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TWO CHEERS FOR CORPORATE AMT REFORM

One of the few bright spots in the Taxpayer Relief Act of 1997 (TRA-97) is reform of the corporate alternative minimum tax (corporate AMT). The act's corporate AMT provisions, which were included largely because of the determination and insightfulness of House Ways And Means Committee Chairman Bill Archer (R-TX), achieve significant improvements in efficiency and simplicity.

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The corporate AMT was enacted as part of the Tax Reform Act of 1986. It constitutes an alternative corporate income tax. Corporations compute their income tax liabilities using the rules of the regular corporate income tax and then using the rules of the corporate AMT and pay whichever of the two is larger. The corporate AMT has a lower rate than the regular corporate income tax (20% vs. 35%) but a broader base.

TRA-97 makes two major changes in the corporate AMT. First, on new investments in depreciable property, AMT recovery periods will now be the same as regular-income-tax recovery periods. This is a very significant reform because the corporate AMT accomplished much of its base broadening by forcing companies to write off depreciable costs over longer time periods than the regular income tax permits. As three examples, for residential real estate the recovery period is 27.5 years under the regular income tax but was 40 years under the AMT; for transportation equipment serving air passengers, it was 7 years vs. 12 years; and for assets used in the production of wood products, it was 7 years vs. 10 years. Because of this change, the difference between corporations' regular and AMT incomes will decline sharply in future years, reducing the proportion of companies in the AMT. AMT depreciation will still be somewhat slower, however, on properties eligible under the regular income tax for the 200% declining balance depreciation method because the AMT substitutes the slower 150% declining balance method.

Second, TRA-97 frees most corporations from the AMT's laborious and confusing computations: small companies, defined as having gross revenue under $5 million, are henceforth exempt from the corporate AMT. (And, once exempt, companies remain exempt until their gross revenue exceeds $7.5 million.) It is revealing that this provision has a low revenue cost (less than $600 million over 5 years). Previously, all corporations with more than a few thousand dollars of income were required to wade through the complexities of the AMT. Very few of those companies found at the end that they actually owed the tax, but all were forced to pay a stiff price in terms of the tax-compliance costs created by the corporate AMT's heavy paperwork demands.

The rationale for the corporate AMT has been that without it some successful companies could take so many tax deductions that they could artificially reduce their taxable incomes to zero, or nearly so, and thereby avoid paying their "fair share" of tax. The corporate AMT supposedly

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guards against this alleged abuse by denying or restricting certain write offs when computing AMT income.

Underlying this rationale is the implicit assumption that many deductions are not really legitimate, that they do not help measure income accurately but instead are "tax breaks" the government extends to taxpayers for social policy or other reasons. After all, if the deductions in question are needed to compute income correctly, arbitrarily restricting them produces an overstatement—and overtaxation—of income, not a better and fairer measure of income.

In fact, the deductions of the regular income tax, far from being excessive, tend to be inadequate. By restricting them further, the corporate AMT has worsened, not improved, the measurement of income.

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Deductions, properly defined, are crucial in accurately measuring income because income is a net concept. Income is not gross revenues; it is revenues minus expenses incurred in generating revenues. Income-related expenses must be subtracted in full to calculate income correctly. Moreover, because time has value, costs must be written off when incurred — "expensed" — if income is to be measured accurately. If a cost write off is delayed, the delay will understate cost in present value terms and, so, exaggerate income.

To illustrate the timing problem created by a delayed cost write off, suppose a company buys a machine for $1,000 today but must depreciate it over 10 years using straight-line depreciation and suppose the market interest rate is 10%. When discounted, the 10-year write off has a present value of only $676. But the current cost of the machine is $1,000. Thus, the delayed write off effectively understates the actual cost by $324 and overstates true income by the same amount. That overstatement of income raises the income tax in present value terms. (A postponed write off can still afford neutral tax treatment if its nominal amount is increased sufficiently—in this example, 10% a year—to equal the current cost in present value terms, but that is much more complicated than expensing.)

It is ironic that the corporate AMT has been defended as a tax-loophole closer because, even without it, returns on corporate equity are badly overtaxed. The regular corporate income tax bars companies from deducting many of their expenditures, particularly those related to investments, when the costs occur. With depreciable assets, its misleadingly labelled accelerated depreciation schedules require current costs to be stretched out over several years. By further delaying inadequate depreciation allowances, the old corporate AMT did not remove a tax subsidy but intensified an anti-investment bias. Returns on corporate equity are also overtaxed by the regular income tax because they face not one but two rounds of income taxation: the corporate income tax and the individual income tax.

The pre-reform corporate AMT hurt the economy in two major ways. First, by overstating corporate income, it raised effective marginal tax rates, which diminishes after-tax reward for investing. To compensate for the anti-investment tax bias, businesses required higher before-tax returns on investments, causing them to reject some projects they would otherwise have undertaken. Because economic growth depends heavily on investment, the tax-induced slowdown in investment results in lower productivity, less output, lower real wages, weakened growth, and less prosperity. This year's AMT reform greatly lessened the extent to which the corporate AMT will contribute to this destructive bias in the future.

Second, compliance costs of the corporate AMT divert resources from productive uses—producing goods and services desired by consumers—to wasteful activities: more tax recordkeeping, more (very complex) tax calculations, and more tax forms. That is a deadweight loss for the American people.

A perverse characteristic of the corporate AMT is that, in practice, it is much more likely to trip up struggling companies than successful ones. When companies are doing well, their regular tax liability tends to be considerably larger than their AMT liability; hence, they pay the regular tax. Companies suffering weak current revenues but investing vigorously to remain competitive are much more likely to be caught by the corporate AMT. Particularly at risk are businesses in capital intensive, cyclical industries. Also at heightened risk are high-technology and start-up companies that invest heavily relative to current revenues. In addition to being unfair to shareholders in the affected companies, the result is a less resilient, less forward-thinking economy.

While the corporate AMT reforms are praiseworthy—they are virtually the only section of TRA-97 that both eases a tax bias and simplifies the tax code—the AMT is still a problem, albeit a smaller one than before. Because AMT depreciation does not fully conform with regular depreciation and the corporate AMT has other adjustments besides depreciation, some companies will still fall into the AMT, and the danger of that may cause those companies to reject some worthwhile investments. Also, for the corporations not exempted from the AMT, its compliance costs remain high.

Ideally, the corporate AMT, which violates basic tax principles and is costly to the economy, should be repealed. Rep. Archer recognized that and tried to phase out the corporate AMT, but the provision did not survive opposition from the Administration and the Congress. Rep. Archer also understood that the individual AMT likewise violates basic tax principles and generates serious problems of its own, but his principled effort to ease that tax was unsuccessful. Thus, the AMT is less of a drag on the economy than before, but more remains to be done.

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Note: Nothing written here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before Congress.