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INDIVIDUAL AND CORPORATE PLANNING TO AVOID PITFALLS OF MINIMUM TAX

OLIVER C. MURRAY, JR.

I. Background

A. Generally

Although the standard method of calculating income tax under the Internal Revenue Code of 1954 \(^1\) simply involves multiplying taxable income by those tax rates set forth in Sec. 1 (for individuals) or 11 (for corporations), there have been and continue to be a number of instances where special taxing methods or conventions are used in order to encourage or discourage certain activities, or to avoid hardships being imposed on taxpayers or achieve greater equity among them. For example, the Code requires an individual taxpayer to exclude 60\% of net capital gain \(^2\) from his taxable income. \(^3\) This is an arbitrary method of encouraging capital risks by providing preferential taxation on gains attributable to such risks. An additional justification for this preferential treatment is that it tends to avoid taxation of capital "appreciation" which represents inflationary adjustment to value rather than gain. For tax years beginning prior to 1979, an alternative taxation method was provided for taxing net capital gains of individuals if this alternative method produced a lesser income tax liability. \(^4\) For corporations, no exclusion of net capital gain is permitted, but an alternative tax prevents their taxation on net capital gain at a rate greater than 28\%. \(^5\)

B. Tax Reform Act of 1969

During and shortly preceding 1969, much publicity was focused on the need for tax reform. \(^6\) There was hardly a major periodical or newspaper which did not devote some space to a discussion of income tax

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\(^1\) Hereinafter referred to as the Code. Reference to "Section" or "Sec." herein will, unless otherwise indicated, refer to a section of the Code.

\(^2\) The excess of net long-term capital gain over net short-term capital loss. Sec. 1222(11).

\(^3\) Sec. 1202.

\(^4\) Sec. 1201(b).

\(^5\) Sec. 1201(a). However, the effective tax rate on net capital gains can be increased due to the application of minimum tax discussed, infra. Other "conventions" used (currently or previously) in taxing income which vary from the "standard" include, but are not intended to be all-inclusive:

(i) Income averaging. Sec. 1301.

(ii) Maximum tax rate on personal service income. Sec. 1301.

(iii) "Ten-year forward averaging" tax on lump sum distributions. Sec. 402(e).

equality. Much thoughtful, albeit extreme, publicity predicted an actual taxpayer revolt if major reforms were not made in the income tax structure. It was advocated that pressure groups had so effectively represented their special interests that "the intention of the Sixteenth Amendment (was) so modified that more than half the total national income (was) . . . exempt from taxation." Thus, along with other reform measures set forth in the 1969 Tax Reform Act, Congress introduced the minimum tax for tax preferences.

While the fundamental motive underlying the minimum tax was the desire to provide more outward appearance of fairness in the taxation system, it was also regarded as an additional source of revenues to assist the reduction of taxes being paid by low to moderate income taxpayers. It wasn't merely to assure that each taxpayer paid at least some tax, but was a surtax on the use of tax preferences even though the taxpayer may otherwise be paying substantial income taxes. Moreover, although the intent was to deal with the problem of the consistent, excessive use of tax preferences, alone or in combination, by individuals subject to the progressive rate structure, at the same time it was to avoid a substantial penalty on the moderate use of such preferences. This recognized that the preferences, after all, were incentives intentionally provided to encourage desirable objectives.

Determination of which tax preferences were most abused (or perceived to be most abused) and how much use of such preferences should be permitted was not an easy task.

It was finally decided that use of tax preferences not in excess of $30,000 ($15,000 in the case of married individuals filing separate returns) plus the regular taxes otherwise imposed by the Code would be considered an acceptably moderate use and should not be subjected

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7 The Miami Herald, Sunday, March 9, 1969, in the first of a series of articles sponsored by that newspaper and entitled "Reform or Revolt? That is the Question?," quoting former Secretary of the Treasury, Joseph Barr, in proceedings before the Joint Economic Committee of Congress.
9 Sec. 56 et seq. The minimum tax has been held to be constitutional (Graff v. Commissioner, 74 T.C. 743 (1980) and a non-deductible income tax rather than a deductible excise tax (Rev. Rul. 77-396, 1977-2 CB 86). See, also, nn. 16 and 71, infra.
12 Other than "penalty" taxes imposed on personal holding companies and unreasonable accumulations of earnings. The 1969 Tax Reform Act did not provide for the additional permitted floor equal to the carryover of regular taxes in excess of tax preferences plus the $30,000 floor. However, the Excise, Estate, and Gift Tax Act of 1970, Pub. Law 91-614, approved Dec. 31, 1970, did so provide, with an effective date generally the same as the 1969 Tax Reform Act. For purposes of the permitted floor, early in the history of the minimum tax regular taxes did
to minimum tax. However, there was considerable sentiment to the effect that this permitted "floor" was too generous and that the minimum tax should be triggered at a lower threshold.\textsuperscript{13}

C. Tax Reform Act of 1976

Because the minimum tax was considered to be largely ineffective,\textsuperscript{14} in the Tax Reform Act of 1976,\textsuperscript{15} it was strengthened by reducing the floor to $10,000 plus one-half of the regular taxes for individuals and the full amount of regular taxes for corporations. Furthermore, except for corporate taxes imposed on income from timber, tax carryovers in excess of tax preferences plus the permitted floor which had theretofore been added as a part of regular taxes were no longer to be considered. At the same time, the minimum tax rate was increased from 10% to 15%.\textsuperscript{16}

D. Revenue Act of 1978

Still not satisfied that all taxpayers were paying their fair share of taxes, Congress, in the Revenue Act of 1978,\textsuperscript{17} unveiled the "alternative" minimum tax\textsuperscript{18} as a supplement to the then-called "add-on" minimum tax, applicable only to taxpayers other than corporations. To the extent a moderately progressive rate from 10% to 25%,\textsuperscript{19} when applied to the amount by which "alternative minimum taxable income" ex-
ceeded $20,000, was greater than regular taxes, such excess, the alternative minimum tax reduced only by the foreign tax credit, had to be paid as additional tax. In general, alternative minimum taxable income was equal to taxable income plus the following tax preference items: (1) adjusted itemized deductions (itemized deductions other than state and local taxes, medical, casualty and Sec. 691(c) deductions); and (2) that portion of the net capital gain deducted from income under Sec. 1202. Since the two preceding tax preference items were included in calculating alternative minimum tax, they were exempted, for taxable years beginning after 1978, from the add-on minimum tax.

Because the alternative minimum tax was offset only by the foreign tax credit, and not by nonrefundable credits such as investment tax credit, the possibility existed whereby it could apply even if the taxpayer had no tax preferences. For example, if a married taxpayer with no tax preferences had a taxable income of $50,000, the tax on which was completely offset by investment tax credit, he would still pay an alternative minimum tax of $3,000 ($50,000-$20,000 exemption times 10%). The investment tax credit which was deemed lost because of the imposition of alternative minimum tax was permitted to be carried back and carried over under the general rules. This would always result in a carryback or carryover equal to the amount of the alternative minimum tax.

E. Tax Equity and Fiscal Responsibility Act

Thereafter, except for additions, deletions and modification of the tax preferences themselves, until enactment of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), only miscellaneous technical and conforming amendments were made to the minimum taxation scheme. Furthermore, until TEFRA, except for certain technical differences between preferences and operations of corporations and individuals (and trusts and estates), minimum taxation was generally equally applied to such taxpayers.

20 Sec. 691(c) allows a taxpayer a deduction for that portion of estate tax represented by income included both in an estate tax return (not the taxpayer's) and the income tax return of the taxpayer. Furthermore, due to the definitional workings of Sec. 55(b)(1) and (2), throwback distributions under Sec. 667 escape alternative minimum tax.

21 For purposes of minimum tax and alternative minimum tax, Sec. 57(a)(9) was amended by the Revenue Act of 1978 to exclude from the definition of tax preference item, gain from the sale or exchange of a principal residence for sales or exchanges made after July 26, 1978.

22 Sec. 57(a), last sentence, as it existed until amendment by TEFRA, infra note 23.


24 Corporations were believed capable of abusing the use of tax preferences and avoiding their "fair share" to the same extent as individuals. See Remarks of Sen.
Taking into account all of the legislative history which had theretofore documented growing concern that the minimum tax was not adequately stemming the excessive use of tax shelters, and the continuing belief that a perception of tax equity was lacking, Congress repealed the add-on minimum tax as it related to all taxpayers other than corporations. At the same time, the alternative minimum tax was greatly expanded, a flat 20% alternative minimum tax rate was adopted, and the number of tax preference items was increased. The result was "intended to insure that, when an individual's ability to pay taxes is measured by a broad-based concept of income, a measure which can be reduced by only a few of the incentive provisions (referring to tax incentives provided in the Code), tax liability is at least a minimum percentage of that broad measure." TEFRA also reduced by 15% the benefits of certain corporate tax preferences, some of which are tax preferences subject to corporate minimum tax.

II. Tax Preference Items

A. Generally

Those tax preference items which remain as the cornerstone of minimum (and alternative minimum) taxation are set out in Sec. 57(a). There are now 12 such preferences, all but two of which are deduction

Kennedy 122 Cong. Rec. 12818. Although, in earlier floor discussion with Senator Holland of Florida, Senator Kennedy did not see the need for treating corporations as strictly as individuals. 115 Cong. Rec. 37507.


26 TEFRA, supra, note 23.

27 In many respects, with the limitation on the variety of deductions permitted and the use of a flat tax rate substantially less than the maximum income tax rate employed in the progressive tax rate schedules, the alternative minimum tax resembles and, indeed, may be the precursor to the much-heralded "flat tax."


29 Sec. 291. Because of the 15% cutback in the utility of these tax preferences, a corresponding reduction in the amounts which must be included in calculating minimum tax is provided. Sec. 57(b). These items are discussed in more detail later in this article.

30 Excess investment interest was originally defined as a tax preference item, but only for taxable years beginning before January 1, 1972. Thereafter, because of limitations imposed upon the deductibility of excess investment interest under Sec. 163(d), this item was no longer considered as an item of tax preference. Adjusted itemized deductions were added as a tax preference by the Tax Reform Act of 1976. While leaving this item as a defined tax preference, the Tax Reform Act of 1978 transferred its effect from the add-on minimum tax to the alternative minimum tax. At the same time, those itemized deductions which were determined to be excluded from adjusted itemized deductions were revised, thus excluding: (a) state, local and foreign tax deductions under Sec. 164(a); (2) medical deductions under Sec. 213; (c) casualty losses deductible under Sec. 165(c)(3) and; (d) the
or exclusion items and therefore tend to reduce regular taxes, thus increasing the minimum tax in the case of corporations. Conversely, the only preference item representing gain, a portion of net capital gain, tends to increase regular taxes, thus reducing minimum tax. The remaining preference item, relative to the exercise of an Incentive Stock Option, has no immediate impact on regular taxes.

Originally, even tax-exempt interest income from state and municipal obligations and appreciation in the value of property for which deductions were taken as charitable contributions were targeted for some form of minimum tax treatment. Of course, these items were not included in the initial list of tax preferences and are still exempt from minimum tax.

Sec. 691(c) deduction. See Note 20, supra. The term “adjusted itemized deductions” meant itemized deductions to the extent they exceeded 60% of the taxpayer's adjusted gross income reduced by those deductions excluded from adjusted itemized deductions. Of course, if a deduction could be classified as a trade or business expense, it could avoid being tainted as an itemized deduction. See, e.g., Anthony J. Ditunno, 80 TC No. 12 (February 7, 1983), govt appeal dismissed (relative to wagering losses). For trusts and estates, the Revenue Act of 1978 provided that adjusted itemized deductions included all deductions of the trust or estate except: (a) deductions allowable in arriving at adjusted gross income; (b) deduction for the personal exemption under Sec. 642(b); (c) deduction for casualty losses provided by Sec. 165(c)(3); (d) deduction for distributions made or required to be made to beneficiaries under Sec. 651(a) or 661(a); (e) deduction for income in respect of a decedent provided by Sec. 691(c); (f) state and local tax deductions provided by Sec. 164(a); (g) deduction for amounts paid or set aside under Sec. 642(c) for a charitable purpose, provided that a corresponding amount is included in the gross income of the beneficiary under Sec. 62(a)(1) for the taxable year of the beneficiary with which or within which the taxable year of the trust ends. As in the case of individuals, this tax preference item was that amount by which the adjusted itemized deductions for the trust or estate exceeded 60% of its adjusted gross income. In this regard, adjusted gross income was calculated in the same manner as it would be for individuals except that administrative expenses and certain charitable contributions, as more particularly set forth in Sec. 57(b)(2) of the Code as amended by the Revenue Act of 1978, were treated as deductions toward adjusted gross income. For taxable years beginning after 1982, adjusted itemized deductions were removed as a tax preference item since the calculation of alternative minimum tax as determined under TEFRA is to be made by starting with adjusted gross income rather than taxable income. Hence, the alternative minimum taxable income base already includes itemized deductions. Tax preference items comprised of amortization of railroad rolling stock under Sec. 184 to the extent it was in excess of the deduction which would have been allowable under Sec. 167, amortization of on-the-job training and child care facilities under Sec. 188 to the extent it would have been in excess of the deduction which would have been allowable under Sec. 167, and the difference between the fair market value and the option price of stock acquired on exercise of a qualified or restricted stock option were repealed by TEFRA, since the preferences inherent in those items were no longer available to taxpayers.

B. Defined

1. Exclusion of interest and dividends.\textsuperscript{32} This preference, added by TEFRA and effective for taxable years beginning after 1982, consists of dividend income excluded by individuals under Sec. 116\textsuperscript{33} and interest income excluded by individuals under Sec. 128 (interest earned on so-called all-savers' certificates).\textsuperscript{34}

2. Accelerated depreciation on real property.\textsuperscript{35} This preference is currently the same as when enacted by the Tax Reform Act of 1969. It consists of the amount of depreciation allowable for the taxable year under Sec. 167 for exhaustion, wear and tear, obsolescence, or amortization of each item of Section 1250 property\textsuperscript{36} in excess of such amount which would have been allowable for the taxable year had the property been depreciated under the straightline method (taking into account salvage value) for each taxable year of the useful life of the property. Even though rapid amortization of rehabilitation expenditures is permitted under Sec. 167(k), to the extent such amortization exceeds straightline depreciation computed on the basis of that useful life which would have been proper without regard to the artificial (60-months) life of Sec. 167(k), there is a tax preference item.\textsuperscript{37}

Although ERTA added the Accelerated Cost Recovery System ("ACRS") as a measure which largely replaces Sec. 167, accelerated depreciation under Sec. 167 is still applicable in many cases.\textsuperscript{38} Thus this tax preference item is still important.

3. Accelerated depreciation on leased personal property.\textsuperscript{39} Until the Tax Reform Act of 1976 made changes to this tax preference applicable to taxable years beginning after 1975, it had applied since 1969 only to personal property subject to a net lease.\textsuperscript{40} Now, accelerated depreciation

\textsuperscript{32} Sec. 57(a)(1).
\textsuperscript{33} The maximum which can be excluded under Sec. 116 is $100 ($200 in the case of a joint return).
\textsuperscript{34} The maximum which can be excluded under Sec. 128 is $1,000 ($2,000 in the case of a joint return).
\textsuperscript{35} Sec. 57(a)(2).
\textsuperscript{36} Defined in Sec. 1250(c). This property could be somewhat more narrow than what is ordinarily considered real property. For example, some items of real property may be classified as Section 1245 property.
\textsuperscript{37} Similarly, if the depreciation is calculated without regard to a useful life or salvage value (for example, some form of units of production), that straightline depreciation calculable by reference to a proper useful life and salvage value will have to be computed to determine the excess (tax preference) portion.
\textsuperscript{38} ACRS does not apply to property placed in service before 1981, to property acquired after 1980 from related persons who used it before 1981, and in certain other instances set forth in Sec. 168(e).
\textsuperscript{39} Sec. 57(a)(3).
\textsuperscript{40} Property is regarded as subject to a net lease if (1) the deductions of the lessor for the taxable year with respect to such property which are allowable solely by reason of Sec. 162 are less than 15% of the rented income produced by
on each item of leased Section 1245 property is a tax preference item to the extent it exceeds the depreciation which would have been allowable under Sec. 167 had the property been depreciated under the straight-line method (taking into account salvage value) for each taxable year of its useful life for which the taxpayer held the property. Although the term “net lease” no longer has applicability under the minimum tax provisions, it remains defined by Sec. 57(c). This item is not a tax preference for corporations except for personal holding companies as defined in Sec. 542.

4. Amortization of certified pollution control facilities. This is another preference which is the same now as when introduced in 1969. It is comprised of that amount of amortization permitted to a taxpayer under the 60-month amortization provisions of Sec. 169 in excess of what depreciation would have been permitted under Sec. 167 had the property been depreciated under any method (including an accelerated method) permitted under Sec. 167. This tax preference illustrates the seeming contradiction within the Code vis a vis the encouragement of certain social, economic and ecological goals. On the one hand, rapid amortization is permitted. On the other, a penalty in the form of minimum tax is threatened. The only reasonable explanation for this equivocal...

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41 Defined in Sec. 1245(a)(3). This property could be somewhat broader than what is ordinarily considered personal property. See note 36, supra. At page 106 of the General Explanation of the Tax Reform Act of 1976, prepared by the Staff of the Joint Committee on Taxation, it is explained that “The preference for accelerated depreciation on personal property is not intended to apply to personal property which is leased as an incidental part of a real property lease. For example, the inclusion of a refrigerator in the lease of an unfurnished apartment is not to be treated as a lease of personal property.”

42 Depreciation which would have been allowable is determined in the same manner as described in note 37, supra. Note also that the 20% variance in useful life permitted by the Asset Depreciation Range of Sec. 167(m) is not allowable in determining useful life in calculating straightline depreciation hereunder.

43 Sec. 57(a), last sentence.

44 Sec. 57(a)(4).

45 Inclusion of an item under Sec. 57(a)(4) takes precedence over Sec. 57(a)(2) or (3) so that the difference between accelerated and straightline depreciation won't be a tax preference. Only the difference between the rapid amortization and the accelerated depreciation (if the accelerated method is used for determining the Sec. 167 comparison) will be so considered. See Example, Regs. Sec. 1.57-1(d)(7). Although ACRS may apply to that portion of pollution control facilities which is in excess of the amortizable basis of the facilities, the depreciation rules under Sec. 167 must be utilized in ascertaining the tax preference portion of the amortizable basis of such facilities.

46 Useful life and salvage value which would have been permitted under Sec. 167 is to be determined by reference to all facts and circumstances which would be considered for depreciation purposes throughout the period the property is held. Regs. Sec. 1.57-1(d)(4)(ii).
cal treatment is that Congress, while still wanting to encourage certain behavior, did not want any single taxpayer to excessively use the incentives provided.47

5. Mining, exploration and development costs.48 Added by TEFRA, except for corporations other than personal holding companies, this tax preference item is applicable for taxable years beginning after 1982. There is little legislative history specifically to explain why this item was added to the list of tax preferences. Presumably, the feeling was that the taxpayer's election to expense under Sec. 616 or 617 certain expenditures for the development or exploration of a mine or other natural deposit (other than an oil or gas well) was too beneficial. To the extent such amount exceeds the amount which would be deductible if the expenditure were capitalized and amortized ratably over the 10-year period beginning with the taxable year in which made, it is a tax preference. An individual taxpayer may avoid classification of these expenditures as tax preference items by electing to capitalize them and amortize them over the 10-year period referred to.49 For recapture purposes under Sec. 617(d), these capitalized amounts will nevertheless be regarded as having been deducted under Sec. 617(a).50

6. Circulation and research and experimental expenditures.51 These were added at the same time as mining costs, above, and with as little legislative history. They also are not applicable to corporations other than personal holding corporations, and an individual may avoid their classification as a tax preference item by electing to capitalize them and amortize them over the 10-year period beginning with the taxable year in which they were made.52 To the extent amounts under Sec. 173 or 174 for circulation expenditures or research and experimental expenditures, respectively, are deducted in the year paid or incurred, they will otherwise be tax preference items.

7. Reserves for losses on bad debts of financial institutions.53 Generally, banks and savings and loan associations have been entitled to

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47 See text accompanying note 11, supra.
48 Sec. 57(a) (5).
49 Sec. 58(i) (7). Election is made at the partner and S corporation shareholder level. Sec. 58(i) (5) (D). There is no apparent reason why a trust or estate should not be allowed this same election. But the Code provides this election only to "individuals" so that it may require legislative action to permit this. Absent such legislation, to the extent these items and those preferences described in Sec. 57(a) (6) and (11) are not apportioned to beneficiaries, trusts and estates would apparently be unable to avoid tax preference classification under Sec. 58(i). Although the election is provided under Sec. 58, there is no reason why it cannot be made for purposes other than alternative minimum tax.
50 Sec. 58(i) (6) (B).
51 Sec. 57(a) (6).
52 Sec. 58(i) (7) See note 49 in regard to trusts and estates and election by partners and S corporation shareholders.
53 Sec. 57(a) (7).
exceptionally larger deductions for bad debts than most taxpayers.\textsuperscript{54} While these benefits have been phasing out, they still may create preferences under existing law. The Tax Reform Act of 1969 provided both the phase-out mechanics and the minimum tax applicability. To the extent bad debt losses allowed to financial institutions for a taxable year ending after 1969 exceed the deduction which would have been allowed had the taxpayer been utilizing for all of its taxable years the "experience method" of calculating bad debts, they will constitute a tax preference. The experience method, generally, is a 6-year moving average similar to the \textit{Black Motor Co.}\textsuperscript{55} formula. The bad debt deduction for the year is that amount necessary to increase the reserve for losses on loans at the close of the taxable year to the amount which bears the same ratio to loans outstanding at the close of the taxable year as the total of bad debts for the taxable year and the preceding 5 taxable years, net of recoveries, bears to the sum of the loans outstanding at the close of each of such 6 taxable years.\textsuperscript{56}

8. Depletion.\textsuperscript{57} Depletion deduction for a particular mineral deposit is a tax preference item to the extent it exceeds the adjusted basis of the property at the end of the taxable year (determined without regard to the depletion deduction for the taxable year). Percentage depletion has been a target for years, so it is not surprising that this item was found on the original list of tax preferences in 1969.

9. Capital gains.\textsuperscript{58} Because individuals and corporations have different preferential tax treatment of their net capital gains,\textsuperscript{59} different calculation of how much of such gain is a tax preference item is required. For a taxpayer other than a corporation, it is simply that amount of the gain deducted from income pursuant to Sec. 1202.\textsuperscript{60} For a corporation, an equivalent preference is defined currently to be 18/46 of the net capital gain (presumably, net of capital loss carryback or carryover). The regulations provide an alternative means of calculating the capital gains tax preference item for corporations where that would result in a lower amount. This is because there are circumstances where the actual tax preference of a net capital gain is not as great as the preference calculated under the statutory formula.\textsuperscript{61}

\textsuperscript{54} Secs. 585 and 593.

\textsuperscript{55} \textit{Black Motor Co. v. Commissioner}, 125 F.2d 977 (6th Cir. 1942).

\textsuperscript{56} Regs. Sec. 1.57-1(g)(4). Appropriate adjustments are to be made for institutions not in existence at least six years and in certain other circumstances where necessary in order to more accurately calculate the taxpayer's actual loss experience.

\textsuperscript{57} Sec. 57(a)(8).

\textsuperscript{58} Sec. 57(a)(9).

\textsuperscript{59} The excess of net long-term capital gains over net short-term capital losses. Sec. 1222(11).

\textsuperscript{60} Currently, the Sec. 1202 deduction equals 60\% of net capital gain.

\textsuperscript{61} Regs. Sec. 1.57-1(i)(2). The alternative fraction considers the tax itself rather than the tax rates.
10. Incentive Stock Options. Although ISO's were added to the Code by ERTA, effective with respect to options exercised after 1980, they were not added as tax preference items until TEFRA, so that they were not subject to minimum tax until taxable years beginning after 1982. This provision applies only to individuals since only individuals can receive ISO's.

The amount of the preference, as it was when exercise of qualified and restricted stock options could give rise to tax preference items, is the amount by which the fair market value of the stock at the time the option is exercised exceeds the exercise price of the option. In determining the value of restricted property, Sec. 83 disregards any restrictions other than those which by their terms never lapse. The regulations issued relative to valuation of stock for the purpose of determining tax preference amounts on the exercise of stock options incorporate the "without regard to restrictions" language of Sec. 83. In Aaron L. Kolom, the validity of this regulation was not challenged but it was determined that Sec. 16(b) of the Securities Exchange Act of 1934, which restricts a corporate insider's rights to profits from stock transactions in certain cases, did not materially affect determination of traditional fair market value. In Louis B. Gresham the regulation was declared invalid since Sec. 57 has no such statutory requirements in determining fair market value. According to the Tax Court, under Sec. 57 one looks to the historical concepts of fair market and any restrictions, including Sec. 16(b) of the Securities Exchange Act of 1934 or common law buy-sell arrangements, are pertinent. It may be that Sec. 16(b) must be considered in determining fair market value but, under Kolom, it apparently would not have significant effect on such determination.

Although there is no tax preference if the stock acquired is disposed of within the same taxable year as the exercise, the IRS has ruled, on the basis of legislative history, that a premature distribution after the taxable year of exercise does not void the tax preference of the year of exercise since the taxpayer had the benefit of deferral. The Conference Report accompanying TEFRA reverses the prior Congressional intent since it now sets forth the intention "that the incentive stock option

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62 Sec. 57(a)(10).
63 Regs. Sec. 1.57-1(f)(3). This actually applies to the pre-TEFRA stock option tax preference items, but it is likely that it will be substantially applicable to ISO tax preferences.
64 71 TC 235 (1978).
65 79 TC No. 20 (8/26/82), on appeal to 10th Cir.
66 See also, Theron P. Thomsen v. United States, 81-1 USTC ¶ 9253 (DC Iowa Feb. 5, 1981).
67 See Regs. Sec. 1.57-1(f)(5)(i).
69 PLR 8130016.
preference not apply where there is an early disposition of the stock acquired through the exercise of the option."

11. Intangible drilling costs. Originally added by the Tax Reform Act of 1976, this item consisted of intangible drilling and development costs in connection with oil and gas wells which were paid or incurred in taxable years beginning after 1975. The preference amount was the excess of the deduction permitted by Sec. 263(d) over the amount which would have been allowable if such costs were capitalized and amortized over 10 years. For taxable years beginning after 1976, the preference was reduced somewhat by allowing net income from the oil or gas property to offset the excess costs. In addition, it was expanded, for wells commenced after September 1978 in taxable years ending after such date, to include geothermal properties as defined in Sec. 613(e)(3). It is also clear that all gas and oil properties and all geothermal properties are to be aggregated in calculating the tax preference items. This tax preference does not apply to corporations other than personal holding companies.

If a well proves to be incapable of producing in commercial quantities, the costs of developing it will not be considered a tax preference item. If the determination that a well is nonproductive is not made until sometime after the taxable year in which the costs were paid or incurred, the taxpayer may have to file an amended return to obtain a refund of minimum tax paid with respect thereto before such determination. An individual taxpayer may avoid classification of these expenditures as tax preference items by electing to capitalize them and amortize them over a 10-year period beginning with the taxable year in which such expenditures were made. In the case of an individual's intangible drilling costs or his share of such costs other than from an investment in

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70 Conference Report to H.R. 97-760, 97th Cong. 2d Sess. at 475.
71 Sec. 57(a)(11). The retroactive application of this tax preference item was foreseeable and therefore constitutional. Ward v. United States, 659 F.2d 1351 (10th Cir. 1982).
72 Sec. 57(d). Instead of calculating amortization over 10 years, the taxpayer could elect to calculate a hypothetical cost depletion amount as the base against which to compare the costs deducted under Sec. 263(c).
74 Energy Tax Act of 1978, Pub. Law 95-618, approved November 9, 1978. At the same time, it required that calculation of excess costs and amortizable 10-year costs or cost depletion amounts be made for oil and gas properties separately from geothermal properties, Sec. 57(a)(11)(D).
75 Sec. 57(a), last sentence.
77 Sec. 58(i). See note 49 in regard to trusts and estates and election by partners and S corporation shareholders.
a limited partnership or an S corporation in which such individual is not actively engaged in management, an alternative election out of tax preference status can be made under Sec. 58(i). In such case the costs will be treated as 5-year property eligible for investment tax credit and cost recovery in the same manner as if ACRS applied. For recapture purposes under Sec. 1254, amounts capitalized under a Sec. 58(i) election will nevertheless be regarded as having been deducted under Sec. 263(c).

12. Accelerated cost recovery deduction. ERTA revamped the depreciation system effective for property placed in service after 1980 in taxable years ending after such date. Generally, a much faster rate of depreciation is provided as a consequence. For that property which is 15-year real property as defined in Sec. 168 a tax preference was concomitantly created applicable to all taxpayers. This preference is the amount of cost recovery deduction allowed in excess of that amount which would have been allowed had the property been depreciated on the straightline basis (without regard to salvage value) over the same 15-year period. For all other recovery property, the tax preference created does not apply to corporations other than personal holding companies. The preference for such other recovery property is only with respect to that property subject to a lease and is an amount equal to the cost recovery deduction (or amortization deduction for low income housing rehabilitation) on such property in excess of the deduction which would have been allowable using the straightline method (with a half-year convention and without regard to salvage value) over the following permitted recovery periods:

<table>
<thead>
<tr>
<th>Property</th>
<th>Permitted Recovery Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>3-year</td>
<td>5 years</td>
</tr>
<tr>
<td>5-year</td>
<td>8 years</td>
</tr>
<tr>
<td>10-year</td>
<td>15 years</td>
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<tr>
<td>15-year</td>
<td>22 years</td>
</tr>
<tr>
<td>public utility</td>
<td>22 years</td>
</tr>
</tbody>
</table>

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78 Sec. 58(i)(4)(C).
79 Sec. 58(i)(4).
80 Sec. 58(i)(6)(A).
81 Sec. 57(a)(12).
82 Sec. 168.
83 Sec. 57(a), last sentence.
84 Id.
86 These terms have the same meaning as such terms under Sec. 168. Sec. 57(a)(12)(E).
In the event the recovery period for any property is elected to be longer\(^8^7\) than 15 years (in the case of real property) or the permitted recovery period shown above (for other recovery property), and is depreciated using the straightline method, the cost recovery deduction will not be considered a tax preference item.\(^8^8\)

C. Cutback in Certain Corporate Tax Preference Items

TEFRA reduces by 15% the preferential treatment to all corporations\(^8^9\) of several items.\(^9^0\) This was done in recognition that ACRS provided substantial benefits as an offset to such tightening. Furthermore, it was recognized that the economy required some offset to the tax reductions otherwise contained in ERTA and that certain of the incentives were not as necessary as when they were first enacted to stimulate business. Several of these preferences which were cut back were also tax preference items, as defined in Sec. 57, subject to the add-on minimum tax:

- percentage depletion for coal (including lignite) and iron ore, to the extent in excess of the adjusted basis of the property at the end of the taxable year (without regard to the deduction for percentage depletion) (applicable to taxable years beginning after 1983);
- bad debt additions for financial institutions to the extent in excess of deductions which would have been allowed using the experience method of calculating bad debts (applicable to taxable years beginning after 1982);
- long-term capital gain on dispositions of Sec. 1250 to the extent it would have been subject to recapture had the property been Sec. 1245 property (applicable to dispositions of Sec. 1250 property after 1982);
- amortization of pollution control facilities under Sec. 169 in excess of the deduction which would have been permitted under Sec. 167 (applicable to property placed in service after 1982 in taxable years ending after 1982).

\(^8^7\) Sec. 168(b)(3).
\(^8^8\) Sec. 57(a)(12)(C). Additionally, in certain cases involving property used predominantly outside the United States, the recovery period required or permitted could be longer than those set forth above and would therefore not be a tax preference item.
\(^8^9\) Actually, TEFRA excluded S corporations. But the Subchapter S Revision Act of 1982 extended the cutback to all corporations. Since the reduction in tax preference items will increase the taxable income passed through to the shareholder, the shareholder should decrease the relevant tax preference items under Sec. 57(b).
\(^9^0\) Sec. 291.
Because the tax preferences are reduced by 15%, the treatment of these items as tax preference items under Sec. 57 has been correspondingly reduced. Essentially, only 71.6% of the depletion, bad debts, and pollution control tax preference items will be regarded as such for minimum tax purposes. This is intended to equalize the tax effects of the loss of 15% of the preferential tax treatment. For example, if one of these tax preference deductions is reduced under Sec. 291 from $100 to $85, the taxpayer loses the benefit of $6.90 (the maximum corporate tax rate of 46% times $15), offset, however, by savings on minimum tax (since the additional regular tax is a reduction from the add-on minimum tax base) of $1.04 (15% times $6.90), or a net tax cost of $5.86. However, the minimum tax is reduced from $15.00 to $9.13 (15% times 71.6% of the remaining tax preference item). The same result obtains with respect to the net capital gain portion on disposition of Sec. 1250 property, since that portion (85%) of such gain not treated as ordinary income under Sec. 291 is considered a tax preference item only to the extent of 71.6%.

III. Corporate Taxation Under Minimum Tax

A. Generally

A corporation pays, in addition to its other income taxes, a minimum tax equal to 15% of the amount by which the sum of its tax preference items exceeds the greater of (a) $10,000 or (b) its regular taxes (other than accumulated earnings and personal holding company penalty taxes) reduced by tax credits except those for gasoline and special fuels, employee stock ownership credit, and that portion of investment tax credit determined under the employee plan percentage set forth in Sec. 46(a)(2)(E).

B. Net Operating Loss

Section 56 provides that there is no minimum tax in a year that a net operating loss is incurred except to the extent that the tax preferences are utilized. This is accomplished by deferring to the year in which the net operating loss is used, the lesser of 15 percent of such net operat-

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91 Sec. 57(b).
92 Sec. 57(b)(2).
93 Sec. 57(b)(2).
94 Secs. 531 and 541.
95 Sec. 39.
96 Sec. 44G.
ing loss carryover or the amount of the minimum tax otherwise com-
pulated. For example, if the items of tax preference exceed $10,000 by
$1,000,000 in a year in which a net operating loss of $750,000 is in-
curred which cannot be carried back, $112,500 (the lesser of 15 per-
cent of the net operating loss carryover, or the $150,000 minimum tax
otherwise computed) will be deferred until the year the net operating
loss carryover is utilized. In such future year, 15 percent of so much of
the net operating loss carryover as is used to reduce the taxable income
of such future year will be imposed as a tax liability under Section 56.98

If 15% of the net operating loss is greater than 15% of the tax
preference items, a portion of the net operating loss carryover will be
considered comprised of tax preference items. In that case the non-
preference portion will be applied against future income first. Thus, it
is possible to further defer the minimum tax on tax preference item
carryovers.

C. Foreign Source Tax Preference Items

Tax preference items (other than capital gains and stock options)
attributable to foreign sources (including sources within U.S. posses-
sions) are considered in calculating a corporation’s minimum tax only
to the extent they reduce U.S. income taxes.99 The preferences are con-
sidered to reduce such U.S. income taxes to the extent of the smallest
of the following three amounts:100

- items of tax preference attributable to the foreign source;
- the excess (if any) of the total deductions allocable or apportion-
able to foreign source income over the gross income for foreign
sources;
- taxable income from sources within the U.S.

For this purpose, non-preference deductions are first offset against
foreign source income. Thus, tax preferences are considered to reduce
U.S. income taxes before non-preference foreign deductions are so con-
sidered.101 On the other hand, if foreign income exceeds foreign deduc-
tions no tax preference items will result since, presumably, the foreign
country will tax such income and no benefit from the preference will
have accrued to the United States.

If there is an overall net operating loss for the year, to the extent that

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98 Sec. 56(b). That portion of the net operating loss not attributable to tax preference items will be considered as being applied prior to reducing taxable income by the portion attributable to the tax preference items. See 56(b)(3).
99 Sec. 58(g)(1).
100 Regs. Sec. 1.58-7(c)(1)(i).
101 Sec. 58(g)(1), last sentence. See, also, Ex. 2, Regs. Sec. 1.58-7(c)(1).
the foreign source preferences, or the excess of foreign deductions over foreign income, if less, exceeds U.S. taxable income, they will not have offset U.S. taxable income for such year and will be suspended and carried back or over under the general rules. For the year to which the suspended foreign preferences are carried, U.S. deductions and carryovers are applied against U.S. income and the suspended preferences carried over are applied to foreign source income before the suspended preferences are applied against U.S. income and reactivated as tax preference items for such years.

For purposes of the corporate add-on minimum tax, foreign sources capital gains will not be considered tax preferences if the foreign country does not accord such gains preferential treatment. If the foreign country imposes no “significant amount” of tax on such gains, they will be considered to have received preferential treatment. Similar concepts apply with respect to stock options.

D. Tax Benefit

Sec. 58(h) mandates that regulations be promulgated to provide for appropriate adjustment to tax preferences where they do not result in a tax reduction. Those regulations have not yet been proposed. However, other regulations have elements of tax benefit limitations. For example, Regs. Sec. 1.56-2(c)(1) provides that a net operating loss carryover which is comprised partly of tax preference deductions will not be considered applied until after the portion comprised of non-preferences. Furthermore, if the net operating loss attributable to the tax preference items is not used to reduce taxable income in any succeeding year, no minimum tax will be imposed with respect to such portion. Regs. Sec. 1.57-4, applicable to taxable years beginning before 1976, reduced or eliminated tax preference items to the extent no tax benefit accrued due to modifications required under Sec. 172(c) or 172(b)(2). At the moment, it appears that an argument which demonstrates that income is reduced by nonpreference items and that tax

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102 Regs. Sec. 1.58-7(c)(1)(ii). The determination of the amounts which will offset taxable income of the years to which they are carried will be made on a year-by-year basis in the same order as the net operating loss is used in accordance with Sec. 172(b).

103 See Ex. 3, Regs. Sec. 1.58-7(c)(1).

104 Sec. 58(g).

105 Due to its scope, this regulation applied only to individuals. Nevertheless, the equitable principles incorporated in the regulation should be applicable in considering appropriate limitations under Sec. 58(h). There is substantial doubt that a tax benefit limitation was required before Sec. 58(h). See, Occidental Petroleum Corp. v. United States, 82-2 U.S.T.C. ¶ 9531 (Ct. Cl. 1982). However, one court condoned the manner in which Regs. Sec. 1.57-4 was used to reduce a net capital gain tax preference which was partially reduced by Sec. 172(d) modifications. Zilber v. United States, 585 F. 2d 301 (7th Cir. 1978).
preference items will produce no benefit should be successful in avoiding minimum tax with respect to such items.106

IV. Special Entities

- Common trust funds are not specifically identified as to the class of entity they are considered, but by virtue of the requirements that their participants must account directly for their share of the fund's income, they more nearly resemble partnerships than anything else.107 Under Sec. 58(e), the participants must report their ratable share of tax preference items arising in common trust funds. Thus these items will be subjected to alternative minimum tax (if the participant is not a corporation) or minimum tax (if the participant is a corporation).

- An estate or trust must apportion items of tax preference in accordance with the regulations.108 The regulations provide for apportionment in a manner which attributes the preferences to the party benefiting therefrom.109 These apportioned amounts are taken into account by the beneficiary in the taxable year within which or with which ends the taxable year of the estate or trust.110 If the beneficiary is a corporation, the minimum tax treatment should follow under Sec. 56 while an individual beneficiary would be governed by Sec. 55. To the extent the trust or estate is the taxpayer which benefits from the tax preference, it will be subjected to alternative minimum tax treatment. In calculating its alternative minimum taxable income, in addition to expenses normally deductible by individuals in arriving at adjusted gross income,111 it is permitted to deduct costs paid or incurred in connection with its administration.112 Those deductions considered as “alternative itemized deductions”113 are limited to amounts

106 See Rev. Rul. 80-226, 1980-2 CB 26, relating to determining how much tax benefit is received when nonpreference deductions are used first in reducing income, and PLR 8218007, applying the same principles in determining that accelerated depreciation tax preference items later recaptured before the net operating losses partially comprised of the depreciation were used, nevertheless provided tax benefit since taxable income computed without regard to those used portions of the NOL deductions attributable to the accelerated depreciation tax preferences exceeded taxable income computed with regard to such portions. But see n. 153, infra.
107 See Regs. Sec. 1.584.1.
108 Sec. 58(c)(1).
109 Regs. Sec. 1.58-3(a)(1).
110 Regs. Sec. 1.58-3(a)(4).
111 Sec. 62.
112 Sec. 55(e)(6)(B).
113 Sec. 55(e)(6)(A).
paid or permanently set aside for clarity and distributable net income paid or required to be paid to beneficiaries.

- An S Corporation is generally not a taxpayer, but a conduit. However, in some circumstances it is required to consider certain net capital gain as taxable income. To that extent, the S Corporation will be subject to the corporate taxes, including the add-on minimum tax. In such a case, the net capital gain passed through the S corporation to the shareholder will be reduced by the applicable taxes paid at the corporate level. To determine how much net capital gain in excess of $25,000 should be considered a tax preference item at the corporate level, the regulations set forth a complicated "with-without" formula. In any case, since only the taxes paid by the corporation are used to reduce the net capital gain apportioned to shareholders, the result is that some of the gain will be considered a tax preference item in their hands even though it has already been subjected to minimum tax at the corporate level.

- Regulated investment companies and real estate investment trusts ("REIT") are generally regarded as conduits. Therefore, while the tax preference items are determined at the entity level, they are treated as preferences of the shareholders or holders of beneficial interests. However, the accelerated depreciation or accelerated cost recovery deduction tax preferences are not considered preferences of shareholders or holders of beneficial interests of an REIT, even though all income with respect to the properties being depreciated is distributed. Instead, these preferences are taxed for minimum tax pur-

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114 Sec. 642(c).
115 Secs. 651(a) and 661(a).
117 The tax preference items, except to the extent of taxes on the capital gain portion paid by the S Corporation, pass through to the shareholders for inclusion in their tax returns for the taxable years with which or within which ends the taxable year of the S Corporation. Sec. 1366(a). Generally, these preferences will be apportioned among shareholders on a daily basis. Sec. 1377(a).
118 Sec. 58(d).
119 Sec. 1366(f)(2). Since corporations cannot be shareholders of active S corporations, the alternative minimum tax rather than the add-on minimum tax would apply to the pass-thru.
120 Sec. 1374.
121 Regs. Sec. 1.58-4(c).
122 Sec. 851.
123 Sec. 856.
124 Sec. 58(f).
125 Sec. 58(f)(2).
poses to the real estate investment trust.\textsuperscript{126} While that portion of net capital gain not distributed by an REIT will be subjected to minimum tax in its hands, all net capital gain will either be distributed or deemed to be distributed\textsuperscript{127} by a regulated investment company. Therefore, it (regulated investment company) will have no net capital gain tax preference remaining to be subjected to minimum tax. A corporate shareholder or holder of a beneficial interest in these entities will consider its share or tax preference along with its other tax preferences in calculating any add-on minimum tax. A non-corporate owner will, of course, have such preferences subjected to the alternative minimum tax scheme.

- If a tax exempt corporation or trust is subject to unrelated business income, it will be subject also to add-on or alternative minimum tax, respectively, with respect to its tax preference items.\textsuperscript{128}

- Except that the regulations provide for apportionment of the exemption amount between the consolidated group and component members of the group which do not join in the filing of a consolidated return,\textsuperscript{129} no guidance as to minimum tax treatment of consolidated groups has been provided. Presumably determination of tax preferences, regular taxes, net operating losses, tax benefit, etc. will be made at the consolidated level, rather than on a separate corporation basis. Separate corporation consideration may be necessary in certain cases, however, such as in the case of determining the bad debt preference for financial institutions, and in calculating carryovers which will leave the group on a member's departure.

- Corporations with timber income have a number of special provisions\textsuperscript{130} which effectively result in taxing such income for minimum tax purposes approximately in the same way as the tax was applied before changes made by the Tax Reform Act of 1976,\textsuperscript{131} that is, at a 10% rate on tax preferences over $30,000 plus regular taxes and with a seven year carryover for regular taxes in excess of tax preference items. The adjustments having this net effect apply only to the capital gains preference from timber transactions.

\textsuperscript{126} The trust will almost certainly be regarded as a corporation, so that the minimum tax it pays will be the add-on variety. See Secs. 856(a)(3) and 857(b)(1). It has been observed that the trust's minimum tax obligation could, in certain circumstances, jeopardize its ability to comply with the 95% distribution rule of Sec. 857(a). Hevener and Olsen, 288-3rd T.M., Minimum Tax and Alternative Minimum Tax Computation and Application, p. A-15.

\textsuperscript{127} Sec. 852(b)(3).

\textsuperscript{128} Sec. 511(d).

\textsuperscript{129} Sec. 511(d).

\textsuperscript{130} Regs. Sec. 1.58-1(c)(1)(ii).

\textsuperscript{131} Secs. 56(d), 56(e), 57(a)(9)(C), 57(e).

V. Alternative Minimum Tax

A. Generally

The alternative minimum tax applies only to taxpayers other than corporations, i.e., individuals, trusts and estates. It is technically the amount by which 20% of "alternative minimum taxable income" in excess of the "exemption amount" exceeds "regular taxes."

Alternative minimum taxable income equals adjusted gross income (determined without reduction for the net operating loss deduction allowed under Sec. 172) increased by the taxpayer's direct and allocable shares of tax preference items and reduced by the total of: (a) the alternative tax net operating loss deduction; (b) the alternative tax itemized deductions; and (c) any accumulated income deemed distributed in preceding years by a trust to a beneficiary.

B. Exemption Amount

The exemption amount is $40,000 for joint return filers, $30,000 for single individuals and $20,000 for married persons filing separately and for estates and trusts.

C. Regular Taxes

Regular taxes are those imposed by chapter 1 of the Code (generally, normal income and surtaxes) but without regard to:

(a) premature or excess distributions by certain qualified trusts to owner-employees (for amounts received prior to 1984) or key employees (for amounts received after 1983);
(b) premature distributions of income allocable to an investment in an annuity contract;
(c) premature distributions from an Individual Retirement Plan or premature redemption of a retirement bond;
(d) separate 10-year forward averaging taxation of lump sum distributions;\(^{140}\)

(e) a beneficiary's receipt of an accumulation distribution from a trust.\(^{141}\)

From this amount is deducted non-refundable credits (e.g., investment tax credit, credit for the elderly, credit for increasing research activities, and other credits allowed to the extent they are not in excess of income taxes otherwise payable); in other words, all credits other than withholding, gasoline and special fuels taxes refundable and earned income credit. Thus, although there may be little or no "normal" tax due because of offsetting non-refundable credits, since these credits, while reducing "regular taxes," do not reduce alternative minimum tax, there could nevertheless be an alternative minimum tax. For example, even though a taxpayer who earns a $25,000 investment tax credit has adjusted gross income and taxable income of $80,000 (and no tax preferences) and a $24,014 tax liability before investment tax credit would owe no regular tax, he would still have an alternative minimum tax of $8,000 (80,000 - $40,000 \times 20\%).

D. *Alternative Tax Net Operating Loss*

The alternative tax net operating deduction\(^{142}\) is equal to the regular net operating loss taking into account only alternative tax itemized deductions used in computing such loss and reducing such loss by current year tax preferences. A net operating loss arising prior to 1983 and carried over into post-1982 years can be offset against post-1982 alternative minimum taxable income without such adjustment. Tax preferences arising under prior law and deferred to post-1982 years because of net operating loss carryovers continue to be subject to the add-on minimum tax of § 56 of the Code which has otherwise been eliminated with respect to non-corporate taxpayers.\(^{143}\) An alternative tax net operating loss may be carried back three years and

\(^{140}\) Sec. 402(e). Apparently whether or not election to use the 10-year forward averaging is made, the "regular" taxes will be the same. Furthermore, apparently alternative minimum taxable income will be determined by reference to whether such election is made. Therefore, by not making the election, alternative minimum taxable income is increased. At the same time, the separately payable tax on the lump sum amount is eliminated while normal taxable income (and tax) is increased.

\(^{141}\) Sec. 667(b). Thus, there being no "regular tax" on accumulation distributions and there being a deduction of such distributions in arriving at alternative minimum taxable income, there is no alternative minimum tax applied to this item.

\(^{142}\) Sec. 55(d).

\(^{143}\) Sec. 201(e)(1) and (2) of TEFRA, dealing with effective date of amendment to Sec. 56(b).
forward fifteen years and applied against alternative minimum taxable income in the carryback year.\textsuperscript{144}

Of course, the taxpayer may elect not to carryback such loss.\textsuperscript{145} The alternative tax net operating loss will be modified by Sec. 172(d) to the same extent as a regular net operating loss, and will be offset to the extent of available alternative minimum taxable income in the year to which carried even though the taxpayer owed no alternative minimum tax for that year.

For example, if in year one a taxpayer has $20,000 of income and $35,000 of losses, of which $10,000 are preference items, the alternative tax net operating loss for the year is $5,000 ($15,000 regular NOL less $10,000 preference items). Thus, in any subsequent (or prior) year, a $5,000 alternative tax net operating loss deduction will be allowed to reduce income subject to the alternative minimum tax. Assume that in year two the taxpayer has $20,000 of alternative minimum taxable income (without regard to his regular net operating loss deduction). The taxpayer will be allowed to reduce his alternative minimum taxable income to $15,000 by the $5,000 alternative tax net operating loss deduction. The net operating loss deduction for purposes of the normal tax will not be affected by this computation (i.e., the taxpayer will have an NOL carryover of $15,000 from year one to be offset against normal taxable income in the year to which carried).

E. Alternative Tax Itemized Deductions

The only itemized deductions included in alternative tax itemized deductions\textsuperscript{146} which are used in calculating alternative minimum taxable income are:

(a) Deductible casualty and theft losses (losses in excess of $100 each to the extent the aggregate loss exceeds 10% of adjusted gross income);

(b) Medical expenses in excess of 10% of adjusted gross income;

(c) Charitable contributions;

(d) Interest on loans to acquire, construct, or substantially rehabilitate\textsuperscript{147} the taxpayer's principal residence or a qualified dwelling used by the taxpayer or a member of his family;\textsuperscript{148}

\textsuperscript{144} Sec. 55(d)(1).
\textsuperscript{145} Sec. 172(b)(3)(C).
\textsuperscript{146} Sec. 55(e).
\textsuperscript{147} See Regs. Sec. 1.48-11(b)(3) for guidance as to what may constitute substantial rehabilitation.
\textsuperscript{148} Family members are determined under Sec. 267(c)(4). Apparently a qualified dwelling need not be the principal residence of the taxpayer or his family members. It is sufficient that it is "used" by any of them. This probably means "regular use". However, the need for Sec. 55(e)(A)(i) limiting a taxpayer's deduction to interest relative to his "principal residence" would appear to be un-
(e) Other interest expense to the extent not in excess of net investment income from interest, dividends, rents, and royalties (including excluded dividends and all-savers interest) plus depreciation or ACRS deductions recaptured on disposition of investment property plus capital gain net income from sale or exchange of investment property. Any income from a limited business interest also will be treated as net investment income for this purpose. Interest on indebtedness incurred to purchase or carry a limited business interest is not deductible for this purpose in calculating adjusted gross income. Therefore, it will be considered “other interest” deductible only to the extent of net investment income and not in arriving at adjusted gross income, the starting point for calculating alternative minimum taxable income;

(f) Estate taxes attributable to income in respect of a decedent;

(g) Allowable wagering loss deductions.

Except for refundable credits, the alternative minimum tax is offset only by the foreign tax credit and that credit is adjusted to effectively limit it to that proportion of alternative minimum taxable income from foreign sources which is included in the taxpayer's total alternative minimum taxable income.

Those unused non-refundable credits from a year for which the taxpayer is liable for alternative minimum tax may be carried back three years and/or over fifteen years to the extent otherwise permitted by the Code.

F. Tax Benefit

As in the case of minimum tax, a tax preference item which produces no benefit should not be subject to alternative minimum tax. For example, if there has been no benefit from the Sec. 1202 deduction with respect to net capital gain to the extent the modifications of Sec. 172(d) have eliminated its effect, it should be removed from tax preference item status.

necessary if the taxpayer's use is included in Sec. 55(e)(A)(ii). It should be noted that, except for indebtedness already secured by the principal residence or qualified dwelling before July 1, 1982, to be deductible under Sec. 55(c)(1), the indebtedness cannot merely be a new mortgage unrelated to new acquisition, construction or substantial rehabilitation.

Sec. 55(e)(8). The term “limited business interest” means an interest as a limited partner or as a shareholder in an S corporation in which the taxpayer does not actively participate in management.

Sec. 55(c)(2).

Sec. 55(c)(3).

See Sec. 56(h). Sec. Tax Benefit discussion under the minimum tax discussion, supra.

See, Regs. Sec. 1.57-4, esp. examples 5 and 6. That method used in Rev. Rul. 80-226, 1980-2 CB 26, to compute tax benefit, although applicable to Sec. 56
VI. Tax Planning

- Clearly the complexity of the alternative minimum tax coupled with the fact that it can operate even where no tax preferences are utilized demands careful and timely planning. This is no less true with respect to the add-on minimum tax. In this connection, the best planning advice is that a taxpayer be aware of his/its tax status; the adjusted gross income; those items of tax preference being availed of; the extent and nature of deductions; the character and source of income; what tax credits are available for the year; and whether and to what extent net operating or capital loss carryovers are available. While computer programs or models may be available or formulas could be devised to calculate potential applicability of the additional or alternative tax, the most likely approach to analysis will consist of laborious alternative calculations. These should be made with the most accurate information possible and early enough in the taxable year to permit a change in course to optimize tax results.

- The alternative minimum tax is most likely to apply where tax preference items have produced substantial deductions. However, an unusually large amount of itemized deductions which don't qualify as alternative minimum tax itemized deductions and the bargain element on exercise of incentive stock options could give rise to the alternative tax even if more traditional tax preferences, such as those generated by “tax shelters” are not present. A cash basis taxpayer might be able to reduce exposure by timing his expenditures for large, non-qualified deductions to fall in a different year or years. More often than not, the date an option is exercised in a year which would trigger alternative minimum tax, calculations should be made, taking into account tax bracket, market value and costs of disposition, to determine whether the stock acquired should be prematurely disposed of, thereby removing the tax preference item taint.

- The effective tax rate applied to net capital gain in 1983 (joint table) is from 4.4% to 20%, calculated at 40% (the percentage of net capital gain actually subjected to ordering income tax rates) times the tax brackets (from 11% to 50%). The alternative minimum tax rate is a flat 20%. Thus, disregarding all other tax items (e.g., itemized deductions reduced by the zero bracket amount equals the exemption amount), assuming the only taxable income is net capital gain, alternative minimum tax will always be greater than the regular tax. Conversely, as ordinary income approaches the 50% bracket, the addition of net capital gain will be less likely to create alternative minimum

add-on tax, should be equally applicable to Sec. 55 alternative minimum tax. See, PLR 8314006. But note that the IRS has withdrawn that PLR and is “reconsidering the conclusions reached” therein. PLR 8330007. The Oct. 19, 1983, Wall Street Journal reported that the IRS is now issuing private letter rulings providing for a different calculation but still based on Rev. Rul. 80-226.
tax since, at the maximum bracket, the effective regular tax rate applicable to net capital gain will equal the alternative minimum tax rate. There may be circumstances, therefore, where it would be preferable to increase ordinary income by shifting it from other years in order to avoid the alternative minimum tax impact on net capital gain. Furthermore, especially with the liberalization of the installment sales rules, spreading net capital gain over more than one year could better assure inclusion of the item in an amount which would moderate or eliminate the alternative minimum tax effects.

• If a corporation sustains a net operating loss which is partly comprised of tax preference items, by electing to forego carryback to a prior year, it can defer current exposure to add-on minimum tax since it won't currently be enjoying use of its tax preferences. In the case of alternative minimum tax, there is no deferral procedure with respect to net operating losses. This is because the alternative minimum tax, unlike the add-on tax, either applies in the taxable year or it doesn't. Tax preference items are not carried back or carried over since they are eliminated from the net operating loss in calculating the amount available as an alternative tax net operating loss.

• It should be remembered that the alternative minimum tax net operating loss carryover is specially calculated and it is absorbed in carryback or carryover by alternative minimum taxable income, not taxable income. Therefore, it will be incumbent on the taxpayer to keep track of both the regular net operating loss available for carryback and carryover and the separately calculated alternative minimum tax net operating loss.

• An individual can elect to avoid the tax preference classification of certain rapid writeoff assets. It is possible that the immediate tax savings from such an election would more than offset the deferral of the benefits of the rapid amortization.

• The important relationship in the area of alternative minimum tax is that between the alternative minimum tax and the normal tax. Thus, where tax preference items are significant, planning should proceed to reach that point where the normal tax and the alternative minimum tax are equal. This can be accomplished, for example, by accelerating income into the current year and by deferring deductions until a later year. In this manner, the taxpayer may be moving 50% taxable income into an alternative minimum tax rate of 20%, or he may be moving deductions which would be benefitted only at 20% (or not be benefitted at all, if they were not alternative tax itemized deductions) into a year where they would be benefitted up to 50%.

• If an individual receives a lump sum distribution eligible for 10-year forward averaging at a time he is subject to alternative minimum tax, by forgoing the election to use 10-year forward averaging, while there will be no separately payable tax on the lump sum amount, his
remaining normal tax otherwise increases. At the same time, because alternative minimum taxable income increases without a corresponding increase in "regular" taxes, the alternative minimum tax increases. This interrelationship obviously can be quite complex and should be carefully calculated.

- Consideration should be given to deprecating real property on a straightline basis. Not only would this tend to preserve long-term capital gain treatment for the future, but current minimum tax might be avoided. It should be remembered that future depreciation deductions which will cross over to become less than if straightline had been used from the outset will produce no offset to tax preference items at such time—negative preferences receive no benefits to offset their prior minimum tax treatment.

- Taxpayers may find tax exempt investments and greater contributions to qualified retirement plans and IRA's to be more beneficial since they are not defined as tax preference items.

VII. Conclusion

Since 1969, the Code has been increasingly complicated by minimum tax provisions. There is no indication that these principles will be simplified in the future. No one will contend that the provisions reduce tax liability exposure. Obviously the contrary is intended and is occurring. However, like the battle with inflation, there are possibilities that this tax increase can be reduced if sufficient attention to detail and adequate information gathering are acted on with a view to making informed decisions.