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The Alternative Minimum Tax: Proving Again That Two Wrongs Do Not Make a Right

Glenn E. Coven†

A major objective of recent tax reform movements has been to curtail the excessive claiming of tax incentive deductions and exclusions by high income individual taxpayers. This attack on "tax preferences" is important not only because it would improve the tax system's overall equity, but also because it helps to ensure the viability of our self-assessment reporting system. This system of tax collection is threatened by the popular perception that the tax laws are unduly favorable to the rich.¹ Thus, the imposition of effective restrictions on tax reduction techniques available only to high income taxpayers could produce the significant secondary benefit of increased taxpayer compliance.

The attack on preferences, however, was marked by considerable uncertainty of both goal and method. Several widely differing approaches were advanced and those adopted have been amended frequently. Regrettably, the enacted limitations have been among the least rational and least effective of those proposed. The alternative minimum tax,² added to the Internal Revenue Code³ (Code) at the end of 1978,⁴ is the most recent revision in the attack on preferences. Although the present alternative tax was designed to affect only two pref-

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1. See Blum, *Tax Policy and Preferential Provisions in the Income Tax Base*, in HOUSE COMM. ON WAYS AND MEANS, 1 TAX REVISION COMPENDIUM 77, 82 (1959); Roberts, Friedman, Ginsburg, Louthan, Lubick, Young & Zeitlin, *A Report on Complexity and the Income Tax*, 27 TAX. L. REV. 325, 328 (1972).

2. I.R.C. § 55.

3. All references to sections are to sections of the Code unless otherwise specified.

4. Revenue Act of 1978, Pub. L. No. 95-600, § 421(a), 92 Stat. 2763 (1978).

erence items, in time the alternative tax may become the principal mechanism for restricting the concentration of tax preferences.⁵

That evolution would be highly unfortunate. Analysis of the alternative tax demonstrates that it is ill-conceived in every respect. The results reached by application of the alternative tax provisions are either inherently inequitable or involve unduly circuitous and cumbersome calculations. Congress should promptly repeal the tax, and attack the excessive claiming of preferences within the traditional taxing system.

I

INTRODUCTION

Our income tax laws are required to perform two inconsistent tasks. While the Code's primary function is to allocate the costs of government equitably over the entire population, a major portion of the law is designed to implement a wide variety of social objectives through the use of tax incentives to persons undertaking specified desired activities. Such incentives in the form of tax relief reduce the allocable tax burden of responding taxpayers below the level which would be imposed were equitable considerations alone determinative.

By 1969 it had become apparent that some taxpayers were availing themselves of these tax concessions to such an extent that their otherwise substantial tax liabilities were reduced to unacceptably low levels.⁶ To a limited degree, Congress responded to this use of preferences by curtailing the tax incentives extended by certain Code sections.⁷ That approach alone, however, could not eliminate the perceived abuses without substantially eliminating the very incentives that Congress wished to extend. Accordingly, a mechanism was sought that would permit the continued use of tax incentives but would prevent individual taxpayers from aggregating these tax concessions to excessively reduce their tax liabilities.

A seemingly obvious reconciliation of the conflicting objectives of greater equity and continued preference would be to limit the proportion of a taxpayer's income that might be sheltered by tax concessions.

5. See H.R. REP. NO. 95-1800, 95th Cong., 2d Sess. 263-68, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 7198, 7259-65.

6. See H.R. REP. NO. 91-413, pt. 1, 91st Cong., 1st Sess. 8-11, *reprinted in* [1969] U.S. CODE CONG. & AD. NEWS 1645, 1652-56.

7. The 1969 legislation, for example, added I.R.C. § 1251, requiring the recapture of excess farm losses, and I.R.C. § 163(d), limiting the deductibility of excess investment interest. Tax Reform Act of 1969, Pub. L. No. 91-172, §§ 211(a), 221(a), 83 Stat. 488 (1969). The process of gradually tightening specific preferences has continued to the present. See, e.g., Foreign Earned Income Act of 1978, Pub. L. No. 95-615, §§ 201-207, 92 Stat. 3097 (amending and adding I.R.C. §§ 911-913).

The House of Representatives has twice passed proposals to impose such limitations.⁸ Under a 1969 proposal, for example, a taxpayer would have been barred from claiming the tax benefit otherwise attributable to certain preferences in excess of 50% of a calculation of income that was rather inaccurately characterized as "economic" or "total" income⁹—adjusted gross income plus the amounts of those preferences. These measures were ultimately rejected by Congress, however, in favor of a penalty approach that operated essentially outside of the existing taxing framework, the "minimum" tax, coupled with a new tax incentive available to taxpayers willing to forego the other preferences, the so-called "maximum" tax.

A. *The Maximum Tax and The Minimum Tax*

The maximum tax limited the marginal rate of taxation on earned income to 50%.¹⁰ The express purpose of the ceiling rate was to reduce the incentive for high earned-income taxpayers to claim preferences.¹¹ In keeping with this goal, the ceiling was not applicable to an amount of income equal to the sum of the tax preferences nevertheless claimed by the taxpayer.¹² Thus, taxpayers not responding to the inducements of the maximum tax are penalized by the reinstatement of the normal 70% maximum rate.¹³

The minimum (or "preference") tax was a 10% excise tax imposed upon the sum of a specified list of tax preferences in excess of a rela-

8. H.R. 13270, 91st Cong., 1st Sess. § 301(a)(1) (1969); H.R. 10612, 94th Cong., 1st Sess. § 101(a) (1975). The latter measure would have imposed a "limitation on artificial losses" (LAL) by barring the deduction of certain preferential allowances in excess of taxable income, computed after reduction by all other allowances, from the activity in which the preference was claimed. In other words, the LAL was designed to prohibit the reduction of unrelated income with preferences generated in tax sheltering activities.

9. H.R. REP. NO. 91-413, pt. 1, 91st Cong., 1st Sess. 8-9, 77-78, reprinted in [1969] U.S. CONG. & AD. NEWS 1645, 1652-54, 1723-25. See note 35 *infra*.

The House bill would have further penalized the claiming of preferential allowances by requiring that the amount of certain itemized deductions be allocated between taxable and nontaxable income. To the extent the deduction was allocable to the latter, it was to be denied. H.R. 13270, 91st Cong., 1st Sess. § 302(a) (1969). The rejection of this measure was entirely correct. The propriety of limiting a taxpayer's ability to claim tax incentive allowances as a function of the level of his nonpreferential, and perhaps involuntary, expenses, such as his medical expenses, is highly dubious. The two items are simply unrelated. It would appear clearly irrational to extend a larger capital gains exclusion to a healthy man than to a sick one.

10. Tax Reform Act of 1978, Pub. L. No. 91-172, § 804(a), 83 Stat. 488 (1969) (adding I.R.C. § 1348).

11. H.R. REP. NO. 91-413, pt. 1, 91st Cong., 1st Sess. 208, reprinted in [1969] U.S. CODE CONG. & AD. NEWS 1645, 1863-64.

12. I.R.C. § 1348(b)(2)(B).

13. For criticism of the maximum tax, see Levy, *The Maximum Tax on Earned Income: An Inefficient and Inequitable Tax Shelter Deterrent*, 53 NOTRE DAME LAW. 883 (1978).

tively generous exemption.¹⁴ Because the Senate, which proposed the preference tax, was willing to penalize only the most extreme concentrations of tax incentives, the sum of the preferences subject to tax was reduced by \$30,000 plus the amount of regular income tax paid for the year. The resulting penalty was almost completely ineffectual.¹⁵ In 1976, however, the tax was strengthened by an increase in the rate of tax to 15% and by a reduction of the exemption to the greater of \$10,000 or one-half of the regular tax paid.¹⁶

The preference tax contained, and continues to contain, several highly unsatisfactory, if not plainly inequitable, features. The tax imposed an equal penalty on all preferences regardless of the magnitude of distortion of income they produced. Thus the relatively slight preference produced by the excess of accelerated depreciation over straight-line depreciation on property having a short useful life was subjected to the same penalty as the permanent exclusion from income (then) of 50% of capital gains. As a result, the preference tax in effect imposed a relatively substantial penalty on the less preferential allowances¹⁷ but a virtually insignificant penalty on the most preferential.

Furthermore, the incidence of tax was regressive relative to income before reduction by preferences. Because of the progressivity of the regular income tax rate schedule, as a taxpayer's income rose, his regular exemption from taxable preferences for taxes paid rose more rapidly. Thus, for taxpayers sheltering an equal proportion of their otherwise taxable incomes with preferences, the effect of the preference tax declines as income rises.

The reduction of the exemption to one-half of the regular income tax would have reduced this regressivity. However, the 1976 amendment to the preference tax coupled the reduction with the elimination of the fixed dollar exemption, which had somewhat offset the regressivity of the tax. While the combined effect of these amendments significantly increased the penalty imposed at all levels, the greatest increase occurred at the lower income levels, thus actually increasing the regressive character of the tax.¹⁸

14. Tax Reform Act of 1978, Pub. L. No. 91-172, § 301(a), 83 Stat. 488 (1969) (adding I.R.C. §§ 56-58).

15. S. REP. NO. 94-938, pt. 1, 94th Cong., 2d Sess. 109, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3439, 3544-45.

16. Tax Reform Act of 1976, Pub. L. No. 94-455, § 301(a), 90 Stat. 1520 (1976) (amending I.R.C. § 56(a)).

17. See Brogden & Fisher, *Accelerated Depreciation v. the Minimum Tax*, 56 TAXES 530, 530-34.

18. The incidence of the preference tax both before and after the 1976 amendments can be seen from the following table. The table shows, at different levels of taxable income computed before reduction by preference items (theoretical taxable income), the effect of the application of the preference tax when varying proportions of theoretical taxable income are sheltered by prefer-

B. The Alternative Minimum Tax

The paths of reform are rarely straight. By 1978 the congressional priorities were "capital formation" and "energy." It was clear that the pendulum had swung back to using the Code to implement social policy¹⁹ and away from efforts to improve its equitable impact. The alternative minimum tax was the product of a congressional desire to reduce the penalty upon the claiming of tax preferences, particularly upon the long-established capital gains exclusion—which Congress simultaneously raised to 60% from the long-standing 50%.²⁰

From every perspective, the Code would have benefited if capital gains had merely been exempted from the existing preference tax. Instead, Congress took an intermediate step that added little but irrational complexity to the tax laws. While one might have thought that a highly complex tax law supplemented by an additional layer of preference tax would be enough tax law for any single nation, Congress

ences. The effect of the tax is shown as the taxable income (expressed as a percentage of theoretical taxable income) which would produce a regular income tax equal to the tax actually produced by the regular tax plus the preference tax.

TAXABLE INCOME EQUIVALENT PRODUCED BY 1969 AND 1976 PREFERENCE TAX RATES

Taxable Income as a Percent of Theoretical Taxable Income

Theoretical Taxable Income	50%		25%		0%		Proportion Left Unsheltered
	1969	1976	1969	1976	1969	1976	
\$ 100,000	51	61	35	47	28	43	
200,000	52	59	35	44	25	36	
500,000	52	57	34	40	21	29	
1,000,000	52	57	33	39	18	25	

For example, if a taxpayer having a theoretical taxable income of \$100,000 claimed preferences in the amount of \$75,000, he would reduce his taxable income to 25% of his theoretical taxable income. After the 1976 amendment, the resulting preference tax, when added to the regular tax payable on a taxable income of \$25,000, produces the same amount as would the regular income tax alone on a taxable income of approximately \$47,000. Thus, it may be said that the effect of the preference tax is to restore this taxpayer's taxable income from 25% to 47% of his theoretical taxable income. By contrast, were his income \$1 million, the restoration would be from only 25% to 39%.

19. The Carter Administration had proposed not only to facilitate capital formation primarily through a reduction in the tax rates, but also to strengthen the limitations on tax incentives. U.S. TREAS. DEP'T, THE PRESIDENT'S 1978 TAX BUDGET (1978). Congress accepted the general tax reduction, added a reduction in the tax rate on capital gains, and materially weakened the limitations on tax preferences. See text accompanying notes 20-21 *infra*. In addition, Congress enacted the Energy Tax Act of 1978, Pub. L. No. 95-618, 92 Stat. 3174, that, among other things, added a series of inconsequential but highly preferential credits to the law. I.R.C. § 44C. The following year I.R.C. § 44C was expanded, thereby becoming less inconsequential but no less preferential. Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, § 202, 94 Stat. 258.

20. Revenue Act of 1978, Pub. L. No. 95-600, § 402(a), 92 Stat. 2763 (1978). Surprisingly, the Senate had proposed increasing the exclusion to 70%. H.R. 13511, 95th Cong., 2d Sess. § 402(a) (1978).

thought otherwise. The capital gains preference was deleted from the preference tax and a new tax apparently directed at capital gains was adopted.²¹

Unlike the older "add-on" or excise type preference tax, the new tax is a largely independent income tax having its own tax base and rate schedules. Taxpayers are subject to the greater of the tax produced by the regular income tax, increased by the add-on preference tax, or the tax produced by this new "alternative" tax.²² True to its conception, the alternative tax will affect few taxpayers in more than a relatively minor way. However, those unfortunate few will find themselves subject to a most complex and peculiar system of taxation.

The base upon which the alternative tax is computed, "alternative minimum taxable income," consists of the sum of (a) gross income reduced by all allowable deductions,²³ plus (b) the two preferences attributable to capital gains and itemized deductions.²⁴ The first component of the tax base is classical taxable income, that is, taxable income computed without regard to the nondeductibility of itemized deductions to the extent they do not exceed the zero bracket amount.²⁵ However, the

21. I.R.C. § 55 is entitled the "alternative minimum tax" presumably to distinguish it from the minimum tax for tax preferences imposed by I.R.C. § 56. The new tax is referred to herein as the alternative tax.

22. Technically I.R.C. § 55 imposes a tax in addition to the regular tax and the preference tax equal to the excess of the alternative tax, if any, over the sum of the other two. I.R.C. § 55(a).

23. In order to avoid a double tax benefit, I.R.C. § 55(b)(1) (flush language) bars the reduction of the alternative tax base with deductions that may be carried over in reduction of the regular tax in another year. See S. REP. NO. 96-498, 96th Cong., 2d Sess. 68-69, reprinted in [1980] U.S. CODE CONG. & AD. NEWS 914, 975-77.

24. I.R.C. § 55(b)(1). The resulting base is further reduced by two amounts. Presumably in an effort to impede the manipulation of income and regular tax, the amount of any accumulation distribution from a trust included in income under I.R.C. § 667 and the tax attributable to such a distribution are excluded from the computation of the tax base and the regular tax, respectively. I.R.C. §§ 55(b)(1)(B) and 55(b)(2).

Secondly, the amount of any alcohol fuel credit included in income under I.R.C. § 86 is similarly excluded from the alternative tax base. I.R.C. § 55(b)(1)(B). The Crude Oil Windfall Profits Tax Act of 1980 added a tax credit to the Code which was related to the quantity of alcohol used in the production of fuel. Pub. L. No. 96-223, § 232(b)(1), 94 Stat. 258 (adding I.R.C. § 44E). Congress desired, however, to concentrate this new subsidy of the production of gasohol on lower income taxpayers. In order to create a tax credit the benefits of which declined as income rose, a new I.R.C. § 86 was added to require an amount equal to the allowable § 44E credit to be included in income. As a net result, a taxpayer will lose a fraction of the § 44E credit equal to his highest marginal tax rate. In common with most credits, the § 44E credit may not be taken against the alternative tax. See text accompanying note 67 *infra*. Since the inclusion of the credit in income under I.R.C. § 86 is simply a technique for reducing the subsidy extended by I.R.C. § 44E, that inclusion is quite properly ignored in the computation of the alternative tax base.

25. If the zero bracket amount is greater than the sum of the taxpayer's itemized deductions, the entire zero bracket amount is treated as a deduction for alternative tax base purposes. Technical Corrections Act of 1979, Pub. L. No. 96-222, § 104(a)(4)(D), 94 Stat. 194.

The introduction of that allowance into the alternative tax erodes the integrity of that tax in precisely the same manner as the erosion of the integrity of the regular tax computation that produced the need for the alternative tax. Thus the process begins and in time, perhaps, a second

computation permissibly may produce a negative amount.²⁶

The two preference inclusions are the untaxed portion of capital gains and "adjusted itemized deductions."²⁷ This second preference, an adaptation of the "excess itemized deduction" preference that had been included in the preference tax, consists of all itemized deductions other than (1) those allowable in arriving at adjusted gross income, primarily deductions incurred in the conduct of a trade or business;²⁸ (2) the deduction for personal exemptions; and (3) four specific exceptions which are referred to herein as the "favored deductions." The favored deductions include those for medical expenses; casualty losses; state, local, and foreign taxes; and the section 691(c) deduction for estate taxes paid.²⁹ The remaining deductions become "adjusted" or included in the alternative tax base to the extent that in the aggregate they exceed 60% of adjusted gross income reduced by the four favored deductions.

The resulting tax base is then subject to a tax which is derived from a rate schedule entirely separate from the regular tax rate.³⁰ The alternative tax rate schedule roughly parallels the regular schedule in its progression, although it employs only four marginal brackets (including a zero percent bracket), and its rates are far lower. After a relatively high exemption of \$20,000, the minimum rate of 10% is imposed. The rate then leaps to 20% at \$60,000, producing a sharp increase in progressivity. Thereafter, however, the rate schedule remains almost flat with the sole increase, of only 5%, occurring at \$100,000 to produce the maximum rate of 25%. If the tax so produced exceeds the taxpayer's regular income tax liability, including any tax attributable to the preference tax, the amount of the excess becomes an additional tax payable.

The relationship between the alternative tax and the various credits provided under the Code is a complex one. Credits, of course, reduce regular tax liability, thus increasing the likelihood that an alternative tax will be payable. Certain credits, however, may in effect

alternative tax will be enacted in response to the corruption of the first alternative tax base. It would have been preferable for Congress to have permitted the reduction of the alternative tax base by all itemized deductions regardless of whether or not they exceeded the zero bracket amount.

26. S. REP. NO. 95-1263, 95th Cong., 2d Sess. 204, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 6761, 6967 [hereinafter cited as 1978 SENATE REPORT].

27. I.R.C. § 57(b).

28. I.R.C. § 57(b)(1) includes "itemized deductions," which are defined in I.R.C. § 63(f) as deductions from adjusted gross income other than the personal exemption provided by I.R.C. § 151.

29. I.R.C. § 57(b)(1). Trusts and estates were allowed additional exclusions. I.R.C. § 57(b)(2).

30. I.R.C. § 55(a)(1).

be offset against the alternative tax although others may not.³¹ In all, credits are treated in four different ways and the resulting pattern is one of the least satisfactory aspects of this highly dubious measure.

The form of the alternative tax as it was ultimately enacted represented a substantial compromise between the House and Senate versions of how the preference tax should be modified.³² One result of the compromise reached in conference is that there is relatively little in the legislative history to indicate why the tax took the form it did or what the provision was intended to accomplish.³³ From the perspective of the wavering history of tax reform, however, the alternative tax has received unprecedented support and for that reason could well become the model for future congressional efforts. Such support should be an incentive to assess the rationality of the alternative tax.

II

THE ALTERNATIVE MINIMUM TAX IN OPERATION

A. Capital Gains

1. Mechanics

A taxpayer who does not have adjusted itemized deductions has an alternative tax base of classical taxable income plus the amount of the capital gains exclusion. This concept of restoring taxable income by adding back the amount of excluded preferences to produce an amount more nearly resembling a theoretically accurate computation of income is related to the rejected 1969 House proposal that would have limited the ability to claim preferences to 50% of "economic" income.³⁵ Under the alternative tax, however, this restoration lacks the equitable significance it held under the 1969 proposal because the resulting tax base is subjected to the different alternative tax rate schedule rather than to the regular tax. Because different rate schedules are employed, the tax imposed under the alternative tax is not comparable, or even rationally related, to the regular tax.

31. See text accompanying notes 65-69 *infra*.

32. The House had proposed only that capital gains be eliminated from the existing preference tax, H.R. 13511, 95th Cong., 2d Sess. § 402(a)(1978), and subject to a new alternative tax at a flat rate of 10% on the untaxed portion of capital gains in excess of \$10,000, *id.* § 403(a). The Senate, on the other hand, proposed the entire repeal of the preference tax, *id.* § 441, and its replacement with an alternative tax on the sum of all preference items under a progressive rate schedule, *id.* § 421(a).

33. See H.R. REP. NO. 95-1800, 95th Cong., 2d Sess. 267-68, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 7198, 7259-65.

34. I.R.C. §§ 55(b)(1)(A), 55(b)(1)(C)(ii).

35. See text accompanying note 9 *supra*. Both provisions, of course, are adaptations of the economist's notion of "expanded" income. For a recent attempt to refine that concept, see Okner, *Distributional Aspects of Tax Reform During the Past Fifteen Years*, 32 NAT'L TAX J. 11 (1979).

The alternative tax was designed to have only a minimal impact on the tax benefit of the capital gains exclusion alone. While that objective was largely achieved, to the extent that it was not the alternative tax is clearly inequitable. The impact of the tax on the receipt of unsheltered capital gains income can be demonstrated by supposing a taxpayer who has allowable deductions in an amount exactly equal to the amount of his ordinary gross income. The taxable income of such a taxpayer can be said to consist solely of capital gains, plus the non-deductible zero bracket amount. For such a taxpayer, with either relatively small or very large capital gains, the alternative tax will not produce a tax in excess of the regular income tax. However, it will produce a tax penalty over a rather substantial intermediate range.

An alternative tax penalty will not be incurred until the taxpayer has derived capital gains in excess of approximately \$89,000.³⁶ As additional gains are received, both the regular tax and the alternative tax will increase. At this level of income, however, the alternative tax increases at a faster rate. Thus, if the taxpayer derives \$200,000 of capital gains, his regular tax will be \$32,314 on income of \$80,000 plus the \$3,400 zero bracket amount. His alternative tax of \$37,000, however, will exceed that amount by over \$4,500. The absolute amount by which the alternative tax exceeds the regular tax remains roughly constant until gains of about \$450,000 are derived, and thereafter begins to decline. By the time the taxpayer has derived gains of about \$1 million, the regular tax will again exceed the alternative tax. As the foregoing illustrates, the penalty imposed by alternative tax on the receipt of wholly unsheltered capital gains varies widely at different levels of income and, at some levels, can be quite substantial.³⁷

This variance can be quantified by viewing the tax as a reduction in the amount of the capital gains exclusion. So viewed, the effect of the tax on capital gains of \$200,000 is the reduction of the exclusion from 60% to 56%.³⁸ While the absolute size of the alternative tax penalty imposed on larger gains remains relatively stable and then slowly declines, as a proportion of the capital gain itself it disappears far more rapidly. Thus, a taxpayer having a capital gain twice as great will have a taxable income of \$163,400. The alternative tax of \$87,000 on this income will exceed his regular tax of \$82,144 by \$4,856. However, a regular tax of \$87,000 is payable on a classical taxable income of

36. All illustrations herein of the effect of the alternative tax assume that the taxpayer files a joint return, claims four personal exemptions, and employs the tax rates in effect during 1980.

37. The hypothetical taxpayer would have to have a classical taxable income of \$88,129—over 10% greater than the \$80,000 of classical taxable income produced by a \$200,000 capital gain—before a regular income tax of \$37,000 would be assessed.

38. That is, the tax actually paid is the same as the regular tax on approximately \$88,000 or 44% of the capital gain.

\$167,141 or 41.8% of the capital gain. Thus the effective capital gains exclusion has been reduced only to 58.2%. Thereafter, the absolute amount of the penalty declines sharply. On capital gains of \$500,000, the effect of the tax is merely to reduce the exclusion by less than 1% to 59.2%.

2. *Possible Rationales*

It is not entirely clear whether this uneven impact of the alternative tax on different levels of income was deliberate or is merely an unintended side-effect of the new tax. The only justification for deliberately so designing the alternative tax would be a determination by Congress that the combination of the rate of progression of the regular tax and the increased capital gains exclusion produced an inadequate tax on capital gains in the affected range. However, there is no indication in the Committee Reports that Congress so concluded—or even was aware of the uneven impact of the alternative tax.³⁹

Moreover, if the rate of progression is inadequate for taxpayers deriving solely capital gains income, it should be inadequate where the taxpayer also derives a small amount of ordinary income. The additional tax payable on the ordinary income should not alter the inadequacy of the tax paid with respect to the capital gain. However, the alternative tax penalty on capital gains is completely eliminated at all income levels if the taxpayer has small amounts of unsheltered ordinary income. For example, if a taxpayer having \$200,000 of capital gain also derived \$14,000 of ordinary income in excess of his deductions, his regular tax would exceed his alternative tax. Thus, net ordinary income equal to 7% of the capital gain would completely eliminate the reduction of the capital gains exemption. This effect of small additions of ordinary income holds true over the entire range of income.⁴⁰

Accordingly, it seems unlikely that this selective penalty on capital gains was deliberate. If the 60% exclusion was thought appropriate for capital gains below \$89,000 and above \$1 million, it must also be appropriate at intermediate levels.

Rather, because the point at which the alternative tax penalty is incurred roughly parallels at all income levels the point at which ordinary deductions exceed ordinary income and begin to offset capital gains, it appears that the drafters of the alternative tax sought generally to exempt capital gains as such from the alternative tax. Whether or

39. See H.R. REP. NO. 95-1445, 95th Cong., 2d Sess. 122-24, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 7044, 7050-52 [hereinafter cited as 1978 HOUSE REPORT]; 1978 SENATE REPORT, *supra* note 26, at 200-07.

40. See Seago, *The New Alternative Minimum Tax*, 1979 TAX ADVISER 324, 326-27.

not the tax was consciously designed to impose a penalty at such points, a decision to do so would have been logical and would have treated taxpayers at different income levels fairly.⁴¹ The failure of the existing alternative tax to impose a penalty at exactly these points is a material defect in the tax. Indeed, to the extent that the alternative tax imposes a greater penalty on deriving solely capital gains income at some income levels than it does at others, the tax is clearly inequitable.

3. *Inherency*

The primary reason for this uneven impact of the alternative tax is that the tax employs only four tax brackets. As a result, it is clearly impossible for the alternative tax, regardless of the rates employed, precisely to parallel the regular income tax. On the contrary, for an alternative tax to impose a penalty commencing at the same income configuration at every different level of income would require the alternative tax to contain the same number of brackets, with corresponding intervals, as the regular rate schedule. Obviously, achieving a comparable result within the existing taxing system would be preferable to such total duplication.

B. Capital Gains Offset by Deductions

Just as increases in the amount of ordinary income in a taxpayer's return reduce, and quickly eliminate, the alternative tax, increases in the amount of deductions, whether from gross income or itemized, in excess of ordinary income will cause the alternative tax to exceed the regular tax. As deductions are increasingly applied against the taxable portion of capital gains, both the regular tax and the alternative tax are reduced. However, because of its lower rate, the alternative tax declines more slowly than does the regular tax. Ultimately, the alternative tax applied to the broader alternative tax base (taxable income plus the 60% capital gains exclusion) will exceed the regular tax and the penalty commences. While additional deductions will continue to reduce the alternative tax base until the amount of itemized deductions becomes so large as to become "adjusted," those deductions now reduce the alternative tax with its lower marginal rates rather than the regular tax.

Accordingly, once the alternative tax becomes applicable, the tax benefit from deductions becomes a function of the 25% or lower alternative tax rates rather than the regular tax rate. The penalty then of

41. That is not to say that an alternative tax so designed would be appropriate. The view expressed herein is that the very concept of an alternative tax is defective. Moreover, the propriety of penalizing capital gains as a function of the level of unrelated deductions is highly dubious. See note 9 *supra*.

becoming subject to the alternative tax is that a portion of the tax benefit otherwise attributable to the claiming of deductions is withdrawn. The amount of the tax benefit lost will equal the excess of the taxpayer's regular tax rate over the applicable alternative tax rate. This amount will vary, however, in an unfair manner.

The inequity of the alternative tax's consequences can be shown with an illustration. The following is the computation of the regular and alternative tax for a married individual with three additional dependents, no business or other deductions applicable in computing adjusted gross income, and no tax credits:

REGULAR TAX			ALTERNATIVE TAX		
	A	B		A	B
Ordinary Income	\$ 50,000		Net Amount	\$ 46,000	-1
Capital Gains	125,000		60% of Gains	75,000	
40% of Gains	50,000		AMTI	121,000	-1
AGI	100,000		Tax	17,250	- .25
Personal Exemptions	4,000		Marginal Rate	25%	
Itemized Deductions	50,000	+1			
Net Amount	46,000	-1			
ZBA	3,400				
Taxable Income	49,400	-1			
Tax	14,484	- .49			
Marginal Rate	49%				

Columns B demonstrate the effect of claiming an additional itemized deduction of one dollar (although the result would be the same for business deductions). In the absence of the alternative tax, the taxpayer would have reduced his tax burden under the regular tax by forty-nine cents. However, because he is subject to the alternative tax, he will reduce his tax burden by only twenty-five cents. Accordingly, the additional alternative tax penalty incurred is equal to the difference between the tax benefit that the taxpayer would have received from the deduction in the absence of the alternative tax and the tax benefit that he in fact received, or twenty-four cents.

As can be seen, the size of the penalty incurred varies with the marginal bracket rate of the regular tax otherwise payable. The higher the taxpayer's regular marginal rate, the greater becomes the penalty imposed. For example, a taxpayer having the same proportion of ordinary income and capital gains as illustrated above, but in triple the amounts, would also be subject to the alternative tax penalty. However, he would be in a regular tax bracket of 64% and thus would incur a penalty of thirty-nine cents for each additional dollar of itemized de-

ductions claimed, rather than twenty-four cents.⁴²

It is, of course, always true that the loss of a deduction "costs" an upper bracket taxpayer more than the same loss costs a lower bracket taxpayer. The loss of a deduction produces the same consequence as the receipt of additional income, which, of course, produces a greater tax to an upper bracket taxpayer than to a lower bracket taxpayer. The alternative tax, however, imposes a relative burden on upper bracket taxpayers that is far more severe than this normal effect of the disallowance of a deduction.

The excessive penalty on higher bracket taxpayers can be quantified by comparing the effect under the alternative tax of an additional itemized deduction on taxpayers in different marginal brackets with the effect of a provision uniformly disallowing 50% of claimed deductions attributable to specified preferences. Under such a proportional provision, taxpayers at all income levels would be treated as if their taxable incomes had declined by only one-half of the decline that would be recognized in the absence of any disallowance provision. If, for example, a taxpayer incurred a disallowable expenditure in the amount of \$10,000, he would be treated as if he had incurred an expenditure of only \$5,000—regardless of his income level. Thus, all taxpayers would be treated equally under such a provision. The after-tax effect of that disallowance, of course, would vary as a function of the taxpayer's marginal bracket. For a taxpayer in the 49% bracket, a \$10,000 deduction will reduce his tax liability by \$4,900. A 50% disallowance of that deduction would reduce the tax benefit attributable to the deduction from \$4,900 to one-half that amount, or \$2,450. The same disallowance for a taxpayer in the 64% bracket would reduce the tax benefit from the deduction from \$6,400 to \$3,200. All taxpayers would lose an equal proportion of the tax benefit from making the disallowable expenditures—one-half.

Under the alternative tax, the tax benefit from incurring a \$10,000 expenditure is reduced to \$2,500, assuming that the maximum alternative tax bracket is applicable, regardless of the taxpayer's regular tax bracket or the tax benefit that would have been obtained in the absence of the alternative tax. For a taxpayer in the 49% bracket, the tax benefit is reduced from \$4,900 to \$2,500. Accordingly, such a taxpayer is treated as if he had made an expenditure equal to $25/49$ ths of \$10,000, or \$5,102.⁴³ However, a taxpayer in the 64% bracket is treated as if he had made an expenditure of only $25/64$ ths of \$10,000, or \$3,910. The

42. That is, the expenditure would reduce his alternative tax by 25 cents, rather than his regular tax by 64 cents. The penalty, or loss of tax benefit, is 39 cents.

43. Viewed conversely, at the 49% bracket, a deduction of \$5,102 produces a tax benefit of \$2,500.

taxpayers are not treated equally; rather, a disproportionately large penalty is imposed upon the higher bracket taxpayer. Stated differently, under the alternative tax, a taxpayer in the 49% bracket will lose 49% of the tax benefit of his deductions, while a taxpayer in the 64% bracket will lose 61% of the benefit of his deductions.

The disproportionate penalty imposed on higher bracket taxpayers by the alternative tax is particularly objectionable since the greater penalty is imposed not because of any greater abuse by the taxpayer, but rather because of a higher level of *unsheltered* income. Indeed, these relative penalties are always imposed if the alternative tax is applicable and wholly without regard to either the absolute amount of gains that are sheltered or to the proportion of the gain that is sheltered. Thus, the relatively more severe penalty imposed upon our hypothetical 64% bracket taxpayer is applicable even though the amount of capital gains that he sheltered from tax was smaller than the amount sheltered by the 49% bracket taxpayer and, of necessity, represented a far smaller portion of his entire capital gain.

Moreover, if the purpose of the alternative tax is to penalize the offsetting of capital gains with ordinary deductions,⁴⁴ not only is the tax not progressive with respect to the magnitude of the abuse, but the incremental penalty imposed actually declines as a taxpayer shelters increasing amounts of capital gains. At a fixed level of income, as the amount of ordinary deductions claimed by the taxpayer increases, his taxable income and thus his marginal rate of tax decreases. Accordingly, the difference between the taxpayer's regular tax rate and his alternative tax rate will be reduced and the effective penalty imposed by the alternative tax will decline.⁴⁵ Thus, if our hypothetical 64% bracket taxpayer claimed sufficient deductions to reduce his taxable income to \$49,400, he would now be in the 49% bracket and would lose only 49% of the benefit of his further deductions.⁴⁶

In this respect, the alternative tax cannot be judged rational. The sheltering of equal dollar amounts of capital gains at different levels of unsheltered income should be subject either to the same penalty⁴⁷ or, as unsheltered income rises, a lesser penalty because the proportion of the

44. This effect and presumed purpose of the alternative tax is, of course, subject to the imprecision discussed above. Cf. subsection II(A)(2) *supra* (extent of congressional awareness of impacts uncertain). Over a broad range of intermediate gains, some alternative tax will be payable even though no capital gains are offset.

45. If the deductions become so large as to become "adjusted," the alternative tax will no longer decline. See text accompanying notes 53-55 *infra*. A decline in the tax benefit from adding deductions sufficient to put a taxpayer in a lower tax bracket is, of course, a feature of the regular income tax. That tax, however, was not designed to penalize the claiming of itemized deductions.

46. See text following note 43 *supra*.

47. The tax would have been rational if, in this circumstance, either the same dollar amount of penalty were imposed or the same correction of taxable income occurred as under the propor-

entire gain that has been sheltered would have declined. Under the alternative tax, however, the incidence of the tax is just the reverse.⁴⁸

The irrationality of this aspect of the alternative tax is directly attributable to the use of a separate system of taxation. Indeed, the effects described above are inherent in the use of an alternative tax and could not be eliminated even by making the rate structure of the alternative tax parallel the regular income tax rate structure. For example, if the alternative tax rate applicable to a taxpayer in the 64% bracket were 33%, the taxpayer would retain a tax benefit from his deductions equal to 33/64ths or approximately 51% of the expenditure, and thus would be treated the same as the 49% bracket taxpayer described above. Each would lose an equal proportion of the tax benefit from a given expenditure.⁴⁹ However, in this instance, that modification alone would not suffice to make the alternative tax equitable. Because the alternative tax base consists of elements that are not present in the regular tax base, the alternative base will vary independently of the regular base. As long as the rate to be applied is a function of the size of the alternative tax base, there is no method for ensuring that a taxpayer in a regular tax bracket of 64% would be subject to an alternative tax rate of 33% while a taxpayer in a regular bracket of 49% would be subject to an alternative rate of 25%. In order to ensure that result, the alternative tax rate would have to be related to the taxpayer's regular tax rate, rather than to the size of his alternative tax base.

The effect of these improvements to the alternative tax, of course, would be to reduce the differences between these two taxes and to cause the alternative tax to resemble more nearly a modification of the computation of taxable income. If it is understood that the use of a rate schedule unrelated to the regular schedule produces inequitable results, it follows that the proper approach to restricting the use of tax preferences lies solely in making adjustments to the tax base, and not in creating a separate alternative tax. And further, if it is merely the tax base that is to be adjusted, little, if any, purpose is served by defining an entirely independent base rather than modifying the existing computa-

tional disallowance described in the text. Under the latter form, the dollar amount of penalty would vary with the taxpayer's marginal rate of tax.

48. This discriminatory feature of the alternative tax does not constitute a mere increase in the progression of the regular taxing system. On the contrary, had our hypothetical taxpayer derived more income, rather than sustained a greater expense, the added income would have been subject to the far lower alternative rate of tax (25%) until the point was reached that the regular tax exceeded the alternative tax. For a criticism of this aspect of the tax, see notes 62-64 and accompanying text *infra*.

49. This observation further illustrates the point made earlier that the alternative tax cannot be made equitable unless its rate structure exactly parallels that of the regular tax. See generally subsection II(A)(3) *supra*.

tion of taxable income in a manner similar to the rejected 1969 House proposal.

Indeed, the most disturbing aspect of the alternative tax is the ease with which Congress could have achieved its general objective through relatively simple adjustments to the existing computation of taxable income. A reduction in the tax benefit attributable to deductions used to offset capital gains could have been achieved simply by requiring all deductions in excess of ordinary income plus, for example, \$20,000 to be treated as capital losses to the extent of any capital gains.⁵⁰ Not only was it totally unnecessary to introduce the complexity of the alternative tax, but such an adjustment to taxable income would have produced a rational pattern of disallowance and would thus have had a far more equitable impact. The amount of the penalty imposed under such a provision would be uniform with respect to taxpayers at different levels of taxable income. Further, such a provision would eliminate the imprecision of the alternative tax. By directly adjusting taxable income, no class of taxpayers would become subject to a penalty unless deductions in fact exceeded ordinary income. Congress could have achieved its objective more simply and fairly by altering the existing taxing system rather than creating a new level of taxation.⁵¹

C. *Adjusted Itemized Deductions*

The adjusted itemized deductions provisions of the alternative tax serve only to prevent a taxpayer from reducing through itemized deductions his taxable income below a presumably acceptable fraction of his adjusted gross income. As a mechanism for achieving this goal, however, the alternative tax is unduly circuitous and cumbersome. Congress could have achieved the same results far more simply by altering the definition of taxable income.⁵²

The alternative tax base in the presence of adjusted itemized deductions is classical taxable income plus the entire amount of the taxpayer's itemized deductions in excess of 60% of adjusted gross income (reduced by the four favored deductions).⁵³ The effect of this restora-

50. A somewhat similar approach applies in the disallowance of a portion of the deduction for investment interest expense. I.R.C. § 163(d).

51. The statements in the text should not be read as implying approval of treating itemized deductions as capital losses but only as suggesting that, if limits on the tax benefit of certain deductions are to be imposed, there are more rational methods than the alternative tax. See note 9 *supra*.

52. It is beyond the scope of this Article to examine the propriety of treating itemized deductions in excess of an arbitrarily defined level as a preference. Quite clearly, however, the definition of adjusted itemized deductions is a highly inexact approximation of the preferential component of such deductions.

53. I.R.C. §§ 55(b)(1)(C)(i), 57(b)(1).

tion of income is that the taxpayer may not reduce his alternative tax base below 40% of his adjusted gross income as modified. That is, once deductions reach this level, while the taxable income component of the alternative tax base continues to be reduced by one dollar for each dollar of deduction claimed, the base is simultaneously increased by the one dollar larger adjusted itemized deduction. Consequently, if a taxpayer has adjusted itemized deductions but no capital gains, his alternative tax base will always equal 40% of his adjusted gross income less the favored deductions, all reduced by his personal exemptions.⁵⁴

This absolute bar against the claiming of deductions in excess of a specified fraction of income is also reminiscent of the limitation on the claiming of tax preference benefits included in the 1969 House proposal. Unlike that bill, however, the alternative tax subjects a taxpayer to the much lower alternative tax rate schedule for the irreducible level of income rather than to the regular income tax. Furthermore, because an alternative tax does not actually become payable until that tax exceeds the regular income tax, a taxpayer can continue to reduce his taxable income to a level substantially below 40% of adjusted gross income before becoming subject to any penalty. Because an alternative tax can be computed under the formula set forth above for any level of adjusted gross income less the favored deductions for a taxpayer having adjusted itemized deductions, it is possible to determine the extent to which regular taxable income may be depressed by itemized deductions before the alternative tax becomes applicable.⁵⁵ At that point, of course, the taxpayer cannot further reduce his tax liability by claiming itemized deductions because itemized deductions have no effect on the alternative tax base. Accordingly, the general effect of the inclusion of the adjusted itemized deductions preference is to absolutely prohibit the claiming of a tax benefit attributable to itemized deductions in ex-

54. This equivalence can be demonstrated algebraically. Absent capital gains, but in the presence of adjusted itemized deductions, alternative minimum taxable income (*AMTI*) equals gross income (*GI*) less all deductions [including deductions (*D*) in arriving at adjusted gross income (*AGI*), itemized deductions other than the favored deductions (*ID*), the favored deductions (*FD*), and the personal exemptions (*PE*)] plus the amount by which *ID* exceeds 60% of *AGI-FD*. Thus:

$$\begin{aligned} AMTI &= GI - D - ID - FD - PE + ID - .6(AGI - FD) \\ \text{but } AGI &= GI - D \\ \therefore AMTI &= AGI - ID - FD - PE + ID - .6(AGI - FD) \\ &= AGI - FD - .6AGI + .6FD - PE \\ &= .4AGI - .4FD - PE \\ &= .4(AGI - FD) - PE \end{aligned}$$

See Seago, *supra* note 40, at 236.

55. In order to make this comparison of the two taxes, it is necessary to assign a value to the sum of the four favored deductions. For all computations herein, it has been assumed that this value equals 10% of adjusted gross income.

cess of a specified fraction of adjusted gross income. The fraction, however, is not 40%, but rather a much lower (and variable) number.

Because of the relatively high exemption and low rate schedule of the alternative tax, the point at which an alternative tax will become payable is not reached until the taxpayer has sheltered almost all of his income. For example, a married taxpayer having an adjusted gross income of \$100,000, favored deductions of \$10,000, and four personal exemptions cannot reduce his alternative tax below \$1,200.⁵⁶ His regular tax liability, assuming he had no tax credits, will not be depressed to that amount until the taxpayer has claimed itemized deductions of \$78,633.⁵⁷ Until that amount of deductions is claimed (and assuming no capital gains), the regular tax will always exceed the alternative tax. Accordingly, the taxpayer will be able to reduce his classical taxable income to \$7,367, or 7.4% of his adjusted gross income, before becoming subject to the alternative tax and thereby barred from obtaining any tax benefit from further itemized deductions. The alternative tax, then, permits this taxpayer to shelter up to 92.6% of his adjusted gross income with itemized deductions and personal exemptions.

As adjusted gross income increases, the proportion of adjusted gross income that may be sheltered before the alternative tax becomes payable declines somewhat. Thus, of an adjusted gross income of \$200,000, 87.7% may be sheltered without penalty, and of \$500,000, 84.5% may be sheltered. This progressive impact of the alternative tax is, of course, attributable to the progressivity of the alternative tax rate schedule. However, the effect of this progressivity is chiefly experienced on alternative taxable incomes of between \$60,000 (when the 20% rate bracket is reached) and approximately twice that amount. For the income configurations presently being considered, that level of alternative taxable income roughly corresponds to adjusted gross incomes of between \$178,000 and \$344,000.

The use of the complex mechanics of the alternative tax simply to bar the reduction of taxable income below a fraction, even a variable fraction, of the taxpayer's adjusted gross income through itemized deductions is particularly odd since Congress was already familiar with the 1969 proposal to uniformly bar the deduction (or exclusion) of preferences in excess of 50% of "economic" income. The incidence of the

56. Under the formula in note 54 *supra*, 40% of \$90,000 (\$100,000 less \$10,000) creates an AMTI of \$36,000, from which personal exemptions of \$4,000 are subtracted. The alternative tax on an AMTI of \$32,000 is \$1,200. Additional itemized deductions will have no effect on this final figure.

57. AGI of \$100,000 less favored deductions of \$10,000, less itemized deductions of \$78,633 (of which \$3,400 are not deductible because of the zero bracket amount provision), less \$4,000 produces a taxable income of \$10,767, the regular tax on which is \$1,200. Ignoring the zero bracket amount, the classical taxable income of this taxpayer would be \$7,367.

alternative tax is somewhat different from that of the 1969 bill because the proportion of income that can be sheltered under the alternative tax declines somewhat as adjusted gross income rises. However, a similar progression could easily be achieved under the older approach by the simple addition of a fixed dollar exemption. Deductions in excess of 80% of adjusted gross income plus \$5,000, for example, could be the amount restored to income. Thus, of an adjusted gross income of \$100,000 with four personal exemptions, a taxpayer could shelter 89% (\$80,000 + \$5,000 + \$4,000) with itemized deductions, but of an adjusted gross income of \$500,000, only 81.8% (\$400,000 + \$5,000 + \$4,000) could be sheltered. In sum, the alternative tax is totally unnecessary and a better result could be achieved by a modification of taxable income.⁵⁸

D. The Combined Effect of Both Preferences

Analysis of the alternative tax when only one preference item is present suggests that the tax is neither necessary in principle nor properly constructed in practice. If there is any redeeming merit to the tax it must come from some uniquely appropriate pattern of taxation that emerges when *both* items of preference are present. No such advantage of the alternative tax exists, however. Except for the relatively minor consequences of the progressive rate structure of the alternative tax, the penalty imposed when both preferences are present is merely the sum of the penalties that would be imposed on the separate preferences.

When both preferences are present, the alternative tax base will equal 40% of adjusted gross income less the favored deductions, all less the personal exemptions, and increased by 60% of capital gains. This is simply the formula for computing the alternative tax base in the presence of adjusted itemized deductions increased by the amount of the untaxed capital gain. It initially might appear that the effect of the

58. If an alternative tax liability is incurred by a taxpayer because of adjusted itemized deductions, the penalty is not limited to the claiming of those deductions. While the alternative tax might appear to exempt the claiming of favored deductions, in fact those deductions are penalized almost as heavily as are all other itemized deductions. In this circumstance the alternative tax base will equal 40% of adjusted gross income less the favored deductions, all reduced by the personal exemptions. See note 54 *supra*. Thus, incurring one additional dollar of a favored deduction will reduce the alternative tax base by only 40 cents. Since the maximum alternative tax rate is 25%, the maximum tax benefit that can be obtained from a favored deduction under the alternative tax is 10% (40% of 25%) of the amount of an expenditure. For example, a taxpayer having an adjusted gross income of \$200,000 and total deductions (and personal exemptions) of \$171,900 will have a taxable income of \$31,500. While his regular tax marginal bracket rate would be 37%, in fact he would be subject to the alternative tax at the 20% rate. If the taxpayer claims an additional medical expense deduction of one dollar, he will reduce his alternative tax liability by only 8 cents (\$1 x 40% x 20%). Since the tax benefit that he would have obtained under the regular tax would have been 37 cents, the alternative tax has withdrawn nearly 80% of the tax benefit attributable to this "favored" deduction.

resulting alternative tax would be to prevent the reduction of taxable income below some fraction of the sum of adjusted gross income⁵⁹ plus the untaxed capital gains, such fraction varying only with income. Such income variance would thus resemble the case of the taxpayer having adjusted itemized deductions but no capital gains. The effect of having both preferences, however, is not that simple.

The alternative tax does not reduce adjusted itemized deductions and capital gains to fungible commodities in the same manner that the regular income tax reduces income from various sources to equivalent values that may be added to produce the tax base. Rather, the preferences have quite different impacts and, as a result, a given level of adjusted gross income plus untaxed capital gains can produce a wide range of alternative taxes depending upon the mix of ordinary income and capital gains.⁶⁰

The effect of the alternative tax when both preferences are present can best be understood by tracing the effect of claiming increasing amounts of itemized deductions by a taxpayer having substantial capital gains. As seen above,⁶¹ as the itemized deductions begin to exceed the taxpayer's ordinary income and shelter the capital gains from tax, the taxpayer will begin to incur an alternative tax penalty. The penalty incurred is the partial loss of the tax benefit from the itemized deductions. Additional deductions will result in not only a reduction of the alternative tax liability, but also a widening of the gap between the alternative tax and the regular tax and thus an increase in the penalty. When the amount of itemized deductions becomes so large as to become adjusted, the alternative tax base will become fixed. If the taxpayer had no capital gains, he would still not be subject to an alternative tax penalty. Even though the alternative tax base was fixed at 40% of adjusted gross income (less the favored deductions), the regular tax would continue to exceed the alternative tax until the itemized deductions offset approximately 90% of adjusted gross income. However, since the alternative tax already exceeds the regular tax because of the penalty attributable to the capital gain, the taxpayer may not further reduce his tax liability with itemized deductions.

59. Less the favored deductions and personal exemptions.

60. For example, a taxpayer having adjusted itemized deductions and a capital gain of \$50,000 and an AGI of \$170,000 will have a total of AGI plus untaxed capital gains of \$200,000. If the taxpayer has favored deductions of \$17,000 and four personal exemptions, his alternative tax base will be \$87,200, or 43.6% of AGI plus untaxed gains. However, were the capital gain \$150,000, AGI \$110,000, and favored deductions \$11,000, the total of AGI plus untaxed gains would still equal \$200,000 but the resulting alternative tax base would be \$125,600 or 62.8% of \$200,000. As appears from the foregoing illustration, the penalty imposed with respect to capital gains is far more severe than is the penalty imposed with respect to adjusted itemized deductions.

61. See text accompanying note 41 *supra*.

The level of income at which this point is reached is dependent upon the proportion of the income that consists of capital gains. If the gains are very small, the alternative tax will, of course, approach the tax imposed with respect to adjusted itemized deductions alone. As the proportion of capital gains increases, the alternative tax is progressively increased by the penalty attributable to the capital gain.

Thus, the alternative tax in the presence of both preferences is nothing more or less than the sum of the taxes that would be imposed independently, slightly increased by the progressivity of the alternative tax rates. The equitable impact of the alternative tax is not improved in the least when the tax is applied to both preferences.

In fact, when both preferences are present, the alternative tax creates a distorted pattern of taxation that penalizes capital gains far more harshly than Congress probably intended. Whenever a taxpayer has more expenses than he is entitled to deduct fully because of a limitation related to income, the addition of income will not produce a tax at the taxpayer's normal tax rates. Under a provision similar to the 50% ceiling proposed in 1969, for example, the addition of one dollar of ordinary income would permit the deduction of an additional fifty cents attributable to the preference. Thus, if the restriction were applicable to a taxpayer, his receipt of additional ordinary income would, in effect, be subject to tax at only one-half of his normal rate. Under the alternative tax, the lower marginal rate on added income is partly the indirect consequence of becoming entitled to additional deductions and partly the direct consequence of the lower alternative tax rate structure.

The alternative tax base, it will be recalled, generally comprises the sum of (a) gross income less all deductions, (b) the untaxed 60% of capital gains, and (c) the amount of itemized deductions in excess of 60% of adjusted gross income less the favored deductions. The alternative tax schedule consists of four tax brackets ranging in rate from 10% to 25%. If a taxpayer is subject to the alternative tax but does not have adjusted itemized deductions, additional income will be subject to tax at the same rate, a maximum of 25%, regardless of whether it constitutes ordinary income or capital gains. Because of the addition of the untaxed portion of capital gains to the alternative tax base, both classes of income are fully subject to tax at the alternative tax rate.⁶² If the taxpayer has adjusted itemized deductions, however, the marginal rate of tax applicable to capital gains will be greater than the marginal rate

62. The only preference that remains for capital gains under the alternative tax is that the taxpayer is able to derive substantially larger amounts of capital gains income before arriving at the point at which the regular tax will again exceed the alternative tax. The addition of ordinary income, of course, will cause the regular tax to increase more rapidly than will the addition of capital gains.

applicable to ordinary income.⁶³ The receipt of an additional dollar of ordinary income would increase a taxpayer's alternative tax base by only forty cents—the income would be added in full to the tax base but at the same time would permit the deduction of an additional sixty cents of itemized deduction. As a result, the effective marginal tax rate becomes only 40% of the alternative tax rate of 25%, or 10%. An additional dollar of capital gain, on the other hand, will cause a one dollar increase in the alternative tax base (a forty cent increase in classical taxable income plus sixty cents untaxed capital gains preference). The gain will increase adjusted gross income by forty cents, thus permitting the taxpayer to deduct an additional amount of itemized deductions equal to 60% of that forty cent increase, or twenty-four cents. Thus, the net increase in the alternative tax base will be seventy-six cents (one dollar total increase minus twenty-four cents itemized deduction now allowable) if the added income is a capital gain rather than the forty cent increase that would occur if the income were ordinary.⁶⁴ Accord-

63. This somewhat surprising result can be illustrated by tracing the effect of independently adding one dollar of ordinary income and one dollar of capital gains to the computation of a taxpayer's alternative tax liability.

		Ordinary Income	Capital Gain
Ordinary Income	\$ 128,000	+1	
Capital Gain	180,000		+1
40% of Gain	72,000		+ .40
AGI	200,000	+1	+ .40
Itemized Deductions*	(130,000)		
Favored Deductions	(10,000)		
Personal Exemptions	(4,000)		
Net Amount	56,000	+1	+ .40
60% of Gain	108,000		+ .60
Itemized Deductions*	130,000		
Less: AGI	\$200,000	+1	+ .40
Favored Deductions	10,000		
	190,000	+1	+ .40
60% of [AGI - Favored Deductions]	(114,000)	(+ .60)	(+ .24)
AID	16,000	- .60	- .24
AMTI	180,000	+ .40	+ .76
Alternative Tax (Maximum Rate)	32,000	+ .10	+ .19

* Other Than Favored

64. This distortion occurs because the alternative tax simultaneously attacks both the offsetting of capital gains and the taking of excessive ordinary deductions. If the alternative tax did not require increasing the tax base by the amount of untaxed capital gains, the addition of one dollar of capital gains would increase the tax base by 40 cents while continuing to permit the additional deduction of 24 cents of itemized deductions. Thus, the net increase in the alternative tax base would be 16 cents, or 40% of the increase that would occur if the additional income were ordinary, and the relationship between these two classes of income would be preserved.

ingly, the maximum effective alternative tax rate applicable to an additional dollar of capital gains is 25% of 76%, or 19%, rather than the 10% that is applicable to ordinary income.

While the alternative tax was designed to penalize the sheltering of the taxable portion of capital gains with ordinary deductions, that objective does not justify imposing a higher rate of tax on capital gains than on ordinary income. Moreover, since the more general objective in adopting the alternative tax was to reduce the rate of tax to which capital gains were subject, it seems most unlikely that this result of the alternative tax was intended by Congress.

E. Credits

Although the alternative tax was designed to address the abuse of the capital gains exclusion and the excessive claiming of itemized deductions, the tax's effect on credits is often greater than that on itemized deductions. This exaggerated effect, naturally, is coupled with much complexity.

For the purpose of the alternative tax, the increasing number of tax credits are divided into four categories. The first category includes those credits that were left unimpaired by the new tax: the two credits that in effect discharge obligations of the United States to the taxpayer (the section 31 credit for withheld taxes and the section 39 credit for certain excise taxes) and the section 43 earned income credit, in effect a part of the rate structure. These three credits are disregarded in computing regular tax liability for purposes of comparison with alternative tax liability.⁶⁵ The general effect of this comparison is to permit the full amount of the credits to offset the alternative tax liability.

A similarly protective approach is adopted toward the foreign tax credit, analytically separable as a second category because of its complex modification before being offset against the alternative tax.⁶⁶

The credits comprising the remaining two categories may not be offset against the alternative tax.⁶⁷ As a result, a taxpayer subject to the alternative tax will obtain no current tax benefit at all from most credits. For example, assume that a taxpayer has an alternative tax liability precisely equal to his regular tax liability so that no penalty is incurred. If he then makes an expenditure for which a section 44A child care credit is allowable, his regular tax will be reduced by the amount of the credit but his alternative tax liability will be unaffected. As a result, a

65. I.R.C. § 55(b)(2).

66. I.R.C. § 55(c)(2). In general, a taxpayer is permitted to apply foreign tax credits against his regular tax, excluding the preference tax, enlarged by his alternative tax. The § 904 limitation is modified to become the ratio of the taxpayer's foreign source AMTI to his entire AMTI.

67. I.R.C. § 55(c)(1).

penalty equal to the full amount of the credit will be imposed, and he will have entirely lost the tax benefit of that expenditure.

This extreme harshness of the alternative tax is substantially ameliorated for certain favored credits for which carryovers of unused credits are permitted.⁶⁸ The entire amount of any such credits that do not provide a tax benefit in the current year because of the application of the alternative tax may be carried over and credited in another year.⁶⁹ Thus, the alternative tax merely requires the deferral of a tax benefit from these three credits rather than its complete elimination. The net penalty thereby imposed is merely the cost of the loss of the use of the amount of the credit for the relevant period of time.⁷⁰ Accordingly, the alternative tax penalty on these credits will generally be far less than the penalty upon itemized deductions.

In contrast to credits which cannot be carried over, a taxpayer will always obtain some tax benefit from the claiming of itemized deductions under the alternative tax until their aggregate amount exceeds 60% of adjusted gross income (less the favored deductions), that is, becomes "adjusted." Since this tolerance is lacking in the case of these credits, the effect of the alternative tax on credits will frequently be far more severe than its effect on the deductions that apparently were the primary target of the tax.

The effect of the alternative tax upon credits is in fact similar to the effect of the tax on the claiming of itemized deductions once the taxpayer has adjusted itemized deductions. In that event, a taxpayer in effect cannot reduce his classical taxable income below a percentage of adjusted gross income which ranges from 7% to 15%.⁷¹ The point at which the taxpayer will entirely lose the benefit of a credit, however, is

68. I.R.C. § 55(c)(3). As the alternative tax was originally enacted, the favored credits included only the § 44B new jobs credit, the § 40 work incentive program credit, and the § 38 investment tax credit. Revenue Act of 1978, Pub. L. No. 95-600, § 421(a), 92 Stat. 2763. One year later, however, this list of favored credits was expanded by the addition of two credits relating to energy conservation, one of the policies currently most popular in Congress: the existing § 44C residential energy credit, Technical Corrections Act of 1979, Pub. L. No. 96-222, § 104(a)(4)(G), 94 Stat. 194 (1980), and the newly added § 44E alcohol fuel credit, Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, §§ 232(b)(1), 232(b)(2), 94 Stat. 229.

69. I.R.C. § 55(c)(3).

70. The amount of the penalty imposed on these credits will vary from none to the complete elimination of any tax benefit. In many cases, no penalty at all will be incurred because the unused credit will merely be carried back and claimed for a prior year. At the other extreme, if the alternative tax caused the deferral of a carried-over credit from a previous year that would expire in the year in which the alternative tax was imposed, the effect would be to eliminate completely the tax benefit from the credit. Between these extremes, the effect of the tax is to accelerate the payment of tax. Thus, the cost to the taxpayer will be a function of his cost of borrowing and the number of years that the credit is deferred.

71. See text accompanying notes 57-58 *supra*.

at higher percentages of adjusted gross income over all levels of income.

This harsher treatment of credits can be illustrated by comparing the effect of the alternative tax on adjusted itemized deductions with its effect on the extreme case of a taxpayer having no itemized deductions at all but sheltering his income with credits. In connection with the analysis of adjusted itemized deductions, we hypothesized an individual having adjusted gross income of \$100,000, favored deductions of \$10,000, and four personal exemptions. This taxpayer could claim itemized deductions of up to \$78,633. His taxable income would be \$10,767 (classical taxable income of \$7,367 plus the non-deductible \$3,400 zero bracket amount) and his tax would be \$1,200. Because his alternative tax base of \$7,367 plus adjusted itemized deductions of \$24,633, or \$32,000, would also produce a tax of \$1,200, the taxpayer would not be subject to the alternative tax.

Had the taxpayer claimed no itemized deductions other than the favored deductions, but rather made expenditures producing tax credits, his alternative tax base would consist of his classical taxable income of \$86,000 and his alternative tax would be \$9,200. Since that tax liability cannot be affected by the claiming of credits, the taxpayer could obtain the tax benefit of credits only until his regular tax were reduced to \$9,200 and any further credits would be permanently lost. A regular tax of \$9,200 is payable on a taxable income of \$37,614. Thus, while the taxpayer would be entitled to reduce his adjusted gross income through deductions by 92.6%, in effect he could reduce it through credits by only 62.4%.

A similar relationship prevails at all income levels. A taxpayer having adjusted gross income of \$50,000 cannot be subject to an alternative tax by virtue of itemized deductions even if he could completely eliminate his regular tax. However, he could not reduce his tax below \$2,100 through tax credits. At an adjusted gross income of \$500,000, a taxpayer can reduce his taxable income with itemized deductions to \$80,967, producing a tax of \$31,000 before incurring an alternative tax liability that cannot be further reduced. However, he cannot reduce his tax below \$98,500 with credits, the equivalent of a taxable income of \$187,453, without incurring an alternative tax.

In the example set forth above, an alternative tax liability was incurred even though the taxpayer did not have any capital gains or adjusted itemized deductions. Accordingly, and perhaps somewhat surprisingly, one effect of the alternative tax is to impose a penalty solely upon the claiming of tax credits. There is no indication in the legislative history to the alternative tax that such a penalty was in-

tended.⁷²

This result may have been an unavoidable side-effect. Nevertheless, the treatment of tax credits as preferences and restricting the amount of such preferences that may be claimed would be entirely appropriate in a properly conceived attack on preferences, since credits generally are purely policy-executing provisions unrelated to the equitable computation of the burden of taxation. However, because of the quite different ways in which deductions and credits affect the computation of taxable income, it may well be that no single form of penalty can be fashioned that would appropriately limit both forms of allowances. The 1969 ceiling on preferences, for example, would not have affected the claiming of credits at all. That provision, however, could quite easily have been supplemented with a limitation on the proportion of the tax that could be offset by all, or a specified group, of credits.⁷³

III

A NOTE ON COMPLEXITY

In spite of the increased concern that has been expressed in recent years over the complexity of the tax laws, the Code has continued to become more complex. Much of that complexity is amply justified by the inherent complexity of the subject matter addressed. It seems unlikely, for example, that the tax avoidance potential of generation-skipping trusts could equitably have been addressed by a provision much simpler than the present chapter thirteen of the Code.⁷⁴ Similarly, the

72. See 1978 HOUSE REPORT, *supra* note 39, at 122-24; 1978 SENATE REPORT, *supra* note 26, at 200-07. With the debatable exception of the § 44A child care credit, tax credits are purely tax incentive provisions wholly unrelated to the equitable computation of taxable income. Accordingly, there can be no objection on equitable grounds to the reduction or elimination of such a credit, or to a greater reduction in one credit than in another, as long as the reduction itself is effected in a manner that does not unjustly favor one class of taxpayers. On the other hand, many of the itemized deductions that are penalized by the alternative tax, such as those provided by § 212, are not merely policy-executing provisions but rather are integral to the equitable computation of taxable income. It might be questioned whether any limitation of the tax benefit attributable to such allowances is appropriate. Regardless of the resolution of that doubt, however, it would seem clearly inappropriate to penalize nonpreferential, equitably required deductions more heavily than purely preferential, policy-executing credits. Yet, the alternative tax does precisely that in providing more favorable treatment to the employment and investment enhancing credits (which can be carried over) than to deductions necessary to the integrity of the computation of taxable income.

73. One further side-effect of the adoption of the alternative tax deserves note. The removal of these preferences from the existing minimum tax quite commonly will reduce the impact of the preference tax on the remaining preference items. The exemption that previously might have been exhausted by the capital gains preference will not be available to shelter the remaining preferences. Thus, the deletion of these two preference items has not only reduced the penalty applicable to those items, but has substantially reduced the penalty applicable to all preferences.

74. I.R.C. §§ 2601-2622.

hard fought political compromise that produced the windfall profits tax necessarily required complex statutory definition.⁷⁵ On the other hand, the complexity of the alternative tax is quite unnecessary and therefore highly objectionable.

The very existence of a duplicate income tax is an obvious source of complexity in the law. That complexity could be justified if the alternative tax were a clearly superior approach to restricting the excessive concentration of tax preferences. This Article has undertaken to demonstrate, however, that results comparable to those obtained under the alternative tax could have been obtained far more simply by directly amending the computation of taxable income. Moreover, the simpler proposals made in past years could have been adapted to produce results far more equitable than those reached by the alternative tax.

Not only is the existence of the alternative tax an unnecessary source of complexity in the law, but the manner in which the tax operates is also needlessly complex. Under the alternative tax, deductions and credits are divided into seven different categories producing a multitude of different limitations that range from the slight to the severe on the tax benefits of these allowances. It seems improbable that any objective of the alternative tax requires such a complex mosaic.

This complex pattern of restrictions is particularly objectionable because the complexity was created solely for the purposes of the alternative tax. It may be assumed that Congress created these distinctions among tax allowances in an effort to improve the equitable impact of the new tax. But the differences in importance or preferential character among the various allowances is not nearly as great as are the differences in tax consequence among the several categories. Arguably, perhaps, the policies underlying the credits for which carryovers are preserved are stronger than the policies underlying the remaining credits. Yet it seems unlikely that the policies are so much stronger that one credit should be entirely disallowed if an alternative tax is payable, while another is merely postponed for a year or more. The arbitrariness of this disproportionate impact of the alternative tax is aggravated by the process of assigning the various tax allowances to the several categories. Ranking the relative importance of the tax allowances that have been added to the law over time necessarily requires making difficult value judgments grounded in minimal factual bases. Certainly, many could dispute the rankings made by Congress in the alternative tax, and one amendment to that ranking has already occurred.⁷⁶ Un-

75. Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, 94 Stat. 229.

76. See note 68 *supra*.

fortunately, while the distinctions may be subtle and debatable, the tax consequences are considerable.

Finally, at least some of the tax consequences seem highly inappropriate, if not arbitrary. It seems unlikely, for example, that Congress affirmatively desired to eliminate all tax benefit from the claiming of certain tax credits if an alternative tax was payable, in view of the milder penalty imposed on all itemized deductions. Rather, one suspects that Congress accepted that result because of an inability to deal more precisely with the effect of the tax on credits. As a result of all of these distinctions and their varying consequences, the resulting pattern of taxation appears almost random and certainly so arbitrary as not to be worth the complexity created.⁷⁷ The distinctions drawn are far more likely to enrage a taxpayer seeking to understand the consequences of his transactions than to reassure him that the equity of the taxing system is being furthered.

CONCLUSION

There was really no reason to expect the alternative tax to produce an equitable redress of the abuse of tax preferences. The measurement of two differently defined taxpaying capacities with two different yardsticks is hardly designed to produce comparable results. The roots of the alternative tax and its unsatisfactory impact unquestionably lie in the insistence by the Senate in 1969 that the concentration of tax preference be addressed outside of the existing taxing system. In retrospect that decision seems clearly wrong. The impact of the preference tax was, and is, inequitable, and the alternative tax has greatly exaggerated those defects.

This criticism is not intended to suggest that the resolution of the problem faced by Congress in 1969, and still present today, was easy or evident.⁷⁸ That resolution requires identifying a relatively simple

77. The alternative tax may also be undesirable because of its inflexibility. A change in the tax rate, for instance, has many conflicting consequences. It would reduce the proportion of AGI that could be sheltered with itemized deductions, which might be desirable. However, it would also produce a penalty, or a greater penalty, on unsheltered capital gains, which might not be desirable. Moreover, while the total penalty attributable to capital gains would be increased, the incremental penalty upon claiming additional deductions would actually be reduced, as the difference between the regular and alternative tax rates would be reduced.

78. Indeed, there may not be any one form that is perfect. The LAL approach, *see* note 8 *supra*, of limiting the claiming of preferences to the income from the activity in which the preference was claimed had several desirable features. Most significantly, this restriction would have affected ventures undertaken primarily for tax sheltering purposes far more heavily than ventures entered into for economic profit, and thus the attack was more focused upon the abuse. However, for the same reasons, the LAL might have favored established business at the expense of small or new business and thus might have been anticompetitive. Further, the LAL could have encouraged the restructuring of business activities to avoid its limitation. Not only is it undesirable

mechanism¹ for curtailing the excessive use of preferences without too greatly undermining the incentives that those preferences were designed to create.

Nevertheless, there cannot be any legitimate doubt that a serious effort to restore a measure of equity to the tax laws must begin by restoring a measure of integrity to the computation of taxable income. Since the excessive concentration of tax preferences results from the excessive reduction of taxable income through these preferences, the most logical avenue of redress is a direct limitation on the aggregate amount of preferences that any single taxpayer can claim.

Unfortunately, two different approaches operating outside of the basic taxing system have now been tried. Neither is satisfactory. Perhaps it is now apparent that to restrict equitably and rationally the excessive use of tax preferences, Congress should repeal these misguided efforts and reconsider more direct limitations on the amount of preferences that may be claimed.

for the tax law to affect business organization, but those efforts undoubtedly would have precipitated a complex set of rules defining separate activities.