

1987

1986 Tax Reform Act: Alternative Minimum Tax on Corporations (Section 55, IRC and Section 701(a) ACT)

Paul Broderick

Repository Citation

Broderick, Paul, "1986 Tax Reform Act: Alternative Minimum Tax on Corporations (Section 55, IRC and Section 701(a) ACT)" (1987). *William & Mary Annual Tax Conference*. 582.
<https://scholarship.law.wm.edu/tax/582>

PAUL BRODERICK

1986 TAX REFORM ACT
ALTERNATIVE MINIMUM TAX ON CORPORATIONS
(SECTION 55, IRC AND SECTION 701(a) ACT)

SUMMARY ANALYSIS:

The Tax Reform Act of 1986 (TRA) imposes on corporations what is in reality a second system for taxing income - called the Alternative Minimum Tax (AMT).

Each year every corporation will be required to compute its alternative minimum taxable income. This starts with regular taxable income but can require up to 18 adjustments for various items, including separate computations of depreciation and property basis, and a "book income" adjustment that can arise if financial statement income exceeds alternative minimum taxable income as otherwise determined. The AMT system also includes separate operating loss carryover, foreign tax credit, and general business credit computations.

The rate is 20 percent. If AMT as computed exceeds regular tax, it is the tax for the year. AMT paid is available as a credit, with limitations, against regular tax of future years. Payments of estimated tax must take AMT into account.

While it appears that many corporations will not actually incur AMT in most years, this must be determined each year. Because of the interrelationships of various factors that enter into the determination, it can be difficult to predict whether AMT will be incurred.

Further, "superfund" legislation enacted in 1986 includes a special tax of .12 percent on all corporations whose modified alternative minimum taxable income exceeds \$2 million. Thus, despite the fact that a corporation might not be subject to AMT, it will be required to determine alternative minimum taxable income and might have to pay the superfund tax.

DEFINITIONS:

- TRA - Tax Reform Act of 1986
 - AMT - Alternative Minimum Tax
 - AMTI - Alternative Minimum Taxable Income
 - MTC - Minimum Tax Credit
 - FTC - Foreign Tax Credit
 - ITC - Investment Tax Credit
 - NOL - Net Operating Loss
 - BURP - Book Unreported Profits Adjustment
 - POC - Percentage of Completion-Capitalized Cost
 - POC-CC - Percentage of Completion-Capitalized Cost
 - AMT-FTC- Alternative Minimum Tax-Foreign Tax Credit
- Tentative minimum tax (TMT) - 20% of AMTI reduced by exemption amount and by alternative minimum foreign tax credit (section 55(b))

Section 55 tax - Tentative minimum tax less regular tax for taxable year

Regular tax - Regular tax liability reduced by foreign tax credit allowable

Net minimum tax - Tax imposed by section 55

Adjusted net minimum tax - Net minimum tax reduced by the amount which would be the net minimum tax if the only adjustments and items of tax preference were exclusion preferences

DEPRECIATION:

The requirements of AMT in the area of depreciation are extensive. The AMT is a function of book depreciation, regular tax depreciation (facts and circumstances, ADR, "original ACRS", "new ACRS", and alternative depreciation), AMT depreciation on "new ACRS" assets, and depreciation-related preference items. In addition, alternative minimum taxable income is also a function of gains and losses on dispositions of depreciable property and any related depreciation recapture.

AMT depreciation is a separate and complete system for accounting for assets. It has all the features of the regular depreciation "new ACRS" system. However, because the lives and depreciation method are usually different, the two systems will generally result in different depreciation deductions, different bases, different gain or loss on dispositions, different depreciation recapture on dispositions, etc. Generally, depreciation will be "slower" for AMT purposes than for regular tax purposes.

The AMT depreciation applies only to assets recovered for regular tax purposes, under the "new ACRS" rules.

Generally, this includes assets placed in service after December 31, 1986. However, the TRA allows taxpayers to elect "new ACRS" for property placed in service after July 31, 1986. If this election is made, the assets affected by the election will also be subject to AMT depreciation.

Various transition rules allow certain property with a class life of at least 7 years to be recovered under "original ACRS", even though the property is placed in service after December 31, 1986. To qualify for "original ACRS", the property must meet one of the following requirements:

- (i) The property was constructed, reconstructed or acquired by the taxpayer pursuant to a written contract which was binding on March 1, 1986, or
- (ii) The property is considered an equipped building or plant facility and, as of March 1, 1986, construction had commenced and more than half of the cost had been incurred or committed.

In addition, the property must meet certain placed-in-service deadlines:

<u>Class Life</u>	<u>Must Be Placed in Service Before</u>
At least 7 but less than 20 years	January 1, 1989
20 years or more	January 1, 1991

Residential rental and
nonresidential real property

January 1, 1991

If property meets these transition rules, it will qualify for the generally more favorable "original ACRS" and, at the same time, avoid any AMT depreciation problems.

If the property is subject to "new ACRS", the AMT depreciation is computed using the rules for the Alternative Depreciation System (section 168(g)), except that AMT depreciation

ENERGY INDUSTRY:

The AMT will have a significant effect on the Energy Industry. Although the TRA preserved most of the special tax incentive deductions available to the Energy Industry, the imposition of the AMT may substantially eliminate the tax benefits of these deductions.

The items affecting the calculation of the AMT discussed in this section are as follows:

- (i) Percentage Depletion
- (ii) Intangible Drilling and Development Costs for Oil & Gas and Geothermal Wells
- (iii) Mining Exploration and Development Costs

PERCENTAGE DEPLETION:

Percentage depletion in excess of the taxpayer's basis in a property is a tax preference item under section 57(a)(1). Although redesignated from section 57(a)(8) to section 57(a)(1). Although redesignated from section 57(a)(8) to section 57(a)(1), this item was not changed by the TRA. Accordingly, the calculation of the preference item for percentage depletion is still described in Reg. 1.57-1(h).

INCOME FROM A LONG-TERM CONTRACT

Section 56(a)(3) provides that in determining the amount of the alternative minimum taxable income from any long-term contract entered into by the taxpayer on or after March 1, 1986, the percentage of completion method of accounting (POC method) must be used, as modified by section 460(b).

Section 460(f) defines the term "long-term contract" as a building, installation, or construction contract that is not completed within the tax year in which it is entered into and a manufacturing contract that involves the manufacture of (a) any unique item of a type that is not normally carried in the finished goods inventory of the taxpayer or (b) items that normally require more than 12 calendar months to complete.

The TRA also changed the reporting of income for long-term contracts under the regular tax. The new law requires a taxpayer to use the POC method if it is currently using the POC method. Taxpayers not using the POC method must use the percentage of completion - capitalized cost method (POC-CC). The POC-CC method provides that 40% of the

items be taken into account under the POC method and 60% of the items with respect to the contract be taken into account under the taxpayer's normal method of accounting. A taxpayer's normal method of accounting includes the cash receipts and disbursements method, the accrual method or the completed contract method of accounting.

INSTALLMENT METHOD ADJUSTMENT:

The TRA changed the method of recognizing income under the installment sales method for both the regular tax and AMT.

Generally, the TRA places limits on the availability of the installment method for specified property through the use of the proportionate disallowance rule. The proportionate disallowance rule applies to installment obligations arising from the sale of the following property:

- (i) Personal property disposed of after February 28, 1986 under the installment method by a person who regularly sells or otherwise disposes of personal property of the same type on the installment plan. [Section 453C(e)(1)(A)(i)(I)].
- (ii) Real property disposed of after February 28, 1986 under the installment plan which is held by the seller for sale to customers in the ordinary course of the taxpayer's trade or business. [Section 453C(e)(1)(A)(i)(II)].
- (iii) Real property disposed of after August 16, 1986 under the installment method which is property used in the taxpayer's trade or business or held for the production of rental income if the sales price exceeds \$150,000. [Section 453C(e)(1)(A)(i)(III)].

CIRCULATION EXPENDITURES:

Section 173 generally provides for the deduction from gross income of all expenditures incurred by a taxpayer to establish, maintain, or increase the circulation of a newspaper, magazine or periodical.

The excess of that deduction over a three-year amortization thereof is a preference for individual taxpayers and personal holding companies (as defined by section 543). Circulation expenditures incurred by these taxpayers after 1986 must be capitalized and deducted ratably over three years in computing alternative minimum taxable income.

Section 59(e) provides an election whereby circulation expenditures can be amortized over a 3-year period in determining regular tax thereby eliminating any adjustment for alternative minimum tax purposes.

SHIPPING COMPANIES:

Section 607 of the Merchant Marine Act of 1936 provided for the establishment of special capital construction funds and their tax treatment. The tax rules have been recodified in section 7518 of the IRC.

Section 7518 provides that amounts deposited in these funds are deductible and any earnings (including gains and losses) on amounts in the fund are excludible for purposes of regular tax. Amounts withdrawn from the fund operate to reduce basis of related property.

Effective for amounts deposited after December 31, 1986 and earnings on the fund after December 31, 1986, the deduction and exclusion are not applicable in determining alternative minimum taxable income.

BLUE CROSS/BLUE SHIELD ORGANIZATIONS:

Section 833 provides a special deduction for Blue Cross/Blue Shield organizations and certain other otherwise tax exempt health insurance organizations. The deduction is equal to 25 percent of the sum of (1) claims incurred during the taxable year, and (2) expenses incurred during the taxable year in connection with the administration, adjustment or settlement of claims, less adjusted surplus at the beginning of the year, but limited to taxable income computed without regard to the deduction. However, this deduction is not allowed for purposes of the AMT.

PASSIVE ACTIVITIES OF CLOSELY HELD AND PERSONAL SERVICE CORPORATIONS:

Under the TRA, limitations were imposed on the deductibility of passive activity losses for regular tax purposes. These loss disallowance rules are phased in gradually over a 5-year period. Disallowed losses (suspended losses) in any year may be carried forward indefinitely and deducted from income from passive activities in subsequent tax years. Suspended losses may be deducted in full upon disposition of the taxpayer's entire interest in the passive activity. The passive activity rules are not applicable to corporations other than "closely held C corporations" and "personal service corporations". S corporations are subject to the limitations at the shareholder level.

The same rules apply in limiting passive losses for AMT purposes that apply for regular tax purposes, with three exceptions:

- (i) There is no phase-in of the disallowance for AMT purposes.
- (ii) Losses that would otherwise be disallowed for the taxable year are reduced for AMT purposes to the extent of the taxpayer's insolvency (i.e., liabilities in excess of the fair market value of assets).
- (iii) In applying the limitations, for AMT purposes, the AMT rules apply to the measurement and allowability of all items of income, deduction, and credit for the activity.

The rules with respect to utilization of the suspended loss carryovers are applied in the same manner for both regular and AMT tax purposes.

COMMERCIAL BANKS:

The TRA retained the tax preference treatment of prior law for loan loss reserve additions. Under section 585(b), commercial banks which are entitled to continue using the reserve method may claim a deduction for a loan loss addition under either the percentage method (section 585(b)(2)) or the experience method (section 585(b)(3)). However, section 57(a)(4), provides that if the amount of loan loss deducted under the percentage method exceeds the amount allowed based on a hypothetical experience calculation, the excess is considered a preference item and is included in the AMT calculation.

Inclusion of the bad debt addition as a preference item under this computation should no longer be an issue for commercial banks' taxable years beginning after December 1987.

PRIVATE ACTIVITY BONDS:

Under section 57(a)(5)(A), as amended by TRA section 701(a), certain tax-exempt interest income is considered a preference item and therefore includable in the computation of AMTI. The TRA treats interest income which is exempt for regular tax purposes as a preference if such interest was derived from "specified private activity bonds". Only specified private activity bonds issued after August 7, 1986 will give rise to a preference item.

CHARITABLE CONTRIBUTIONS:

A new item of tax preference added by the TRA relates to charitable contributions of appreciated capital gain property. The tax preference is the amount by which the regular tax charitable contribution deduction allowed under section 170 would be reduced if only the adjusted basis for the property were deducted. Section 57(a)(6).

ACCELERATED DEPRECIATION ON REAL PROPERTY:

The TRA, in section 57(a)(7), maintained the prior-law preference for accelerated depreciation on real (section 1250) property. This preference was described in sections 57(a)(2) and 57(a)(12)(B) of prior law as the excess of accelerated depreciation over the depreciation which would have been allowed under the straight line method. Although these provisions were repealed by the TRA, they continue in effect for AMT purposes.

ACCELERATED DEPRECIATION ON LEASED PROPERTY:

The TRA maintained, in section 57(a)(7), the prior law preference for accelerated depreciation of leased personal property. This preference was described in sections 57(a)(3) and 57(a)(12)(A) of prior law as the excess of accelerated depreciation on leased section 1245 property over the deduction allowable had the property been depreciated on a straight line basis. Generally, this preference applies to property placed in service before 1987 or that is eligible for the transitional rules of the TRA.

BOOK UNREPORTED PROFITS PREFERENCE:

The most controversial and unique adjustment in determining the alternative minimum taxable income (AMTI) is the inclusion as a tax preference of 50 percent of the excess of a corporation's pre-tax book or financial statement income (with certain adjustments) over alternative minimum taxable income.

The rationale behind the book income preference is "to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions and credits". S. Rep. No. 313, 99th Cong. 2nd Sess. 518 -520 (1986). The Senate Finance Committee believed that the new corporate minimum tax could not successfully address perceived fairness concerns solely by having as its base a list of specific items to be treated as preferences, as done in prior law. Instead, the Committee adopted an unprecedented approach: taxing income based upon the financial earnings of a corporation:

NET OPERATING LOSSES:

A net operating loss deduction is allowed in computing AMTI. The NOL deduction may not exceed 90% of the taxpayer's AMTI before the NOL deduction. For AMT purposes, current year NOL deductions are determined using a separate computation of AMT NOL's and carryovers. The loss computation takes into account the differences between the regular tax base and the AMT tax base. The items of tax preference other than the preference arising in that year attributable to charitable contributions are added back to taxable income (or, as with depreciation, adjustments relating to those items are made).

FOREIGN TAX CREDIT:

The foreign tax credit, with certain modifications is allowable for purposes fo the AMT. These modifications involve separate applications, for minimum tax purposes, of the section 904 limitations and are necessary to reflect the differences between regular taxable income and alternative minimum taxable income.

To the extent preferences allocable to U.S. source income alter the ratio of foreign taxable income to worldwide income for AMT purposes, the section 904 limitation may lead to different results under regular tax and AMT. In addition, in computing the section 78 gross-up for foreign taxes deemed paid, it is necessary to compute earnings and profits of the foreign subsidiary. This must be done on an AMT basis, which could include separate computations of inventory, depreciation, and other items on a basis different from regular tax. Thus, the amount of gross-up could differ as could the amount of foreign tax deemed paid.

TAX CREDITS:

General business credits include the research and development credit, the investment tax credit (including the energy credit and rehabilitation credit), targeted jobs credit, the alcohol fuels credit, and the employee stock ownership credit.

Generally these credits cannot be claimed to the extent that they reduce regular tax below tentative minimum tax. An exception is provided for regular investment tax credits. The effect of the exception is to allow regular ITC to reduce minimum tax liability by 25 percent.

Because of the interrelationship of the regular and alternative minimum tax as affected by the use of business credits, each taxpayer is to maintain a single business tax credit account for both regular and minimum tax purposes.

ENVIRONMENTAL (SUPERFUND) TAX

Section 59A, which was enacted in late 1986, imposes an environmental tax, measured by reference to alternative minimum taxable income.

GENERAL RULES:

- (i) The tax applies to all corporations, not just chemical and petroleum firms.
- (ii) The tax is not part of the alternative minimum tax. Taxpayers can be liable for this tax whether or not they are liable for alternative minimum tax or regular tax.

- (iii) The tax base is alternative minimum taxable income computed without regard to net operating loss deductions or the deduction allowed for the tax itself. There is a \$2 million exemption.
- (iv) The tax rate is 0.12 percent (\$12 per \$10,000). No credits are allowed.
- (v) The tax is to be taken into account in determining corporate estimated taxes starting on April 15, 1987.
- (vi) The tax is deductible for regular tax and AMT purposes (section 164(a)).

MINIMUM TAX CREDIT:

To alleviate potential inequities of the new alternative minimum tax resulting from timing differences between tax and financial accounting income recognition, the TRA introduces a new concept, the Minimum Tax Credit (MTC).

The MTC is a credit allowed against regular tax liability for minimum tax paid in prior years. The credit is provided to eliminate the "penalty" to a taxpayer caused by going from the AMT in one year to the regular tax in another year. Under this theory, if all transactions were combined into a single year, the total tax payable should be the same as it would be if they occurred in several years.

ESTIMATED TAX:

AMT must be taken into account in determining corporate payments of estimated tax. That is, in determining whether a corporation's payments of estimated tax are at least 90 percent of the tax for the year, AMT is treated in the same manner as regular tax.

In addition, tax for the year includes tax due under the environmental or "superfund" tax.

Corporations who seek to avoid penalties for underpayment of estimated tax by making payments based on 90 percent of tax, determined by annualizing taxable income for portions of the year, must also compute annualized alternative minimum taxable income for the various short periods. This includes determining the various preferences, adjustments and credits for the annualization period.

It also includes computing an estimated book income adjustment. For this purpose, regulations provide that the applicable financial statement for the annualization period is the statement of highest priority that is issued by the installment due date.