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MINIMUM INCOME TAX

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

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TABLE OF CONTENTS

Introduction

This pamphlet presents background information on the minimum tax. The pamphlet initially discusses the existing minimum tax. Then, it provides a detailed description of the stages of the legislative history of the minimum tax. This is done because there is considerable debate on which type of minimum tax is more appropriate; that is, an additional minimum tax (i.e. a tax on the sum of a taxpayer's preference income, which is the present law) or an alternative minimum tax (i.e., the greater of the regular tax on a taxpayer's regular income or a reduced tax, such as one-half the regular rates, on his regular income plus his preference income). Thus, this discussion traces the legislative history from the original 1968 Treasury proposals through every stage of the Tax Reform Act of 1969 and includes subsequent amendments. The pamphlet then describes briefly the revisions provided in the 1975 House-passed bill (H.R. 10612) as well as the recent Treasury proposal. Finally, the pamphlet provides a discussion of the issues involved, which includes the basic purpose of the minimum tax and the arguments for and against an additional tax versus an alternative tax as well as a number of issues related to either type of minimum tax. Subsequent pamphlets will discuss alternative proposals in the area of a minimum income tax.

1. Present Law

Present law (sec. 56 of the code) provides a minimum tax on certain kinds of tax preferences. The minimum tax amounts to 10 percent of the sum of an individual or corporation's (or estate or trust's) tax preferences in excess of the sum of $30,000 and the taxpayer's regular income tax.[1]

The tax preference items included in the base of the minimum tax are the following:

(1) Accelerated depreciation on real property in excess of straight-line depreciation;

(2) Accelerated depreciation on personal property subject to a net lease in excess of straight-line depreciation;[2]

(3) Amortization of certified pollution control facilities (the excess of 60-month amortization (sec. 169) over depreciation otherwise allowable (sec. 167));

(4) Amortization of railroad rolling stock (the excess of 60-month amortization (sec. 184) over depreciation otherwise allowable (sec. 167));

(5) Qualified stock options (the excess of the fair market value at time of exercise over the option price);

(6) Reserves for losses on bad debts of financial institutions (the excess of the special deduction for such institutions over the bad debt reserve deduction allowable on the basis of actual experience);

(7) Percentage depletion in excess of the adjusted basis of the property;

(8) Capital gains (for individuals, one-half of net long-term capital gains; for corporations in general, 18/48 of net long-term gains);[3]

(9) Amortization of on-the-job training and child care facilities (the excess of 60-month amortization (sec. 188) over depreciation otherwise allowable (sec. 167)).

Special rules are provided for net operating losses and for carryovers of "unused" regular income tax deductions. In the case of net operating losses, present law provides for a deferral for part or all of the tax in a year in which the taxpayer incurs a net operating loss which can be carried over to a later year. In addition, there is a rule which provides that in a year in which a taxpayer has regular income

[1] Regular income tax is reduced by various nonrefundable credits, such as the foreign tax and retirement income credits.

[2] The net lease provision does not apply to corporations, other than subchapter S corporations and personal holding companies.

[3] The fraction 18/48 is the difference between the ordinary corporate income tax rate of 48 percent and the corporate capital gains tax rate of 30 percent, divided by the ordinary corporate rate.

tax liability (after tax credits) which exceeds his tax preference income above the $30,000 exemption level, the excess tax liability may be carried forward for 7 years and used to offset tax preference income otherwise subject to the minimum tax in those later years. Finally, tax preferences from foreign sources are subject to the minimum tax only to the extent that they reduce regular income taxes on domestic-source income (sec. 58(g)).

2. Legislative History of the Minimum Tax

Public discussion of the minimum tax began with the testimony before the Joint Economic Committee of Secretary of the Treasury Joseph Barr on January 17, 1969, the last day of business of the Johnson Administration. Secretary Barr noted that in 1967 there were 155 individual tax returns with adjusted gross income (AGI) over $200,000 on which no Federal income tax was paid, including 21 nontaxable returns with AGI over $1 million.

Shortly thereafter, the new Secretary of the Treasury David Kennedy transmitted to the Congress a set of tax reform proposals made by the Treasury staff during the Johnson Administration, the so-called "1968 Treasury proposals." In April 1969, the Treasury of the new administration submitted new tax reform proposals, the so-called "1969 Treasury proposals." The minimum tax and allocation of deductions between tax-exempt and taxable income played a prominent role in both sets of proposals, which became the basis for the Tax Reform Act of 1969. The purpose of the minimum tax, which was enacted in that Act, was primarily to deal with the problem of high-income nontaxable individuals.

The minimum tax was amended in both 1970 and 1971. In 1973, the Treasury proposed a basic restructuring of the minimum tax along the lines of the original 1968 Treasury proposals, but in this case building a form of allocations of deductions into the minimum tax. Important changes in the minimum tax have been approved (although not passed) by the Senate. The House version of the Tax Reform Act of 1975 keeps the basic structure of the current minimum tax but significantly increases its effective rate on individuals.

1968 Treasury Proposals [4]

Under the 1968 Treasury proposals, certain tax preferences received by individuals, estates and trusts would be added to regular taxable income, creating an expanded tax base; that base (less a $10,000 floor for taxpayers who do not itemize their deductions) would be applied against a new rate table (with rates approximately equal to one-half the regular rates; that is, between 7 and 35 percent); and the taxpayer would pay this minimum tax if it exceeded his tax computed in the regular way. The same credits allowed against the regular tax would be allowed against the minimum tax.

Under the 1968 Treasury proposals the minimum tax was an "alternative" tax, payable only if it exceeded an individual's regular income tax and then payable instead of the regular tax. It was pro-

[4] U.S. Treasury Department, *Tax Reform Studies and Proposals*, pp. 13–15, 35–36, 94–95 and 132–148.

gressive in the sense that for a given level of regular taxable income, the increased tax liability resulting from the minimum tax (that is, the excess of the minimum tax over what would have been the regular tax) increased more than porportionately as preference income increased; however, it was regressive in the sense that for a given amount of preference income, the excess of the minimum tax over the regular tax fell as regular income rose. Indeed, a taxpayer whose preference income was less than half his regular income would not have had to pay any minimum tax even if his preference income was very large in absolute terms.[5]

The tax preferences subject to the minimum tax under the 1968 proposals were (1) capital gains;[6] (2) exempt interest from State and local bonds; (3) percentage depletion;[7] and (4) untaxed appreciation on property donated to charity, to the extent a deduction is allowed for such untaxed appreciation. These preferences are either permanent exclusions from income (capital gains and exempt interest) or deductions that do not represent cash outlays (percentage depletion and untaxed appreciation on contributions). The 1968 Treasury proposals on the minimum tax did not attempt to deal with preferences that consist of deferrals of tax liability.

The 1968 proposals also recommended allocating itemized deductions between taxed income and various types of preference income and not allowing a deduction for the portion allocated to preference income. The deductions to be thus allocated were (1) nonbusiness interest (sec. 163), (2) nonbusiness taxes (sec. 164), (3) nonbusiness casualty losses (sec. 165(c)(3)), (4) charitable contributions (sec. 170), (5) medical expenses (sec. 213), and (6) cooperative housing expenses (sec. 216). (Business deductions were not to be so allocated because it was assumed that they related to taxable income.) The untaxed items of income to which these expenses would be allocated were the same as the preference items subject to the minimum tax under the 1968 proposals (but there would be taken into account, for purposes of this allocation, only the excess of preference income over $5,000). In connection with these proposals, the Treasury proposed modifications to the provision (sec. 265) that denies deductions for expenses incurred in relation to tax-exempt income.

1969 Treasury Proposals [8]

The 1969 Treasury proposals also included a minimum tax, termed the "limit on tax preferences." Taxpayers were to compute an expanded income base by adding certain tax preferences to adjusted gross income (exclusive of long-term capital gains). Then they were to determine the excess of their tax preferences over one-half of this expanded income base, add this excess to taxable income and compute

[5] Strictly speaking, the preferences subject to the minimum tax should not be called "preference income," since some of them are deductions against gross income (such as percentage depletion). The term "preference income" is used here as a shorthand for the clumsier but more precise phrase "items of tax preference."

[6] Essentially similar to item (8) described above under "Present law."

[7] Essentially similar to item (7) described above under "Present law."

[8] Ways and Means Committee, *Hearings on Tax Reform*, 1969, pp. 5050–51, 5060–78, and 5280–86.

their income tax by applying the regular tax tables to this expanded taxable income. In effect, tax preferences in excess of one-half of expanded income were disallowed. Taxpayers, however, were permitted at least $10,000 of preferences each year, and any disallowed preferences (that is, preferences added back into taxable income) could be carried forward for five years. As with the 1968 Treasury proposals, corporations were exempted from the minimum tax.

Despite the apparent difference in format, the limit on tax preferences was similar in many respects to the minimum tax in the 1968 Treasury proposals. The minimum tax did not increase a taxpayer's tax liability (that is, no preferences were disallowed) unless his preferences exceeded one-half of his expanded income base, so that as long as a taxpayer had enough regular income, he could avoid paying any minimum tax on his preference income. Disallowed preferences, however, were taxed at progressive rates: one-half of the preferences was taxed at rates ranging from 14 to 70 percent, leading to an effective rate of between 7 and 35 percent on the preference income. The 1969 proposal, however, would have resulted in less tax for most taxpayers than the 1968 proposal because in it preferences had to exceed one-half of "adjusted gross income" in order to be made subject to a minimum tax, while in the 1968 proposals preferences had only to exceed one-half of regular "taxable income" (by more than a $10,000 floor for taxpayers using the standard deduction), which is always less than adjusted gross income.

The preference items under the 1969 Treasury proposals were (1) percentage depletion; (2) untaxed appreciation on property donated to charity to the extent a deduction is allowed for such untaxed appreciation; (3) the excess of intangible drilling expense deductions over straight-line depreciation of such expenditures; (4) accelerated depreciation on real property;[9] and (5) farm losses to the extent such losses computed on a cash basis exceed losses computed on an accrual basis. Because the 1969 minimum tax formula was not as rigorous as the 1968 formula, it was felt appropriate to include as preferences deductions that result in a deferral of tax liability (such as accelerated depreciation, farm losses and intangible drilling expenses) as well as preferences that involve a permanent reduction in tax.

The 1969 proposals also provided for allocation of deductions in essentially the same manner as the 1968 proposals. The deductions to be allocated were the same as under the 1968 proposals. The untaxed income items to which the deductions were to be allocated were also the same as under the 1968 proposals, except that, in addition, there were to be included the following: (1) intangible drilling expenses to the extent they exceed the amounts which would have been allowable if the expenses had been capitalized and recovered through straight-line depreciation; (2) accelerated depreciation on real property; and (3) farm losses to the extent that such losses computed on a cash basis exceed losses computed on an accrual basis. In addition, the 1969 proposals included adjustments to section 265 similar to those that would be made by the 1968 proposals.

[9] Essentially similar to item (1) described above under "Present law."

1969 House Bill

The minimum tax in the House version of the Tax Reform Act of 1969 was modeled largely after the 1969 Treasury proposals. The principal difference was that the bill added to the list of tax preference items capital gains and tax-exempt interest from State and local bonds (over a 10-year transition period) and removed percentage depletion and intangible drilling expenses. The bill provided for basis adjustments in the case of disallowed accelerated depreciation and farm losses; that is, taxpayers could increase their basis for calculating depreciation or gain or loss by the amount of the disallowed deductions. The House bill's allocation of deductions provisions were also modeled after the 1969 Treasury proposals.[10]

Senate Finance Committee Bill [11]

The Senate Finance Committee substituted for the House proposed limit on tax preferences and allocation of deductions a minimum tax of 5 percent on tax preferences in excess of $30,000. The Finance Committee list of tax preferences included intangible drilling expenses, excess investment interest, and the items (1) through (8) described above under "Present law." Unlike the House bill, the Finance Committee version applied to corporations, as well as to individuals, estates, and trusts.[12]

The Finance Committee favored its approach in part at least on the grounds that it was simpler than that of the House bill. Also, it argued that taxpayers with the same amount of tax preference income should not be treated differently merely because they have different amounts of regular taxable income. Under the Finance Committee proposals, all preferences above the $30,000 floor were subjected to the 5-percent minimum tax regardless of the taxpayer's regular income or regular tax. The minimum tax, therefore, was changed from an "alternative" tax to an "additional" tax, one that is payable in addition to the regular income tax. The Finance Committee believed that it was desirable to impose a minimum tax on corporations and that its flat-rate, "additional tax" approach could be applied to corporations more easily than could the approach of the House bill.

Senate Floor

A Senate floor amendment raised the minimum tax rate from 5 percent to 10 percent and permitted a reduction of total tax preferences by

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[10] H. Rept. 91–413 (August 2, 1969), pp. 77–83.

[11] In 1964, Senator Long introduced "The Simplified Tax Method Act of 1964" (S. 3250) to give each taxpayer "the right to elect to pay his taxes—at lower tax rates—without the benefit of the various 'gimmicks' and tax-avoidance schemes which are most frequently employed by high-bracket taxpayers." (*Cong. Rec.*, Oct. 2, 1964 (daily ed.) pp. 23087–88.) Under this proposal, a lower set of rates was to be applied to an expanded tax base. The expanded tax base was essentially equivalent to taxable income plus a large number of items including the following: (1) State and municipal bond interest; (2) State, local, and foreign income taxes; (3) certain employee fringe benefits (such as gain on exercise of stock options and contributions to health insurance plans and pension and profit-sharing plans); (4) certain income from foreign sources; (5) two-thirds of social security and railroad retirement pensions and annuities; (6) net operating losses; (7) intangible drilling expenses; (8) depletion allowances; (9) capital gains; (10) H.R. 10 contributions; and (11) charitable contributions.

[12] S. Rept. 91–552 (Nov. 21, 1969), pp. 111–118.

an amount equal to the regular Federal income tax of the taxpayer. This amendment was introduced by Senator Miller of Iowa who argued that the 5-percent minimum tax rate was too low, and that it would be inequitable to impose a minimum tax on taxpayers who were already paying a substantial regular tax.[13] The Miller amendment transformed the minimum tax into a compromise between the Treasury proposals, which imposed a minimum tax only in cases where a taxpayer's preferences were large in relation to his regular income and regular tax, and the Finance Committee approach, which imposed a flat-rate minimum tax on preferences regardless of the taxpayer's regular income.

Conference Committee

The conference committee basically followed the Senate provision but made the following adjustments:

(1) The preference item for excess investment interest was made to apply only to individuals, subchapter S corporations, and personal holding companies, and only until 1972 (when the limitation on the deduction of excess investment interest of the 1969 Act became applicable).

(2) The preference relating to accelerated depreciation on personal property subject to a net lease was made to apply only in the case of individuals, subchapter S corporations, and personal holding companies;

(3) The preference relating to intangible drilling and development costs was deleted, but the cost or other basis on which the depletion deduction preference is computed was not to include such costs.[14]

1970 Amendment [15]

In the Excise, Estate and Gift Tax Adjustment Act of 1970 (Public Law 91-614, sec. 501(a)), Congress provided that if the regular taxes for any taxable year exceed the otherwise taxable preferences, the excess (that is, the regular income tax liability after tax credits which exceeds the tax preference income above the $30,000 exemption level) could be carried over and deducted from tax preferences for up to 7 succeeding years. This was a modification of a Senate floor amendment introduced by Senator Miller of Iowa. The amendment was supported on the ground that it would prevent discrimination against taxpayers whose amounts of taxable income and tax preferences fluctuated significantly.

1973 Treasury Proposals [16]

In April 1973, the Treasury submitted new tax reform proposals. The Treasury recommended that the present minimum tax on corporations be retained but that the minimum tax on individuals be replaced by a tax on minimum taxable income (MTI), an "alternative" tax concept. Under the Treasury proposal, individuals would calculate

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[13] Cong. Rec., Dec. 10, 1969 (daily ed.) pp .S16371–74, S16387–90.

[14] Joint Committee Staff, *General Explanation of the Tax Reform Act of 1969* (Dec. 3, 1970), pp. 104–107.

[15] The Revenue Act of 1971 (Public Law 92–178) also made several relatively minor changes in the minimum tax, the most significant of which was to add the preference for rapid amortization of on-the-job training and child care facilities.

[16] U.S. Treasury Department, *Proposals for Tax Change*, April 30, 1973.

a minimum taxable income and pay tax on it if it exceeded regular taxable income as calculated under present law. The minimum taxable income would be computed by taking adjusted gross income; adding to it four preference items to get expanded adjusted gross income (EAGI); subtracting from EAGI certain itemized deductions, a $10,000 floor, and personal exemptions to get the MTI base; and dividing the MTI base by two. The preference items added to AGI to get EAGI would be percentage depletion, the excluded half of capital gains, the bargain element of stock options, and exempt earned income from foreign sources. (Except for stock options, preferences that are deferrals of tax were to be excluded from the minimum tax. The Treasury proposed that these be dealt with under the proposal for a "limitation on artificial accounting losses," discussed in prior pamphlets.) The itemized deductions subtracted from EAGI to get the MTI base would be medical expenses, casualty losses and investment interest and expenses to the extent of investment income.

The Treasury proposed that MTI replace the provision in present law disallowing excess investment interest (sec. 163(d)) and that any taxpayer whose investment interest deduction is disallowed by the operation of MTI have the option of deferring the deduction by treating it as an artificial accounting loss under the LAL proposal. Also, the 50-percent limitation on charitable contributions would be repealed, and the alternative tax on capital gains would not apply to anyone whose minimum taxable income exceeds his regular taxable income.

The MTI proposal returns to the "alternative tax" concept of the 1968 Treasury proposals, except that it involves determining an alternative taxable income instead of an alternative tax liability. Under MTI, tax preferences could be subject to tax at rates ranging between 7 and 35 percent (since one-half of the preferences would be taxed under the regular rate schedules at rates between 14 and 70 percent); but there would be no minimum tax at all unless preferences plus disallowed deductions exceeded one-half of the sum of regular taxable income and a $10,000 floor.

The principal change in MTI from the 1968 proposal is its treatment of itemized deductions. Certain itemized deductions that are allowed in determining regular taxable income would not be allowed in determining minimum taxable income, including charitable contributions, State and local taxes, interest other than investment interest, and employee business expenses. In effect, these disallowed itemized deductions are treated precisely like items of tax preference. In some respects this treatment of itemized deductions is similar in effect to the earlier proposals for an allocation of deductions.

Senate Amendment

In January 1974, as an amendment to a tax bill, the Senate passed a minimum tax amendment. (The bill was subsequently recommitted to the Finance Committee and eventually enacted without any minimum tax amendments.)

The amendment would have reduced the $30,000 minimum tax exemption to $10,000 and abolished the deduction for regular taxes paid.

3. 1975 House bill (H.R. 10612)

The House bill (H.R. 10612) makes several changes in the existing minimum tax for individuals. It raises the minimum tax rate from 10 percent to 14 percent and eliminates the deduction from preference income for regular income tax liability. (As reported by the Ways and Means Committee, the bill reduced the deduction to 50 percent of regular taxes; but the House passed a floor amendment eliminating the deduction entirely.) The House bill reduces the exemption from $30,000 to $20,000 and provides for a phaseout of the exemption as preferences increase from $20,000 to $40,000.

The House bill adds several new preferences to the minimum tax base. There is a new preference equal to itemized deductions in excess of 70 percent of adjusted gross income. There are also now preferences for (1) intangible drilling costs on productive wells, (2) accelerated depreciation on all property subject to a lease (currently, only depreciation on net lease property is subject to the minimum tax), (3) interest and taxes during the construction period of a building, and (4) depreciation on player contracts of sports teams if sold in connection with the sale of the franchise. (Except for excess itemized deductions and intangible drilling costs on development wells, these new preferences were added by a House floor amendment.) Under the House bill, deductions that are deferred under LAL are excluded from the minimum tax base.

4. 1976 Treasury proposals

In his March 1976 appearance before the Finance Committee, Secretary Simon made a minimum tax proposal that supersedes the 1973 MTI proposal. Under the 1976 Treasury proposal, taxpayers would compute their tax on their regular taxable income or a minimum taxable income, whichever was larger. The minimum taxable income would be computed by adding two tax preferences to regular taxable income, subtracting a $10,000 exemption and multiplying the sum by 60 percent. The tax preferences are itemized deductions (other than charitable contributions) in excess of 70 percent of adjusted gross income and the excluded part of capital gains.

5. Issues

Basic Purpose of the Minimum Tax

Some argue that the minimum tax has no justification. They suggest that if Congress wishes to enact tax preferences, it should expect some individuals or corporations use these preferences to such an extent that they avoid all income tax. Similarly, it is argued that the minimum tax dilutes the incentive effect of the tax preferences that Congress has put into the law.

A minimum tax may be justified, however, on either of two grounds. One concept is that there should be a minimum tax on all preference income, however defined; that is, instead of excluding some types of income from tax entirely, they should be subject to some minimum tax. This is the theory that underlies the minimum tax changes in the House bill.

Some who accept this theory that the minimum tax should apply some minimum rate to all preference income criticize the fact that aggregate minimum tax liability is a relatively small fraction of aggregate preference income. In 1973, 119,000 individual tax returns with preference income in excess of $15,000 reported $7.28 billion of tax preferences. Of these, 26,000 had a minimum tax liability of $182 million on $4.16 billion of tax preferences. Thus, for individuals with some minimum tax liability (and, therefore, at least $30,000 of preference income) the minimum tax rate was 4.4 percent. Approximately half of the gap between effective rate and the 10-percent nominal rate of the minimum tax was caused by the $30,000 exemption and half by the deduction for regular taxes. Approximately one-sixth of the regular income taxes that are deducted against preference income are carryovers from prior years.

The House bill attempts to raise the effective rate of the minimum tax by lowering the exemption, eliminating the deduction for regular taxes, and raising the rate.

A second theory of the purpose of the minimum tax underlies the Treasury proposals of 1968, 1969, 1973 and 1976, the House version of the Tax Reform Act of 1969, and to some extent the Miller amendment on the Senate floor in 1969. This theory is that there is no need to impose a minimum tax rate on preference income generally, but that an undesirable situation occurs when too much of a taxpayer's income comes from tax-preferred sources, so that in these cases some minimum tax should be imposed; that is, there should be some minimum tax rate on a taxpayer's total income. This theory implies that the minimum tax should be an alternative tax, not an additional tax, and is used to justify the deduction for regular taxes paid in the existing minimum tax.

Those who adhere to this theory of the minimum tax criticize its failure to eliminate the phenomenon of high-income nontaxable individuals, the recognition of which first sparked interest in the minimum tax in 1969. In 1969 there were 745 individual income tax returns with adjusted gross income (AGI) over $100,000 and no Federal income tax after credits.[17] Mainly as a result of the Tax Reform Act of 1969, the number of such nontaxable returns fell to 400 in 1970 and to 300 in 1971. In 1972, however, the number of nontaxable reurns with AGI over $100,000 rose to 425, including 6 nontaxable returns with AGI over $1 million, and in 1973, it rose further to 622, including 7 millionaires. The minimum tax has been criticized for allowing these high-income nontaxable returns to exist. In response, it is argued that these returns are a small fraction of the 136,000 tax returns with AGI over $100,000 in 1973 (and 903 returns with AGI over $1 million) and that otherwise unsound tax policies should not be enacted just to ensure that a small group pays its taxes.

In considering this criticism, the committee should note that the existing minimum tax does make a significant contribution towards reducing the number of nontaxable individuals with high AGI. In 1973, 5,756 individual returns paid no regular income tax but paid some minimum tax (and, therefore, had at least $30,000 of preference income). These included 532 individual returns with AGI over $100,000 and 17 with AGI over $1 million. Thus, in 1973, the minimum tax

[17] The committee should note that these statistics significantly understate the extent of tax avoidance by high-income people. Most tax preferences, including the capital gains exclusion, the exclusion of interest on State and local bonds and so-called tax shelters, have the effect of reducing AGI, so that individuals with high economic incomes who avail themselves of these preferences to such an extent that they avoid all income tax would not be counted in these statistics.

almost halved the number of nontaxable individual returns with AGI over $100,000 and reduced the number of nontaxable returns with AGI over $1 million by almost two-thirds. The total minimum tax paid on returns with no regular tax was $40 million (an average of $7,000 per return), including $10 million from the returns with AGI over $100,000 (an average of $20,000 per return). The 7-year carryforward for regular taxes paid, adopted in 1970, however, may significantly lessen the effect of the minimum tax in reducing the number of high-income nontaxable individuals.

The principal way in which an individual can have high AGI and little or no income tax is to have large itemized deductions. To eliminate the remaining high-AGI nontaxable returns, then, the minimum tax must be amended to deal in some way with itemized deductions or some other limit must be placed on them. This issue is discussed in more detail below. A second source of tax avoidance by people with high AGI is the use of tax credits, principally the foreign tax and investment credits. To eliminate the high-AGI nontaxables completely, these credits would have to be limited in some way or brought into the minimum tax base.

The effect of a minimum tax which is an alternative tax and one which is an additional tax can be summarized as follows: Consider two individuals each with $100,000 of preference income. Mr. A has $100,000 of wage income as well, and Mr. B has no other income. Mr. A pays $43,000 of regular income tax (if he takes the standard deduction, is married, and files a joint return); Mr. B, of course, pays no regular tax. Clearly, Mr. A will have a higher total tax liability than Mr. B because his income is higher. The issue is whether Mr. A or Mr. B should pay the higher rate of minimum tax on his preference income, or whether they should pay the same rate. One who believes that the objective of the minimum tax is to make sure that people pay some minimum rate of tax on their preference income probably want Mr. A and Mr. B to pay at least the same minimum tax, or possibly for Mr. A to pay more because his total income is higher. Those who believe the minimum tax should try to make people pay some minimum rate of tax on their total income would probably want Mr. A to pay little or no minimum tax, and certainly less than Mr. B, because Mr. A pays regular income tax.

Under the present law, Mr. A pays $2,700 of minimum tax (10 percent of the difference between $100,000 and the $30,000 exemption plus the $43,000 regular tax deduction) and Mr. B pays $7,000 (10 percent of the difference between $100,000 and the $30,000 exemption). Thus, because of the deduction for regular taxes, the existing minimum tax conforms more closely to the model of a minimum tax rate on total income, although the fact that Mr. A pays some minimum tax (despite his paying an effective regular tax rate of 21.5 percent) indicates that the existing minimum tax is a compromise between the two models.

If the deduction for regular taxes were repealed, both Mr. A and Mr. B would pay $7,000 of minimum tax, so the minimum tax then would conform to the model of an "additional" minimum tax on preference income. Under an alternative minimum tax, Mr. A would pay no minimum tax (and, therefore, would experience a $2,700 tax reduction from present law), while Mr. B would pay substantially more than he pays under present law.

Treatment of Itemized Deductions

The minimum tax has not directly dealt with itemized deductions (except excess investment interest for a brief transitional period). The 1968 and 1969 Treasury proposals and the House bill in 1969, however, included proposals for the allocation of itemized deductions between taxed and nontaxed income.

Itemized deductions could be included under either the existing or any other minimum tax. If the present structure of the tax is retained, certain itemized deductions could be considered items of tax preference or all itemized deductions in excess of (say) 70 percent of AGI could be considered items of tax preference. (This latter approach is included in the House bill.) If an "alternative tax" concept is adopted, then some or all itemized deductions could not be allowed as deductions in computing the minimum tax or all itemized deductions above (say) 70 percent of AGI could be treated as tax preferences.

Still another possibility would be to impose an overall limit on itemized deductions as a fraction of adjusted gross income (such as 75 percent) similar to the existing limitations on the charitable contribution deduction. As with charitable contributions, there could be an unlimited carryover of disallowed itemized deductions.

Specific Preferences Included in the Minimum Tax

The committee will probably want to reconsider the tax preferences that are subject to the minimum tax, since a criticism of the existing minimum tax is that is applies to only 9 of the approximately 75 tax preferences in the tax expenditure budget. In practice for individuals the present minimum tax is largely a tax on one preference—the excluded part of long-term capital gains.

Table 1 presents data on the tax preferences reported on individual and corporate tax returns for the year 1972 for individuals and 1971 for corporations. Capital gains dominate the tax preferences for individuals, amounting to almost seven-eighths of the total. For corporations in 1970, percentage depletion accounted for over two-fifths of the tax preferences reported, with capital gains equal to one-fifth and accelerated depreciation and bad debt reserves each equal to one-sixth. The repeal of percentage depletion for oil and gas for the major oil companies in the Tax Reduction Act of 1975 will, of course, significantly alter these percentages for corporations.

TABLE 1.—TAX PREFERENCES REPORTED ON TAX RETURNS

Preference	Individuals, 1972		Corporations, 1971	
	Amount (millions)	Percent	Amount (millions)	Percent
Accelerated depreciation:				
Real property	$357	4.5	$995	16.4
Personal property subject to a net lease	26	.3	7	.1
Amortization:				
Pollution control	(1)	(1)	35	.6
Railroad rolling stock	1	(1)	161	2.7
On-the-job training	(1)	(1)	(1)	(1)
Child care	(1)	(1)	(1)	(1)
Stock options	378	4.8	(1)	(1)
Bad debt reserves	(1)	(1)	1,012	16.7
Depletion	241	3.0	2,537	41.9
Capital gains	6,933	87.4	1,280	21.1
Total	7,935	100.0	6,054	100.0

[1] Less than $5,000,000 or 0.05 percent.

As long as the rate of the minimum tax is relatively low, there are no technical problems with putting any tax preferences into the minimum tax; however, if the minimum tax rate exceeds about 15 to 20 percent, there are problems with including in the minimum tax those preferences that represent deferrals of tax liability. These deferral preferences are becoming increasingly important as interest rates rise, since tax deferral is, in effect, an interest-free loan to the taxpayer from the Federal government. It is desirable, therefore, to continue to include them in the minimum tax. When income on which tax is deferred is included in the minimum tax, however, it is taxed once in the minimum tax and later under the regular income tax. As long as the minimum tax rate is relatively low, there need not be any problem, since the modest minimum tax compensates for the benefits from tax deferral, but when the minimum tax rate approaches 35 percent, as under several proposals, the result can be confiscatory taxation, taxing individuals' income once at 35 percent and later at 70 percent.

There are three possible solutions to this problem. One is to keep the top minimum tax rate below, say, 20 percent. A second is to allow averaging under the minimum tax, so that the income tax that is later paid on preference income on which tax is deferred is taken into account in computing the minimum tax. (This averaging is only relevant when the minimum tax is an "alternative tax" where the taxpayer's regular tax liability is considered in determining his minimum tax.) A third solution is to allow basis adjustments. If the minimum tax increases an individual's tax liability, the basis of assets that generate preference income on which tax is deferred could be increased to take account of any minimum tax paid on preference income from that asset. This would, in effect, allow the taxpayer to recapture his minimum tax when he pays his regular tax on the item of tax preference. Both averaging provisions and basis adjustments complicate the minimum tax considerably, so considerations of simplification argue for either keeping the minimum tax rate low or keeping deferral preferences out of the minimum tax.

Averaging

If the committee decides to adopt a minimum tax in which the taxpayer's regular income tax helps determine his minimum tax, it will also have to decide whether to allow averaging; that is, whether to allow regular tax paid in past or future years to reduce the minimum tax in the current year. Under existing law, as a result of a Senate floor amendment in 1970, regular tax liability that is not used to offset preference income in the current year can be carried forward for 7 years and used to offset preference income in those future years. In 1972, when only carryforwards from 1970 and 1971 were available, $510 million in tax carryforwards were offset against preference income on individual returns, leading to a revenue loss of $51 million. This will probably increase substantially in the future.

One argument in favor of permitting averaging in the minimum tax is that the minimum tax should only be used to tax people who have low effective tax rates year after year, so that taxes paid in years when a taxpayer has a high effective rate should be counted in those years when he has a low effective rate. In response, it is argued that the purpose of the minimum tax is either to make sure that all preference income pays some minimum rate or that it is to make sure that individuals pay a minimum rate on their total income in each and every year, not just on the average, both of which purposes imply that averaging is inappropriate. The inclusion of deferral preferences in the minimum tax, especially if the top rate is raised significantly, however, strengthens the case for averaging or a basis adjustment.

Advocates of averaging suggest that the present provisions are insufficient. These allow carrying regular tax forward but not back to prior years. Thus, if a taxpayer has regular tax liability one year and preferences in the next 7 years, he can use the regular tax to offset the preferences; but if his preferences precede his tax, he must pay minimum tax on the preferences because there is no carryback of unused regular tax liability. A carryback, however, is more beneficial to the taxpayer than a carryforward, since it provides a refund immediately.

It is clear that any averaging provisions significantly complicate the minimum tax and reduce its revenue yield.

Progressivity

One criticism of the existing minimum tax is that it is not sufficiently progressive. Generally speaking, a progressive tax is one in which tax liability rises more than proportionately as income rises, and the minimum tax is clearly progressive in this sense. In 1973, 70 percent of the minimum tax was paid by individuals with AGI over $100,000. With the minimum tax, however, two additional concepts of progressivity can be defined: Does the minimum tax rise more than proportionately as preference income rises, given the amount of regular income? Does the minimum tax rise more than proportionately as regular income rises, given the amount of preference income? The existing minimum tax is proportional in the first sense, except for the $30,000 exemption, since it has a flat 10-percent rate. It could be made progressive in this sense by graduating the rate with respect to the level of preference income. The minimum tax, however, is regressive in the second sense: for a given amount of preference income, the minimum tax falls as regular income (and regular tax) rises. This could be improved by eliminating the deduction for regular taxes paid, which would make the minimum tax constant as regular income rises. (There is no simple way to have the minimum tax rise as regular income rises.)

The alternative minimum tax proposed by the Treasury is more progressive in the first sense, but more regressive than the existing minimum tax in the second sense. For a given amount of regular income, the minimum tax rises from 7 to 35 percent as preference income rises; but for a given amount of preference income, the minimum tax falls sharply as regular income rises.

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