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THE CASE FOR RETAINING THE CORPORATE AMT

*Reuven S. Avi-Yonah**

PROFESSORS Chorvat and Knoll present us with a strong argument for repealing the corporate alternative minimum tax (AMT).[1] In 2001, repeal was recommended by the Joint Committee on Taxation as part of their simplification study, endorsed by the ABA/AICPA/TEI tax simplification project, and included in a bill passed by the House of Representatives.[2] Since this issue is likely to arise again, it seems worthwhile to review the arguments raised by Chorvat and Knoll. Upon review, none of these arguments seem particularly persuasive; at best, they make a case for reforming the corporate AMT, not for repealing it. On the other hand, Chorvat and Knoll understate the case for retaining the corporate AMT in some form.

In this comment, I will first state the case for retaining the corporate AMT, possibly with some modifications. I will then review the arguments for repeal presented by Chorvat and Knoll. Finally, I will discuss how the corporate AMT can be modified to make it more palatable in light of the arguments presented by Chorvat and Knoll.

I. THE ARGUMENTS FOR RETENTION[3]

To make the case for the corporate AMT, it is necessary to make the three following assumptions:[4]

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1. Terrence R. Chorvat & Michael S. Knoll, *The Case for Repealing the Corporate Alternative Minimum Tax*, 56 SMU L. REV. 305 (2002).

2. *See* J. COMM. ON TAX'N, STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, JCS-3-01 (Comm. Print 2001); *House Clears $159.4 Billion Economic Stimulus Package by Narrow Margin*, 2001 TAX NOTES TODAY 207-02 (2001); *see Treasury Releases Corporate AMT Figures*, 2001 TAX NOTES TODAY 216-14 (2001) (stating the position of the Treasury, which supports repeal).

3. I am not necessarily arguing for retention of the corporate AMT in its present form. *See* discussion for a proposed reform, *infra* Part III. But I do believe some form of corporate AMT is needed to bolster the corporate tax, and other forms of presumptive taxation have their own defects. *See generally* PRESUMPTIVE INCOME TAXATION (Reuven S. Avi-Yonah ed., 1998).

4. These assumptions represent a political judgment call, which may or may not be correct. To some extent that is true of all writing on tax reform, but to the extent I am defending the status quo, I can at least argue that historically these assumptions have

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1. The corporate income tax will continue to be collected;
2. There will be corporate tax preferences granted; and
3. Congress has no way of determining in advance all the ways in which the corporate tax preferences it grants (or other departures from book income) can be abused to reduce the corporate income tax base.

The first and second assumptions represent political reality.[5] Whatever the merits of the case, which I will not go into here, we are going to continue to have a corporate income tax.[6] And given the political power of specific corporate taxpayers, we are also going to continue to have corporate tax preferences, despite Chorvat and Knoll's plea (following many others from Surrey onward) to have fewer or none.[7] Some of these preferences may even be justified because of their positive externalities or for other reasons.[8]

The third assumption represents a real constraint on Congress and the IRS. As the corporate tax shelter saga has shown, there is virtually no end to the ability of well-financed taxpayers and their advisers to find loopholes in the corporate tax. Many of these loopholes use corporate preferences, while others represent a departure from book income.[9]

Given these assumptions, it seems perfectly reasonable for Congress to say the following: "We are going to grant corporations the preferences they wish for. However, for reasons that we cannot foresee given our limited information, some of these preferences or other departures from book income can be abused to undermine the corporate tax base. Therefore, we are going to enact a corporate AMT that will ensure that no preference we have granted will completely eliminate the tax base."

Allow me to give a couple of examples of how this strategy might work. The first example relates to an item that is not even limited by the corporate AMT—the corporate interest deduction. In the 1980s, Congress was concerned that corporate taxpayers may be able to use the interest deduction to completely eliminate their tax liability. In particular, that concern extended to situations when the interest was paid to related parties and was not taxable to the recipient. Ultimately, that concern led to the enactment of § 163(j), which limits corporate taxpayers' ability to deduct interest to tax-exempt related parties if the deduction results in eliminating over half the corporate tax base.[10] The interest deduction was not limited per se. Rather, a limit was placed on the ability to use the deduc-

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proven correct. My proposal for reform may be no more politically realistic than other proposals. *See infra* Part III (proposing reverting to the pre-1989 corporate AMT).

5. Chorvat & Knoll, *supra* note 1, at 330 (recognizing the political reality of first and second assumptions).

6. For a preliminary explanation of why I believe the corporate tax is normatively justified, see Reuven S. Avi-Yonah, *Why Tax the Rich? Efficiency, Equity, and Progressive Taxation*, 111 YALE L.J. 1391 (2002).

7. Chorvat & Knoll, *supra* note 1, at 330-31.

8. This is recognized by Chorvat & Knoll. *See id.* at 320-21.

9. *See generally* George K. Yin, *Getting Serious About Corporate Tax Shelters: Taking a Lesson from History*, 54 SMU L. REV. 209 (2001).

10. I.R.C. § 163(j) (2002).

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tion to eliminate the corporate tax base in non-arm's length situations and when no revenue was collectible on the interest income. Congress here used a balancing test between the justification for letting corporations deduct interest expenses and the desire to preserve the corporate tax base.

Another example is the foreign tax credit, which is designed to eliminate international double taxation.[11] The credit represents a strongly held and fully justified government policy. However, as a matter of practical reality, the credit sometimes must be given in situations in which the taxpayer claiming the credit does not bear the economic burden of the foreign tax.[12] In that case, there exists the potential for using a foreign tax, not borne by the taxpayer, to eliminate U.S. tax liabilities. The IRS has been only partially successful in limiting this tax shelter.[13] Thus, the corporate AMT places a floor on the ability to use foreign tax credits to completely eliminate U.S. tax liability, even if it sometimes results in double taxation.[14]

In these and similar cases, a balance is struck between the preferences, credits, or deductions Congress wishes to grant, frequently for good reasons, and Congress's wish to make sure that these preferences, credits and deductions do not completely eliminate the corporate income tax base. The corporate AMT is a reasonable way of achieving this balance, *given the three assumptions stated above.* Nothing in Chorvat and Knoll's discussion counters this fundamental argument.

Furthermore, the corporate AMT has other merits, which are dismissed by Chorvat and Knoll for inadequate reasons. Specifically, these merits arise in the issue of fairness, the investment in tax-preferred assets, the issue of tax shelters, and the issue of financial accounting.

A. The Fairness Issue

Chorvat and Knoll acknowledge that given that the likely incidence of the corporate tax (and the corporate AMT) is on owners of capital, and that taxes on capital fall more on the wealthy, the corporate AMT is progressive.[15] However, they argue that a more efficient way to increase progressivity would be to raise the corporate tax rate.[16] This argument ignores the political difficulty of raising the rate without granting more preferences that offset any rate increase. In addition, if the corporate AMT is necessary to prevent widespread evasion of the regular corporate tax, then any argument for the corporate tax is an argument for the corporate AMT as well.

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11. I.R.C. § 901 (2002).
12. Treas. Reg. § 1.901-2(f) (2002) (the so-called "technical taxpayer rule").
13. *See* I.R.S. Notice 98-5, 1998-3 I.R.B. 49. *But see* Compaq Computer Corp. v. Comm'r, 277 F.3d 778 (5th Cir. 2001); IES Indus., Inc. v. United States, 253 F.3d 350 (8th Cir. 2001).
14. I.R.C. § 59(a) (2002).
15. Chorvat & Knoll, *supra* note 1, at 315-16.
16. *Id.* at 316.

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Furthermore, although from an economic perspective "corporations do not pay taxes, only people pay taxes,"[17] the political reality is that the public perceives corporations (and not people) as paying taxes. If highly profitable corporations do not pay any tax, this can undermine the willingness of ordinary people to pay as well. Thus, there is an important perceived fairness element in retaining the corporate AMT.

B. Investment in Tax-Preferred Assets

Chorvat and Knoll reject the argument that the corporate AMT is needed to discourage inefficient over-investment in tax preferred assets, because it would be more efficient to curtail the preferences instead.[18] But, as the history of the tax preferences debate from Surrey onward has shown, repealing preferences is politically very hard given the concentrated lobbying power behind each preference and the collective action problem of opponents of preferences. The corporate AMT may be a poor second best in this regard, but it may be the only politically feasible solution to rampant, non-justified preferences.

C. The Tax Shelters Issue

Chorvat and Knoll argue that the corporate AMT is not needed to combat tax shelters because there are other rules to do so, and if the corporate AMT is perceived as limiting shelters Congress would not adopt other rules to combat them.[19] However, in reality, the other rules are insufficient to combat tax shelters, as is the corporate AMT, but both help in some way.[20] Chorvat and Knoll's argument is like telling a patient that he must choose between quitting smoking, eating healthy foods and exercising. All are necessary, none alone is sufficient.

D. The Financial Accounting Issue

Chorvat and Knoll reject the argument that the corporate AMT helps improve financial disclosure, because the corporate AMT tracks book income more closely than the regular corporate tax. Thus, management has an incentive to not inflate financial income because it results in more AMT being paid. On the contrary, Chorvat and Knoll argue that the AMT helps corporations like Enron pretend they are paying more tax than they actually are.[21]

I will return to this issue below, but for now I do not find the Enron example persuasive. First, if a firm wants to cheat, it will cheat, regardless of the corporate AMT. Second, for each Enron there may be dozens of firms that are profitable but pay no regular tax because of the disparities

17. *Id.* at 315.
18. *Id.* at 316-17.
19. *Id.* at 317-18. To a certain extent, these two arguments contradict each other.
20. *See* discussion of the shelter issue *infra.*
21. Chorvat & Knoll, *supra* note 1, at 319.

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between tax and book income.[22] For those firms, the ACE adjustment in the corporate AMT (discussed below) may serve as a partial corrective to the incentive to further inflate their book profits. Making the corporate AMT track book income more closely, as suggested below, would help.

II. THE ARGUMENTS FOR REPEAL

Chorvat and Knoll make four main arguments against the corporate AMT: (a) The corporate AMT discourages investment; (b) The corporate AMT misallocates resources; (c) The corporate AMT increases tax compliance costs and complicates tax planning; (d) The corporate AMT is poor fiscal policy. None of these arguments are persuasive.

A. Does the Corporate AMT Discourage Investment?

The first argument is that "[t]he corporate AMT discourages affected firms from investing in plant, equipment and other productive activities" by (a) reducing the incentives granted by Congress for such investment, and (b) reducing the effective marginal tax rate so that tax advantaged investments are made less attractive.[23]

The first point seems incongruous, given that Chorvat and Knoll recommend that Congress cut back on tax preferences.[24] If tax preferences for investment are misguided, what is wrong with restricting them via the corporate AMT? Of course, one can always argue that repealing the preferences directly would be better. But, as Stanley Surrey discovered, repealing preferences is very hard given that each preference has a strong lobby behind it, while the case for a broad-base, low-rate income tax suffers from collective action problems. The corporate AMT was introduced in 1986 as part of the one instance in recent tax history when the base was broadened and the rate reduced. Even in 1986, it was realized that restricting preferences further is difficult politically. The corporate AMT can be viewed as a back-door way of achieving precisely what Chorvat and Knoll advocate, namely restricting corporate tax preferences.

The second point is even stranger—Chorvat and Knoll are essentially arguing that it is better to have high rates and steep preferences (i.e., a narrow base) than a low rate and a broad base, because the preferences are more effective in a high rate environment. This flies in the face of the consensus of most tax and public finance experts that low rates on a broad base is better tax policy because of the reduced incentive to misallocate resources.

Finally, it should be noted that this is an argument against the corporate AMT in its present form, not against any corporate AMT. The prob-

22. Mihir Desai, *The Divergence Between Book and Tax Income*, NBER Working Paper 8866, *in* Tax Policy and the Economy (James M. Poterba ed., forthcoming 2003); *see* Martin A. Sullivan, *Study Finds Excess of Book Over Tax Incomes Grew in Late 1990s*, 90 Tax Notes 717, 717 (2001).

23. Chorvat & Knoll, *supra* note 1, at 320.

24. *Id.* at 321.

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lem, if it exists, arises from the denial of specific deductions (e.g., accelerated depreciation) in the corporate AMT. If it could be shown that denial of these deductions has a negative impact, they could be reinstated under the AMT as well.

B. Does the Corporate AMT Misallocate Resources?

The second argument made by Chorvat and Knoll against the corporate AMT is that "it changes who makes specific investments, the legal form these investments take, how they are financed, and when they occur . . . [and t]hese changes are all economically wasteful."[25]

Unfortunately, Chorvat and Knoll present no empirical evidence for any of their arguments in this section. Without such evidence, it is difficult to draw policy conclusions. In fact, some of the effects they mention, such as encouraging firms to use equity rather than debt financing, counteract other well-known distortions in the tax law, therefore, their impact may be positive.[26]

In addition, as Dan Shaviro has noted, all of these problems can be fixed by changing the specific form of the corporate AMT. A proposal for such a change is presented below.[27] There is no reason to throw out the corporate AMT baby just because of problems caused by specific bathwater provisions.

C. Compliance Costs and Tax Planning

There is no question that the corporate AMT, like any tax, imposes costs on taxpayers. The question is, are these costs reasonable in proportion to the revenue raised by the tax?

On first impression, the answer for the corporate AMT would appear to be negative, because the tax raises little revenue (about $1 billion per year) at considerable cost ($7.2 billion to $10.4 billion, according to Chorvat and Knoll's interpretation of Slemrod and Blumenthal). "This admittedly rough estimate of the cost of complying with the corporate AMT is several times the revenue raised by the [minimum] tax."[28]

However, this line of analysis ignores the fact, highlighted by Chorvat and Knoll, that the impact of the corporate AMT may be much broader than the revenue numbers indicate since it may increase tax collections from firms that end up paying the regular corporate tax, "[o]ver one-quarter of all corporate assets were held by companies paying higher

25. *Id.* at 321.

26. *Id.* at 322.

27. Daniel Shaviro, *Tax Simplification and the Alternative Minimum Tax*, 91 Tax Notes 1455, 1467 (2001).

28. Chorvat & Knoll, *supra* note 1, at 324-25 (discussing Joel B. Slemrod & Marsha Blumenthal, *The Income Tax Compliance Cost of Big Business*, 24 Pub. Fin. Q. 411 (1996)).

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taxes [in 1998] due to the AMT."[29] Assume for the moment that these firms pay about one-quarter of corporate tax revenues. In that case, since the cost of the corporate AMT (up to $10.4 billion) is about 25% of the cost of the corporate tax ($40.3 billion), and if the AMT results in about a quarter of the corporate tax revenues of $200 billion being collected, the cost of the AMT appears quite reasonable.[30]

Of course, $50 billion could be an overstatement of the revenue saved by the corporate AMT if the firms in the GAO study pay less in tax than they hold in assets. But, it could also be an underestimate of the revenues saved by the corporate AMT if, as argued below, the corporate AMT acts as a significant brake on corporate tax shelters.

Finally, some of the compliance costs of the corporate AMT could be reduced if the tax were simplified in the ways suggested below. In particular, the need to calculate the ACE adjustment separately would be obviated if the AMT were based directly on book income. This is consistent with the recommendation of Slemrod and Blumenthal's respondents.[31]

D. The Counter-Cyclical Argument

The final argument made by Chorvat and Knoll against the corporate AMT is a familiar one; the corporate AMT is counter-cyclical, because it increases collections during recessions and decreases them during booms.[32] It is not clear that the corporate AMT can have a significant effect on the business cycle; as Chorvat and Knoll recognize, most taxes do not.[33] But, even if it can, the correct response is a temporary suspension during recession, not abolition. Moreover, as Shaviro has argued, the counter-cyclical character of the corporate AMT can be eliminated with relatively minor changes to the tax.[34]

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29. *Id.* at 307 (alteration in original) (quoting *Treasury Releases Data on the Corporate Alternative Minimum Tax*, PO-762, Nov. 6, 2001). Note that this is not the same as "paying higher AMT."

30. Where the regular corporate tax and corporate AMT liabilities are close, the corporate AMT can result in significant regular tax collections while appearing to raise no revenue. Suppose corporation X can deduct some item for regular tax purposes but not for AMT. It has 100 gross income and 40 of the relevant deduction, so its regular tax liability is 100 – 40 = 60 x 0.35 = 21. Its AMT liability is 100 x 0.2 =20, so it pays the regular tax of 21. Result: no revenue from AMT. At this point the corporation has no incentive to try to increase its deduction from this item, because if, for example, it had 50 of the deduction, it would have regular tax liability of 100 – 50 = 50 x 0.35 = 17.5, and would have to pay AMT of 20. But if the AMT were repealed, it could freely try to increase its deduction—at the extreme to 100, so its tax liability would be 100 – 100 = 0 x 0.35 = 0. So even though the AMT in this case raises no revenue, it saves 21 of regular tax revenue. This analysis can, for example, apply to the difference between accelerated and straight line depreciation. Another example would be if the value of stock granted upon exercise of employee stock options were not deductible for AMT purposes, as some have proposed (currently, this deduction wipes out the tax liability of corporations like Intel on U.S. source income). *See* Desai, *supra* note 22.

31. Chorvat & Knoll, *supra* note 1, at 323-26.

32. *Id.* at 326.

33. *Id.* at 326-27.

34. Shaviro, *supra* note 27, at 1458.

III. HOW TO IMPROVE THE CORPORATE AMT

Chorvat and Knoll make two proposals in their article on how to replace the corporate AMT. The first is to restrict corporate preferences when they do not have redeeming social value.[35] This is a laudable goal but politically unrealistic—even the tax expenditure budget did not help. The second is to improve disclosure by making corporations state how much regular tax they pay.[36] That may influence some highly visible corporations to actually pay more, but I doubt it—in today's political climate, paying less tax in the interest of shareholders can be perceived as a virtue. Nor will disclosure help with the tax shelter problem—the IRS has all the information and still lags behind the tax shelter phenomenon.

Retaining the corporate AMT can, however, have a significant positive impact on the corporate tax shelter problem. This problem has been getting worse recently as the government begins to lose major shelter cases on appeal.[37] But, it is likely to get even worse if the corporate AMT is repealed, because of the impact of the ACE adjustment.[38]

A little history is in order. The ACE adjustment replaced the book income adjustment that was part of the corporate AMT from 1986 to 1989. Instead of tying corporate AMT to book income, it ties it to "adjusted current earnings," which are based on earnings and profits. Earnings and profits are, of course, distinguishable from book income, but they are still closer to book income than to taxable income (for regular tax purposes).

Professor George Yin has suggested that the solution to the corporate tax shelter problem may be to tax public corporations on their book income, as is common in other countries.[39] The obvious advantage of such a proposal is that corporate managers have an incentive to increase book income, which translates into earnings per share and affects both the stock price and their compensation. Thus, the incentives of management restrict their tendency to reduce taxable income. This incentive generally overcomes the conservative nature of book accounting, which is the usual explanation for why book accounting should not be used for tax purposes.[40]

It may be no accident that the repeal of the book income adjustment for corporate AMT purposes in 1989 was followed by a huge increase in

35. Chorvat & Knoll, *supra* note 1, at 315 n.44, 330-31.

36. *Id.* at 331-32.

37. *See, e.g.*, United Parcel Serv. v. Comm'r, 254 F.3d 1014, 1019 (11th Cir. 2001); IES Indus., Inc. v. United States, 253 F.3d 350 (8th Cir. 2001); Compaq Computer Corp. v. Comm'r, 277 F.3d 778 (5th Cir. 2001).

38. I.R.C. § 56(g) (2002).

39. Yin, *supra* note 9, at 224-29; *see also* George K. Yin, *Using Book Earnings as the Default Tax Base for Public Corporations*, 92 TAX NOTES 135 (2001). *But see* Lee Sheppard, *Corporate Tax Shelters: Red Herrings and Real Solutions*, 91 TAX NOTES 2075 (2001).

40. *See* Thor Power Tool Co. v. Comm'r, 439 U.S. 522 (1979) (not one of Justice Blackmun's better tax decisions).

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the disparity between book and taxable income in the 1990s.[41] The discrepancy is only partially accounted for by the different treatment of stock options, which are deductible when exercised for tax purposes but not for book purposes, and by other obvious differences such as deferral of foreign source income.[42] One therefore suspects that part of the discrepancy is due to corporate tax shelters.[43]

The ACE adjustment serves as a partial limit to this trend, since it requires corporations to calculate their AMT based in part on adjusted earnings and profits—a measure closer to book income than to taxable income. Tax payments by corporations currently average about 20% of book income—down from about 30% after the 1986 Tax Reform Act, and approximately the same as before the 1986 Act.[44] Coincidentally or not, 20% is also the current rate of the corporate AMT.[45]

If the corporate AMT were repealed, there would be no more limits to the ability of corporate management to reduce taxable income to zero while reporting high book income for EPS purposes. Corporate tax sheltering activity would presumably increase, and with it transactional complexity and litigation activity—precisely the opposite effect from what true simplification seeks to achieve.

However, the current corporate AMT is an imperfect tool in this regard, because the ACE adjustment is not based directly on book profits. Instead, it requires corporations to calculate income in three ways—for financial accounting, for regular corporate tax, and for the ACE. As Chorvat and Knoll argue, this is unnecessarily wasteful.[46] I would suggest reverting to the pre- 1989 version of the corporate AMT and making corporations pay AMT on their book income.

Basing the corporate AMT on book income has several advantages. First, it aligns managerial incentives with those of shareholders and society; the price for inflating financial profit is paying more tax.

Second, it addresses some of the problems identified by Chorvat and Knoll with the current corporate AMT. Since there would be no direct relationship between the corporate AMT and tax preferences, basing the AMT solely on book income would mitigate any negative or distortionary effect on those preferences. And since corporations have to calculate book income anyway, it would reduce the compliance costs of the corporate AMT significantly.

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41. Martin A. Sullivan, *Study Finds Excess of Book Over Tax Income Grew in Late 1990s*, 90 TAX NOTES 717 (Feb. 5, 2001); Desai, *supra* note 22. It would be interesting to conduct an empirical study on the effects of the repeal of the book income adjustment on corporate tax revenues.

42. Desai, *supra* note 22; *see* I.R.C. § 83(h) (2002), Accounting for Stock-Based Compensation, SFAS No. 123; Accounting for Stock Issued to Employees, APB No. 25.

43. Desai, *supra* note 22.

44. This is just one of the many ways in which the 1986 Act has been reversed by recent developments. The tax rates have increased, the base has shrunk, the capital gains preference has been reintroduced, and we are back in the pre-1986 mess.

45. I.R.C. § 55(b)(1)(B)(i) (2002).

46. Chorvat & Knoll, *supra* note 1, at 313.

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Third, basing the corporate AMT on book income acts as a break on the corporate tax shelter phenomenon, in the ways identified by George Yin.[47]

IV. CONCLUSION

The corporate AMT is a low-rate, broad-based tax on corporations. As such, it would typically be considered preferable to the higher-rate, narrower-base regular corporate tax. So why not just repeal the regular tax?

The answer, of course, is revenue; the corporate AMT standing by itself would not raise the $200 billion raised by the regular corporate tax. So the solution is to retain the corporate AMT but raise its rate to 35% (or so), while abolishing the corporate tax. Alternatively, one could do what Chorvat and Knoll propose: Keep the regular tax at 35%, but make it more like the corporate AMT by abolishing all the preferences.

Unfortunately, in my opinion, none of these proposals are politically feasible. Nor is George Yin's proposal to just have a regular corporate tax based on book income.[48] In the foreseeable future, we are going to have a regular corporate tax with preferences, and Congress will be unable to prevent taxpayers from finding loopholes in it. In those second or third-best circumstances, retaining the corporate AMT is the best solution. However, it can be improved and simplified, primarily by basing it more on book income in the way proposed above.

47. Yin, *supra* note 9.
48. *Id.*

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