The Alternative Minimum Tax for Individuals: Present Problems and Future Possibilities

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THE ALTERNATIVE MINIMUM TAX FOR INDIVIDUALS: PRESENT PROBLEMS AND FUTURE POSSIBILITIES

The 1986 Tax Reform Act has drastically changed the alternative tax for individuals. It is no longer a penalty-like tax limited to the very wealthy taxpayer who overuses tax incentives. The revised alternative tax will raise substantial revenues and impose a substantial tax on a greater number of individuals. The problem with the alternative tax is that it generates complexity which, in turn, creates compliance and planning problems. The short-term solution is to expand the alternative tax base so that it, as nearly as practicable, measures economic income. The long-term solution is to gradually phase in the alternative tax as a total substitute for the regular tax.

This Comment addresses the problems presented by the revised alternative tax. First, the alternative tax is described in the context of the 1986 Tax Reform Act. Second, the new provisions of the alternative tax are analyzed to show that even with them, the alternative tax still does not tax all economic income. Third, the inefficiency and inequitable nature of the alternative tax are examined. Fourth, short and long-term solutions to the current alternative tax problems are proposed.

1. The label "alternative tax" originates from section 55 of the Internal Revenue Code which prescribes that an independent tax be levied on a specified base. This independent tax is paid in lieu of the regular tax when it exceeds the regular tax liability. I.R.C. § 55(a) (1986). The regular tax is the tax imposed by chapter one of the Internal Revenue Code of 1986 and reduced by the foreign tax credit allowed under section 27(a). Id. § 55(c).


Because the estimated alternative tax must be paid quarterly, I.R.C. § 6654(d) (1986), and the 1986 Tax Reform Act increased the required payment, JOINT COMMITTEE, supra, at 1294, and penalty for underpayment, JOINT COMMITTEE, supra, at 1272–73, the alternative tax liability and calculation must be treated seriously and will have a serious impact on the taxpayer.
I. BACKGROUND: THE ALTERNATIVE MINIMUM TAX UNDER THE 1986 TAX REFORM ACT

In the Tax Reform Act of 1986, Congress elevated the alternative tax to a key position in the federal tax system. Congress reformed the alternative tax to impose a significant tax burden on all individuals with substantial economic income and to redistribute tax burdens onto high-income taxpayers who would otherwise benefit from the Act's reduced marginal rates. The alternative tax does not, however, apply to all taxpayers all of the time. In fact, it is substituted for the regular tax when alternative tax liability exceeds regular tax liability. The 1986 alternative tax can be understood by looking at: The definition of the alternative tax base, the computation method, the rate structure and exemptions, and the provisions incorporating the alternative tax into the regular tax.

A. The Alternative Tax Base Under the 1986 Tax Reform Act

The alternative tax is a tax reform showpiece enacted by Congress in response to public concern that wealthy individuals were paying too little tax. The alternative tax is an independent measure of tax liability paid when this “alternative” amount exceeds the taxpayer's regular tax liability. Alternative taxable income differs from regular taxable income in that it includes items excluded from regular taxable income, and prescribes independent treatment of deferrals.

Before alternative taxable income can be understood, however, the different types of income must be defined and distinguished. Many income items included in the regular tax are included in the alternative tax, and are not subject to any special treatment. “Deferrals” are income items eventually subject to the regular tax, but currently subject to the alternative tax according to a separate measure.

3. See supra note 2 and accompanying text.
7. Alternative taxable income is the tax base for the alternative tax. I.R.C. § 55(b)(2) (1986). The terms “alternative taxable income” and “alternative tax base” will be used interchangeably in this Comment. Regular taxable income is the tax base for the regular tax. Id. § 63(b).
8. An example is salary income currently paid to an employee. I.R.C. § 61(a)(1) (1986). These income items are not subject to any special treatment by the alternative tax, but are included because one starts with regular taxable income in determining alternative taxable income. Id. § 55(b). These income items are not taxed twice because the alternative tax is only paid to the extent that it exceeds the regular tax. Id. § 55(a).
9. The regular tax treatment of deferrals generally allows deductions exceeding actual loss to be taken currently, thereby deferring the regular tax. For example, the entire cost of residential...
Alternative Minimum Tax Possibilities

"sions" are income items never subject to the regular tax, but subject to the alternative tax. Because deferrals and exclusions are the only types of alternative taxable income which deviate from regular taxable income, these will be described in detail below.

The deferral items most likely to cause alternative tax liability are real and personal property depreciation, incentive stock options, and income reported on the installment method of accounting. The alternative tax depreciation deduction for most real and personal property is taken in lieu of the depreciation deduction allowed for the regular tax. The substitution of a lower depreciation deduction will probably cause alternative taxable income to increase relative to regular taxable income in earlier years. The excess of the fair market value over the exercise price of incentive stock options is included in alternative taxable income, although this excess is excluded from regular taxable income until the stock is transferred. In determining gain or loss for the alternative tax, the fair market value is substituted for the adjusted basis in the stock. Income accounted for under the installment method must, for certain transactions, be recognized to the extent of the full amount realized in rental property is deducted within 27.5 years for the regular tax even though the property has a useful life exceeding 27.5 years.

10. For example, the regular tax does not include interest income on private activity bonds in taxable income. I.R.C. §§ 103(a), 141 (1986). The alternative tax, however, includes this interest income in alternative taxable income. Id. § 57(a)(5).

11. I.R.C. § 168(g) (1986). The alternative depreciation generally requires a longer depreciation period. For example, the depreciation period for residential rental property is 40 years, id. § 168(g)(2)(C)(iii), as opposed to 27.5 years for the regular tax computation, id. § 168(c).


13. Id. § 56(a)(6). The alternative tax contains the following deferral items: Real and personal property depreciation, id. § 56(a)(1); mining exploration and development costs, id. § 56(a)(2); accounting for certain long-term contracts, id. § 56(a)(3); certified pollution control facilities, id. § 56(a)(5); the installment method of accounting, id. § 56(a)(6); circulation and research expenditures, id. § 56(b)(2); intangible drilling costs, id. § 57(a)(2); and incentive stock options, id. § 57(a)(3).

14. I.R.C. § 56(a)(1) (1986). For section 1250 property and property for which the depreciation deduction for the regular tax is calculated under the straight line convention, the straight line convention is used for the alternative tax. Id. § 56(a)(1)(A). The 150 declining balance convention is used for other tangible property except certain public utility property, films and video tape, sound recordings, and property depreciated under the unit-of-production method. Id. §§ 56(a)(1)(B), 168(f). The alternative tax base has been extended from prior law to include all tangible personal property. Id. § 56(a)(1)(A).

15. Joint Committee, supra note 2, at 439 n.11. Because the regular tax depreciation deduction is typically overstated in earlier years, the alternative tax deduction will be less.


17. Id. § 56(a)(3)(B).
the disposition year.\textsuperscript{18}

The measure of excluded income under the alternative tax also differs from the regular tax. The alternative tax personal interest deduction is more restrictive than the regular tax personal interest deduction. The regular tax allows a deduction for interest on indebtedness secured by the taxpayer's home and one other residence, to the extent that the indebtedness does not exceed the combined adjusted basis of these residences, increased by certain medical and educational expenses.\textsuperscript{19} In contrast, the alternative tax limits interest deductions to amounts used to acquire or construct a principal plus one other residence.\textsuperscript{20} The phase-in rules that apply to the regular tax do not apply to the alternative tax.\textsuperscript{21}

Some exclusionary preferences are added to the alternative tax base but not to the regular tax base. Tax-exempt interest income on specified private activity bonds is included in alternative taxable income.\textsuperscript{22} The excess of the regular tax deduction over the adjusted basis of property donated to a charity is included in alternative taxable income.\textsuperscript{23} Personal exemptions\textsuperscript{24} and the standard deduction\textsuperscript{25} which offset regular taxable income are added back into alternative taxable income.

\textsuperscript{18} Id. § 56(a)(6). This treatment applies to the sale of section 1221(1) property, id. § 56(a)(6)(A), or applicable installment obligations, id. § 56(a)(6)(B). Applicable installment obligations include the sale of personal property and real property by a dealer, and the sale of rental property where the fair market value exceeds $150,000. Id. § 453C(3)(1)(A)(i).

\textsuperscript{19} I.R.C. § 163(h) (1986).

\textsuperscript{20} Id. § 56(e).

\textsuperscript{21} Id. § 56(b)(1)(c)(ii). The alternative tax treatment of the remaining exclusions has not changed significantly. The sum in excess of the deduction for depletion taken over the adjusted basis of the property is included in alternative taxable income. Id. § 57(a)(1).

Generally, the remaining itemized deductions include those for investment interest to the extent of net investment income, id. § 163; gambling losses to the extent of gambling gains, id. § 165(d); casualty losses, id. § 165(h); charitable contributions, id. § 170; medical expenses to the extent they exceed ten percent of adjusted gross income, id. § 213; and the estate tax deduction. Id. § 691(c).

Under the 1986 Tax Reform Act, itemized deductions are generally allowed, because the alternative tax begins with regular taxable income. Id. § 55(b). Miscellaneous itemized deductions and the deduction for property and income taxes, however, are not allowed. Id. § 56(b)(a)(A).

\textsuperscript{22} I.R.C. § 57(a)(5) (1986).

\textsuperscript{23} Id. § 57(a)(6).


\textsuperscript{25} I.R.C. § 56(b)(2)(E) (1986).
B. Calculating the Alternative Tax

The 1986 Tax Reform Act separates the alternative tax from the regular tax and applies the alternative tax to the alternative tax base, not the regular tax base. Rather than measuring alternative tax liability by the deductions from regular taxable income, the alternative tax prescribes an independent method for calculating deferral items. Because deferrals for the alternative tax are calculated independently from the regular tax, the alternative tax measures income more consistently. Furthermore, under the alternative tax, an independent adjusted basis for property is used to measure gain or loss. The result of these provisions is that the alternative tax is independent from the regular tax.

The alternative tax is, thus, computed from alternative taxable income not regular taxable income. The 1986 Tax Reform Act defines alternative taxable income as regular taxable income, adjusted by the realignment of deferral preferences, increased by the exclusionary income preferences, and decreased by the alternative tax net operating loss. The alternative tax net operating loss is the counter-
part to the regular tax net operating loss, and arises when there is negative alternative taxable income. The alternative tax net operating loss, however, cannot reduce alternative taxable income by more than 90%.\textsuperscript{35} In calculating alternative taxable income, certain losses cannot be deducted or may only be partially deducted.\textsuperscript{36} The at-risk limitations apply.\textsuperscript{37}

Alternative taxable income is reduced by a $40,000 exemption amount\textsuperscript{38} and the remainder taxed at 21%.\textsuperscript{39} The exemption amount, however, is phased out for alternative taxable income in excess of $150,000.\textsuperscript{40} The alternative tax is itself reduced by the alternative tax

\textsuperscript{35} \textit{Id.} § 56(d)(1)(B)(ii). The alternative tax net operating loss consists of any negative alternative taxable income after deferrals, exclusions and investment interest limit have been applied. \textit{Id.} § 56(d)(2). Because these alternative tax provisions must be applied, the alternative tax net operating loss is independent of the regular tax and causes different amounts to be carried forward. JOINT COMMITTEE, \textit{supra} note 2, at 468–69.

\textsuperscript{36} The alternative tax maintains the passive loss rules for the regular tax, I.R.C. § 58(b) (1986), and the investment interest limit, \textit{id.} § 163(d). The application of these rules to alternative taxable income, however, generally allows the taxpayer to suspend a smaller amount of loss. JOINT COMMITTEE, \textit{supra} note 2, at 447-48. For example, passive losses are less under the alternative tax than under the regular tax when deferral items offset alternative taxable income to a lesser extent than regular taxable income. Specifically, in early years, the depreciation allowance for equipment will be greater under the regular tax than the alternative tax. Assuming other expenses equal gross income, the regular tax loss generated by the depreciation allowance will be greater than the alternative tax loss.

\textsuperscript{37} H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-262 (1986), \textit{reprinted in The Tax Reform Act of 1986, 986 Tax Mgmt.} (BNA) 758 (1986). The at-risk limitation defined in section 465 of the Internal Revenue Code applies to amounts otherwise deductible from the alternative tax. \textit{Id.} Like the passive loss limitation, the at-risk limitation is applied after deferral items are adjusted, and exclusionary items are added in. \textit{Id.} Because deductions will usually be less for the alternative tax, the at-risk limitations will cause lesser amounts to be suspended.

\textsuperscript{38} All explanations and examples in this Comment are based on married individuals filing jointly. The numerical amounts differ for single individuals and estates or trusts. The status of the taxpayer determines which exemption amount is applicable. For a married couple filing jointly or a surviving spouse, the exemption is $40,000. The exemption is $30,000 for other individuals and $20,000 for a married individual filing separately or an estate or trust. I.R.C. § 55(d)(1) (1986).

\textsuperscript{39} I.R.C. § 55(b)(1) (1986).

\textsuperscript{40} The exemption is phased out for married individuals filing jointly and surviving spouses with income over $150,000. \textit{Id.} § 55(d)(3)(A). The level is set at $112,500 for other individuals and estates or trusts, and $75,000 for married individuals filing separately. \textit{Id.} § 55(d)(3)(B)–(C). For example, a married couple filing jointly will be allowed the following exemption (amounts are in thousands):

108
foreign tax credit. Finally, taxes computed under the alternative tax provisions are paid only to the extent that they exceed regular taxes.

C. The New Role of the Tax Rate and Exemption Amount Under the 1986 Tax Reform Act

The net effect of the 1986 Tax Reform Act is that the alternative tax will exceed regular tax liability more often and the individual, therefore, will incur alternative tax liability more often. While the new law increased the alternative tax from 20% to 21% of taxable income, the 1986 Tax Reform Act reduced the maximum regular tax rate from 50% to 28%. Because of these two factors, the relative increase in the alternative tax rate is substantial. For example, under prior law, the marginal regular tax rate increased from 0% to 50%. The maximum average tax rate, therefore, nearly equaled 50%. Where the alternative tax rate was 20%, the alternative rate was 40% of the regular rate. Under new law, where the alternative tax rate is 21% and the regular rate is 28%, the alternative rate is 75% of the regular rate. The alternative tax will thus more often exceed the regular tax.

The alternative tax is more likely to apply because of the treatment of the exemption. Additional income will be subject to the alternative tax.

<table>
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<th>Amt. of Income</th>
<th>Exemption</th>
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<tr>
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<tr>
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<td>2.5</td>
</tr>
<tr>
<td>310+</td>
<td>0.0</td>
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41. I.R.C. § 55(b)(1)(B) (1986). This credit, however, may only reduce the alternative tax liability by 90%. Id. § 59(a)(2). The limitation on the alternative foreign tax credit and the alternative net operating loss applies cumulatively, so both taken together may not reduce the taxpayer's alternative tax liability by more than 90%. JOINT COMMITTEE, supra note 2, at 470–71.

42. I.R.C. § 55(a) (1986).

43. The projected increase in revenues raised by the alternative tax demonstrates this effect. See supra note 2 and accompanying text.

44. The maximum marginal rate is 33% for income exceeding a stated level, but is reduced to 28% when the tax on personal exemptions and lower levels of income is the equivalent of 28%. I.R.C. § 1(g) (1986). Consider, for example, a married couple filing jointly with taxable income of $250,000 and two personal exemptions. Assuming no standard deduction, the couple will take $4,000 for personal exemptions, pay tax at 15% on the first $29,750; 28% on the following $42,150; 33% on $99,750; and then 28% on the remaining $74,350. Id. §§ 1(a), 1(g), 151(d). The overall effect of these three marginal tax rates is an average tax rate of 28% on $250,000 of the couple's taxable income. Since the tax rate for higher income levels for the couple will always be 28%, the maximum average tax rate is 28%.
tax because the exemption is phased out when alternative taxable income exceeds a certain level. For example, when the exemption was constant, a taxpayer with alternative taxable income of $310,000 paid tax on $270,000. Now, the $40,000 exemption amount is completely phased out and the individual pays tax on $310,000.

D. Provisions Integrating the Alternative Tax with the Regular Tax

Two alternative tax provisions integrate with the regular tax. The minimum tax credit prevents double taxation of deferral items. To the extent that alternative tax is incurred because of the inclusion of deferral items, the minimum tax credit offsets alternative tax liability against regular tax liability. In order to determine the minimum tax credit, the taxpayer recalculates alternative tax liability using exclusionary preferences, not deferral preferences. The minimum tax credit amount is the total alternative tax liability decreased by the portion recalculated using only exclusionary items. The minimum tax credit reduces regular, not alternative, tax liability in subsequent years to the extent the regular tax exceeds the subsequent alternative tax. The unused portion of the minimum tax credit is carried forward until it is applied against the regular tax.

The taxpayer may avoid alternative tax liability by electing alterna-

45. See supra note 40 and accompanying text.
46. I.R.C. § 53(b) (1986).
47. Id. The exclusions for this second calculation include the preferences for depletion, tax exempt interest, charitable contributions of appreciated property, and the disallowed portion of itemized deductions. Id. § 53(d)(1)(B)(ii). See supra note 13 and accompanying text for a list of deferrals accounted for by the minimum tax credit.
48. I.R.C. § 53(b) (1986). This method of calculating the minimum tax credit allows the taxpayer the full benefit of the exemption amount.

The minimum tax credit reduces the regular tax in subsequent years to the extent that it was incurred because of deferral items. Since deferral items are eventually subject to the regular tax, the minimum tax credit is necessary in order to avoid double taxation. JOINT COMMITTEE, supra note 2, at 436; Streer & Holland, Working with the Revised Alternative Tax for Individuals, TAX ADVISER, Mar. 1987, at 150. The potential for double taxation is illustrated by the following example. When an employee exercises an incentive stock option, the employee has income subject to the alternative tax equal to the difference between the exercise price and the fair market value at the time the option is exercised. I.R.C. § 57(a)(3) (1986). Regular tax liability only occurs upon the subsequent disposition of the stock purchased with the option. Id. § 421(a). When disposition of stock occurs, the employee will recognize gain for regular tax purposes equal to the difference in the exercise price and the amount realized. Id. § 1001. Thus, without the minimum tax credit, the difference between the exercise price and the fair market value at the time the option was exercised would be taxed by both the alternative tax and the regular tax.
49. I.R.C. § 55(c) (1986).
50. Id. § 53(b).
tive tax treatment of deferrals for the regular tax.\textsuperscript{51} If such an election is made, certain “qualified expenditures” are omitted from alternative taxable income calculations.\textsuperscript{52} These expenditures do not increase alternative taxable income relative to taxable income, thus taxpayers decrease their chance of incurring alternative tax liability. Although alternative taxable income would not change for “qualified expenditures,” a taxpayer with excess income from exclusions still incurs alternative tax liability.

II. ANALYSIS: PROBLEMS AND PROPOSED SOLUTIONS

The alternative tax is fundamentally flawed because of the problems it presents to the tax system by not accurately measuring economic income. Rather than taxing all economic income, the alternative tax adds a complex layer of unnecessary provisions that limit or suspend deductions.\textsuperscript{53} A dual tax system, with both an alternative tax and a regular tax, creates inefficiencies and inequities.\textsuperscript{54} The short-term solution is to expand the alternative tax base until it accurately measures economic income. When it does so, the regular tax should be gradually phased out to eliminate the dual tax system.\textsuperscript{55}

A. The Alternative Tax Does Not Tax Economic Income

The alternative tax does not tax all economic income. Economic income is classically defined as “the algebraic sum of (1) the market

\begin{itemize}
\item \textsuperscript{51}\textit{Joint Committee}, \textit{supra} note 2, at 437. The regular tax provides that the taxpayer may elect to depreciate other deferrals under section 168(g) of the Internal Revenue Code. I.R.C. § 168(b)(3) (1986). Electing to depreciate under section 168(g) also will reduce the potential for incurring alternative tax liability.
\item \textsuperscript{52} “Qualified expenditures” include circulation and research and experimentation expenditures, mining exploration expenditures, and, to some extent, intangible drilling costs. I.R.C. § 59(e) (1986).
\item \textsuperscript{53} These are the passive loss, investment interest, and net operating loss limits. \textit{See supra} notes 35-36 and accompanying text.
\item \textsuperscript{54} Rather than reforming the tax system to provide for one simple tax that taxed all economic income, without an added layer of complicated limits, Congress devised two complicated taxes. The tax system under the 1986 Tax Reform Act consists of a regular tax with an added layer of limits and an alternative tax with a similar layer of limits.
\item \textsuperscript{55} Congress could instead reform the regular tax and repeal the alternative tax. This course would result in a simple and fair tax in an arguably more direct manner. Reforming the alternative tax, however, may be more feasible given the political process. The alternative tax could be reformed to tax all economic income without substantially impacting most taxpayers. When the alternative tax rate is increased in relation to the regular tax rate, all preferences are impacted. Each special interest group by itself, therefore, has less of an incentive to challenge incremental increases in the alternative tax rate. \textit{See generally Graetz}, \textit{The 1982 Minimum Tax Amendments as a First Step in the Transition to a “Flat-Rate” Tax}, 56 S. CAL. L. REV. 527 (1983) [hereinafter Graetz].
\end{itemize}
value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question.\footnote{56} Despite the definition's straightforward simplicity, scholars have vigorously debated whether specific items are income, and whether such items should remain untaxed.\footnote{57} This Comment's analysis of the alternative tax does not require a precise definition of all sources of economic income. Instead, this section establishes the premise that the alternative tax does not measure economic income even to the extent practicable. Before noting income sources that the alternative tax excludes entirely, this section examines the measure of certain alternative tax provisions that are inconsistent with the concept of economic income.

1. The Alternative Tax Improperly Measures Income Included in the Alternative Tax Base

The alternative tax inaccurately measures economic income for several reasons. The alternative tax defers income from installment sale proceeds. Economic income from installment sales of property is realized in full at the time of the sale,\footnote{58} but the alternative tax only taxes current income from some installment sales.\footnote{59}

The alternative tax also does not account properly for research and development expenditures and circulation costs. Both are capital costs, and to measure economic income accurately these costs should be amortized over the duration of the research project or the circulation subscription, not over ten and three years respectively. Where useful lives cannot be pragmatically measured, these costs are usually allowed on the disposition of the enterprise generating the costs.\footnote{60} The failure to capitalize these costs over the proper period causes the

\footnote{56. H. Simons, Personal Income Taxation 50 (1938).}
\footnote{58. Id. at 40-41.}
\footnote{59. See supra note 18 and accompanying text. The failure to include all items sold on the installment method in the alternative tax base may allow the taxpayer to avoid paying tax on those items which are included in the alternative tax base. A taxpayer could presumably incorporate the property as an S-Corporation prior to the transaction, and then sell the stock in the S-Corporation on the installment method. Because the alternative tax does not include installment sales of stock in its disallowance of installment treatment, the taxpayer effectively sold a rental home on the installment method without paying the alternative tax. Id.}
\footnote{60. This is the treatment received by other capital costs where the applicable useful life cannot be measured, such as goodwill. I.R.C. § 263(b) (1986).}
amount of the deduction and the alternative taxable income to deviate from economic income.

Because the alternative tax convention for depreciating real and personal property sometimes allows a deduction greater than economic loss, the alternative tax does not measure economic income. Although straight-line depreciation is used for real property, the alternative tax retains incentive treatment for personal property. In addition, economic depreciation depends on the choice of the asset life. While the alternative depreciation uses longer property lives for depreciable assets than the regular tax depreciation, these lives still do not correspond to the property's actual life. By allowing a taxpayer a deduction greater than economic loss, the alternative tax inaccurately measures economic income.

Like the regular tax, the alternative tax does not tax all interest income. The interest on public purpose bonds remains untaxed by either the regular or alternative tax, yet the alternative tax includes interest on private activity bonds.

Finally, economic income is offset because the alternative tax does not treat drilling costs as capital costs. Under the regular tax, certain taxpayers elect percentage depletion in lieu of cost depletion for tangible and intangible drilling costs. Although the alternative tax prevents offsetting economic income by limiting the percentage depletion for the regular tax, it should require the substitution of cost depletion for the regular tax allowance. The alternative tax also expenses intangible drilling costs for nonproductive wells. These expenditures should be deducted according to cost depletion because they are capital costs incurred in the search for a productive well.

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61. **Joint Committee, supra** note 2, at 433 (the 150% depreciation rate allowance for certain property exists for investment incentive purposes; it is not intended to reflect an attempt to measure economic depreciation).


63. **I.R.C. § 168(g)** (1986). For example, the alternative depreciation allows the full cost of a home to be deducted within 40 years. **Id. § 168(g)(2).** Most residential real property likely has a useful life longer than 40 years.

64. **I.R.C. §§ 57(a)(5), 103(a)** (1986).

65. **Id. § 57(a)(5).**

66. **Id. § 613.**

67. **Id. § 263(c).**

68. **Id. § 57(a)(2).**

69. **Id. § 57(a)(2)(B)(i).**

70. These expenditures are analogous to research and development expenditures for a nonproductive project. The alternative tax, however, does not allow these expenditures to be expensed. **Id. § 56(b)(2).**
2. *The Alternative Tax Does Not Include All Income Excluded from the Regular Tax*

Even more critical, if the alternative tax is to measure economic income accurately, many other sources of income should be taxed by the alternative tax. Some of the more significant omissions include: Reinvested proceeds from home sales;\(^1\) $125,000 one-time exclusion for a home sale by a taxpayer over fifty-five years of age;\(^2\) deferral of recognition from like-kind exchanges of property;\(^3\) other nontaxable exchanges;\(^4\) unrealized appreciation;\(^5\) interest on life insurance reserves; exempt unrealized appreciation for assets held until death; amounts received by gift or inheritance to the extent not taxed elsewhere; and nonstatutory and statutory fringe benefits.\(^6\)

B. *The Alternative Tax Is Inefficient*

The alternative tax is inefficient because it creates a dual tax system and it contains unnecessary and complicated provisions that stem from the tax’s failure to accurately measure economic income. These provisions include the alternative tax net operating loss limit, the passive activity loss limit, and investment interest limit.\(^7\) All of these limits do not allow amounts otherwise deductible and create inefficiency. The dual tax system also implements the minimum tax credit, independent treatment of deferrals, alternative net operating loss, and alternative foreign tax credit. These alternative tax provisions complicate the tax system by requiring that various allowances be accounted for separately and extra calculations be performed to determine alternative tax liability. The extra calculations and bookkeeping impair the taxpayer’s ability to make investment decisions informed of the tax costs.

The passive loss, investment interest, and the net operating loss limits all lead to additional and inefficient calculations for the alternative tax. The passive loss limit requires the taxpayer to carry forward passive losses in excess of passive gains.\(^8\) The investment interest limit requires the taxpayer to suspend an otherwise allowable investment

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\(^1\) *Id.* § 1034(a).
\(^2\) *Id.* § 121(a).
\(^3\) *Id.* § 1031(a).
\(^4\) *Id.* §§ 1031–1042.
\(^5\) *Id.* § 1001.
\(^6\) See Graetz, *supra* note 55, at 555–59, for a thorough discussion of sources of economic income which should be included in the alternative tax base.
\(^7\) See *supra* note 35–36 and accompanying text.
\(^8\) I.R.C. § 58(b) (1986).
interest deduction when investment interest exceeds investment income.\textsuperscript{79} The net operating loss limit requires any alternative tax net operating loss in excess of 90% of alternative taxable income to be carried forward.\textsuperscript{80} The taxpayer must calculate each of these limits after determining the measure of all exclusions and deferrals.

Not surprisingly, the passive loss,\textsuperscript{81} investment interest,\textsuperscript{82} and the net operating loss limits\textsuperscript{83} require the taxpayer to keep extensive records of certain income, expenses, and losses as well as records of amounts suspended or carried forward for each of these limits. The taxpayer must apply the passive loss and investment interest limits independently from similar limits applied under the regular tax.\textsuperscript{84} The taxpayer must keep separate records because the alternative tax limits require different amounts to be carried forward.\textsuperscript{85} The taxpayer must also record suspended passive losses for individual passive activities because these losses will later be allowed if the taxpayer disposes of the entire interest in the passive activity.\textsuperscript{86} The net operating loss limit is unique to the alternative tax, so the taxpayer will record suspended net operating losses for the alternative tax.

The taxpayer also must perform separate calculations on deferrals,\textsuperscript{87} the alternative tax net operating loss,\textsuperscript{88} the foreign tax credit,\textsuperscript{89} and the minimum tax credit.\textsuperscript{90} The taxpayer is required to calculate deferrals for the alternative tax because the measure of each deferral is independent of the regular tax.\textsuperscript{91} In addition to the net operating loss calculation under the regular tax, the taxpayer calculates the alternative tax net operating loss after exclusions and deferrals are included in the tax base.\textsuperscript{92} Independent of the regular foreign tax credit, the taxpayer determines the alternative tax foreign tax credit based on alternative taxable income subject to foreign taxation.\textsuperscript{93} The minimum tax

\begin{flushleft}
\textsuperscript{79} Id. § 56(b)(1)(c).
\textsuperscript{80} Id. § 56(d).
\textsuperscript{81} Id. § 58(b).
\textsuperscript{82} Id. § 56(b)(1)(e).
\textsuperscript{83} Id. § 56(d).
\textsuperscript{84} Id. § 58(b); JOINT COMMITTEE, supra note 2, at 447.
\textsuperscript{85} See supra notes 35-36 and accompanying text.
\textsuperscript{86} I.R.C. § 469(g) (1986). The passive loss provisions, such as the allowance of suspended losses on disposition, apply for the alternative tax after the taxpayer accounts for deferrals and exclusions. Id. § 55(b).
\textsuperscript{87} See supra note 9 and accompanying text.
\textsuperscript{88} See supra note 35 and accompanying text.
\textsuperscript{89} See supra note 41 and accompanying text.
\textsuperscript{90} See supra notes 46-50 and accompanying text.
\textsuperscript{91} See supra note 9 and accompanying text.
\textsuperscript{92} See supra note 35 and accompanying text.
\textsuperscript{93} See supra note 41 and accompanying text.
\end{flushleft}
credit, unique to the alternative tax, requires two calculations of alternative tax liability, the first with all exclusions and deferrals, and the second with only exclusions. 94 Finally, the taxpayer calculates the minimum tax credit limit by which the regular tax is reduced in the future. 95

Deferrals, the alternative tax net operating loss, the foreign tax credit, and the minimum tax credit also require extra bookkeeping. Because the adjusted basis for deferrals differs from the adjusted basis for the regular tax and applies when the taxpayer calculates future gain or loss, the taxpayer must maintain separate books for the adjusted basis of each deferral. Similarly, the taxpayer must record the alternative tax net operating loss and foreign tax credit separately from the regular tax amount because these amounts also differ for the alternative tax. The minimum tax credit must be recorded also, so that the taxpayer can reduce regular tax liability in the future.

The problem with the alternative tax is that because it is complicated, taxpayers may not calculate the tax cost for an individual business decision. The taxpayer, therefore, cannot make informed investment decisions. Taxpayers who face a variable tax rate cannot determine the tax cost until every item of alternative taxable income is estimated. For alternative taxable income less than $310,000, the effective alternative tax rate 96 is variable, and depends on the amount of alternative taxable income. 97 The estimated income from all the

94. See supra notes 47–48 and accompanying text.
95. See supra note 49 and accompanying text.
96. As used herein, the effective tax rate is the flat rate which would yield the same tax cost as the regular tax or alternative tax. Once the effective rate is known, the tax cost is calculated by multiplying the rate by taxable income for the investment.
97. A married individual filing jointly, will face the following exemption amount and effective tax rate for each level of alternative taxable income:

<table>
<thead>
<tr>
<th>AMTI</th>
<th>EXMT</th>
<th>NET</th>
<th>TAX</th>
<th>EFF RATE</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>40.0</td>
<td>(40.0)</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>40</td>
<td>40.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>50</td>
<td>40.0</td>
<td>10.0</td>
<td>2.1</td>
<td>4.2</td>
</tr>
<tr>
<td>75</td>
<td>40.0</td>
<td>35.0</td>
<td>7.35</td>
<td>9.8</td>
</tr>
<tr>
<td>100</td>
<td>40.0</td>
<td>50.0</td>
<td>12.6</td>
<td>12.6</td>
</tr>
<tr>
<td>125</td>
<td>40.0</td>
<td>85.0</td>
<td>17.85</td>
<td>14.3</td>
</tr>
<tr>
<td>150</td>
<td>40.0</td>
<td>110.0</td>
<td>23.1</td>
<td>15.4</td>
</tr>
<tr>
<td>175</td>
<td>33.75</td>
<td>141.2</td>
<td>29.66</td>
<td>17.0</td>
</tr>
<tr>
<td>200</td>
<td>27.5</td>
<td>172.5</td>
<td>36.23</td>
<td>18.1</td>
</tr>
<tr>
<td>225</td>
<td>21.25</td>
<td>203.75</td>
<td>42.79</td>
<td>19.0</td>
</tr>
<tr>
<td>275</td>
<td>8.75</td>
<td>266.25</td>
<td>55.9</td>
<td>20.3</td>
</tr>
<tr>
<td>300</td>
<td>2.5</td>
<td>297.5</td>
<td>62.48</td>
<td>20.8</td>
</tr>
<tr>
<td>310+</td>
<td>0.0</td>
<td>310</td>
<td>65.1</td>
<td>21.0</td>
</tr>
</tbody>
</table>
Alternative Minimum Tax Possibilities

year's investments must be known in order to predict the amount of the alternative tax. Moreover, because the alternative tax is paid only when it exceeds the regular tax, the taxpayer must calculate both the regular tax and alternative tax with these estimates. Since many taxpayers will now have to calculate two complicated taxes, the taxpayer's ability to make informed business decisions is impaired.

For taxpayers who face a constant tax rate, the minimum tax credit still complicates predicting the tax cost of a particular business decision, even though neither the regular nor alternative tax for the entire year must be calculated.98 Because of this problem, these taxpayers also cannot make informed investment decisions. Taxpayers with alternative taxable income well in excess of $310,000 and greater than 133% of regular taxable income will face a constant rate of 21%.99 Similarly, taxpayers with income well in excess of $171,650 and with alternative taxable income well under 133% of regular taxable income will face a constant rate of 28%.100 Although these taxpayers can accurately predict the tax cost of a particular investment without knowing all sources of income,101 they still must know whether they will be subject to the regular tax in determining if the prior year's alternative tax liability is reduced.102


For alternative taxable income between zero and $310,000, the phase out of the exemption causes the effective rate to increase from 0% to 21%. Because the exemption is completely phased out for alternative taxable income greater than $310,000, this taxpayer will face a constant 21% alternative tax rate.

98. Because the tax rate for these taxpayers does not depend on alternative taxable income, this calculation is not necessary.

99. For alternative taxable income greater than $310,000, the exemptions are phased out and all income is subject to the flat 21% alternative tax rate. See supra note 97 and accompanying text. Where alternative taxable income is greater than 133% of regular taxable income, the alternative tax will exceed the regular tax, and the taxpayer will be subject to a constant 21% tax rate. For example, consider a taxpayer with regular taxable income of $300,000, and alternative taxable income of $400,000 (133% of $300,000). The alternative tax equals $84,000 (21% of $400,000), and the regular tax also equals $84,000 (28% of $300,000). If alternative taxable income is any greater than 133% of regular taxable income, the alternative tax exceeds the regular tax and the taxpayer is subject to a constant 21% tax rate.

100. The regular tax is effectively a flat tax where income exceeds $171,650. If alternative taxable income is less than 133% of regular taxable income, the regular tax will exceed the alternative tax, and the regular tax rate will apply. The taxpayer, therefore, will face a constant 28% tax rate.

101. Because these taxpayers face a flat tax rate, the effective tax rate does not depend on total alternative or regular taxable income. The tax cost, therefore, can be calculated without knowing the entire year's estimated income.

102. See supra note 49 and accompanying text. Where the minimum tax credit allows the current tax cost for an investment to offset the regular tax in future years, the tax cost is reduced.
The passive loss, investment interest, and net operating loss limits still prevent all taxpayers from making informed investment decisions. For example, by suspending losses in excess of passive gains, the passive loss limit forces the taxpayer to assess the source and extent of all passive income and losses before the taxpayer knows the amount of passive income from an investment subject to tax.\textsuperscript{103} The taxpayer also must predict when and whether to dispose of any interest in a passive activity that will further reduce the effective tax on passive income.\textsuperscript{104} The investment interest limitation similarly requires that the taxpayer know all investment income and expenses before determining the amount of income subject to tax.\textsuperscript{105} Finally, the net operating loss limit requires not only that the taxpayer know all items of loss, but also the total alternative taxable income.\textsuperscript{106} All of these limits force the taxpayer to estimate income and losses other than that of the single investment and thereby prevent the taxpayer from making an informed investment decision.

In addition, the alternative tax will increase compliance costs. The taxpayer will need to consult computer experts, accountants, and tax lawyers in an attempt to understand the alternative tax and make informed business decisions. Taxpayers and government alike will struggle with the extra calculations and extra records that benefit no one and are lost to all.\textsuperscript{107}

C. The Alternative Tax Is Inequitable

The alternative tax is inequitable because it is one of two taxes in a dual tax system and it does not measure economic income. The failure to measure economic income prevents the alternative tax from being a horizontally equitable tax and from being a graduated tax. Even if the alternative tax measured economic income and Congress eliminated the added layer of complex limits, the dual tax system would still limit the equity of the overall tax structure.

First, the alternative tax fails to achieve horizontal equity. Horizontal equity is achieved when taxpayers of the same economic income

\textsuperscript{103} If passive losses are disallowed, then more passive income is subject to tax.
\textsuperscript{104} Formerly suspended passive losses are allowed in full when the taxpayer disposes of his entire interest in a passive activity. I.R.C. § 469(g) (1986).
\textsuperscript{105} Because investment interest can only be deducted to the extent of investment income, taxable income and thus the effective tax rate depends on the total investment income. Id. § 163(d).
\textsuperscript{106} The net operating loss limit restricts losses to 90% of alternative taxable income, id. § 56(d), so alternative taxable income must be known before the limit can be calculated.
bear similar tax burdens. The alternative tax does not tax all economic income, so one taxpayer is taxed on a greater portion of economic income and bears a greater tax burden than another taxpayer with the same economic income. The alternative tax’s treatment of income derived from installment sales demonstrates this lack of horizontal equity. For example, if one taxpayer, \( T_1 \), sells a rental home for $200,000 on contract and reports the income under the regular tax installment method, the alternative taxable income in the year of the sale is $200,000 less any return on the adjusted basis in the taxpayer’s home.\(^{108}\) If another taxpayer, \( T_2 \), sells a yacht for $200,000 on contract and reports the income on the installment method, the alternative taxable income is the amount of the downpayment less any return on the adjusted basis in the yacht.\(^{109}\) Both \( T_1 \) and \( T_2 \) have the same economic income but \( T_2 \) has substantially less alternative tax liability, and can defer the regular tax liability on the disposition of the yacht.\(^{110}\) The sophisticated taxpayer may take advantage of this failure to tax all economic income and be rewarded while the less sophisticated taxpayer is penalized by the complicated provisions of the alternative tax.\(^{111}\)

Even if the alternative tax measured economic income, the tax system is not horizontally equitable to the extent the taxpayer is not subject to the alternative tax. For example, consider \( T_1 \) and \( T_2 \), both with $30,000 of fully taxable salary income. Although \( T_2 \) has an additional $10,000 of tax exempt interest income, both \( T_1 \) and \( T_2 \) bear the same regular tax burden, and neither is subject to the alternative tax.\(^{112}\) If the tax was horizontally equitable, \( T_2 \), with the greater economic income, would pay more tax than \( T_1 \), but instead \( T_1 \) pays a greater percentage of income.

The alternative tax is also not equitable because it is not progressive. A graduated or progressive tax is one that imposes a higher tax rate on


\(^{109}\) Id. § 453. The special alternative tax treatment of installment sales does not apply to the sale of a yacht. Id. §§ 56(a)(6), 453C(e)(1)(A).

\(^{110}\) One may argue that the sale of rental property should be taxed while the sale of personal property, such as a yacht, should not. Both transactions, however, give rise to the same amount of economic income. Both \( T_1 \) and \( T_2 \) received the same right to $200,000 in installment payments. Economic income does not depend on the source of the income, only on the extent of the value received.

\(^{111}\) See supra note 59 and accompanying text for an example of how a sophisticated taxpayer may avoid the alternative tax.

\(^{112}\) This example assumes for illustration that both \( T_1 \) and \( T_2 \) are married and filing jointly so that all of their income would be offset by the $40,000 exemption amount. I.R.C. § 55(d)(1) (1986).
higher income taxpayers. Under a graduated tax, a taxpayer with higher economic income pays more tax, and pays a larger portion of income than a lower income taxpayer. For example, assume $T_2$ has salary income of $10,000, and $T_1$ has no income. When $T_1$ sells a home for $200,000 and $T_2$ sells a yacht for the same amount, $T_2$ has $10,000 more economic income than $T_1$. $T_1$, however, has alternative taxable income of $200,000, while $T_2$ has alternative taxable income of $10,000 plus the downpayment from the yacht sale. Assuming a negligible downpayment, $T_2$ pays no alternative tax because the $10,000 interest income is offset by the exemption for the alternative tax. $T_1$, however, pays alternative tax on $172,500, $200,000 minus the $27,500 exemption. If $T_1$ and $T_2$ each paid alternative tax on their respective economic incomes, $T_1$ would face an effective tax rate of 18.1% on $200,000 and $T_2$ would face an effective tax rate of 18.5% on $210,000. This absence of equity is not fair or desirable.

Finally, the overall tax system is not graduated because not all taxpayers are subject to the alternative tax. Consider two taxpayers, $T_1$ and $T_2$, with economic income of $500,000 and $600,000 respectively. $T_1$ has salary income subject to the regular tax. $T_2$ has income subject to the alternative tax but not the regular tax. $T_1$ pays tax at the rate of 28% on $500,000, while $T_2$ pays tax at the rate of 21% on $600,000. $T_2$ pays a smaller percentage of tax notwithstanding the fact that all income is subject to the alternative tax.

D. The Alternative Tax Would Be More Efficient and Equitable If All Economic Income Were Taxed

The short-term solution to these problems is to broaden the alternative tax base until it accurately measures economic income. Once all economic income is subject to the tax, the passive loss, investment interest, and net operating loss limits may be eliminated. This simplification would, in turn, ease burdensome side effects making the tax

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113. $T_1$ pays tax at the rate of 21% on $200,000 minus a $27,500 exemption, or 36,225. This corresponds to an effective tax rate of 18.1% on $200,000. $T_2$ pays tax at the rate of 21% on $210,000 minus a $25,000 exemption, or $38,850. This amount corresponds to an effective tax rate of 18.5% on $210,000. For this example, horizontal equity is achieved because $T_2$ has higher economic income and would face a higher effective tax rate.

114. Because of the high level of income, both of these taxpayers face a constant tax rate. See supra notes 44, 97 and accompanying text.

115. This Comment will outline the course that Congress should take to reform the alternative tax so that it may measure economic income. See United States Treasury Department, Blueprints for Basic Tax Reform (1977), for a discussion of the proper measure of economic income. See Graetz, supra note 55 (thorough analysis of steps necessary for the 1982 alternative tax to measure economic income).

116. See supra notes 35–36 and accompanying text.
Alternative Minimum Tax Possibilities

system more efficient and equitable.\textsuperscript{117}

1. \textit{The Passive Loss, Investment Interest, and the Net Operating Loss Limits Could Be Eliminated}

The alternative tax would be more efficient if economic income were measured more accurately and certain limits were repealed. The alternative tax provisions for suspending passive and interest related losses and the net operating loss limit are only in place because the alternative tax base does not adequately measure economic income.\textsuperscript{118} Repealing these limits would simplify the process of planning and complying with the alternative tax.\textsuperscript{119} Separate accounts of the source, timing, and carry forwards would no longer be necessary. If all economic income were subject to the alternative tax, planning investments on the basis of the source and timing of the income would be irrelevant.\textsuperscript{120} The prudent investor would only compute whether and when the investment was subject to the alternative tax not the regular tax.

2. \textit{The Alternative Tax Could Be Completely Graduated}

If the alternative tax included all economic income as proposed, it would be graduated notwithstanding the tax's flat marginal rate of 21\%. The proposed tax is graduated because the alternative tax exemption amount is phased out, subjecting more high level income earners to the tax.\textsuperscript{121} Although the marginal rate remains at 21\%, the effective tax rate increases more rapidly to a maximum of 21\%.\textsuperscript{122} Two taxpayers with similar economic income face the same tax burden. Similarly, taxpayers with income between $40,000 and $310,000 pay a higher proposed tax rate.

Finally, if all economic income were included, the sophisticated taxpayer could not avoid paying tax by manipulating the character of

\textsuperscript{117} \textit{See supra} notes 101–11 and accompanying text.

\textsuperscript{118} Congress stated the following purpose behind the passive loss limit:

\textit{Any loss realized by the [passive] activity is not truly realized by such individual prior to disposition of his or her interest in the activity. Moreover, the effort to measure, on an annual basis, real economic losses from passive activities gives rise to distortions in light of the potential for underlying appreciation of assets the taxation of which is deferred, as well as the failure to measure precisely all items which may mismatch tax deductions and economic income.}


\textsuperscript{119} \textit{See supra} note 107 and accompanying text.

\textsuperscript{120} \textit{UNITED STATES TREASURY DEPARTMENT, BLUEPRINTS FOR BASIC TAX REFORM} 36 (1977).

\textsuperscript{121} \textit{See supra} note 97 and accompanying text.

\textsuperscript{122} \textit{Id.}
income because no income is exempt or deferred by the proposed alternative tax.123 Ironically, the sophisticated taxpayer will benefit only by structuring income sources so they are subject to the lower proposed alternative tax rates.

The overall tax system would be more progressive if the proposed tax were coordinated with the regular tax. One of Congress' goals was to place a larger tax burden on high-income taxpayers. Imposing this burden through the proposed alternative tax would partially negate the benefits high income taxpayers receive with the reduction in the regular tax rates. Implicit in Congress' intent is the belief that, before the Tax Reform Act of 1986, high-income taxpayers avoided both the regular tax and the alternative tax by structuring the source and timing of their income. Congress could achieve this goal and impose a greater tax burden on high-income taxpayers with the proposed alternative tax because it includes all income. To the extent that the former tax system did not achieve this end, the proposed alternative tax makes the overall tax system more progressive.

3. The Alternative Tax Could Replace the Regular Tax

Future tax reform may be accomplished by using the proposed alternative tax as a starting point for transition. Increases in the proposed alternative tax rate would bring the tax system closer to taxing the economic income of all taxpayers. At some point, the regular tax could be discarded, and the proposed alternative tax could be the single remaining tax.124 A single alternative tax would remove the remaining complexity that arises from a dual tax system. The need for a minimum tax credit would disappear because deferral preferences would not be subject to two taxes.125 The taxpayer would no longer be required to maintain two sets of books for recording independent adjusted bases or carryforward items.126 The need for a second tax would be gone because the proposed alternative tax would ensure that all individuals paid a significant tax on economic income. Most important, the tax system would be more simple because the taxpayer would only need to calcu-

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123. See supra note 59 and accompanying text.
124. See Graetz, supra note 55, at 529.
125. Letter From Chairman Rostenkowski to House Ways and Means Committee Members, reprinted in TAX ANALYSTS, TAX NOTES, Aug. 12, 1985, at 798; see supra notes 46–50 and accompanying text.
126. See supra notes 78–101 and accompanying text. These items include sums suspended by the passive loss or at-risk limitations, the alternative net operating loss, and the alternative foreign tax credit.

122
The alternative tax is fundamentally flawed because of the complexity it adds to the tax system. Congress intended that all individuals with substantial economic income pay a substantial tax. Congress did not choose to reform the regular tax to accomplish this goal. Instead it increased the impact and prominence of the alternative tax. Rather than restructuring the alternative tax so that it accurately measured economic income, Congress imposed several limiting provisions which complicate the alternative tax and the entire tax system.

To simplify the tax system, Congress should first broaden the alternative tax base to ensure that individuals with high economic income actually pay a significant tax. The limits may then be repealed, the alternative tax simplified, and the regular tax phased out and replaced with the simpler alternative tax.

*Kerry Sean Bucklin*