TO PRAISE THE AMT OR TO BURY IT

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TABLE OF CONTENTS

I.	INTRODUCTION	835
II.	THE AMT – AN OVERVIEW	838
III.	THE CURRENT RUSH TOWARDS REFORM OF THE AMT	844
IV.	THE AMT – AN EVALUATION	
	A. The Dual System	847
	B. The Large Exemption Amount	850
	C. Flat Rate Tax	850
	D. Base Broadening	
	E. Personal Exemptions for Dependents	
	F. Business and Investment Provisions: Timing of	
	Deductions and Allowance of Credits	854
V	CONCLUSION	859

I. INTRODUCTION

The alternative minimum tax (AMT) has recently become a cause celebre because many more taxpayers are now subject to it than originally envisioned at the time of its enactment in 1969 (and, indeed, than after any of its several modifications over the years).¹ As such, it

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¹ According to the Congressional Budget Office, prior to 2000 less than 1% of

836

Virginia Tax Review

[Vol. 24:835

has been discussed and criticized in the press and by tax professionals and academics, most recently in Tax Notes by four former Internal Revenue Service (Service) commissioners who advocated scrapping it entirely.² The American Bar Association expressed similar views in early 2004 when it recommended that "Congress reduce the federal tax burdens and compliance costs attributable to the Alternative Minimum Tax on individuals by repealing the individual AMT.³ The AMT was also the subject of a Revenue and Tax Policy Brief by the Congressional Budget Office in April 2004.⁴ The criticism has questioned the wisdom of the inadvertent expansion of the AMT in coverage, that is, the number of taxpayers who will be subject to it.⁵ This expansion of the AMT's coverage has largely resulted from the reduction in rates of the regular tax without a concomitant reduction in rates of the AMT.⁶ The focus of the recent discussion of the AMT, however, has been on a glass half empty instead of on a glass half full.

The recently advocated "reform" of simply scrapping the AMT would leave the regular tax, with all of its defects, intact, without mitigation by the AMT. On the other hand, merely modifying the

³ Richard A. Shaw, *Report to the House of Delegates*, 2004 A.B.A. SEC. ADMIN. LAW AND REG. PRAC. 1 (2004), *at http://www.abanet.org/leadership/2004/annual/120.doc*.

⁵ Other criticisms of the AMT include doubts as to "whether the AMT achieves its policy objectives, the extreme complexity of the system, its lack of administrability, [and] the presence of horizontal inequities." Stewart S. Karlinsky, *A Report on Reforming the Alternative Minimum Tax System*, 12 AM. J. TAX POL'Y 139, 149 (1995).

⁶ Analysts also suggest that another major reason for the expansion of AMT coverage is the fact that the AMT is not indexed for inflation, while the regular income brackets are adjusted annually for inflation. THE ALTERNATIVE MINIMUM TAX, *supra* note 1.

all taxpayers in any year were subject to the AMT. However, under current law, the AMT is expected to expand exponentially in the years to come, and it is projected that the AMT will affect approximately 20% of all taxpayers by 2010. CONG. BUDGET OFF., REVENUE AND TAX POLICY BRIEF, THE ALTERNATIVE MINIMUM TAX, No. 4 (April 15, 2004) [hereinafter THE ALTERNATIVE MINIMUM TAX]. For additional information, see Burman et al., *infra* note 54 and accompanying text.

² Allen Kenney, *Former Commissioners Say It's Time to Scrap AMT*, 103 TAX NOTES 1466 (June 21, 2004). Former Service Commissioners Fred Goldberg and Sheldon Cohen explicitly stated that they recommended eliminating the AMT. Former commissioners Donald Alexander and Mortimer Caplin appeared with Goldberg and Cohen.

⁴ THE ALTERNATIVE MINIMUM TAX, *supra* note 1. The brief considers the complexity and projected growth of the AMT, concluding that the AMT imposes costs on both taxpayers and the economy as a whole, and suggests that "[t]he simplest way to deal with the growth of the AMT would be to eliminate the alternative tax entirely." *Id.* at 6–7.

2005]

To Praise the AMT or to Bury It

AMT would leave us with a dual system, with all of its needless complication. These are not the only choices, however. A fairer and better income tax could be achieved by eliminating the dual system and incorporating the core principles of the current AMT into the income tax.⁷

In actuality, the current tax system is not a pure income tax but rather is more accurately characterized as a hybrid of an income tax and a consumption tax.⁸ Under this view, a fairer and better tax system also can be achieved by eliminating the dual system but incorporating most but not all of the core principles of the current AMT into the basic tax system. Specifically, the business and investment provisions of the current AMT would be abandoned. This idea is explored in greater detail later in this article.

Regardless of whether the goal is to refine the tax system into a better income tax, or into a better income tax-consumption tax hybrid, principles of the AMT should be preserved in the basic system. To simply throw out the AMT without at least saving some of the provisions that reflect its core principles would represent a significant step backwards in tax reform. Ultimately, however, determining which of the AMT's provisions reflect core principles in the tax system depends upon the nature of the tax system that is desired — an income tax or an income tax-consumption tax hybrid.

The analysis in this Article begins in Part II by briefly reviewing the history, goals, and operation of the AMT. Part III then explains why the AMT has suddenly risen to the prominence it now has. Part IV evaluates the AMT by dissecting it into its core principles and discussing each of those principles, with special attention given to the business and investment tax provisions of the current AMT. Part V provides a recommendation to incorporate all but the business and investment principles of the AMT into the regular tax and suggests that pursuing that recommendation will achieve a fairer and better tax system than simply eliminating the AMT, as has been proposed.

⁷ Other academics agree that one of the best solutions would be to "[r]epeal the corporate and individual AMT system and incorporate the desired provisions and limitations [of the AMT] directly into the regular tax system," which would have the result of retaining the benefits of the AMT without the unnecessary complexity of the dual system. Karlinsky, *supra* note 5, at 151.

⁸ See Daniel S. Goldberg, *The U.S. Consumption Tax: Evolution, Not Revolution,* 57 TAX LAW. 1 (2003).

[Vol. 24:835

II. THE AMT - AN OVERVIEW

The AMT was originally enacted in 1969 to ensure that those taxpayers with substantial economic income who made use of special "tax shelter" preferences like accelerated depreciation, depletion, and other special tax incentive deductions⁹ in order to reduce or to eliminate their regular tax liability would be required to pay at least some minimum amount of tax.¹⁰ So was born the AMT, with the stigma of tax abuser attached to those who fell within it.

In its first incarnation, the AMT was an "add-on" minimum tax; its structure provided that certain tax preferences (which included preferentially taxed long-term capital gains), after reduction by an exemption amount, were subject to a separate surcharge which was payable in addition to the regular \tan^{11} . The surcharge tax rate, originally 10%, was increased to 15% in 1976, at which time new preferences were added, including one for a portion of some taxpayers' itemized deductions, and the exemption amount was reduced.¹² In 1978, Congress introduced an alternative minimum tax for taxpayers other than corporations to supplement the add-on version, into which it moved the preference for capital gains.¹³ In 1982, the alternative minimum tax replaced the add-on minimum tax entirely for taxpayers other than corporations.¹⁴ The 1986 Tax Reform Act expanded the potential tax base to all taxpayers¹⁵ and replaced a three tier rate structure with a single 21% rate for a taxpayer other than a corporation,¹⁶ which was increased in 1991 to

⁹ Over the years, this list (which covers both items of "tax preference" under section 57 of the Internal Revenue Code (Code) and adjustments under section 56) was expanded as new tax incentive provisions were enacted to include other preferences such as the spread between the value and cost of stock obtained through exercise of an incentive stock option (section 56(b)(3)), interest on private activity state or municipal bonds (section 57(a)(5)), and others. *See generally* I.R.C. §§ 56, 57.

 $^{^{10}}$ See 4 Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts ¶ 114.1.1, at 111-89 (2d ed. 1992).

¹¹ *Id.* at 111-89 to 111-90. Hence, the original AMT was a tax imposed in addition to regular tax liability, unlike today's variety, which is imposed in lieu of the regular tax for those subject to it. *Id.*

¹² *Id.* at 111-90.

¹³ *Id*.

¹⁴ *Id.* at 111-90 to 111-91.

¹⁵ *Id.* at 111-91.

¹⁶ Tax Reform Act of 1986, Pub. L. No. 99-514, § 701, 100 Stat. 2085, 2321 (1986).

2005]

To Praise the AMT or to Bury It

839

 $24\%^{17}$ and modified again in 1994 as a result of the tax legislation of 1993 to a two-tier rate structure with rates of 26% and 28%.¹⁸

The original purposes for enacting a minimum tax of ensuring a tax system that was fair and, perhaps more importantly, was perceived as fair, remain essentially its general purposes today.¹⁹ The nature of the tax, however, and means of accomplishing its purposes have undergone varied and inconsistent thinking during the long history of the AMT. At times, as in 1969, the AMT appeared to be most concerned with high-income people who used tax preferences to avoid paying any income tax.²⁰ This theme reappeared during the various modifications of the AMT, including 1986,²¹ but at times has expanded into an attempt at base broadening to be applicable to all individuals, regardless of their success at eliminating their tax liability completely under the regular tax.²² The leading commentators on the AMT acknowledge this schizophrenia in the objectives of the AMT, but find justification for an AMT, although not necessarily the present

¹⁷ Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11,102, 104 Stat. 1388, 1388–406 (1990).

¹⁸ Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13,202, 107 Stat. 312, 461–62 (1993) (codified at I.R.C. § 55(b)(1)(A)).

¹⁹ See THE ALTERNATIVE MINIMUM TAX, *supra* note 1; 4 BITTKER & LOKKEN, *supra* note 10, at 111-89.

²⁰ "In 1966, 154 individuals with adjusted gross incomes exceeding \$200,000 succeeded in entirely eliminating any income tax liability by extensive use of allowances authorized by the Code...." 4 BITTKER & LOKKEN, *supra* note 10, at 111-88. The ability of high income individuals to evade tax through means of legal exemptions was perceived as unfair, and a major threat to taxpayer morale. *Id.* at 111-89. The Senate Finance Committee addressed the issue, acknowledging that loss of taxpayer morale could threaten the government's ability to collect necessary revenues, but fearing that repeal of tax allowances would create economic dislocations. *Id.* As a compromise, a minimum tax on tax preferences was enacted in 1969. *Id.*

²¹ See Staff of Joint Comm. on Taxation, 99th Cong., General Explanation of the Tax Reform Act of 1986, at 432–33 (Joint Comm. Print 1987).

²² *Id.* at 430–32 (listing "tax preference items that were added to the adjusted gross income base"). When the alternative version of the AMT replaced the add-on version entirely for individuals in 1982, it was expressly stated by the Joint Committee that "[t]he only deductions allowed, other than costs of producing income, are for important personal or unavoidable expenditures (housing interest, medical expenses and casualty losses) or for charitable contributions, the deduction of which is already limited to a percentage of adjusted gross income." STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, at 17–18 (Joint Comm. Print 1982).

[Vol. 24:835

incarnation, as a means of balancing these objectives with Congress's desire to use the income tax to encourage investments or other activities deemed desirable for society.²³ The balancing of these competing goals has not been easy, as the unstable history of the AMT demonstrates.

The current AMT is a tax system that runs parallel to the regular tax system. The AMT uses a broader base than the regular tax, called alternative minimum taxable income (AMTI);²⁴ it starts with the concept of gross income, but does not allow deductions for various expenditures for which deductions are allowed under the regular tax²⁵ and requires inclusion for some receipts that are excluded from income under the regular tax.²⁶ The calculation provides a subtraction for an exemption amount, which subtraction has the effect of allowing an amount of AMTI to not be subject to AMT.²⁷ The resulting AMTI is subjected to a virtually flat rate of tax at the nominal rates of 26% and 28%.²⁸ Importantly, the exemption amount is phased out for higher income individuals.²⁹ As a result, the flat rate is somewhat

²⁷ See I.R.C. § 55(d).

²⁸ See I.R.C. § 55(b)(1) (applying the 26% rate to the first \$175,000 of AMTI and the 28% rate to amounts in excess of \$175,000). But see I.R.C. § 55(d) (giving exemption amounts). A lower tax rate is applied to net capital gain, however. I.R.C. § 55(b)(3).

²⁹ See I.R.C. § 55(d) (exempting the first \$58,000 from AMTI for a married couple filing a joint return or a surviving spouse, \$40,250 for an unmarried individual, and \$29,000 for a married individual filing separately). These amounts are scheduled to decrease in future years to \$45,000 for a married couple filing a joint return or a surviving spouse and \$33,750 for an unmarried individual, although this decrease was recently delayed under the Working Families Tax Relief Act of 2004, which extended the higher exemption amounts through 2005. Working Families Tax Relief Act of 2004, Pub. L. 108-311, § 103, 118 Stat. 1166 (2004). These exemption amounts are phased out for higher income taxpayers, that is, married, joint-filing taxpayers (or a surviving spouse taxpayer) whose income exceeds \$150,000 (\$75,000 for married individuals filing separately) and \$112,500 for an unmarried individual, at the rate of 25% of the taxpayer's AMTI in excess of those amounts. I.R.C. § 55(d)(3).

²³ Michael J. Graetz & Emil M. Sunley, *Minimum Taxes and Comprehensive Tax Reform*, *in* UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME-CONSUMPTION TAX 385, 387–88 (Henry J. Aaron et al. eds., 1988).

²⁴ 4 BITTKER & LOKKEN, *supra* note 10, at 111-92.

²⁵ See generally I.R.C. § 57.

²⁶ See, e.g., I.R.C. § 57(a)(5) (requiring inclusion of interest on private activity state or municipal bonds, which is exempt under the regular tax). The actual computation on the tax return, in simplified form, starts with regular taxable income, adds back (or subtracts, as the case may be) adjustments under sections 56 and 58, and adds back items of tax preference under section 57. I.R.C. § 55(b)(2).

illusory, because the phase-out of the exemption amount has the effect of creating additional marginal AMT brackets of 32.5% and 35%.³⁰ Computationally on the tax return, the AMT tax rates of 26% and 28% are applied to AMTI and the regular tax is subtracted to arrive at the AMT "additional tax."³¹

For everyday, non-tax sheltered individuals under the current AMT, the most significant inclusions in the alternative minimum taxable income computation that are deductible under the regular income tax computation (technically called "adjustments") are (1) the taxes deductible on schedule A (state income tax, real estate tax, etc.),³² (2) interest on home equity indebtedness,³³ (3) miscellaneous itemized deductions that survive the 2% floor under the regular tax,³⁴ and (4) the deduction for personal and dependency exemptions.³⁵ Other individual adjustments, such as the standard deduction, which is disallowed under the AMT³⁶ but permitted under the regular tax,³⁷ and a lesser medical expense deduction available under the AMT than under the regular tax,³⁸ can trigger an AMT liability.³⁹ These

³³ I.R.C. § 56(b)(1)(C)(i). Home equity indebtedness interest represents an even stronger example of a deductible personal living expense under the regular tax, because the interest is generally regarded as an additional cost of consuming the personal benefit purchased with the loan proceeds. Under the regular tax, it represents a carve-out from otherwise nondeductible personal interest. I.R.C. § 163(h)(2)(D), (h)(3). If the indebtedness proceeds can be traced to a profit-seeking activity, however, the interest would be treated as an expense of that activity and deductible, subject to the limits that may be applicable to that activity, such as the limit on deductibility of investment interest and the passive activity loss limitations. I.R.C. §§ 163(d), 469(h).

 34 See I.R.C. § 56(b)(1)(A)(i) (disallowing all miscellaneous itemized deductions).

³⁷ I.R.C. § 63(b).

³⁰ See Leonard E. Burman, An Analysis of the 2004 House Tax Cuts, 103 TAX NOTES 1635, 1638 n.3 (June 28, 2004).

 $^{^{31}\,}$ I.R.C. § 55(a). A subtraction is permitted for certain credits under the AMT as well. *See, e.g.*, I.R.C. § 59.

 $^{^{32}}$ I.R.C. § 56(b)(1)(A)(ii). State and local taxes and real property taxes, even though involuntary once incurred, result from the personal choice of where the taxpayer chooses to live and the purchase of state and local government services that the choice reflects. These taxes purchase education services, sanitation services, police and fire protection in everyday (as opposed to business) life, all of which would be classified as personal consumption. Indeed, these are purchased by tenants with non-deductible after-tax dollars as part of their rent.

³⁵ I.R.C. § 56(b)(1)(E).

³⁶ *Id*.

³⁸ Section 213(a) permits a deduction for medical expenses in excess of 7.5% of

[Vol. 24:835

differences between the AMT and the regular tax have nothing to do with tax shelters.⁴⁰

There are several other adjustments and preferences, generally designed to eliminate business and investment tax incentive provisions from the AMTI computation.⁴¹ These provisions in the AMT

⁴⁰ See STAFF OF JOINT COMM. ON TAXATION, *supra* note 22, (expressing the view that these expenditures are regarded as personal but not "unavoidable").

 $^{\rm 41}$ Additional adjustments in the AMT that serve to reduce a taxpayer's deductions include:

(1) Different treatment of depreciation deductions, resulting in a smaller deduction under section 56(a)(1);

(2) Mining exploration and development costs are not deductible in the year incurred, but are amortized according to specific schedules under section 56(a)(2);

(3) Companies must compute a special AMT net operating loss to take a net operating loss deduction under section 56(a)(4);

(4) Costs of pollution control facilities must be deducted under the AMT's alternative depreciation system or by using the straight-line depreciation method, rather than as amortized deductions under section 56(a)(5);

(5) Circulation expenditures and research and developmental expenditures must be deducted over time via amortization deductions rather than as same-year deductions under section 56(b)(2);

(6) Certain corporate deductions for capital construction funds and insurance companies are disallowed under section 56(c)(2), (3);

(7) Tax shelter farm activity losses are disallowed under section 58(a);

(8) Different formulae for computing disallowed passive losses under section 58(b);

(9) Different treatment of long term contracts under section 56(a)(3);

(10) Gains and losses from the sale or exchange of property are treated differently, with the adjusted basis of an asset being determined based on the amount of deductions permitted for AMTI purposes under section 56(a)(6);

adjusted gross income while section 56(b)(1)(B) only permits a deduction for medical expenses in excess of 10% of adjusted gross income. I.R.C. §§ 56(b)(1)(B), 213(a).

³⁹ Additionally, interest on any specified private activity bond, and any deduction allowed under section 57(a)(5)(A) (tax exempt interest for "specified private activity bonds reduced by any deduction....which would have been allowable if such interest were includable in gross income") is treated as includable in gross income. I.R.C. § 56(b)(1)(C)(iii).

sometimes have the effect of disallowing or deferring deductions for certain business and investment expenditures in the AMT that are deductible under the regular tax or accelerating income in the AMT. For example, as an adjustment, an alternative system of depreciation is used for AMT purposes, and it prescribes a slower recovery rate than under the regular tax.⁴² Similarly, individuals who exercise incentive stock options (ISOs) can be subject to AMT coverage because the bargain purchase element (value of the stock less the exercise price) is an adjustment under the AMT,⁴³ although it is non-taxable under the regular tax.⁴⁴ As a result, during the dot-com boom, ISOs were a significant trigger for the AMT.⁴⁵

Most of the differences relating to business and investment are in the nature of timing benefits in the regular tax that are curtailed in the AMT⁴⁶ rather than items that are deductible under the regular tax but are simply not deductible under the AMT.⁴⁷ The timing adjustments, to the extent that they create an AMT liability, also create an AMT credit available to offset future regular income tax.⁴⁸ But the

⁴² I.R.C. § 56(a)(1). Also, the accelerated portion of depreciation is added back in the AMTI computation, as a preference, on property placed in service before 1987. I.R.C. § 57(a)(6).

⁴³ I.R.C. § 56(b)(3).

⁴⁴ I.R.C. §§ 421, 422.

⁴⁵ The exercise of an ISO is not recognized as income to the employee. I.R.C. \$ 421(a). Under the AMT, however, ISOs are treated as a tax preference item, and thus the bargain element of the exercise of each stock is included in the AMT base. I.R.C. \$ 56(b)(3). Hence, taxpayers may be subject to "unrealized paper profits" on their ISOs under the AMT, even if there has been no event of realization under the Code. Agnes Gesiko, *The Taxation of Phantom Profits under the Alternative Minimum Tax*, 26 S. ILL. U. L.J. 443, 444 (2002).

⁴⁶ See, e.g, I.R.C. § 56(a)(1) (dealing with depreciation).

⁴⁷ Even the deduction for research and experimental expenses under section 174, for which no deduction is allowed under the AMT for those individual taxpayers who do not materially participate in the activity within the meaning of section 469(h), is in the nature of a timing benefit, because the AMT allows amortization of the capitalized research expense over ten years. I.R.C. § 56(b)(2)(A)(ii), (D).

⁴⁸ See I.R.C. § 53.

⁽¹¹⁾ The alcohol fuel credit is not applicable (i.e. alcohol fuel credit may not be used to offset the AMT liability) under section 56(a)(7);

⁽¹²⁾ Incentive stock options are treated differently in that ISOs are essentially treated as NSOs for AMT purposes under section 56(b)(3).

James E. Maule & Lisa M. Starczewski, 503-2nd T.M., *Deductions: Overview and Conceptual Aspects* A-27 (2000); Lisa M. Starczewski, 587 T.M., *Noncorporate Alternative Minimum Tax* A-5 (2002).

[Vol. 24:835

adjustments for non-business, non-investment expenses enumerated earlier, which involve more than mere timing, create extra tax without any future credit or offset.⁴⁹

III. THE CURRENT RUSH TOWARDS REFORM OF THE AMT

As long as the AMT was relegated to a backwater of the tax law, applicable to only a relatively small number of individual taxpayers who made use of tax shelter preferences, Congress viewed it as appropriate to re-compute those individual taxpayers' tax liability under an alternative computation by ignoring those preferences.⁵⁰ The alternative computations for those particular taxpayers also required them to include in the alternative tax base the itemized deductions available under the regular tax which are not available under the AMT, without which the timing preferences that created the tax shelter benefits may not have caused an AMT liability.⁵¹ These two very different components of the income tax are inextricably tied together in the AMT.

Through most of its history, while the AMT added to the complexity of the tax system because it required a dual computation of tax, its scope was so limited that it did not apply to most taxpayers and therefore could be ignored.⁵² Indeed, many taxpayers had never heard of the AMT – that is, until recently.

Under the Jobs and Growth Tax Relief Reconciliation Act of 2003, tax rates were reduced under the regular tax, but AMT rates were not.⁵³ Thus, when the regular tax rates included brackets of

⁴⁹ *Id.* The preference for ISOs is technically in the nature of a timing preference, because the taxpayer gets a special AMT basis equal to the value of the acquired stock. Any loss from the subsequent sale of the stock, however, could be restricted to \$3000 per year (plus any AMT capital gains) and therefore could end up being of limited use.

⁵⁰ See supra notes 9–10 and accompanying text.

⁵¹ See supra notes 24–27 and accompanying text.

⁵² Despite the fact that most taxpayers were not in fact subject to the AMT, however, some have criticized the AMT for requiring all taxpayers to needlessly compute a second tax. *See, e.g.,* Kendyl K. Monroe, *The Alternative Minimum Tax from a Practical Perspective: Its Role in the Income Tax Structure Under Current Law, and Its Possible Role in Future Deficit Reduction Legislation,* 1988 COLUM. BUS. L. REV. 341. According to Monroe, "[t]he imposition of unnecessary and meaningless reporting and compliance burdens may in fact be eroding confidence in the system." *Id.* at 342.

⁵³ Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. 108-27, §§ 105, 106, 117 Stat. 752, 755 (2003). The exemption amount was increased,

28%, 31%, 36%, and 39.6%, while the AMT rates stood at 26% and 28% and there was a substantial AMT exemption amount, the AMT had little applicability to most taxpayers.⁵⁴ The reduction in the top regular rates to 25%, 28%, 33%, and 35% together with an expansion of the income subject to the lower brackets, without any proportional reduction in AMT rates, will cause the AMT to be applicable to many additional taxpayers.⁵⁵ This rate reduction under the regular tax alone caused more taxpayers to be covered under the AMT because the spread between the higher rates under the regular tax and AMT rates narrowed significantly.

Interestingly, several years before, in 1993, the regular tax rates were increased with the creation of the 36% and 39.6% brackets.⁵⁶ At that time, the AMT rates were increased from 24% (they had stood at 21% from 1986 to 1991) to 26% and 28%.⁵⁷ Thus, the roll-back of the regular rates in 2001 without a corresponding roll-back of AMT rates created the situation of expanding AMT applicability, which would not have existed had the 1991 and 1993 AMT rate increases not occurred.⁵⁸

In addition, regular tax rate brackets, exemptions, deductions such as for personal exemptions, and credits are typically indexed for

however. Id. § 105, 117 Stat. at 755.

⁵⁴ See Omnibus Budget Reconciliation Act of 1993, Pub. L. 103-66, §§ 13,201, 13,202, 107 Stat. 312, 458, 461–62 (1993) (lowering regular tax rates while leaving AMT rates unchanged). The effects of this change are described in Leonard E. Burman et. al., *The AMT: Projections and Problems*, 100 TAX NOTES 105 (July 7, 2003).

⁵⁵ Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, §§ 104–106, 117 Stat. 752, 754–755 (2003). It is estimated that the applicability of the AMT to taxpayers will significantly increase in the future. Burman et. al., *supra* note 54. A 2003 report in Tax Analysts estimates that households with income less than \$100,000 will account for 52% of AMT taxpayers by 2010 (compared to 9% in 2003), accounting for 23% of total AMT revenue (compared with 5% in 2003). *Id*.

⁵⁶ Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13,202, 107 Stat. 312, 461 (1993).

 $^{^{57}}$ From 1986 to 1991, the AMT rate was 21% for a taxpayer other than a corporation. Tax Reform Act of 1986, Pub. L. 99-514, § 701, 100 Stat. 2085, 2320-21 (1986). From 1991 to 1993, the AMT tax rate was 24%. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11,102, 104 Stat. 1388, 1388–406 (1990). In 1993, the AMT rates were increased to 26% and 28%. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13,203, 107 Stat. 312, 461–62 (1993).

⁵⁸ It is estimated that the 2001 tax cut will increase the number of taxpayers subject to the AMT from fourteen million to thirty-three million in the year 2010. Burman et al., *supra* note 54, at 105.

[Vol. 24:835

inflation, whereas AMT rates and brackets are not.⁵⁹ This difference will continue to draw more taxpayers into the AMT.

The expanded role of the AMT in the tax system because of the expanded number of taxpayers who will be subject to it adds a significant layer of complexity to the system in terms of compliance and administration. The income tax is already under fire from critics because it cannot support its own weight.⁶⁰ For the income tax to survive replacement by a simpler, consumption type tax, as has been proposed by many academics and legislators, it must be reformed into a much less complex system, at least as it applies to the mass of individual taxpayers.

It is not only the number of taxpayers who are becoming subject to the AMT that is causing concern among taxpayers, but the effect on those taxpavers of being taxed under the AMT regime instead of the regular tax.⁶¹ Indeed, advocates of a progressive income tax may be alarmed by the increasing importance of the AMT in the overall income tax system because, when it applies (and it will apply frequently unless substantially modified or eliminated by future legislation), the AMT replaces a progressive rate system with an almost flat rate one⁶² and relies for what progressivity it contains largely on the phase-out of the exclusion amount for upper income taxpayers.⁶³ It also abandons any standard deduction or deduction for personal exemptions,⁶⁴ both of which tend to favor lower income taxpayers.⁶⁵ The standard deduction favors lower income taxpayers because those taxpayers tend not to have sufficient income or wealth to cause their itemized deductions to exceed the standard deduction. Itemized deductions, as a practical matter, are based on income or

- ⁶³ See supra notes 29–30 and accompanying text.
- ⁶⁴ I.R.C. § 56(b)(1)(E).

⁶⁵ The AMT's failure to grant personal deductions has been castigated by some for creating marriage and child penalties. *See, e.g.*, Leonard E. Burman et al., *The Individual AMT: Problems and Potential Solutions* (Sept. 18, 2002), *available at www.taxpolicycenter.org.* This 2002 Tax Analysts report stated that unless the AMT is reformed, couples will be more than twenty times as likely as singles to be subject to the AMT in 2010 and, due to the AMT's lack of deductions for dependents, "[a]mong married couples with two or more children and income between \$75,000 and \$500,000, the AMT participation rate will approach 100 percent." *Id.* at 6–7, tbl. 4.

⁵⁹ See THE ALTERNATIVE MINIMUM TAX, supra note 1.

⁶⁰ Many academic and legislative proposals have been made to replace the income tax with a consumption tax. *See, e.g.*, William Andrews, *A Consumption-Type of Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974).

⁶¹ See Burman et al., supra note 54.

⁶² See supra notes 28–30 and accompanying text.

wealth, such as state income tax,⁶⁶ home mortgage interest,⁶⁷ and real estate taxes.⁶⁸ Also, personal exemptions are available for lower and middle income taxpayers, whereas they are phased out for upper income taxpayers.⁶⁹ On the other hand, the AMT eliminates deductions for interest on home equity indebtedness⁷⁰ and state and local taxes,⁷¹ which, under a progressive rate structure, represent upside down subsidies favoring high bracket taxpayers more than low bracket taxpayers.⁷²

IV. THE AMT - AN EVALUATION

The best way to evaluate the AMT is to break it down into its core concepts or provisions and analyze each of them separately to determine its desirability. They are (1) a dual system of computation of income and tax; (2) a large exemption amount below which no AMT is imposed; (3) a flat or nearly flat tax rate structure; (4) a broad base upon which the tax is imposed, which eliminates many of the deductions for personal consumption expenses that have been deductible as itemized deductions for many years; (5) a determination of the tax burden that is independent of the number of dependents the taxpayer has, particularly with respect to those taxpayers whose income exceeds the exemption amount; and (6) the elimination or curtailment of deductions that do not measure net income but rather are designed to provide incentives for business or investment activities or expenditures.

A. The Dual System

There are many good things about the AMT from the point of view of income tax reformers who advocate a more comprehensive tax base and one free of incentive provisions. The regular tax allows deductions for some personal consumption expenses and special accelerated deductions or credits for business and investment

⁶⁶ I.R.C. § 164(a)(3).

⁶⁷ I.R.C. § 163(a), (h)(2)(D).

⁶⁸ I.R.C. § 164(a)(1).

⁶⁹ I.R.C. § 151(d)(3).

⁷⁰ I.R.C. § 56(b)(1)(C)(i).

⁷¹ I.R.C. § 56(b)(1)(A)(ii).

⁷² For a discussion of this topic, see STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES 71–82 (1985).

[Vol. 24:835

expenses that Congress desires to encourage.⁷³ A purist's income tax would not allow most if not all of the personal consumption expenses and would force deferral of the incentive portions of the business and investment deductions and elimination of the credits.⁷⁴ The AMT compromise approach is that all of these expenses are eliminated as deductions and credits are not allowed, but only for those taxpayers who make too great of a use of them.⁷⁵ It is this compromise that leads to the dual system and the resulting complexity that many now desire to abandon because a second computation of the tax base, with various modifications, is required to compute an alternative tax in order to determine who is over-using these tax benefits.

Moreover, separate recordkeeping is required for such items as regular tax basis, AMT basis, regular tax passive activity loss carryovers, and AMT passive activity loss carryovers.⁷⁶ This extra recordkeeping adds to both the taxpayers' compliance costs and the Internal Revenue Service's administrative audit burdens and costs. It also invites taxpayers to fail to comply, which likely results in lost revenues.⁷⁷

The reality of the current AMT stands in stark contrast to the ideals of the AMT. Tax reformers for years have focused on broadening the base of the income tax and at the same time, in what appeared to be a complementary objective, ensuring that all those taxpayers with high income will pay some tax. The former objective

⁷⁵ Congress's goal in enacting the AMT was to achieve the dual goals of: (1) retaining tax incentives while (2) ensuring that some taxpayers did not overuse the incentives. 4 BITTKER & LOKKEN, *supra* note 10, at 111-89. A derision of the tax system for not taxing all economic income ignores the fact that Congress has long used the tax system to encourage taxpayers to engage in certain activities. Deborah M. Weiss, *Tax Incentives Without Inequity*, 41 UCLA L. REV. 1949, 1950 (1994). Deborah Weiss points out that "[t]he principle mechanism for tax policy is the tax incentive... Tax incentives, however, create opportunities for high-income taxpayers to reduce their taxes by holding their wealth in tax-preferred items." *Id*.

⁷⁶ See Bucklin, supra note 74, at 111.

⁷⁷ An additional cost created by the inefficiencies of the dual system is that it impairs taxpayers' ability to make informed investment decisions regarding tax costs. *See* Bucklin, *supra* note 74, at 111.

 $^{^{73}}$ See *id.* at 1–6 (discussing the use of tools such as deductions to further congressional policy objectives).

⁷⁴ Some "purists" deride the AMT for not going far enough. *See* Kerry Sean Bucklin, Comment, *The Alternative Minimum Tax for Individuals: Present Problems and Future Possibilities*, 63 WASH. L. REV. 103 (1988). Bucklin states that the AMT fails to tax all economic income and suggests that it should be reformed to do so. Bucklin concludes that this reformed AMT should then replace the regular tax system. *Id.* at 111.

could have been accomplished in the regular tax simply by eliminating deductions for expenditures that would properly be viewed as personal in nature rather than profit seeking and by limiting tax incentive provisions which lend themselves to tax sheltering. Tax reformers' ideal of a "comprehensive income tax base" would then be achieved. In that way, a tax law encompassing a broader base would better accomplish the taxation of "net income" as one might define that term under the Haig-Simons definition of income, that is, the sum of a taxpayer's personal consumption and increase in wealth during the year.⁷⁸ This definition is the standard used by most academics as the idealized income tax base, against which the income tax system's actual measurement of income should be compared.⁷⁹

Congress, however, has been unwilling to broaden the income base for everyone or eliminate tax incentives for all business taxpayers and investors.⁸⁰ Thus, the AMT was enacted and modified perpetually to strike a compromise - a middle ground. The AMT, from the time of its inception in 1969, has represented an attempt to broaden the base of the income tax by concentrating on only a small percentage of taxpayers – those who made substantial use of various tax incentives in the tax law to reduce or eliminate their taxes.⁸¹ The AMT was designed to limit the permissible reduction so that everybody paid some tax on their income.⁸² It did this by constructing a shadow, or alternative, system that was much simpler and more comprehensive than the regular tax.⁸³ Thus, some taxpayers lived by the regular tax rules, but others were subject to the AMT rules, which could be quite different than the regular tax rules.⁸⁴ Furthermore, some taxpayers could slip from one set of rules to another, depending upon expenditures made or transactions entered into by the taxpayer during the year.

The AMT seeks an important reform goal, but does not go far enough. Under fundamental income tax reform, the approach to tax incentive provisions and personal consumption deductions adopted by the AMT is the correct one and should establish the rule for the entire income tax system. Most importantly, there should be only one set of

⁷⁸ Daniel S. Goldberg, *E-Tax: Fundamental Tax Reform and the Transition to a Currency-Free Economy*, 20 VA. TAX REV. 1, 43–44 (2000) (citations omitted).

⁷⁹ *Id*. at 44.

⁸⁰ 4 BITTKER & LOKKEN, *supra* note 10.

⁸¹ See The Alternative Minimum Tax, supra note 1.

⁸² See id.

⁸³ See id.

⁸⁴ See id.

850

Virginia Tax Review

[Vol. 24:835

rules, not two, and that set of rules should largely follow those that are in the current AMT, not the regular tax. Such an approach would broaden the tax base by eliminating tax incentive subsidies and include more items of taxpayers' personal consumption than are currently included in the regular income tax. To stop short of this ideal could be practical under certain circumstances, but to draw the line between taxpayers rather than among provisions based upon how many of the special rules the taxpayers seek to use elevates appearance over logic and substance.

B. The Large Exemption Amount

The AMT reflects a policy choice that there should be a large exemption amount,⁸⁵ preferably without a phase-out for high income individuals (although a phase-out could be acceptable if some progressivity were desired). A large exemption amount eliminates low income taxpayers from the requirement to pay income tax and thereby achieves fairer burden sharing by relieving the burden of those who are likely to have the least amount of resources. A large exemption amount also achieves substantial simplification in the system by eliminating the tax filing obligations of low income taxpayers.

Under the current AMT, however, the exemption amount is only for the AMT computation.⁸⁶ It should be expanded to the entire income tax in the event the AMT is eliminated.

C. Flat Rate Tax

The AMT uses a flat rate or near flat rate tax bracket structure after the exemption amount has been exceeded.⁸⁷ A flat rate certainly gives the perception of simplicity to "tax civilians" and in many respects creates simplicity, particularly by reducing income shifting and planning around income shifting among taxpayers who have incomes above the exemption amount.

The choice between a flat rate system and a progressive or graduated rate system has been reviewed by many tax scholars.⁸⁸ No

⁸⁵ *See supra* note 29 and accompanying text. The precise amount of the level of income at which tax should begin can be determined in the future.

⁸⁶ I.R.C. § 55(d).

⁸⁷ See supra notes 29–30 and accompanying text.

⁸⁸ See, e.g., WALTER J. BLUM & HARRY KALVEN, JR., THE UNEASY CASE FOR PROGRESSIVE TAXATION (1953); Joseph Bankman & Thomas Griffith, *Social Welfare*

resolution of the issue will be attempted here, although the flat rate system was a core principle of the AMT and could be extended to the entire tax upon elimination of the AMT. While this may appear reactionary to advocates of a progressive income tax, a flat rate system apparently appealed to enough legislators on the basis of simplicity and fairness during the 1986 tax reform proceedings to achieve passage of the Tax Reform Act of 1986.⁸⁹ Moreover, a flat rate system with an exemption amount accomplishes progressivity with regard to average tax rates, although not marginal tax rates, at high income levels. Some progressivity of marginal tax rates could be achieved by phasing out the exemption amount, as indicated above,⁹⁰ without doing much damage to the perception of a flat rate tax.

The flat rate aspect of the AMT may be one of the reasons (besides revenue losses) for the current administration's reluctance to abandon the AMT.⁹¹ Moreover, as an increasingly greater number of earners become subject to the AMT, and those earners represent a disproportionately large amount of revenue collections, the achievement of a flat rate by the AMT back door may be viewed as worth the wasteful complexity of the dual computation. In this scenario, eventually the regular tax would be viewed as the special computation, largely reserved for low income taxpayers because they are the only ones entitled to a meaningful exemption amount that is not phased out.

Such a potential evolution, though perhaps politically expedient in the short run, should be avoided. Instead, the flat rate principle should be adopted outright as part of a reformed tax system so as not to leave a lengthy transition period between the current dual computation system and the single computation system.

D. Base Broadening

The AMT uses a broad tax base as one of its core principles and this concept could be extended to the regular tax upon elimination of the AMT. Of course, the precise areas of base broadening would very

and the Rate Structure: A New Look at Progressive Taxation, 75 CAL. L. REV. 1905 (1987); Lawrence Zelenak & Kemper Moreland, *Can the Graduated Income Tax Survive Optimal Tax Analysis?*, 53 TAX L. REV. 51 (1999).

⁸⁹ See supra note 16 and accompanying text.

⁹⁰ See supra notes 28–30 and accompanying text.

⁹¹ See Lawrence Zelenak, Framing the Distributional Effects of the Bush Tax Cuts, 105 TAX NOTES 83 (Oct. 4, 2004). Zelenak, however, views the flat tax aspect of the AMT with disfavor because it lacks sufficient progressivity.

[Vol. 24:835

well be the subject of substantial disagreement. The issues should really be separated into broadening the base with regard to personal consumption expenditures and broadening the base with regard to business and investment expenditures. Only the first is dealt with in the following discussion.

The current AMT's solution to base broadening for consumption expenditures would be a good starting point for reform of the income tax, because it is already a part of congressionally-enacted tax law.⁹² For example, the AMT adjustments for state and local taxes, home equity interest, medical expenses, and personal exemptions may credibly be argued to be personal consumption expenditures.⁹³ Under a comprehensive income or consumption tax system, no deductions would be allowed for these, which is the current approach of the AMT.⁹⁴ Tax reformers should argue that this should become the universal rule in the income tax.

In contrast, the AMT treatment of miscellaneous itemized deductions represents an exception to the treatment that should obtain under a comprehensive income or consumption tax. The regular tax has chosen to treat miscellaneous itemized deductions disadvantageously, in essence as partly personal consumption expenses, even though they are clearly not. Miscellaneous itemized deductions include income earning expenses such as unreimbursed employee business expenses, investment expenses, and legal fees incurred to secure a damage recovery of amounts not in connection with a trade or business⁹⁵ - all properly deductible under a Haig-Simons-based income tax system or a consumption tax.⁹⁶ The regular tax disallows these expenses up to two percent of a taxpayer's adjusted gross income.⁹⁷ This was done for both simplicity purposes and as a revenue generator.⁹⁸ The AMT extends this disallowance treatment to the entire category of expenses deductible as miscellaneous itemized deductions⁹⁹ and thereby causes the AMT tax base to be unfairly over-inclusive. Reform should allow a full

⁹² See supra notes 15–18 and accompanying text.

⁹³ See supra note 22 and accompanying text.

⁹⁴ See supra notes 32–40 and accompanying text.

⁹⁵ I.R.C. §§ 62, 67, 162, 212.

⁹⁶ See Goldberg, supra note 78.

⁹⁷ I.R.C. § 67(a).

⁹⁸ Robert J. Peroni, *Reform in the Use of Phase-Outs and Floors in the Individual Income Tax System*, 91 TAX NOTES 1415, 1418 (May 28, 2001).

⁹⁹ I.R.C. § 56(b)(1)(A)(i).

2005]

To Praise the AMT or to Bury It

deduction for miscellaneous itemized deductions.¹⁰⁰

E. Personal Exemptions for Dependents

The current AMT does not allow deductions for personal exemptions, presumably viewing them as a matter of personal choice.¹⁰¹ Personal exemptions, however, may be argued to present a different kind of issue than personal consumption expenditures. They bear no connection to any income earning expense. As such, elimination of the deduction for personal exemptions, as under the AMT, would better conform the tax base to the Haig-Simons base. On the other hand, one could argue that deductions for personal exemptions could be retained because they represent part of the underlying tax rate structure and reflect a determination of reduced

¹⁰¹ I.R.C. § 56(b)(1)(E).

¹⁰⁰ Section 162 allows miscellaneous itemized deductions under the regular tax, but such deductions are disallowed under the AMT. I.R.C. §§ 56(b)(1)(A)(i), 162. This has created significant problems in recent years, especially regarding contingent attorney's fees, because it is perceived as unfair to require taxpayers to include the entire amount of taxable damages, including the portion paid to or retained by the attorney as a contingent fee, to be included in gross income. Ilir Mujalovic, Note, Yet Another Alternative Minimum Tax Disaster: How Recovery of Damages Turns into a Liability, 47 N.Y.L. SCH. L. REV. 355, 356-57 (2003). This situation has led to inequitable results, with some taxpayers being subject to tax greatly exceeding the amount of their take-home award. Id. Another commentator suggests that "Congress should amend the AMT to allow a deduction for contingent attorney's fees characterized as miscellaneous itemized deductions," presumably as an item deductible under the AMT, notwithstanding that it is otherwise a miscellaneous itemized deduction. Darren J. Campbell, Comment, Wiping the Slate Clean: An Examination of How a Court's Characterization of Contingent Attorney's Fees Implicates the Alternative Minimum Tax and Affects the Taxpayers, 35 U.C. DAVIS L. REV. 171, 205 (2001). Congress, however, in its recently passed American Jobs Creation Act of 2004 fixed part of the problem by allowing an above the line deduction, rather than a miscellaneous itemized deduction, for attorney's fees and court costs incurred in connection with an unlawful discrimination claim, and certain other specified claims. American Jobs Creation Act of 2004, 108 Pub. L. No. 108-357, § 703, 118 Stat. 1418 (2004). As such, the attorney's fees and costs would be deductible for AMT purposes, since they would fall outside of the adjustment for miscellaneous itemized deductions. Congress's fix, however, was not complete because it failed to provide the same relief for all attorney's fees and court costs incurred to recover taxable damage awards. Id. Moreover, the Supreme Court held recently that the amount of a litigant's recovery that is includible in income includes the amount paid to the litigant's attorney as a contingent fee. Commissioner v. Banks, 125 S. Ct. 826 (2005). The AMT treatment of the fee therefore remains important in cases of taxable damage awards other than those specifically carved out by the new statute.

854

Virginia Tax Review

[Vol. 24:835

burden sharing for families based on the principle that they have a lesser ability to bear that burden. Neither resolution would be inconsistent with a comprehensive income tax base.

F. Business and Investment Provisions: Timing of Deductions and Allowance of Credits

The AMT does not allow taxpayers to use accelerated deductions or business tax credits¹⁰² that are permitted under the regular tax,¹⁰³ which are designed to provide incentives for business and investment expenditures. Thus, the AMT adopts its own depreciation schedules, disallows some immediate write-offs for expenditures that in theory should have to be capitalized and depreciated, and does not allow incentive business credits.¹⁰⁴ These provisions in the regular tax have traditionally led to tax shelters.¹⁰⁵ Under a broad based income tax that is free from distortions, however, incentives should be eliminated in order to reduce the opportunity for tax sheltering. Elimination would also have the effect of reducing the impact of the tax system on controlling social and economic policy. Under a comprehensive, broad based income tax, such incentives should be eliminated or curtailed under the regular tax upon elimination of the AMT. Such an approach would elevate the fairness objectives of the income tax law, which seeks to ensure that all taxpayers with economic income pay some tax, over the desire to encourage business or investment activities.

On the other hand, due to the desirability of, and pressures for, economic stimulus and investment incentives at appropriate times, this area might be intentionally left open to permit the government flexibility to employ fiscal policy remedies when the health of the economy requires them. Admittedly, the prospect of retaining

¹⁰² See supra note 41 and accompanying text (relating to accelerated deductions); see also I.R.C. § 38 (relating to business tax credits). Because section 38(c)(1) prescribes that the credit must not exceed the excess (if any) of the taxpayer's "net income tax" over the greater of (a) the taxpayer's "tentative minimum tax" for the tax year or (b) 25% of so much of the taxpayer's "net regular tax liability as exceeds \$25,000", the effect of the limitation rule of section 38(c)(1) is that in any year that a taxpayer is subject to the alternative minimum tax, the taxpayer can take no general business credit. See I.R.C. § 38(c)(1)(A).

¹⁰³ See, e.g., I.R.C. § 168 (relating to accelerated depreciation); see also I.R.C. § 38 (relating to the general business credit).

¹⁰⁴ See I.R.C. § 56(a)(1); see also supra notes 102 and 103 and accompanying text.

¹⁰⁵ See generally David P. Hariton, Sorting out the Tangle of Economic Substance, 52 TAX LAW. 235 (1999).

business tax incentive provisions raises the specter of tax shelter abuse and creates a risk that these may gut the base-broadening objective of the current AMT if they are abused by Congress. Perhaps that risk is unavoidable as a practical matter, and one can hope that the political process can hold Congress in check on these matters. In any event, these provisions either should or should not be included in the tax system. A dual computation as under the current AMT blunts the incentive by leaving some taxpayers out of it and creates unwelcome complexity, as discussed previously.

The foregoing discussion of timing provisions for business and investment expenditures is framed in traditional income tax terms. But if the tax system were viewed as a consumption tax instead of an income tax, or as a hybrid income-consumption tax, then the analysis of the AMT business timing provisions must proceed differently. In fact, the current system is really such a hybrid. Its consumption tax features incorporate both a "cash flow consumed income" type consumption tax, as well as a "yield exemption" type consumption tax.¹⁰⁶

As noted above, under the "cash flow consumed income" tax version of a consumption tax, the individual taxpayer includes all items of income, both from labor and from capital, in his tax base, and then subtracts or deducts the portion of that income that he saves or invests. The resulting amount represents the portion of his income that he has not saved, (that is, that he has consumed), and is the amount that is subject to tax.¹⁰⁷ In that manner, the consumed income tax would levy the tax directly on consumption.¹⁰⁸ The consumed income tax is computed and collected at the individual level.¹⁰⁹ Thus, for example, an individual who saves \$10,000 from his \$100,000 income for the year would only be taxed on his net of \$90,000.

The counterpart to this process for the business taxpayer permits that taxpayer to deduct currently from gross income any amounts spent on investments in plant and equipment during the year (in addition to ordinary operating expenses). Under the income tax, in general, these expenditures could require capitalization if they create an asset or benefit extending substantially beyond the year of the

¹⁰⁶ See Goldberg, supra note 8 (arguing that the current income tax already approaches a consumption tax and that the trend is likely to move even further in that direction).

¹⁰⁷ See Andrews, supra note 60, at 1149.

¹⁰⁸ See *id.* Under Andrews's formulation, a taxpayer would also include borrowings in his tax base and deduct repayments. *Id.*

¹⁰⁹ See generally id. at 1120.

[Vol. 24:835

expenditure.¹¹⁰

The analysis of a consumption tax often focuses on the cash flow consumed income tax because it can be collected, mechanically, in a manner similar to the current income tax. It therefore is most easily compared and contrasted to the income tax.

A similar end result – taxing consumption, not savings – can be achieved by allowing income from capital to be exempt from income tax, that is, by employing a "yield exemption" system. For example, suppose instead of permitting a deduction for a taxpayer's savings or investment during the year, the tax law permitted the returns from that investment to be exempt from tax instead. Under certain specific circumstances (involving (1) tax rates are uniform over time,¹¹¹ (2) the deduction produces an immediate tax saving determined by that uniform rate, and (3) the tax savings from the deduction will yield the same return as the rest of the investment),¹¹² this variation will replicate the effect of allowing the deduction.

¹¹³ Goldberg, *supra* note 8, at 2–3. To illustrate the equality of these two forms of consumption tax (cash flow consumed income and yield exemption) under the foregoing assumptions,

consider a taxpayer's investment of \$100 in year 1 for which a deduction would be allowed under the cash flow consumption tax model. Suppose that the taxpayer's tax rate is 30% and the item will generate the cumulative amount of \$200 in year 3, which will be withdrawn for consumption and therefore taxable. As a result, a post-tax investment of \$70 (the result of a pre-tax investment of \$100 for which a deduction is allowed) will result in pre-tax income of \$200, which when withdrawn and taxed will amount to post-tax income of \$140 (\$200 – \$60 (tax)). Under these facts, the taxpayer's net after-tax profit is \$70 (\$140 (post tax return) – \$70 (post-tax investment)) and rate of profit for the relevant years is 100%.

Similarly, if no deduction is allowed for the investment, but the resulting income is exempted from tax, as under the yield exemption model, then under these same assumptions, the taxpayer's rate of profit will be the same as the foregoing illustration. Specifically, the \$100 nondeductible expenditure represents a post tax investment of \$100. In year 3, it generates the cumulative amount of \$200, which is exempt from tax. Under these facts, the taxpayer's net after-tax profit is \$100 and rate of profit for

¹¹⁰ I.R.C. § 263; Treas. Reg. § 1.263(a)-2(a) (1994).

¹¹¹ This assures that the tax saved by virtue of the deduction will be collected at the same rate upon sale of the asset.

¹¹² This equates a yield exemption investment with an immediately deductible investment of the same amount. If the equivalence is instead based on the amount of after-tax investment, then the assumption is not necessary.

2005]

To Praise the AMT or to Bury It

857

The consumption tax features of the current tax law include:¹¹⁴

(1) The deferral of gain subject to tax until there is an event of realization. The tax law's realization requirement constitutes a yield exemption type consumption tax treatment because appreciated investments are not subject to tax until they are sold.¹¹⁵ Moreover, any tax on the appreciation would be eliminated entirely under section 1014 if the taxpayer dies with the property.¹¹⁶ The realization requirement of the income tax, capital gains preference, and stepped-up basis at death all combine to create a yield exemption or partial yield exemption regime;¹¹⁷

(2) The favorable treatment of retirement plans. Generally, retirement plans constitute a consumed income type consumption tax because funds are deposited into the plans tax free and are taxed only when withdrawn, although some plans, such as the Roth IRA, exemplify a yield exemption type consumption tax because funds are taxed up front but are tax exempt when withdrawn;¹¹⁸

the relevant years is \$100%.

In these two examples, the taxpayer's rate of profit is the same, namely 100%. Further, the taxpayer in the first example could duplicate the second taxpayer's amount of profit by investing the after-tax contribution amount of \$100 instead of only \$70. For example, suppose the taxpayer invested \$142.86 before tax and therefore \$100 (142.86 - \$42.86 (tax savings)) after tax to generate \$285.72 before tax, representing \$200 after tax amount (285.72 - \$85.72 (tax)), and \$100 after-tax profit from the \$100 after-tax profit amount invested. The taxpayer's rate of profit remains at 100%, and his after-tax profit amount is \$100 (\$200 - \$100).

Id. at 3-4 (citation omitted).

- ¹¹⁴ *See id.* at 8–20.
- ¹¹⁵ *Id.* at 9.
- ¹¹⁶ I.R.C. § 1014.

¹¹⁷ Under a yield exemption type consumption tax, gains from investments are untaxed. Goldberg, *supra* note 8, at 9. The realization requirement in the current "income tax" system constitutes a yield exemption type consumption tax, because appreciated investments are not subjected to tax until they are sold. *Id.* Hence, the taxpayer gains the benefits of tax deferral until the property has been sold (consumed). The yield exemption properties of the realization requirement are even more pronounced when the realization requirement is coupled with section 1014, which provides for stepped up basis at death. *Id.* In this case, the gains from the appreciated property are never taxed. *Id.*

¹¹⁸ Under the cash flow consumed income type consumption tax, the portion of the taxpayer's saved income is subtracted from his tax base. Goldberg, *supra* note 8, at 2. Most retirement plans (including traditional IRAs, section 401(k) plans, etc.) may be classified under the cash flow consumed income type consumption tax

[Vol. 24:835

(3) *Yield exemption treatment for Section 529 Education Plans.* Section 529 Education Plans are treated under a yield exemption regime because funds invested in the plans are subject to tax, but any withdrawn yield is tax exempt;¹¹⁹

(4) *Home Ownership Benefits*. Home ownership exempts imputed income from the home and (in most cases) gain from its sale, both of which are yield exemption treatments because only the initial investment is subject to tax;¹²⁰

(5) *Business Tax Incentives.* Business tax incentives typically employ the consumed income model, as under section 179 which allows the taxpayer to defer tax until the property is consumed, or partly that model, as under accelerated depreciation.¹²¹

Thus, the significant tax advantages enjoyed by those taxpayers who derive income from capital, such as the deferral of gain subject to tax until realization, advantageous treatment of contributions to

¹¹⁹ Section 529 Education plans allow states to create "qualified tuition programs" under which funds invested in the plans are subject to federal income tax, but the gains are exempt from tax when distributed and used to pay qualified tuition expenses. I.R.C. § 529. This constitutes a yield exemption type consumption tax at the federal level, similar to the treatment of the Roth IRA. Goldberg, *supra* note 8, at 15–17.

¹²⁰ The non-taxability of imputed income of a home constitutes a yield exemption type tax benefit, because although the funds used to purchase the home are subject to tax, the benefit of the use of the home (the rental value) is not. Goldberg, *supra* note 8, at 17. Similarly, the excludability from income of all or most of the gain on the sale of the home (up to the statutory limit of \$500,000) constitutes a yield exemption type consumption tax, because the gains realized on the home (due to appreciation) are exempted from tax. *Id*.

¹²¹ Section 179 provides that "[a] taxpayer may elect to treat the cost of any section 179 property as an expense which is not chargeable to capital account." I.R.C. § 179(a). Hence, the taxpayer may elect to immediately expense tangible personal property (such as equipment) used by the taxpayer in his trade or business, thus completely deferring taxes until "consumed." Goldberg, *supra* note 8, at 18–20. Accelerated depreciation schedules, which allow for depreciation deductions on equipment more quickly than the rate at which the item is likely to get used up economically, employ a partial consumed income type model, because some, though not all, of the taxes are deferred until the item has been "consumed." *Id*.

because deductions and exclusions are available for the funds initially invested, and as long as the funds remain in the plan, they accrue tax free interest and appreciation. *Id.* at 12. When the funds are taken out, they are taxed. *Id.* at 13. The Roth IRA constitutes a yield exemption type consumption tax because the funds put into the Roth IRA are fully taxable, but the gains are exempt from tax when taken out (consumed). *Id.* Whether under a cash flow consumed income or a yield exemption type scheme, however, retirement funds are clearly subject to a consumption tax, not the income tax. *Id.* at 14.

retirement plans and deferral of inclusion of earnings from those retirement plans, the special low tax rates applicable to dividends and long-term capital gains and the special benefits associated with homeownership and funded education plans that exist under the current income tax system, all reflect consumption tax features of the current tax system and combine to make the system an incomeconsumption tax hybrid.

Viewing the tax system as a modified consumption tax system, none of these so-called timing preferences for business and investment expenditures are preferences at all. Rather, under a pure consumption tax model, they should be deductible immediately and never capitalized. Any deviation from this treatment would constitute a penalty.

Accelerated deductions short of complete write-offs would be perfectly permissible under a hybrid system. That treatment is consumption tax oriented because it allows faster deductions than those allowable under a pure income tax, but lesser deductions than would be allowable under a cash flow consumed income type consumption tax. This hybrid treatment in what is a hybrid tax system should not be subjected to any additional tax, because business or investment income tax preferences simply reflect consumption tax elements of the tax system. As such, it perhaps should be up to Congress to make individual decisions with regard to both the proper treatment of each of these timing provisions, without resort to a dual computation as under the AMT, and the extent to which one or more of these provisions may be used by an individual taxpayer.

V. CONCLUSION

I would suggest that income tax reformers should not view the ascendancy of the AMT as an evil at all. Rather, they should embrace the increased importance of the AMT, because it incorporates the kind of base broadening and simplification for which tax reformers have been arguing for many years. Indeed, they should view the ascendancy as an opportunity to push for tax reform and be prepared to incorporate the core principles of the AMT into the regular income tax as a substitute for the dual tax computation required under the current AMT. They should also propose to make the resulting system fairer, such as by ending the denial of any deduction for miscellaneous itemized deductions, a provision that currently diverges from a comprehensive income tax base. In any event, they should not now surrender the prospect of income tax reform by eliminating the AMT,

Virginia Tax Review [Vol. 24:835

as the four former Commissioners and the American Bar Association have recommended,¹²² without securing some base broadening, because to do so would set income tax reform backwards and forgo substantial revenue for the government.

Provisions in the current AMT seeking to eliminate business and investment timing preferences, on the other hand, should be abandoned. While curtailing these preferences pursues the original objective of the AMT in an income tax system, that objective is no longer appropriate under the current income tax-consumption tax hybrid system.

The reforms advocated above could have important implications for the future development of the tax law. The foregoing discussion suggests a "back to the future" approach to tax policy and a revival of the base broadening and flat rates enacted under the Tax Reform Act of 1986. The abandonment of these principles in the years following 1986 gave fuel to the movement advocating a consumption tax. Indeed, the incorporation of the core principles of the AMT into the income tax is the kind of tax reform that may save the income tax itself from the onrush of consumption tax advocates, whose major argument (although not their only one) is that the consumption tax is simpler than the income tax, which is weighed down with too many special provisions and the AMT, which make it even more complicated.

While the consumption tax advocates are likely correct with regard to the structural elements of the tax, they are only correct with regard to the technical complexities in individual special tax provisions to the extent that the income tax cannot be cleansed of these special provisions. Abandoning the duality of the AMT, providing a large exemption amount in the income tax and a flat rate tax on income in excess of that exemption amount, and eliminating personal consumption deductions (thereby easing the compliance burden) are the kinds of reforms that would counter this argument of consumption tax advocates. The income tax would be strengthened significantly if it were more broadly based and less complex than the current regular tax. In this light, the adoption of the core AMT principles in the regular tax coupled with the elimination of the separate AMT would create a more defensible income tax.

Of course, incorporating the AMT into the regular tax will not fix all of the problems that income tax advocates typically have with the

¹²² Kenney, *supra* note 2; Shaw, *supra* note 3.

current, post-2003 income tax. Because the system is an income taxconsumption tax hybrid rather than a pure income tax system, the nature of the hybrid will continue to be at issue. The issues that involve consumption tax elements in the income tax will remain in dispute, with income tax reformers seeking to reduce or eliminate them, and consumption tax advocates seeking to retain or expand them. A new broad based, relatively flat rate version of the current tax, however, will make it more defensible against the attacks of consumption tax advocates, who seek to replace the current tax system with a pure consumption tax. As a result, incorporating the core principles of the AMT, other than the business and investment provisions, into the regular income tax instead of seeking simply to abolish the AMT could ultimately prove to be a better strategy for those who seek to preserve the current hybrid system.