and which had the effect of employing thousands of workers during the construction phase of the plants and presently during the operational phase of the plants) would have caused TU not to have paid Federal income taxes during 1990, 1991 and 1992, primarily as a result of depreciation deductions associated with the plant. It simply makes no sense to punish TU by essentially requiring it to prepay its Federal income taxes because it engaged in significant capital-intensive activities.

The CTJ statement decries AMT reform as a "return to the bad old days of corporate tax freeloading. " This characterization of AMT reform borders on the absurd. TU has made an $8 billion real economic investment. In doing so, it has created thousands of jobs. Under the regular tax system, in the absence of the AMT, its tax liability would have been substantially reduced below the level that it would have been had it not made such an investment. TU's behavior cannot reasonably be characterized as freeloading. To the contrary, TU should be permitted to receive the Federal income tax benefits associated with an extraordinary investment. Had TU not made its $8 billion investment and created the attendant jobs, it would not have incurred liability for the AMT and instead would have faced substantially higher Federal income tax liability.

SUMMARY

Many capital-intensive taxpayers such as TU have been placed in the position of long-term AMT status with the resulting long-term interest-free loans to the government. Current law should be changed to permit these taxpayers to use the funds that they have essentially loaned to the government to finance their own operations and thereby to contribute to economic growth and job creation and to promote the ability of domestic corporations to compete in the international economy.

Surely, the current scenario is not what Congress intended when it enacted the AMT. TU has made a legitimate $8 billion investment with the attendant job creation and contribution to the economy and has faced a steep Federal income tax penalty for doing so, a penalty that, under current law, will extend nearly 20 years.

The effect of the AMT upon TU and other capital-intensive taxpayers has been to increase their cost of capital in the increasingly competitive domestic and international economies. The AMT therefore discourages taxpayers from making capital investments. By repealing or reforming the AMT, Congress would take a significant step to alleviating the inequity imposed on taxpayers such as TU whose only "fault" has been to make substantial capital investments.

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## STATEMENT OF U.S. CHAMBER OF COMMERCE

(BY WILLIAM T. SINCLAIRE SENIOR TAX COUNCIL AND DIRECTOR OF TAX POLICY)

The U.S. Chamber of Commerce appreciates this opportunity to express its views on the alternative minimum tax (AMT). The Chamber is the world's largest business federation, representing 215,000 business members, 3,000 state and local chambers of commerce, 1,200 trade and professional associations, and 72 American Chambers of Commerce abroad.

The Chamber strongly urges reform of the current AMT system. Since its inception, the AMT has grown into a colossal, complex, burdensome and inequitable tax structure whose numerous disadvantages clearly outweigh any of its advantages. AMT reform would spur investment in the business community, thereby creating more jobs and expanding our overall economy.

The current AMT system is fraught with inequities and disincentives. The AMT penalizes those businesses that invest heavily in plant, equipment and other income-producing assets by relegating them to one of the worst cost-recovery systems in the industrial world. AMT taxpayers are not entitled to many of the investment incentives that are available to regular taxpayers, such as various credits. In addition, many unprofitable businesses have become perpetually trapped in the AMT system, unable to utilize their AMT credits from earlier years. To make matters worse, the AMT system is extremely complex and overly burdensome for most taxpayers, even for those who are not actually subject to the tax.

### BACKGROUND

The AMT was originally created to ensure that all taxpayers with economic income pay a minimum amount of income tax. This was in response to well-publicized cases of individuals and corporations who paid little or no income tax, even though they had substantial amounts of economic income. The individual AMT was introduced in 1978, while the corporate AMT was introduced in 1986 as part of the Tax Reform Act of 1986. Prior to the AMT, individuals and corporations were subject to an "add-on" minimum tax which was introduced in 1969.

A taxpayer's AMT is calculated by multiplying the applicable tax rate by the excess of its alternative minimum taxable income (AMTI) over a certain exemption amount (which is subject to phase-out). Currently, individuals are subject to AMT rates of 26 and 28 percent, while corporations are subject to a 20 percent rate. AMTI is computed by adding and/or subtracting various adjustments and preference items from a taxpayer's regular taxable income. One of the corporate adjustments is a very complicated and time-consuming adjusted current earnings (ACE) adjustment.

### THE AMT HAS OPPRESSIVE COST-RECOVERY METHODS

It takes businesses more time to recover their capital investments through depreciation deductions under the present AMT system than the regular tax system since the former utilizes both longer asset recovery periods and slower depreciation methods. For instance, assets with recovery periods of five years under regular tax depreciation, such as automobiles and computers, are generally relegated to recovery periods of seven years under AMT. Likewise, real property with regular tax recovery periods of 27.5, 31.5 or 39 years, such as buildings and structures, are assigned AMT recovery periods of 40 years.

Furthermore, while taxpayers can depreciate most personal property under the 200 percent declining balance method for regular tax purposes, they are forced to depreciate such property under the 150 percent declining balance method for AMT purposes. The difference between the two methods is that the depreciation deductions in the earlier years of an asset's life are invariably greater for regular tax purposes than for AMT purposes.

The recent elimination of the ACE depreciation adjustment for tangible personal property placed in service after 1993 does not resolve the problem because, even though those assets are not subject to the slower straight-line ACE depreciation system, they are still subject to the AMT depreciation system. Tangible personal property placed in service before 1994, as well as real property, are still subject to the AMT and ACE depreciation systems.

In order to demonstrate the AMT's slower cost-recovery system, assume a start-up company wanted to equip its office with $100,000 worth of computer equipment. Under the regular tax system, the business could depreciate $52,000 of its investment in its first two years (not taking into account immediate expensing under Section 179). Under AMT, however, only $29,860 could be recovered during the first two years. Therefore, assuming no other adjustments or preferences, the taxpayer's AMTI over the two-year period would be $22,140 greater than its regular income. Even though total accumulated depreciation under both methods would equal $100,000 after their respective recovery periods, the depreciation deductions under the regular tax system would be significantly greater in the earlier years than under AMT.

While costly to established firms, lower AMT depreciation deductions and resulting AMT liabilities can be detrimental to fledgling businesses that need to invest their limited resources in equipment and other income-producing assets. Given the difficulty of starting a business, the high rate of business failures and increasing domestic and international competition, most start-up companies can ill afford to be saddled with an AMT tax.

## THE AMT CONTAINS OTHER INVESTMENT DISINCENTIVES

In addition to unfavorable depreciation treatment, AMT taxpayers are unable to take either partial or full advantage of other investment incentives, such as various tax credits, that are made available to regular taxpayers. Many of the incentives added to the tax code to spur investment are negated by their exclusion from the AMT system.

As with capital-intensive firms, businesses that would otherwise be able to take advantage of these incentives are placed at an economic disadvantage when compared to other domestic and foreign firms. Originally designed to ensure that all companies with economic income pay a certain amount of income tax, the AMT has instead turned into an inequitable system that favors certain industries over others.

## MANY COMPANIES ARE PERPETUALLY TRAPPED IN AMT

An unintended result of the AMT is that it has become the primary tax system for many of our nation's basic industries, including the steel, energy, paper, chemical, mining, transportation and building sectors. The tax code, through AMT depreciation adjustments, not only places capital-intensive firms at an economic and competitive disadvantage compared to labor-intensive firms, but it negatively affects those businesses that produce capital assets since there is ultimately less demand for their products.

While companies are generally permitted to offset their AMT liabilities against future regular tax liabilities, many are unable to utilize their minimum tax credits since they either have not generated sufficient income to incur regular tax liabilities or have been further subject to additional AMT. The AMT system has become a genuine "Catch 22" for many companies since, in order to reach economies of scale and become profitable, they have to invest heavily in capital equipment, machinery and other income- producing assets. Unfortunately, the more these companies invest, the more susceptible they are to AMT, leaving them with fewer resources, as well as less incentive, to invest in such assets.

Even if a business is able to utilize part or all of its minimum tax credits against its future regular income tax liabilities, because the credits accrue in nominal dollars, inflation erodes the future value of such credits. This factor is significant to those companies that have generated large amounts of minimum tax credits, but do not expect to incur regular tax liabilities for many years in the future. The diminishing value of the dollar, therefore, adds to the misery of those businesses caught in the AMT trap.

THE AMT IS OVERLY COMPLEX AND BURDENSOME

The AMT is extremely complex and imposes a large administrative burden on most businesses. Determining a company's AMTI requires numerous calculations and adjustments, including those relating to depreciation, amortization, inventory and gains/losses. The system has become so convoluted, complicated and confusing that computing AMTI can no longer be considered a peripheral or academic exercise. Instead, it has become a mind-numbing, cancerous growth of the tax code which, at times, is more tedious and costly to administer than the company's regular tax liability.

Even those who are not liable for AMT must still painstakenly compute their AMT in order for it to be compared to their regular tax. According to the Joint Committee on Taxation and the Government Accounting Office, while only 28,000 corporations owed AMT in 1992, 400,000 corporations filed the applicable AMT form (Form 4626). There are many other businesses that do not file Form 4626, but nonetheless compute their AMT only to discover that no additional tax is due. The labor costs incurred by businesses to comply with the AMT requirements are significant and show no signs of diminishing.

CONCLUSION

The tax code should reward, rather than penalize, businesses for investing in their (and their employees') future. The current AMT system needs to provide better cost recovery methods and other investment incentives in order to encourage businesses to make additional capital investments . The system should also prevent companies in certain industries from being perpetually frozen in AMT status. In addition, the entire AMT process needs to be simplified and made easier to comply with. Congress needs to reform the present AMT system to encourage more companies to invest in this country. In order to adequately compete in today's global economy and improve our nation's productivity, create jobs and expand our overall economy, the harsh treatment provided under the current AMT system needs to be eliminated.

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