[COMMITTEE PRINT]

# ANALYSIS OF THE REUSS-VANIK MINIMUM TAX AMENDMENT TO THE DEBT LIMIT BILL

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## ANALYSIS OF REUSS-VANIK MINIMUM TAX AMENDMENT

*Present law*

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

The tax preference income 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 loss carryovers and for carryovers of "unused" regular income tax deductions. In the case of net operating loss carryovers, 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 provision for carryovers of excess regular income tax which provides that in a year in which a taxpayer has regular income tax liability (after tax credits) which exceeds his tax preference income above the $30,000 exemption level, the excess tax liability may be

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[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.

carried forward for 7 years and used to offset tax preference income otherwise subject to the minimum tax in those later years.

*Reuss-Vanik amendment*

The Reuss-Vanik amendment (H.R. 11155) to the debt limit bill makes three principal changes in the present law. First, the $30,000 exemption in existing law is reduced to $10,000. Second, the deduction in the minimum income tax for regular income taxes paid (individual or corporate as the case may be) and the related carryover provisions are eliminated. Third, the rate of the minimum income tax is changed from the current flat rate of 10 percent to one-half the rates of the regular income taxes. Thus, for individuals the rate of the minimum tax would vary from 7 percent to 35 percent and for corporations the rate would be 11 percent on the first $25,000 of preference income and 24 percent on all additional preference income.

In certain cases, the amendment would lead to tax rates on preference income that would be higher than the rates on nonpreference income. To deal with these situations, the amendment provides that a taxpayer may elect not to claim a tax preference and instead may pay the tax rate applicable to regular income.

It is estimated that at 1972 income levels the amendment would lead to an increase in tax revenue of $2.69 billion. Of this, $1.64 billion would come from individuals and $1.05 billion would come from corporations.

*Effect of amendment on corporate income*

Table 1 shows the various items of corporate tax preferences included in the minimum income tax base for 1970. Depletion constituted 48.7 percent of these tax preference items. Capital gains were 21.0 percent, and accelerated depreciation on real property was 16.0 percent. Bad debt reserves of financial institutions were 10.9 percent of the total. Since the amendment makes no changes in the base of the minimum income tax, this table also shows the kinds of income which would be affected by the amendment and their relative importance. The main burden would clearly fall on depletion and capital gains.

Table 2 shows the actual 1970 minimum tax liabilities for all corporations in certain major industries and what the minimum tax liabilities would have been had the amendment been in effect. The actual minimum tax liability in 1970 for the oil and gas industry was $158.2 million. If the amendment had been applicable in 1970, it would have raised this to $478.6 million, an increase of $320.4 million or 50.7 percent of total corporate income taxes paid that year. (Dividends paid by the industry in 1970 totaled approximately $4 billion.)

TABLE 1.—CORPORATE TAX PREFERENCE INCOME, 1970

| Preference item | Amount of income (millions) | Percent of total preference income |
|---|---|---|
| Accelerated depreciation on real property | $919 | 16.0 |
| Accelerated depreciaton on personal property | 11 | 0.2 |
| Amortization of polluton control equipment | 5 | 0.1 |
| Amortization of railroad rolling stock | 178 | 3.1 |
| Stock options | 1 | ---- |
| Bad debt reserves | 630 | 10.9 |
| Depletion | 2,799 | 48.6 |
| Capital gains | 1,210 | 21.0 |
| Total | 5,753 | 100.0 |

Note: Excess investment interest, which was a preference item in 1970 but is not now, is excluded from the total.

TABLE 2.—CORPORATE INCOME TAX LIABILITY OF SELECTED INDUSTRIES UNDER PRESENT LAW AND UNDER REUSS-VANIK AMENDMENT, 1970

[In millions of dollars]

| Industry | Minimum tax under present law (1) | Total corporate tax under present law [1] (2) | Estimated minimum tax under amendment (3) | Increases in tax (3)−(1) (4) | Percentage increase in tax (4)÷(2) (5) |
|---|---|---|---|---|---|
| Oil and gas [2] | 158.2 | 631.4 | 478.6 | 320.4 | 50.7 |
| Other mining | 12.9 | 241.7 | 83.9 | 71.0 | 29.4 |
| Lumber and wood products | 4.0 | 162.0 | 26.2 | 22.2 | 13.7 |
| Commercial banks | 2.1 | 1,337.6 | 53.7 | 51.6 | 3.9 |
| Mutual savings banks | 3.6 | 34.0 | 16.5 | 12.9 | 37.9 |
| Savings and loan associations | 21.7 | 180.1 | 103.0 | 81.3 | 45.1 |

[1] Total regular and minimum corporate tax after credits, excluding surcharge.
[2] Includes crude petroleum and natural gas and petroleum refining.

Under the regular income tax, the rate of percentage depletion for oil and gas is 22 percent of gross income. The existing minimum tax lowers this to approximately 18½ percent.[4] By taxing percentage depletion in excess of cost depletion at one-half the rate applicable to normal income, the amendment in effect lowers the rate of percentage depletion to 11 percent of gross income.

Table 2 also shows that other mining corporations paid $12.9 million in minimum tax in 1970. Had the amendment been in effect, their minimum tax liability would have been $83.9 million, an increase of $71.0 million or 29.4 percent of the taxes paid by this industry in 1970.

The lumber and wood products industry paid $4.0 million in minimum tax in 1970 and would have paid $26.2 million under the amendment. This increase occurs mainly because the amendment would raise the effective tax rate on corporate capital gains from roughly 31 percent to 39 percent.[5] The percentage increase in tax, had the amendment been in effect in 1970 would have been 13.7 percent.

Financial institutions would also experience significant increases in their taxes under the proposed amendment. Commercial banks paid $2.1 million in minimum tax in 1970, and their liability would rise to $53.7 million under the amendment. Mutual savings banks paid minimum tax of $3.6 million in 1970, and under the amendment this would increase to $16.5 million. Savings and loan associations paid $21.7 million in minimum tax in 1970 and would have paid $103.0 million that year under the amendment. Savings and loan associations and mutual savings banks would experience significantly larger percentage increases in corporate income taxes (a 45.1 percent and a 37.9 percent increase respectively in total tax under the amend-

[4] The effective rate of the current minimum tax on the oil industry is about 7.8 percent because of the deduction for regular taxes paid and the $30,000 exclusion. Assuming no cost depletion, the inclusion of 22 percent of gross income in the minimum tax leads to a minimum tax liability of 1.7 percent of gross income. With a regular corporate rate of 48 percent of net income, this minimum tax of 1.7 percent of gross income is equivalent to losing a deduction of 3.5 percent of gross income. Without the deduction for regular taxes paid and the $30,000 exclusion, the 10-percent minimum tax would be equivalent to losing a deduction of (10/48) (22 percent) = 4.6 percent. Thus, the effective rate of percentage depletion in this case would be 17.4 percent. Since the minimum tax rate is about one-fifth of the regular corporate tax rate, the minimum tax reduces the value of depletion by about one-fifth.

[5] Under present law, the regular corporate capital gains tax rate is generally 30 percent. Therefore, for a $100 capital gain, regular income tax is $30. In addition, 18/48 of the gain, or $37.50, is subject to the minimum tax. With the $30 deduction for regular taxes paid, the minimum tax is 10 percent of $7.50, or $0.75, giving rise to an overall tax liability of $30.75. Under the amendment, the minimum tax liability is 24 percent of $37.50, or $9.00, so that total tax liability is $39.00.

ment) than would their competitors, commercial banks, whose increase would be only 3.9 percent.

*Effect of amendment on income of individuals*

Table 3 shows the amount and percentage distribution of tax preferences subject to the minimum income tax in 1970 and 1971 for individuals. As is clear from the table, the minimum tax on individuals is largely a tax on their realized capital gains. In both years over 85 percent of tax preferences were capital gains. In 1971, accelerated depreciation accounted for slightly over 5 percent of the minimum tax base for individuals, and stock options and depletion each accounted for about 4 percent.

TABLE 3.—AMOUNT AND PERCENTAGE DISTRIBUTION OF TAX PREFERENCES IN RETURNS WITH TAX PREFERENCES—INCOME YEARS 1970 AND 1971

| Tax preferences | Amount (millions) | | Percentage distribution | |
|---|---|---|---|---|
| | 1970 | 1971 | 1970 | 1971 |
| Accelarated depreciation: | | | | |
| Real property | $255.6 | $304.2 | 6.0 | 5.0 |
| Personal property subject to net lease | 25.6 | 22.5 | .6 | .4 |
| Amortization: | | | | |
| Certified pollution control facilities | 0.1 | .3 | (1) | (1) |
| Railroad rolling stock | 1.5 | 1.8 | (1) | (1) |
| Stock options | 131.8 | 248.9 | 3.1 | 4.1 |
| Bad debt reserves | .5 | .4 | (1) | (1) |
| Depletion | 210.6 | 229.2 | 4.9 | 3.7 |
| Capital gains | 3,650.6 | 5,316.0 | 85.4 | 86.8 |
| Total | 4,276.3 | 6,123.3 | 100.0 | 100.0 |

[1] Less than 0.05 percent.

Note: Excess investment interest is omitted, since it is no longer an item of tax preference subject to the minimum tax.

The proposed amendment therefore, would lead to a significant increase in capital gains tax rates for individuals. With the existing minimum tax, the effective maximum tax rate on realized capital gains is 36.5 percent except in certain cases where there is an interaction with the maximum tax rate on earned income. Under the amendment, the maximum rate on capital gains would rise to 52.5 percent.[6] It should be noted, however, that even though the proposed amendment raises the maximum tax rate on realized capital gains by roughly 44 percent, it would not raise the average capital gains rate by nearly that much. This is because the regular income tax and the minimum tax are separate from each other, so that recipients of capital gains in effect can split up their gain so that it is taxed under two separate progressive taxes. For a married couple filing a joint return, the maximum rate of 52.5 percent would apply only to that portion of capital gains in excess of $420,000.

Table 4 shows the distribution of minimum tax liability and the number of tax returns affected by the minimum tax under present law and under the amendment by adjusted gross income (AGI) classes. The table shows that by far the largest impact is on tax returns with AGI over $100,000. Eighty-one percent of the additional mini-

[6] Under present law the maximum rate on capital gains under the regular income tax is 35 percent. For a $100 gain, then, regular income tax is $35. In addition, $50 is subject to the minimum tax. The deduction for regular taxes paid is $35, leaving $15 to be taxed at a 10-percent rate. The total tax, then, is $36.50. Under the proposed amendment, the minimum tax could be as high as 35 percent of $50, or $17.50, leading to a total tax on the capital gain of $52.50

mum tax liability from the amendment would be paid by people in this class. The amendment would affect 3,000 returns with AGI under $3,000. As is evident from the large amount of additional tax paid by these returns, however, this group is composed largely of people with low AGI but large amounts of preference income. A total of 273,000 returns in all AGI classes would be affected by the proposed amendment.

TABLE 4.—DISTRIBUTION OF MINIMUM TAX LIABILITY UNDER PRESENT LAW AND UNDER REUSS-VANIK AMENDMENT

| Adjusted gross income class (thousands) | Present law | | Reuss-Vanik amendment | | |
|---|---|---|---|---|---|
| | Number of returns affected (thousands) | Tax liability (millions) | Number of returns affected (thousands) | Tax liability: Additional (millions) | Tax liability: Total (millions) |
| 0 to $3,000 | 1 | $11 | 3 | $27 | $38 |
| $3,000 to $5,000 | (1) | (1) | 1 | 1 | 1 |
| $5,000 to $7,000 | (1) | (1) | (1) | 1 | 1 |
| $7,000 to $10,000 | (1) | (1) | 17 | 4 | 4 |
| $10,000 to $15,000 | (1) | (1) | 19 | 4 | 5 |
| $15,000 to $20,000 | (1) | (1) | 39 | 10 | 11 |
| $20,000 to $50,000 | 6 | 7 | 98 | 105 | 112 |
| $50,000 to $100,000 | 8 | 18 | 56 | 162 | 180 |
| $100,000 or more | 17 | 154 | 40 | 1,329 | 1,483 |
| Total | 32 | 192 | 273 | 1,642 | 1,834 |

[1] Less than 500 returns or $500,000.