

TAX SECTION

New York State Bar Association

Table of Contents

Introduction:.....	i
Cover Letter:.....	ii
MEMORANDUM.....	iii
Book Income Preference.....	iii
I. Operation of Corporate Minimum Tax.....	1
II. Analysis of New Section 56(f).....	3
A. Policy.....	3
B. Technical.....	6
III. Earnings and Profits As An Alternative.....	10

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Attached letter dated 7/17/86 enclosing report of the Alternative Minimum Tax and Corporations Committees regarding comments on the proposal in H.R. 3838 sent to the following:

The Honorable Dan Rostenkowski
cc: The Honorable John J. Duncan
Robert J. Leonard, Esq.

The Honorable Bob Packwood
Chairman
Senate Finance Committee
cc: The Honorable Russell B. Long
John Colvin, Esq.

The Honorable J. Roger Mentz
Assistant Secretary (Tax Policy)
Department of the Treasury

The Honorable David H. Brockway
Chief of Staff
Joint Committee on Taxation

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July 17, 1986

The Honorable Dan Rostenkowski
 2232 Rayburn Building
 Washington, DC 20515

Dear Representative Rostenkowski:

The enclosed report, principally prepared by Eugene L. Vogel, William H. Weigel, Edward D. Kleinbard and Michael L. Schler, Co-Chairmen of the Committees on Alternative Minimum Tax and Corporations of the Tax Section of the New York State Bar Association, comments on the proposal in H.R. 3838 to include as a preference item for alternative minimum tax purposes a corporation's book income.

I hope the report proves useful to you.

Sincerely,

Richard G. Cohen
 Chairman

Enclosure
 cc: The Hon. John J. Duncan) with
 Robert J. Leonard, Esq.) enclosure

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MEMORANDUM

Book Income Preference

July 17, 1986

The Senate version of H.R. 3838, the Tax Bill of 1986 (the "Bill"), would expand the scope of the minimum tax applicable to corporate taxpayers* in an effort to ensure that taxpayers with significant economic income pay at least some tax. In particular, section 1101 of the Bill would insert a new section 56(f) in the Internal Revenue Code (the "Code") that would, in effect, subject to the minimum tax one-half the difference between a corporation's book income and other alternative minimum taxable income. This memorandum expresses our concern that proposed section 56(f) leaves unresolved several serious technical issues and would produce results that have received inadequate consideration from a policy perspective.

* The New York State Bar Association Tax Section has previously issued a report on the individual provisions of the minimum tax as they appeared in the House version of the Bill. See N.Y. State Bar Ass'n tax Section, "Report on the Individual Minimum Tax Provisions of H.R. 3838" (March 31, 1986).

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I. Operation of Corporate Minimum Tax

Section 55 of the Code, after its amendment by the Bill, would impose a minimum tax equal to 20 percent of a corporate taxpayer's "alternative minimum taxable income" -i.e., regular taxable income as adjusted by sections 56 and 58 and increased by the amount of tax preference items listed in new section 57. For that purpose, new section 56(f) would require a positive adjustment of 50 percent of the amount by which a corporation's "adjusted net book income" exceeded its alternative minimum taxable income (without regard to section 56(f) itself or the applicable net operating loss deduction).^{*} All corporations other than flow-through entities would be subject to the new provision. The section 56(f) adjustment reflects an apparent concern that "piecemeal" adjustments on a preference-by-preference basis will not adequately prevent a corporation with large economic income from escaping tax. See S. Rep. No. 313, 99th Cong., 2d Sess. 520 (1986).

In determining "adjusted net book income," section 56(f) would look first to income figures on SEC

* Section 56(f)(1) refers to alternative minimum taxable income rather than regular taxable income to prevent double counting of preference items already subject to the minimum tax.

filings. If no such statements exist, figures on (i) certified financials prepared for shareholders, creditors, or another "substantial non-tax purpose," (ii) other submissions to federal, state, or local governments, or (iii) unaudited statements prepared for shareholders, creditors, or other nontax reasons would (in that order of preference) provide the book income figure. If the corporation maintains no such statements, then its "net book income" would equal its earnings and profits for the year. Specific adjustments in the book income figure would be necessary where the taxpayer files a consolidated return or receives dividends from an unaffiliated corporation. New section 56(f)(2)(E) would give the secretary authority to adjust book income further "to prevent the omission or duplication of any item."

In certain circumstances -- specifically, where book income is more than 2.3 times as large as the corporation's other alternative minimum taxable income -- new section 56(f) alone would cause a liability for minimum tax. For example, a corporation with regular taxable income of \$100 would, under the Bill, pay \$33 in tax. If the corporation had \$230 in book income for that year (and had no other preference items), the adjustment under section 56(f) would be \$65 $((\$230 - \$100) \times 50\%)$. The

minimum tax would be $((\$100 + \$65) \times 20\%)$, or \$33. Any book income over \$230 would thus produce a minimum tax liability. The existence of other preference items would, of course, affect that calculation.*

II. Analysis of New Section 56(f)

New section 56(f) is an unprecedented importation of book accounting concepts into the tax system. We believe that the proposal would create many serious problems, both of a policy and technical nature.

A. Policy.

A basic concern with the proposal is that the different concepts of book and taxable income stem from

* Alternative minimum taxable income must be more than 165 percent of regular taxable income to generate a minimum tax liability ($\$165 \times 20\% = \$100 \times 33\% = \$33$). Thus, if a corporation has \$100 in taxable income and \$40 in preference income, the excess of book income over alternative liability for minimum tax $((\$190 - \$140) + 2 + \$140 = \$165)$. But if a corporation has sufficient preference items, even a significant disparity between book and tax income may not itself give rise to a minimum tax liability. In the example described in the text, preference items totaling \$130 would mean that the book-tax discrepancy. In many cases, preference items will in any event be fully includible in book income. Thus, subtracting such items from book income in determining alternative minimum taxable income prevents double counting of the same item.

differing needs and goals in the two areas. The exclusion or inclusion of items in taxable income -- for example, the exclusion of interest on municipal bonds, which under new section 56(f) could result in a minimum tax liability* -- reflect particular theoretical and policy concerns that inclusion of such items in alternative minimum taxable income would undermine. In that connection, we note that evolving accounting standards may, over time, produce changing definitions of reportable book income. Such factors indicate that basing tax liability on book accounting concepts is unsound.

We are also concerned that new section 56(f) would place an undesirable pressure on accountants and the accounting system generally. The provision would create an obvious incentive for companies to reduce their book income. It is overly facile to respond that the normal desire to enhance book earnings would adequately offset that incentive. Many companies have no strong need to report favorable earnings to shareholders (or, for that matter, to creditors as long as the balance sheet remains sound). Moreover, it seems a vain hope that

* See S. Rep. No. 313, supra, at 530 n. 10.

the conflict between the tax incentive to report lower earnings and a purported desire to reflect higher earnings will produce an appropriate calculation of a firm's economic income.

Situations involving preliminary financial statements reporting low earnings, followed by supplemental disclosures of report accompanying the Bill suggests that the primary, formal financial statements would determine book income for purposed of section 56(f), an approach that section 472 adopts in the LIFO conformity context. Such an approach would permit taxpayers to reduce their exposure to minimum tax by issuing an an initial tax-oriented statement with footnotes, a covering letter, or supplemental disclosures giving more favorable information. On the other hand, taking into account earnings disclosed on all supplementary material would place the Internal Revenue Service in the difficult position of monitoring all corporate utterances (including, for example, hand-outs at stockholders' meetings).

Intercorporate dividends and municipal bond interest would presumably be includible in alternative

minimum taxable income,* raising significant policy and constitutional questions. The tax Section is concerned about the lack of attention those very significant issues have received.

B. Technical.

We believe that new section 56(f) in its current form also raises many significant technical issues. First, the provision would take into account all differences between book and taxable income, whether permanent or timing, the desirability of which is doubtful.

For example, the book income of a corporation selling assets pursuant to a plan of liquidation under section 337 would apparently include gain the corporation did not recognize pursuant to section 337(a). Other tax-free.

* Municipal bond interest, apart from proposed section 56(f) represents income that is never subject to tax. By contrast, an intercorporate dividend comes out of income upon which the dividend payor has presumably paid tax. Subjecting such a distribution to tax reduces the benefits of the dividends-received deduction. Assume, for example, that an operating company breaks even on its business operations but has \$1 million of net dividend income and no other items of tax preference. The corporation would pay \$66,000 in regular tax (($\$1,000,000 - \$800,000$ dividends received deduction) x 33%). Presumably, however, the entire dividend would be includible in book income. Alternative minimum taxable income would equal \$600,000 (($\$1,000,000 - \$200,000$) + 2 + \$200,000). The minimum tax on that amount would be \$120,000. Effectively, section 56(f) would subject more than 20 percent of the dividend to tax, reducing the benefit of the dividends-received deduction.

exchanges, such as certain reorganizations and involuntary conversions of property, could also increase book income.* Conversely, certain book-tax discrepancies may favor the taxpayer. For example, an acquirer who accounts for an acquisition under the purchase accounting method may realize larger deductions for book purposes than for tax if it does not make a section 338 election.** In an effort to create a broad income base for minimum tax liability, the Bill has thus failed to consider the appropriateness of taxing income arising from such transactions.

The distinction between timing and permanent differences, which new section 56(f) does not address,*** leads to a major problem in the proposal. In situations where a corporation recognizes an income item for book

* Transactions qualifying for nonrecognition treatment under sections 1042, 1071, and 1081 of the Code may also produce current income for book purposes, resulting in a timing difference.

** It is not difficult to imagine a corporation with large book earnings and low taxable income -- presumably on appropriate candidate for application of the minimum tax -- avoiding that tax entirely through purchase accounting. Absent a section 338 election, purchase accounting could in theory permit a corporation to reduce the disparity between book and tax income to the extent that no minimum tax liability arises.

*** One timing difference, the situation of a loss being tax effected for book purposes when incurred, and not being allowed for book purposes when it is allowed for tax purposes as a carryforward, is dealt with in the proposal. See proposed section 56(f)(4)(B) and (d)(1).

purposes before it enters taxable income (or recognizes an expense item for tax purposes before it reduces book income), the discrepancy might result in a minimum tax liability. In the later year when the corporation recognizes the income for tax purposes (or the expense for book but not tax Purposes), it will presumably be subject to a full regular tax. The appropriateness of fully taxing such income in the later period is dubious.

Timing differences would also cause problems where recognition of taxable income preceded recognition of book income.* Although such a situation is obviously nonabusive, in the later year the excess of book income over taxable income may produce a minimum tax liability even though the taxpayer has fully paid regular tax on the income. Such a situation may arise frequently; for example, it would occur where a reserve is necessary for book purposes but is impermissible for tax purposes (e.g., in the case of bad debts, future expenses such as those in Schlude v. Commissioner, 372 U.S. 128 (1963), inventory write-downs as in Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979), or asset

* The Bill provides a narrow transition rule that would ameliorate the problem, but apparently the rule applies only to one corporate taxpayer.

Write-down in anticipation of terminating a business). The issue will also surface where generally accepted accounting principles require expensing an item but no deduction is allowable for tax purposes (e.g., in the case of deferred compensation or a capital loss in excess of capital gain).

A possible solution to the foregoing problems would involve use of a carry-forward and carry-back mechanism.* The carried-over amount would equal the difference between tax-able income and related book income, and use of the carry-over would in theory reduce the book-tax discrepancy and prevent double taxation. That solution is, however, at best incomplete, because realization of the related income item may never occur, a carry-over mechanism may, as a practical matter, offer no relief.

Another technical problem arises from the rule (Senate Report, p. 534) that if book income is restated retroactively, the entire net adjustment is to be taken into account for amt purposes in the adjustment year. We believe it is essential that a taxpayer be given the

* Conceivably, section 56(f)(2)(E), authorizing regulations "to prevent the omission or duplication of any item," could answer those problems. That provision appears, however, to be aimed at a much narrower class of cases, those relating to restatement of prior period GAAP financials. See, Senate Report at p. 534. Moreover, the scope of such a regulations project would be enormous.

option (or else for it to be mandatory) to recomputed the minimum tax for past years on the basis of the restated financials. Otherwise, a taxpayer that would have been under the regular tax at all times if the adjustment had properly been taken into account on a current basis (because of sufficient regular tax liability in all years) could face an enormous minimum tax bill in the adjustment year because of the lumping together of several years of book income into one year.

III. Earnings and Profits As An Alternative

If some new measure of overall economic income is to be included for alternative minimum tax purposes, we see many advantages to the use of earnings and profits (Code section 312) as the measure of the preference instead of book income. Earnings and profits are intended to be a measure of economic income and are based upon traditional tax principles, thus solving the problems of reliance up and interaction with the financial accounting system. Use of earning and profits would also solve various other technical issues discussed in this letter, such as the treatment of tax-free reorganizations, involuntary conversions and the like, the timing problems which arise when tax income precedes book income, and the problem of restating prior years' earnings for book purposes.

Admittedly, use of earnings and profits would not automatically solve certain other problems (such as the inclusion of tax-exempt interest), and it would be appropriate to have special adjustments for such items. In addition, existing law defining earnings and profits is admittedly far less precise than that defining taxable income. Nonetheless, earnings and profits are at least a familiar notion within the tax system, and the alternative minimum tax could far more readily adopt and earnings and profits concept than go outside the tax system to ensure that economically profitable corporations pay some taxes.

As a final suggestion, we believe that if the general approach of using earnings and profits were adopted, serious consideration could be given to basing the entire corporate alternative minimum tax solely upon earnings and profits. The existing system for determining earnings and profits is designed to represent economic income and could be further refined to reflect particular policy concerns. Such an approach would, in our view, be vastly preferable to the introduction of an entirely new and independent accounting system which is designed to achieve a very similar goal, as contemplated by the senate Bill.