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(Alternative) minimum tax: Precursor to a flat-rate income tax?

William D. Samson

THE (ALTERNATIVE) MINIMUM TAX: PRECURSOR TO A FLAT-RATE INCOME TAX?

by
William D. Samson
University of Alabama

The alternative minimum tax is a complete tax calculation that haunts a relative small, but growing, percentage of individual taxpayers. It has evolved since 1969 from a conceptual nuisance which bothered almost no one to a tax which can be a nightmare for the unsuspecting. The alternative minimum tax with its almost uniform rate structure, applied to a broader base of taxable income, computed after a large exemption, seems to be a mirror of the "flat" rate income tax proposals that have recently been described in the press. The 25 year history and evolution of the minimum tax seems relevant in the debate regarding proposals of change in the current graduated income tax to a broader-based, flat rate structure.

The Evolution of the Minimum Tax

In the mid-1960s, a study reported that 154 taxpayers with incomes in excess of $200,000 (more than $600,000 in 1996 dollars) escaped from paying U.S. income tax. This study became widely publicized, and Congress became concerned about erosion of the average taxpayer's confidence in the fairness of the income tax, especially when 154 wealthy taxpayers were paying no income tax through maximizing excluded income and tax deductions. Mrs. Dodge, heir to the Chrysler fortune who lived in Palm Beach on more than $1,000,000 of municipal bond interest and paid no income tax, was cited in Congress as an example of the unfairness of the income tax structure.

Congress could have solved the problem of wealthy taxpayers owing no federal income tax by "plugging the loopholes" via taxing municipal bond interest, fully taxing capital gain, and repealing or limiting various itemized deductions. However, this approach was believed to have large negative economic and social consequences. Instead, Congress adopted Joseph Pechman's idea of imposing a tax on the use of loopholes. This tax (ironically known as the "minimum" tax, while the tax rate on earned income was capped at 50% was called the "maximum tax") would be in addition to the regular income tax. Simply put, the taxpayers would add up the amount of loopholes (called "tax preferences"), subtract a generous exemption amount and multiply the amount of preference in excess of the exemption by the 10% "minimum" tax rate.

Implementation of the Add-On Minimum Tax

Ironies abound. First, the Mrs. Dodges of the world still were not subject to tax because Congress decided not to include municipal bond interest as a preference item. Second, the 1969 version of the tax was very ineffective at imposing tax on the wealthy because of the large exemption. Third, as an equity mechanism, the tax failed because a 10% tax rate was too low when wealthy taxpayers otherwise saved tax via preferences at rates up to 70 percent.

Perhaps the greatest irony in this add-on minimum tax scheme was that in 1970, President Richard Nixon became one of the first "victims" of this tax. President Nixon, as it was revealed at the same time as the Watergate controversy, paid only $792 in federal income tax in 1970 and $878 in federal income tax in 1971. 1972's federal income tax soared by comparison to $4,298. Thus, less than $6,000 of income was paid during this three year period when Nixon's income exceeded $780,000. The income tax paid during this period was not the "regular" income tax, but the minimum tax. By contrast, his 1969 income was $328,000, and he had paid more than $72,600 of federal income tax.

What had changed on Nixon's tax return after 1969 was a charitable contribution deduction for the "donation" of his collection of Vice Presidential papers to the federal government. These papers were stored by the General Service Administration until the Nixon Library, which he hoped would be constructed at his alma mater, Duke University, could be built. Nixon's appraiser generously valued this charitable contribution of Vice Presidential Papers at $576,000, so that Nixon reduced his taxable income to zero in both 1970 and 1971 and was finally able to exhaust this deduction in 1972.[1] Because the charitable contribution deduction for appreciated property was a tax preference, the meager tax that Nixon did pay in 1970 and 1971 was the minimum tax, not the regular income tax.

The Alternative Minimum Tax

In 1976, Congress replaced the ineffective 10% add-on minimum tax with the alternative minimum tax. Conceptually, this tax was different. Instead of adding the minimum tax (imposed on preferences only) to the regular income tax, the alternative minimum tax meant that the taxpayer recalculated taxable income base by adding back the preferences to the regular taxable income amount, to which was applied the 15% minimum tax rate. Finally, the taxpayer compared the minimum tax result to his regular income tax amount and paid the larger of the regular income tax or alternative minimum tax. Noteworthy is the fact that the alternative minimum tax of the late 1970s had several elements of current flat rate income tax proposals. Certainly, the tax rate of 15% is close to the proposed 17% figure. Also, the notion that the flat-rate be applied to a broad base with few, if any, itemized deductions is found in the alternative minimum tax which adjusts or adds back to taxable income much of these deductions. The alternative minimum tax allowed a relatively large exemption which was $40,000 (now $45,000) for married taxpayers. This too seems reminiscent of the proposed $35,000 – "family of four exemption" that is being discussed with the flat-rate income tax.[2]

Simultaneously with the reduction of the regular income tax rate for 1982 and after, the 1981 Economic Recovery Tax Act raised the minimum tax rate to 20%. Over the decade of the 1980s (See Figure) this pattern of lowering the regular income tax rates while increasing the alternative minimum tax rate continued. By 1988, the rate differential between the highest regular income tax rate of 28% and the alternative minimum tax rate of 21% was only seven percentage points. This small rate differential has only increased slightly as both tax rates have been increased during the 1990s. Today the differential stands at 11.6 percentage points as the top regular income tax rate is 39.6% and the alternative minimum tax rate is 28%.

Not seen in the Figure is the relative frequency of changes that has redefined the tax base for the minimum tax. Since 1969, Congress has periodically changed the definition of what is a preference as well as the adjustments that are made to the amount of regular taxable income. These changes then impact the base to which the minimum tax rate is applied.

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[1] During subsequent revelations, it appears that the $576,000 value for these papers was very excessive. Also, the issue of when the donation of papers actually occurred was raised. While the papers were physically transferred to the GSA before the July 25 cut-off, the agreements were not drafted and title was not conveyed until more than a year later. Indeed, one of Nixon's tax advisers went to jail because documents were backdated to make it appear that the transfer was within the period that entitled the President to this huge tax deduction.

[2] However, if the alternative minimum tax is the forerunner of the flat rate income tax, the fact that the 15% minimum tax rate is now 28%, is significant of the problem that a 17% flat rate income tax is likely to have. Also, the one rate (flat) minimum tax has since 1993 become a two-tiered structure of 26% and 28%.

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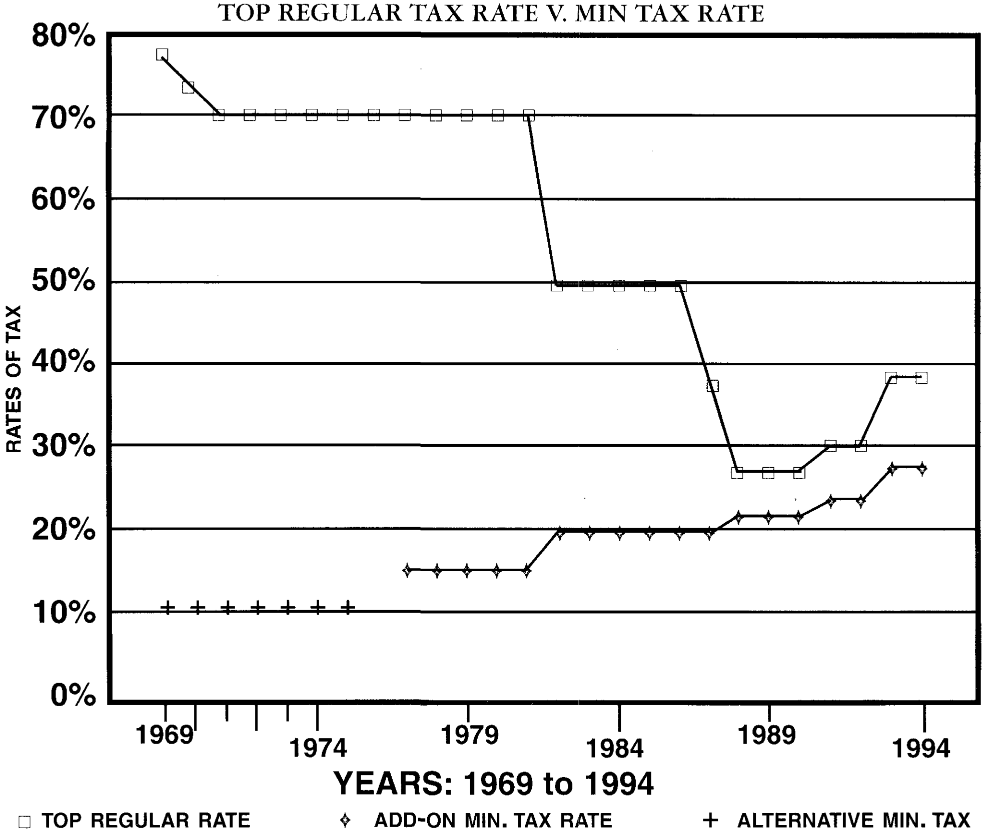
One final irony is that the current alternative minimum tax is really an "add on" tax to the regular income tax. This is because the taxpayer in the alternative minimum tax calculation subtracts the regular income tax from the gross alternative minimum tax (as if the regular income tax is a credit). The net alternative minimum tax (the excess of the gross AMT over the regular income tax) is then added on the back page of Form 1040 to the regular income tax.

REGULAR INCOME TAX VERSUS MINIMUM TAX:
TOP REGULAR TAX RATE V. MIN TAX RATE



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TAKE A MONK HOME

The Academy again is selling T-shirts bearing, on the back of the shirt, a print of the famous *Summa* pose of Luca Pacioli. The shirts are ivory with rust-colored print and made of Fruit of the Loom 50/50 cotton polyester material. Shirts can be ordered for $10 each (plus $3 shipping charge *per shirt*). Sizes XX-Large and up are $12. To get your T-shirt(s), please contact Jeanette Sanfilippo. She has several monks who need a home with warmth and love.

The Academy of Accounting Historians
ATTN: Prof. Jeanette Sanfilippo
John E. Simon School of Business
Maryville University
13550 Conway Road
St. Louis, Missouri USA 63141
or: Telephone: (314) 529-9571
FAX: (314) 529-9975
E-mail: jsan@Maryville.edu
Please allow 6-8 weeks for delivery.