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COMMENTS

THE BOOK INCOME ADJUSTMENT IN THE 1986 TAX REFORM ACT CORPORATE MINIMUM TAX: HAS CONGRESS ADDED NEEDLESS COMPLEXITY IN THE NAME OF FAIRNESS?

by Sandra G. Soneff Redmond

A recent survey indicated that of the nation's 259 largest and most profitable companies, forty-four paid zero or negative federal income taxes for the tax years 1981 through 1984. During the same period these forty-four companies grew by eleven percent, increased their dividend payouts by twenty-two percent, and added fifty-four percent to their top executives' salaries. The average wage earner, on the other hand, generally has not escaped the tax bite. Public reaction to such inherent inequities in the tax system often erupts into outspoken dissatisfaction and a marked decrease in respect for, and compliance with, the tax laws.


3. Federal taxes on low and middle income individuals have more than doubled since 1979. CITIZEN FOR TAX JUSTICE, supra note 1, at 15. Recently, some Fortune 500 companies have paid less in taxes than the people who waxed the companies' floors or typed the companies' letters. Id.

4. For example, in 1969 Secretary of the Treasury Joseph Bar issued a report stating that over 150 taxpayers with $200,000 or more of adjusted gross income paid no income tax. This generated a public response of more letters to Congress that year than had been received on any other subject. Tax Reform Proposals—XXIV: Hearing Before the Senate Comm. on Finance, 99th Cong., 1st Sess. 36 (1985) [hereinafter Hearing] (statement of Professor Michael J. Graetz, Yale Law School).

5. A recent New York Times article discussed a recent poll commissioned by the Internal Revenue Service and conducted by the Daniel Yankelovich firm. That study, according to the article, "found that one-third of those polled considered cheating on taxes perfectly acceptable, one-third were ambivalent and only the remaining third thought tax cheating was wrong. The Reagan Administration's Commissioner of Internal Revenue has characterized tax cheating as the 'revenge' of citizens against an unfair system." Haskell, The Bottom Line of Real Tax Reform, N.Y. Times, Jan. 17, 1986, at Y23, col. 2 (nat'l ed.). According to a Time article, tax evasion has more than doubled between 1976 and 1981, from $42.6 billion to $90.5 billion. Church, The Making of a Miracle—Against All Odds, Congress Hammers Out a Radical Tax Reform Plan, TIME, Aug. 25, 1986, at 12; see also Nacey, Public Attitudes and Taxes, 32 TAX...
For over a decade the minimum tax concept has been a part of the political response to this public outcry. Both Republicans and Democrats have long included a minimum tax as a tax reform showpiece. Although the idea of a minimum tax is politically popular, much controversy exists over how such a tax should operate.

The Tax Reform Act of 1986 contains a strict corporate minimum tax provision. This Comment analyzes the new corporate minimum tax provisions with emphasis from a policy perspective on the new book income adjustment item. The book income adjustment allows the government to tax one-half of a corporation's net income, as reported on the corporation's applicable financial statement, that exceeds the corporation's regular minimum taxable income. This very significant provision has generated much controversy and debate over the propriety of reliance on financial accounting figures for income tax purposes. Congress itself lacks confidence in the details of this provision: the Act replaces the book income adjustment approach with another approach for tax years beginning after 1989 and commissions a Treasury report to explore the operation and effect of each approach. The Treasury report is to be completed before the 1989 switch. Future revisions and fine tuning of the book income adjustment provision are both necessary and likely.

For an insightful critique of the book income adjustment, an understanding of the history and justifications of minimum tax provisions is helpful. Section I of this Comment briefly examines the history and justifications of the minimum tax. Since computation of the book income adjustment requires the use of financial accounting procedures, section II of this Comment examines case law dealing with the use of financial accounting for income tax purposes. Section III reviews the operation and legislative history of book income adjustment. Finally, section IV addresses the question of whether the book income adjustment adds needless complexity to the tax system in the name of fairness. Following discussion of this issue, the section poses and evaluates three alternative approaches to the problems that the book income adjustment is meant to address.

Notes, July 7, 1986, at 17 (discussing results of annual survey of public attitudes toward government and taxes, conducted for Advisory Commission on Intergovernmental Relations, that shows public dissatisfaction with the tax system).


11. Id. at II-278 to -79.
I. BACKGROUND OF THE MINIMUM TAX

A. Development of the Minimum Tax

The first minimum tax provision appeared in the Internal Revenue Code in 1969. The provision created a minimum tax on tax preferences as recommended by President Nixon's 1969 tax reform proposals. The impetus for President Nixon's recommendation came from the 1968 Treasury Tax Reform Studies under the Johnson Administration. The ideas found in the 1968 Treasury Tax Reform Studies can be traced to Democratic Senator Russell Long's proposals made in 1964. Senator Long proposed a simplified tax under which taxpayers could choose to apply a lower rate schedule to an expanded tax base rather than applying the regular rate in the normal manner. This proposal was criticized and rejected on the grounds that its elective nature would add complexity to the tax system.

As enacted in 1969 the minimum tax applied to individuals and corporations. The purpose behind the minimum tax was to limit the portion of economic income that taxpayers could exclude from taxation through various tax preferences in the income tax law. The motivation behind the

14. Graetz, supra note 6, at 545 (citing Hearings Before the House Comm. on Ways and Means on the Subject of Tax Reform, 91st Cong., 1st Sess. 5050-63, 5504-05 (1969)).
15. Id. at 544 (citing UNITED STATES DEPT. OF TREASURY, TAX REFORM STUDIES AND PROPOSALS 132 (Comm. Print 1969)).
16. Id. at 545.

Professor Graetz, who worked for the Treasury Department on the first minimum tax provisions, has noted that the 1969 minimum tax for corporations was not as well received as that for individuals. Hearing, supra note 4, at 43 (statement of Professor Michael J. Graetz, Yale Law School). According to Professor Graetz:

Neither the Treasury Departments of the Johnson or Nixon Administrations had proposed or supported a corporate minimum tax, and no corporate minimum tax provision was contained in the House version of the 1969 act. . . . [The Senate proposed] corporate minimum tax was enacted principally to make up the revenue loss that would otherwise have occurred from the Senate's restructuring of the House minimum tax provisions.

Id.

adoption of the minimum tax in 1969, as well as in 1986, was Congress's concern with negative public perception of the tax law.\textsuperscript{21}

The 1969 provision, applicable to both individuals and corporations, consisted of a ten percent add-on tax. This provision required the taxpayer first to compute its regular tax and then to calculate its amount of tax preferences.\textsuperscript{22} The taxpayer next applied a $30,000 exemption to the aggregate preference amount. The taxpayer then subtracted from that amount its regular tax paid for the year to yield a net amount that would be subject to the minimum tax. Finally, the taxpayer added ten percent of this net amount to its regular tax liability.

Commentators have argued that this add-on tax had little if any effect because of the $30,000 exclusion, the deduction for taxes owed, and the limited list of included preference items.\textsuperscript{23} The limitations of the tax were explainable, perhaps, because of the competing policies that Congress faced in considering the tax. On the one hand, Congress faced public reaction to perceived inequities in the Code; Congress could not ignore a public mandate to ensure that high income taxpayers paid their fair share of tax. On the other hand, Congress had a tax code with tax incentives designed to stimulate certain economic sectors and achieve social objectives.\textsuperscript{24} Congress was forced, therefore, to give with one hand and take away with the other. Congress was able to encourage certain activity, but remained ready to penalize if the response to that encouragement was too strong. The government, no doubt, implemented the minimum tax in order to avoid eliminating tax preferences, a move that could have caused severe political backlashes. At the same time, members of Congress had a provision to display to their constituents as an example of efforts to make the tax code fair.

From 1969 to 1982 the minimum tax rules went through minor modifications. In 1970 Congress added a seven-year carry-forward of regular income taxes.\textsuperscript{25} The Revenue Act of 1971 then added a new tax preference item,\textsuperscript{26} the excess of straight-line amortization over straight-line depreciation of job train-

22. The list of preferences included: (1) accelerated depreciation in excess of straight-line depreciation on real estate; (2) accelerated depreciation in excess of straight-line depreciation on personal property subject to a net lease; (3) amortization of pollution control facilities in excess of the accelerated depreciation of such facilities; (4) amortization of railroad rolling stock in excess of accelerated depreciation; (5) at the time of exercise of an employee stock option, the excess of the fair market value of the optioned shares over the option price; (6) excess of bad debt deduction over an amount that would have been allowed based on actual bad debts; (7) percentage depletion in excess of the adjusted basis of property; (8) excluded portion of capital gains. Tax Reform Act of 1969, Pub. L. No. 91-172, § 301, 83 Stat. 487 (codified as amended at I.R.C. §§ 56-58 (1982)).
23. Coven, supra note 20, at 1095-96. Coven argues that the Senate was willing to penalize only the most extreme use of tax preferences. Id. at 1096.
24. See, e.g., I.R.C. § 46 (1986) (investment tax credit); id. § 22 (formerly § 37) (tax credit for the elderly); id. § 169 (pollution control facilities deduction); id. § 280(g) (disallowance of deduction for golden parachute payments and imposition of excise tax on same).
25. Id. § 56(c) (1974) (current version at I.R.C. § 55(c)(2) (1986)).
26. Id. § 57(a)(10) (1971) (repealed 1982).}
ing and child care facilities.\textsuperscript{27} Changes in 1976 increased the minimum tax rate from ten to fifteen percent and eliminated the $30,000 deduction and the deduction for regular tax paid.\textsuperscript{28} The 1976 changes also added a new exemption, the greater of $10,000 or one-half of the regular tax owed for the year.\textsuperscript{29} Along with other modifications, these 1976 changes significantly increased the total amount of tax collected through the minimum tax provisions.\textsuperscript{30}

In 1978 Congress focused its concern on capital formation and energy.\textsuperscript{31} As a result of this focus, Congress altered the minimum tax rules as they applied to individuals. The alteration created two minimum tax methods for individuals. One method was the old, add-on minimum tax on tax preferences with capital gains preferences deleted.\textsuperscript{32} The other method was an alternative minimum tax with a separate tax base and separate rate schedules that applied to capital gains and adjusted itemized deductions.\textsuperscript{33} The Tax Equity and Fiscal Responsibility Act of 1982\textsuperscript{34} eliminated the two-tier minimum tax for individuals and replaced it with a single, fortified, alternative tax for individuals.\textsuperscript{35} The minimum tax for corporations, however, remained an add-on tax.\textsuperscript{36}

The corporate minimum tax rules existing before the enactment of the 1986 Act required corporations to pay an add-on tax of fifteen percent of the corporation's tax preferences that exceeded the greater of $10,000 or the regular tax liability for the year.\textsuperscript{37} In addition to this add-on minimum tax, pre-Act law imposed a cutback in the use of certain corporate tax preferences.\textsuperscript{38} An adjustment was made to the add-on minimum tax, however, so

\begin{itemize}
\item \textsuperscript{27} See id. § 188 (1986). Rapid amortization would yield a larger depreciation deduction in early years than would straight line depreciation. A deduction in early years is more valuable than the same deduction in later years because of the time value of money.
\item \textsuperscript{29} Id.
\item \textsuperscript{30} Graetz, supra note 6 at 547.
\item \textsuperscript{31} Id. § 55 (1986) (added by the Revenue Act of 1978); see Coven, supra note 20, at 1097-98 (criticizing the 1978 changes as introducing unneeded complexity); Graetz, supra note 6, at 548-49 (explaining provision).
\item \textsuperscript{32} I.R.C. § 56 (1979) (amended 1982).
\item \textsuperscript{33} I.R.C. § 56 (1986).
\item \textsuperscript{34} See Graetz, supra note 6 at 549-54.
\item \textsuperscript{35} The corporate minimum tax provisions have not developed to the same extent as the individual minimum tax provisions. Graetz argues that the corporate minimum tax provisions "have never quite overcome their uncertain beginnings." Hearing, supra note 4, at 37 (statement of Professor Michael J. Graetz, Yale Law School).
\item \textsuperscript{36} Id. § 56 (1986). Regular tax liability for purposes of this section is defined by § 56(c). Tax preference categories include: (1) exclusion of dividends; (2) accelerated depreciation on real property; (3) accelerated depreciation on leased personal property; (4) amortization of certified pollution control facilities; (5) mining exploration and development costs; (6) circulation and research and experimental expenditures; (7) reserves for losses on bad debts of financial institutions; (8) depletion; (9) capital gains; (10) incentive stock options; (11) intangible drilling costs; and (12) accelerated cost recovery deduction. Id. § 57.
\item \textsuperscript{37} Id. § 291. This cutback applied in differing degrees to the following: certain capital gains; reduction in percentage depletion; certain financial institution preference items; certain
that the tax covered only a certain percentage of a preference that was also subject to the cutback provision.\(^3\) This adjustment was necessary to prevent the cumulative effect of the add-on minimum tax provision and the cutback in preference use provision from neutralizing the incentive effect of a tax preference.\(^4\)

**B. Justifications for a Minimum Tax**

Congress first introduced the minimum tax provisions as a result of perceived inequities in the tax code.\(^4\) The minimum tax provided the legislators with a compromise vehicle to avoid directly resolving the conflicting purposes of the income tax, those of raising revenue fairly, and stimulating certain economic and social activities.\(^4\) Such a compromise is politically attractive in that it pleases the public because it sounds fair and, by not revoking preferences, it does not alienate special interest groups. Furthermore, because the impact of such a tax is difficult to measure, political accountability is not of paramount concern.\(^4\)

A minimum tax can be viewed from three perspectives: revenue, fairness, and complexity.\(^4\) With respect to revenue, commentators argue that the most effective minimum tax, in terms of supporting the regular tax system, is one that does not raise any revenue.\(^4\) The 1969 minimum tax provisions allowed generous exceptions and consequently had little revenue effect.\(^4\) In 1982 the strengthened minimum tax raised less than $500 million from corporations.\(^4\) Commentators have generally argued that the main objective of a minimum tax should not be to raise revenue, but rather to influence corporations to structure their activities so as to avoid the application of the minimum tax.\(^4\) Higher regular tax liability would accrue as a result.

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39. Id. § 291(a).
41. See supra notes 12-21 and accompanying text.
42. Hearing, supra note 4, at 37, 39 (statement of Professor Michael J. Graetz, Yale Law School); id. at 56 (statement of Professor Harry Gutman, University of Pennsylvania Law School); id. at 69 (statement of Emil Sunley, Deloitte Haskins and Sells).
43. Id. at 57 (statement of Professor Harry Gutman, University of Pennsylvania Law School).
44. Id.
45. Id. Graetz, however, argues that although a minimum tax may not generate income itself, it will result in an increase in revenue from the regular tax. Id. at 52 (statement of Professor Michael J. Graetz, Yale Law School). "It is only an accident of accounting that the increase in revenue produced under the regular income tax due to the existence of an effective minimum tax is not attributed to the minimum tax." Id.
46. Id. at 9, 13 (statement of Bernard Shapiro, National Director for Tax Policy, Price Waterhouse).
47. Id. at 70 (statement of Emil Sunley, Deloitte Haskins and Sells).
48. Id. at 57 (statement of Professor Harry Gutman, University of Pennsylvania Law School); id. at 14 (statement of Bernard Shapiro, National Director for Tax Policy, Price
A minimum tax provision may increase the fairness of the tax system, at least as the minimum tax applies to individuals. A corporate minimum tax is not as easily justified, however. Corporations are subject to fluctuations in income, whereas individual income is generally more stable. In addition, high corporate income does not translate into ability to pay as readily as does high individual income. A corporate minimum tax also may not bring about fairness because the tax may be distorted across firms in the same industry depending on the amount of regular tax liability available to a corporation to enable it to avoid the minimum tax. Furthermore, corporations will likely pass the burden of the minimum tax on to their shareholders and customers, who presumably pay their share of tax already.

On the other hand, a corporate minimum tax does prevent the corporate entity from becoming a device that an individual can use to avoid individual income taxes. The minimum tax may also decrease wide disparities in corporate tax burdens within and among industries that result from variations in debt financing, gains and losses, and accounting practices. Finally, and perhaps most importantly, the perception of tax equity will increase if an effective minimum tax eliminates the possibility that high economic income corporations may pay little or no tax.

A minimum tax undoubtedly adds complexity to the tax system. A minimum tax is at least partially justified, however, by its corresponding fairness and political attractiveness. The current tax system does not include a broad base flat rate tax; the minimum tax is, therefore, generally a necessary compromise and worth the added complexity. Whether the book income adjustment aspect of the minimum tax is necessary, fair, and worth the added complexity is addressed later in this Comment.

Waterhouse); id. at 70-71 (statement of Emil Sunley, Deloitte Haskins and Sells). More direct ways exist to increase revenue than through a minimum tax. Using the minimum tax primarily to raise revenue would be a direct assault on the tax incentives in the Code. Furthermore, a revenue raising focus does not provide a principle on which to structure a minimum tax that will fortify the regular tax system. Rather, such a focus will only result in a minimum tax system that will clash with the regular tax system. The proper focus of a minimum tax is to ensure that taxpayers pay their fair share of tax in the regular tax system by imposing penalties in the form of minimum tax liability for excessive use of regular tax preferences.

49. Id. at 41 (statement of Professor Michael J. Graetz, Yale Law School); id. at 58-59 (statement of Professor Harry Gutman, University of Pennsylvania Law School); id. at 6 (statement of Bernard Shapiro, National Director for Tax Policy, Price Waterhouse); id. at 71-72 (statement of Emil Sunley, Deloitte Haskins and Sells).

50. Id. at 8 (statement of Bernard Shapiro, National Director for Tax Policy, Price Waterhouse).

51. Id. at 42 (statement of Professor Michael J. Graetz, Yale Law School).

52. Id. at 73 (statement of Emil Sunley, Deloitte Haskins and Sells). As an example, Sunley posed the situation of a company with numerous tax preferences. Id. Standing alone, such a company may have a minimum tax liability. Id. If the company is part of a diversified group, however, the group on a consolidated basis may have enough regular tax liability to avoid minimum tax liability. Id.

53. Id. at 53-74.

54. Id. at 44 (statement of Professor Michael J. Graetz, Yale Law School).

55. Id. at 44-45.

56. Id. at 45-46.
II. THE USE OF FINANCIAL ACCOUNTING FOR TAX PURPOSES: THOR POWER TOOL CO. v. COMMISSIONER

The income adjustment item included in the new corporate minimum tax is based on income as reported and calculated using financial accounting standards. Consideration of how the courts have viewed the use of financial accounting for income tax purposes is, therefore, important. A recent Supreme Court case, Thor Power Tool Co. v. Commissioner,57 is the leading case in this regard.58

Thor involved valuation issues concerning inventories and bad-debt reserves. The Tax Court disallowed an inventory write-down59 that conformed to generally accepted accounting principles on the grounds that such a write-down failed to reflect Thor's income clearly.60 The Supreme Court affirmed.61

In Thor the taxpayer's primary argument was that the write-down conformed with generally accepted accounting principles and thus, unless the Commissioner could demonstrate otherwise, clearly reflected income within the meaning of the Code.62 The Supreme Court rejected this argument on the basis of past decisions and the differing objectives of tax and financial accounting.63 The Court concluded that, for tax purposes, a taxpayer could not take a current deduction for future estimated losses in inventory.64

In analyzing past cases the Thor Court indicated that prepaid income is recognized for tax purposes when received, although such a practice mismatches revenue and expenses in contradiction of generally accepted accounting principles.65 The Court pointed out that financial and tax

59. Closing inventory is valued at the lower of cost or market value. When the market value is used for inventory valuation, the result is referred to as an inventory write-down, the effect of which is to reduce net income. See R. AMORY, JR. & C. HARDEE, MATERIALS ON ACCOUNTING 178-79 (3d ed. 1959).
60. Thor Power Tool Co. v. Commissioner, 64 T.C. 154, 175 (1975).
61. 439 U.S. at 537.
62. Id. at 538-39. The Thor Court relied on Treas. Reg. § 1.446-1(a)(2) (as amended in 1986) for the proposition that compliance with generally accepted accounting principles will ordinarily clearly reflect income. 439 U.S. at 538-39.
63. 439 U.S. at 540.
64. Id. at 542.
65. Id. at 541. The Thor Court based this observation on American Auto. Ass'n v. United States, 367 U.S. 687, 690 (1961). When an association receives dues covering a period that extends past the reporting year, American Auto. held that the association must report the full amount of the membership dues as income when the dues are received, rather than merely the amount that corresponds with the number of membership months in the reporting year covered by those dues. Id. at 689. The American Auto. Court went on to say that just because an
accounting may characterize transactions differently and may treat timing issues differently because of the vastly different objectives of financial and tax accounting. Financial accounting is designed to provide useful information to management, shareholders, and creditors; tax accounting seeks to achieve the equitable collection of revenue. This difference understandably results in inconsistent treatment of accounting issues.

According to Thor, an important factor in determining appropriate tax accounting standards is the administrative burden that would result from the indiscriminate use of financial accounting for tax purposes. Generally accepted accounting principles leave much to the discretion of management; the principles tolerate a range of acceptable treatments rather than require exact compliance with specific rules. The Thor Court characterized such an approach as inappropriate for tax accounting purposes because it would result in inconsistency and unfairness in the tax system.

III. ALTERNATIVE MINIMUM TAX FOR CORPORATE TAXPAYERS AND THE BOOK VALUE ADJUSTMENT IN THE TAX REFORM ACT OF 1986

A. Statutory Provisions

The corporate minimum tax provisions in the Tax Reform Act of 1986 accounting method conforms to generally accepted accounting practices does not mean that it necessarily clearly reflects income for tax purposes. Id. at 693.

66. Thor, 439 U.S. at 541. The Court relied on Frank Lyon Co. v. United States, 435 U.S. 561, 577 (1978), for this proposition. Frank Lyon held that a sale-and-leaseback arrangement would be characterized as such for tax purposes if it was a genuine transaction with economic substance, but the Court noted that "the characterization of a transaction for financial accounting purposes, on the one hand, and for tax purposes, on the other, need not necessarily be the same." Thor, 439 U.S. at 541 (quoting Frank Lyon, 435 U.S. at 577). The Court in Thor also referred to Commissioner v. Idaho Power Co., 418 U.S. 1, 15 (1974), to support this proposition.

67. Thor, 439 U.S. at 541. As examples for this observation the Court cited Commissioner v. Hansen, 360 U.S. 446 (1959); Brown v. Helvering, 291 U.S. 193 (1934); and Lucas v. American Code Co., 280 U.S. 445 (1930). All three of those cases dealt with reserves maintained in order to satisfy future liabilities. Current deductions to cover future expenses are not allowed for tax purposes even though such deductions are consistent with generally accepted accounting principles. Thor, 439 U.S. at 542; Hansen, 360 U.S. at 448; Brown, 291 U.S. at 199; Lucas, 280 U.S. at 452.

68. Thor, 439 U.S. at 542-43.

69. Id. at 542.

70. Id. at 543.

71. Id. at 544.

72. Generally accepted accounting principles (GAAP) are promulgated by the Financial Accounting Standards Board of the American Institute of Certified Public Accountants. E. FARIS, JR., ACCOUNTING FOR LAWYERS 7 (4th ed. 1982).

73. Thor, 439 U.S. at 544. The Court stated:

[Such variances] ... may be tolerable in financial reporting, but they are questionable in a tax system designed to ensure as far as possible that similarly situated taxpayers pay the same tax. If management's election among "acceptable" options were dispositive for tax purposes, a firm, indeed, could decide unilaterally—within limits dictated only by its accountants—the tax it wished to pay. Such unilateral decisions would not just make the Code inequitable; they would make it unenforceable.

Id.
significantly strengthens the impact of the minimum tax on corporations. A twenty percent alternative minimum tax similar to the individual minimum tax replaces the add-on corporate minimum tax under the new law. An exemption of $40,000 exists, but it phases out at the rate of twenty-five cents for every dollar of alternative taxable income in excess of $150,000. The book income adjustment, applicable to the taxable years 1987, 1988, and 1989, increases the alternative minimum taxable income by one-half of the amount of a taxpayer's adjusted net book income that exceeds the alternative minimum taxable income. This effectively results in a ten percent tax on book income. Ignoring the $40,000 exemption amount, if book income is greater than 2.3 times the amount of alternative minimum taxable income, then, without any other preference items, the book income adjustment will generate a minimum tax liability.

A corporation's adjusted net book income is the net income reported on the corporation's applicable financial statement adjusted to disregard any federal income taxes. Adjustment must also be made for consolidated returns and returns covering a taxable period that is different from the period covered in the financial statement. Furthermore, special adjustments exist for cooperatives, for dividends received from companies eligible for the credit provided by section 936 on income from Puerto Rico, and for Alaska native corporations. The Act also authorizes the Secretary of the

76. Id. § 56(f). This provision does not apply to any S corporations, regulated investment companies, real estate investment trusts, or REMIC. Id. § 56(f)(4).
77. The alternative minimum taxable income is determined before application of the book income adjustment and the net operating loss deduction. Id. § 56(f)(1).
78. Senate Tax Reform Bill: Forecast and Implications, [12 Washington Tax Rev.] Tax Mgmt. (BNA) No. 6, at 168 (June 1986) [hereinafter Forecast and Implications].
79. Committees, supra note 58, at 570. Tax Notes provides the example of a corporation with regular taxable income of $100 and no other preferences, such that the alternative minimum taxable income base would be $100. With $230 of book income the book income preference amount would be $65 (50% x ($230 - $100)). The minimum tax would thus be ($100 + $65) x 20%, or $33. The regular tax would be $33 (33% x $100), thus an alternative minimum tax liability would result solely by virtue of the book income adjustment. Id. (This example ignores the $40,000 exemption amount provided by I.R.C. § 55(d)(2) (1986)).
81. Id. § 56(f)(2)(B). Foreign taxes are also disregarded unless the taxpayer elects not to take the benefit of I.R.C. § 901, the foreign tax credit. Id.
82. Id. § 56(f)(2)(C)(i) and (ii). Adjustment must be made so that items on the taxpayer's applicable financial statement are properly allocated to members included on the consolidated return. Id. § 56(f)(2)(C)(i). Furthermore, if a related corporation is not included on a consolidated return, the taxpayer's net book income must be adjusted to account for earnings of the related corporation. Id. § 56(f)(2)(C)(ii). The adjustment is required only to the extent of the sum of the dividends received from the related corporation and other amounts required to be included in gross income with respect to the related corporation's earnings under I.R.C. ch. 1.
83. Id. § 56(f)(2)(D).
84. Id. § 56(f)(2)(E).
85. Id. § 56(f)(2)(F).
Treasury to adjust the book income to prevent the omission or duplication of any item.\footnote{87} This grant of authority is an open-ended mandate for the Secretary to issue regulations as the need arises.

In computing the book income adjustment a corporation must use the net income figure reported on an applicable financial statement.\footnote{88} Acceptable financial statements include the following, listed in the order of priority established in the Act: (1) a financial statement required to be filed with the Securities and Exchange Commission; (2) a certified, audited income statement used for creditors or shareholders, or for any other substantial nontax purpose; (3) an income statement to be provided to a government agency; or (4) an income statement to be provided to creditors or shareholders, or for any substantial nontax purpose.\footnote{89} If a taxpayer does not have one of the enumerated applicable financial statements, or if it has none other than one of those listed in (4) above, the taxpayer may elect to use an earnings and profits figure rather than a net income figure for the purpose of determining the book income adjustment.\footnote{90} Under this election, the taxpayer’s earnings and profits for the taxable year are treated as equal to the net income derived from applicable financial statements.\footnote{91} Once the taxpayer makes this election, it remains in effect unless the taxpayer revokes it with consent of the Secretary.\footnote{92}

For taxable years beginning after 1989 the Act replaces the book income adjustment with an adjustment based on adjusted current earnings.\footnote{93} This adjustment increases alternative minimum taxable income by seventy-five percent of the excess of the adjusted current earnings of the corporation over the alternative minimum taxable income.\footnote{94} If the alternative minimum taxa-

\footnote{87. I.R.C. § 56(f)(2)(H) (1986). Anticipated rules include those to adjust the allocation of income and deductions among two or more businesses owned or controlled by the same interests, to prevent tax evasion or to reflect clearly the income of the business, as per the principles of I.R.C. § 482. \textit{H.R. CONF. REP.} No. 841, \textit{supra} note 10, at II-273 to -74. Rules to adjust book income may also be necessary to avoid distortions of the book income figure via disclosure of financial information through footnotes to the applicable financial statements and through supplemental statements. \textit{Id.}

\footnote{88. I.R.C. § 56(f)(2)(A) (1986).}

\footnote{89. \textit{Id.} § 56(f)(3)(C). In establishing priority, the corporation must actually use the financial statements for the specified purpose; otherwise, the statements will not be eligible for use as an applicable financial statement. \textit{SENATE COMM. ON FINANCE, TAx REFORM ACT OF 1986, S. REP. NO. 313, 99th Cong., 2d Sess.} 531 (1986).}

\footnote{90. I.R.C. § 56(f)(3)(A) (1986). Neither the Act nor the legislative history elaborate on the meaning of the phrase “substantial nontax purpose.”}

\footnote{91. \textit{Id.} § 56(f)(3)(B). For purposes of this provision, the adjusted current earnings calculation in I.R.C. § 56(g) (the adjustment for minimum tax for years beginning after 1989) is not relevant. \textit{Id.} Furthermore, the earnings and profits figure may not be reduced by the amount of distributions or federal income taxes payable during the taxable year. \textit{Id.} Adjustments must be made for purposes of consolidated returns to prevent the double inclusion of earnings and profits of an affiliated group of corporations. \textit{Id.} These adjustments will be governed by rules prescribed by the Secretary of the Treasury. \textit{Id.}}
ble income is greater than the adjusted earnings, then seventy-five percent of the excess applies to reduce the alternative minimum taxable income.\textsuperscript{96} Any such reduction, however, may not exceed the excess of aggregate increases in alternative minimum taxable income attributable to the current earnings adjustment in prior years, over aggregate reductions.\textsuperscript{97}

In order to determine adjusted current earnings the taxpayer starts from its alternative minimum taxable income for the taxable year, as determined prior to application of the current earnings adjustment and the net operating loss deduction.\textsuperscript{98} The taxpayer must adjust this figure\textsuperscript{99} for depreciation,\textsuperscript{100} for amounts included in calculating earnings and profits,\textsuperscript{101} for deductions used in calculating earnings and profits,\textsuperscript{102} for other adjustments to earnings and profits,\textsuperscript{103} for loss on exchange of debt pools,\textsuperscript{104} for acquisition expenses of life insurance companies,\textsuperscript{105} and for depletion.\textsuperscript{106} Generally, these adjust-

\begin{itemize}
\item \textsuperscript{96} \textit{Id.} § 56(g)(2)(A). A positive amount exceeds a negative amount and a smaller negative amount exceeds a larger negative amount for purposes of this provision.
\item \textsuperscript{97} \textit{Id.} § 56(g)(2)(B). For example:
\item \textsuperscript{98} \textit{Id.} § 56(g)(3).
\item \textsuperscript{99} \textit{Id.}
\item \textsuperscript{100} \textit{Id.} § 56(g)(4)(A). For the purpose of this provision depreciation is computed using either the method used by the taxpayer in preparing its applicable financial statement or the applicable earnings and profit methods, whichever yields the smaller present value. The interest rate used in the present value calculation is the applicable federal rate for the period equal to the ACR life of the property, unless the Treasury publishes interest rates to be used. H.R. CONF. REP. NO. 841, supra note 10, at II-276.
\item \textsuperscript{101} I.R.C. § 56(g)(4)(B) (1986). Some amounts are excluded from gross income for purposes of alternative minimum taxable income, but are included in determining earnings and profits. These amounts are included in income for determining adjusted current earnings, but are reduced by any deduction that would have been allowed in computing alternative minimum taxable income if such amounts had been included in computing alternative minimum taxable income. \textit{Id.} Generally, expense items are not allowed for regular alternative minimum tax purposes in computing adjusted current earnings. Thus, interest and carrying costs of tax-exempt bonds are included in calculating adjusted current earnings. H.R. CONF. REP. NO. 841, supra note 10, at II-275.
\item \textsuperscript{102} I.R.C. § 56(g)(4)(C) (1986). If an item would not be deductible for purposes of computing earnings and profits, it will not be deductible in computing adjusted current earnings. \textit{Id.}
\item \textsuperscript{103} \textit{Id.} § 56(g)(4)(D). I.R.C. § 312(n) adjustments to earnings and profits, which are made to reflect more accurately economic gain and loss, generally do apply in calculating adjusted current earnings. \textit{Id.} Such adjustments include mineral exploration and development cost capitalization and LIFO inventory adjustments. See \textit{id.} § 312(n) (paragraphs (7) and (8) of § 312(n) do not apply under § 56(g)(4)(D)).
\item \textsuperscript{104} \textit{Id.} § 56(g)(4)(E). A loss will not be recognized from an exchange of debt obligations having substantially the same terms. \textit{Id.}
\item \textsuperscript{105} \textit{Id.} § 56(g)(4)(F). Such expenses must be capitalized and amortized according to generally accepted accounting principles in all taxable years. \textit{Id.}
\end{itemize}
ments are designed to account for exclusion items, that is, items of income and expense that are included in regular earnings and profits, but are never included in the calculation of minimum taxable income, such as interest on tax-exempt bonds.107

Given the complicated adjustments involved in computing the alternative minimum taxable income, record-keeping will pose a formidable problem. The Secretary of the Treasury will likely provide regulations or rulings in this regard.108 The mandated Treasury report on the book income and earnings and profits adjustments will likewise address the matter of record-keeping.109

B. Legislative History

The book income adjustment item was not included in the House version of the tax reform bill,110 but rather was adopted from the Senate report.111 The conference committee adopted the Senate Report minimum tax provisions practically verbatim, with the addition of special rules for cooperatives and the switch to the adjustment based on adjusted current earnings after 1989. The conferees also commissioned the Treasury report on the adjustments, thereby expressing some doubt as to the appropriateness of the book income adjustment or, at least, doubt as to its mechanics.112

The Senate Finance Committee indicated that the Senate included the book income and current earnings adjustments to ensure that taxpayers with substantial economic income could not avoid their fair tax liability through the excessive use of exclusions, deductions, and credits,113 Both the perception and the reality of fairness were the target of the Senate in drafting the provisions.114 Tax liabilities based on a closer approximation of economic income, and elimination of publicized instances of corporations with high book income and low tax liability were goals of the Senate.115 According to the Finance Committee, the regular minimum tax system alone could not meet these objectives.116

106. Id. § 56(g)(4)(G). The depletion allowance is calculated by either the method used for book purposes, or the method provided for in I.R.C. § 611, whichever yields the smaller present value. Id.
108. Id.
109. Id.
112. H.R. CONF. REP. NO. 841, supra note 10, at II-278 to -79.
113. SENATE COMM. ON FINANCE, TAX REFORM ACT OF 1986, supra note 89, at 518.
114. Id. at 519.
115. Id. The committee recognized that financial accounting is more conservative than tax accounting and that financial accounting errs on the side of understatement. The committee felt that because of that understatement alternative minimum taxable income should not fall below the book income figure. Id. at 519 n.4.
116. Id. at 519. The Senate Report specified that: The minimum tax cannot successfully address concerns of both real and appar-
The Senate had debated the matter of a broad-based corporate minimum tax.\textsuperscript{117} Senate hearings were held several days after this debate. At these hearings on October 9, 1985, Professor Michael J. Graetz spoke to the Finance Committee on the subject of minimum tax.\textsuperscript{118} Professor Graetz proposed a broad-based minimum tax\textsuperscript{119} with reported profits used as a floor for minimum taxable income.\textsuperscript{120} According to Professor Graetz, connecting the corporate minimum tax with book income would eliminate publicized incidents of high-profit companies paying little or no tax, and would restore a public perception of fairness in the tax system.\textsuperscript{121} Such a floor would not add more complexity to the system because corporations must calculate their book income for financial reporting purposes anyway. Professor Graetz concluded that such a floor on corporate minimum tax would, indeed, increase revenue.\textsuperscript{122}

During these hearings the Senate Finance Committee also heard from Pennsylvania Law Professor Harry Gutman, from Bernard Shapiro, National Director for Tax Policy for Price Waterhouse, and from Emil Sunley of Deloitte Haskins and Sells.\textsuperscript{123} Generally, their statements reinforced the idea of using the corporate minimum tax as a vehicle to promote fairness, but they warned against using the tax to increase revenue. The speakers further warned of the added complexities of the alternative minimum tax and its dampening effect on the use of tax incentives. None of the speakers’ statements responded directly to Professor Graetz’s proposal to set book income as a floor for the corporate alternative minimum tax.

Congress’s motive behind the book income adjustment provisions was to ent fairness unless there is certainty that whenever a company publicly reports substantial earnings ... that company will pay some tax. . . .

Thus, the committee believes that it is important to provide that the alternative minimum taxable income of a corporation will be increased when book income for the year exceeds alternative minimum taxable income. Such a provision will increase both the real and the perceived fairness of the tax system, eliminate the highly publicized instances in which corporations with substantial book income have paid no tax, and further broaden the minimum tax base to approach economic income more closely.

\textit{Id.} at 520.

\textsuperscript{117} See 131 \textit{Cong. Rec.} S12,874-80 (daily ed. Oct. 9, 1985). The focus of the debate was deficit reduction. \textit{Id.} at S12,874-75 (Statement of Sen. Boren). “I think it is imperative that, before we do anything else, we use the funds that are raised by this corporate minimum tax to apply to reduce the deficit in this country.” \textit{Id.} at S12,876. The minimum tax proposal passed 88 to 11 after the Senate considered a study by Citizens for Tax Justice. \textit{Id.} at S12,877-79. This 1985 study entitled “Corporate Taxpayers and Corporate Freeloaders” reported that of 275 major profitable corporations, 129 paid no federal income taxes in at least one of the four years from 1981 to 1984. \textit{Id.} Congress also considered research conducted by Senator DeConcini. \textit{Id.} at S12,879. Senator DeConcini reported that in 1983 five of the top 10 Department of Defense contractors paid no corporate income tax. \textit{Id.}

\textsuperscript{118} \textit{Hearing, supra} note 4, at 36 (statement of Professor Michael J. Graetz, Yale Law School).

\textsuperscript{119} \textit{Id.} at 47.

\textsuperscript{120} \textit{Id.} at 50-52.

\textsuperscript{121} \textit{Id.} at 51.

\textsuperscript{122} \textit{Id.} at 52.

\textsuperscript{123} \textit{Id.} at 56 (statement of Professor Harry Gutman, University of Pennsylvania Law School); \textit{Id.} at 5 (statement of Bernard Shapiro, National Director for Tax Policy, Price Waterhouse); \textit{Id.} at 69 (statement of Emil Sunley, Deloitte Haskins and Sells).
increase the fairness of the system. Raising revenue was another consideration. Congress was not deterred by the problems of increased complexity, financial accounting policies and standards, or the blunting of tax incentives. Congress did evidence some hesitation, however, by including the switch from the book income adjustment to the current earnings adjustment for tax years after 1989 and by mandating a study to be completed before the time of the switch. Politically, Congress did what it felt it had to do. The rhetoric of the new tax code is fairness and simplicity, and these new adjustments appear fair and simple to voters.\textsuperscript{124} The Senate and Conference Reports stressed the fairness angle while ignoring or substantially downplaying the added complexity.\textsuperscript{125}

\section*{IV. \textbf{Options and Alternatives Concerning the Book Income Adjustment}}

Four different approaches are available to Congress regarding the book income adjustment in the corporate alternative minimum tax scheme. These four options are: (A) fine tune and retain the existing book income adjustment; (B) replace the book income adjustment with an earnings and profits adjustment; (C) strengthen the corporate alternative minimum tax scheme so that the book income adjustment is not needed as a backstop provision; or (D) move to a flat rate, broad-based tax system so that a corporate alternative minimum tax and its accompanying adjustment is not needed at all. The first two alternatives merely involve alterations to the minimum tax adjustment; the other two options entail broad changes to the corporate alternative tax structure.

\subsection*{A. \textit{Fine Tune the Existing Book Income Adjustment}}

The book income adjustment proposals generated extensive concern.\textsuperscript{126} As corporate taxpayers file their 1987 tax returns and have to deal with the book income adjustment provision, this concern will likely grow. Items of
concern include the use of financial accounting figures for tax purposes,\(^\text{127}\) the increased complexity in determining tax liability,\(^\text{128}\) and the taxation of tax-exempt income\(^\text{129}\) that will result from the adjustment.

The use of financial accounting for tax purposes raises both policy and technical concerns.\(^\text{130}\) The book income adjustment indiscriminately taxes reported income in excess of the alternative minimum taxable income. In so doing, the adjustment indirectly cuts back on other preference items, thereby hampering these preferences.\(^\text{131}\) For example, if the accounting rules are different for inclusion of a preference item for tax versus financial reporting purposes, a preference item may be taxed by the minimum income tax and then taxed again by the book income adjustment to the minimum tax.\(^\text{132}\)

The concern over timing issues is also important even when no tax preferences are involved. Financial accounting is often based on the accrual method of reporting income, whereas some provisions in the tax code force use of the cash method.\(^\text{133}\) A taxpayer will likely recognize an income item for book purposes before he does so for tax purposes.\(^\text{134}\) This result will increase book income in reference to the minimum taxable income and could cause a minimum tax liability through operation of the book income adjustment. When the taxpayer finally realizes the income item for tax purposes, the income will be fully taxable under the regular income tax scheme.\(^\text{135}\)

For example, if the cost of a major hazardous waste cleanup is accrued for book purposes one year and expensed for tax purposes the next, the book

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\(^{127}\) Tax Report [Minimum Tax Plans]. supra note 126, at 1, col. 5.

\(^{128}\) Sunley, supra note 126, at 397.

\(^{129}\) Forecast and Implications, supra note 78, at 168.

\(^{130}\) See generally supra notes 57-73 and accompanying text; Cox, Conflicting Concepts of Income for Managerial and Federal Income Tax Purposes, 33 ACCT. REV. 242, 242-45 (1958) (major points of conflict exist between tax and financial accounting; tax law can improperly influence accounting principles); Healy, Narrowing the Gap Between Tax and Financial Accounting, 22 TUL. TAX. INST. 407, 414-20 (1973) (financial and tax accounting have different goals and timing differences; Treasury should not attempt to regulate this area; regulation (as proposed by 1986 Tax Reform Act) would break down spirit of cooperation between IRS and accounting profession); McClure, Diverse Tax Interpretations of Accounting Concepts, 142 J. ACCT., Oct. 1976, at 67, 68-74 (IRS and accounting profession interpret differently such underlying concepts as the accrual method, the going concern concept, the matching concept, and the realization concept); Raby & Richter, Conformity of Tax and Financial Accounting, 139 J. ACCT., Mar. 1975, at 42, 44-48 (from accountant's point of view, use of financial accounting figures for tax purposes exerts pressure on accountants to use procedures that produce the best tax benefits; such procedures do not provide meaningful figures for either the IRS or shareholders, do not reduce cost for either group, and dull evolutionary changes in financial accounting; from IRS viewpoint use of financial accounting figures handicaps administration of tax law and converts the IRS into arbiter of accounting practice); Simonetti, A Challenge, Can the Accounting Profession Lead the Tax System, 126 J. ACCT., Sept. 1968, at 66, 68 (requirements of income tax system are often different from requirements of good accounting).


\(^{132}\) Sunley, supra note 126, at 397.

\(^{133}\) See generally Cox, supra note 130, at 243.

\(^{134}\) For example, some expenses must be prorated for tax purposes, but treated as current expenses for financial accounting purposes. Cf. Peoples Bank & Trust Co. v. Commissioner, 415 F.2d 1341, 1343-44 (7th Cir. 1969) (disallowed deduction for interest expense even though it would be an expense for financial accounting).

\(^{135}\) Sunley, supra note 126, at 397; Committees, supra note 58, at 569, 571.
income in the later year may be higher than the alternative minimum taxable income because the expenses will not be deducted from book income that year. Thus, an alternative minimum tax liability may result solely from the book income adjustment.136 Congress could add a credit to bridge timing differences and alleviate this problem;137 such a credit, however, would add yet another layer of complexity to the book income adjustment provision.138

On a broader level, the use of financial accounting figures for tax purposes will likely cause companies to have tax consequences in mind as they prepare their financial statements.139 A related concern is that the book income adjustment will lead tax officials into the arena of financial accounting standards.140 The problem is that tax and financial accounting serve two separate purposes.141 Using a tax provision that may alter financial reporting may not be wise. The practice will likely undermine the quality of information provided to shareholders, management, and creditors of corporations.142 Furthermore, the provision will result in accountants having too much control over a corporation's minimum tax base143 such that similarly situated companies will be taxed differently depending on their chosen method of financial accounting.144

Adjustments to book income for purposes of the book income adjustment could alleviate some of the problems mentioned above. Some adjustments already required to be made to the book income figure145 are necessary,146 but complicated. Congress could further modify book income for each pref-

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136. Sunley, supra note 126, at 397.
137. Id.
138. See infra notes 145-47 and accompanying text.
139. Uhlfelder, supra note 58, at 197. A recent Wall Street Journal article quotes Mr. Alfred King, managing director of the National Association of Accountants, as saying: "The purpose of tax simplification should be to get away from a tax-driven economy filled with tax shelters. But this provision puts pressure on businessmen and accountants alike to make tax-driven decisions." Berton, supra note 126, at 4, col. 5. The Berton article also quotes the Financial Accounting Standards Board as saying the book value preference is a bad idea and that "[t]ax policies shouldn't interfere with external financial reporting, which has different aims and goals." Id. col. 4. The Berton article notes that the reason that reported income is often higher than tax income is that certain deductions are allowed for tax purposes that are not recognized for reporting purposes. Id. Another concern caused by using financial accounting figures for tax purposes is that the independence of outside auditors may be compromised.
140. Tax Report, Minimum Tax Plans, supra note 126, at 1, col. 3.
141. See supra note 130 and accompanying text; Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 542-43 (1979); supra notes 57-73 and accompanying text.
142. Uhlfelder, supra note 58, at 197; see Sunley, supra note 126, at 396 (book income preference creates incentive to use reserves to reduce book income).
143. Uhlfelder, supra note 58, at 197; see Committees, supra note 58, at 571 n.7 (accountant's use of purchase accounting may allow a corporation to realize larger deductions for book purposes than for tax, thereby reducing disparity between book income and taxable income and avoiding tax liability imposed by book income adjustment); Raby & Richter, supra note 130, at 48 (accounting figures are often approximations unsuited for income determination); Sunley, supra note 126, at 396-97 (Treasury would lose control over tax base if minimum tax base defined as book income; same problem exists to a lesser degree under book income preference provision).
144. Uhlfelder, supra note 58, at 197.
146. Sunley, supra note 126, at 396.
ference item added back or not added back to taxable income; Congress could also make modifications to account for timing differences. These modifications would avoid double taxation or omissions. Nevertheless, the resulting book income adjustment provision would be exceedingly complex.

Another unattractive feature of the book income adjustment is that it taxes otherwise tax-exempt increases in book income, such as tax-exempt bond income, gain on liquidation of property not recognized under section 337, and other tax-free exchanges such as certain reorganizations and involuntary conversions of property. The book income adjustment thus interferes with the policies of the regular tax, and is, therefore, unfair. Adjustments to book income might avoid this problem, but again, more adjustments would add to the complexity of the minimum tax provisions.

The proponents of the book income adjustment stress that it will increase the perceived fairness of the tax system. The question is: At what expense? The book income adjustment is unfair to corporations. It improperly involves the use of financial accounting for tax purposes, it adds complexity to the tax system at a time when simplicity is sought, and it taxes otherwise tax-exempt income. Further adjustments to avoid some of these problems would improve the provision. Such adjustments, however, would complicate the system further without curing all of the problems accompanying the provision. For these reasons, Congress should not retain the book income adjustment.

B. Replace the Book Income Adjustment with the Current Earnings Adjustment

The earnings adjustment alternative avoids the problems of using financial accounting for tax purposes, but involves a good deal of complexity. This alternative has been described as the lesser of two evils as between the book income adjustment and the earnings adjustment. The earnings adjustment involves concepts somewhat familiar to tax accounting. The Tax

147. Id. at 397; Committees, supra note 58, at 571.
148. Forecast and Implications, supra note 78, at 168; Government Finance Officers Association Finds "Serious Flaw" in Finance Committee Bill's Alternative Minimum Tax Provision, 31 Tax Notes, June 13, 1986, at 305. Some bond income is not taxed. I.R.C. § 103 (1986). This bond income, however, is included in income for financial reporting purposes. A tax on financially reported income would thus tax bond income that Congress has deemed nontaxable.
149. I.R.C. § 337 (1986) deems gain on certain liquidation sales nontaxable. Such gain would be included in book income, so a tax on book income would tax a gain that Congress has deemed nontaxable.
150. Committees, supra note 58, at 571. The Code treats reorganizations in certain receivership and bankruptcy proceedings as nontaxable. I.R.C. § 371 (1986). The Code also does not tax gain from the sale of stock to stock ownership plans. Id. § 1042. Gain from sales or exchanges undertaken to effectuate the policies of the Federal Communications Commission is likewise nontaxable; id. § 1071, as is gain on exchanges or distributions made pursuant to orders of the S.E.C., id. § 1081.
151. The regular tax policies encourage certain activity. The minimum tax provisions then come in through the back door to tax that activity.
152. Uhlfelder, supra note 58, at 197.
153. I.R.C. § 312 (1986). The Code does not actually define earnings and profits, but rather § 312 prescribes the effects of particular transactions on earnings and profits. Other
Reform Act of 1984\textsuperscript{154} modified the earnings and profits calculation such that it now can be a fairly close measure of economic income.\textsuperscript{155} The earnings adjustment approach may not, however, alleviate instances in which corporations report income to shareholders, yet pay no tax.\textsuperscript{156} This alternative is fair because it taxes economic income. Nevertheless, the alternative fails to address the problem of perceived fairness of the tax system to the same extent that the book income adjustment does because earnings and profits are less comprehensible to the general public. Thus, the earnings adjustment alternative lacks the political appeal of the book income adjustment; it does not provide Congress with an approach that the general public will perceive as simple and fair.

The current earnings adjustment also has another problem. Not only does the adjustment appear complex, it is complex. Special adjustments are required for exclusion items,\textsuperscript{157} and even more adjustments are needed to avoid taxing tax-exempt income.\textsuperscript{158} Even if such adjustments were not required, this alternative would still add complexity to the tax system for it is yet another taxable income figure that taxpayers must spend time and money to compute.

\textbf{C. Strengthen the Alternative Minimum Tax Scheme So That Adjustments Such as the Book Income or Current Earnings Adjustment Are Not Needed}

Under the Tax Reform Act of 1986, the book income adjustment acts as a backstop to the alternative minimum tax; the adjustment comes into effect if book income exceeds alternative minimum taxable income. Congress, by providing such a backstop, avoided the question of whether to strengthen the alternative minimum tax to avoid the need for a backstop provision in the first place. A strong minimum tax might not need a backstop.

Fortifying the minimum tax could be done in one of two ways. First, the existing alternative tax could be strengthened through modifications such as decreasing the exemption amount, increasing the tax rate, capping the use of preferences so that a taxpayer's effective tax rate does not fall below a certain level,\textsuperscript{159} and expanding the list of preferences subject to the minimum tax so as to move to a broad-based minimum tax.\textsuperscript{160} A second alternative for strengthening the minimum tax would be to base the minimum tax solely on


155. J. PARKER, \textit{supra} note 13, ¶ 9.07a; Sunley, \textit{supra} note 126, at 397.
156. Sunley, \textit{supra} note 126, at 397.
158. Committees, \textit{supra} note 58, at 572.
159. Sunley, \textit{supra} note 126, at 396.
160. A broad-based minimum tax was proposed by Professor Graetz. \textit{Hearing, supra} note 4, at 47-48 (statement of Professor Michael J. Graetz, Yale Law School).}
earnings and profits. Rather than starting with taxable income and adding back preferences, the earnings and profits figure could serve as a base, reduced by specific deductions. One problem with this second alternative, however, is that earnings and profits are not that well defined in the Code and are difficult to calculate. The earnings and profits calculation, though, is intended to measure economic income, and in that respect using earnings and profits as a minimum tax base is fair. Also, in some cases the earnings and profits figure is calculated to determine whether a corporate distribution represents dividends or a return of capital, so that in such a case the alternative minimum tax calculation would merely involve adapting the predetermined earnings and profits figure. Thus, using the earnings and profits approach could be simple. Most taxpayers, however, do not compute earnings and profits each year.

Strengthening the alternative minimum tax by making it broad-based, with lower exemptions, higher rates, caps on use of preferences, and a longer list of preferences, is more desirable than using earnings and profits as a base for the tax. The earnings and profits calculation is more complicated and less well defined, and it involves taxing otherwise tax-free income. Using a broad-based alternative minimum tax based on preferences undoubtedly adds fairness to the tax system. Thus, such an approach is politically appealing in the context of tax reform rhetoric. The biggest problems remain both the complexity of such a tax and the inconsistency of allowing tax preferences in the regular tax system and then taxing them in the alternative tax system. The complexity involved, however, is less than that involved with either the book income adjustment or the current earnings adjustment because both adjustment calculations involve the alternative minimum tax calculation complexity as well as the adjustment calculation complexity.

D. Move to a Flat-Rate, Broad-Based Income Tax System That Eliminates the Need for a Minimum Tax

Arguably, eliminating the need for a minimum tax is the most direct approach available to Congress. This approach is both simple and fair.

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161. Committees, supra note 58, at 572.
162. I.R.C. § 312 (1986) could be used to determine earnings and profits with further refinements as necessary.
163. Professor Graetz proposed a similar approach except that he used gross income as a base. Hearing, supra note 4, at 48-49 (statement of Professor Michael J. Graetz, Yale Law School).
164. Committees, supra note 58, at 572.
165. Id. at 571. In determining earnings and profits, adjustments are made to taxable income to net out such items as federal income taxes, dividends paid, and life insurance premiums paid, and to add back such items as the dividend received deduction, nontaxable interest income, and depreciation deducted in excess of straight-line depreciation. J. PARKER, supra note 13, at 364-65.
166. Sunley, supra note 126, at 397; J. PARKER, supra note 13, at 365.
167. See Graetz, supra note 6, at 529 n.9, citing the following for discussion of the merits of a broad-based tax: Bittker, A "Comprehensive Tax Base" as a Goal of Income Tax Reform, 80 HARV. L. REV. 925 (1967); Galvin, More on Boris Bittker and the Comprehensive Tax Base: The Practicabilities of Tax Reform and the ABA's CSTR, 81 HARV. L. REV. 1052 (1968); Mus-
Congress, however, is not likely to change the tax system in such a manner because the change is not politically attractive since all taxpayers would lose their favorite tax preferences. The minimum tax system is complicated, and its very existence is an admission that something is wrong with the regular tax system. Since a move to a broad-based income tax with low, flat rates is politically unlikely, the minimum tax provision must serve as a compromise solution to the competing policies of the tax system.

E. Recommendation

Given that the political restraints on Congress make it unlikely that the legislators will seriously consider eliminating the need for a minimum tax, Congress should adopt the third alternative approach by strengthening the alternative minimum tax scheme so that backstop provisions such as the book income adjustment are not needed. This option is the most fair, simple, effective, and realistic approach. Admittedly, this approach does add some complexity to the tax system. The complexity is, however, less than that involved in the book income adjustment and the current earnings adjustment, and it is a necessary compromise for the added fairness that the approach will bring to the Code.

V. Conclusion

In the area of the minimum tax Congress faces the task of achieving a fair and simple income tax system in the face of the competing and contradictory objectives of fair revenue raising and social and economic policy incentives. Congress is not likely to drop either objective in the near future. The problem of reconciling the two objectives will, therefore, remain. The book income adjustment provision in the Tax Reform Act of 1986, although not an adequate solution, is at least an admission of the problem and a first step toward solving the problem. The book income adjustment remains too complicated and relies too heavily on financial accounting to deserve a permanent place in the income tax system. The current earnings adjustment is better, but it also is too complicated. The abolition of the minimum tax system altogether in favor of a broad-based regular income tax system is theoretically attractive; its implementation is unlikely, however, considering that the minimum tax system is a necessary compromise between the competing goals of the tax system: the goal to use preferences to promote policy objectives and to respond to special interest groups, and the goal to increase tax revenue. Both goals seem politically necessary. The remaining alternative is to strengthen the alternative minimum tax system with a lower ex-grave, In Defense of an Income Concept, 81 HARV. L. REV. 63 (1967). See generally Graetz, supra note 6 (general discussion of a broad-based income tax systems).


169. See generally Graetz, supra note 6.

170. Hearing, supra note 4, at 39-40 (statement of Professor Michael J. Graetz, Yale Law School).
emption amount and a more comprehensive list of tax preferences. This strengthened minimum tax would effectively limit the benefit of tax preferences so as not to reduce effective corporate tax rates below a certain level. Such an approach would make the tax system more fair, with the least amount of additional complexity, and would be a politically realistic compromise to the competing goals of the income tax system.