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Why the Corporate AMT Should Be Retained

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The corporate AMT is under attack. Repeal has been proposed by the White House, endorsed by the ABA/AICPA/TEI tax simplification project, and included in the stimulus bill passed by the House of Representatives.[1] Repeal is supported on two principal grounds: That the corporate AMT increases complexity, and that it is pro-cyclical.[2]

Both of these grounds are questionable. As for complexity, this would principally be an argument for repealing the individual AMT.[3] Corporate AMT payors can typically deal with complexity (and have to deal with considerable complexity in their regular tax returns). In addition, the key issue is transactional complexity, and I will argue below that transactional complexity will actually tend to increase if the corporate AMT is repealed.

As for the pro-cyclical character of the corporate AMT, this is only an argument for suspending it, not for permanent repeal. In addition, as Shaviro notes, the pro-cyclical character of the AMT can easily be mitigated by relatively minor changes in it or in the regular tax.[4] There is a danger here of letting the temporary economic crisis tail wag the long-term tax policy dog.

In addition, there is one aspect of the corporate AMT that has been left out of the current debate — its interaction with the corporate tax shelter problem. This problem has been getting worse recently as the government begins to lose major shelter cases on appeal.[5] But it is likely to get even worse if the corporate AMT is repealed, because of the impact of the ACE adjustment.[6]

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 is 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).

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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.[7] 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. The incentives of management thus restrict their tendency to reduce taxable income.

[1]Mohr, "House Barely Approves $160 Billion Economic Stimulus Bill," *Tax Notes*, Oct. 29, 2001, p. 586; for the position of the Treasury, *see* p. 995 of this issue.

[2]*See* Daniel Shaviro, "Tax Simplification and the Alternative Minimum Tax," *Tax Notes*, May 28, 2001, p. 1455.

[3]Significantly, the Joint Committee report on tax simplification, issued earlier this year, recommended repeal of the individual AMT but not of the corporate AMT. I would support drastically increasing the exemption from individual AMT so it only affects the taxpayers it was intended to affect — the top 1 percent of the income distribution, who can also deal with complexity.

[4]Shaviro, *supra,* note 2.

[5]*See, e.g., United Parcel Service v. Commissioner,* 254 F.3d 1014, *Doc 2001-17453 (8 original pages), 2001 TNT 122-5* (11th Cir. 2001); *IES Industries v. United States,* 2001 US App. Lexis 12881, *Doc 2001-16769 (16 original pages), 2001 TNT 116-12* (8th Cir. 2001).

[6]Section 56(g). Section references are to the Internal Revenue Code of 1986, as amended.

[7]George K. Yin, "Getting Serious About Corporate Tax Shelters: Taking a Lesson From History," 54 *SMU L. Rev.* 209 (2001); *see also* George K. Yin, "Using Book Earning as the Default Tax Base for Public Corporations," *Tax Notes*, July 2, 2001, p. 135; *but see* Lee Sheppard, "Corporate Tax Shelters: Red Herrings and Real Solutions," *Tax Notes*, June 18, 2001, p. 2075.

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.[8]

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 the disparity between book and taxable income in the 1990s.[9] 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.[10] One therefore suspects that part of the discrepancy is due to corporate tax shelters.

The ACE adjustment serves as a partial limit to this trend, since it requires corporations to calculate their AMTI 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 percent of book income — down from about 30 percent after the 1986 Tax Reform Act, and approximately the same as before the 1986 act.[11] Coincidentally or not, 20 percent is also the current rate of the corporate AMT.[12]

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. This seems a high price to pay for a temporary stimulus to the economy.[13] If the corporate AMT truly has such strong pro-cyclical effects, let us suspend it for a year and see what happens.

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[8]*See Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979) — not one of Justice Blackmun's better tax decisions.

[9]Martin A. Sullivan, "Study Finds Excess of Book Over Tax Income Grew in Late 1990s," *Tax Notes*, Feb. 5, 2001, p. 717. It would be interesting to conduct an empirical study on the effects of the repeal of the book income adjustment on corporate tax revenues.

[10]*Id.; see* section 83(h); Accounting for Stock-Based Compensation, SFAS No. 123; Accounting for Stock Issued to Employees, APB No. 25.

[11]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.

[12]Section 55(b)(1)(B)(i).

[13]Some, including the Secretary of the Treasury, would of course prefer to see the corporate tax repealed altogether. That will indeed be a simplifying move, but it may have other costs, which should be debated directly.