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## CONGRESS DEALS AVIATION ANOTHER BAD HAND: TIME TO LEARN HOW TO PLAY THE ACE

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**F**EDERAL TREASURY receipts from direct corporate taxes rose 14.9% to \$109.9 billion in 1987 and accounted for 11.6% of gross federal tax collections.<sup>1</sup> This increase came just one year after passage of the landmark Tax Reform Act of 1986 (the "Act").<sup>2</sup> Among the many modifications and additions to the Internal Revenue Code (the "Code") was the new corporate alternative minimum tax (CAMT).<sup>3</sup> Much has been written about the CAMT,<sup>4</sup>

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<sup>1</sup> 1987 IRS ANN. REP. 8, 10. In 1988, gross collections from corporate taxes were \$109.7 billion and represented 11.7% of collections. 1988 IRS ANN. REP. 9, 10.

<sup>2</sup> Pub. L. No. 99-514, 100 Stat. 2085 (codified in scattered sections of 26 U.S.C.).

<sup>3</sup> I.R.C. §§ 53, 55-57, 59 (1990) (all Code references are to the Internal Revenue Code of 1986, as amended most recently by the Revenue Reconciliation Act of 1989, H.R. 3299, 101st Cong., 1st Sess. (Nov. 21, 1989) (hereinafter "RRA"), unless otherwise specified). In theory, the CAMT is paid *instead* of the regular tax by taxpayers who have obtained substantial tax benefits from income or deduction items considered favorably treated by Congress, or through the use of tax credits.

<sup>4</sup> See, e.g., Anthony & Dilley, *The Tax Pressure on Financial Reporting*, 66 TAXES 466 (1988); Brown & Massoglia, *Corporate Alternative Minimum Tax*, 1986 N.Y.U. INST. ON FED. TAX'N ch. 7; Chesser, *Controlling Income and Deductions Can Prevent Imposition of the AMT*, TAX'N FOR LAW., May-June 1989, at 366; Gould, *The New Corporate AMT: Where We Are Today: Where We May Be Tomorrow*, 1987 N.Y.U. INST. ON FED. TAX'N ch. 36; Shavito, *Perception, Reality and Strategy: The New Alternative Minimum Tax*, 66 TAXES 91 (1988); Silverman & Fabor, *New Law Makes Sweeping Changes to Corporate Minimum Tax*, 66 J. TAX'N 22 (1987); Soukup & Stone, *Planning for the Corporate Alternative Minimum Tax*, 1989 U.S.C. L. CTR. TAX INST. ch. 2; Comment, *The Book Income Adjustment in the Tax Reform Act Corporate Minimum Tax: Has Congress Added Needless Complexity in the Name of Fairness?*, 40 Sw. L. J. 1219 (1987) (authored by Sandra G. Soneff Redmond).

including its anticipated effects on the aviation industry,<sup>5</sup> but tax practitioners have been slow to develop effective strategies for dealing with it.<sup>6</sup> Congressional leaders acknowledge that the CAMT provisions were among the most complicated in the Act.<sup>7</sup> Beginning in 1990 new strategies are necessary because the book income adjustment is replaced with the adjusted current earnings (ACE) adjustment as a component of the CAMT.<sup>8</sup>

The CAMT was designed to assure that no corporation "with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits."<sup>9</sup> Of particular concern to Congress were large corporations that reported substantially greater income for financial accounting purposes than for tax purposes.<sup>10</sup> Between 1981 and 1985, 130 of the 250 largest U.S. corporations paid no federal income tax in one or more years.<sup>11</sup>

Congress faced a steady relative decline in the contribution of corporate income taxes to the federal treasury.<sup>12</sup>

<sup>5</sup> Comment, *The Impact of the Tax Reform Act of 1986 on the Aviation Industry*, 53 J. AIR L. & COM. 191 (1987)(authored by Grant F. Adamson, CPA).

<sup>6</sup> Rosenthal, *Changes Sought in AMT Adjusted Current Earnings Preference*, TAX NOTES, July 11, 1988. Regarding planning for years beyond 1989, Andy Yood of the American Petroleum Institute acknowledges, "[m]ost of us are still drowning in the 1986 Act." *Id.*

<sup>7</sup> H.R. 1761, 101st Cong., 1st Sess. (1989).

<sup>8</sup> I.R.C. § 56(f), (g). For an explanation of the ACE and book income adjustments, see *infra* notes 92-169 and 218-227 and accompanying text, respectively.

<sup>9</sup> STAFF OF JOINT COMM. ON TAX'N, 99TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 432 (Jt. Comm. Print 1987)(hereinafter the "Bluebook").

<sup>10</sup> *Id.* at 433. Congress concluded that "both the perception and the reality of fairness have been harmed by instances in which corporations paid little or no tax in years when they reported substantial earnings . . ." *Id.* One frequently cited example is General Dynamics Corporation, which in 1983 reported book income in excess of estimated taxable income of \$1.145 billion. Anthony, *supra* note 4, at 468. Corporations generally try to maximize book income reported to shareholders but minimize taxable income reported to the IRS.

<sup>11</sup> Karlinsky & Hickey, *Corporate Alternative Minimum Tax Book/Tax Adjustment*, 1989 U.S.C. L. CTR. TAX INST. ch. 3, at 3-2; see also Starr & Solether, *The Corporate AMT: Is Adjusted Current Earnings an Ace-in-the Hole?*, 1989 N.Y.U. INST. ON FED. TAX'N ch. 39, at 39-7.

<sup>12</sup> In three decades, corporate taxes as a percentage of total revenue collections fell from 25.6% in 1958, to a low of 9.8% in 1983. 1987 IRS ANN. REP. 47.

With expected continued deficits,<sup>13</sup> significant revenues were sought.<sup>14</sup> Because of their indirect effect and political safeness, corporate taxes were a relatively easy target.

Although congressional intent was fairly clear, evidence does not suggest that the CAMT and, in particular, the aforementioned book income and ACE adjustments<sup>15</sup> were well reasoned.<sup>16</sup> In an inadequate attempt to address the situation, Congress ordered a Treasury Department study of the anticipated effects of the ACE adjustment.<sup>17</sup> The study was due by January 1989, but as of this writing, and much to Congress' chagrin,<sup>18</sup> the study has not been completed. The report is expected to emphasize administrative, enforcement, complexity, and general economic issues, but not the originally hoped for macroeconomic and tax burden distribution issues.<sup>19</sup>

The airline industry faced substantial challenges in the eighties:<sup>20</sup> deregulation, mergers and acquisitions, maintenance and safety problems (coupled with greater public awareness and safety consciousness),<sup>21</sup> fuel supply and price disruptions, costly frequent flyer programs, skyrocketing aircraft<sup>22</sup> and fuel costs,<sup>23</sup> new financial reporting re-

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<sup>13</sup> The federal budget for 1989 exceeds \$1 trillion, and long range projections forecast a 20% increase by 1992. Long range estimates predict deficits of \$100 billion plus through 1995. CONGRESSIONAL BUDGET OFFICE (1988) (as reported in Wall St. J., Mar. 14, 1990, at A12, col. 2).

<sup>14</sup> The gross revenue projections from the CAMT are approximately \$22 billion through 1991. Bluebook, *supra* note 9, at 473.

<sup>15</sup> I.R.C. § 56(f), (g).

<sup>16</sup> See generally Rosenthal, *supra* note 6.

<sup>17</sup> H.R. CONF. REP. NO. 99-841, 99TH CONG., 2D SESS. § 702 (1986).

<sup>18</sup> H.R. 1761, *supra* note 7.

<sup>19</sup> According to Mark Levy of the Internal Revenue Service Office of Tax Legislative Counsel, the report will incorporate a general economic and revenue analysis, plus much of the Treasury Department testimony before the House Ways & Means subcommittee on Select Revenue Measures of June 8, 1989. Regulations on anything more extensive are unlikely.

<sup>20</sup> See generally Zimmerman, *Heirs of Deregulation*, Dallas Morning News, Oct. 23, 1988, at H1, col. 1.

<sup>21</sup> *Repairs Urged for Aging Jets*, Dallas Morning News, Feb. 28, 1989, at A4, col. 4.

<sup>22</sup> *Id.*

<sup>23</sup> *Here's What May Fuel More Air Fare Rises*, Wall St. J., Jan. 31, 1989, at B1, col. 1.

quirements,<sup>24</sup> and of course, tax reform.<sup>25</sup> These changes also affected related industries, including suppliers, aviation manufacturers, contractors, and support service providers. Although aviation was not the only industry to suffer, it has certainly experienced more than its share of troubles.<sup>26</sup>

The CAMT will likely play an important role when Congress looks at budgets and taxes in the future.<sup>27</sup> Consequently, airlines, aviation companies, and heavy equipment users in general have every reason to begin thinking about desired modifications and alternatives to the CAMT that will better promote their own interest. The first section<sup>28</sup> of this article provides a summary of the CAMT rules as they apply in 1990, focusing on deferral<sup>29</sup> and exclusion<sup>30</sup> preferences<sup>31</sup> and adjustments.<sup>32</sup> Section II<sup>33</sup> consists of an analysis of the application of the CAMT in an aviation context. In particular, practical implications of the CAMT and tax planning will be discussed. The final section<sup>34</sup> consists of predictions and

<sup>24</sup> Most recently the Financial Accounting Standards Board promulgated ACCOUNTING FOR INCOME TAXES, Statement of Financial Accounting Standards No. 96 (Fin. Accounting Standards Bd. 1988), in response to the Act.

<sup>25</sup> Between 1981 and 1986, tax legislation seriously affected heavy equipment industries by reducing capital recovery deductions, limiting the advantages of leasing, eliminating investment tax credits, and broadening the corporate tax base. See generally Comment, *supra* note 5.

<sup>26</sup> The problems of many historically stable companies such as Eastern, Continental and Pan Am, are evidence of this trend.

<sup>27</sup> See Gould, *supra* note 4, at 36-59; see generally Rosenthal, *supra* note 6.

<sup>28</sup> See *infra* notes 35-227 and accompanying text.

<sup>29</sup> These are items that differ as to the timing of amounts reported for CAMT and regular tax purposes, but which reverse or reconcile over time.

<sup>30</sup> These are items that differ as to the amount reported for CAMT and regular tax purposes and will not reverse or reconcile over time.

<sup>31</sup> I.R.C. § 57. Generally, preferences are additions to the CAMT base resulting from the disallowance of otherwise favorable methods of reporting tax income or deduction items. Preferences may be either deferral or exclusion items, but generally the latter.

<sup>32</sup> *Id.* §§ 56, 58. Generally, adjustments are either positive or negative modifications to the CAMT base resulting from the recomputation of income or deduction items using an alternative method to that otherwise allowed by the Code. Most adjustments are deferred items.

<sup>33</sup> See *infra* notes 228-330 and accompanying text.

<sup>34</sup> See *infra* notes 336-341 and accompanying text.

proposals.

## I. LAW

### A. *Background*

Congress has been writing and revising the alternative minimum tax (AMT) for approximately 20 years. The first version affecting corporations was included in the Tax Reform Act of 1969 and imposed a 10% corporate add-on minimum tax.<sup>35</sup> Subsequent amendments and alterations were made, including changes made in each of the five major tax laws passed prior to the Act<sup>36</sup> and in two subsequent tax bills.<sup>37</sup> The Act substantially modified sections 55, 56, 57, and 58 of the Code, integrating a corporate alternative minimum tax into the previous individual AMT, as well as adding sections 53 and 59.<sup>38</sup>

The CAMT computation is made on Form 4626,<sup>39</sup> which must be filed by all applicable corporate taxpayers with taxable income, adjustments and preferences in excess of the \$40,000 exemption amount.<sup>40</sup> A review of the form is suggested as a starting point for understanding

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<sup>35</sup> Pub. L. No. 91-172, 83 Stat. 487 (1969), as Code §§ 56, 57, 58. The reason for the original imposition of the minimum tax in 1969 was not unlike the reason for change in 1986 — public perception and disenchantment with the complexity and fairness of the tax law. 1969 U.S. CODE CONG. & ADMIN. NEWS 1645, 1652-56.

<sup>36</sup> In 1976, Congress increased the corporate minimum tax rate from 10% to 15%. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976). Then, in 1978 Congress added the § 55 noncorporate alternative minimum tax (AMT). Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763 (1978). The amount of AMT was limited to 20% on all alternative minimum taxable income exceeding \$60,000 in 1981. Economic Recovery Tax Act, Pub. L. No. 97-34, 95 Stat. 172 (1981). The individual add-on minimum tax was repealed, the AMT expanded, and Code § 291 was added (limiting the availability of certain corporate preference items) in 1982. Tax Equity & Fiscal Responsibility Act, Pub. L. No. 97-248, 96 Stat. 324 (1982). Finally, additional technical corrections and further expansion of § 291 occurred in 1984. Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984).

<sup>37</sup> Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342 (1988), at § 1007; RRA, *supra* note 3.

<sup>38</sup> These are the minimum tax credit and other rules sections.

<sup>39</sup> The Alternative Minimum Tax-Corporations, Form 4626 (1989).

<sup>40</sup> IRS TAX INFORMATION ON CORPORATIONS, I.R.S. PUBLICATION 542 at 7 (1988). As a practical matter, all companies need to go through the computation,

the many details of the tax.<sup>41</sup>

### B. Statutory Analysis

The CAMT is imposed by section 55 of the Code.<sup>42</sup> The tax is the excess of the tentative minimum tax (TMT)

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including loss companies (because of the net operating loss limitation provisions of I.R.C. § 56(d)).

<sup>41</sup> The expected Form 4626 computation for 1990 and after can be summarized as follows:

- i) Start: Corporate taxable income before net operating loss and special deductions;
- ii) Add or subtract adjustments (including, e.g. the difference between actual and recomputed depreciation on assets placed in service after 1986; recomputed gains on installment sales by not utilizing that method; recomputed gains on other dispositions using the AMT rather than regular tax basis for the assets disposed of);
- iii) Subtotal (ii) as "Adjustments";
- iv) Add preferences (including, e.g., accelerated depreciation on certain pre-1987 assets on a property by property basis; appreciation on charitable contributions of property; net investment income on private activity bonds);
- v) Subtotal (iv) as "Preferences";
- vi) Subtotal i, plus/minus iii, plus v;
- vii) Add or subtract 75% of the difference (if any) between Adjusted Current Earnings (ACE) and vi, subtotal vi plus or minus vii;
- viii) Subtract the CAMT net operating loss (AMT NOL) deduction, generally limited to 90% of vii;
- ix) Subtotal vii and viii as Alternative Minimum Taxable Income (AMTI);
- x) Subtract the allowable minimum tax exemption (maximum of \$40,000, if any (none allowed if ix exceeds \$310,000), subtotal;
- xi) Multiply x by 20%, subtotal;
- xii) Subtract the allowable foreign tax credit (AMT FTC). Note that the foreign tax credit may be limited to reducing CAMT by no more than 90%, computed without regard to viii (RRA permits full use of the FTC in some situations);
- xiii) Subtotal xi and xii as Tentative Minimum Tax (TMT);
- xiv) Subtract any allowable general business credit, subtotal;
- xv) Subtract the regular tax after FTC but before other credits, subtotal as the Corporate Alternative Minimum Tax;
- xvi) Additionally, compute the Environmental Tax (ET). Multiply .12% by the excess of "Hypothetical" AMTI (which is a separate calculation of AMTI done *first* to determine the ET), over \$2 million. A deduction for the ET is allowed in computing regular taxable income, and then the actual calculation of AMTI is performed.

<sup>42</sup> I.R.C. § 55(a)-(c). Regular taxable income is modified for certain tax preferences and adjustments. An exemption is subtracted and the difference is multiplied by 20%. This is the TMT. The TMT is then reduced by the FTC and compared to the regular tax. *Id.*

for the taxable year over the regular tax for the taxable year.<sup>43</sup> The taxes differ as a result of adjustments to income, provided for in sections 56 and 58 of the Code, and preferences provided for in section 57.<sup>44</sup> Regular taxable income is adjusted for these items and an exemption of up to \$40,000 may be available as a reduction in arriving at alternative minimum taxable income (AMTI).<sup>45</sup> A 20% tax rate is then applied to AMTI, resulting in TMT.<sup>46</sup> A minimum tax credit (MTC) is available for use in regular tax years after the year in which the credit was generated, pursuant to section 53.

## 1. *Adjustments*

### a. *General Adjustments*

The CAMT adjustments most relevant to the aviation industry are depreciation,<sup>47</sup> long-term contracts,<sup>48</sup> net operating losses (NOLs),<sup>49</sup> installment sales,<sup>50</sup> adjusted basis,<sup>51</sup> and ACE.<sup>52</sup> As adjustments, they may increase or reduce AMTI.<sup>53</sup> Of these adjustments, all except the NOL adjustment are of a "deferral" type. That is, the adjustment recomputation changes the timing, not the ultimate amount, that is recognized by the taxpayer.<sup>54</sup> The NOL adjustment may consist of both deferral and exclusion components, depending upon which items create differences between the AMT NOL and the regular NOL.<sup>55</sup>

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<sup>43</sup> *Id.* § 55(a).

<sup>44</sup> *See supra* notes 31-32 for discussion of §§ 56, 57, 58 and 59.

<sup>45</sup> I.R.C. § 55(d)(2).

<sup>46</sup> *Id.* § 55(b).

<sup>47</sup> *Id.* § 56(a)(1).

<sup>48</sup> *Id.* § 56(a)(3).

<sup>49</sup> *Id.* § 56(a)(4), (d).

<sup>50</sup> *Id.* § 56(a)(6).

<sup>51</sup> *Id.* § 56(a)(7).

<sup>52</sup> *Id.* § 56(c)(1), (g).

<sup>53</sup> *See generally id.* § 56(a). Since the "adjustment" results from using a specified method to compute certain income and deductions, conceivably the CAMT method could yield a larger or smaller result than the regular tax method. The NOL adjustment will always be a reduction in AMTI. *See infra* note 75.

<sup>54</sup> *See supra* note 29 for a definition of deferral items.

<sup>55</sup> For example, an exclusion item like tax exempt income reduces the amount



The depreciation adjustment requires the taxpayer to recompute depreciation on tangible personal property using the 150% declining balance method, switching to the straight-line method at the point when straight-line yields the greater deduction.<sup>56</sup> For non-residential real property, residential rental property, other property depreciated straight-line, and property depreciated using the alternative depreciation system (ADS) (either mandatory or elective),<sup>57</sup> the adjustment is the difference between the depreciation allowance under the ADS method and the regular tax method.<sup>58</sup> The adjustment applies only to property placed in service after 1986, subject to certain transitional rules.<sup>59</sup>

Most airline property is depreciated for tax purposes over seven years or less.<sup>60</sup> The depreciable life of an airplane increases from 7 to 12 years under the ADS method.<sup>61</sup> As a result, the depreciation adjustment will cause an increase in AMTI in years where regular depreciation is greater than ADS depreciation.<sup>62</sup> For example, a new aircraft could generate a regular tax deduction more than 3 times as large as the corresponding ADS allow-

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of regular tax NOL when it is converted to an AMT NOL, creating a permanent loss of NOL because the income is not exempt for AMT purposes.

<sup>56</sup> I.R.C. § 56(a)(1). The regular tax depreciation method permitted is the 200% declining balance method. *Id.* § 168(b).

<sup>57</sup> *Id.* § 168(g). This system is straight-line depreciation over the class life (as opposed to recovery period) of the property. *Id.* § 168(g)(2). Class lives are generally longer than recovery periods.

<sup>58</sup> *Id.* § 56(a)(1)(A).

<sup>59</sup> *Id.* § 56(a)(1)(A)(i). Several transition rules are provided in § 56(a)(1)(c) and at Act §§ 203-204. For a thorough discussion see Comment, *supra* note 5, at 198-200.

<sup>60</sup> I.R.C. § 168(d)(1)-(2); *see also* Rev. Proc. 87-56, 1987-2 C.B. 674. An airline's principal assets are its aircraft, furniture, fixtures, equipment, vehicles and buildings. All but the last have a recovery period of 7 years or less. Rev. Proc. 87-56 at 676. Depending on the use of the buildings, the life is either 27.5 or 31.5 years. *Id.* at 675.

<sup>61</sup> Rev. Proc. 87-56, *supra* note 60, at 683.

<sup>62</sup> Bluebook, *supra* note 9, at 440. If the regular tax depreciation in year 1 on an asset with a depreciable basis of 10x is 10x, and the AMT deduction is 5x per year, a 5x adjustment is necessary. In the next year, however, all else being constant, regular taxable income will exceed AMTI because depreciation for regular tax is zero but for AMT purposes 5x. *Id.*

ance.<sup>63</sup> On a single-year purchase contract of \$7 billion,<sup>64</sup> a one year difference of more than \$1 billion may result.<sup>65</sup>

The ADS method can be elected for regular tax purposes for any one or more classes of property, annually,<sup>66</sup> thus avoiding any depreciation adjustment. Depreciation of pre-1987 property does not result in a depreciation adjustment.<sup>67</sup>

For manufacturers, the percentage of completion method is required when computing AMTI for long term contracts entered into after March 1, 1986.<sup>68</sup> The resulting effect is to prevent the deferral of income until the contract is completed.

The NOL adjustment, which is actually the last modification to AMTI before computing TMT,<sup>69</sup> represents the regular NOL deduction,<sup>70</sup> recomputed as an AMT NOL deduction.<sup>71</sup> The regular NOL is adjusted for preference items.<sup>72</sup> Transition rules provide that a NOL carried forward from pre-1987 years into post-1986 years shall not be adjusted for pre-1987 preferences and will equal the

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<sup>63</sup> Using the 200% declining balance method, a 7-year life, and ignoring the half-year convention, the regular depreciation deduction is  $100\% / 7$  multiplied by 2.00, or 29% of the adjusted basis, whereas the corresponding ADS allowance is straight line over a 12-year class life, which is  $100\% / 12$ , or 8% of the adjusted basis.

<sup>64</sup> This was the approximate size of a recent order placed by United with Boeing for 757's and 737's. Similar orders in the hundreds of millions and even billions of dollars have been made by airlines including Texas Air, British Airways, American, and others.

<sup>65</sup> Using the assumptions in *supra* note 63, the regular tax allowance would be approximately \$2 billion and the ADS allowance less than \$600 million.

<sup>66</sup> I.R.C. § 168(g)(7).

<sup>67</sup> *Id.* § 56(a)(1)(A)(i). But see *infra* notes 150-154 and accompanying text regarding the depreciation component of the ACE adjustment and *infra* note 174 and accompanying text regarding the depreciation preference.

<sup>68</sup> I.R.C. § 56(a)(3).

<sup>69</sup> See *supra* note 41, at (viii).

<sup>70</sup> I.R.C. § 172. The NOL deduction is a reduction in current year taxable income due to prior year (or subsequent year carryback of) tax deductions in excess of income. *Id.* § 172(a),(e).

<sup>71</sup> *Id.* § 56(a)(4),(d). Simply stated, the regular tax NOL is modified by adjustments and preferences in the same way regular taxable income is modified in arriving at AMTI.

<sup>72</sup> *Id.* § 56(d)(2).

NOL deduction allowable for regular tax purposes.<sup>73</sup> The main "catch" is that no more than 90% of the AMTI before considering the NOL deduction may be offset by the AMT NOL.<sup>74</sup> The AMT NOL can only decrease AMTI, even if the items added back to the NOL eliminate the loss altogether.<sup>75</sup>

The AMT NOL may be carried back 3 years and forward 15, like the regular NOL.<sup>76</sup> An election to forego the regular NOL carryback<sup>77</sup> applies to both the regular NOL and the AMT NOL.<sup>78</sup> If a NOL is carried back and utilized in a pre-1987 year, the AMT NOL is reduced even though the CAMT was not in existence in those years.<sup>79</sup> Furthermore, each year, regardless of which type of NOL is actually used, both NOLs must be reduced "as if" they were utilized.<sup>80</sup> All other NOL limitations, such as the purchased NOL limitations and separate return limitation year restrictions, apply to the AMT NOL.<sup>81</sup>

The installment sale adjustment<sup>82</sup> requires recomputation of income from dispositions of certain dealer property<sup>83</sup> and property subject to the proportional disallowance rules,<sup>84</sup> without regard to the section 453A installment method.<sup>85</sup> The adjustment applies to any dis-

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<sup>73</sup> *Id.* § 56(d)(2)(B). For example, a corporation with substantial losses from accelerated depreciation incurred before 1987 may use the full loss in computing AMTI. *Id.*

<sup>74</sup> *Id.* § 56(d)(1)(A). For example, a corporation with AMTI of 10x and a 10x NOL carryforward can only use 9x of the NOL in the current year.

<sup>75</sup> *Id.* § 56(d). The term "deduction" as opposed to adjustment is used.

<sup>76</sup> *Id.* § 172(b).

<sup>77</sup> *Id.* § 172(b)(3)(C).

<sup>78</sup> Rev. Rul. 87-44, 1987-1 C.B. 3.

<sup>79</sup> Bluebook, *supra* note 9, at 469. For example, if a corporation had regular taxable income of 25x, 40x, and 10x for 1984-86, and an AMT NOL of (100x) for 1987, after carryback, a 25x loss would be available for carryover to 1988. *Id.*

<sup>80</sup> *Id.* For example, assume a corporation incurs a \$15,000 NOL, with \$10,000 due to preference items, and has AMTI of \$20,000 in the subsequent year. Assuming carryover of the NOL, subsequent year AMTI is only reduced by \$5,000 to \$15,000. *Id.*

<sup>81</sup> I.R.C. §§ 381, 382.

<sup>82</sup> *Id.* § 56(a)(6).

<sup>83</sup> *Id.* § 1221(1).

<sup>84</sup> Bluebook, *supra* note 9, at 441.

<sup>85</sup> I.R.C. § 453A. Generally, under the installment method, taxpayers may re-

position of dealer property after March 1, 1986<sup>86</sup> and certain proportional disallowance property.<sup>87</sup>

The adjusted basis adjustment<sup>88</sup> requires a special CAMT recomputation of asset basis upon disposition of depreciated property.<sup>89</sup> The recomputation is done in accordance with the method used to compute the depreciation adjustment under section 56(a)(1).<sup>90</sup> The effect of the adjustment is to change the gain or loss on sale, exchange, or other disposition of an asset by substituting the AMT basis for the regular tax basis.<sup>91</sup>

### b. *ACE Adjustment*

The most complex adjustment in computing the CAMT is the ACE adjustment.<sup>92</sup> ACE replaces a conceptually similar adjustment, the book income adjustment, which was effective between 1987 and 1989.<sup>93</sup> The book income adjustment was very complex.<sup>94</sup> The book income adjustment will be generally referred to in this Comment, even though it is no longer applicable, due to its lingering effects and as a point of reference in discussing ACE. The Treasury issued lengthy temporary regulations in 1987,<sup>95</sup> and similar regulations are required for the ACE adjust-

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port gain on deferred payment sales as the payments are received *rather* than all in the year of sale. *Id.*

<sup>86</sup> *Id.* § 1221(1).

<sup>87</sup> Bluebook, *supra* note 9, at 441.

<sup>88</sup> I.R.C. § 56(a)(7).

<sup>89</sup> The asset basis is used in determining gain or loss upon sale or disposition of an asset. *Id.* § 1001(a).

<sup>90</sup> *Id.*

<sup>91</sup> Bluebook, *supra* note 9, at 439.

<sup>92</sup> I.R.C. § 56(c)(1), (g).

<sup>93</sup> *Id.* § 56(g)(6).

<sup>94</sup> For a discussion of these complexities see Feinberg & Robinson, *The Corporate Alternative Minimum Tax: Working with BURP While Waiting For ACE*, 15 J. CORP. TAX'N 3 (1988); Karlinsky & Hickey, *supra* note 11; and articles listed at *supra* note 4. Many experts thought the book income adjustment would last for more than the three year period specified by the Act due to the confusion surrounding the CAMT and the uncertainty regarding the ACE adjustment.

<sup>95</sup> Temp. Treas. Reg. § 1.56-1T (1987). The temporary regulations are quite lengthy, including 45 examples. *Id.*

ment by March 15, 1991.<sup>96</sup>

Adjusted current earnings (ACE) is a federal tax concept based on earnings and profits (E&P).<sup>97</sup> ACE does not include a reduction for federal income taxes, foreign taxes on which credit is taken, or dividends paid.<sup>98</sup> Like the book income adjustment, the ACE adjustment does not apply to certain entities.<sup>99</sup>

Simply stated, the adjustment equals 75% of adjusted current earnings in excess of AMTI, without regard to the ACE adjustment or NOL deduction.<sup>100</sup> Unlike the book income adjustment, ACE adjustments can be either positive or negative.<sup>101</sup> Adjusted current earnings are computed by starting with AMTI before the NOL deduction,<sup>102</sup> adjusting it for certain Code specified items,<sup>103</sup> adding income excluded from gross income in computing AMTI *but* included in E&P (net of related deductions),<sup>104</sup> and adding amounts which were deducted in arriving in AMTI but which do not reduce E&P in any taxable year.<sup>105</sup>

The ACE adjustment is different from the E&P computation. One significant difference is that the ACE adjustment does not include reductions for amounts which reduce E&P but are not otherwise deducted in arriving at AMTI (unless the deductions relate to excluded income

<sup>96</sup> RRA § 7611(g)(3).

<sup>97</sup> I.R.C. § 56(g)(3).

<sup>98</sup> *Id.* § 56(g)(4)(B).

<sup>99</sup> *Id.* § 56(g)(6).

<sup>100</sup> *Id.* § 56(g)(1). For example, assume a corporation has adjusted current earnings of 400x, 300x, and 200x in years 1, 2 and 3, respectively. Assume unadjusted AMTI of 300x each year. The adjustment is 75x, zero, and a reduction of 75x in each year, respectively. Bluebook *supra* note 9, at 457.

<sup>101</sup> I.R.C. § 56(g)(2). Compare I.R.C. § 56(f)(1). For an example, see *supra* note 100. The negative adjustment, however, is limited to prior positive adjustments. I.R.C. § 56(g)(2). In the example, *supra* note 100, if year 3 adjusted current earnings were 150x instead of 200x, the adjustment would still be limited to a reduction of 75x.

<sup>102</sup> I.R.C. § 56(g)(3).

<sup>103</sup> Most important are the provisions at I.R.C. § 56(g)(3), (4)(A), (D), (H), and (I).

<sup>104</sup> *Id.* § 56(g)(4)(B).

<sup>105</sup> *Id.* § 56(g)(4)(C).

mentioned above).<sup>106</sup> To provide a more complete understanding of the ACE adjustment components, the next section will summarize the E&P computation.

i. *An Overview of E&P*

Implicit in the computation of the ACE adjustment is an understanding of E&P. The term E&P has been around as long as the Code itself, is referred to in more than four dozen Code sections,<sup>107</sup> but is not explicitly defined therein. A complete discussion of E&P is beyond the scope of this article,<sup>108</sup> but the E&P computation and highlights of important provisions for aviation entities are worth summarizing.

The E&P computation has been important historically in determining the taxability of corporate distributions with respect to stock and in determining the accumulated earnings tax.<sup>109</sup> The E&P computation was originally formulated to facilitate the accurate reflection of a taxpayer's true economic earnings and dividend paying abilities. Taxable income reflects policy decisions, through exemptions and exclusions, that bear no direct relationship to economic resources. The principal E&P Code section is 312, and the starting point for the computation is taxable income.<sup>110</sup>

The first relevant adjustment mentioned in section 312 is for gains and losses recognized for regular tax purposes but not E&P purposes.<sup>111</sup> Such adjustments arise because

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<sup>106</sup> *Id.* § 56(g)(4)(B).

<sup>107</sup> Volpi & DeAngelis, *Using E&P to Compute AMT*, TAX. ADVISER, July 1989, at 441.

<sup>108</sup> For a full discussion of E&P, see B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ch. 7 (1987) (hereinafter "B&E"); Karlinsky & Hickey, *supra* note 11; and Volpi & DeAngelis, *supra* note 107. There are several items which arise in normal corporate activity for which the E&P treatment is unresolved. See B&E, *supra*, § 7.03.

<sup>109</sup> I.R.C. § 301 (dividends), §§ 302-305 (redemptions), § 306 (stock dispositions), and § 532 (accumulated earnings tax).

<sup>110</sup> Rev. Proc. 75-17, 1975-1 C.B. 677 (the earnings and profits calculation starts with taxable income).

<sup>111</sup> I.R.C. § 312(f)(1).

of differences between regular tax basis and E&P basis in assets,<sup>112</sup> and due to special non-recognition and income deferral methods allowed for regular tax purposes.<sup>113</sup> Most of the significant non-recognition provisions, however, are permitted in computing E&P.<sup>114</sup>

An additional adjustment relates to depreciation.<sup>115</sup> Generally, E&P depreciation is straight-line over a longer period than used for regular tax purposes.<sup>116</sup> An exception exists for certain other non-accelerated methods of depreciation approved by the Secretary of the Treasury.<sup>117</sup> Section 312 also requires that the alternate depreciation system (ADS)<sup>118</sup> be utilized when computing E&P depreciation for tangible personal property to which section 168 applies.<sup>119</sup> For E&P purposes, amounts for which the current year expense election of section 179 is utilized must be amortized over five years.<sup>120</sup>

An E&P adjustment is also required for any unrecognized discharge of indebtedness income unless the discharge is applied to reduce basis.<sup>121</sup> The provision states the adjustment in the negative by not requiring an adjustment if amounts discharged are applied to reduce basis under section 1017.<sup>122</sup>

In addition to these special adjustments, other adjustments are required to accurately reflect economic gain or

<sup>112</sup> E&P basis can differ from regular tax basis because of different E&P depreciation and amortization rules.

<sup>113</sup> Examples of non-recognition and deferral methods are the related party loss disallowance rules of I.R.C. § 267 and the installment sale method of § 453, respectively.

<sup>114</sup> These provisions include I.R.C. §§ 1031, 1033, 351, 361 and 1091. B&E, *supra* note 108, § 7.03.

<sup>115</sup> I.R.C. § 312(k)(1).

<sup>116</sup> *Id.*

<sup>117</sup> *Id.* § 312(k)(2). Sum of the year's digits or declining balance methods are disallowed, but the units of production method is allowed.

<sup>118</sup> *Id.* § 312(k)(3); *see also id.* § 168(g)(2).

<sup>119</sup> *Id.* § 168. This section applies to most depreciable property.

<sup>120</sup> *Id.* § 312(k)(3). Section 179 permits an annual expense election up to \$10,000.

<sup>121</sup> *Id.* § 312(l).

<sup>122</sup> *Id.*

loss.<sup>123</sup> The first of these adjustments requires that construction period carrying costs that are deductible be capitalized for purposes of computing E&P.<sup>124</sup> Such costs include deductible interest, property taxes and other carrying charges attributable to the construction period.<sup>125</sup>

Organizational expenditures must also be capitalized when computing E&P.<sup>126</sup> Normally, such expenses are amortizable over sixty months.<sup>127</sup> An adjustment to E&P is also required for differences between the LIFO and FIFO inventory methods.<sup>128</sup> The result is to increase or decrease E&P for changes in inventory layers in the case of taxpayers who use the LIFO inventory method.<sup>129</sup>

For taxpayers that make installment sales, E&P computations disallow the deferral effect of the installment reporting method.<sup>130</sup> Gain is fully recognized in the year of sale or as otherwise appropriate under the taxpayer's method of accounting.<sup>131</sup> Taxpayers using the completed contract method of accounting also lose the income deferral benefit because the percentage of completion method is required in computing E&P.<sup>132</sup> These two provisions could significantly impact manufacturers and contractors.

In addition to these straight-forward adjustments to E&P, there are related regulations requiring other adjustments. These regulations specifically require the inclusion of tax exempt or excluded income,<sup>133</sup> specified gains

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<sup>123</sup> *Id.* § 312(n).

<sup>124</sup> *Id.* § 312(n)(1)(A).

<sup>125</sup> *Id.* § 312(n)(1)(B).

<sup>126</sup> *Id.* § 312(n)(2)(A), (B).

<sup>127</sup> *Id.* § 248.

<sup>128</sup> *Id.* § 312(n)(4). The LIFO inventory method usually results in a larger cost of goods sold, leaving less taxable income during periods of rising prices. The most recently purchased higher cost inventory is treated as sold first. The FIFO method treats the oldest inventory as sold first.

<sup>129</sup> *Id.*

<sup>130</sup> *Id.* § 312(n)(5).

<sup>131</sup> Treas. Reg. § 1.312-6(a) (1955).

<sup>132</sup> I.R.C. § 312(n)(6).

<sup>133</sup> Treas. Reg. § 1.312-6(b), and B&E, *supra* note 108, § 7.03 n. 31 (the authors list several examples of items which fit into this classification).



and losses,<sup>134</sup> and other deductions or losses which are limited or disallowed for regular tax purposes, such as related party transaction losses.<sup>135</sup> The deduction and loss recognition provisions also have the effect of disallowing deduction and loss carryovers.<sup>136</sup>

Several other adjustments are required by Treasury pronouncements, legislative history and by analogy. Proceeds from key man life insurance, reduced by related premiums, increases E&P even if excluded from regular taxable income.<sup>137</sup> Amortization of patents and trademarks is generally not allowed for E&P purposes.<sup>138</sup> The dividends received deduction for dividends received by a corporation is also added back when computing E&P.<sup>139</sup> Theoretically, the list could go on indefinitely since the regulations provide that "all income exempted by statute, income not taxable by the Federal government under the Constitution,"<sup>140</sup> as well as all income that is taxable, is included in E&P.<sup>141</sup>

Many items considered in respect to the E&P computation are limited by the ACE computation rules, discussed at (ii) below. Some E&P items which are not included in the ACE computation are also noteworthy. The primary category of adjustments ignored in the computation of ACE are deductions which are not allowed when computing taxable income, but which do reduce E&P.<sup>142</sup> These

<sup>134</sup> Treas. Reg. § 1.312-7 (1972).

<sup>135</sup> *Id.* § 1.312-7(b)(1).

<sup>136</sup> *Id.* Authority for disallowing carryovers in the E&P calculation stems from the fact that such items are permitted to reduce E&P in full in the year originally incurred. E&P is also increased if a loss carryback results in a tax refund. *Deutsch v. Commissioner*, 38 T.C. 118, *aff'd*, 405 F.2d 889 (1982); *see also* Rev. Rul. 64-146, 1964-1 C.B. 129.

<sup>137</sup> Rev. Rul. 54-230, 1954-2 C.B. 114; Treas. Reg. § 1.312-7(b)(1) (1972).

<sup>138</sup> STAFF OF THE JOINT COMM. ON TAXATION, 97TH CONG., 2D. SESS., GENERAL EXPLANATION OF THE DEFICIT REDUCTION ACT OF 1984 177 (Jt. Comm. Print 1985).

<sup>139</sup> B&E, *supra* note 108, § 7.03.

<sup>140</sup> Treas. Reg. § 1.312-6(b) (1955).

<sup>141</sup> *Id.*

<sup>142</sup> The ACE computation rules at I.R.C. §§ 56(g)(4)(B) and (C) only require inclusion of income (less related expenses) currently excluded from AMTI but included in E&P, and exclusion of deductions not allowed in any year for E&P

deductions include, among others, federal income tax expense, penalties, bribes and fines, certain lobbying and political contribution expenses, excess travel and entertainment expenses, tax exempt bond amortization expense, and employee stock option bargain purchase element amounts.<sup>143</sup> Such deductions are only allowed for E&P and do not reduce ACE.

A second category of items not considered in the ACE computation is income included for regular tax purposes, but not included in E&P.<sup>144</sup> Such an item would be rare since most taxable income is included in E&P. Components of E&P such as contributions to capital, changes in capital structure, and changes due to mergers, consolidations, and reorganizations (but not related to realization or recognition events) are probably excluded from the computation of ACE because of their non-income or expense character.

Finally, it is important to realize that E&P is not a subset of ACE. The E&P computations and rules are only partially incorporated into the ACE computation. Difficulties will arise in determining which E&P rules are and which rules are not incorporated. For example, since E&P computations have no statute of limitations,<sup>145</sup> does that mean ACE, either in whole or in part, is indefinitely an open tax return item? Also, special problems arise in computing E&P for multiple entities based on the consolidated return rules and regulations.<sup>146</sup>

## ii. *Computing Adjusted Current Earnings*

The ACE computation begins with AMTI after all other adjustments and preferences have been included, but

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purposes but currently allowable in computing AMTI. These rules omit all other items which if taken into account would equate ACE and E&P.

<sup>143</sup> See B&E, *supra* note 108, § 7.03(4); Volpi & DeAngelis, *supra* note 107, at 451-52.

<sup>144</sup> See, e.g., I.R.C. § 312(f)(2); B&E, *supra* note 108, at § 7.03(1) n. 30.

<sup>145</sup> See Volpi & DeAngelis, *supra* note 107, at 444.

<sup>146</sup> For consolidated entity rules, see provisions starting at I.R.C. § 1502 and Volpi & DeAngelis, *supra* note 107, at 453-59.

before the AMT NOL deduction has been utilized.<sup>147</sup> To this amount adjustments for depreciation, income and deductions excluded from E&P, certain section 312(n) amounts, and certain other adjustments including those for post-1989 ownership changes, are added or subtracted.<sup>148</sup> The net result, ACE, is compared to the AMTI starting point. Seventy-five percent of the difference is then added or subtracted as an additional adjustment item.<sup>149</sup> Some of the adjustments are not relevant to aviation entities, but the most relevant are discussed below.

The first adjustment is depreciation.<sup>150</sup> The ACE depreciation adjustment is in addition to and separate from the previously mentioned AMTI depreciation adjustment.<sup>151</sup> For property placed in service after December 31, 1989, the ADS depreciation method must be used.<sup>152</sup> For property placed in service after 1980 and before 1990, the AMT adjusted basis (if any) existing in those assets for years beginning on or after January 1, 1990 must be depreciated straight line over the remaining ADS life.<sup>153</sup> For property placed in service before 1981, the regular taxable income depreciation method is used.<sup>154</sup> The result is that all property placed in service after 1980 is converted to the ADS straight-line, class life method as of the first year beginning on or after January 1, 1990.

Another adjustment requires that items excluded from gross income in computing AMTI, but included in E&P, be added to AMTI for computing ACE.<sup>155</sup> Based on the previous E&P discussion,<sup>156</sup> such items include tax ex-

<sup>147</sup> I.R.C. § 56(g)(3).

<sup>148</sup> *Id.* § 56(g)(4).

<sup>149</sup> *Id.* § 56(g)(1), (3).

<sup>150</sup> *Id.* § 56(g)(4)(A).

<sup>151</sup> Presumably no "double" inclusion would occur since the AMTI adjustment rules require an alternative computation method, part or all of the effect of which is already included in the ACE starting point, AMTI.

<sup>152</sup> I.R.C. § 56(g)(4)(A)(i); see *supra* note 57 and accompanying text for the definition of the ADS method of depreciation.

<sup>153</sup> I.R.C. § 56(g)(4)(A)(iii), (iv).

<sup>154</sup> *Id.* § 56(g)(4)(A)(iv).

<sup>155</sup> *Id.* § 56(g)(4)(A).

<sup>156</sup> See *supra* notes beginning with note 111 and related text.

empt income, deferred installment sale and completed contract income, other E&P gains which exceed AMTI gains due to basis differences, income from LIFO/FIFO differences, key man life insurance proceeds, and so forth. Some of these items, however, may already be included in AMTI due to a different adjustment or preference and should not be added in again.<sup>157</sup> Additionally, deductions relating to this excluded income, such as expenses incurred in generating tax exempt income, are allowed in computing ACE.<sup>158</sup> The income from the discharge of indebtedness may be excluded when computing AMTI,<sup>159</sup> but a special rule keeps it from being added back for ACE purposes.<sup>160</sup>

In addition to "capturing" excluded income, no deduction is allowed when computing ACE unless the deduction would be allowed in "some" year in computing E&P.<sup>161</sup> Based on the previous E&P analysis<sup>162</sup> the "never in E&P" category might include E&P losses which exceed AMTI losses due to basis differences, certain amortization deductions, carryover loss deductions, or the dividends received deduction. Again, any of these amounts included in AMTI due to another adjustment or preference item, should not be used a second time to increase or decrease ACE.<sup>163</sup>

A special provision prevents adding back the dividends received deduction for certain companies.<sup>164</sup> In the case of 100% dividends under sections 243 and 245 of the Code and also for dividends received from a 20% owned corporation, the dividends received deduction is allowed for ACE purposes if the dividends are paid out of income

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<sup>157</sup> See *supra* note 151.

<sup>158</sup> I.R.C. § 56(g)(4)(B)(i).

<sup>159</sup> *Id.* § 108.

<sup>160</sup> *Id.* § 56(g)(4)(B)(i).

<sup>161</sup> *Id.* § 56(g)(4)(C).

<sup>162</sup> See *supra* notes beginning with note 111 and related text.

<sup>163</sup> See *supra* note 151 for a discussion of why there would be no "double" inclusion.

<sup>164</sup> I.R.C. § 56(g)(4)(c).

taxable to the payor corporation.<sup>165</sup>

Although ACE is an adjustment, the explicit E&P income deduction exclusion provisions just discussed may only increase ACE. These provisions do not specifically use the word increase, but the principle of inclusion of income and disallowance of deductions leads to that result. All other components of ACE represent adjustments under alternative methods of computation which could result in a negative (subtraction) adjustment.

Certain adjustments in computing ACE are limited to amounts incurred after December 31, 1989. These include the section 248 amortization disallowance and the installment sale income deferral method.<sup>166</sup> However, the installment method is allowable and does not result in an adjustment to the extent of the applicable percentage of gain determined under section 453A.<sup>167</sup>

Finally, the Code requires an adjustment for certain ownership changes after 1989 where a net unrealized built-in loss exists. The adjusted basis of each asset of an acquired corporation is based on its proportionate share of the total fair market value of all assets acquired.<sup>168</sup> Presumably, such adjusted basis would affect other adjustment and preference computations.<sup>169</sup>

## 2. Preferences

In addition to adjustments, certain preferences enter into the computation of AMTI. The preferences are added after all adjustments, except for ACE and NOL adjustments.<sup>170</sup> Tax preferences can only increase AMTI.<sup>171</sup> The preferences most likely to affect the aviation industry

<sup>165</sup> *Id.*

<sup>166</sup> *Id.* § 56(g)(4)(D).

<sup>167</sup> *Id.*; see also *id.* § 453A.

<sup>168</sup> *Id.* § 56(g)(4)(H).

<sup>169</sup> Starr & Solether, *supra* note 11, at 39-20.

<sup>170</sup> See discussion of Form 4626 at *supra* note 39.

<sup>171</sup> I.R.C. § 55(b)(2). The statutory terminology is "increased" as contrasted with "adjust" or "adjusted". *Id.*

are private activity tax exempt bond interest,<sup>172</sup> appreciated charitable contributions,<sup>173</sup> and pre-1987 depreciation.<sup>174</sup> The depreciation preference is treated the same as under previous law.<sup>175</sup> For non-personal holding companies, the depreciation preference amount is the difference, for real property, between regular tax depreciation and straight-line, class life depreciation.<sup>176</sup>

The private activity tax exempt bond interest preference also requires an addition to AMTI. This addition equals the excess interest on specified private activity bonds<sup>177</sup> over the excess deductions attributable to the bonds which would be allowed if the bonds were included in gross income.<sup>178</sup> The appreciated charitable contribution preference requires that the taxpayer add the appreciation on charitable contributions of capital assets to AMTI.<sup>179</sup> As previously mentioned, preferences can result only in additions to AMTI.

With respect to both preferences and adjustments, it is important to note that the provisions of section 291 also apply.<sup>180</sup> To the extent the benefit of a preference or ad-

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<sup>172</sup> *Id.* § 57(a)(5).

<sup>173</sup> *Id.* § 57(a)(6).

<sup>174</sup> *Id.* § 57(a)(7).

<sup>175</sup> *Id.*

<sup>176</sup> *Id.* Because this computation is done on an asset by asset basis, the benefit of netting positive and negative differences is not obtained.

<sup>177</sup> *Id.* § 57(a)(5)(C). These bonds are generally private activity bonds issued after August 7, 1986. *Id.*

<sup>178</sup> *Id.* § 57(a)(5)(A). Presumably this would include any premium amortization or related investment expenses.

<sup>179</sup> *Id.* § 57(a)(6)(A). The preference applies to capital gain property as defined in Code § 170(b)(1)(C)(iv) and does not include any property for which the appreciation reduction is elected. *Id.* § 57(a)(6)(B). For example, if an individual taxpayer contributes appreciated property with a basis of \$50,000, fair market value of \$150,000, and has adjusted gross income of \$100,000, the deduction will be limited to 30%, or \$30,000. Assuming year two income of \$100,000 and no additional contributions, the regular tax deduction is again \$30,000, but the minimum tax deduction is limited in total to basis, \$50,000, the adjusted basis. Bluebook, *supra* note 9, at 444. The preference only applies to contributions made after August 16, 1986, which are deducted in whole or in part in years beginning with December 31, 1986. *Id.*

<sup>180</sup> I.R.C. §§ 59(f), 291. Section 291 reduces certain tax preference items by 20% to 30%. *Id.* § 291(a)-(b).

justment item is limited by this section, such amounts so limited will not be added to AMTI.<sup>181</sup>

### 3. Minimum Tax Credit

A minimum tax credit (MTC) for corporations is allowed to offset regular tax liability.<sup>182</sup> The credit originated in any given year is the amount of AMT paid and is fully utilizable against regular tax liability in later years.<sup>183</sup> This rule is slightly different from the rule applicable to individuals and corporations prior to 1990.<sup>184</sup> The amount of credit which may be used in a year is limited to the excess of the regular tax over the CAMT for that year.<sup>185</sup> The credit may be carried forward.<sup>186</sup> No guidance has been provided regarding interactions between net operating losses and the MTC in mixed carryback and carryforward years. The 1989 form for computing the minimum tax credit,<sup>187</sup> however, includes a change likely to reduce the available minimum tax credit of taxpayers with NOL's.<sup>188</sup> The change requires the computation of an MTC NOL which effectively removes

<sup>181</sup> *Id.* § 59(f).

<sup>182</sup> *Id.* § 53(a), (d).

<sup>183</sup> *Id.* § 53(d)(1)(B).

<sup>184</sup> The MTC originally provided for by the Act was the difference between the actual CAMT and the CAMT arising because of exclusion adjustments and preferences. This meant only deferral items created MTC. I.R.C. § 53(d)(1)(B)(i)-(iii). For example, an individual taxpayer with no regular taxable income, deferral items of \$350,000 and exclusion items of \$250,000, would owe a minimum tax of \$126,000 at a 21% rate, with the exemption phased out. With only exclusion items, however, the tax would be \$49,350 because the taxpayer only benefits from \$15,000 of the exemption. The credit, then, would be the difference: \$76,650. Bluebook, *supra* note 9, at 464. The book income adjustment was considered a deferral item even though some of the components of it were permanent. *Id.*

<sup>185</sup> I.R.C. § 53(c).

<sup>186</sup> Bluebook, *supra* note 9, at 463.

<sup>187</sup> IRS Form 8801, Credit for Prior Year Minimum Tax (1989).

<sup>188</sup> According to corporate tax specialists consulted, the "refinement" made in the 1989 form is not required by the statute or supported by any other authority. The Service, however, plans to include the change in the AMT regulations expected to be issued by the end of 1990. Therefore, those taxpayers who expect to pay the regular tax after 1988, and who have unused MTC carryovers, a regular tax NOL carryforward, and exclusion preferences, should consider the change in their planning and estimated tax payment calculations.

the benefits of exclusion preference deductions from the regular tax NOL for purposes of computing the "as if" CAMT used in determining the MTC. Because a MTC is generated for all CAMT paid in years after 1989 (there is no "as if" calculation), the form change should have no effect on subsequent year calculations.

#### 4. *Other Rules*

In addition to the minimum tax and credit computation provisions, rules also exist for AMT foreign tax credits (AMT FTC),<sup>189</sup> the tax benefit rule,<sup>190</sup> investment tax credit (ITC) carryover,<sup>191</sup> normative elections,<sup>192</sup> and AMT estimated tax payments.<sup>193</sup> The AMT FTC is the FTC computed by substituting AMT amounts for regular tax amounts under section 27(a).<sup>194</sup> The principal restriction is that only 90% of the CAMT, computed without regard to the AMT NOL, may be offset by the AMT FTC.<sup>195</sup> Any excess is carried back or forward in accordance with normal FTC rules.<sup>196</sup>

The Code provides an exception to the 90% limitation for certain domestic corporations.<sup>197</sup> The limitation does not apply to corporations: (1) which are 50% or more owned by U.S. persons, not members of an affiliated group, (2) with all activities in one foreign country with whom the U.S. has a tax treaty providing for the exchange of information, (3) which distribute all E&P not needed for maintenance, replacements and improvements, and

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<sup>189</sup> I.R.C. § 59(a).

<sup>190</sup> *Id.* § 59(g).

<sup>191</sup> *Id.* § 38(c)(3).

<sup>192</sup> An example is the election to use the ADS method and the longer ADS class life. *Id.* § 168(e).

<sup>193</sup> *Id.* § 6655(f); Temp. Treas. Reg. § 1.6655-7T (1987). The regulation provides for estimating CAMT and the book income adjustment, along with the regular tax, under the annualization method and paying estimated taxes on the greater amount. *Id.*

<sup>194</sup> I.R.C. § 56(a).

<sup>195</sup> *Id.* § 56(a)(2). This section limits the total benefit of the NOL and the AMT FTC to 90% of the CAMT.

<sup>196</sup> *Id.* § 56(a)(2)(B).

<sup>197</sup> *Id.* § 56(a)(2)(D).



(4) whose E&P distributions are used by U.S. persons in a U.S. trade or business.<sup>198</sup>

The Code grants the Treasury authority to prescribe tax benefit rules and regulations under the new CAMT.<sup>199</sup> Regulations were recently issued with respect to the minimum tax in existence prior to 1987.<sup>200</sup> Relief is provided for taxpayers who utilize preference items but obtain no tax benefits (defined as an exclusion of or reduction in tax liability) due to the minimum tax. Congress provided the Treasury with no guidance regarding the tax benefit rule, but the regulations issued provide taxpayers with a method of computing the amount of the tax preference items for which no current tax benefit was received.<sup>201</sup>

Although the new regulations are only applicable to preference items that arise before January 1, 1987, a brief summary is presented here based upon the expectation that the post-1986 regulations will be very similar. Most of the rules are in response to and in accordance with *First Chicago Corp. v. Commissioner*.<sup>202</sup> The principal scenario addressed by the regulations is one where a taxpayer has available credits which reduce or eliminate the regular tax liability even if the preferential deductions are not allowed.<sup>203</sup> In such cases, no minimum tax is due, but the "freed up credits" are reduced by the amount of minimum tax that would have been imposed if a current tax

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<sup>198</sup> *Id.*

<sup>199</sup> *Id.* § 59(g). The section states that:

The Secretary may prescribe regulations under which differently treated items shall be properly adjusted where the tax treatment giving rise to such items will not result in the reduction of the taxpayer's regular tax for the taxable year for which the item is taken into account or for any other taxable year.

*Id.* (emphasis added).

<sup>200</sup> Temp. Treas. Reg. § 1.58-9T, 54 Fed. Reg. 19,363(1989).

<sup>201</sup> *Id.*

<sup>202</sup> 842 F.2d 180 (7th Cir. 1988) (corporate minimum tax was improperly imposed when no present or carryback tax benefit was received and future benefit, if any, was so uncertain that present taxation of preferences may unfairly result in an overpayment of tax for which there would be no future recourse or, in present value terms, a loss from the use of the tax preference item; the tax may be imposed in the future if the benefit arises).

<sup>203</sup> 54 Fed. Reg. 19,363 (1989) (introduction to Temp. Treas. § 1.58-9T).

benefit had been derived from the preferences.<sup>204</sup>

In summary form, the process involves (1) computing the difference between the credits that would have been used if no preferences were allowed and the actual credits allowable against regular tax ("freed up credits"), (2) determining the amount of the preferences which did and did not yield a tax benefit, (3) determining the portion of the minimum tax attributable to the nonbeneficial preferences, and (4) subtracting the result in (3) from the result in (1).<sup>205</sup> The regulations explain each of the computations in detail, but the end result is that, although no minimum tax is paid to the extent preferences do not yield a tax benefit, the available credits are reduced by the minimum tax that would be attributable to the nonbeneficial credits.

Under the previous AMT scheme, the Code provided for an adjustment to tax preference items where the regular tax treatment of the item did not give rise to a tax benefit during the tax year.<sup>206</sup> The taxpayer was treated as using non-preference deductions first such that the tax benefit, if any, was the difference between taxable income computed without regard to preferences over the taxable income (but not below zero) computed with preferences.<sup>207</sup> The tax benefit rule was applied in a variety of circumstances to prevent the inclusion of preferences in the computation of the minimum tax.<sup>208</sup>

Under present law, the minimum tax credit provides some relief from random switching between the two dif-

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<sup>204</sup> *Id.*

<sup>205</sup> *Id.*

<sup>206</sup> I.R.C. § 58(h) (1985).

<sup>207</sup> Rev. Rul. 80-226, 1980-2 C.B. 26.

<sup>208</sup> See, e.g., *First Chicago*, 842 F.2d at 181; Tech. Adv. Mem. 86-46-005 (July 30, 1986) (nonpreference NOL carryback reduces taxable income before NOL or current preference items); Priv. Ltr. Rul. 86-24-003 (Sept. 21, 1984) (nonpreference NOL carryforward reduced tax preference deductions for minimum tax purposes). *But cf.* *Segel v. Commissioner*, 89 T.C. 816 (1988) (minimum tax reduced benefit of investment tax credits but full amount of investment tax credits had to be recaptured upon early disposition of property); Rev. Rul. 87-56, 1987-2 C.B. 27.

ferent tax systems (regular and alternative) and from receiving no benefit under either of the systems.<sup>209</sup> Logically, the old tax benefit rule should still apply to exclusion type preferences and *First Chicago Corp.* should apply to deferral preferences for which the benefit is not forthcoming in the near future, if at all.<sup>210</sup> The tax benefit regulations to be issued by the Treasury regarding the new CAMT will presumably provide similar relief and address anomalous situations including probable permanent loss of benefit from deferral items, lack of benefit from exclusion preference items, and CAMT applications causing results contrary to legislative intent.<sup>211</sup>

In addition to the new regulations regarding the tax benefit rule, the Treasury has also issued temporary regulations relating to the manner and method of absorbing the section 382 limitation (NOL carryforward usage limitation in change of ownership situations) with respect to certain excess credits.<sup>212</sup> In summary, the general effect of the new regulations is to include corporations with carryover capital losses and credits, including an MTC, in the definition of loss corporations and to subject such tax attributes to annual percentage limitations applicable to NOLs.<sup>213</sup> Additional guidance has been provided by recent private letter rulings in the area.<sup>214</sup>

The use of ITC carryovers against the CAMT is limited to the allowable portion of the regular tax, or the excess of the regular tax over 75% of the CAMT. In no event, however, can ITC reduce the tax below 10% of the CAMT without regard to the AMT NOL.<sup>215</sup> Using ITC

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<sup>209</sup> Bluebook, *supra* note 9, at 472-73.

<sup>210</sup> *First Chicago*, 842 F.2d at 180.

<sup>211</sup> See Bluebook, *supra* note 9, at 473.

<sup>212</sup> Temp. Treas. Reg. § 1.382-3T, 54 Fed. Reg. 38,664 (1987) (including amendments to Temp. Treas. Reg. 1.382-1T, -2T and 1.383-1T).

<sup>213</sup> *Id.*

<sup>214</sup> Priv. Ltr. Rul. 89-47-053 (Aug. 31, 1989); Priv. Ltr. Rul. 89-01-055 (Oct. 14, 1988).

<sup>215</sup> I.R.C. § 38(c)(3). For example, a corporation with regular tax liability of \$10 million, minimum tax liability of \$4 million, and ITC of \$7 million, can use all \$7 million of ITC in the present year without violating either of the 75% or 10%

does not decrease the available MTC.<sup>216</sup> Finally, if an AMT NOL, AMT FTC, and ITC are all in play at once, as a group they generally cannot reduce the CAMT below 2% of pre-NOL AMTI.<sup>217</sup>

### 5. *The "Old" Book Income Adjustment*

A general understanding of the book income adjustment, which was used in computing CAMT between 1987 and 1990, is helpful in understanding tax planning strategies and evaluating the future of the CAMT.

Conceptually, the book income adjustment worked as follows: AMTI before the NOL and book income adjustment was computed, adjusted net book income (ANBI) was subtracted, and 50% of any positive difference was added to AMTI.<sup>218</sup> ANBI represented the corporation's applicable financial statement (AFS) net income, adjusted for federal tax expense and certain consolidation entries.<sup>219</sup> As a practical matter, however, the AFS for most large public entities was their annual financial statements, plus revisions, filed with the Securities and Exchange Commission or otherwise issued as a result of a certified audit.<sup>220</sup> For other entities, the Code specified alternative financial statements that could be used as an AFS and permitted an elective earnings and profits based adjustment

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rules discussed. Also, since the minimum tax was not imposed, no MTC was created. *Id.* at 467.

<sup>216</sup> I.R.C. § 53(c). Because the credit is based on TMT, which is computed before application of the ITC, ITC has no effect on the MTC. For example, a corporation with no regular tax liability, a minimum tax liability of \$4 million, and ITC of \$1 million, can use the full \$1 million of ITC and still generate a \$4 million MTC. Bluebook, *supra* note 9, at 467.

<sup>217</sup> For example, a taxpayer with no regular tax liability and TMT of \$10 million before NOLs, credits, or ITC, can reduce the CAMT base to no lower than \$1 million regardless of the total and character of the losses and credits. Bluebook, *supra* note 9, at 468. Stated another way, pre-NOL AMTI times the 10% limitation, times the 20% tax rate, equals 2%, and the result is a flat 2% tax on AMTI. *Id.* at 470-71. The floor for the tax on \$10,000,000 of AMTI before the NOL, is \$200,000 regardless of the available NOL, FTC, and ITC sufficient to reduce tax to zero. *Id.*

<sup>218</sup> I.R.C. § 56(f).

<sup>219</sup> *Id.*

<sup>220</sup> *Id.*

in extreme cases.<sup>221</sup>

Several problems resulted from use of the book income adjustment. Two of the more frequently discussed issues were the AFS concept and the related rules regarding supplemental financial statement disclosures. The Treasury issued lengthy regulations addressing those subjects and recently issued a pair of private letter rulings.<sup>222</sup> A thorough analysis of the book income regulations is beyond the scope of this discussion, but major sections of the regulations were devoted to the: (1) 50% adjustment computation, (2) comprehensive scope of ANBI, (3) AFS and omission, duplication, and restatement rules, and (4) related corporation rules.<sup>223</sup>

A principal disadvantage of the book income adjustment was its tie to financial accounting practices. The basic income provisions reached outside the Code to rules which varied from company to company and industry to industry. The rules conceivably treated items differently than for tax purposes even though the items were not of the type that Congress was interested in capturing in the AMT base (*e.g.*, a nonpreference item). Furthermore, the rules did not permit negative book income adjustments or minimum tax credits on exclusion preferences. These rules created problems in the transition to the new CAMT due to possible permanent taxes on timing items, possible double taxation on both deferral and exclusion items, significant limitations on the generation and use of the minimum tax credit, and potential losses of previously earned minimum tax credits due to negative adjustments.<sup>224</sup>

The service, through regulations, attempted to sort out some of the procedural problems, but in the process pre-

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<sup>221</sup> *Id.* The E&P adjustment was generally available only if the taxpayer had no AFS or only had the lowest priority financial statement. *Id.* § 56(f)(3)(B).

<sup>222</sup> See Temp. Treas. Reg. § 1.56-1T (1987); Priv. Ltr. Rul. 89-22-038 (undated 1989) (applicable financial statements); Priv. Ltr. Rul. 89-13-039 (undated 1989) (supplementary disclosures).

<sup>223</sup> See generally Temp. Treas. Reg. § 1.56-1T (1987).

<sup>224</sup> See generally Brown & Massoglia, *supra* note 4; Gould, *supra* note 4 and Starr & Solether, *supra* note 11.

scribed very complex rules. These included rules regarding selection of the applicable financial statement, adjustments for certain omissions and duplications from ANBI, and adjustments for prior restatements and supplemental disclosures.<sup>225</sup>

Outside the tax calculation, definitional problems between book and tax applications arose. There was probable interference with decisions regarding financial reporting practices, and many questions were raised about the interaction of unrelated CAMT provisions including credits, carryovers, and carrybacks.<sup>226</sup> Overall, the computation was too complex, too technical, and the foundation of the book income adjustment was too unrelated to traditional tax concepts. The biggest advantage for most major corporations was that the concept of book income was easy to grasp quickly. For Congress, the benefit was that immediate revenue could be anticipated from corporations previously paying little, if any, income tax. The plethora of complications was deemed acceptable by Congress in the short run due to the perceived urgent need to restore public confidence in the system.<sup>227</sup>

## II. ANALYSIS

Given this statutory and regulatory framework the discussion will continue with an analysis of the CAMT. This

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<sup>225</sup> The rules cited included the priority of AFSs, the inclusion of certain omissions and duplications from income, adjustments for restated financial statements, and adjustments for certain supplementary data disclosures. Temp. Treas. Reg. § 1.56-1T (1987).

<sup>226</sup> *Id.* One example of the definition problem includes "substantial non-tax purpose" which has no meaning for accounting purposes. *Id.* § 1.56-1T(c)(4). An example of a decision that might be influenced by the adjustment is the choice of leasing or buying an asset because of the depreciation adjustment and preference.

<sup>227</sup> Bluebook, *supra* note 9, at 434-35. "Congress concluded that it was particularly appropriate to base minimum tax liability in part upon book income during the first three years after enactment of the Act, in order to ensure that the Act will succeed in restoring public confidence in the fairness of the tax system." *Id.* at 434. Using the new CAMT in the General Dynamics situation, *supra* note 10, tax liability could increase by more than \$100 million based on the book income adjustment (\$1.1 billion multiplied by .5 multiplied by 20% = \$110 million).

analysis consists of a discussion of the practical implications of the tax, including the complexities, transition issues, statutory inadequacies, and a few often overlooked realities of the CAMT. General tax planning opportunities will also be analyzed for 1990 and thereafter. The focus will be on issues and items most applicable to aviation entities.

## A. *Practical Implications*

### 1. *Complexities*

Great complexity is associated with the record keeping required by the CAMT. Potentially, six sets of books are necessary, one set each for: regular federal tax (NOLs, asset basis, and depreciation), state tax, E&P calculations, financial reporting, the ACE adjustment (including ADS depreciation, basis and the negative adjustment limitation), and AMTI depreciation and basis. These are in addition to the related carryback and carryforward deduction and credit schedules. The probable effect of this record keeping burden is substantial noncompliance.<sup>228</sup>

Many corporations that never worried about the minimum tax before are now forced to analyze potential preference items, adjustments, timing differences, earnings and profits, minimum tax credits, and related limitations.<sup>229</sup> An already complicated process is made more so because many large corporations not subject to the CAMT may be liable for the environmental tax, which means they must analyze their CAMT adjustments and preferences for that reason alone.<sup>230</sup>

The lack of guidance with respect to the tax benefit rule also creates complexity. The fact that exclusion preferences arising during the book income adjustment years

<sup>228</sup> Starr & Slother, *supra* note 11, at 39-21, 39-22.

<sup>229</sup> See, e.g., AMR CORPORATION, 1987 FORM 10-K (1988). In the tax footnotes AMR discloses a minimum tax liability as a reduction in the deferred tax provision, and reflects the effects of ITC and other tax benefit transactions. *Id.*

<sup>230</sup> I.R.C. § 59A.

may not have generated a regular tax benefit (or a minimum tax credit) should result in application of the old tax benefit rule.<sup>231</sup> But whether the old rule applies is presently unclear. Tax benefit rule problems are less likely to arise with the ACE adjustment than with the book income adjustment. This expectation is due primarily to the availability of a negative ACE adjustment, a more complete minimum tax credit (*i.e.*, for all minimum tax paid), and the fact that ACE is a tax-based calculation. Many issues dealt with by the temporary regulations under the old minimum tax linger on under the present CAMT scheme.<sup>232</sup>

As mentioned in the ACE adjustment discussion, it is presumed that items which create an adjustment or preference, other than in the ACE computation context, will not be double counted. The difficulty is clear: because E&P is not well defined and the components of ACE which relate to E&P are vague (currently excluded gross income and permanently non-included deductions), developing a system or checklist for tracking the items which need to be considered in the ACE computation will be complicated and time consuming. Schedule M-1 of the Form 1120 filed by corporations is suggested as a helpful starting point.<sup>233</sup>

Additionally, many of the complexities which arose in computing the CAMT during 1987-1989 remain in 1990. These include the difficulties associated with interactive limitations such as the NOL, FTC, and ITC, the carryover computation, use of the MTC (although it should be easier now that all adjustments and preferences create the credit), and the new financial accounting rules for federal

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<sup>231</sup> See Brown & Massoglia, *supra* note 4.

<sup>232</sup> See *supra* notes 200-211 and accompanying text for a discussion of the tax benefit rule issues.

<sup>233</sup> Schedule M-1 of IRS Form 1120 is a reconciliation of book to taxable income. Many items which differ between taxable income and E&P also differ between taxable income and book income.



income tax disclosures.<sup>234</sup> The new accounting rules differ from the previous rules under Accounting Principles Board Opinion No. 11 in several respects.<sup>235</sup> Essentially, the tax liability computation is the same as before, but the deferred tax provision is computed by analyzing all temporary differences, expected tax benefit turnarounds, future tax rates, and, through an elaborate netting process, the cumulative effect of all the temporary differences existing at year end.<sup>236</sup>

The accounting tax computation is made for both the regular and minimum tax.<sup>237</sup> The difference between the beginning balance in the deferred tax account and the computed ending balance is the current tax expense.<sup>238</sup> The new rules were scheduled to go into effect no later than 1989, but the effective date has been postponed until years beginning after December 15, 1991.<sup>239</sup>

The pressure placed on financial reporting will likely yield no public benefit. Congress did not intend to interfere with financial reporting and accounting decisions,<sup>240</sup> but the potential for such interference is clear. The book income adjustment created a great incentive to select "tax methods" for financial reporting.<sup>241</sup> The ACE adjustment may encourage noneconomic decisions solely due to tax

<sup>234</sup> See ACCOUNTING FOR INCOME TAXES, Statement of Financial Accounting Standards No. 96 (Fin. Accounting Standards Bd. 1987) [hereinafter FASB 96].

<sup>235</sup> Keely & Schafer, *Implemented SFAS No. 96*, TODAY'S CPA, Nov.-Dec. 1988, at 20, 21. Under previous rules, the liability provision for taxes was based on actual taxes due on the tax return whereas the income statement expense was based on book income. *Id.*; see also M. RUTLEDGE, S. HOLTON & H. MCMURRIAN, GUIDE TO ACCOUNTING FOR INCOME TAXES (1988); Fischer, *Shortcutting FASB No. 96's Scheduling Exercise*, J. OF ACCOUNTANCY, Feb. 1989, at 42 (thorough discussion of implementation strategies); Knight, Knight & McGrath, *Double Jeopardy: The AMT and FASB 96*, J. OF ACCOUNTANCY, May 1988, at 40.

<sup>236</sup> FASB 96, *supra* note 234.

<sup>237</sup> *Id.*

<sup>238</sup> *Id.* A handy checklist for computing the expense amount when the AMT is relevant is provided in Knight, Knight & McGrath *supra* note 235, at exhibit 4.

<sup>239</sup> FASB Delays Tax Standards, THE CPA LETTER, Dec. 1989, at 1.

<sup>240</sup> Bluebook, *supra* note 9, at 456.

<sup>241</sup> Anthony & Dilley, *supra* note 4, at 468. In theory, corporations have some flexibility in the determination of useful lives and residual values of assets which could substantially change book depreciation.

factors in an attempt to avoid adjustments and preferences.<sup>242</sup> The risk is also clear: financial statements are used by owners and management for investment and business decisions and, to the extent tax accounting methods or tax driven decisions interfere with the quality of information and the decision making process, taxes have become a "pilot" instead of a "passenger" in the financial reporting journey.

Finally, one bright spot after 1989 is the absence of reference in the CAMT statutory language to book reporting methods. The CAMT computation is driven by tax concepts rather than a mixture of tax and financial accounting rules. Unfortunately, that is the extent of the good news.

## 2. *Transition Issues and Other Inadequacies*

Closely related to the complexities are transition issues. No transition period was created to mitigate the immediate impact of the book income adjustment. Congress desired immediate progress in restoring faith in the tax system, particularly in eliminating abuses resulting from differences in tax and financial reporting.<sup>243</sup> Progress made in restoring taxpayer faith is hard to measure, however, and arguably any progress was offset by lost faith in the system resulting from rising complexity.

The immediate application of the CAMT and book income adjustment allowed no time for reevaluation of book reporting methods with respect to "tax insignificant" practices for which more tax favorable reporting alternatives may have been available. Furthermore, timing differences which arose before 1987, but reversed in years after 1986 may have resulted in a permanent tax on otherwise deferrable items.<sup>244</sup> A similar observation applies to the ACE adjustment. Taxpayers had more preparation

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<sup>242</sup> For example, leasing instead of owning.

<sup>243</sup> See *supra* note 227 and accompanying text.

<sup>244</sup> For example, the reporting of a book expense in 1986 that is allowable for tax purposes in 1987, with AMTI and regular taxable income otherwise constant, potentially results in a CAMT on 50% of the difference.

time but, for example, a book income item giving rise to CAMT in a year before 1990 that never arises for regular tax purposes after 1990 due to a book reversal or redetermination, potentially generates a permanent tax.<sup>245</sup> Other items could cause a similar result due to an imperfect minimum tax credit.<sup>246</sup>

Another important transition issue arises with respect to the capital loss and charitable contribution carryovers. Because the ACE computation involves the disallowance of deductions for AMTI that are not allowed in any year for E&P, the question arises whether, under this rule, deductions previously allowed in computing E&P will qualify as deductions for AMTI. The capital loss and charitable carryovers reduce E&P in the year incurred, but affect AMT over more than one year because they carry over. Such an item incurred before 1990 is arguably required to be added back to AMTI in computing ACE.

The CAMT is inadequate in many other respects as well. Whereas book income adjustments were *only* positive, an ACE adjustment can be either positive or negative

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<sup>245</sup> This could result from a contingency reserve provision where the related event never arises. See ACCOUNTING FOR CONTINGENCIES, Statement of Financial Accounting Standards No. 5 (Fin. Accounting Standards Bd. 1975). Common examples of contingency reserves include the bad debt reserve, appraisal write-downs for inventory, market writedowns of marketable equity securities, unrecognized foreign currency translation losses, reserves for losses on discontinued operations, and miscellaneous other contingencies for warranty repairs and prospective litigation. See generally B. JARNAGIN, FINANCIAL ACCOUNTING STANDARDS (10th ed. 1988) (Contains analysis of financial accounting standards). The provision would usually be for expected loss or expense reserves, often established at an amount greater than the actual result, due to a conservative accounting philosophy. For example, if a company expects a \$500,000 loss on the sale of a discontinued business which is ultimately sold at breakeven (and for which no loss is recognized for tax purposes), with all else constant for book and tax purposes, the \$500,000 book gain due to the previous contingent loss creates a potential book income adjustment.

<sup>246</sup> The credit is only available in regular tax years so that taxpayers permanently in an AMT position will not benefit from it. Also, in years before 1990, corporations only earned the credit for the tax paid due to deferral adjustments and preferences. Furthermore, there are substantial limitations on the amount which can be used in the regular tax year. Finally, certain situations could arise where the MTC carryforward was actually reduced without being used. See Bluebook, *supra* note 9, at 464.

(but negative adjustments are limited by prior positive adjustments).<sup>247</sup> The MTC partially ameliorates tax arising due to a book income or ACE adjustment, but a taxpayer permanently in a minimum tax situation will never be able to benefit from the MTC, whether caused by book income or ACE adjustments, since the MTC can only be used in regular tax years. Furthermore, positive book income adjustments in one year which later reverse may result in permanent tax if they cause a net negative adjustment in a reversal year before 1990.<sup>248</sup>

Also, with E&P not clearly defined, some unusual items may arise in computing ACE. For example, Code section 56(g)(4)(B) requires that all amounts excluded from gross income be included in AMTI net of related deductions for purposes of computing ACE. Federal income tax and similar taxes paid reduce E&P<sup>249</sup> but do not reduce AMTI. If a corporation receives a tax refund, must this be included in ACE? Similar questions arise with respect to related party losses which are later recovered, refunded penalties, and reimbursed "excess" travel and entertainment expenses, to name a few. All reduce E&P but do not reduce AMTI or ACE, unless they fit within the section 56(g)(4)(B)(i)(II) exception for related expenses.

With the book income adjustment, double taxation was a possible result.<sup>250</sup> This result is unlikely with respect to the ACE adjustment because of the minimum tax credit and negative ACE adjustment.

The MTC raises some interesting issues regarding its interaction with the ITC and AMT NOL. Since the MTC is determined before the minimum tax is reduced by

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<sup>247</sup> I.R.C. § 56(f)-(g).

<sup>248</sup> For example, an item of income accrued for book purposes but subsequently not realized, and which was never recognized for tax purposes, could have caused a positive book income adjustment in one year, and then, have caused ANBI to be less than AMTI before the adjustment in the reversal year. The result is no tax benefit and a permanent tax.

<sup>249</sup> B&E, *supra* note 108 § 7.03(4).

<sup>250</sup> Gould, *supra* note 4, at 36-45.

ITC,<sup>251</sup> to the extent ITC reduces the CAMT paid in a tax year, a double benefit may arise if the full MTC is later used. With respect to the AMT NOL, a problem can arise in the following situation: an MTC is generated in 1988, utilized in part in years 1989 and 1990, and then an AMT NOL is generated in 1991. If the taxpayer elects to carry the NOL back to 1988, many results are possible.

In this example, the taxpayer may be entitled to a refund of CAMT paid in 1988, but part of the tax may have already been refunded through the use of the MTC. Amended returns may be required, or no tax refunds may be allowed on minimum taxes paid for which a credit was generated. A negative adjustment to the taxpayer's minimum tax credit carryover may be required. In any event, there is not a clear answer to the problem.

Finally, the MTC can only be carried forward.<sup>252</sup> As a result, a corporation liquidating at a loss, with a lower final tax liability than the MTC carryforward, or in an AMT position in the liquidation year, will receive no benefit in its final return for unused MTC.

### 3. Limitations

Aside from the complexities and inadequacies, limitations further complicate the CAMT. First, only 90% of an NOL may offset AMTI in any year.<sup>253</sup> As a result, if a corporation is in a loss position throughout its entire existence and experiences a gain on liquidation,<sup>254</sup> it could pay CAMT if the regular tax NOL completely eliminated regular tax and 10% of AMTI exceeds the exemption amount.<sup>255</sup> A corporation might also pay CAMT in pre-

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<sup>251</sup> I.R.C. § 53(b).

<sup>252</sup> *Id.*

<sup>253</sup> *Id.* § 56(d).

<sup>254</sup> The Act repealed the *General Utilities* doctrine (which permitted tax free corporate liquidations).

<sup>255</sup> For example, a corporation with a \$1,000,000 NOL carryover for regular tax and AMT purposes which liquidates at a gain of \$1,000,000, could only use \$900,000 of the AMT NOL, leaving \$100,000, less the exemption of \$40,000, taxable at 20%.

liquidation loss carryforward years solely because of the AMT NOL limitation.<sup>256</sup>

Another limitation, with limited application,<sup>257</sup> is found in the AMT FTC rules. Again, a corporation could pay CAMT solely due to the AMT FTC limitation.<sup>258</sup> What makes this situation even more unfair is that the corporation paid taxes, although not to the United States government.

These limitations are compounded when the AMT NOL, AMT FTC, and ITC carryover or carryback arise in the same year. The net result can be an absolute 2% tax on AMTI before the AMT NOL deduction.<sup>259</sup> This result seems even more unfair when combined with the limitation on using the MTC *only* in subsequent regular tax years, the possibility of remaining in a minimum tax situation indefinitely, and in light of the other concerns already discussed.

The most often overlooked aspect of the CAMT is the inclusion of many items historically thought safe from preferential classification. Few planners are surprised that depreciation, deferral recognition methods, and special exclusions have been brought into the CAMT computation. The inclusion of items like tax exempt income, life insurance proceeds, intangible amortization and charitable contributions is more surprising.

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<sup>256</sup> Using the previous example, assume instead of liquidating, the corporation has \$500,000 of income each year for two years. AMTI would be \$500,000, less the 90% limit of \$450,000 and the exemption of \$40,000, leaving \$10,000 subject to the AMT in each year.

<sup>257</sup> I.R.C. § 59(a)(2)(C).

<sup>258</sup> Using the previous example, if regular tax is completely offset by FTC, and AMTI is greater than zero, AMT FTC can only offset 90% of the CAMT.

<sup>259</sup> Bluebook, *supra* note 9, at 470-71. Consider this comprehensive example of the interaction of the three: A corporation has no regular tax liability and \$10 million AMTI before NOL or credit. The NOL is \$7 million, FTC is \$350,000, and ITC is \$200,000. The full NOL may be used, leaving \$3 million of AMTI. The TMT on that amount would be 20%, or \$600,000. The absolute floor on tax is 2% of \$10 million, or \$200,000. Therefore, the full FTC may be used, leaving \$250,000, and \$50,000 of ITC may be used, leaving an ITC carryover of \$150,000. *Id.* Assuming the full minimum tax liability was due to deferral items under the old book income adjustment, the MTC is \$250,000 (unaffected by ITC).

The ACE adjustment captures all tax-exempt income and almost all excluded income.<sup>260</sup> That private activity bond interest income is included as a preference is not surprising, but that state and municipal obligation income causes an adjustment is more unexpected. A similar statement can be made about life insurance proceeds, mainly due to the general social policy considerations which justify the regular tax exclusion. As for amortization expenses, requiring an increased period of recovery similar to depreciation would not have been surprising, but effectively eliminating recovery altogether seems unfair.<sup>261</sup> Finally, during a time of widening gaps between rich and poor, civic apathy, and community and family decline, potential discouragement of charitable giving is inappropriate.<sup>262</sup> Although the charitable preference applies only to appreciated property gifts, there is no denying the true economic detriment to the donor and the possible tax liability without associated cash flow.<sup>263</sup>

### B. *General Tax Planning*

The CAMT makes planning a very complex task. Each corporation must consider its unique tax situation, and there is no substitute for "cranking through the numbers." Short-cut methods can yield inaccurate results.<sup>264</sup>

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<sup>260</sup> I.R.C. § 56(g)(4)(B).

<sup>261</sup> Certain organizational expenditures are not deductible for E&P, and property with no set life or an undeterminable life are likely to be treated similarly.

<sup>262</sup> In fact, a bill was introduced in the House of Representatives in 1989 by Congressman Frenzel (R-NM) to eliminate the appreciated charitable gift preference. H.R. 173, 135 Cong. Rec. H47-02 (January 4, 1989).

<sup>263</sup> When a taxpayer donates appreciated property, the taxpayer suffers a real economic detriment equal to the fair market value of the property. By disallowing the appreciation, the taxpayer suffers a cash loss in three ways: the tax liability is greater than had the full value been permitted as a deduction; the taxpayer may lose some leveraging capability due to the reduction in its total assets; and if the property was already leveraged, the taxpayer may have to come up with additional cash to pay off the debt and obtain a net deduction, avoiding "liability in excess of basis" gain.

<sup>264</sup> For example, when the book income adjustment was in effect, merely taking the AMT and reducing it by the product of exclusion adjustments and preferences, then multiplying by 20%, would not yield the same result as would making a "with" and "without" computation. This situation would likely arise when

This section begins with a review of some key terms, followed by a discussion of some general rules of thumb. All applications are based on the rules discussed in section I.

Before tax planning begins, the planner must understand key distinctions and tax treatments which affect the outcome under the CAMT. As previously discussed, taxpayers pay the CAMT because of adjustments, preferences and limitations. Adjustments may be either positive or negative. Preferences are always positive, and limitations may create a minimum tax when losses or credits would otherwise prevent it.

By way of review, a preference or adjustment can be characterized as either a deferral or exclusion item. A deferral item will be recognized both for regular and minimum tax purposes in the same amount but at different times. An exclusion item is one that is treated differently under the two tax systems, being partially or fully excluded from recognition by one system. The ACE adjustment consists of both deferral and exclusion components. The tax income effect of a deferral item eventually reverses whereas the impact of an exclusion item does not. The latter statement is not entirely accurate because "negative" ACE adjustments are permitted and a minimum tax credit is generally available. If they work optimally, the two convert the CAMT into regular tax prepayment. Finally, nonpreference items affect the regular tax and minimum tax systems in the same way.

### 1. *Rules of Thumb*

There are a few rules of thumb. Based on a current maximum corporate tax of 34% on regular taxable income and 20% on AMTI, AMTI must be at least 170% of taxable income before the CAMT is due.<sup>265</sup> Similarly, the ACE adjustment alone can cause AMT if it exceeds 193%

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AMTI is close to the exemption amount, when deferral adjustments are negative, or when the FTC limitation creates all or part of the minimum tax liability.

<sup>265</sup> 34%/20% equals 1.7 or 170%. If an exemption is available, the percentage is a little greater than 170%.



of regular taxable income.<sup>266</sup> The environmental tax may be due even if AMTI is equaled or exceeded by regular taxable income.<sup>267</sup> With only a 14% rate spread between the two tax systems, planners may feel there is little incentive to plan. In some situations, however, deferral of an item may be a difference of 20%,<sup>268</sup> up to 34%.<sup>269</sup>

The general rule of thumb used with respect to the *individual* AMT in existence prior to the Act was to defer income to years where the taxpayer owed the AMT, and to accelerate deductions into regular tax years, until the breakeven point tax liability between the two systems.<sup>270</sup> Under the new CAMT, however, the rule is not so simple. A determination of how an item affects E&P is important due to the ACE adjustment. Expectations for the type of tax application in the future will affect decisions in the present. It may be that timing items are of minimal or no importance because of the negative ACE adjustment and the MTC. Also, as in the case of leased assets, planning between unaffiliated taxpayers may be desirable.<sup>271</sup>

If a taxpayer will be in one tax system for a continuous period of years, well-planned deferral and acceleration is a good idea because it can operate like an interest free loan (or investment) which saves (or yields) 15% to

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<sup>266</sup> ACE of 193x, less 100x regular taxable income, equals 93x, multiplied by 75% ACE adjustment percentage, equals 70. Add 100x and 70x to total 170x, which is the same as in note 265, *supra*. Again, the exemption could increase the percentage.

<sup>267</sup> Specifically, if AMTI before the AMT NOL and exemption is greater than \$2 million, the environmental tax is due. I.R.C. § 59A.

<sup>268</sup> For example, most tax exempt income generates no tax in a regular tax year, but may cause a 20% tax in an AMT year. *Id.* § 57(a)(5).

<sup>269</sup> A charitable contribution of appreciated property in an AMT year may yield no tax benefit on the appreciated portion and may generate no MTC, but it may yield up to a 34% benefit in a regular tax year. *Id.* § 57(a)(6). Another example is that of a taxpayer who cannot benefit from the depreciation due to a minimum tax situation created by the depreciation, but would pay the regular tax if the same assets were leased, thus receiving a 34% tax benefit for the lease payments.

<sup>270</sup> The rationale was that, while income was only marginally taxed at 20%, the tax benefit of deductions was as high as 50%.

<sup>271</sup> An entity that can use the full depreciation deduction could lease to a company that cannot.

34%.<sup>272</sup> If the taxpayer is expected to be in an AMT position for many years, the present value benefit of the MTC is nominal, and the minimum tax replaces the regular tax. However, beyond this simple scenario, other strategies are less clear.

## 2. *AMT v. Regular Tax Scenario*

For a taxpayer in an AMT position in the present year but expected to be in a regular tax position in the near future, nonpreference taxable income accelerated into the present year will be taxed at 20% instead of 34%; similar deductions will yield only a 20% benefit. Generally, nonpreference deductions should be postponed to a regular tax year.

As for adjustment and preference items, those most likely to arise are income which is recognized for AMT but not for regular tax (*e.g.*, installment sale), and deductions which are allowed for regular tax but not for AMT (*e.g.*, accelerated depreciation). If the item is a deferral item (as most adjustments are), the amount of income or deduction captured by the adjustment will yield no present tax benefit because it will be "picked up" in AMTI. In future years, though, a potentially beneficial reversal may occur. For example, in the second year of an installment sale, a negative adjustment arises *reducing* AMTI by the current year gross profit percentage recognized for regular tax purposes but not for AMTI. This is true because the installment *method* (not just the income) is disallowed for AMTI. Deferral preferences (*e.g.* accelerated depreciation) on the other hand, can only increase AMTI and will not reverse and reduce AMTI in a subsequent year.

If the item affects the computation of the ACE adjustment, it could be either a deferral or exclusion item. In this case, the preceding analysis applies except that only

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<sup>272</sup> The difference between paying a bill on December 31 or January 1, from a cash flow standpoint, is immaterial. But the later payment postpones the tax benefit of up to 34% for one full year. The minimum savings of 15% represents an ACE adjustment which is partially taxed, 75% multiplied by 20%.

75% of the ACE difference is subject to tax or reverses in a later year. Based on the language of section 56(g)(4)(C), there is no adjustment required for deductions which are recognized for AMTI before E&P as long as the item is eventually recognized for E&P purposes.

In the case of exclusion items (mostly preferences and other components of the ACE adjustment), current regular tax recognition will yield no (e.g., preferences) or reduced (e.g., 75% of ACE excess) tax benefit and will not reverse in a subsequent year. Thus, items such as private activity bond income, other tax exempt income, or the dividend received and appreciated charitable contribution deductions should be postponed until a regular tax year.

When a taxpayer is in a regular tax position, the reasoning is generally reversed. A taxpayer should postpone nonpreference income until an AMT year (due to the 20% rate) but claim nonpreference deductions in the current year. The only possible incentive for recognizing income would be to utilize the MTC or some expiring tax benefit if an AMT situation was expected to defer its use indefinitely.

Acceleration of both deferral and exclusion income and deductions may yield present and future benefits. Initiating a deferral income event (like an installment sale) will cause recognition of a small percentage amount of income presently but will create a "negative," or reduce a positive, AMTI adjustment in the future.<sup>273</sup> Recognizing deferral deductions now will also maximize the current tax benefit and minimize the future CAMT exposure.<sup>274</sup>

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<sup>273</sup> For example, if an installment sale transaction is initiated in a regular tax year, a percentage of the total gross profit on the contract will be recognized for regular tax purposes. The entire amount is recognized for AMTI purposes because an adjustment is made to eliminate the effect of the installment reporting method. In subsequent years, additional increments of income would be recognized for regular tax purposes, but the AMTI adjustment would be negative since no income would have been recognized if the taxpayer had not been using the installment method.

<sup>274</sup> A taxpayer's exposure to a CAMT in the future is reduced by current use of deferral deductions in a regular tax year because the number of years in which the item can arise is reduced by current use. This would be true of a depreciable or

Similar benefits result from exclusion item recognition, since exclusion income is tax free in a regular tax year (*e.g.*, tax exempt income). In addition, exclusion deductions are fully deductible (*e.g.*, appreciated charitable deduction).

However, if a taxpayer expects to stay in a regular tax situation, the "negative" ACE adjustment yields no benefit (since AMTI is not important in regular tax years) and may waste part of the "ceiling" created by previous positive adjustments on the allowable amount of negative ACE adjustment in an AMT year (which avoids negative adjustment or reduces the CAMT). Exclusion income escapes taxation altogether and exclusion deductions are available in full.

As for the MTC, the accumulated credit may be used, but only to the extent the current year regular tax exceeds the current year "as if" CAMT. Thus, the more adjustment and preference items used, the smaller the regular tax and the smaller the usable credit. The MTC does carryover indefinitely, however, so steps need not be taken to accelerate its utilization. When utilized, the net effect is to pay the marginal tax, that is, the rate difference between the regular tax and the minimum tax on the income (presently 14%).

The other possible scenario is to be close to one tax or the other, moving in and out of the regular tax and the CAMT. In these situations, there is no simple strategy or easy statement of general principles. The general rules discussed are still applicable, but the timing of recognition events, the capacity for and availability of negative adjustments, and the availability of the MTC and other credits, coupled with projected future activity, all become more critical.

With regard to the various CAMT limitations, minimum tax paid due to an AMT NOL generates a MTC because it

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amortizable asset with a short life. Another example is of an asset qualifying for the § 179 annual expense election: making the election in a regular tax year eliminates the effect of a depreciation or ACE adjustment on the amount expensed.

is like any other adjustment. Minimum tax paid due to a FTC limitation does not generate a MTC because the MTC is computed after consideration of the FTC.<sup>275</sup> The ITC indirectly yields a MTC because it reduces the current year tax due after the MTC is calculated.<sup>276</sup>

### 3. *Other Planning Issues*

Several other planning opportunities also exist. With respect to the NOL, use of the regular NOL in a regular tax year yields the most benefit because of a higher rate. The AMT NOL is adjusted (the size of the NOL is generally reduced) for preferential items, and when used in AMT years, causes an "as if used" reduction in the regular NOL. Thus, actions taken to accelerate taxable income into a regular tax year with an available NOL will prove more tax beneficial if no minimum tax liability is created in the process. The AMT NOL must, therefore, be monitored in the planning process.

Additionally, a small window of opportunity exists for an NOL carryback election.<sup>277</sup> A 46% rate benefit may be available because of higher prior year tax rates. A carryback is still available for a calendar year taxpayer's 1989 return on extension, to the 1986 calendar year if that year's return was filed on extension. Note, however, that the AMT NOL is reduced in carryback years even though there was no CAMT in the carryback year.<sup>278</sup> In some situations a taxpayer may be justified in creating a current regular tax NOL, even if this results in a current year minimum tax liability, depending on the taxpayer's marginal tax rate in the pre-1987 years.<sup>279</sup> This can be an especially effective strategy if the marginal preference deduction has

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<sup>275</sup> I.R.C. § 53(d).

<sup>276</sup> *Id.*

<sup>277</sup> *Id.* § 172(b).

<sup>278</sup> See *Bluebook*, *supra* note 9.

<sup>279</sup> For example, if preferential deductions cause a NOL, even though no current benefit is received and the CAMT is paid, the regular tax carryback to a 46% year more than offsets the present 20% minimum tax. In addition, an MTC may be created by the minimum tax paid.

no effect on the present year minimum tax liability.<sup>280</sup>

Careful planning with regard to NOL carryforwards is also important. A carryforward could potentially cause a 90% limitation in the carryforward year. On the other hand, deferring a deduction in an NOL year to a carryforward year may generate a tax benefit.<sup>281</sup>

Another major area for tax planning is in the capital asset area. Because the aviation industry is very capital intensive, depreciation and basis adjustments can be very significant, as can installment sales of assets and long-term construction contracts. Leasing may be a better alternative for an airline that cannot fully benefit from accelerated depreciation deductions, for example. It is likely an airline could structure the lease as an operating lease<sup>282</sup> and shift the tax deductions associated with ownership to an unrelated party<sup>283</sup> that can utilize them.

The business issues to consider are whether a lease makes economic sense and whether the lease should be structured to qualify as an operating lease. The principal business advantages of a lease arrangement include better financing, increased operational flexibility, increased liquidity, and less expense overall due to the shift of tax benefits which allow the lessor to offer a better deal to the lessee.<sup>284</sup> To assure operating lease treatment the follow-

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<sup>280</sup> For example, a taxpayer in an AMT situation experiences no present tax benefit or detriment from additional preference depreciation because regular taxable income decreases and AMTI increases by the same amount leaving the CAMT the same. A carryback of the NOL may yield a net benefit of 46%.

<sup>281</sup> For example, if a taxpayer incurs a 1987 NOL of 100x, carries it forward to an AMT year with AMTI of 100x, only 90x of the NOL can be used to offset AMTI, leaving 10x taxable at 20%, or a tax of 2x. If 10x of the deductions were postponed to the next year, the NOL carryforward would be 90x, AMTI would now be 100x minus 10x, or 90x, the AMT limit would be 90% of 90x, or 81x, leaving 9x taxable at 20%, or a tax of 1.8x. The net savings is .2x.

<sup>282</sup> Rev. Proc. 75-21, 1975-1 C.B. 715.

<sup>283</sup> A related party transaction, especially within a consolidated group, would likely result in a wash transaction based on consolidation adjustments.

<sup>284</sup> See EQUIPMENT LEASING, 36-3RD TAX MGT. (BNA) A-1, A-2 (1988) (general discussion of advantages and disadvantages to lessees and lessors); Endres, *Leasing After the Tax Reform Act of 1986*, 19 TAX ADVISER 537 (1988) (detailed discussion of leasing after the Act). While the rules are different, tax rules are stringent enough to prevent true sales from being classified as leases. Rev. Proc. 75-21,

ing should occur. First, the amounts and parties involved should deal at arms length. Next, incidents of ownership should shift to the owner (as much as possible) and the life of the lease should not exceed the asset's economic life. Finally, the lease should be a bona fide business transaction, and the owner should have substantial rights and equity in the property.<sup>285</sup>

Equipment leases were particularly tax-beneficial under the old "safe-harbor" provisions and can be good deals today.<sup>286</sup> The lessee benefits from fully utilizable deductions and potentially better financing, while the lessor receives accelerated depreciation deductions, front-end loaded interest deductions, level lease payments, and usually a good return on investment.<sup>287</sup> Even if a corporation is not sure it will be in an AMT position, the lease arrangement may still make sense.<sup>288</sup> Leasing has become fairly common among both large and small airlines.<sup>289</sup>

Besides leasing, there are other situations that merit consideration.<sup>290</sup> One particularly simple opportunity to

*supra* note 282. Furthermore, the courts look at intent, the nature of the lessee's interest, who bears the benefits and burdens of ownership and the nontax reasons for the lease. Endres, *supra* at 546.

<sup>285</sup> Footnote 272.

<sup>286</sup> See EQUIPMENT LEASING, 12-6TH TAX MGMT. (BNA) (1983).

<sup>287</sup> See Ferguson, 260 PRAC. L. INST. 407 (1987).

<sup>288</sup> See Endres, *supra* note 284. The author gives two examples, one of a 10 year lease on a \$750,000 asset in both a regular and AMT year, and an example of the same asset with much less favorable terms to the lessee. In each case, the lease resulted in a substantial positive net present value when compared to asset ownership. *Id.* at 539-45.

<sup>289</sup> Continental Airlines leased 198 out of 352 aircraft in 1987 and Eastern leased 91 out of 284. TEXAS AIR CORPORATION, 1987 FORM 10-K, at 12-13 (1988). The consolidated balance sheet for Texas Air Corporation disclosed total capital leases of over \$1 billion. *Id.* at F-4. In contrast, start-up airline North American Airlines leases its one and only aircraft. Wall St. J., Jan. 22, 1990, at A1, col. 1.

<sup>290</sup> Corporate tax planning specialists consulted suggested the following (some of which relate to the book income adjustment): 1) In acquisition situations, structuring the deal as a purchase instead of a pooling, selecting shorter life for goodwill amortization, stepping up assets, if possible, in a leveraged buyout, careful selection of which method to use in the transition to the new tax accounting rules, and using push down accounting, will all result in lower book income than tax and help to minimize the book income adjustment; (2) in debt and asset oriented transactions, structuring dispositions as stock exchanges or shareholder transactions rather than corporate sales, employing the leasing device instead of asset

watch for is a merger situation between firms with tax situations that permit maximization of the combined tax characteristics.<sup>291</sup> Of course, a merger may substantially limit NOL utilization<sup>292</sup> and may cause an ACE adjustment in an otherwise tax free transaction due to ACE recognition of excluded gains. Careful consideration should be given to the adoption of E&P methods for regular tax purposes if the CAMT is inevitable. For example, a section 168(g) election is available for depreciable assets, allowing use of the alternative depreciation system.

### III. PREDICTIONS AND PROPOSALS

#### A. *The Future*

The CAMT is likely to remain in existence in one form or another unless the tax system is completely revamped.<sup>293</sup> When contemplating tax law changes, Congress must consider issues such as the deficit, technical corrections, and acceptable economic distributional effects, among others. With respect to the latter, capital intensive firms are expected to carry more than their share of the AMT burden due to the adjustments and preferences related to fixed asset recovery and dispositions.<sup>294</sup> Also, a substantial disadvantage of the CAMT is the mas-

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ownership, carefully structuring real estate deals to avoid accelerated reporting of gain on the front end, and restructuring alternatives to discharge of indebtedness in bankruptcy; and (3) modifying accounting and tax policies with respect to asset lives, marketable security classification, and timing of transactions so as to minimize book/tax or ACE differences.

<sup>291</sup> One example is an AMT entity with substantial accelerated depreciation merging with a "high" ordinary income taxpayer that can fully utilize depreciation benefits.

<sup>292</sup> I.R.C. § 382.

<sup>293</sup> For example, if a pure flat tax, value added tax, or consumption tax system is adopted, then the minimum tax would become unnecessary and inappropriate.

<sup>294</sup> Companies with relatively large amounts of depreciable property will be thrown into the CAMT scenario more readily than less capital intensive and service companies. In addition, the substantial recordkeeping and compliance burden will be even greater for capital intensive companies. See Starr & Solether, *supra* note 11, at 39-22 to 39-24. Companies with substantial property but little cash may be discouraged from property gifts due to the appreciated property contribution preference.



sive recordkeeping, enforcement, and compliance burden.<sup>295</sup>

With a 1989 budget of over \$1 trillion, a projected deficit of about \$150 billion, and a federal debt in excess of \$3 trillion,<sup>296</sup> Congress has no choice but to actively look for additional revenue.<sup>297</sup> With defense, medicare, social security, and debt service totalling more than three-fourths of the budget,<sup>298</sup> meaningful cuts are politically difficult. President Bush promised no new taxes, making a complete overhaul in 1990 unlikely. He has since reneged on his promise, but initial indications are that selective revenue measures, not tax reform, will be the focus of congressional deliberations. Hopefully, when Congress begins shopping for revenues in 1991 attention will turn to a more comprehensive method of income measurement, rather than income reporting (not likely in this election year).<sup>299</sup>

### B. Alternatives

Some have suggested selective modification of the CAMT or elimination of the CAMT altogether.<sup>300</sup> As a practical matter, a major change such as the latter so soon after adoption of the CAMT is unlikely. For the first time in many years, however, the United States is experiencing a continuity of popular political leadership with the election of George Bush to the Presidency. That fact, coupled

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<sup>295</sup> In addition to the tax cost, the recordkeeping, compliance, and other costs may make the "price" extolled from certain corporations too large in light of the relative risk of an audit, thus encouraging noncompliance. *Id.* at 39-22.

<sup>296</sup> Klein & Morse, *Go Ahead: You Try Making A Budget*, U.S. NEWS & WORLD REP., Mar. 6, 1989, at 42.

<sup>297</sup> See Gould, *supra* note 4, at 36-59 to 39-61.

<sup>298</sup> MILITARY SPENDING RESEARCH SERVICES, *reprinted in* PARADE MAGAZINE, Nov. 27, 1988, at 5 (Dallas Morning News).

<sup>299</sup> Shavero, *supra* note 4, at 95.

<sup>300</sup> See, e.g., Starr & Solether, *supra* note 11, at 39-23 to 39-29; Comment, *supra* note 4, at 1233-39. The authors suggest several alternatives including revising the book income adjustment to eliminate the technical problems, using only the ACE adjustment, moving to a flat tax so that the AMT is unnecessary, using current E&P for AMT purposes, and removing the technical and complex components of ACE. *Id.*

with severe deficits and the present level of tax complexity, may prove the right combination for true tax reform. Congress is likely to continue tinkering with the ACE adjustment<sup>301</sup> — revenue raising in the guise of fine tuning.

It is unlikely there will be a return to the book income adjustment. Besides the problems resulting from different reporting philosophies and the inefficient results previously discussed, Congressional leadership has indicated contempt for the approach.<sup>302</sup> A pure E&P based method is also unlikely due to the lack of guidance with respect to the E&P computation and public policy reasons behind disallowing certain items as tax deductions but which are allowed to reduce E&P.<sup>303</sup>

Several alternatives to the present tax system have been suggested before, and will probably be revisited after 1990. The likely alternatives include modifying the income concept,<sup>304</sup> a modified flat tax,<sup>305</sup> a value added tax (VAT),<sup>306</sup> a pure consumption tax,<sup>307</sup> and complete elimi-

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<sup>301</sup> In the Revenue Reconciliation Act of 1989, *see supra* note 3, Congress simplified the ACE depreciation computation, eased the dividends received, installment sales, foreign tax credit, and minimum tax credit limitation provisions, eliminated references to book income, and made the effective date provisions more uniform. I.R.C. §§ 7611, 7612. The original bill was written so that 100% of the ACE/AMTI difference would have been an adjustment but the 75% factor was ultimately retained. *See* H.R. 1761, *supra* note 7.

<sup>302</sup> H.R. 1761, *supra* note 7. Rep. Rostenkowski states he will "oppose any attempt to extend the arbitrary book income preference beyond its scheduled expiration . . ." *Id.*

<sup>303</sup> As previously discussed, E&P is not defined and is subject to much uncertainty. Further, many items which reduce E&P would not be acceptable deductions from a policy standpoint. For instance, bribes, penalties, and federal income taxes are not tax deductible but reduce E&P.

<sup>304</sup> For a recent discussion of the problems in defining income and establishing a meaningful tax base, *Tax Corporate Cash-Flow, Not Income*, Wall St. J., Feb. 16, 1989, at A14, col. 3.

<sup>305</sup> *See, e.g.*, S. 1421, 98th Cong., 1st Sess. (1983). This bill was sponsored in the Senate by Sen. Bill Bradley (D-NJ) and in the house by Rep. Richard Gebhart. It was known as the Bradley-Gephhardt Fair Tax Plan. Many of its provisions were ultimately included in the 1984 and 1986 tax acts, including the two tax bracket system, lower rate system, and fewer deductions for individuals. However, many complexities eliminated by S. 1421 did not make it into the final legislation and additional complexities were included. *See, e.g.*, I.R.C. § 58 (passive loss rules).

<sup>306</sup> *See* Collins, *A VAT in Your Future?*, J. OF ACCT., Nov. 1987, at 62.

<sup>307</sup> *See* Kupfer, *The Case for a Consumption Tax*, FORTUNE, Aug. 15, 1988, at 36.

nation of the direct corporate tax.<sup>308</sup> Of these, the modified flat tax is the most politically viable.

### 1. *Modified Flat Tax*

The theory underlying a flat tax is that everything is taxable<sup>309</sup> and deductions are by legislative grace; exceptions should be kept to a minimum. Congress has experienced difficulty trying to equalize the distributional effect of taxes through deductions and trying to promote certain activity through tax favored treatment, resulting in unintended benefit to certain groups not targeted, and causing a growing underground economy.<sup>310</sup>

One solution is to substantially limit individual deductions only to those activities in which the government has a great interest. Even then, there should be third party reporting requirements which will improve verifiability of both income and deductions reported (or not reported).<sup>311</sup> Additional attention needs to be given by the Treasury to reducing the complexity of tax forms and tax calculations.<sup>312</sup> As for corporations and sophisticated in-

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<sup>308</sup> While this alternative has received little if any serious consideration, as a practical matter corporations do not pay tax regardless of whether a tax is levied on their income or assets. The reason is that, as part of the business planning process, the effect of taxes is taken into account and prices, wages, investment, expenditure, and dividends are adjusted based on the anticipated effect of taxes. Therefore, prices will rise as taxes rise, greater taxes may affect both labor demand and labor price, investment and expenditure will reflect after tax considerations, and dividends will differ depending on available cash flow and investor after tax valuations. Additionally, uncertainties and expectations about taxes also affect market valuation of debt and securities, which may affect the corporation in other ways.

<sup>309</sup> See I.R.C. § 61 and related regulations.

<sup>310</sup> The underground economy represents taxable activities for which the income recipients do not report income or pay tax. The unpaid tax estimates on underground income are generally considered to be in excess of \$100 billion annually and existing enforcement mechanisms are inadequate to track it all.

<sup>311</sup> Examples of these might include state taxes, mortgage interest, and documented charitable contributions, all of which can be easily verified by third parties. As for sole proprietors, more stringent documentation requirements and more extensive tax return attachments would improve compliance, as would third party payor income verification (1099s, and the like) and reduction or elimination of business entertainment and similar expenses.

<sup>312</sup> This could include merely having the taxpayer fill in simple standardized

vestors, rules could be simplified for those few items which Congress does decide to treat favorably, and for all others, third party verification could be required. Furthermore, for certain types of investments, losses could be postponed or eliminated altogether until disposition of the investment occurs.<sup>313</sup>

## 2. *VAT and Consumption Tax*

The VAT and consumption taxes will be difficult to achieve politically, but the eminence of "Europe 1992"<sup>314</sup> and the prevalence of these taxes in different forms in Western Europe will encourage their reconsideration. Furthermore, many states are presently considering VAT's as an alternative to state income and franchise taxes.<sup>315</sup>

The typical value added tax operates by levying a tax on goods at each stage throughout the process of delivering a good to its final consumer.<sup>316</sup> At the retail level, it resembles the consumption tax discussed below. Other nations have adopted the VAT, but it is considered a very complicated tax to enforce.<sup>317</sup> It is difficult to anticipate the effect of such a tax on the U.S. economy. In a large service economy, the task of taxing and valuing services or

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information forms and allowing the Treasury to calculate the income and tax from that information, thus reducing errors and irregularities.

<sup>313</sup> For example, passive activity investment rules could permit a certain percentage deduction of cost each year (to the extent not already resulting from depreciation) and a final loss upon disposition of the investment equal to the difference between total cost less total returns and prior deductions.

<sup>314</sup> By December 1992, eleven European countries will create a unified internal market with all artificial barriers eliminated. M. EMERSON, M. AJUJEAN, M. CATINAT, P. GOYBET & A. JACQVEMIN, *THE ECONOMICS OF 1992*, at 11 (1988).

<sup>315</sup> For example, Michigan passed a VAT law in 1988 that was upheld by the Michigan Supreme Court in early 1990. *Trinova Corp. v. Michigan*, No. 89-1106 (Mich. 1990).

<sup>316</sup> The transaction process might include, for example: the sale of raw goods from a mine to a processor, a material wholesaler, a manufacturer, a retail wholesaler, a retailer, and finally to a consumer. At each state the full cumulative tax would be levied, and a credit would be available for verifiable tax paid at previous stages. The net tax at any level should consequently equal the value added by that level.

<sup>317</sup> See Collins, *supra* note 306, at 68-69; Kupfer, *supra* note 307, at 39.

combination product/services would be even more difficult than product valuation.

With a VAT, consumption as opposed to saving and investing is taxed, thus encouraging capital formation. Further, some measure of self-policing exists among taxpayers. Each link in the product chain is responsible for the whole tax to the extent prior links have not paid their tax. Many details need to be worked out, including providing for numerous international transactions and dealing with concerns about the distributional effect on small business.<sup>318</sup> The cost of administering such a tax is estimated to be just less than \$1 billion per year.<sup>319</sup>

The pure consumption tax is probably the most "enforcement friendly" of the tax options (excluding a no tax option, of course).<sup>320</sup> Many scholars use the concept of a VAT and a consumption tax interchangeably because a VAT functions like a consumption tax in many instances.<sup>321</sup> However, the more familiar consumption tax is the retail sales or excise tax.<sup>322</sup> The biggest criticism of the consumption tax is that it can be very inequitable.<sup>323</sup>

On the bright side, the consumption tax rate is easy to change (possibly too easy), the system benefits from a rapid multiplier effect, and it is much easier to enforce

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<sup>318</sup> *VAT Called Harmful to Small Businesses*, INSIGHT, Dec. 5, 1988, at 49.

<sup>319</sup> *Id.* In 1984, the Internal Revenue Service estimated the cost at \$692.2 million. *Id.*

<sup>320</sup> This is due to the substantial documentation of product and service sales for state tax collection purposes which could be easily applied to pre-retail level situations.

<sup>321</sup> Kupfer, *supra* note 307, at 36-37.

<sup>322</sup> *Id.* at 36. Examples of consumption taxes include the gasoline tax and the cigarette tax.

<sup>323</sup> See *infra* note 332 (definitions of vertical and horizontal equity). The horizontal inequity comes from the fact that excise taxes only affect those who buy the goods on which the tax is levied. Thus taxpayers with equal incomes consuming different goods may bear different tax burdens. The vertical inequity arises from the fact that lower income taxpayers must necessarily spend a greater portion of their income on necessities. As a result, in the case of the national sales tax, lower income taxpayers pay tax on a larger portion of their non-discretionary income, making the tax regressive. To the extent lower income taxpayers spend more of their income on certain excise taxed items (*e.g.*, cigarettes), the excise tax is also regressive.

within our present reporting framework.<sup>324</sup> Regressiveness problems can be eliminated by establishing an exempt level of consumption entitling specified persons or entities to complete exemption upon proof of income, or a rebate upon filing of a prior year's report of income. The consumption tax may eliminate the need for all income tax returns. Alternately, a corporate tax combined with a retail consumption tax may be used, and substantially reduce the number of returns.<sup>325</sup>

### 3. *No Corporate Tax*

Corporations act in many respects as mere conduits of tax liability by reflecting increased taxes in increased prices, lower wages, and/or reduced after-tax return to investors. An argument can be made for eliminating the corporate income tax. Presently, instead of a deliberate decision by Congress regarding whom and what should be taxed, a convoluted series of consumer and corporate spending, pricing and investment decisions result in a corporate tax. Corporations have been put in the position of distributing the tax burden.

Although the aforementioned alternatives may still result in the conduit effect, all would be less subjective, more cost effective to administer, and much simpler than the present system. The revenue losses could be replaced through a direct consumption tax or increased personal income taxes. This would not be an easy political move, but ultimately the corporate tax elimination should encourage business and capital formation, employment, and lower prices.

Furthermore, corporations pay substantially more of the tax burden than the percentage reflected by the direct

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<sup>324</sup> A national sales tax, for example, could be easily changed by merely adjusting the rate. To the extent more than just retail sales are taxed, the sales tax would be generated at each resale of an item. Finally, much of the collection system is in place since all states have some state or local sales tax.

<sup>325</sup> Eighty-six million individual returns were filed in 1987. 1987 I.R.S. ANN. REP. 8.

income tax. The percentage of corporate tax collections to total federal tax collections is just over 10%,<sup>326</sup> however, when all federal employment related taxes are considered, the percentage is closer to 28%.<sup>327</sup>

The corporate tax burden stated as a percentage of corporate taxable income is also misleading. In 1987, American corporations paid an effective federal tax rate of 22.1% on their net income.<sup>328</sup> But the federal tax burden is exclusive of other tax costs such as state franchise and sales taxes, filing fees, and the tax compliance and planning costs paid to both in-house and outside accountants and lawyers. These additional costs may as much as double the true "tax cost" to most corporations.

Finally, now is not the time for Congress to be filling its coffers at the expense of corporations, particularly aviation and airline companies that are struggling in a stagnant and unstable economy (witness the second collapse of Braniff). Recent industry data indicates that airlines are experiencing lower net income,<sup>329</sup> declining return on investment, and decreasing per passenger yield.<sup>330</sup> Also, before the government tries to collect its share of the bottom line, labor unions and shareholders may ask for increases to make up for severe cuts taken in previous years. The CAMT becomes particularly unfair for those airlines experiencing real losses due to debt service and asset deterioration but paying taxes due to tax preferences, adjustments, and loss limitations.

#### 4. Other Considerations

After the Act, what still remains to be done is to reduce complexity, trim deductions and rates, and reduce or

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<sup>326</sup> *Id.* at 10.

<sup>327</sup> *Id.*

<sup>328</sup> *Corporate Tax Rate Rises by Close to Half*, INSIGHT, Oct. 17, 1988, at 44 [hereinafter INSIGHT].

<sup>329</sup> For the fourth quarter of 1989, seven large U.S. airlines reported combined losses of \$343,998,000, down from a profit in the fourth quarter of 1988 of \$43,342,000. Wall St. J., Feb. 20, 1990, at A16, col. 6.

<sup>330</sup> See generally Zimmerman, *supra* note 10.

eliminate tax subsidies for special interests.<sup>331</sup> The goal should be to create the best tax system possible, though what is the best tax system is a matter of opinion. Generally, most scholars would agree on a few key characteristics in an "appropriate balance." These include, at least, vertical equity, horizontal equity, economic efficiency, and simplicity.<sup>332</sup>

No system can optimize all the characteristics; they must be balanced.<sup>333</sup> For instance, what is most fair may be very complex, or what is economically efficient may be burdensome to a particular group. But these characteristics provide a useful guide when evaluating an existing or proposed system, and hopefully Congress will keep them in mind. In the first "official" evaluation since the Act, administration tax officials and Congressional leaders agreed that the Act succeeded in making the income tax code fairer.<sup>334</sup> This is, however, a matter of opinion.<sup>335</sup>

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<sup>331</sup> Rep. Rostenkowski ordered a formal study of the complexity problem, open to public comment and hearings. Wall St. J., Feb. 8, 1990, at A2, col. 2.

<sup>332</sup> The characteristics mentioned are those advanced in G. BREAK & J. PECHMAN, *FEDERAL TAX REFORM: THE IMPOSSIBLE DREAM* (1975). Vertical equity measures the fairness of the relative tax burden borne by taxpayers with different levels of income. *Id.* at 6. Horizontal equity is a determination of whether taxpayers situated in similar economic positions pay similar levels of tax. *Id.* Economic efficiency is a measure of how well the tax system promotes optimum resource allocation. *Id.* at 7-8. Simplicity, for purposes of this discussion, measures the ability of the government to administer the tax system efficiently, of taxpayers to comply with the tax system efficiently and effectively, and of taxpayers to perceive a reasonable level of certainty (or predictability) in their relative taxpaying responsibilities. *Id.*

<sup>333</sup> *Id.* at 16. The authors observe that a good tax system is a delicate balance because:

[a]t one and the same time it must be: simple enough to be widely understood but complex enough to deal effectively with economic reality; equitable in its allocation of burdens between rich and poor but sensitive to the potential disincentive effects of high tax rates; frugal in its commitment of resources to administration and compliance but generous in applying them to the pursuit of fairness and justice; evenhanded in its treatment of similarly situated taxpayers but alert to the social benefits attainable with well-designed tax incentives.

*Id.* at 17. For a discussion of the tax policy implications of the Act, see Shaviro, *supra* note 4.

<sup>334</sup> Wall St. J., *supra* note 331.



## III. CONCLUSION

For those particularly concerned about corporations not paying enough tax, recent news was good because the effective corporate tax rate rose from 14.9% before the Act to 22.1% a year after it.<sup>336</sup> Corporations paying little or no tax were down to less than 10% of all large corporations.<sup>337</sup> This amounted to an additional \$9 billion in tax revenues from 250 of America's largest corporations.<sup>338</sup> The share of total tax collections attributable to corporations reached an all time low in 1983, but increased 27.9% in just one year after the Act.<sup>339</sup> From a revenue perspective, the Act was a success. However, it is time to face the reality that true tax reform is long overdue.

Very few firms are likely to have looked at the ACE adjustment, except with respect to the new tax accounting rules, and its eleventh hour conception in Congress means the tax writers have probably not studied the provision in much depth before now.<sup>340</sup> The Treasury study and ACE regulations, whenever they are completed, may clear up questions about the ACE adjustment, but in the meantime, to most practitioners the ACE adjustment is nothing more than "primordial cosmic soup."<sup>341</sup>

The Act changed the Code so much that the Code was renamed the Internal Revenue Code of 1986. But the basic philosophies underlying the system of taxation in existence since the last major overhaul in 1954 changed

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<sup>335</sup> Rep. Bill Archer (R-TX) said the tax law had become so complicated that in 1988, for the first time, he could not prepare his own tax return. *Id.*

<sup>336</sup> INSIGHT, *supra* note 328. The share of corporate tax collected as compared to all other sources reached an all time low in 1983, but increased 27.9% in just one year between 1986 and 1987. 1987 I.R.S. ANN. REP. 8.

<sup>337</sup> 'Tax Expenditures' Fall in Reform's Aftermath, INSIGHT, May 1, 1989, at 44. Of corporations with over \$10 million in assets, those showing earnings on their books but paying no tax fell from 38% in 1985 to 23% in 1987. Wall St. J., *supra* note 331.

<sup>338</sup> INSIGHT, *supra* note 328.

<sup>339</sup> 1987 I.R.S. ANN. REP. 8.

<sup>340</sup> See Rosenthal, *supra* note 6. Congressional leadership acknowledges that the CAMT was among the most complex provisions and difficult compromises of the Act. H.R. 1761, *supra* note 7.

<sup>341</sup> Rosenthal, *supra* note 6.

very little. Lou Holtz, head football coach at Notre Dame and 1988 coach of the year may have provided the best description of the present tax system when he described his 1988 National Championship team early in the season: "We aren't where we want to be, we aren't where we should be, we aren't where we're gonna be. But, thank goodness, we aren't where we used to be." We can only hope the corporate tax future is as bright as Notre Dame's 1988 season.



# **Current Literature**

