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ALTERNATIVE MINIMUM TAX

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION

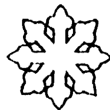
OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED SECOND CONGRESS

SECOND SESSION

FEBRUARY 19, 1992



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ALTERNATIVE MINIMUM TAX

THURSDAY, FEBRUARY 19, 1992

U.S. SENATE,
SUBCOMMITTEE ON TAXATION,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 2:20 p.m., in room SD-215, Dirksen Senate Office Building, Hon. David L. Boren (chairman of the subcommittee) presiding.

[The press release announcing the hearing follows:]

[Press Release No. H-7, Feb. 13, 1992]

SUBCOMMITTEE TO HOLD HEARING ON ALTERNATIVE MINIMUM TAX, BOREN SAYS AMT MAY NOT BE WORKING AS INTENDED

WASHINGTON, DC—Senator David Boren, Chairman of the Senate Finance Subcommittee on Taxation, Thursday announced a hearing on the effects of the alternative minimum tax, or AMT.

Boren (D., Okla.) said the hearing will be at *2 p.m., Wednesday, February 19, 1992* in Room SD-215 of the Dirksen Senate Office Building.

"Congress had good intentions when it created the AMT in 1986, but it is clear now that the AMT may not be working the way Congress intended," Boren said. "With about 50 percent of all major U.S. companies paying the AMT, we cannot afford a situation in which a tax regime causes their capital recovery rates to be only half to one-third as high as those of their foreign competitors. When income is low, as in our current recession, the situation becomes even worse as more firms are paying the AMT.

"This hearing will give us an excellent opportunity to take a close look at the AMT and its effect on American business so that we can determine whether the AMT needs to be fixed," Boren said.

OPENING STATEMENT OF HON. DAVID L. BOREN, A U.S. SENATOR FROM OKLAHOMA, CHAIRMAN OF THE SUBCOMMITTEE

Senator BOREN. The hearing will commence. There are other colleagues on the Subcommittee that are expected to be present soon. But given the interest of time and the problems of other meetings that are going on this afternoon, I think we will proceed.

First, let me welcome our distinguished witnesses and thank them for spending time with us this afternoon discussing the alternative minimum tax system. Since 1986 we have not focused much attention on the AMT, except to discuss whether the rates should be increased or lowered.

The lack of interest is explained in part because the AMT is complicated. Its goal—and it is a laudable objective—is to ensure that profitable corporations pay their fair share of taxes. This concept is easy to understand, but the actual operation of the system is very difficult.

In part, lack of attention to the AMT has been caused because it takes some time before we can learn and analyze the economic effects of any system. We now have 4 years of experience by which we can judge how this system is working. In fact, enough time has passed for us to be able to embark on today's discussion of the system.

Indeed, we must engage in a serious analysis of the AMT system because it has become obvious that some sort of modification will occur. Both the President's proposed budget and the House Democratic alternative tax legislation include changes in the present AMT structure.

I have several concerns with the AMT that I will outline in the hope that our witnesses will address these issues in their statements and in their answers to the Subcommittee's questions.

First, I am concerned about the statistics that indicate that the alternative minimum tax has a significant, negative impact on the ability of U.S. companies to compete internationally. The cost of capital for our businesses is comparatively greater than the cost to foreign corporations because of the heavy U.S. tax burden on capital assets.

One study indicated that after 5 years a German company recovers over 81 percent of the cost of a factory robot, for example; and a Korean business recovers the entire cost of that equipment. In sharp contrast, a U.S. company that is paying the alternative minimum tax recovers only 37 percent of the original cost in 5 years. There are similar figures for engine blocks—industry after industry.

It is clear that with that kind of comparative disadvantage, the United States simply will not be important in many businesses. We will simply no longer be a competitor in the world market if we are hampered by such an imbalance in the cost of capital in the future.

Perhaps when the Congress enacted the AMT it did not expect such an extreme effect on the competitive posture of American businesses or perhaps we did not think internationally when we enacted this policy. We have to come to realize that what we have thought of in the past as purely domestic decisions now must be viewed in an international context.

We cannot afford to set our tax rates and to set our tax policy in a vacuum, given our dependence on exports and our need to compete in the world markets, any more than I could set our tax rates or recommend changing our tax rates when I was Governor of a State without considering the tax rates on similar sources of income and products in bordering States. Every Governor in the United States understands that. It is time for the Senate Finance Committee and the House Ways and Means Committee and all of us collectively to understand that. We must have the same kind of outlook in terms of understanding what our competition is doing with their tax codes as we write tax policy in this country.

We simply cannot afford to write our tax policy in a vacuum because we refuse to acknowledge the importance of the international market and the increasing interdependence of the world economics. We will soon find ourselves a second-rate economic power.

Second, I am concerned that the impact of the recession has resulted in the AMT operating differently than Congress intended or

anticipated. Part of the AMT scheme is the provision that allows a corporation a credit in the amount of the excess of minimum tax over its regular tax. That AMT credit is then applied against regular tax liability in future years, but it is not available for use to offset AMT liability.

We expected the corporations would revert to paying regular corporation taxes soon enough for them to use these credits while they still had some value. However, some commentators have noted that a number of corporations will be paying the AMT for many years. Therefore, they will never be able to use the AMT credit in the foreseeable future. So we are in essence penalizing those companies that are making the largest capital investments to make themselves productive—the very thing we want to encourage in this country.

Some experts note that this situation will result inherently during recessionary times because the economic downturns cause profits to be low while capital expenses may well continue to be high. So you have AMT credits that are built up because you are continuing a level of capital investment. You have a falling or plunging income because of the recession.

I hope that our witnesses can address the reasons why companies that are not emerging from the AMT position, what we should do about it, how prevalent a phenomenon this is, and what, if anything, Congress can do to modify the AMT credits so they can be used within a meaningful time frame.

Finally, I am concerned about one industry in particular. And it is certainly one that concerns me because I am very familiar with it. I live in an area that is principally dependent upon it and so I see the effects of it every day. The independent oil and gas industry appears to be suffering unduly from the alternative minimum tax system.

Since 1986 domestic oil production has declined by more than 1.7 million barrels per day. This lost production equates to measurable loss in wealth to the U.S. society, before any multiplier effects, of $160 to $250 billion. The number of domestic independent producers has dropped by more than one-third, and the industry has lost 317,000 jobs in the last decade.

These figures reveal a crisis in the industry, a crisis with wide implications because 60 percent of this country's natural gas and 40 percent of our crude oil are produced by independents. Some of our colleagues, I see, my colleague from Idaho here and he has heard this rhetoric from others, certainly not from him, are fond of bashing the major oil companies.

I would say to my colleagues who are fond of attacking the independent oil companies if they want to change this industry and leave only the major companies operating principally internationally off our shores in existence, and destroy the competitive structure of the industry by forcing out of business the smaller independent producers, we are on the road to doing exactly that. I would not think that would please even those who are fond of talking about the evils of major oil and gas companies. We are absolutely wiping out the independent sector.

Another decade like we have had, like we have just gone through, and there will be virtually nothing left. The next genera-

tion is simply not able to go into the business now. They are not even taking the courses in petroleum engineering offered by our colleges and universities. We are destroying an industry that we will be sorry to lose—more than sorry. We will be damaged as a nation severely if we lose it; we had better wake up now.

Experts have pointed to the alternative minimum tax as a cause of this decline. They argue that the AMT treats unfavorably two necessary and ordinary business expenses of the independent oil and gas business—intangible drilling costs and percentage depletion. Because both of these expenses are treated as a preference under the AMT they are subject to being added back into taxable income rather than being deducted like most other business expenses.

This treatment may well be discouraging exploration and development of our oil and gas resources. So it is something we need to focus upon. We do not treat as preference items ordinary expenses in other businesses. A misunderstanding has prevailed for several decades in Congress about the oil and gas industry, especially in the independent sector: Congress views the industry as monolithic. Thus, these kinds of expenses have been made preference items when they should not be and would not have been if they were in an industry that was viewed differently by the Congress from a political point of view.

So I welcome the testimony of our witnesses. This is a very serious problem for our country. We have on the witness panel today those of various perspectives. We have tried to be balanced in terms of the presentations that will be made. We are sincere in trying to find a way not to open a loophole because profitable companies should not avoid paying some taxes, but to make a system work as it was intended, as opposed to having the destructive impact that it apparently is now having.

[The prepared statement of Senator Boren appears in the appendix.]

Senator BOREN. We have been joined by our colleagues, Senator Symms and Senator Danforth.

Senator Symms, are there any opening comments that you would like to make?

OPENING STATEMENT OF HON. STEVE SYMMS, A U.S. SENATOR FROM IDAHO

Senator SYMMS. Mr. Chairman, I will be very brief, but I would like to compliment you on what I consider to be a very excellent statement. I agree with you that some of our colleagues, in their zeal for having wanted to bash what used to be called those evil big oil companies, have now made offshore drilling off limits. We have made Alaska off limits. We have made the Tax Code unacceptable, and anti-capitalistic in the country.

We are now sending those big oil companies off to what used to be the evil empire, where they are finding it is easier to drill oil wells than in this country. I think it is a very serious problem.

I think we all agree that the AMT started out with an idea that was based on achieving fairness and equity in the Tax Code. But the cost of capital is a very important consideration in competitiveness. When you find out that we have people and companies that

are paying taxes that actually have had cash losses in their industry and their businesses are losing money yet they are still being expected to pay taxes, that is extremely anti-producer, anti-capitalistic, anti-private property, anti-jobs; and I think it needs to be fixed.

You know, I just returned from my State where we all tend to get out on the stump and sometimes speak a little more partisan manner. But I think it is worthy of observing that when you look around the world there are only three places remaining where there seems to be a real strong body of anti-growth mentality left. That is Kemosung's North Korea, Fidel Castro's Cuba, and, unfortunately, some of the policies that have come out of this Congress that we cannot seem to get changed.

I just hope that we can get AMT changed and I compliment the Chairman for trying to address a problem that needs to be changed. You have my support.

I welcome these distinguished witnesses that you have called in this afternoon, particularly your colleague from Oklahoma. I must note that Oklahoma is very rapidly getting one of the most senior delegations in the Senate at the very youngest age. I mean senior in terms that they have been here and have influence, but in terms of age, they are young. I welcome both of you here and all of you gentlemen.

Senator BOREN. Senator Symms, if you want to extend your remarks any longer you may do so. There is no problem with it. [Laughter.]

We will not run the clock on you at all. [Laughter.]

I appreciate your not listing me with Kemosung and your emphasis on youth, although Senator Nickles and I have now changed our mutual slogans to "Maturity and Experience Counts" instead of "Give a Young Person a Chance." [Laughter.]

Senator Danforth.

OPENING STATEMENT OF HON. JOHN C. DANFORTH, A U.S. SENATOR FROM MISSOURI

Senator DANFORTH. Mr. Chairman, thank you very much. Clearly the alternative minimum tax has become a problem. I do not know the percentage of American corporations that are taxed under the AMT. I think it is a very significant number, half or so. It is much more than the number that it was intended to cover when it was developed.

I hope that this hearing is going to go beyond the effect of the AMT on the oil industry, although I recognize the importance of that subject.

Senator BOREN. Yes.

Senator DANFORTH. The research and development tax credit is said by companies that are involved in research to be the most important thing we have in the Tax Code to help them. Yet the research and development tax credit is not creditable against the AMT.

That means that for half or so of American business that is now under the AMT are not helped by the R&D tax credit.

Senator BOREN. Right.

Senator DANFORTH. If we were to decide, and I say "if" because I recognize that this is probably an unlikely event. But if we were to decide, for example, that the concept of a middle class tax cut does nothing to help our country or to make it stronger, and if we were to decide instead that we would rather place emphasis on, for example, restoring an investment tax credit to encourage American business to grow and modernize and be more competitive and provide more jobs, if we were to decide to do that, that tax credit would not normally be available to companies that were covered by an alternative minimum tax.

So the AMT, while it was designed to provide equity, has had the perverse effect of discouraging just the kinds of things we think should be done in our country if our country is going to grow and going to prosper. It has turned into something it was never intended to be in the first place. My hope is that we will focus the effect of the AMT on a variety of industries in America.

Senator BOREN. I agree with you. In fact, several of our witnesses today are from a variety of industries and will discuss the impact on the industries with which they are involved. So we will hear from at least four or five different sectors of the economy in the course of today's hearings.

I agree with you in terms of what you said about the need to craft carefully whatever we do in our Committee so that it is geared toward long-range economic growth. I do not think we are getting huge demands from people for 90 cents a day rebates. What we are hearing from people is: We want to make sure our children and grandchildren have jobs.

In fact, that was sort of a message to both sides of the aisle. In the New Hampshire primary, the candidate on my side of the aisle who won the primary also made the same comments. So it is very encouraging, I might say, to hear those comments made by Senator Tsongas, which shows a lot of bipartisan support for dealing with the cost of capital and restoring economic growth in the country. I think that is something that bodes well.

We can build a bipartisan consensus around that kind of thinking instead of divisive partisanship on strategies for economic growth. Then we will get back to competing. Maybe we can start competing with the rest of the world for a change, instead of fussing with each other. I hope that is a sign that that is going to happen.

I welcome as our first witness today my colleague, who has already been mentioned by Senator Symms. It is a privilege to have him here. We have worked together on numerous legislative proposals. He has been tireless in his efforts to encourage capital investment and specifically in his efforts to try to salvage what is left of the independent oil and gas industry. Maybe salvage is the wrong word—that seems to be the most active business as part of the independent oil and gas business these days. To save what is left of the independent oil and gas sector in our economy.

So I am happy to welcome Senator Nickles today. He will make some comments. I know that he has with him Mr. Jack Graves, Mr. Mike Cantrell and Mr. Keith Brown, all of whom are currently serving as president or have been presidents of the Oklahoma Inde-

pendent Producers Association. We are happy to have all of them here.

Perhaps after you have completed your comments we might—for the sake of time we will not have opening comments from all four of you—but after you have finished your comments, we might direct any questions members might have to any of the four of you.

We welcome you.

STATEMENT OF HON. DON NICKLES, A U.S. SENATOR FROM OKLAHOMA, ACCOMPANIED BY MICHAEL CANTRELL, PRESIDENT/OWNER, OKLAHOMA BASIC ECONOMY CORP., ADA, OK; ALSO ACCOMPANIED BY F.W. BROWN, PRESIDENT/OWNER, BROWN & BORELL, INC., KING FISHER, OK; ALSO ACCOMPANIED BY J.M. GRAVES, PRESIDENT/OWNER, CALLMET OIL CO., TULSA, OK

Senator NICKLES. Mr. Chairman, thank you very much. I have a statement. I will just ask you to insert that in the record.

Senator BOREN. That will be inserted.

Senator NICKLES. I would like to echo the comments that were made by yourself and also Senator Symms and Senator Danforth.

Senator Danforth, I will make a comment concerning AMT. It is almost the opposite of an ITC, investment tax credit. I will tell you from my private business experience in running a machine shop, not in the oil and gas business from the production side of producing minerals, but having a manufacturing facility, investment tax credit, accelerated depreciation, we had those things. We encouraged investment. We had an actual policy that encouraged people to make investments, plants and equipment.

Frankly, Congress in 1986 went too far. In its imposition of AMT and also increasing the rates in 1990 did just the opposite of an investment tax credit. Not only did we eliminate investment tax credit, but with the alternative minimum tax we really punish or penalize investment.

If you look at the independent producers, the intangible drilling costs, there actually is a surcharge on expense items. There is no other business that you actually have a surcharge on expense items. You are supposed to have alternative minimum tax or taxes on profits, net profits. This is not a tax on net profits. It is not a tax on profits. A tax on IDC's is a 20-percent surcharge for a corporation; it is a tax out-of-pocket nonrecoverable business expenses. This is a serious mistake. It needs to be reversed.

Frankly, the results since 1986, as Senator Boren mentioned, have resulted in a depression in the drilling industry. We have the lowest number of drilling rigs since we have kept records, going all the way back since 1940. It has never been this low. So we are not just talking about a seasonal fluctuation. We are talking about economic disaster in the drilling industry, part of which is caused by Congress making some mistakes and putting the alternative minimum tax, both on intangible drilling costs and on percentage depletion.

It is not just on the drilling industry. I will echo that. Because again as a manufacturer, I am delighted that you are going to have American Airlines testify today. They have lost hundreds of mil-

lions of dollars. This industry is hurting. Frankly, it is not just the independents.

Phillips Petroleum had an article in today's paper, front page, Phillip's Petroleum is reducing their employment by 1,100 in Bartersville, OK. Now this is very serious, and in part has been caused by excessive regulation and part has been caused by taxation policy that does not work.

AMT, the alternative minimum tax, is right in the middle of it. It needs to be changed. I hope that when Congress revisits this area that we will make these changes, particularly taking intangible drilling costs off as a preference item as well as percentage depletion.

I am happy to cosponsor legislation, Senator Boren, with you to do this. I think it is vitally important that we do so. I want to make one final comment. Some of our colleagues would say, wait a minute, this is going to cost some money. I would say just the opposite.

Frankly, if we do not make these changes you are going to cease to have a drilling industry. This number of rigs running—I mentioned 653 last month—if you go all the way back to 1981 we had 4,000; back in 1985 we had a couple of thousand, over a couple of thousand.

So you see we are down, and dwindling down, and if we do not have any drilling rigs, hey, this is not a tax advantage for anybody. It is disaster. There are no jobs. There is no economic activity. So we need to make these changes. I think frankly the economic activity that these changes will generate will far more than offset whatever potential loss of revenue that somebody with green eyeshades might say in some of the various agencies.

So I compliment you, Senator Boren, for this hearing and I am hopeful that this will be the year that we will make some much needed reform on this tax for manufacturers and also in particular for the oil and gas industry.

Senator BOREN. Thank you very much, Senator Nickles. We will receive your full statement into the record.

[The prepared statement of Senator Nickles appears in the appendix.]

Senator BOREN. I would like to ask Mr. Graves, and Mr. Brown, and Mr. Cantrell if they might just comment because I know each one of them is an independent oil and gas producer. I am well acquainted with each of them and they have all been counselors of mine. I have worked with them over a number of years. If you could share with the Committee briefly how the alternative minimum tax affects you, because I think to many people this is very difficult to grasp, it is complex. If you ask the average member of the Senate, he or she would say we were not penalizing people for investing, we were just going to make sure that companies with enormous profits did not evade all taxes.

I really think that is what the average member of Congress thought he or she was doing in voting for this provision. How does that tax, in fact, affect you in your own business? I think it would help us to understand if you could give us your personal experience, briefly the kind of operation you have, how it affects you, and maybe some examples of it.

Mr. Graves?

Mr. GRAVES. Thank you, Senator Boren. It is a pleasure to be here with you as always. As you know, sir, I have been in the business for something over 45 years. I have a company called Callmet Oil Co. It operates primarily in Osage County and we operate over 500 wells.

Coincidentally, we took our tax return and refigured it as to what would happen to us if we did not have the AMT and then we extrapolated that number to what it would be State-wide and nationally. Believe it or not, with a rounding of the numbers, we came up with almost the identical numbers that IPAA and others had come up with—i.e., as we saw it, $1.6 billion in 5 years.

Now that is unbelievable; and it is that much money that is not going back into the industry. I try to drill wells out of our cash flow from the oil production, but considering alternative minimum tax for depletion and IDC's, there is just not the cash flow to do it.

Now you made one mention that we would be without a drilling industry. I would also submit, sir, that we will also be without a producing industry. Because if no wells are drilled to offset the decline, the natural decline, in production of course the decline then accelerates. That is what is happening here in the United States.

Since 1986, as you know, there have been more wells plugged than any other comparable time in our history. We find this as very real. It is not just something, a theoretical number. We noticed in our cash flow and there is just no way we can continue to replace our reserves.

Senator BOREN. So your cash flow has really been the source of your drilling in the past?

Mr. GRAVES. Yes, sir.

Senator BOREN. And you simply cannot continue the drilling because the cash flow will not support it?

Mr. GRAVES. That is right. We cannot replace our reserves with the cash flow we have on hand.

Senator BOREN. What percentage of your cash flow have you plowed back in the past in terms of new drilling? What would be the industry average?

Mr. GRAVES. Well, the independents historically have plowed back something 105 to 107 percent of their cash flow for drilling. I mean that is just the independent. If there is an opportunity to drill a well he is going to do it.

Now you can see from that, that that means that we have lived off of the depletion allowance. If we plow back everything, why, what little we got off of the depletion allowance was what put bread and butter on the table.

Does that answer your question?

Senator BOREN. Yes, thank you.

Mr. CANTRELL. Senator, I appreciate this opportunity also. I am a small, typical probably producer in Oklahoma. I have 81 wells that produce an average of 2.4 barrels of oil a day per well and 30 barrels of salt water per day. All 41 of these wells are within a 25-mile radius of my home which is Ada, Oklahoma.

I think Mr. Brown and Mr. Graves have similar situations, different sizes but we are all right in the middle of our production. Probably the most significant thing to recognize in looking at why

depletion and intangible drilling are so necessary to us as an industry is the fact that as independents, the day we quit either acquiring reserves or drilling for reserves we are liquidating our businesses.

This industry is in a state of liquidation as we speak. About the only activity going on really is people getting out and people acquiring their resources. So we really are not producing many new resources and a big part of that is due to the Tax Code and the alternative minimum tax and the depletion and intangible drilling.

The marginal nature of these wells—I looked at my tax returns for the last 3 years without a drilling program basically, because I have not had those incremental dollars to plow back into drilling and exploration, so I am liquidating. I have not paid alternative minimum tax because the net income limitation to where 100 percent of my net income, I only received depletion against 100 percent of my net income on the property.

So if the properties are marginal and do not make very much net income you do not get depletion. You get the lesser of the two. So that on marginal properties like we have in Oklahoma where the average well is 2.7 barrels a day, a lot of us are not getting depletion in the first place. That depletion is the money that we use to plow back drilling new wells.

Senator BOREN. Mr. Brown?

Mr. BROWN. Senator, thank you.

I, like Mike and Jack, am a small independent operator and right now am President of the Oklahoma Independent Petroleum Association. In that capacity I would like to say I represent the independents in Oklahoma and I feel like I do. I believe one of the overriding aspects of the alternative minimum tax has been the fact that we simply do not have the capital to drill the wells.

That capital is dried up because the investor base from which we drilled will not expose their money to a tax on their expenses. So we do not have the money to drill. That is the reason the drilling count is down to 653 rigs today. And as Mike said, we are simply going out of business.

Because of that the net result will be that the oil we produce in the domestic 48 States—about 6 million barrels of oil is produced domestically in the lower 48—we produce in Oklahoma 77 percent of the oil produced in Oklahoma. On nationwide it is estimated between 40 and 45 percent. We are going to lose over 1 million barrels a day production if we allow our infrastructure to continue to erode at an alarming rate.

I do not think this Nation can afford to lose that type of oil reserves. I do not think the consumer wants to face the consequences of what happens to him when we lose that base of reserves. We had long lines in the 1970's when we went below the supply and demand curve. We are headed in that direction in short order. We will not be here to salvage it again.

So I urge this Committee, and I urge your constituents, to consider the net effect or the adverse effect of alternative minimum tax and eliminate alternative minimum tax as a preference item on IDC's and depletion.

Senator BOREN. Thank you very much.

Senator Symms, any questions at this time?

Senator SYMMS. No questions, Mr. Chairman.

I just thank all of you for being here and for your input.

Senator BOREN. Senator Danforth?

Senator DANFORTH. No questions, Mr. Chairman.

Senator BOREN. Thank you very much. We appreciate your being with us and we appreciate your testimony. It will be helpful to the Committee and, of course, it will be shared with the full Committee as well.

Our next panel includes Dr. Andrew Lyon. Dr. Lyon is the assistant professor of economics at the University of Maryland. Before joining the faculty he served as an economist at the Joint Committee on Taxation. Let me say he has prepared one of the most fascinating reports that I have read on the comparative costs of capital internationally, various industries, and a study that I have read, that I have cited on numerous occasions, and that I find very, very interesting.

Robert S. McIntyre is director of the Citizens for Tax Justice, and certainly was one of the people who prepared much of the research that led Congress to adopt the alternative minimum tax in 1986. As I indicated, our goal at that time was to make sure that companies that were hugely profitable did not escape all tax liability, and Mr. McIntyre did some very effective research that indicated situations in which that was occurring. I think by doing so, he certainly highlighted an area of abuse that needed to be addressed.

Mr. Craig Goodman served as Director of Oil Policy and is the Director of Energy Tax Policy within the U.S. Department of Energy and is now vice president for government affairs for Mitchell Energy and Development Corporations.

We are very happy to have all of you here. I guess we will just proceed in the order in which I introduced you. So, Dr. Lyon, we would welcome your opening comments.

Senator SYMMS. Mr. Chairman, if I could just interject. I apologize to the witnesses but I have another meeting I must attend.

Senator BOREN. I understand.

Senator SYMMS. But thank you.

Senator BOREN. Dr. Lyon?

STATEMENT OF ANDREW B. LYON, PH.D., ASSISTANT PROFESSOR OF ECONOMICS, UNIVERSITY OF MARYLAND, COLLEGE PARK, MD

Dr. LYON. Thank you. I have a written statement which I would like to summarize.

Senator BOREN. We will receive all your statements. Let me say it will help us if you can summarize within about 5 minutes your opening comments. We will receive your full statements, of course, for the hearing record. Thank you very much.

Dr. LYON. Thank you. I appreciate the opportunity to be here today to testify on the effects of the corporate alternative minimum tax. As you mentioned, in my research at the University of Maryland I have given considerable attention to the AMT. This research was motivated by my desire to measure the relative incentives firms on the AMT face when contemplating new investments.

In some instances the AMT may be a significant deterrent to new investment. GIven this deterrent effect, I have also thought about

whether the AMT may be rigorously justified on other grounds. I should state here that I am a strong supporter of the general goals of the Tax Reform Act of 1986 to establish a fairer and more efficient tax system. As you mentioned, I was on the staff of the Joint Committee on Taxation during tax reform and I believe that the 1986 Tax Act was a general improvement over the prior law. I am, however, doubtful that the corporate AMT enacted in 1986 can be said to increase either the equity or the efficiency of the tax system. I believe these goals can be achieved more reliably by altering the rules of the regular tax system rather than through a separate corporate AMT.

Data collected by the IRS indicate that tax revenues from the corporate AMT from 1987 through 1989 have cumulatively totaled $9 billion. In the first 3 years of operation, 20 percent of the largest U.S. corporations were paying AMT. Today current estimates are that from 40 to 60 percent of these same corporations are paying tax under the AMT.

Firms on the AMT may undertake less investment because the tax reduces their available retained earnings and because investment incentives under the AMT are reduced. Analysis of the investment incentives under the AMT is complex because it depends on a larger number of tax attributes of the firm.

Under the AMT, deductions for most investment projects are taken at a slower rate. As a result, more of a projects income is subject to taxation up front. This less favorable tax treatment increases the firm's cost of capital.

In my written testimony I have prepared a table with estimates of the cost of capital under the regular tax system and under the AMT for a variety of assets. The table shows that the cost of capital for most equipment is more than 10 percent higher for a firm subject to the AMT for 5 years or more—10 percent higher than for regular tax firms.

I have also examined the effect of current proposals to reform the AMT. Under current law, the adjusted current earnings—or ACE—provision reduces depreciation allowances available to firms on the AMT for recently purchased assets.

In addition to its effect on the cost of capital it is frequently cited as a source of complexity since it requires firms to keep track of three different depreciation schedules for a single asset.

Repeal of the ACE provision reduces the cost of capital for AMT firms. Repeal reduces the gap between the higher AMT cost of capital and the lower, regular tax cost of capital by about 15 percent for a firm on the AMT for 5 years. However, even with repeal of ACE the cost of capital under the AMT remains significantly higher than under the regular tax.

The President's budget proposal also proposes enactment of a temporary 15 percent investment tax allowance—or ITA—that could be used by both regular tax firms or AMT firms. AMT depreciation combined with the ITA still results in a cost of capital higher than under the present law regular tax system. Because the ITA would be available for regular tax firms as well, AMT firms would continue to face a relative disadvantage when competing against regular tax firms.

Although many of the reforms of the 1986 Tax Reform Act were an attempt to level the playing field I do not believe the AMT was helpful in this regard. As the cost of capital analysis indicates, the AMT results in different firms facing different incentives to invest in the identical asset. For firms currently subject to the AMT, investment incentives are generally reduced.

Another set of incentives is faced by firms that are currently on the regular tax system, but which anticipate in later years to be on the AMT. These firms might have a greater incentive to invest today before they become subject to the AMT. Although the intent of the AMT may have been to diminish tax planning from the investment decision, ironically, the AMT may have the opposite effect in practice.

While the desire for a minimum tax may be motivated on the basis of both equity and efficiency concerns, there is no guarantee that either objective will be attained. The minimum tax may create production inefficiencies by imposing widely divergent investment incentives across firms and across assets.

A minimum tax has a number of other drawbacks. Administrative costs per dollar of tax revenue for both the corporations that have to comply with the provisions and the IRS are higher than those resulting from many possible changes to the regular tax system. The minimum tax decreases the automatic stabilizing force of the income tax. As you mentioned, during recessions firms are more prone to be on the AMT, increasing tax payments at a time when we would generally like to reduce tax payments. Finally, the AMT increases the uncertainty firms face in undertaking investment.

I believe legislation that lessens the discrepancies between the AMT and the regular tax provisions would be beneficial.

Senator BOREN. Thank you very much.

[The prepared statement of Dr. Lyon appears in the appendix.]

Senator BOREN. Mr. Goodman?

STATEMENT OF CRAIG G. GOODMAN, VICE PRESIDENT, MITCHELL ENERGY CORP., THE WOODLANDS, TX

Mr. GOODMAN. Thank you, sir.

Thank you, Mr. Chairman. As you mentioned, I spent the years 1987 through 1989 as the Director of Oil Policy and the Director of Energy Tax Policy for the U.S. Department of Energy. It was during this period of time we performed with the help of two prominent national laboratories, and the international accounting firm of Arthur Anderson, and the international consulting firm of Petroleum Finance Corp., we performed a series of sophisticated quantitative analyses of the micro-economic effect of the alternative minimum tax on marginal investment behavior in this country and on U.S.-based taxpayers.

As an opening statement, I would just like to reinforce what you said previously. Because as you know competition comes in many forms and forums. However, the competitiveness of a tax and fiscal system is measured by its impact on the risk weighted, after tax rate of return on capital invested domestically or internationally by taxpayers headquartered within its boundaries.

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Capital is a very scare resource and it theoretically has no national boundaries and it pledges its allegiance solely to a risk weighted, after-tax rate of return. On the margin, after the underlying economics of an investment are computed, government take policies will basically determine whether capital is competitively employed.

To summarize my research for you very quickly, since 1986 we found that the United States has become in many important respects one of the least competitive environments in the world in which to be headquartered and to save and to invest productively new capital.

Contrary to traditional principals of "income taxation" a new form of U.S. taxation labeled the AMT directly taxes capital invested to produce new jobs and increased wealth for U.S. society rather than the true economic income generated from these investments.

Under this new structure, taxpayers who are least able to afford higher taxes are forced to lend the Federal Government money interest-free by paying income taxes before income is earned and are repaid if, and only if, they are considered by the government to be sufficiently profitable.

As a result, smaller, low or no margin enterprises, startup ventures, industries actually losing monies from operations and those hit hardest by a recession are at a severe competitive disadvantage compared to higher margin foreign and domestic industries and those industries impacted least by the recession.

The research I am submitting into the record today demonstrates quantitatively numerous regressive and anti-competitive structural components in the U.S. system of income taxation that are creating enormous losses in wealth to this country that were never intended under the tax fairness and neutrality policies of the 1986 Act.

Basically, in true economic terms, Senator, the true structure of the U.S. Alternative Minimum Tax Code increases taxes as product prices decline, increases taxes as profits from operations decline, increases taxes as revenues from operations decline, increases taxes as the costs of production increase, and increases taxes as the economy declines, as you will hear later. It does not apply to foreign-based competitors in the world market place and it penalizes U.S. industrial expansion and the startup of new industry.

These basic structural flaws within our tax system hold significant implications for competitive U.S. economic policies affecting growth, high-quality job creation, the U.S. balance of payments, domestic energy resources, environmental quality, both air and water, and future U.S. income tax receipts.

To give you an example, since energy taxation was our basic policy focus, and since oil and gas prices collapsed simultaneously with the passage of tax reform, our analyses provided the first quantifiable evidence of numerous anti-growth structural flaws in the U.S. tax and fiscal system.

For example, the average geological prospect in the United States today, for an independent producer in an AMT position, he can expect to lose on that prospect $33,000 after all expenses are paid, all royalties, severance taxes, et cetera.

However, if that geological prospect was marginally profitable to an independent producer in an AMT position, it would generate $12.5 million in added wealth to U.S. society, $2.5 million in added U.S. tax receipts and $1.0 million in additional State severance taxes. This is only one prospect, one average prospect. Since 1986, the United States has lost the equivalent of over 13,500 average prospects.

Before I close, I would like to make one other point. Obviously, under the short-term static revenue estimates required by the Joint Committee on Taxation, they would score a loss of tax revenues attributable to a reduction in AMT.

However, over the life of any new capital investment that is made as a result of a reduction in AMT, the undiscounted revenue loss to the U.S. Treasury is zero. Each dollar in AMT reduction in 1 year is matched with an equal reduction in AMT credits in future years. Since AMT liability occurs when capital is invested, rather than when income is generated merely matching income tax liability more closely with the receipt of income does not lower the total taxes paid, only the time within which they are paid.

Consequently, of all the proposals on the table, Senator, the AMT reduction is one of the few, if not the only, that does not increase the long-term U.S. structural deficit and increases economic activity at the same time.

Thank you, sir.

Senator BOREN. Thank you very much, Mr. Goodman. Your comments and the statistics that you are putting into the record will be very helpful to us.

[The prepared statement of Mr. Goodman appears in the appendix.]

Senator BOREN. Mr. McIntyre, we are happy to have you with us today, and we welcome your opening comments.

STATEMENT OF ROBERT S. McINTYRE, DIRECTOR, CITIZENS FOR TAX JUSTICE, WASHINGTON, DC

Mr. MCINTYRE. Well, I am happy to be here. I appreciate your comment about the balanced nature of the hearing. I am not quite sure whether to treat that as a huge compliment to me or just sort of a jovial remark, but I appreciate it in either case.

I guess all of us know why the alternative minimum tax was put into place back in 1986. Surveys by my group and by others had found that as many as half or more of the biggest companies in the country were not paying taxes, some of them year in and year out, even though they made large profits. The public found that intolerable. The members of this Committee found it intolerable.

Since the 1986 reforms were put into place, including the minimum tax, we have seen a large fall off in the number of no-tax corporate free-loaders. In our most recent survey which got us through 1988 there were only seven companies that managed to pay no taxes at all despite large profits. It was a huge drop from the earlier years.

Also we found in our more recent surveys that the minimum tax was playing a key role in bringing what would otherwise have been large, no-tax companies back onto the tax rolls.

Now the fact that the AMT has done its job in that regard does not mean that it is the biggest deal in the income tax code. The IRS says that only about 1 percent of the active corporations paid the minimum tax in 1988, and that it only added about 3 percent to total corporate tax revenues. That is true across the board. It is also true for the largest companies, where it added about 3.4 percent to the total tax payments for the largest companies that the IRS analyzes.

While it looms rather small in the total corporate tax picture, the minimum tax does make a major difference for the companies that are affected. Some of them, obviously, would be paying nothing at all without the minimum tax. However, we do think that you could strengthen the minimum tax to make it more effective, both by increasing the rate to as high as the personal rate and also by closing down some of the remaining loopholes that are allowed under the alternative minimum tax. I have listed some of those loopholes in my testimony.

Let me now get to the issue that obviously everybody wants to talk about here today. Does the alternative minimum tax somehow hurt our companies' ability to do business and compete in the world economy?

For the life of me, I cannot understand the argument, Senator. The AMT rate is 20 percent. It is 15 percent if you are taxed under the adjusted current earnings test. That is the lowest corporate tax rate of any country in the world. And you can see it in the gross statistics. We raise less than half as much in corporate income taxes as a share of our gross domestic product as do other Western countries. We raise less than a third as much as the Japanese. We are a low-tax corporate tax haven and that is well known around the world.

It is hard to figure that the AMT, which is a low-rate tax that affects only about 1 percent of our companies, and only raises a few billion dollars a year, could possibly be guilty of all the crimes it allegedly causes.

In fact, it seems to me that the AMT helps to level the playing field by getting rid of some of the economic distortions that you will otherwise inevitably have when certain industries and certain companies enjoy very low tax status while others have to pay significant taxes.

Now we do have some evidence of what happened to business investment before and after tax reform. If you look at the loophole years, 1981 through 1986, when we had everything conceivable as an investment incentive in the Tax Code, business investment did terrible. It grew by less than 2 percent a year. After tax reform it grew 42 percent faster.

What led the way in the surge in investment after 1986 was industrial plant and equipment investment, which you would think is the thing we want.

It seems to me that the real reason this AMT issue has come up again was well stated by Representative Archer over on the House Ways and Means Committee when he gave a speech the other day in which he said, if we could get rid of the alternative minimum tax, it would allow some profitable companies "to pay no tax." And that is right.

In fact, there is no doubt that if you want to create a Full Employment Act for Citizens for Tax Justice, go ahead and weaken the minimum tax. Then, I will be back in business putting out reports on corporate tax abuses.

Look around at some of the witnesses you have here today, and look at their taxes over the last several years. Mitchell Energy paid 3 percent in 1990. It paid nothing at all from 1982 through 1986, and barely anything in the intervening 3 years.

Champion International's, tax rate has gone up after tax reform from less than 2 percent to 16 percent. It does not sound very onerous.

LTV paid 4 percent in 1989, 15 percent in 1990.

I do not think we need to lower taxes further on these companies or on others that pay the alternative minimum tax in order to compete in world markets. On the contrary, it seems to me that the fact that they are still paying such low taxes suggests that we need to strengthen the minimum tax—and perhaps the regular tax—not weaken it.

If by some chance the minimum tax is weakened and the abuses that it was designed to correct are recreated, not only will it cost the Treasury revenues, but you will further undermine the confidence of the average taxpayer in the integrity of the Federal tax system.

Then it is going to be even more difficult to raise the revenues we need to cut the budget deficit and address our needs in the social and public investment areas. If you do not address those problems, and they are very serious, then you will have caused some very serious damage to our ability to compete in international markets.

So in conclusion we urge you to strengthen, not weaken, the minimum tax and move to get us more in the swing of things with the rest of the world where companies actually have to pay some taxes.

Thank you.

Senator BOREN. Thank you very much.

[The prepared statement of Mr. McIntyre appears in the appendix.]

Senator BOREN. We have had a buzzer go off with a vote on the floor. So we may be interrupted very briefly. But let me begin by comments.

Mr. McIntyre, have you read Dr. Lyon's study?

Mr. MCINTYRE. No, I haven't.

Senator BOREN. He indicates—and I would like to ask him to respond in a minute about—that a much higher percentage of companies are now paying the alternative minimum tax. You cited a figure of 1 percent. I believe that was, what, 1988?

Mr. MCINTYRE. It was 1988 and it was all companies. He, obviously, has a much smaller sample that is not in the published IRS data.

Senator BOREN. Right.

I might ask, Dr. Lyon, would you explain so that we know if we can compare apples and apples and oranges and oranges?

Dr. LYON. Yes. I have a paper from an economist at the Treasury Department. For 1989, which is now the latest data and it is preliminary data, 0.7 percent, as Mr. McIntyre indicates almost 1 per-

cent, of all corporations paid AMT. However, if we look at each asset category of the largest corporations, those with assets greater than $250 million or greater than $500 million, consistently from 1987, 1988, and 1989, 20 percent of these firms have paid AMT. Unfortunately, we do not yet have the official data for 1990. We can only rely on informal estimates. Those have been cited in the range of 40 to 60 percent. That is an astounding increase.

Senator BOREN. You are talking about larger companies as opposed to the whole universe. Are you also talking about certain categories of more capital intensive industries?

Dr. LYON. No, I am referring to all corporations, but categorized by their asset size.

Senator BOREN. Okay.

Let me go back to another question, and again ask Mr. McIntyre. I do not think anyone is advocating repeal of the alternative minimum tax totally, at least this Senator is not advocating that. Nor would we advocate going back to a situation where there are X number of corporations in this country making very large profits which are even being reported to their stockholders in their annual statements and which are paying no tax or virtually no tax. That is not the intent.

There are certainly ways to craft minimum levels. For example, we could provide that AMT credits could be used against AMT tax, but in a way that you would not ever have a 100-percent tax free situation. That can be crafted with any level of threshold that would be deemed fair so that you can avoid a total zeroing out of liability. There are various ways you could avoid a zeroing out.

Again, I have read a good bit of Dr. Lyon's study which was done at the University of Maryland, indicating our relative cost of capital, and I assume his figures are correct. If you have a situation, for example, like with robots where you are recovering two to three times as much your cost of investment if you are in that business in, say, Korea and Japan or Germany, as you are in the United States. We will not be in that business for very long.

Mr. MCINTYRE. I do not think anybody would suggest that the Japanese have lower tax burdens on capital than we do. I think everyone agrees the Japanese have much higher capital taxes, particularly much higher corporate taxes. Now if they have a slightly faster write-off period for something and a much higher corporate tax rate, that is not a winning tax situation for business.

But it may not matter since the Japanese obviously compete well.

Senator BOREN. Well, it might be a winning situation in terms of encouraging certain kinds of capital investment to make you competitive.

Mr. MCINTYRE. Well, we had that system, Senator.

Senator BOREN. In other words, what drives your productivity in the future is the fact that you are investing in new plant equipment technology which I gather is the only way we are going to stay in business in this country. I assume we would agree on that.

Mr. MCINTYRE. Yes.

Senator BOREN. We want to encourage new investment.

Mr. McINTYRE. But we want that investment to be market driven. We do not want it to be run by the Senate Finance Committee, with all due respect.

Senator BOREN. Well, you want it to be market driven. What market are we talking about? In other words, do you think it is wrong for us to consider the cost of making an investment, to make a company modern and productive and competitive in this country, versus the cost of making the same investment in another country? Surely that is not a wrong thing to do.

Mr. McINTYRE. No, I think you should consider it. What you will find is that we are the tax haven country of the world. We have a very, very low corporate tax rate. And many of our companies do not pay anything near that rate.

Senator BOREN. Well, if we found, for example, that Dr. Lyon's figures were anything close to correct—and he uses, for example, I'll just use two examples, here is capital cost recovery after 5 years for scrubbers. We recover 17 percent in the United States in the first 5 years, versus 90 percent in Brazil, 53 percent in Germany, 64 percent in Japan, 98 percent in Korea.

I indicated factory robots—67 percent Brazil, 81 percent in Germany, 60 percent in Japan, over 100 percent in Korea, less than 50 percent in the United States. I remember engine blocks, for example, is in the 30 percent range in the United States up to the 90 percent range in Korea with Germany and Japan being somewhere in the 60's and 80's.

If those are accurate, does that not mean we are very unlikely to be in those businesses very long?

Mr. McINTYRE. Not at all. Because those countries have higher taxes on the profits from those investments. So that when you look at the effective tax rates on different kinds of investments, which is the right way to analyze it, not just with a one side of the picture, you will find we have lower taxes.

I think that is universally agreed.

Senator BOREN. But if you want to encourage certain kinds of things to happen because—and I for one do not agree with your premise that it is evil to use the Tax Code to encourage things that will make this country a better country—for example, charitable donations or investment in equipment and plant technology to modernize us, God help us if we in this Committee do not have the sense to use the Tax Code to encourage things that ought to be encouraged.

Mr. McINTYRE. I think you tried that before, Senator, and that is when we had all the tax shelters floating around in the economy.

Senator BOREN. I would say there were a lot of abuses that were incorrect. But I do not think it makes a point that you do not want to encourage savings investment and capital formation. Because I do not know of any economist that says we do not want to encourage that.

Mr. McINTYRE. Well, I assume you did not set out in 1981 to create all the abuses that you did create. The problem is that when you start playing around in this area you are going to end up with a big mess. We will end up with some fiasco we do not anticipate, but it might be as bad as the savings and loan crisis which was

caused largely if not almost entirely, I think, by the 1981 Tax Act real estate tax loopholes.

Senator BOREN. I think the savings and loan debacle was also caused largely by the 1986 Act which overreacted in the area of passive loss, which has done more to lose revenue for this country and destroy the economy of this country and close banks than any other Act ever passed.

If we had had enough sense to listen to Chairman Bentsen and not vote down his proposal to close some of the loophole, but not overcorrecting, we would have probably saved several billions of dollars. I do not know what the actual range is to the RTC and the FDIC, but it has been a major contribution to the economic status of this country at the current time. I think the record speaks for itself on that.

But let me just ask you: If the code—I believe Mr. Goodman said this—does cause companies that are in regular corporate taxes—and again, I am not disagreeing at all that people ought to pay a certain minimum amount of tax. And I think whatever solution we craft should absolutely preserve that. I think we need to keep our eye on that ball all the time. I do not disagree with you about that at all. If we are encouraging some companies—we talk about tax neutrality—let's consider this example: there are two companies, one of them is under the minimum tax, one is not. Because of the variations of the way the preference items are treated, we provide a tax incentive for a company in the regular corporate tax to invest in a piece of equipment and a relative disincentive to a competitor in this very same business, maybe the same sized company, maybe the same level of profitability this year but with a higher level of capital investment in the past and therefore more preference items under the AMT, wouldn't that be a distortion of the principal of tax neutrality? Shouldn't we try to find a way of dealing with that if we are discouraging one company more than another from making a particular kind of investment? Not because of the market but because of the Tax Code. Should we not try to correct that, while still finding a way not to let companies out of liability for paying when they make a profit?

Mr. MCINTYRE. I think there is no doubt that the alternative minimum tax is what you might call a second best solution. No one could persuade you to close the loopholes in the regular tax fully, so it was only at a very low minimum rate of tax that you were willing to get rid of some of these special breaks.

If you want my advice to be, yes, close them loopholes in the regular tax and we will not need the minimum tax, absolutely. I agree with that.

Senator BOREN. Take away the preference item and have different treatment in the regular tax?

Mr. MCINTYRE. Well, if you didn't have the loopholes in the regular tax, then everybody would be in the regular tax. You would not have to worry about the minimum tax.

Senator BOREN. I will give equal time, I assure you, to your colleagues on the panel. I am going to have to go over to vote. I will be right back. It should not be more than about a 5-minute recess.

Thank you very much.

[Whereupon, the hearing recessed at 3:21 p.m. and resumed at 3:42 p.m.]

Senator BOREN. We will resume. I apologize for the delay because of the vote on the floor.

We were discussing the question of the possible problem, Mr. Goodman, that perhaps we are not really practicing tax neutrality between AMT taxpayers and regular corporate taxpayers in terms of their incentive to go into certain kinds of investments, and ways to deal with that problem.

We had also been talking about the general tax situation. Mr. McIntyre has raised the question of the general tax burden and therefore we cannot focus in isolation only on the effect of the AMT without considering the impact on cost of capital of the total corporate tax burdens. So I want to go back and give both Mr. Goodman and Dr. Lyon an opportunity to comment on that basic point as to whether or not we are focusing too narrowly without regard to the total tax burden and also specifically on this point of favoring one company in essence of the same business over another in terms of encouraging or discouraging investment because of the way the AMT is now working.

Mr. Goodman, let me first turn to you. I know that you were wanting to comment on that matter.

Mr. GOODMAN. Thank you, Mr. Chairman.

First, I would like to make two or three points because I feel that the record is somewhat misleading. The term "no-tax, corporate freeloaders" is obviously a loaded term that is intended as a great "sound bite." But I would like to suggest that corporations pay Federal taxes, they pay State taxes, they pay local taxes, they pay property taxes and franchise taxes. In the oil business they also pay severance taxes and royalties which can equal over 50 percent of the net cashflow at a 4-percent severance tax rate and 18 percent royalty rate. They also create jobs and substantial social wealth. So the idea of "no-tax corporate freeloading" in any real economic sense is very disingenuous.

Secondly, to suggest that manufacturing an automobile or steel or oil or robots is a tax shelter is an outrage. That is what I believe the testimony here today suggests. It is flat out not true. The tax neutrality and the tax fairness provisions of 1986 virtually eliminated what were known as tax shelters. A "tax shelter" is when you invest $1 and get $5 worth of tax write-offs against some low-income base. Not when you invest in new plant and equipment or add people to your payroll.

So for corporate AMT reductions to be characterized as a loophole or while it is virtually prohibiting the competitive use of capital by 40 to 60 percent of the basic industries in this country—steel, forestry, paper, automotives, chemicals, oil is absurd. These are not tax shelters, and these changes are baseless.

When you produce a job and you produce a product, that is not social freeloading and that is not a tax shelter. Additionally, you hear a lot about tax rates. But if an investor is not allowed to recover the capital that he invests in new plant and equipment, new jobs, new wealth and an increased standard of living for this country, if that investor cannot recover that capital—and all of the statistics that you have been given here today show that an AMT tax-

payer is not allowed to recover all of it or all of it as quickly as either a regular taxpayer or a foreign investor who is not subject to the AMT—then the rate that you charge on what you define as income, is almost meaningless because income is now defined to include capital investment for AMT purposes. Income now includes out-of-pocket cash expenses. That is not the constitutional definition of income. It is actually 180 degrees different from its constitutional basis.

Senator BOREN. Let me ask this question. Let me bring you back to two specifics. One, did you put in your prepared statement—you do not need to read it now but I just want to make sure it is there for the record—the methodology and examples you have used in terms of how an AMT taxpayer has less of an incentive to make an investment in say a piece of equipment than a non-AMT payer would have in the same business?

Mr. GOODMAN. Absolutely.

In fact, just to give you an example from the average geological prospect which I mentioned before, where an AMT producer can expect—and these are audited numbers—a loss of $32,581 on the same project that a regular independent producer of oil in this country, subject only to the regular Tax Code, can expect a profit on the exact same investment of $53,037.

Senator BOREN. Strictly because one is under the AMT and the other is not?

Mr. GOODMAN. Yes sir, exactly the same investment, the differences is solely by virtue of a different tax position.

You mentioned a $250 billion loss in wealth to U.S. society. We are talking about the lost production of 1.7 million barrels per day since tax reform. It is not only equivalent to the entire production of Kuwait just prior to the war, but that 1.7 million barrels of oil represents over 13,500 average U.S. geological prospects. We can count to the dollar at peak production from those projects $250 billion in lost wealth to U.S. society and $50 billion in lost taxes before S&L's, multiplier effects, trade balance affects, effects on local real estate markets, and banking multiplier effects. These are countable dollars.

Senator BOREN. Let me ask you, and then I want to turn to Dr. Lyon: What about the point that Mr. McIntyre makes that well, that is all well and good but in terms of specific investment you might have a faster writeoff in one country than another, but the total burden of taxation on profits, for example, is higher in a country like Japan than it is in the United States. Therefore when you look at the total tax picture the cost of capital is not higher in the United States than the cost of capital in, say, Japan?

Mr. GOODMAN. To give you a specific example, the take in the United States—that is the full financial burden that the U.S. Government and our tax and fiscal system places on the average U.S. geological prospect that is developed by an AMT taxpayer, is 106 percent of the expected net revenues that are generated from that project. That is why that project shows an expected loss of $32,000.

Over 100 percent of the discounted, risk-weighted net revenues from this project are currently being taken by the U.S. tax and fiscal system.

Senator BOREN. Dr. Lyon, would you maybe comment on these two issues as to whether or not there is a neutrality in terms of kinds of investment and how we should weigh the consideration that Mr. McIntyre is pointing out in terms of total corporate tax burden? How do those concerns fit into the cost of capital equation?

Dr. LYON. Okay.

I agree that the level playing field argument is important and it does not seem to make sense why you should penalize some firms because they have maybe made poor investments in the past or there is a recession, so that they have a smaller incentive to undertake new investment than other firms which at the moment have high profits and are paying regular taxes.

In my prepared testimony I simply examined equipment investment which is not subject to any special tax provisions. There is no investment tax credit under present law. I am looking at equipment that might be written off over 7 years; and the cost of capital for a firm on the AMT is 10 percent higher to make a comparable investment, the identical investment.

Senator Danforth earlier referred to how the search and development tax credit is taken away. I am not even looking at special investments like that which are much more severely penalized.

So I really think there is an unequal playing field and there is just no simple reason why we should disfavor certain firms. I would see it beneficial to make the AMT provisions more comparable to those on the regular tax.

Just as an example to show how much of a disincentive the AMT provisions are, I mentioned that if you repealed ACE—the adjusted current earnings preference—and if you instituted the 15 percent investment tax allowance which sounds like a very generous provision, alternative minimum tax firms would still face a higher cost of capital for routine investment in equipment than under the present law regular tax.

Senator BOREN. Let me give you an example. Both of us have used the robot example. Mr. McIntyre, correct me if I am wrong. I think what Mr.McIntyre would argue is that suppose I grant you your figures on the investment and producing or buying some robotic equipment that you could recover the cost of capital on that particular investment more quickly say in Japan than in the United States. But on the other hand any profit that you realize as a result of having that piece of equipment working for you in your plant is going to be taxed at a higher level on that profit you make in Japan than it is in the United States.

How would you answer that as a reason for not changing the AMT or changing the rate of cost recovery on the robotic equipment itself?

Dr. LYON. If one wishes to make international tax comparisons it is important to look equally at the rate of the deductions and the rate at which the income is subsequently taxed. The study which you referred to earlier which made the international comparisons—I would like to take credit for all studies written, but that study was written by Steve Corrick for a symposium that I also appeared at. I don't know if he has also taken a look at the rate at which the income is taxed. But certainly one would like to do that to make comparison of the tax systems.

Again, there are a lot of international differences. Some firms in other countries may use more debt. The interest rates may be lower in some countries than others. So there are a whole group of factors that you would like to take into account when comparing the cost of capital across countries.

Senator BOREN. If you were ideally going to do this though, it seems to me just thinking through the argument that was made, it would seem to me that a company would be from a national interest point of view—let's suppose it is in the national interest point of view for plants to modernize and therefore for people to have robotic equipment and so on in order to get their productivity out—I would assume that from the point of national policy it would be better to have a quicker capital cost recovery on that piece of equipment because that encourages you to get it. If you get it, in theory, you are going to generate more profits because you are going to be more productive.

Therefore, if you are going to favor a company with a tax break, it is better to favor them with the break to encourage them to make the investment than tax them more on any profits they make as a result of using the investment.

Does that make sense? It seems to me what I do not understand is why we tax investment instead of taxing profit. I would agree with Mr. McIntyre that we ought to have a fair tax rate on profits and that companies making profits should not be able to avoid paying some tax. I realize there is a certain minimum amount. In other words, you could have a company plowing back 100 percent and avoid all tax by doing so. Although I would say if that is how they avoided the tax it probably would not be a bad thing if it were productive investment really to help the company in the future.

But still, I think I would agree with the argument that even a company like that should pay some minimal amount of tax, not avoid all tax responsibility. But wouldn't we be better off if we had to trade off one for the other to put a heavier burden of taxes on actual profits and a lighter burden of taxes on investment?

Dr. LYON. That may be a better way of proceeding. As Mr. Goodman mentioned, a lot of the problem firms face in getting out of the AMT is simply a timing problem. The firm undertaking a great deal of investment that is going to be building factory robots may not have high taxable income at that moment.

Senator BOREN. Yes.

Dr. LYON. It is going to be put on the AMT simply because of this. In later years it may have profits and in later years it will be taxed under the regular tax system.

Senator BOREN. Of course, there are several proposals here for modifying the minimum tax. There is the President's proposal that would eliminate the depreciation component of ACE for new equipment. Other proposals include reducing the corporate AMT rate from 20 to 19 percent. We have the proposal for an investment tax allowance, reduction of corporate tax rate. All of these things are aimed at getting cost of capital down.

Then we have the proposal that I have made in terms of carrying forward credits up to a certain percentage of income. I think we said 90 percent. That is not engraved upon stone as to whether or

not that is the appropriate amount to assure you would have some collection of tax. But that is the concept of it.

Conceptually, which one of these proposals do you think is better and why?

Dr. LYON. I have not analyzed all of the policies. I think either——

Senator BOREN. Let's say ITA and ACE.

Dr. LYON. ITA is a nice provision, but as it is proposed it is only a 2-year temporary provision. I am analyzing it as a permanent provision and I do not think there seems to be a suggestion that it be made permanent. The 1-percent rate reduction seems comparable to eliminating ACE as far as the cost of capital. I am not familiar with how the revenue costs may differ.

As Mr. Goodman indicated, the cost of AMT comes because you must utilize the AMT credits in later years rather than in earlier years. So in present value that is what hurts the firm. So depending on the rate at which the AMT credit could be utilized, that proposal may have the biggest bang for the buck.

Senator BOREN. In the immediate term, in terms of getting your cost of capital down in the 5-year cost recovery period?

Dr. LYON. That is correct, Senator.

Senator BOREN. Mr. McIntyre, let me ask you this question. I hope I stated your position fairly about the general corporate tax burden.

If, indeed, there are some problems that have resulted partly because of recessionary effects on the AMT system. Again, I go back to the point that no one is suggesting total repeal, and I grant you several of the points you have made about the initial problem that led to the response in 1986.

But let's suppose you have a company that has a high level of capital investment. They have become capital intensive. Let's suppose they may be fighting for their survival, and, therefore, they are really plowing everything they can into new plant and equipment.

The recession comes along. They know that even though it is going to be even tougher for them to continue this high level of capital investment in a new plant during the period of recession, that they are going to need to do it for their survival 5 years from now or they are not going to be around. So they continue this.

They have had a high level for 3 or 4 years here. All of a sudden we get into a recessionary period and for 2 to 3 years they make no profit. In fact, they might even be losing money. How do we deal with the problem of wanting them to continue investment? Because we do. We want them to continue their high level of investment. How do we deal with the problem that they now have no regular corporate tax income at all to offset their AMT credit against because they have been a high capital investment industry?

Do you have any suggestions on how we could do that without opening another loophole as you have described earlier in your testimony that could be abused or that could cause companies to avoid any tax liability when they are being very profitable?

Because I am very concerned about that. I think we have a number of industries in the country right now that are suffering very painful times. They may be losing money. It is very painful for

them to be continuing to keep up their level of capital investment. Some of our major industries are going to have to do this to maintain their ability to compete. The recession hits. They really do not have income that helps to keep them in the regular corporate tax and to allow them to recoup on their costs of capital investments that they are now making, at least let's say for a 2 or 3-year period. Is there some way of dealing with that problem, the disincentive that is now there in the AMT, without opening a loophole?

Mr. MCINTYRE. Well, the same disincentive is pretty much in the regular tax. If you get down to zero you may be able to carry things back a couple of years, but basically you carry it forward, which I think is right. I am not sure that even limited carrybacks at all make a whole lot of sense, but carryforwards do.

But, you know, all we are trying to do is try to measure income here. People have talked about taxing capital. But we are not taxing capital. We are trying to figure out how much of it is worn out in the year that you should take as a deduction.

We have heard from several witnesses saying they should be able to write off their capital investments right away. But then you are not measuring their income. You are measuring something quite different. If we are going to have an income tax, and I think we should, then we have to figure out how to measure income. The AMT is an attempt to measure income a little bit more accurately than the regular tax.

Senator BOREN. Say I am looking at my 5-year cost of capital recovery period. I had some income in the first year or two. I made these investments. I am continuing to make these investments. Now I have no income. I am not paying any tax because I do not have any income. My credit is now worthless because I cannot carry it forward, because I have no income to apply it against, ordinary corporate income. And if I cannot apply it against my AMT liability, which I am still having to pay, how does it do any good for me then?

I agree with you that generally the carryforward in a normal circumstance would work. But in some circumstances it might not work.

Mr. MCINTYRE. If you are really not making any money you will not have any AMT liability either.

Senator BOREN. You are not able to recoup your cost of capital in theory.

Mr. MCINTYRE. Right. The regular tax code, I think everybody would agree, lets businesses write off capital investments too rapidly. The AMT says we are not going to let you do that because we want you to pay your 3 or 5 or 7 percent in taxes.

Senator BOREN. I am in a company struggling to survive in the marketplace, and I have made these investments in order to try to survive. I would like to continue to make investments, but this year I do not have any cash flow. Obviously, I am not making money. I might be losing money. Obviously, if I want to keep up my capital investment level I have to have some money from somewhere.

Under those circumstances, would not some modification be in order that would allow me to apply the AMT credit against my AMT as opposed to my ordinary income? That way I would have

some cash flow out of it in essence. It would keep me on the same plane that I would have had normally.

If my credits become worthless because I do not have anything to apply them against, then my real cost of capital of the company has gone up. Should we not have some way of trying to deal with that?

Mr. MCINTYRE. I do not think the tax code is the right place. I am not sure the government is the right place. I mean anybody who starts up a business is in that situation. Anybody who has a bad year is in that situation. Basically, if we are looking at investing for future profits, which you are always looking at if it is a good investment, capital will go to it.

If you cannot finance investment out of cash flow because you do not have any that year or because you did not have a business until that year or you are doing lousy or whatever, you can still attract capital if it is a good investment.

Senator BOREN. I understand what you are saying. But I think there also is some truth to what has been said here that a company that is paying ordinary income tax as opposed to a company under the AMT, and especially one that gets caught in what I call this recessionary switch, might have a significant disincentive not because of the value of their investments—the very same investment, the very same property, the very same piece of equipment—simply because the operation of the tax code on them?

Mr. MCINTYRE. Well, I mean anybody who does not have profits——

Senator BOREN. I am not talking about interference with the ordinary economic forces. Maybe it is a little bit hypocritical for me to argue that the tax code shouldn't play a role here, but I frankly think that there are some cases where I do not think it is an inherent evil for us to use the tax code to enhance national economic strength or charitable giving or something else. I think it is a positive good.

So I am proud to say I am judged guilty of that and I want to stay guilty of that as long as I serve in public office. Otherwise, I think people ought to send me home. But I understand there is an honest intellectual disagreement about that. If we just start from the premise of neutrality here we do appear to have the tax code having the effect of really distorting an investment decision; do we not?

Mr. MCINTYRE. I do not think you can do any more through the tax code once you get down to zero tax. Going into negative rates, I think, is a bad idea.

Senator BOREN. Well, I thank you all for being here. If you have any additional studies or information, statistical data that you would wish to submit to us, we would be very happy indeed to receive it. I thank all of you, and it has been a most stimulating discussion and I think a very valuable clash of views. That always illuminates our understanding.

Our next panel is composed of Mr. Michael Durham, senior vice president and chief financial officer of American Airlines; Mr. Joseph W. O'Toole, vice president and general tax officer of the Phillips Petroleum Co., Bartlesville, OK; Mr. David Hoag, president, chief executive officer and chairman of the board of LTV Corp., of

course, LTV is a diversified manufacturing company involved in steel, aerospace, defense and energy products; Mr. L.C. Heist is the president and chief operating officer of Champion International Corp., a manufacturer of paper. It also manufactures plywood and lumber products.

I apologize to all of you again our shortage of time. We are going to need to complete by approximately 4:30 because of a meeting that I simply cannot miss. So if you could, if each of you could summarize your comments, we will receive all of your full statements for the record. Also feel free to discuss any of the questions that have been raised by previous witnesses or the panel, and also to comment. Obviously, we have several proposals before us. We cannot begin to do them all. We have to make difficult choices in terms of what is more effective, whether we change the depreciation component of ACE, whether we go to investment tax allowance, corporate tax rate changes, carryforwards of credits under AMT, ITC's, what approach we should follow. Any thoughts that you have on that on the relative merits of various proposals would also be welcome.

Let me say that no one should have hesitation to say they prefer others over those that I personally have put forward, because our goal here is to do what will really be helpful, do it in a fair way and an effective way, and get the most for the dollar in terms of the benefit derived. So I certainly do not approach this with any pride of authorship. We genuinely would like to know based upon your own experience what you think would be the best way for us to proceed.

Mr. Durham, why don't we begin with you.

STATEMENT OF MICHAEL J. DURHAM, SENIOR VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, AMERICAN AIRLINES, FORT WORTH, TX

Mr. DURHAM. Thank you, Mr. Chairman. I appreciate the opportunity to appear before you this afternoon. I should mention I am also testifying on behalf of the Air Transport Association.

American Airlines strongly supports the Chairman's bill, S. 2159, and we are very encouraged that your Subcommittee has seized the initiative to address the restructuring of the alternative minimum tax. We believe that the AMT has had vastly different consequences than was intended by the 99th Congress. It has certainly had a dramatic adverse impact on the airlines, the aerospace and the travel and tourism industries.

Specifically, it has reduced the incentives for those industries to undertake capital investments. It has lowered the number of jobs in our Nations. It has hampered our ability to compete internationally and has lowered the overall level of economic activity in the United States. That, frankly, in our opinion, should be the issue—jobs, economic stimulus and competitiveness.

American Airlines is the largest airline in the world. We currently employ approximately 97,000 people in numerous locations around the United States. Of those 97,000, 11,000 of our best are located in the Chairman's State of Oklahoma, which makes us the largest private employer in that State.

The airline industry presents a somewhat unique set of challenges that we are both highly capital intensive and a fiercely competitive business. Our industry spends billions of dollars a year to acquire the newer, quieter, more environmentally friendly aircraft that our customers and all of our constituents require, and also to comply with the Federally mandated programs such as the Aging Aircraft and Safety Act of 1991 and the Airport, Noise and Capacity Act of 1990.

Because we are fiercely competitive the airline industry has historically had relatively low profit margins. From 1986 to 1990 the industry average net margin was only 0.6 percent which compares very unfavorably with 5 percent average for the S&P 500.

During the same time our industry's average return on equity was a rather paltry 2.1 percent which again compares poorly to the S&P average of 12.4 percent.

During the last 2 years alone our industry has lost nearly $6 billion which is more than its aggregate profits since its inception in 1925. Because of these low profit margins and our heavy capital spending AMT is having consequences to us that I do not believe were ever intended by Congress.

In 1990 and 1991 American Airlines reported a net loss to its shareholders of $280 million. During those 2 years we paid $226 million of alternative minimum tax. I am not sure how Mr. McIntyre would calculate that percentage. Because we do not anticipate that our historical profit margins are going to change very significantly in the future.

Senator BOREN. Say again how much you lost.

Mr. DURHAM. We lost $280 million in the last 2 years—1990 and 1991.

Senator BOREN. $280 million.

And you paid how much minimum tax?

Mr. DURHAM. $226 million in alternative minimum tax.

Senator BOREN. While losing money?

Mr. DURHAM. While reporting losses to our shareholders. That is correct.

Senator BOREN. That is astounding, and I do not understand how that enhances tax equity and fairness.

Mr. DURHAM. We, of course, would agree with you, Mr. Chairman. [Laughter.]

Because our profit margins have historically been low, it is our expectation that if we continue to invest capital in this business that we are likely to continue to be subject to AMT for the foreseeable future.

In fact, we have no reasonable expectations of ever growing our way out of AMT without stopping our capital spending. For instance, in order to become just a marginal regular taxpayer and not subject to AMT in 1992 American would have to have taxable income of $1.5 billion. That compares to $440 million in pre-tax income that we recorded in our best year in our history.

AMT is denying the airline industry any real economic benefit of accelerated depreciation and it reduces the incentive to us to spend capital and to create jobs. And jobs are clearly in jeopardy. Our industry alone employs 500,000 and economic studies suggest that it supports the employment of approximately 8 million other people

in the United States. Directly and indirectly that represents a combined payroll of slightly less than $200 billion a year.

Industry bankruptcies and layoffs have cut employment in our industry by more than 10 percent. In the face of continued economic uncertainty American has recently announced capital spending cuts in excess of $8 billion. Those spending cuts represent 237 aircraft and will result in the loss of approximately 17,000 future employment opportunities just at American Airlines.

Of course, American Airline and airline industry employees are not the only casualties. Reduction in aircraft orders have an adverse impact on employment in the aircraft and supplier manufacturing business. A study conducted by Boeing suggests that $1 billion in aircraft expenditures supports 31,000 jobs.

Furthermore, economic studies estimate that each airline job translates into five jobs in those industries that are direct suppliers to the airline business. A recent article in the Wall Street Journal noted this problem. And, of course, no one has yet sought to estimate the impact in the related industries of shrinkage or non-growth in the airline business, industries such as hotels, restaurants, cruise lines, et cetera, who all are dependent on airline travelers.

Mr. Chairman, American supports the underlying purpose of AMT, that is to ensure that companies that report substantial economic income pay their fair share of taxes. However, the current system discourages airlines from making investments that are necessary, both to stimulate economic activity and create jobs and to ensure that the United States continues to enjoy the benefit of the finest air transportation system in the world.

We do not think that was Congress' intent. We applaud your solution to the problem. The credit proposal in S. 2159 does justice to the underlying principles of AMT as well as recognizing that the Congress did not intend to permanently deny the benefits of accelerated depreciation to capital intensive businesses like the airline industry.

Thank you very much.

Senator BOREN. Thank you very much.

[The prepared statement of Mr. Durham appears in the appendix.]

Senator BOREN. Mr. O'Toole?

STATEMENT OF JOSEPH W. O'TOOLE, VICE PRESIDENT AND GENERAL TAX OFFICER, PHILLIPS PETROLEUM CO., BARTLESVILLE, OK

Mr. O'TOOLE. Thank you, Senator. I appreciate the opportunity to appear before you and I am very delighted that you are addressing the serious problems caused by the AMT. I am pleased to present to you from Phillips Petroleum's perspective some of the immediate effects which the AMT has had on us.

We have suffered economic losses in the United States during the past several years. Yet we have paid AMT in some of those years and we paid AMT totalling about $100 million over the past 5 years.

We see the AMT as effectively depriving us of the use of accelerated depreciation when we analyze economic projects in the United

States. We seem to be in a chronic AMT position and because of that we have to look at projects as if we are not going to be able to use the accelerated depreciation methods that are available to other taxpayers who are not in an AMT position.

We have made very substantial environmental investments in the past and we are continuing to do so now. It appears to us that we are going to spend about 22 percent of our capital budget this year on environmental expenditures. You know that these do not present any economic returns to us. They are the result, of course, of good stewardship. Some of these are also mandated by Federal and State laws.

The AMT from our perspective is applicable to a much larger group of companies than was initially expected. My own experience tells me that about 50 to 60 percent of our colleagues in the large oil industry category are paying the AMT right now.

In our own situation you are aware, since we are both from Oklahoma, of Phillips' problems that are causing layoffs in our headquarters. We are doing this because we have had shortfalls in our cashflow which are caused primarily by business conditions and by the prices of our commodity products.

However, what we found is that the AMT, when we have a distressful situation, has the affect of worsening it. It makes tough times tougher. We also see in the larger perspective that there are some unexpected and other unintended effects. It has to do with the competitive features.

You are aware of the larger policies in the United States concerning competitiveness. The United States over the past 100 years has been fostering competitiveness. It attempts to give opportunities for smaller companies. It attempts to give opportunities for companies that are less well off. And it does this through the anti-trust laws and through economic incentives.

What the AMT does is effectively repeal those and operates in a contrary way. The companies who are productive and in a profitable situation can utilize the incentives of the Tax Code whereas other companies like ourselves cannot.

We also see that companies like ourselves who have very strong domestic presences are finding it more difficult to compete internationally. We do a lot of chemicals investments, plastics investments. But because of the AMT situation the economics that we face here are much worse than the economics which our competitors in the international marketplace face.

Lastly, Senator, I would like to talk about the proposals which are on the table. We have examined S. 2159, your bill. It is an excellent bill. We recognize that taxpayers must not be allowed to escape total taxation if they have economic income. Your bill would not permit that to occur.

What it does do is effectively put a cap on, a substantial cap on, AMT paid by companies who have been chronically in an AMT position. This will enable us and I am sure a number of other companies to look at new investments and to make those new investments on a going forward basis on a parity with other companies who are not in an AMT position.

We also welcome the proposals by President Bush. However, we think those are inadequate. They would help somewhat for new in-

vestments, but they would not be a very substantial help such as your bill would be.

In short, Senator, we encourage you to press forward in the direction you are heading and we certainly wish you the best. Thank you.

Senator BOREN. Thank you very much.

[The prepared statement of Mr. O'Toole appears in the appendix.]

Senator BOREN. I think that the examples we have heard both now from American and from Phillips of how you are impacted, especially those companies that have gone through very tough economic conditions, cash flow problems and the rest, how this is exacerbating the problems, penalizing companies in essence that are having the hardest time, that most need to make the investments to bring themselves out of it. So it has been very, very helpful testimony.

Mr. Hoag?

STATEMENT OF DAVID H. HOAG, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, THE LTV CORP., CLEVELAND, OH

Mr. HOAG. Thank you, Mr. Chairman. I am going to be very, very short in the interest of your opening remarks. As you know, we in the steel industry too are also in a fiercely competitive business. In my mind steel equals capital spending. This industry has spent $7.8 billion over the last 3 years despite a very poor profit margin. The nature of our business means that we are continuously and continually investing in huge amounts of capital. Further, as a cyclical industry, our margins have been even lower over the last few years, especially in this economic downturn. As the result the depreciation add back pushes us into this AMT situation and, frankly, it looks to us like it will be sometime in the next century before we finally get out of the AMT posture. So we cannot take advantage of a more competitive shorter depreciation permitted under the regular tax.

As long-term minimum tax taxpayers, we are penalized with a much slower depreciation system and a longer time period to recover our investment\ And even if the steel industry spent nothing on capital improvements in a given year we still would not be able to get out of the AMT tax situation because of the buildup of prior deferred depreciation.

I do want to make the point that this is a competitiveness issue. Capital formation is very important to this steel business. The recent study conducted by Arthur Anderson concludes that over a 5-year period the extent to which steel has recovered its capital is 30 percent in the United States, 60 percent in Japan, 90 percent in Korea, and 100 percent in Brazil and Singapore.

I also want to make note of the fact that the AMT depreciation addback also includes capital expenditures for pollution control equipment. We salute your efforts to remove those nonproductive assets from depreciation that must be added back for AMT purposes.

Thank you.

Senator BOREN. Thank you very much, Mr. Hoag.

[The prepared statement of Mr. Hoag appears in the appendix.]

Senator BOREN. Again, these basic industries which are so capital intensive are absolutely vital in terms of maintaining the economic strength of the country. I think that the comments you have made are very helpful to our record, and I hope will ask my colleagues to really take another look at this situation.

Mr. HOAG. Thank you.

Senator BOREN. Mr. Heist.

STATEMENT OF L.C. HEIST, PRESIDENT AND CHIEF OPERATING OFFICER, CHAMPION INTERNATIONAL CORP., STAMFORD, CT

Mr. HEIST. Thank you, Senator.

When President Bush addressed the Nation in his State of the Union message, all those listening who heard that his first suggestion for a short-term economic stimulus package was AMT reform must certainly have been mystified. Even among some Members of Congress at times, eyes tend to glaze over on the subject of AMT and ACE adjustments, and certainly many of the corporate executives in this world are confused.

No wonder, it is a very complicated issue. Although I am certainly not an expert, I do know about the substantial negative impact that it is having on Champion and on the pulp and paper industry. Our information at the moment is that 85 percent of the productive capacity of the pulp and paper industry in this country is now under the AMT system.

I believe the impact on us and others can best be understood in very simple terms. The AMT has put a significant segment of American industry at a severe competitive disadvantage. The segment of business most harmed by the AMT includes the basic manufacturing companies that must make continuous and substantial capital investments to remain globally competitive and to meet environmental requirements.

The pulp and paper industry is particularly a global business. We certainly have had to make significant capital and environmental investments. Today, for example, the initial investment for a new world class competitive paper machine is about $350 million. And that does not include the pulp mill, the energy, or the timberlands to back it up with.

The AMT penalizes this manufacturing segment by increasing our effective tax rate every time we increase our investments, and even worse by increasing our effective tax rate every time our profits go down.

Capital intensive companies are disadvantaged compared with other domestic businesses which may have higher profit margins for their products or which are not required by the very nature of their business to continue to make substantial capital investments. They remain in the regular tax system and, as a result, pay a lower effective rate on the same amount of regular taxable income.

Studies have found that the cost of capital for investments by AMT taxpayers in the paper industry seems to be about 20 percent higher than for regular taxpayers. A more serious problem perhaps for basic industries is that we are disadvantaged vis-a-vis our foreign competitors. By our analysis the capital cost recovery system under AMT is the worst in the industrialized world.

The negative impact of the AMT is especially pronounced during a recession which this industry has now been experiencing for some 2 years. Depreciation deductions stay relatively constant over the years, particularly for companies that must make annual or regular investments in assets with long, useful lives.

What changes substantially is the amount of income a taxpayer may have. Under AMT, as the taxpayer's regular taxable income declines its effective tax rate actually increases. Essentially, the AMT reduces cash flow at a time when profits are already weakened by low prices and lack of demand.

The combined effect of AMT and a recession is that fewer new investments can be made and, in many cases, planned investments are either stopped or have to be delayed. This obviously reduces our competitiveness and the number of jobs that we can maintain.

When Congress enacted the alternative minimum tax as part of the Tax Reform Act of 1986 members were reacting to the fact that certain corporations were reporting income to shareholders and paying no Federal income tax. AMT was intended to avoid this outcome by preventing corporate taxpayers from making so-called excessive use of beneficial tax provisions. Accelerated depreciation, originally enacted to stimulate investment in plant and equipment, was considered such a preference.

I think it is our understanding, however, that Congress did not intend to permanently deprive taxpayers of the benefits of accelerated depreciation and other tax incentives. Rather, members intended to simply prevent excess use of these benefits in any one year which would allow a corporation to zero out, i.e., pay no taxes.

Thus, Congress created a credit for the amount paid under AMT that exceeds regular tax liability, but it can only be used when a taxpayer returns to the regular tax system. This credit was designed to ensure that over time taxpayers paid no more than their regular tax liability. Unfortunately, the AMT credit is not working as intended. Champion and many other companies in our industry with relatively low-profit margins and substantial capital investments find ourselves paying the higher alternative minimum tax year after year and accumulating larger and larger amounts of AMT credits which we will be able to use in any meaningful timeframe.

As a result, capital intensive companies such as Champion, find that they may be permanently subject to a higher cost of capital than their non-AMT and foreign competitors. The effect of the recession, in which many companies are experiencing severe losses for both tax and book purposes will exacerbate the AMT credit accumulation problem.

Our suggestions: First, we think Senator Boren's proposal to allow some portion of the accumulated AMT credits to be used to partially offset AMT liability is an excellent solution to one aspect of the problem—the fact that these accumulated credits lose value every year that they cannot be used.

Further, we certainly support Senator Boren's proposal to eliminate the accelerated depreciation add-back associated with environmental improvement projects for purposes of calculating the AMT. This is particularly appropriate and meaningful to this industry. These investments do not directly improve productivity or profit-

ability, but they are critical to a clean environment and should certainly not be penalized or made more costly by the AMT.

In addition to your proposals I would like to point out that the President's AMT proposal is a step in the right direction. Although it does not actually provide us a great deal of immediate benefit, it does help raise awareness of the problem and for that we are grateful.

While we appreciate the Administration's effort, we would request that Congress undertake a more fundamental reform of the AMT depreciation system. Eliminating the ACE adjustment for future investments as the President has proposed will eventually provide a modest benefit to AMT taxpayers. Even if the President's plan were adopted, however, the remaining AMT depreciation system however, would still result in significantly higher costs of capital for such taxpayers.

The companies who need help in these difficult times are the basic manufacturing companies of America. With limited resources and with the goal of providing an immediate investment stimulus without hurting the economy in the long run, the most effective action Congress can take is to modify the current AMT.

AMT reform provides the following benefits: It provides increased cash flow immediately; it saves existing jobs and helps create new ones; and, last but not least, it makes a permanent improvement in our tax system at a relatively low cost.

We think it is the best bang that you can get for the buck and we certainly thank you for the opportunity to present our views today.

Senator BOREN. Thank you very much.

[The prepared statement of Mr. Heist appears in the appendix.]

Senator BOREN. I am glad you also mentioned the aspect of the environmental investments and the preference that they now constitute. That is an additional point that has not been raised as yet in the hearings. I think that is so important. Because here we are really asking companies to undertake a public purpose investment. As you say, not one that in most cases will contribute to economic competitiveness, but really almost in essence like a social tax, if you want to call it that.

Instead of paying into a fund to clean up the environment, the company is asked to make this investment itself. So it is certainly a public purpose, the preference treatment in essence penalizes a company through the tax code for doing what we say we want to do as environmental and social policy. Again we seem to be working at cross purposes.

It is very odd to me that those who advocate on the one hand certain policies, be it taking care of people in need in the country through charitable organizations or be it cleaning up the environment, then turn around to oppose incentives of the tax code for doing those very things and accomplishing those very objectives.

So we have an ironic situation indeed in terms of the arguments that are made.

Again, I apologize to each of you that we have gotten a little short on time because of our interruption midstream with what happens on the floor. But your testimony has been very helpful. We will receive your full statements for the record.

I think that the hearing this afternoon has made a very compelling case in my mind, and I think will in the minds of others, for making some modifications in the AMT so that we can get back to its basic objective of fairness, while not having unintended consequences that obviously are occurring and that I do not think were in the minds of the vast majority of those that supported this proposal in the beginning.

So as with many things in the tax code, we certainly see here spelled out unintended consequences that are really having a debilitating affect on the nation's ability to compete, and we simply cannot afford to let this situation go on because it is inflicting grave and permanent damage.

So I thank all of you for your testimony and for the information you brought to us this afternoon.

[Whereupon, the hearing adjourned at 4:34 p.m.]

APPENDIX

Additional Material Submitted

Prepared Statement of Senator David Boren

First, let me welcome our distinguished witnesses and thank them for spending time with us this afternoon discussing the alternative minimum tax system. Since 1986, we have not focused much attention on the AMT, except to discuss whether the rate should be increased or lowered. This lack of interest is explained in part because the AMT is complicated. Its goal—and it's a laudable objective—is to ensure that profitable corporations pay their fair share of taxes. This concept is easy to understand, but the actual operation of the system is very difficult. In part, lack of attention to the AMT has been caused because it takes some time before we can learn and analyze the economic effects of any tax system.

But now, enough time has passed for us to be able to embark on today's discussion of the system. Indeed, we must engage in a serious analysis of the AMT system because it has become obvious that some sort of modification will occur; both the President's proposed budget and the House's Democratic alternative tax legislation include changes to the present AMT structure.

I have several concerns with the AMT that I will outline now, in the hope that our witnesses will address these issues in their statements and in their answers to the Subcommittee's questions. First, I am concerned about statistics that indicate that the alternative minimum tax has a significant negative impact on the ability of U.S. companies to compete internationally. The cost of capital for our businesses is comparatively greater than the cost to foreign corporations because of the heavy U.S. tax burden on capital assets. One study indicated that after five years, a German company recovers over 81 percent of the cost of a factory robot, and a Korean business recovers the entire cost of that equipment. In sharp contrast, a U.S. company that is paying the alternative minimum tax recovers only 37 percent of the original cost in five years.

Perhaps when the Congress enacted the AMT it did not expect such an extreme effect on the competitive posture of American businesses. Or perhaps we didn't think internationally when we enacted this policy. Whatever the reason, we *must* consider more than our own economy as we discuss possible changes to the AMT. We simply cannot afford to write our tax policy in a vacuum. If we refuse to acknowledge the importance of the international market and the increasing interdependence of the world's economies, we will soon find ourselves to be a second-rate economic power.

Second, I am concerned that the impact of the recession has resulted in the AMT operating differently than Congress intended. Part of the AMT scheme is the provision that allows a corporation a credit in the amount of the excess of its minimum tax over its regular tax; that AMT credit is applied against regular tax liability in future years. Although we did not allow this AMT credit to offset AMT liability, we expected that corporations would revert to paying regular corporation tax soon enough for them to use these credits while they still had some value.

Some commentators have noted that a number of corporations will be paying the AMT for many years and therefore will not be able to use the AMT credit in the foreseeable future. They note that this situation may inherently result from recessionary times because an economic downturn causes profits to be low, while capital expenses may well continue to be high. The AMT credit decreases in value as the ability to use it is postponed further and further into the future. I hope that our witnesses can address the reasons why companies are not emerging from an AMT position, how prevalent a phenomenon this is, and what, if anything, Congress can do to allow companies to use their AMT credits within a meaningful time frame.

Finally, I am concerned that one industry in particular—the independent oil and gas industry—appears to be suffering unduly from the alternative minimum tax system. Since 1986, domestic oil production has declined by more than 1.7 million barrels per day. This lost production equates to a measurable loss in wealth to U.S. society, before any multiplier effects, of $160 billion to $250 billion. The number of domestic independent producers has dropped by more than one-third, and the industry has lost 317,000 jobs in the last decade. These figures reveal a crisis in the industry, a crisis with wide implications because 60 percent of this country's natural gas and 40 percent of our crude oil are produced by independents.

Experts have pointed to the alternative minimum tax as a cause of this decline. They argue that the AMT treats unfavorably two necessary and ordinary business expenses of the independent oil and gas business—intangible drilling costs and percentage depletion. Because both of these expenses are treated as preferences under the AMT, they are subject to being added back into taxable income, father than being deducted like most other ordinary business expenses. This treatment may well be discouraging exploration and development of our oil and gas resources.

I look forward to our witnesses' discussion of these issues and others that will be raised during the course of this hearing.

[SUBMITTED BY SENATOR BOB DOLE]

THE SECRETARY OF THE TREASURY,
Washington, DC, February 29, 1992.

Hon. BOB DOLE,
Republican Leader,
U.S. Senate,
Washington, DC.

Dear Leader: I am writing in response to the concerns you have expressed with respect to the impact on independent oil and gas producers of the alternative minimum tax treatment of intangible drilling costs. I thank you for bringing this matter to my attention.

The President remains deeply concerned about the continuing low level of domestic drilling activity. This trend could weaken our energy security by reducing our nation's oil and gas reserves and making us more dependent on imported oil. It is contrary to the goals of our National Energy Strategy. This concern has been made more acute by the Democrats' failure to enact our proposals for the Arctic National Wildlife Refuge.

We recognize that the alternative minimum tax treatment of intangible drilling costs can result in a "cliff effect" which deters drillers from undertaking projects that would otherwise be attractive. We understand that independent producers may be particularly affected by the alternative minimum tax, as they have to rely on internally generated capital to finance drilling and expend a high percentage of their capital on drilling costs. Thus, the alternative minimum tax exacerbates disincentives to drilling.

The President agrees with you that the impact of these rules on independent producers should be ameliorated. As always, you are at the forefront of efforts to strengthen our nation's energy security. I look forward to working with you on this important project.

Sincerely,

NICHOLAS F. BRADY.

PREPARED STATEMENT OF MICHAEL J. DURHAM

INTRODUCTION

Mr. Chairman, Members of this Subcommittee and staff, I am Michael J. Durham, Senior Vice President of AMR Corporation, and Senior Vice President-Finance and Chief Financial Officer of American Airlines, Inc., the principal subsidiary of AMR Corporation. American Airlines accounts for approximately 94 percent of AMR's assets and operating revenues for 1991.

Thank you, Mr. Chairman, for the opportunity to appear before your Subcommittee this afternoon. American Airlines strongly believes that substantial modifications in the corporate alternative minimum tax are needed to improve the current business climate and to permit the airline industry to meet the country's current and future transportation needs. We are particularly encouraged that the Sub-

committee has taken an interest in restructuring the alternative minimum tax as it affects not only the livelihood of those in the industry, but also all those employed in the aerospace and travel and tourism industries as well as the traveling public.

American Airlines is the largest airline in the world. The company serves 190 cities worldwide with 2,551 daily departures.

In order to maintain our worldwide competitive position and to provide high quality service, American annually invests billions of dollars in aircraft, facilities and other capital expenditures. The Company employs more than 97,000 people; 55,000 of whom have joined American's ranks since 1985. American has major hub operations in Dallas/Fort Worth, Chicago, Miami, Nashville, San Jose and San Juan, and two principal maintenance bases in Fort Worth and Tulsa. American is the largest. private employer in Oklahoma. In all those locations American Airlines is a major employer and our activities generate thousands of jobs in related industries. By virtually any measure, American Airlines is a major economic force and an integral part of the economic health of many regions within our nation.

Mr. Chairman, we are proud of our accomplishments. We have fueled economic growth throughout our country and we have created jobs. But we are very concerned about the aviation industry's lack of profitability in recent years and the unintended impact the alternative minimum tax has on our business. Contrary to the intent of the law, the alternative minimum tax has become a penalty tax on low margin capital intensive industries. In our opinion substantial alternative minimum tax modifications must be a fundamental part of any package this Committee designs to restore economic health to our Country.

AIRLINE INDUSTRY FUNDAMENTALS

The airline business presents a unique set of challenges. It is a service industry that is very capital intensive. As a fiercely competitive business, it has historically generated very modest profit margins.

The airline industry spends billions of dollars on aircraft, facilities and ground equipment. Large amounts of external capital in the form of debt, equity and lease financing are necessary to fund this level of investment. In order to attract sufficient capital, we must earn an adequate return for our investors.

Although there has been much change and consolidation since deregulation, the airline business has remained fiercely competitive. The consumer has benefited significantly from this competition as the battle over market share has continually driven down air fares. During the 1980's, the price of air travel grew much slower than inflation and actually declined about 20 percent on a real basis. This intense fare competition has had an adverse impact on industry profitability.

The airline industry is a low profit margin business. From 1986 to 1990, the industry's average net margin was 0.6 percent; poor when compared to the S&P 500 average at 5.0 percent. During that period, the airline industry's average return on stockholder equity was only 2.1 percent compared to the S&P 500 average of 12.4 percent. Even American, which achieved the best results in the industry, had only a 9.3 percent average return on equity, well below U.S. industry standards.

RECENT INDUSTRY LOSSES: IMPACT ON JOBS

In the past two years, the U.S. airline industry has posted record losses of nearly $6 billion, which has *eliminated all industry profits* earned since 1925. Even the relatively healthy U.S. carriers (American, United, Delta, USAir, Northwest and Southwest) had a combined operating loss of $2.3 billion in 1990–1991. American Airlines' performance has been among the strongest in the industry, yet American reported a net loss of $240 million to its shareholders in 1991. Recent industry losses have substantially eroded industry shareholder equity. Equity has decreased from a high of 62 percent of capital in 1978 to just 46 percent in 1990. 1991 will be still worse.

The air transport industry directly employs more than 500,000 people and indirectly supports another 8 million who work for commercial airports, airframe and aircraft equipment manufacturers, aviation industry vendors and the travel and tourism industry. These 8.5 million people earn $178 billion annually. However, many of these jobs are in jeopardy as a direct result of the industry's recent downward earnings trend. Recent liquidations and announced layoffs by U.S. airlines total more than 58,000 employees. No one can even estimate how many jobs in related industries were lost.

Because the outlook for a return to profitability is so uncertain, in September, 1991 AMR announced a capital spending reduction of $8.2 billion. The largest component of our capital plan, aircraft spending, was cut by $6.8 billion. This $6.8 billion reduction represents 91 fewer jet aircraft and 146 fewer turbo prop commuter

aircraft. On average, one additional jet aircraft would add 136 new airline jobs and one additional commuter aircraft would add 30 new airline jobs to our payroll. Thus, this planned reduction in aircraft spending represents a loss of 16,756 future jobs.

American is not the only airline to reduce its capital spending. Recently, United Airlines announced it was cutting its four-year $18.7 billion expansion program by nearly one-third, a $6.7 billion reduction representing 122 fewer aircraft deliveries.

Lack of profitability has had a major impact on local economies. In 1991, American built a new maintenance base at Alliance Airport in Fort Worth, Texas based upon its original 775 aircraft fleet plan. Initial plans called for Alliance to eventually employ 4,500 people. Phase I of the project, at a cost of $481 million, was completed in January and by 1995 will employ 2,500 people, mostly aircraft and jet engine mechanics. However, Phase II of the program, at a cost of $300 million, has been deferred with a net loss of 2,000 jobs for the area. The economic impact to the region was estimated to be $800 million a year once Alliance was fully developed. It now will be substantially less as a direct result of our downsized fleet plan.

In Oklahoma, American employs over 11,000 people in a state-of-the-art maintenance facility. This facility has seen tremendous growth as we have increased the size of our fleet. However, if the trend towards the lack of business incentives continues, American cannot continue to invest in new aircraft and the total number of aircraft in the fleet will be reduced as aircraft are withdrawn from service. As this occurs, the need for our maintenance facilities and skilled mechanics will be reduced throughout our system, including those at Tulsa. The cancellation of these aircraft orders will also impact American's ability in the future to open new routes, such as Sioux Falls scheduled to begin on May 1, and to expand service to existing ones.

But airline employees have not been the only casualties. In the airline industry, a reduction in the number of planes purchased also translates into lost jobs in the airframe and aircraft equipment manufacturing industry. Boeing Aircraft Company has projected, after United announced its revamped expansion plans, that 1,100 layoffs might result from the production rate change in its Wichita, Kansas facility. But this does not tell the whole story. The aircraft manufacturing industry estimates that every $1 billion in aircraft orders translates into 31,000 jobs for airframe and aircraft equipment manufacturing industries and related industry suppliers. The combined reduction in aircraft orders by American and United alone, totalling $13.5 billion, represents a staggering loss of jobs.

The air transport industry's economic problems have also impacted airline-related suppliers. Economists estimate every airline job translates into five jobs with vendors that sell directly to the airline industry. A recent article in the Wall Street Journal notes "the carriers' problems are dragging down a big cross section of the nation's economy, ranging from giant aircraft makers to bakers that supply buns for breakfast flights and vendors of cocktail napkins." By way of example, the Journal article reported that Caterair International Corp., the largest airline caterer, either froze or rolled-back most of the wages of its 20,000 employees.

IMPACT OF ALTERNATIVE MINIMUM TAX ON AMERICAN AIRLINES

While American Airlines continually reviews its need for additional aircraft and ground equipment and determines its requirements based on both short-term and long-term profitability forecasts, the simple fact is that the dynamics of the airline business require American to contract for delivery of aircraft far in advance of the delivery date. Therefore, even in the face of a sustained economic downturn, American has substantial commitments to purchase aircraft. For example, in 1990 and 1991 American took delivery of 137 aircraft, all of which it committed to receiving long before the effects of the economy could be predicted. As of December 31, 1991, American had 156 aircraft on firm order, totalling approximately $7.0 billion, for delivery through 1995. In 1992, American expects to take delivery of 72 aircraft representing $3.1 billion in aircraft and related equipment acquisition costs. The combined impact of American's aircraft acquisition program has ensured that the Company, as a low margin, capital intensive business, will be subject to the alternative minimum tax at least through 1997.

The negative effect of the alternative minimum tax is especially pronounced during periods when American Airlines experiences low profits or economic losses. Our 1990 and 1991 results provide a dramatic example of this perverse impact. In those two years, AMR reported a total *net book loss* to its shareholders of $280 million yet still paid $226 million in alternative minimum tax. This is a result Congress surely did not intend.

Congress designed the alternative minimum tax credit mechanism so taxpayers, as they moved in and out of the alternative minimum tax system, could utilize their credit carryforwards. Yet, American's $226 million of alternative minimum tax cred-

it has effectively been rendered useless for many years due to American's future capital spending commitments and the industry's low earnings history. As a consequence, American has been denied any real economic benefit under the tax laws from accelerated depreciation as compared to non-alternative minimum taxpayers.

American has no reasonable escape from alternative minimum tax short of dramatically reducing future capital investment. American would need approximately $1.5 billion of taxable income to escape alternative minimum tax in 1992. It is extremely unlikely that this amount of income will be achieved given the industry's low profit margins. The highest taxable income year American has reported in its history was approximately $440 million.

The alternative minimum tax system also places the airline industry at a competitive disadvantage versus its international competitors. Internationally, American primarily competes with airlines located in Japan, Germany, France and the United Kingdom. A survey of their tax depreciation systems applicable to aircraft showed that the U.S. alternative minimum tax depreciation system had by far the lowest present value of any cost recovery system. No other country in the world appears to penalize new investment like the U.S.

SENATOR BOREN'S ALTERNATIVE MINIMUM TAX CREDIT PROPOSAL IN S. 2159

The alternative minimum tax credit proposal included in S. 2159 would provide relief to habitual alternative minimum taxpayers by permitting taxpayers with certain unused minimum tax credits to offset up to 90 percent of current year regular and net minimum tax liabilities. This proposal goes a long way towards recognizing that Congress did not intend to deny permanently the benefit of accelerated depreciation, but only to limit the amount of benefit a taxpayer can receive in any given year. If passed, S. 2159 would stimulate capital spending, create thousands of jobs and help the airline industry to meet its task of ensuring that the U.S. will continue to enjoy the finest, most efficient air transportation system in the world. We applaud you, Mr. Chairman, on your innovative alternative minimum tax proposal which will benefit the air transportation industry and hundreds of thousands of workers in Oklahoma, Texas and throughout the country.

PREPARED STATEMENT OF CRAIG G. GOODMAN*

As the election year approaches, both parties have begun another round of debates over budget deficits, trade deficits, foreign competition, income redistribution and how to use a "peace dividend" to increase economic activity during 1992. At the core of these debates is U.S. tax policy. Unlike prior debates, however, there is now a growing body of quantitative analysis which permits informed policy-makers to measure the impact of U.S. policies on real-world investment behavior, and the creation and measurement of new wealth for U.S. society.

The results of this research hold significant implications for the United States and its ability to compete in the global economy. Until now, U.S. tax and economic policies have relied on relatively static macro-economic models and rhetoric to "predict" America's response to any given set of policy proposals. As the U.S. falls further behind in the quest for new markets and a higher standard of living, it is becoming painfully clear that any new world economic order demands a far more dynamic approach to policymaking.

Presented in graphic form on the pages that follow are economic analyses of the impacts of U.S. tax policies on U.S.-based companies competing in the global economy. The results strongly suggest that merely reshuffling spending priorities or slightly shifting relative tax burdens according to voting potentials will not necessarily increase America's economic well-being or its standard of living over the long-term.

The combination of what many see as continued U.S. profligacy, ever-increasing private and public debt loads, embarrassingly-low savings rates, and tax policies which punish capital formation, could easily foreshadow undesirable consequences. Much is already known about America's public and private consumption rates, its spending habits, its savings rates and, of course, its debt loads. However, new

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*Craig G. Goodman served as director of oil policy, and as the Director of the Office of Energy Tax Policy within the U.S. Department of Energy under the Reagan and Bush Administrations. Mr. Goodman currently is Vice President of Mitchell Energy Corporation in The Woodlands, Texas. Prior to government service, Mr. Goodman was senior counsel and director of energy and tax policy for the Independent Petroleum Association of America. Mr. Goodman is a member of the Bars of the States of Texas, Florida, and Washington, D.C. and is admitted to practice before the United States Supreme Court.

microeconomic research allows us to see the dynamic real-world impacts of America's tax policies.[1]

The following article incorporates this research to offer insight on how to reverse America's declining share of global wealth. In sum, the U. S. form of capitalism can no longer afford to impose tax penalties on capital seeking to create new jobs, new wealth and new economic opportunities for U.S. citizens and U.S.-based business enterprises.**

I—THE HISTORY OF U.S. CAPITAL TAXATION POLICIES

Historically, U.S. tax policies affecting capital have held a revered place in the foundations of American democracy.[2] The 18th Century outcry against taxation without representation can be traced forward directly as the basis for the 20th Century Constitutional prohibition against taxing capital. However, when America shifted its budgetary reliance on excise taxes and import fees to income-based taxation, a "vexed question"[3] became how to distinguish income from capital. This has been no minor feat, particularly when the answer depends (among other things) on whether the capital is depreciating or depleting, tangible or intangible. The Supreme Court has wrestled with this question repeatedly. Yet, from the start it was clear that the question was primarily legal, with significant economic implications.[4] Regardless of the circumstance or type, it has always been clear that taxing capital is not only unconstitutional, but also is contrary to many of the basic precepts of U.S.-styled free-market democracy. The Constitutional prohibition against taxing capital is deeply rooted in the American notion of private property rights and the inherent distrust the founding fathers had of political factions arising that could tax property existing disproportionately in states having only minority representation in the "lower-house of Congress".[5] This Constitutional safeguard reflects America's disdain for taxation without representation. Interestingly, this basic principle of 18th and 19th Century American-styled capitalism is also an important part of late 20th Century global capitalism. The research presented below indicates that the United States has not only lost sight of the roots of its prosperity, but that its competition has studied well the U.S. formula for success and is capturing large portions of America's historical share of global wealth. In the past, other countries modeled their tax codes around that of the United States because of its sheer economic power. In the last three decades, however, America's stature in the world economy has declined dramatically. After decades of being the world's largest lender of capital, the United States is now the world's largest debtor nation. The United States has gone from an unparalleled economic superpower with a 40% share of the world's total production, to one of several regional economic powers fiercely competing for market share. In the process, the U.S. has lost more than 28% of its global-market share. During the same time, the U.S. share of the world's total direct investment declined 38% as foreign direct investment in the United States increased thirty-fold (3000%).[6]

Over the last five years alone, the U.S. has borrowed over $100 billion annually just to finance its trade deficit, the majority of which is related to the importation of crude oil and foreign automobiles; the two industries that were synonymous with U.S. prosperity, and its preeminent standard-of-living in the first half of the 20th Century.

During this period of marked decline in U.S. global economic stature, other trends also emerged. The U.S. economy became more reliant on consumption of all types, and the foreign production of cars, crude oil, and, more recently, high-tech products have captured ever increasing shares of the U.S. and world markets. Not surprising, this period is marked also by a substantial shift in America's tax burden onto productive capital and income generated from capital, thereby freeing up more personal income, after taxes, for added consumption. "Tax equity and efficiency" may sound like taxation without representation, but as shown below, certain impacts of current U.S. tax policies are neither equitable nor efficient.

II—RECENT CHANGES IN U.S. CAPITAL POLICIES

Over the last twenty years, political concerns about tax equity and efficiency have motivated a reform of the U.S. system of income taxation. This reform has taken the form of slower capital-cost recoveries in the regular tax code and the creation of a new form of taxation called the alternative minimum tax (AMT). Contrary to traditional principles of income taxation, at the margin, the incidence of this new tax falls directly on capital itself rather than solely on the income generated from

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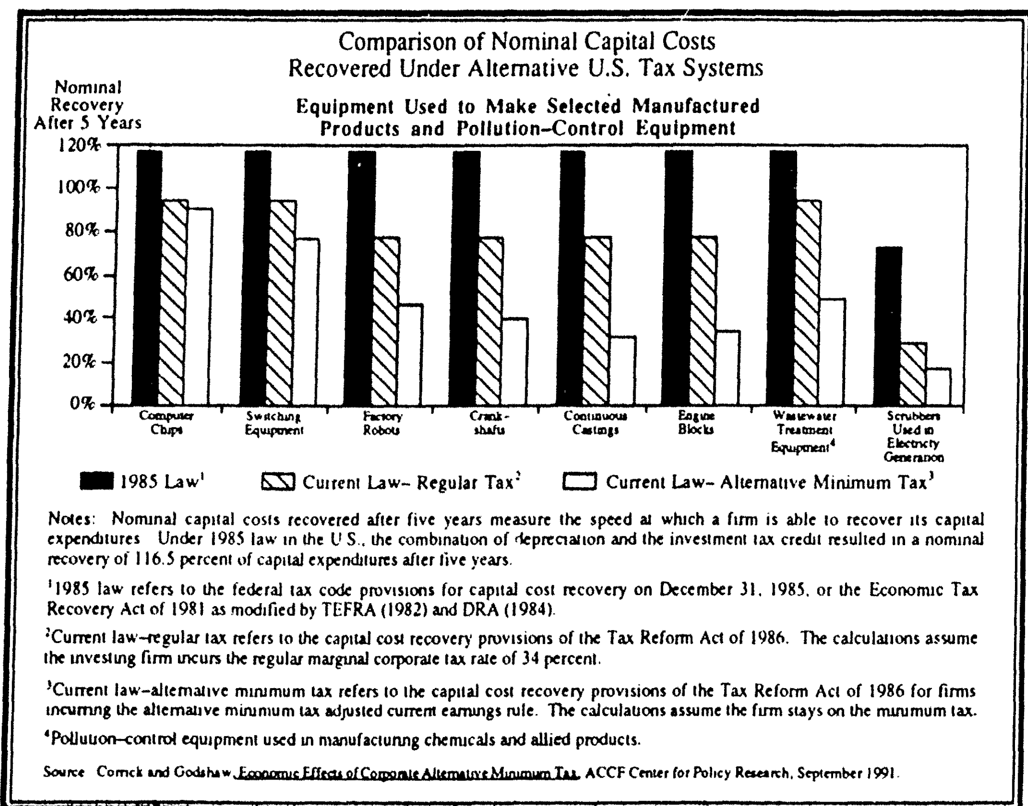
** This article addresses taxes on capital and income generated from capital, not the taxation of *capital gains*.

that capital. In the process, the various tax reform acts between 1969 and 1986 have increased substantially the economic impact of U.S. taxation on virtually all capital investments, and particularly on high-risk depleting capital investments such as petroleum.[7]

In response to the OPEC embargoes and price spikes of the 1970s, the United States repealed time-honored rules allowing recovery of sufficient funds to replace reserves for more than 70% of all proven domestic petroleum assets. The U.S. definition of taxable income which now includes drilling costs and asset depletion, represents a major departure from the historical structure of the U.S. system of income taxation as well as from its constitutional underpinnings. As a result, in the U.S. tax code today, a long-term AMT petroleum taxpayer is no longer guaranteed a return of, much less a return on, new drilling capital.[8]

The following chart presents a side-by-side comparison of the pre- and post-tax-reform systems of capital and capital-income taxation in the United States for a variety of significant capital investments. As shown, the ability of U.S.-based taxpayers to recover capital invested in virtually any type of depreciating asset has deteriorated significantly in the last five years.



Notes: Nominal capital costs recovered after five years measure the speed at which a firm is able to recover its capital expenditures. Under 1985 law in the U.S., the combination of depreciation and the investment tax credit resulted in a nominal recovery of 116.5 percent of capital expenditures after five years.

[1] 1985 law refers to the federal tax code provisions for capital cost recovery on December 31, 1985, or the Economic Tax Recovery Act of 1981 as modified by TEFRA (1982) and DRA (1984).

[2] Current law–regular tax refers to the capital cost recovery provisions of the Tax Reform Act of 1986. The calculations assume the investing firm incurs the regular marginal corporate tax rate of 34 percent.

[3] Current law–alternative minimum tax refers to the capital cost recovery provisions of the Tax Reform Act of 1986 for firms incurring the alternative minimum tax adjusted current earnings rule. The calculations assume the firm stays on the minimum tax.

[4] Pollution–control equipment used in manufacturing chemicals and allied products.

Source: Cornick and Godshaw, Economic Effects of Corporate Alternative Minimum Tax, ACCF Center for Policy Research, September 1991.

When capital recovery periods lengthen, as has occurred, the cost of new investment capital increases and the after-tax return on that capital declines. Additionally, as shown in the section dealing with depleting capital, as the tax code stretches out the time it takes to recover capital, both the costs and the risks associated with that capital increase significantly. Moreover, the longer capital is at risk, the increased costs of U.S. policies are even more significant in determining whether such capital is competitively employed.

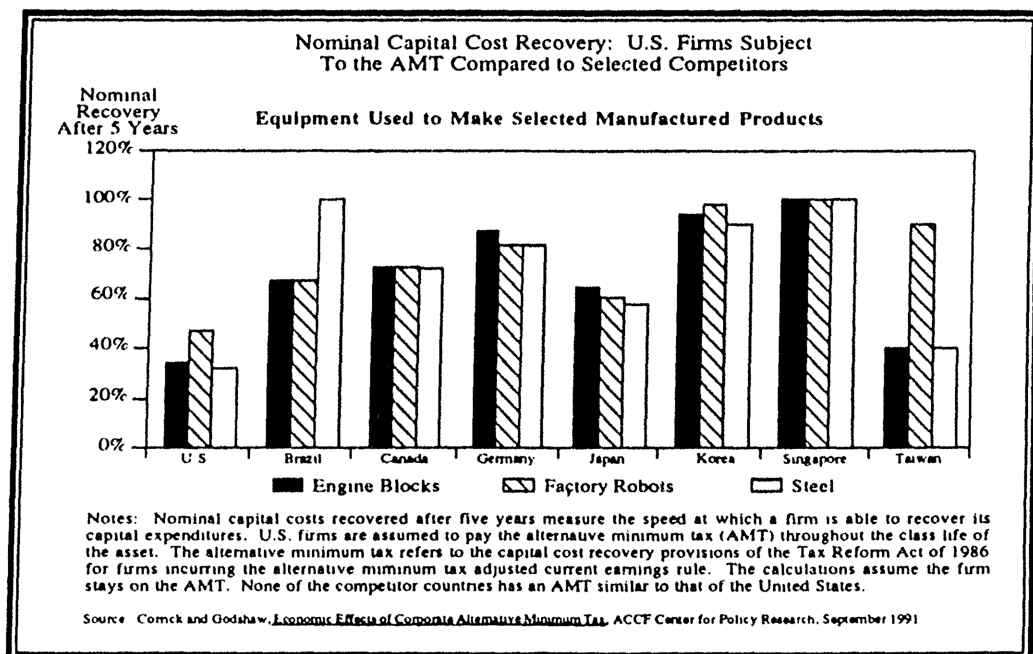
As shown, the United States is one of the more hostile environments in the world in which to be headquartered and to invest new capital. As is also shown, U.S.-based companies are at significant competitive disadvantages when doing business anywhere in the world. Consequently, capital invested by U.S.-based corporations both domestically and internationally will cost more and return less than capital similarly invested by companies based in virtually all of our major trading partners.[9] Today, the majority of U.S. depleting assets and 40% of U.S. depreciating assets are subject to these new policies.[10]

Research presented below suggests strongly that revising U.S. capital policies can increase U.S. social wealth, its job base, its economic activity and ultimately increase federal tax revenues as well. This research also suggests strongly that such revisions could help the United States to compete more successfully, and to create and bring home a greater share of new wealth from the global marketplace.

III—U.S. TAXATION OF DEPRECIATING CAPITAL

Capital and capital-income tax policies in the United States are now controlled primarily by the provisions of the Tax Reform Act of 1986. As shown above, these policies lengthened considerably the period in which a U.S.-based taxpayer can recover the capital needed to generate income, jobs and social wealth. Consequently, there is growing concern as to whether current tax and capital policies can or will foster the type of economic growth and prosperity American culture has come to expect.

The following is a chart of the time it takes to recover capital invested in the U.S. automotive, steel and robotics industries compared to seven of our major trading partners. This chart demonstrates persuasively that U.S.-based taxpayers investing in new depreciating capital assets are at a significant competitive disadvantage both domestically and internationally.[11] Foreign tax regimes have nothing remotely similar to the AMT and generally allow significantly more favorable returns of and on new capital invested under their respective tax regimes.



Notes: Nominal capital costs recovered after five years measure the speed at which a firm is able to recover its capital expenditures. U.S. firms are assumed to pay the alternative minimum tax (AMT) throughout the class life of the asset. The alternative minimum tax refers to the capital cost recovery provisions of the Tax Reform Act of 1986 for firms incurring the alternative miminum tax adjusted current earnings rule. The calculations assume the firm stays on the AMT. None of the competitor countries has an AMT similar to that of the United States.

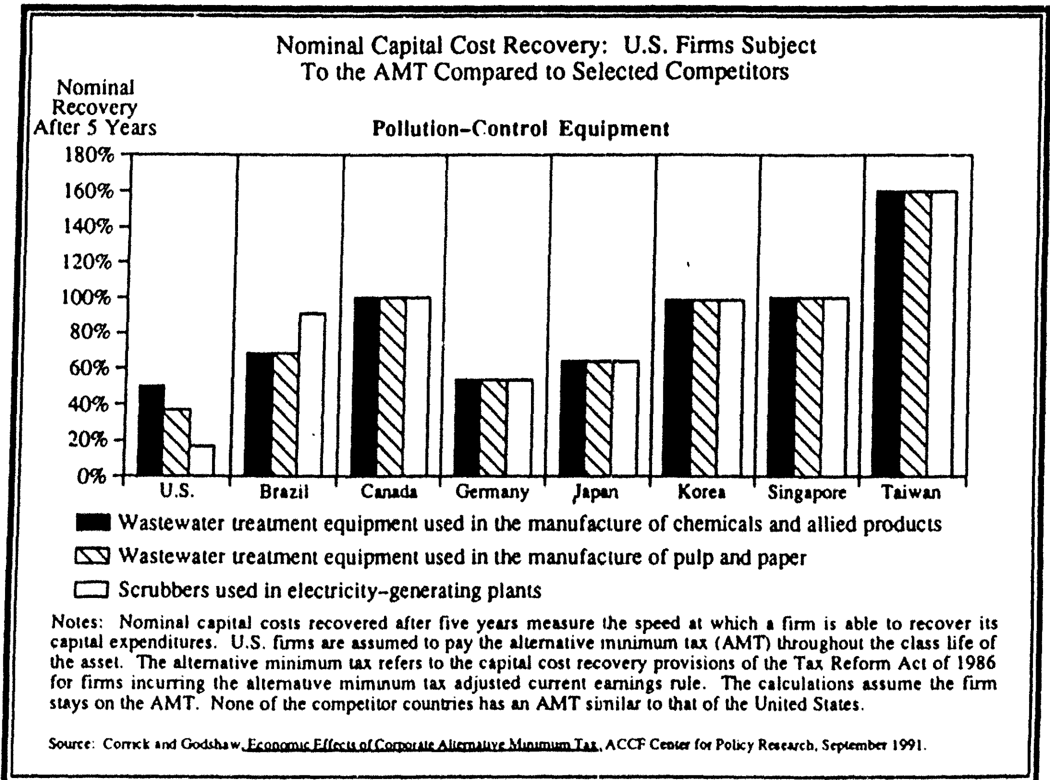
Source Cornck and Godshaw, Economic Effects of Corporate Alternative Minimum Tax, ACCF Center for Policy Research, September 1991

As shown, U.S. capital recovery policies present major disincentives for firms located in the United States to invest in these three significant asset categories. Capital invested in equipment to manufacture steel, engine blocks or robots under the tax regimes of any of the other countries shown, will cost less and return more than it would in the United States. In five years, an auto-maker in Germany can recover over twice as much of its investment than its U.S. competition. Similar results occur in Japan and Canada. With a 3% investment tax credit available in Korea, the results of an automotive investment are far more competitive than in the United States. Singapore even more aggressively pursues capital formation by offering a three-year capital recovery period.

A U.S.-based automotive, steel or high-tech company subject to the AMT is at a significant disadvantage when compared with its foreign competition. U.S. firms competing in foreign-countries are further penalized by U.S. foreign tax laws[12] which essentially impose a surcharge, not borne by foreign competitors, in amounts of 4% to 10%.[13]

Interestingly, as the United States has become increasingly concerned about the quality of its environment, it has simultaneously imposed significant tax disincentives on capital invested in equipment used to clean-up the environment. Com-

pared with Taiwan, Singapore, Korea, Canada and Brazil, environmental investments in the United States are not a competitive use of capital. The Taiwan government allows a complete return of and a 60% return *on* environmental investments, while a U.S.-based company subject to the AMT can only recover 17.5% *of* its capital invested in new scrubbers, and less than 50% *of* its capital invested in new wastewater treatment equipment, after five years.[14] The following chart provides a graphic comparison of the relative returns *of* and returns *on* depreciating capital used to enhance environmental quality in the United States and seven of its major trading partners.



Notes: Nominal capital costs recovered after five years measure the speed at which a firm is able to recover its capital expenditures. U.S. firms are assumed to pay the alternative minimum tax (AMT) throughout the class life of the asset. The alternative minimum tax refers to the capital cost recovery provisions of the Tax Reform Act of 1986 for firms incurring the alternative minimum tax adjusted current earnings rule. The calculations assume the firm stays on the AMT. None of the competitor countries has an AMT similar to that of the United States.

Source: Corrick and Godshaw, Economic Effects of Corporate Alternative Minimum Tax, ACCF Center for Policy Research, September 1991.

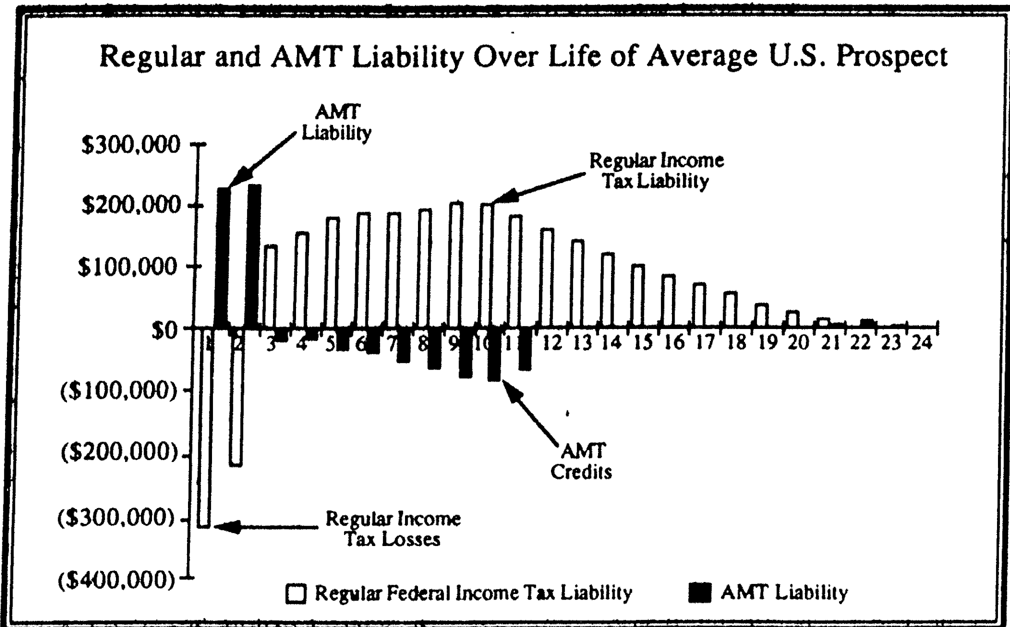
In each asset category shown, the U.S. yields the worst results. Yet, depreciating capital is only part of the story. The impact of U.S. policies on depleting capital is also significant.

IV—U.S. TAXATION OF DEPLETING CAPITAL

Capital used to maintain, enhance and replace America's depleting reserves of petroleum also has been affected greatly by changing U.S. capital policies. According to pre-tax reform Joint Tax Committee studies, no other industry contributes as much either to the wealth of nations or to U.S. and foreign treasuries as the U.S. petroleum industry.[15]

Today, over 50% of U.S.-based petroleum taxpayers pay both regular and AMT, yet compete against other taxpayers that pay only regular taxes or foreign-based taxpayers only partially subject to U.S. taxation. Additionally, high-risk depleting capital is more negatively affected by the impact of the U.S. take system than low-risk-depreciating capital because of the effects of risk and the fact that virtually every major expenditure that is required for a U.S.-based petroleum taxpayer to stay in business is considered taxable income for AMT purposes.

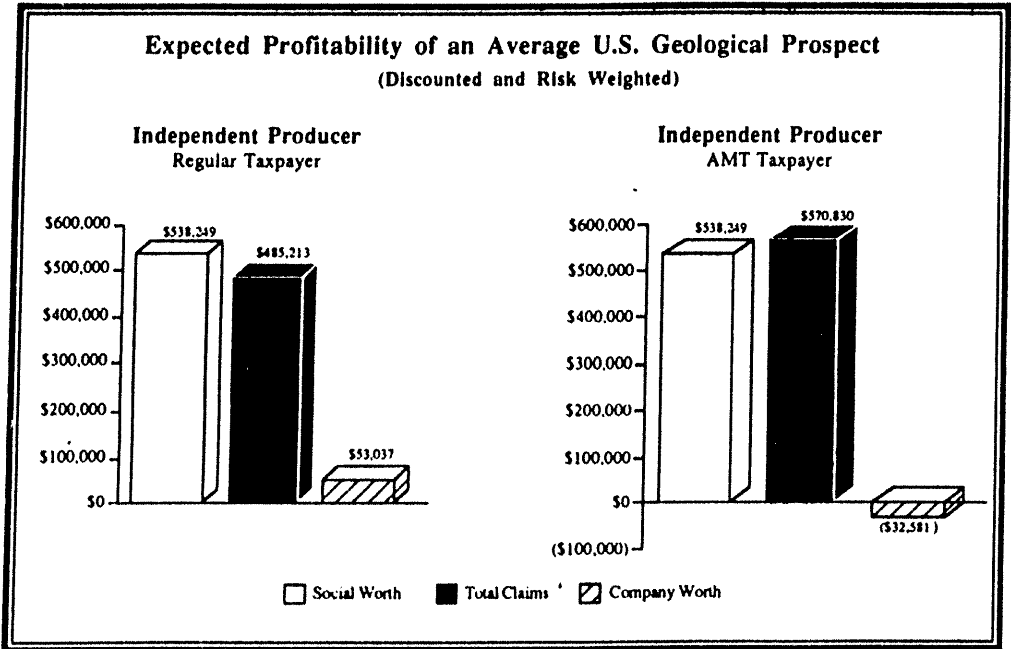
The following chart demonstrates the difference in timing between the regular and AMT systems of U.S. capital taxation. Shown are the regular U.S. income tax liability and the added burden of the AMT on the statistically average U.S. geological prospect.



As can be seen, AMT liability occurs during the first two years because the taxpayer is investing capital in new drilling over this period. For regular tax purposes, drilling costs are treated as ordinary and necessary business expenses. For AMT purposes, however, a substantial portion of this capital is treated as *taxable income.*

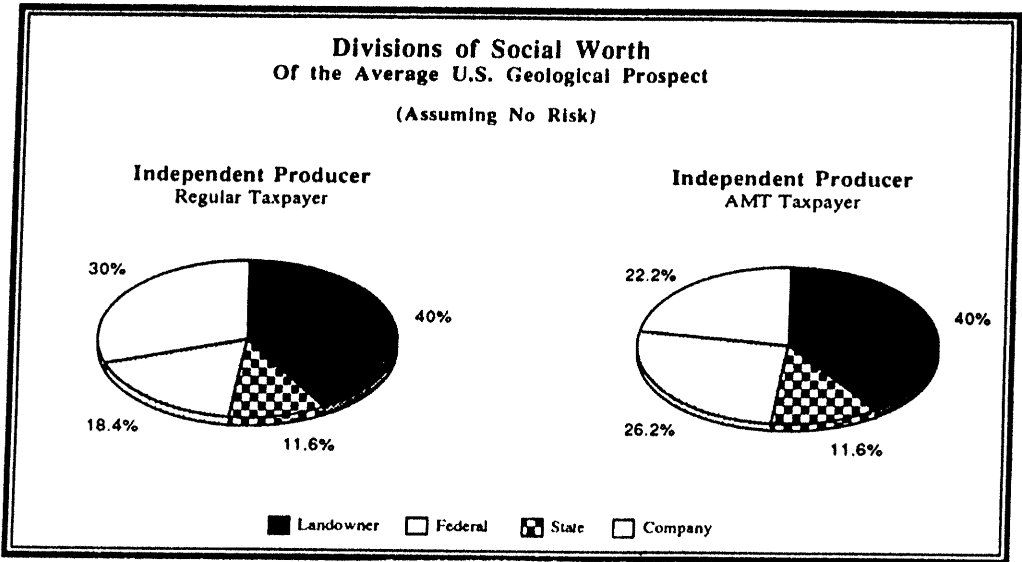
As also shown, an AMT taxpayer takes approximately 11 years to recover the tax paid on the capital used to replace depleting U.S. petroleum assets. Contrary to the intent of law, recovery of the up-front AMT payment is not guaranteed. Only *if* a taxpayer eventually becomes profitable enough to pay regular taxes is a credit provided to recover the upfront AMT tax on this capital.[16] Under this structure a U.S.-based taxpayer lends the federal government money, interest free, by paying income taxes before income is earned, and gets paid back only if sufficiently profitable in the future.[17] For most U.S.-based petroleum taxpayers, AMT credits are not available or are unusable, and the AMT thus becomes a direct tax on the capital invested to maintain and replace America's depleting petroleum capital.

Today, a regular U.S. taxpayer exploring for crude oil in the United States can expect a profit in an amount that is almost identical to the expected loss of a competing AMT taxpayer on the exact same investment. Shown below is a side-by-side comparison of the expected after-tax economics of an identical investment made by competing taxpayers.

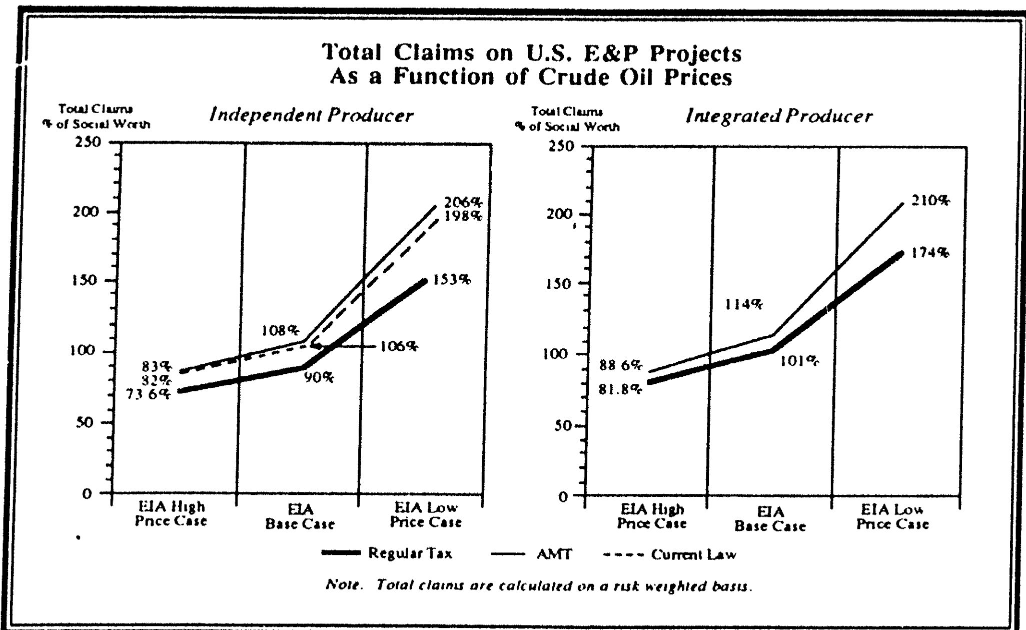


The revenues generated by this investment, if undertaken, would be divided in the manner shown in the following pie chart. As shown, when a taxpayer moves from a regular tax position to an AMT position, this capital investment is rendered unprofitable because the federal government's share of the net revenues generated from the capital increases over forty percent, from 18% to 26%.

Principles of tax neutrality require that the underlying economics of a project not be affected differentially by the tax code. However, both the bar and pie charts show that different U.S.-based taxpayers are treated very differently.[16] Under current U.S. tax policies, after-tax economics of new capital investments do not approach similarity until investments become far more profitable. In essence, on the margin, the U.S. tax system rewards more-profitable taxpayers and penalizes less-profitable competitors, on the exact same investment.

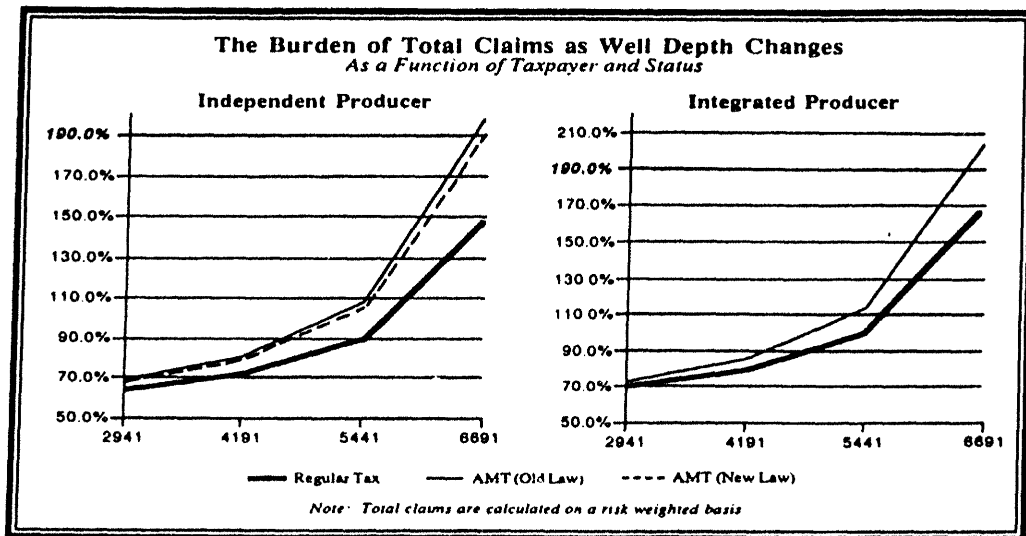


The following chart shows that as crude oil prices decline, the percentage of the net revenues taken by the U.S. tax and fiscal System increases dramatically for every type of U.S.-based taxpayer. The chart also shows that at any given price level, the after-tax return to a U.S.-based AMT taxpayer will always be lower than the return to a regular taxpayer, on lhe exact same investment. As can be seen, U.S.-based taxpayers subject to the AMT can no longer make a competitive rate of return on the statistically average U.S. geological prospect.



The next chart demonstrates the economic impact of the U.S. take system as the costs of production rise. When a U.S.-based taxpayer is forced to explore deeper for new petroleum assets, the impact of both the AMT and regular systems increases dramatically. At relatively shallow depths, U.S. take exceeds the expected social

wealth that would be generated from an average U.S. geological prospect, thus rendering it unprofitable. The same regressive economic impacts occur when either revenues or profitability decline.[19]



These policies have contributed to a marked decline in U.S. crude oil production. Since the Tax Reform Act of 1986, crude oil production in the United States has declined over 1.7 million barrels per day, despite interim price increases of more than 100 percent. This lost production alone equates to a measurable loss in wealth to U.S. Society, before multiplier effects, of $160 billion to $250 billion, a loss in federal and state revenues of more than $50 billion, plus hundreds of billions of dollars in S&L-related losses, trade deficits, increased military spending and economic multiplier effects.[20]

Since the OPEC-controlled price collapse of 1986, virtually every major non-OPEC producer of crude oil except the United States has reduced the economic impact of its take system on new petroleum investments.[21] Over the same period, the U.S. foreign tax code has compounded the disparities by severely limiting the ability of U.S.-based firms to recover capital invested anywhere in the world.

Recent comparative analyses of the U.S. petroleum take system demonstrate that identical extraction investments earn higher after-tax returns elsewhere. At virtually every level of geological risk and at any level of crude oil prices, an oil and gas investment in the United Kingdom will yield its investor a higher after-tax return than a similar investment would in the United States, solely because of the structure and operation of the U.S. take system.[22] Similar results were also found in Canada.[23] Immediately after the collapse, unlike the United States, Canada provided cash grants for new drilling expenses, implemented tax and royalty holidays and numerous other take reductions to avoid damage to its natural resource base.

RECOMMENDATIONS TO IMPROVE THE COMPETITIVENESS OF U.S. TAX POLICY

Competition comes in many forms and forums. The competitiveness of a tax and fiscal system is measured by its impact on the risk-weighted, after-tax, rate of return on capital invested domestically or internationally by businesses headquartered within its boundaries. Capital is a scarce resource that theoretically has no national boundaries and pledges its allegiance solely to a risk-weighted, after-tax rate of return.

On the margin, after the underlying economics of an investment are computed, government take policies will basically determine whether capital is competitively employed. To eliminate completely the anti-competitive impacts of the U.S. tax code on both domestic and international investments would require a significant restructuring of U.S. capital and income taxation. Essentially, it would require a uniform, low-rate, tax structure which allows immediate and complete cost recoveries without a distinction between expenditures for labor or capital and without a distinction between debt or equity sources of funds.

In the absence of a complete restructuring, shortening recovery periods for new investments in both depletable and depreciable assets for both regular and AMT taxpayers will help. This will lower the costs and risks of new capital investments made by U.S.-based taxpayers. Second, existing tax credits should be available equally to either regular or AMT taxpayers, and at a minimum, AMT credits should be usable against any subsequent tax liability. These changes will promote equity, efficiency and neutrality within the existing System. These changes also will generate substantial new economic activity and create substantially more wealth to the federal treasury and U.S. society than it would cost in lost tax revenues.[24]

Such a tax structure would substantially reduce the time it takes a U.S.-based taxpayer to recover capital invested productively anywhere in the world. The federal government can improve expected economics of new capital investments at virtually no "real" cost. As demonstrated above, by moving the tax from the investment capital to the project's income, the project becomes marginally profitable, thereby yielding disproportionately greater increments of wealth to U.S. society.[25]

CONCLUSION

There is clearly a new world economic order. The United States must compete for new capital, new jobs, new markets and for its share of global wealth in an increasingly regionalized global economy. U.S.-based companies compete against foreign companies and their governments. Unlike the Unites States, which traditionally has relied on relatively free-market principles, its new competition is more experienced at integrating social and economic policies with underlying tax policies. Competing for new jobs, new wealth, increased capital flows, surplus trade balances and an affluent standard of living should be the object and purpose of future U.S. capital, tax and economic policies.

Taxing—capital, and raising taxes as prices, revenues and profits fall and as the costs of production increase are clearly contrary to the basic precepts of U.S. income and capital tax policies. To replenish its resource, asset and job base, investments to maintain, enhance and replace America's depleting and depreciating capital must be competitive with other investments.

Until U.S. policies change to reflect the intense competition for capital, jobs and economic prosperity within the global marketplace, the United States will continue liquidating it's proven resource base, and exporting its standard of living to competitor—countries that foster capital formation and new wealth creation. New capital recovery policies should allow U.S.-based taxpayers to earn competitive, risk-weighted, after-tax returns of and on both depletable and depreciable capital. Such policies can increase U.S. social wealth, economic activity, employment, income tax collections and improve our product-related trade balances at a very low marginal social cost.

ENDNOTES

1. **Impacts of U.S. tax reform on investments in depreciable assets:** *Economic Report of the President,* January 1989 (Washington, D.C.: U.S. Government Printing Office), p.92; *An Analysis of the Alternative Minimum Tax: Equity, Efficiency, and Incentive Effects,* A. Lyon, 1991; *AMT Depreciation: How Bad is Bad,* S. Corrick and G. Godshaw, *Economic Effects of The Corporate Alternative Minimum Tax,* American Council for Capital Formation Center for Policy Research, September 1991; *Approaches to Efficient Capital Taxation: Leveling the Playing Field vs. Living by the Golden Rule,* Goulder and Thalmann, National Bureau of Economic Research Working Paper #3559, December 1990; *Tax Neutrality and Intangible Capital,* Fullerton and Lyon, National Bureau of Economic Research Working Paper #2430, November 1987. **Impacts of U.S. tax reform on investments in depletable assets:** *The Microeconomic Impact of the U.S. Tax System on Domestic Petroleum Extraction, A Quantitative Analysis of the Post-Tax Reform System of Take in the United States,* Goodman, Gordon and Youngblood, 1990; *The Impact of the Omnibus Budget Reconciliation Act of 1990 on Investments in Domestic Petroleum Extraction,* C. Goodman, 1991.

2. For a more detailed discussion *See U.S. Petroleum Income Taxation: 1890–1990,* C. Goodman, Oil and Gas Tax Quarterly, vol. xxxix, Nos. 2, 3 and 4 (Dec. 1990, March 1991, and June 1991).

3. *Stratton Independence, Ltd.* v. *Howbert,* 231 U.S. 399,422(1913).

4. *Ibid.,* at 417, *See Burnet* v. *Logan,* 283 U.S. 404(1931), wherein the Supreme Court enunciated the return of capital doctrine as follows: "*In order to determine whether there has been gain or loss, [income] and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration.*"

5. *See Pollock* v. *Farmers' Loan & Trust Co.*, 158 U.S. 601, at 621–622, *"they retained this security by providing that direct taxation and representation in the lower house of Congress should be adjusted on the same measure."*

6. *See U.S. International Tax Policy for a Global Economy,* Price Waterhouse, 1991.

7. *See The Microeconomic Impact of the U.S. Tax System on Domestic Petroleum Extraction, A Quantitative Analysis of the Post-Tax Reform System of Take in the United States, supra. See also U.S. Tax Policies Distorting Economics of Exploration, Development Ventures,* Oil & Gas Journal October 7, 1991. at page 58.

8. *See* charts on pages 8 and 9 *infra. See also, U.S. Petroleum Income Taxation: 1890-1990,* March 1991 and June 1991 and *The Impact of Current Tax Policy on U.S. Energy Production,* C. Goodman, *Economic Effects of The Corporate Alternative Minimum Tax,* American Council for Capital Formation Center for Policy Research, September 1991.

9. *See* Notes 1, 6 and 8, *supra. See also AMT Depreciation: How Bad is Bad, supra.*

10. *Ibid., See also An Analysis of the Alternative Minimum Tax: Equity, Efficiency, and Incentive Effects, supra.*

11. *See AMT Depreciation: How Bad is Bad,* S. Corrick and G. Godshaw, *Economic Effects of The Corporate Alternative Minimum Tax,* American Council for Capital Formation Center for Policy Research, September 1991. *See also The International Competitiveness of the U.S. Petroleum Licensing System,* R. Gordon, 1988; *U.S. and Canadian Tax and Fiscal Treatment of Oil and Gas Production,* C. Goodman, Working Paper, U.S. Department of Energy, May 1989; *Taxation Effects on the Competitiveness of U.S. Oil and Gas Investments: Promoting Stability in the 1990's,* Flaim, Gordon and Hemphill, 1989; *U.S. International Tax Policy for a Global Economy,* Price Waterhouse, 1991.

12. The most onerous domestic impacts of the U.S. tax code occur because of the conflicting structure of the regular and the alternative tax systems and because of overly complicated and restrictive capital and non-capital investment cost-recovery provisions. Additional anti-competitive impacts are created internationally by higher taxes on capital and income from capital, artificial allocation rules, foreign and domestic "ring-fence" and exploration-loss-recapture rules, and rules which effectively bar cost recoveries or tax certain income twice. Each of these structural impacts increases both the costs and risks for U.S.-based taxpayers to do business anywhere in the world.

13. *U.S. International Tax Policy for a Global Economy, supra.*

14. For recent analysis of the macroeconomic impacts of U.S. environmental policies *See* D. Jorgenson and P. Wilcoxen, *U.S. Environmental Policy and Economic Growth: How Do We Fare?,* The Impact of Environmental Legislation on U.S. Economic Growth, Investment, and Capital Costs, American Council for Capital Formation Center for Policy Research, September 12, 1991. For microeconomic analysis of the impact of U.S. tax laws on environmental investments *See AMT Depreciation: How Bad is Bad, S. Corrick and G. Godshaw, supra.,* and J. McCallum, *Economic Effects of The Corporate Alternative Minimum Tax,* supra.

15. See attachment.

16. *See* chart on page 7, *infra.*

17. The chart on page 7 assumes that the taxpayer is profitable enough to pay regular income taxes starting in year three of the project.

18. Each of the charts on pages 8 through 10 demonstrate the difference in the after-tax value of the exact same investment to different taxpayers.

19. *See The Microeconomic Impact of the U.S. Tax System on Domestic Petroleum Extraction, A Quantitative Analysis of the Post-Tax Reform System of Take in the United States, supra. See also U.S. Tax Policies Distorting Economics of Exploration, Development Ventures, supra.*

20. *Ibid.*

21. *See generally* notes 1, 8 and 11, supra.

22. *Taxation Effects on the Competitiveness of U.S. Oil and Gas Investments: Promoting Stability in the 1990's, supra.*

23. *U.S. and Canadian Tax and Fiscal Treatment of Oil and Gas Production,* Working Paper, U.S. Department of Energy, supra. The Province of Alberta Canada has recently announced additional take reductions in the form of tax and royalty holidays.

24. For example, if U.S. tax policy renders the statistically average U.S. geological prospect marginally economic to an AMT taxpayer (75% of the domestic industry), the prospect would generate over $12.5 million in "actual" new wealth to U.S. society, of which $2.5 million would go to the federal treasury, and $1 million would go to the state treasury. Yet, this does not occur because the investor faces an ex-

pected loss solely because of the impact of the AMT. *See* chart on page 8. In expected terms, even at high social discount rates the payback to society is over fifteen times the cost. For more detailed quantitative microeconomic analyses of the U.S. take system generally, *See The Microeconomic Impact of the U.S. Tax System on Domestic Petroleum Extraction, A Quantitative Analysis of the Post-Tax Reform System of Take in the United States, supra.*

25. This is demonstrated graphically in the charts on pages 46 and 47.

GLOBAL INCOME TAXES PAID BY INDUSTRIES SAMPLED IN 1983

[Thousands of Dollars]

	U.S. income before tax	Foreign income before tax	Worldwide income before tax	Current U.S. tax expense	Current foreign tax expense	Current worldwide tax expense
Aerospace	3,287,418	373,107	3,660,525	459,337	201,611	660,948
Beverages	1,688.161	577,327	2,265,488	316,120	301,673	617,793
Broadcasting	1,081,109	209,552	1,290,661	199,818	79,957	279,775
Chemicals	1,164,100	3,416,300	4,580,400	(11,100)	2,433,900	2,422,800
Computers and office equipment	***6,842,475***	***4,972,408***	***11,814,883***	***1,796,917***	***2,702,044***	***4,498,961***
Construction	59,386	195,035	254,421	429	74,134	74,563
Electronics and appliance	**3,952,658**	1,482,062	5,434,720	**290,863**	598,646	889,509
Financial institutions	2,862,830	3,460,057	6,322,887	182,040	1,354,023	1,536,063
Food processors	3,810,004	1,309,634	5,119,638	987,286	511,118	1,498,404
Glass and concrete	605,401	180,435	785,836	105,754	85,754	191,479
Instruments	2,256,478	659,639	2,916,117	739,600	330,291	1,069.891
Insurance	1,755,975	48,800	1,804,775	174,398	58,491	232,889
Investment companies	979,855	680,650	1,660,505	91,478	137,383	228,861
Metal manufacturing	(1,341,203)	16,600	(1,324,603)	25,396	40,300	65,696
Metal products	286,113	318,686	604,799	43,296	133,960	177,256
Mining	(485,812)	145,328	(340,484)	(18,861)	70,961	52,100
Motor vehicles	**5,759,186**	1,281,402	**7,040,588**	**202,308**	527,330	**729,638**
Paper and wood products	759,318	118,263	877,581	(3,846)	66,917	63,071
Petroleum	***19,255,863***	***22,171,133***	***41,426,996***	***4,094,087***	***13,303,397***	***17,397,484***
Pharmaceuticals	2,301,842	1,549,400	3,851,242	626,033	608,331	1,234,364
Retailing	5,067,076	288,367	5,355,443	1,015,447	125,630	1,141,077
Rubber	618,089	283,821	901,910	121,366	194,260	315.626
Soaps and cosmetics	2,027,044	513,380	2,540,424	720,699	266,857	987,556
Telecommunications	**11,072,260**	127,117	**11,199,377**	**530,913**	96,978	**627,891**
Tobacco	3,083,254	539,760	3,623,014	1,041,548	150,751	1,192,299
Transportation:						
Airlines	(272,024)	169,123	(102,901)	(58,828)	4,464	(54,364)
Railroads	**2,164,765**		2,164,765	**71,899**		71,899
Trucking	1,283,557	7,824	1,291,381	442,768	4,278	447.046
Utilities (electric and gas)	**7,158,433**		7,158,433	**505,298**		505,298
Wholesalers	947,776	9,200	956,976	329,472	13,806	343,278
Total Sample, All Companies	90,031,387	45,104,410	135,135.797	15,021,935	24,477,216	39,499,151

Source: Joint Committee Print JSC–40–84, Nov. 28, 1984.

PREPARED STATEMENT OF L.C. (WHITEY) HEIST

When President Bush addressed the nation in his State of the Union message and listed reform of the corporate Alternative Minimum Tax (AMT) as the first item in his short-term economic stimulus package, probably 99 percent of the American public did not know what he was referring to. Even among Members of Congress, eyes sometimes glaze over when "AMT depreciation and ACE[1] adjustments" are discussed. And among corporate executives, I find that there is also confusion about the technical operation and ramifications of the AMT.

It is really no wonder since this is an enormously complicated issue. While I am certainly no expert on the technicalities of the AMT, I do know about the substantial negative impact it is having on Champion and the entire paper industry.

That is why I am so appreciative of the Committee's interest in this subject and the opportunity to describe the impact of the AMT on basic industry. Senator Boren, I particularly want to thank you for your leadership in this area and to applaud your proposed legislation to reform the AMT.

I believe the impact of the AMT can best be understood in its simplest and starkest terms—the AMT has put a significant segment of American industry at a severe competitive disadvantage. The segment of American business most harmed by the AMT includes the basic manufacturing companies that must make continuous and substantial capital investments, both to remain globally competitive and to meet environmental requirements. The AMT penalizes the manufacturing backbone of America by increasing our effective tax rate[2] every time we increase our investments and, even worse, by increasing our effective tax rate every time our profits decline.

Capital intensive companies are disadvantaged compared with other domestic businesses which may have higher profit margins for their products or which are not required by the nature of their business to make substantial investments in plant and equipment. The advantaged companies remain in the regular tax system and, as a result, pay a lower effective tax rate on the same amount of regular taxable income. AMT companies are faced not only with higher effective tax rates, but, correspondingly with a higher cost of capital for purchases of equipment than their regular tax competitors. Studies have found that the cost of capital for investments made by AMT taxpayers is from 10 to 22 percent higher than for regular taxpayers. For pulp and papermaking assets the cost of capital is about 20% higher.

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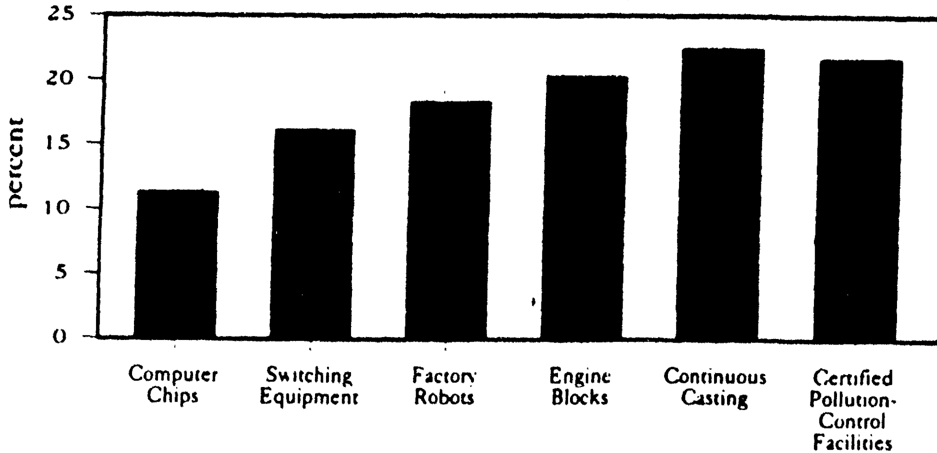
[1] Section 56(g) of the Internal Revenue Code of 1986, as amended, ("Code") defines Adjusted Current Earnings which is referred to as "ACE."

[2] "Effective Tax Rate," refers to the amount of tax paid in relation to regular taxable income.

FIGURE 1
INCREASED COST OF CAPITAL INCURRED BY AMT FIRMS COMPARED TO FIRMS PAYING THE REGULAR INCOME TAX
Equipment Used to Make Selected Manufactured Products and Pollution-Control Equipment



Source: Andrew B. Lyon, "An Analysis of the Alternative Minimum Tax: Equity, Efficiency, and Incentive Effects," in *Economic Effects of the Corporate Alternative Minimum Tax* (Washington, D.C.: ACCF Center for Policy Research, forthcoming), pp. 51–82.

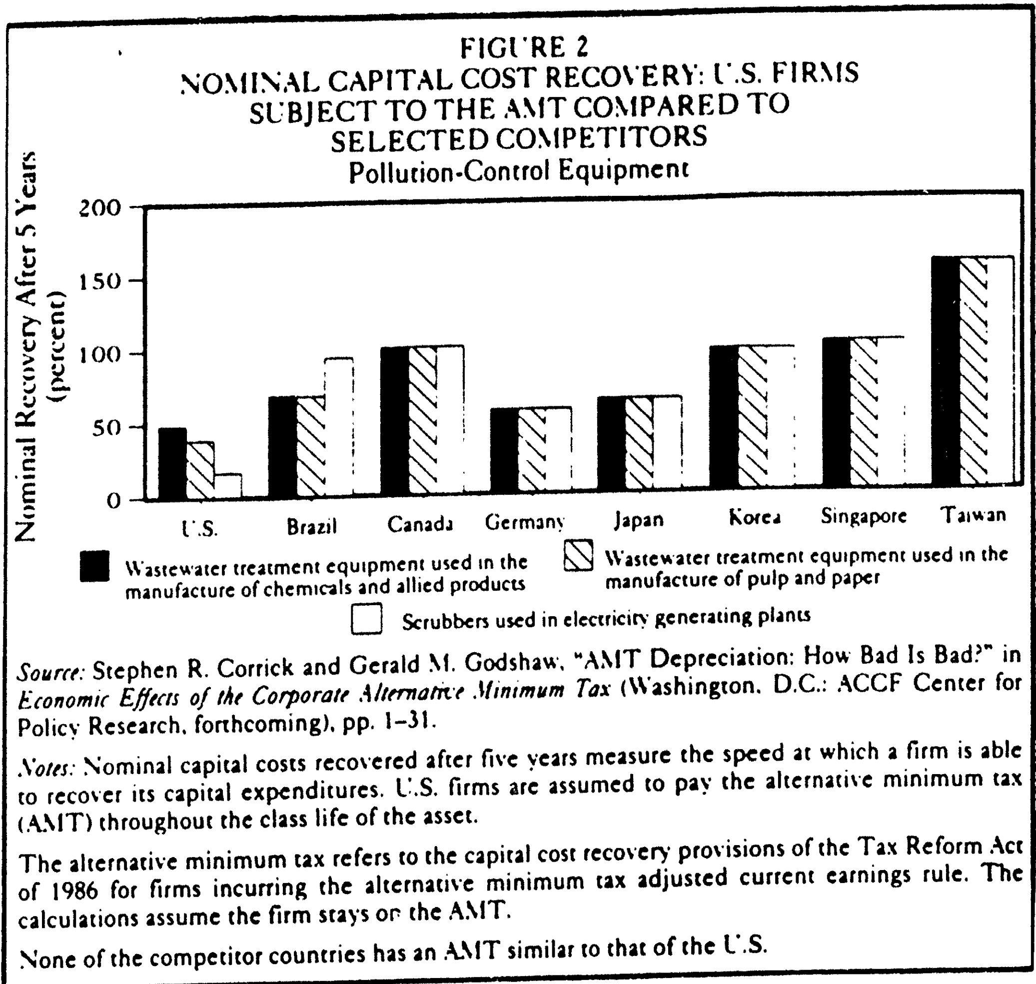
Notes: The analysis assumes that firms are alternative minimum tax (AMT) payers for ten years. The cost of capital calculations are net of economic depreciation.

This result violates the most basic tax policy principle of horizontal equity among taxpayers in two ways. First, assets acquired by similarly situated companies should not be subject to vastly different tax treatment simply because one firm is more profitable than another. second, the AMT simply ignores the fact that some businesses must invest more in plant and equipment to earn a similar amount of income than their less capital-intensive counterparts. Adding accelerated depreciation back into the AMT base, as required by current law, grossly distorts the amount of "income" subject to tax. For most capital intensive companies, the minimum tax base is not made up of income; instead, it is made up predominately of provisions in the tax Code which provide a benefit to regular taxpayers.

The tax Code is currently directing the flow of capital to companies with less capital spending in relation to profits. This investment direction may have no relation to how efficiently the more profitable, regular tax-paying company is being run. For example, a company with outdated plant and equipment must invest heavily to remain competitive. Making that investment is the right business decision, yet the AMT company is penalized by the tax Code vis-a-vis their non-AMT competitors. If U.S. tax policy remains unchanged, capital investment in basic manufacturing will decline further resulting in more lost manufacturing jobs and a lower standard of living for U.S. workers. The manufacturing sector is essential to the U.S. economy; without it America cannot remain a world industrial leader.

An even more serious problem for basic industries, however, is that we are disadvantaged vis-a-vis our foreign competitors. The capital cost recovery system under the AMT is the worst in the industrialized world. While depreciation under the regular tax system ranks our cost recovery among the top five in the industrialized world, the U.S. is squarely at the bottom under the AMT. As Figure 2 demonstrates for certain pollution control equipment, the U.S. firm under the AMT has only recovered approximately 36% of the cost of the investment after 5 years. The Canadian firm has recovered 100%, the Japanese firm 64% and the German firm 54%.

The non-AMT U.S. firm has, under the regular corporate income tax, recovered nearly 78% of the cost of the investment.[8]



Source: Stephen R. Corrick and Gerald M. Godshaw, "AMT Depreciation: How Bad Is Bad?" in *Economic Effects of the Corporate Alternative Minimum Tax* (Washington, D.C.: ACCF Center for Policy Research, forthcoming), pp. 1–31.

Notes: Nominal capital costs recovered after five years measure the speed at which a firm is able to recover its capital expenditures. U.S. firms are assumed to pay the alternative minimum tax (AMT) throughout the class life of the asset.

The alternative minimum tax refers to the capital cost recovery provisions of the Tax Reform Act of 1986 for firms incurring the alternative minimum tax adjusted current earnings rule. The calculations assume the firm stays on the AMT.

None of the competitor countries has an AMT similar to that of the U.S.

As more firms are subject to the AMT, it, and not the regular tax, is becoming our primary system of taxation.[4] Consequently, U.S. tax policy is encouraging the flight of capital away from basic U.S. manufacturing firms toward non-AMT firms. Should this continue, there is a danger that the U.S. will lose its manufacturing base altogether—an outcome that, many view, is not in the best interest of this country.

The negative impacts of the AMT are especially pronounced during a recession. Depreciation deductions stay relatively constant over the years, particularly for companies making continuous investments in assets with long useful lives. What changes substantially is the amount of income a taxpayer may have. Under AMT, as the taxpayer's regular taxable income declines, its effective tax rate actually increases.

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[8] Stephen R. Corrick and Gerald M. Godshaw, "AMT Depreciation: How Bad is Bad?" in *Economic Effects of the Corporate Alternative Minimum Tax*. Washington DC, ACCF Center for Policy Research, 1991, pp 13–14.

[4] A recent survey of the American Paper institute showed that nearly 85% of the survey respondents represented firms currently in the AMT. While this industry is by most measurements more capital intensive than others, it is clearly not alone in AMT status. base altogether—an outcome that, many view, is not in the best interest of this country.

FIGURE 3
AMT AND DECLINING PROFITABILITY
PULP & PAPERMAKING ASSETS*

	Normal Year	Recession Year
Income before depreciation	$100.0	$50.0
Depreciation (year 2 on Year 1&2 additions)	(38.8)	(38.8)
REGULAR TAXABLE INCOME	61.2	11.2
AMT Adj. (Diff. between Reg & AMT depr.)	22.1	22.1
ACE Adj. (75% of diff betwn AMT & ACE depr.)	3.8	3.8
ALTERNATIVE MINIMUM TAXABLE INCOME	87.1	37.1
Regular Tax @ 34% of REGULAR Taxable Income	20.8	3.8
Tentative Minimum Tax @ 20% of AMTI	17.4	7.4
Excess of TMT over REGULAR Tax (AMT credit)	0.0	3.6
EFFECTIVE TAX RATE (as % of REGULAR Taxable Inc.)	34%	66.1%

* Assumptions:	
Asset Cost	100.0 each year for two years
Reg Tax Method/Life	200% DB - 7 years
AMT Method/Life	150% DB - 13 years
ACE Method/Life	S/L - 13 years

Essentially, the AMT reduces cash flow at a time when profits are already weakened by low prices and lack of demand for products. The combined effect of the AMT and the recess ion is that fewer new investments can be made and, in many cases, planned investments are stopped or delayed. This reduces the number of jobs that can be maintained or created and has a negative ripple effect throughout the economy.

The AMT has a reinforcing effect on the recession because its tax base fails to decrease in proportion to real reductions in earnings. The forced recognition of accelerated depreciation as part of AMT "income" artificially increases the amount of tax the firm must pay. Although the firm is technically entitled to recoup those excess tax payments in the future, the increased tax liability comes at exactly the wrong time, i.e., when the taxpayer can least afford it. Decreased profits and increased taxes often result in additional borrowing which encumbers the company well into the future after the recession has ended.

When Congress enacted the Alternative Minimum Tax as part of the Tax Reform Act of 1986, Members were reacting to the fact that certain corporations were reporting income to shareholders, but paying no federal income tax. Based on comparisons which inappropriately matched financial statement income to actual current

year taxes paid, it appeared to Congress that some corporations were not paying their fair share of taxes.

Even today, critics of American business will select financial statement statistics that show only part of the total tax liability of a company to suggest that the corporate tax burden should be increased. This analysis is misguided and incomplete at best, because it compares one measurement of income (i.e. financial statement income) to another measure of tax liability (i.e. tax liability based on corporate taxable income.) Mixing data from two different measures of income is like comparing apples to oranges.

The appropriate analysis compares financial statement income to the total tax provision for corporate income taxes on the financial statement.[5] This is the approach which conforms to Generally Accepted Accounting principles and allows for an accurate matching of income earned to taxes owed. Alternatively, it is fair to compare current year corporate regular taxable income to current year taxes paid in that this approach also provides for a consistent method of matching income to taxes owed.

Nonetheless, the AMT was designed to address the perception that some corporations were not paying their fair share of taxes while earning income. Thus, the AMT attempted to prevent corporate taxpayers from making "excessive" use of the beneficial tax provisions in the Code, commonly referred to as "preferences." Accelerated depreciation, originally enacted to stimulate investment in plant and equipment, was considered just such a preference.

It is my understanding, however, that Congress did not intend to permanently deprive taxpayers of the benefits of accelerated depreciation and other tax benefits; rather, Members intended to simply prevent excessive use of these benefits in any one year which would allow a corporation to "zero out," i.e., pay no taxes. Thus, Congress created a credit for the amount paid under the AMT which exceeds regular tax liability. Unlike the investment Tax Credit or Research and Development Credits, the AMT credit is not a redistribution of tax dollars. instead, it is a credit which represents prepaid regular taxes and can, therefore, be used only when the taxpayer returns to the regular tax system. This credit was designed to ensure that, over time, taxpayers pay no more than their regular tax liability.

Unfortunately, the AMT credit system is not working as intended. it is not working for companies with relatively low profit margins and substantial capital investment needs. These companies find themselves paying the higher Alternative Minimum Tax year after year, and accumulating larger and larger amounts of AMT credits which they will not be able to use in any meaningful time frame. As a result, capital intensive companies, such as Champion, find that they may be permanently subject to a higher cost of capital than their non-AMT and foreign competitors.

The effect of the recession, in which many companies are experiencing severe losses for both tax and book purposes, will exacerbate the AMT credit accumulation problem. The AMT is going far beyond its stated objective of ensuring that financially profitable firms pay a reasonable amount of tax. It is actually requiring unprofitable companies to pay large amounts of tax even when they report a sizable loss to shareholders.

Under current law, the only way to escape the penalty of the AMT is either to stop investing or sell assets. Following either course would be ruinous to Champion International as well as most other basic industrial firms. Furthermore, it is bad economic and social policy and would spell disaster for the future of our nation as an economic and industrial leader.

As the Senate deliberates over which actions to take to ensure long-term economic growth, I hope you will begin by recognizing that fundamental reform of the AMT is an essential component of any economic growth package.

I am delighted to note that Senator Boren's economic growth bill, S. 2159, does recognize this need. The provision in Senator Boren's bill to allow some portion of the accumulated AMT credits to be used to partially offset AMT liability is an excellent solution to one aspect of the AMT problem—the fact that these accumulated credits lose value every year that they cannot be used. This proposal would help minimize the permanent loss of regular tax benefits that were put into the Code for important public policy reasons.

A fundamental principle of the AMT, that profitable firms should not be able to "zero out," is preserved in this proposal by limiting the amount of AMT credits that could be used in any given year. At the same time, the proposal's benefit is targeted to those firms which have been most severely penalized by the current system. Finally, Senator Borenls proposal has the added benefit of not increasing the long-

[5] Using this analysis, Champion's effective tax rate based on domestic financial statement income was 39.3% in 1990 and 34.2% in 1989.

term structural deficit. While there may be a revenue loss in the short-run, the only actual loss to the government is the "time value of money" loss resulting from quicker utilization of the credits. Even this loss, however, should be partially offset by the economic growth that will occur as a result of putting this cash back in the hands of those taxpayers who will make new investments.

I also fully support Senator Boren's proposal to eliminate the accelerated depreciation add-back associated with environmental improvement projects for purposes of calculating the AMT. These investments do not directly improve productivity or profitability, but they are critical to a clean environment and, at a minimum, should not be penalized and made costlier by the AMT.

Basic industry is spending a growing percentage of total capital expenditures on environmental improvement assets.[6] This is due to a number of factors such as advances in environmental technology, new regulations imposed by the Clean Air Act and the Clean Water Act, as well as voluntary efforts to improve environmental quality. This proposal will assist basic manufacturing firms in meeting their obligations to protect the environment.

Each of Senator Boren's AMT reform proposals would help alleviate specific problems created by current law and would promote long-term economic growth by reducing the cost of capital for AMT taxpayers.

In addition to Senator Boren's proposals, I want to point out that the president's AMT proposal is a step in the right direction. By recognizing the disincentive to invest which is inherent in the AMT and putting forth a proposal for improvement, the president has assisted in the educational effort necessary to bring about needed reform.

While I appreciate this step by the Administration, I would urgently request that Congress undertake a more fundamental reform of the AMT depreciation system. Eliminating the ACE adjustment for future investments, as the president has proposed, will eventually provide a modest improvement for AMT taxpayers. Even if the President's plan were adopted, however, the remaining AMT depreciation system would still result in a significantly less favorable depreciation system for AMT taxpayers than our foreign and non-AMT competitors. Therefore, AMT depreciation should be further modified to restore some meaningful benefit of accelerated depreciation for AMT taxpayers.

Depreciation for AMT taxpayers could be improved in several ways while still preserving the integrity of the AMT and not allowing taxpayers to "zero-out." Building on the president's proposal to repeal the ACE depreciation adjustment, Congress could also shorten the AMT depreciation recovery period approximately 20% by using the ADR-lower range life rather than the ADR midpoint life in calculating AMT depreciation. This proposal is quite consistent with the notion of "economic depreciation" on which the AMT relies. The Asset Depreciation Range (ADR) system provides a high and low range for recovery purposes and was used to determine the recovery period for tax purposes during the 1970's.

Another alternative is to provide a more accelerated method for recovering the cost of the investment while continuing to use the ADR midpoint life for the recovery period. Most economists agree that the largest amount of decline in an asset's value occurs during the earlier years of the asset's life. Prior to 1981, 200% declining balance was used as the method for recovering the cost of an asset for tax purposes and was not thought to be overly generous. Although still significantly less beneficial than regular tax depreciation, this approach would also reduce the penalty currently imposed on capital investments under the AMT.

I am providing in the Appendix to my testimony an example of how several different depreciation improvement options would affect a hypothetical, but typical AMT taxpayer. I believe these examples will be useful as you attempt to evaluate the relative benefit and, therefore, the cost of providing meaningful reform to the depreciation system under the AMT. I want to especially note, however, that enactment by Congress of any of these options can not result in "zeroing out" by taxpayers who earn real income. The current law limitations on the use of Net Operating Losses and Foreign Tax Credits will continue to prevent "zeroing out" under the AMT.

In addition to AMT depreciation reforms, several Members of Congress have proposed reinstating some form of an Investment Tax Credit (ITC) to reduce the cost of capital for all taxpayers and to provide an immediate economic stimulus which would create new jobs. Since these proposals are also under consideration by this

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[6] The U.S. paper industry alone anticipates spending approximately $20 billion between 1991 and 2000 on environmental projects. To put this number in perspective, total industry capital spending is expected to be $90–100 billion in the same period. For Champion, we estimate that 20–25% of the company's total capital budget is dedicated to environmental projects.

subcommittee, I wanted to comment on the interrelationship between broad-based investment incentives and the AMT.

First, since a growing number of firms are now subject to the AMT, any investment incentive must be fully usable by AMT firms if the objective of economic stimulus and new job creation is to be achieved. The Administration's Investment Tax Allowance (ITA) proposal recognized this need and appropriately allowed the full benefit to flow through to AMT taxpayers.[7] Likewise, an ITC will only be effective if the incentive is available to those-whose businesses require investment regardless of their status as an AMT taxpayer.

An ITC does help reduce the cost of capital for eligible investments. it does not, however, reduce the so-called "spread" between regular tax depreciation and AMT depreciation. In relative terms, AMT taxpayers will still have a significantly higher cost of capital than their non-AMT competitors. only structural AMT depreciation reform will help to alleviate the anticompetitive nature of AMT depreciation.

Second, ITC proposals which are "incremental," based on past capital spending, are seriously flawed in that they reward firms that fortuitously have not been investing during the baseline period at the expense of those who have. A baseline of past capital spending is arbitrary in nature and would result in a misallocation of capital. Firms which need capital the least to remain competitive would be advantaged over those which need it most.

Furthermore, past investment history is not an appropriate guide for identifying which type of investment will result in more long-term economic growth to the nation. Businesses which do not require sustained capital spending and who can "pick" the timing of their investment will disproportionately benefit from the incremental approach. Most firms are in the AMT precisely because they have been investing large amounts of capital during the past few years.

In summary, an investment tax credit can be a powerful tool for stimulating business investment and reducing the overall cost of capital. But, even if Congress adopts an ITC, fundamental AMT reform will still be needed to reduce the disparity between AMT and non-AMT taxpayers and to ensure that U.S. basic industries can remain competitive in the global marketplace.

AMT reforms which provide a meaningful way to use the AMT credits accumulated during this recession, as well as improve depreciation for all productive equipment and environmental improvement assets are urgently needed to ensure long-term economic growth.

The companies which most need your attention in these hard times are the basic manufacturing industries of America. With limited government resources available, and with the goal of providing an immediate investment stimulus without hurting the economy in the long-run, the most effective action Congress can take is to modify the AMT. AMT reform provides the following benefits: it immediately improves the cash flow of companies most needing to make investments; it saves existing jobs and helps create new ones; and, last but not least, it makes a permanent improvement in our tax system at a relatively low cost that will go far to preventing the next economic downturn from being as devastating to capital intensive industries as this one. In short, AMT reform will give you the most bang for the least buck! Thank you again for the opportunity to present these views.

Appendix—Options for Modifying Depreciation Under AMT

For capital intensive companies, the most serious flaw in the Alternative Minimum Tax (AMT) is the treatment of depreciation. As currently structured, the AMT takes away the benefit of accelerated depreciation for AMT taxpayers and increases their cost of capital for investments by 15 to 20% over the cost to regular taxpayers. The capital cost recovery system under the AMT is the worst in the industrialized world.

There are a number of options for improving the treatment of depreciation under the AMT. For each of the options described below, there is provided an example of the proposal's dollar impact on a hypothetical, but typical AMT taxpayer. The example assumes that the corporation has steady capital investment of $100 million per year and income before depreciation of $115 million per year. it also assumes that the acquired assets have a 7 year life under the regular tax system (MACRS) and a 13 year life under the AMT (ADR-midpoint).

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[7] Unfortunately, the short time frame allowed under the ITA will make it virtually impossible for any major capital project to qualify since it takes between three and five years to complete these projects.

CURRENT LAW

Under current law taxpayers must calculate both regular tax liability and Alternative Minimum Tax (AMT) liability. In calculating AMT liability, two depreciation adjustments are made. First, a 150% declining balance method of depreciation is substituted for the regular tax method of 200% declining balance, and ADR midpoint lives (13 year in this case) are substituted for regular tax lives (7 years in this case). A second AMT depreciation adjustment is made based on Adjusted Current Earnings (ACE) which effectively uses 75% of the difference between straight line depreciation over 13 years, and the 150% declining balance method used in the first AMT depreciation calculation. The net effect of the two adjustments is a single adjustment of 120% declining balance over 13 years. Once these adjustments have been made, the taxpayer compares regular tax liability to AMT liability and pays the higher of the two. Any amount of AMT liability above regular tax liability is considered a prepayment of future regular tax liability and is carried forward as an AMT credit.

Dollar Impact [In thousands]

	1992	1993	1994	1995	1996	Total
Regular tax liability	9,653	6,616	5,100	5,100	5,100	31,569
Current AMT liability	13,890	12,397	10,903	9,410	7,917	54,517
AMT credits carried forward	4,238	10,018	15,821	20,131	22,948	22,948

OPTION 1—THE PRESIDENT'S PROPOSAL

The President's budget proposal eliminates the second (ACE) depreciation adjustment for property placed in service after February 1, 1992. The effect of this proposal is to provide a single method of depreciation under the AMT of 150% declining balance over ADR midpoints (13 years for these assets) for all new additions. It continues to require that both AMT depreciation adjustments be made for prior year assets until they have been fully depreciated under current law.

Dollar Impact [In thousands]

	1992	1993	1994	1995	1996	Total
Regular tax liability	9,653	6,616	5,100	5,100	5,100	31,569
Current AMT liability	13,890	12,397	10,903	9,410	7,917	54,517
Proposed AMT liability	13,602	11,632	9,849	8,233	6,764	50,080
AMT credits carried forward	3,949	8,964	13,713	16,133	18,510	18,510

OPTION 2—REPEAL ACE DEPRECIATION ADJUSTMENT ENTIRELY

When ACE became effective in 1990, it retroactively picked up all property placed in service before 1990. Unless the President's proposal is modified to include all ACE property, the simplification benefit of the proposal will not be achieved until all prior additions have been fully depreciated over ADR lives, or well into the next decade. The modification modeled in Option 2 includes a tax basis adjustment which would allow taxpayers to go forward with the President's proposal for all property without losing any tax basis as a result of the total elimination of the ACE depreciation adjustment. In this example, the lost basis is recovered over a two-year period.

Dollar Impact [In thousands]

	1992	1993	1994	1995	1996	Total
Regular tax liability	9,653	6,616	5,100	5,100	5,100	31,569
Current AMT liability	13,890	12,397	10,903	9,410	7,917	54,517
Proposed AMT liability	10,752	9,394	10,466	9,108	7,750	47,470
AMT credits carried forward	1,099	3,876	9,242	13,250	15,900	15,900

OPTION 3—REPEAL ACE FOR NEW ASSETS AND SHORTEN AMT RECOVERY PERIOD

The ADR midpoint of assets is often two times greater than the regular tax depreciation recovery period. The ADR system of determining an asset's useful life has a low and a high end of the range. In the case of 13 year ADR midpoint property,

the lower range is 10.5 years which compares to 7 years under the regular tax accelerated life. AMT depreciation could be improved by using the lower range life as the recovery period for AMT depreciation purposes for all asset additions after 1991.

Dollar Impact [In thousands]

	1992	1993	1994	1995	1996	Total
Regular tax liability	9,653	6,616	5,100	5,100	5,100	31,569
Current AMT liability	13,890	12,397	10,903	9,410	7,917	54,517
Proposed AMT liability	13,328	10,878	8,745	6,881	5,248	45,080
AMT credits carried forward	3,675	7,936	11,581	13,362	13,510	13,510

OPTION 4—REPEAL ACE FOR NEW ASSETS AND ACCELERATE AMT METHOD OF DEPRECIATION

AMT depreciation could be improved by changing the method of depreciation used for calculating AMT. The idea modeled in Option 4 would be to use 200% declining balance as the method of depreciation with a continuation of current law ADR midpoints as the recovery period for AMT purposes. 200% declining balance is the method currently used for regular tax purposes and is the method which was used during most of the 1970's. From an "economic" depreciation standpoint, it recognizes that assets lose more value in the earlier years than in later years.

Dollar Impact [In thousands]

	1992	1993	1994	1995	1996	Total
Regular Tax liability	9,653	6,616	5,100	5,100	5,100	31,569
Current AMT liability	13,890	12,397	10,903	9,410	7,917	54,517
Proposed AMT liability	13,217	10,581	8,319	6,372	4,688	43,177
AMT credits carried forward	3,565	7,530	10,749	12,021	11,609	11,609

SUMMARY OF OPTIONS—AMT LIABILITY FOR TYPICAL AMT CORPORATION

[In thousands of dollars]

	1992	1993	1994	1995	1996	Total AMT liability	Total regular liability
Current Law	13,890	12,397	10,903	9,410	7,917	54,517	31,569
OPTION 1	13,602	11,632	9,849	8,233	6,764	50,080	31,569
OPTION 2	10,752	9,394	10,466	9,108	7,750	47,470	31,569
OPTION 3	13,328	10,878	8,745	6,881	5,248	45,080	31,569
OPTION 4	13,217	10,581	8,319	6,372	4,688	43,177	31,569

	1992	1993	1994	1995	1996	Total
CURRENT LAW						
Regular tax liability	9,653	6,616	5,100	5,100	5,100	31,569
Current AMT liability	13,890	12,397	10,903	9,410	7,917	54,517
AMT credits carried forward	4,238	10,018	15,821	20,131	22,948	22,948
OPTION 1—PRESIDENT'S PROPOSAL						
Regular tax liability	9,653	6,616	5,100	5,100	5,100	31,569
Current AMT liability	13,890	12,397	10,903	9,410	7,917	54,517
Proposed AMT liability	13,602	11,632	9,849	8,233	6,764	50,080
AMT credits carried forward	3,949	8,964	13,713	16,133	18,510	18,510
OPTION 2—REPEAL ACE ENTIRELY						
Regular tax liability	9,653	6,616	5,100	5,100	5,100	31,569
Current AMT liability	13,890	12,397	10,903	9,410	7,917	54,517
Proposed AMT liability	10,752	9,394	10,466	9,108	7,750	47,470
AMT credits carried forward	1,099	3,876	9,242	13,250	15,900	15,900
OPTION 3—REPEAL ACE FOR NEW ASSETS PLUS SHORTER RECOVERY PERIOD						
Regular tax liability	9,653	6,616	5,100	5,100	5,100	31,569
Current AMT liability	13,890	12,397	10,903	9,410	7,917	54,517

	1992	1993	1994	1995	1996	Total
Proposed AMT liability	13,328	10,878	8,745	6,881	5,248	45,080
AMT credits carried forward	3,675	7,936	11,581	13,362	13,510	13,510
OPTION 4—REPEAL ACE FOR NEW ASSETS PLUS USE 200% D.B., AS AMT METHOD						
Regular tax liability	9,653	6,616	5,100	5,100	5,100	31,569
Current AMT liability	13,890	12,397	10,903	9,410	7,917	54,517
Proposed AMT liability	13,217	10,581	8,319	6,372	4,699	43,177
AMT credits carried forward	3,565	7,530	10,749	12,021	11,609	11,609

PREPARED STATEMENT OF DAVID H. HOAG

Good afternoon, Mr. Chairman and Members of the Committee. I am Dave Hoag, Chairman and CEO of The LTV Corporation. Our LTV Steel subsidiary is one of America's largest producers of flat-rolled steel. Thank you for inviting me to speak today on an issue of great importance to the steel industry and to my company—the alternative minimum tax, or AMT.

The alternative minimum tax is having an unintended, and very harmful effect on mature industries like steel, which are cyclical and capital-intensive. There is one simple reason for this harmful effect—the treatment of depreciation.

Our company's depreciation of continuous capital investment constantly subjects us to the AMT, rather than regular corporate income tax. In fact, we even pay taxes when we have no profits, and that impairs our ability to compete. Therefore, the industry's cost of capital has increased dramatically since the 1986 Tax Reform Act and impairs our ability to compete worldwide.

Last year LTV lost more than $200 million in our steel business, spent over $330 million on our capital investment for steel production—for needed replacements and modernizations—and still owes tax. Let me explain.

As you know, the 1986 Tax Reform Act replaced the prior law add-on minimum tax for corporations and created a new minimum tax system. Under the new minimum tax, companies calculate their tax both under the regular tax and the minimum tax, and pay the higher amount. The tax base for each is *vastly* different. This difference occurs because accelerated depreciation under the regular tax is considered a preference item that must be added back for purposes of the minimum tax calculation.

The new minimum tax calculation penalizes steel companies in two ways. First, it contains a slower depreciation method; and second, it spreads it out over a longer period of time [see Chart A]. Thus, for its regular tax calculation, a steel company is permitted a 200 percent declining balance method over 7 years, but for minimum tax, it must re-calculate using a slower, declining balance method over a 15-year period. This is more than *twice* the time period allowed under the regular tax. Thus, the minimum tax is actually a *maximum* tax that penalizes productive capital investment.

Integrated steel companies all share the same characteristics: One, they require significant, continuous investment in productive equipment; two, they are cyclical in nature; and three, the industry's competitiveness—both domestic and foreign imports—keeps profit margins low. As a result, the depreciation add-back pushes them into—and keeps them in—minimum tax status so they cannot take advantage of the more favorable depreciation scheme permitted under the regular tax.

For integrated steelmakers, the minimum tax is the regular tax. Because basic manufacturing industries are all cyclical and must invest heavily and regularly in productive equipment, many of us are long-term, if not permanent, AMT taxpayers as a result of the depreciation add-back.

As shown in the example in the attached Chart B, as a steel company's income declines, its effective tax rate increases. Thus, an AMT company's cash flow is adversely affected, and its ability to invest is further hampered. Moreover, even assuming that a steel company stopped making capital improvements, it would still pay more tax in a given year because all its depreciation add-backs relate to prior years' capital spending. Consequently, minimum tax companies are forced to pay tax that reduces cash flow at a time when cash flow is already weakened by low profits. Capital-intensive companies, like steel, that must continue to modernize immediately preceding or during an economic downturn, are penalized the most because of their buildup of deferred depreciation. The steel industry alone has spent $7.8 billion from 1987 through 1990 on capital improvements.

In 1991, the American Council for Capital Formation testified before the Ways and Means Committee that the depreciation add-back also puts basic manufacturing at a severe disadvantage vis-a-vis our foreign competitors, who do not pay income taxes when they have no profits. Our foreign competitors are at a decided advantage because their depreciation is not subject to any alternative minimum tax. According to a recent study conducted by the Arthur Andersen & Company, the capital cost recovery system for U.S. steel companies is the world's worst. After five years, the extent to which a steel company has recovered on its investment is 30 percent in the U.S., 60 percent in Japan, 90 percent in Korea, and 100 percent in Brazil and Singapore [see Chart C].

Theoretically, companies that pay the higher minimum tax instead of the regular tax can carryforward the difference and use it as a credit against regular tax—when it is no longer a minimum tax taxpayer. This was designed to ensure that over time, no company pays in more tax than it would if it were in the regular tax. Notwithstanding this intent, steel companies either cannot use the credit in a meaningful time frame, or could well be permanently denied the use of the credit. This is because their cyclical nature, low profit margins, and buildup of deferred depreciation add-backs constantly keep them in the minimum tax and unable to use their "pre-payments" in a meaningful time frame. Meanwhile, the government has the advantage of our funds, interest-free, for many years. For that reason, we support the concept of Senator Boren's bill, S. 2159, to use those credits to offset up to 90 percent of our current year minimum tax liability. Most companies, however, cannot use this benefit currently due to recent losses.

As you know, the AMT was enacted to ensure that no corporation with substantial economic income could avoid significant tax liability by deliberately structuring its finances to combine or to excessively use various exclusions, deductions and credits to "zero out" any tax. It was not intended to penalize basic industries which must modernize on a continuous basis in the normal course of business, regardless of economic cycles. The only way for basic industry to avoid the AMT penalty is to stop making capital investments. *This is clearly unacceptable!*

Let me now talk about a couple of specific proposals:

To begin, President Bush took a positive step when he recognized the negative impact of the AMT depreciation system in his budget. The first part of his proposal eliminates one of the two depreciation calculations in the minimum tax for property placed in service after February 1, 1992. This is a constructive approach because it reduces the depreciation spread—albeit by a minuscule amount—between the two taxes. But the depreciation spread between the regular and the minimum tax is so large that it does not really reduce the cost of capital for AMT steel companies, because all prior and future investment still must be added back and depreciated over 15 years under the alternative minimum tax. AMT companies making capital investments need more help than this to reduce the severe tax penalty on their investment. At a minimum, we support the permanent elimination of the slowest depreciation method for *all property*.

Another part of the President's proposal provides a 15% Investment Tax Allowance (ITA) on new equipment purchased from February through December of this year, if it is placed into service within 18 months (before July 1993).

Our companies have little choice as to the timing of many capital expenditures. They are massive in scope, take years to complete, and cannot easily be shifted from year to year, so that the economic effect of an ITA on our investment is very small.

Second, pollution control equipment. The AMT depreciation add-back also includes capital expenditures for pollution control equipment. Steel intends to do its fair share to keep the environment clean, allocating limited funds for these nonproductive assets. But these nonproductive assets are treated the same as productive depreciable assets, which must be added back under the AMT.

For this reason, we applaud the recognition in Senator Boren's bill, S. 2159, that investment in environmental improvement assets *should not* be included in AMT depreciation.

Third, different investment tax credits are currently being discussed to promote economic growth. Although an ITC could be helpful to reduce capital costs for productive equipment—and thus secure jobs—it cannot be used by the majority of capital-intensive, basic manufacturing industries. To be a meaningful economic stimulus, any ITC must be fully creditable against both regular and minimum tax.

Some Members of Congress are supporting an *incremental* investment tax credit. Under this approach, a company would receive a tax credit for spending above its five-year past investment base. Unfortunately, an incremental ITC would be of nominal benefit to AMT capital-intensive steel companies because (1) an ITC is not fully creditable against minimum tax under present law, and (2) even if it were, most capital-intensive industries have made huge infusions of capital investments

since the last recession in order to modernize and to remain competitive. The steel industry has spent over $18 billion in the past 10 years to modernize, while at the same time we incurred massive losses. As a result, a company would not be able to significantly increase spending in the near future above its large base line of investment, in order to meaningfully take advantage of this proposal.

An incremental ITC would be an unfair and selective rate reduction, benefiting only a few companies with atypical investment patterns, who can pick and choose the timing of their investments. Such a baseline is arbitrary and would result in a misallocation of capital. It would not spur either short- or long-term economic growth for basic manufacturing industries.

In conclusion, the AMT severely impacts steel and its scarce resources, and steel is not alone in this problem. The Business Roundtable estimates that 60 percent of U.S. companies are on the minimum tax. Basic industries like steel are the backbone of the American economy and provide needed jobs in our country. I urge you, therefore, to provide a tax stimulus package that (1) removes the disincentive effect of the corporate AMT, and (2) promotes needed investment.

Thank you very much.

CHART A
REGULAR TAX VS. AMT DEPRECIATION
PRIMARY STEEL MAKING ASSETS

ASSET COST: 100

YEAR	REGULAR DEPRECIATION	TAX BENEFIT @ 34%	AMT/ACE DEPRECIATION	TAX BENEFIT @ 20%
1992	14.29	4.86	3.75	0.75
1993	24.49	8.33	7.38	1.48
1994	17.49	5.95	7.14	1.43
1995	12.49	4.25	6.92	1.38
1996	8.93	3.04	6.73	1.35
1997	8.92	3.03	6.56	1.31
1998	8.93	3.04	6.48	1.30
1999	4.46	1.52	6.48	1.30
2000			6.48	1.30
2001			6.48	1.30
2002			6.48	1.30
2003			6.48	1.30
2004			6.48	1.30
2005			6.48	1.30
2006			6.48	1.30
2007			3.20	0.64
TOTAL DEPRECIATION	100		100	
TOTAL TAX BENEFIT		34		20
NPV @ 8% (NOTE)		26.0		11.1
AFTER TAX COST OF INVESTMENT		73.95		88.86

NOTE- ASSUMES TAXPAYER REMAINS IN REG OR AMT POSITION DURING THE ASSET RECOVERY PERIOD

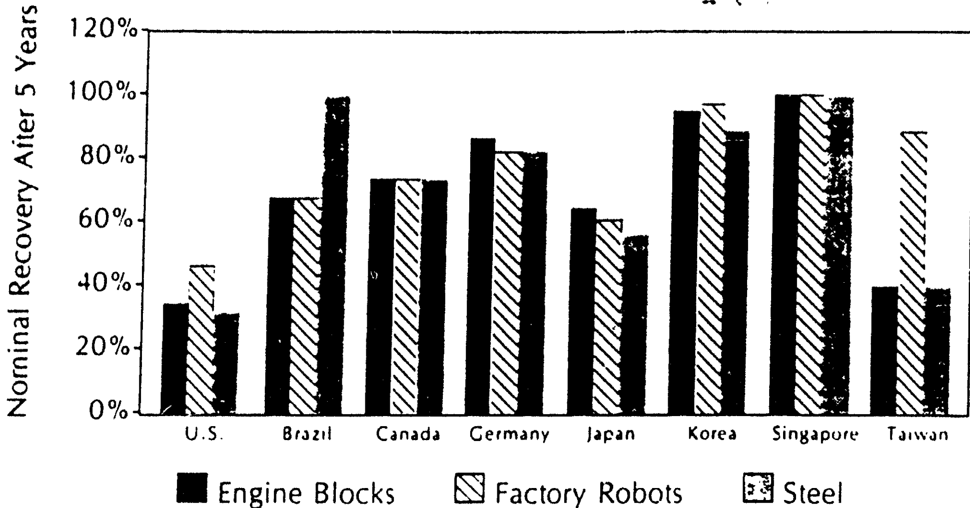
CHART B
AMT AND DECLINING PROFITABILITY
PRIMARY STEEL MAKING ASSETS

ASSUMPTIONS:	
ASSET COST	200 EACH YEAR FOR TWO YEARS
REG TAX METHOD/LIFE	200% DB-7 YEARS
AMT METHOD/LIFE	150% DB 15 YEARS
ACE METHOD/LIFE	S/L - 15 YEARS

		HIGH PROFIT YEAR	LOW PROFIT YEAR
1	INCOME BEFORE DEPRECIATION	180.0	80.0
2	DEPRECIATION (YEAR 2 ON YEAR 1 & 2 ADDITIONS)	(77.6)	(77.6)
3	REGULAR TAXABLE INCOME	102.4	2.4
4	AMT ADJ. (DIFF. BETWEEN REG & AMT DEPR.)	48.6	48.6
5	ACE ADJ. (75% OF DIFF BETWEEN AMT & ACE DEPR.)	8.8	8.8
6	ALTERNATIVE MINIMUM TAXABLE INCOME (AMT)	159.8	59.8
7	REGULAR TAX AT 34% OF REGULAR TAXABLE INCOME (LINE 3)	34.8 *	0.8
8	ALTERNATIVE MINIMUM TAX AT 20% OF AMTI (LINE 6)	32.0	12.0 *
9	AMT OVER (UNDER) REGULAR TAX	(2.9)	11.2
10	EFFECTIVE TAX RATE(AS A % OF REGULAR TAXABLE INCOME, LINE 3)	34.0%	500.0%

* THIS IS THE TAX LIABILITY (HIGHER OF REGULAR OR AMT: LINE 7 OR 8)

CHART C



Notes: Nominal capital costs recovered after five years measure the speed at which a firm is able to recover its capital expenditures. U.S. firms are assumed to pay the alternative minimum tax (AMT) throughout the class life of the asset. The alternative minimum tax refers to the capital cost recovery provisions of the Tax Reform Act of 1986 for firms incurring the alternative minimum tax adjusted current earnings rule. The calculations assume the firm stays on the AMT. None of the competitor countries has an AMT similar to that of the United States.

Prepared Statement of Andrew B. Lyon [1]

I appreciate the opportunity to be here today to testify on the effects of the corporate Alternative Minimum Tax (AMT). In my academic research at the University of Maryland I have given considerable attention to the AMT. This research was motivated by my desire to measure the relative incentives firms on the AMT face when contemplating new investment. In some instances, the AMT may be a significant deterrent to new investment.

Given this deterrent effect, I have also thought about whether the AMT may be rigorously justified on other grounds. I should state here that I am a strong supporter of the general goals of the Tax Reform Act of 1986 to establish a fairer and more efficient tax system. I was on the staff of the Joint Committee on Taxation during tax reform and believe that the 1986 act was a general improvement over the prior law. I am, however, doubtful that the corporate AMT enacted in 1986 can be said to increase either the equity or the efficiency of the tax system. I believe these goals can be achieved more reliably by altering the rules of the regular tax system rather than through a separate corporate AMT. Tax revenues from the corporate AMT in 1987 through 1989 cumulatively totalled $9 billion. In the first three years of the AMT, 20 percent of the largest U.S. corporations paid AMT. Current

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[1] Kevin G. Salwen, *Wall Street Journal*, January 30, 1992, p. A7.

estimates are that 40 to 60 percent of the largest U.S. corporations are paying tax under the AMT.[2]

The structure of the AMT makes it more likely for a firm to pay AMT when revenues are low. The economic recession that began in July 1990 appears to be the major reason for the large increase in the number of firms paying AMT. It is generally thought that the built-in flexibility of income taxes creates a natural stabilizing force in the economy. Income tax revenues fall during recessions, automatically leaving more income in the hands of consumers and firms. Taxes under the AMT, however, may increase while the economy is slumping and this increase partially offsets the stabilizing feature of the regular income tax.

Firms on the AMT may undertake less investment because the tax reduces their available retained earnings and because investment incentives under the AMT are reduced. Analysis of investment incentives under the AMT is complex because it depends importantly on many tax attributes of the firm, including its net operating losses, foreign tax credits, and the length of time the firm will remain on the AMT.

Investment decisions are influenced by many factors. For instance, businesses must evaluate the future demand for their product, the best technology to produce their product, the location of production, the timing of new investment relative to future demand, and the regulatory and tax rules. In this very complex decision environment, businesses make their best evaluation of these factors and decide whether the expected return on an investment project is sufficient to justify undertaking it.

The before-tax return on an investment project at which a firm is just indifferent to invest or not to invest can be thought of as the "break even" return. Economists refer to this required break even return as the cost of capital. Taxes affect investment decisions by altering the required return, or cost of capital. Less favorable tax treatment increases the cost of capital. A project must now yield a higher pretax return before it is worthwhile to undertake. Because higher yielding projects are scarcer, investment declines. Alternatively, more favorable tax treatment reduces the cost of capital allowing lower yielding projects to be undertaken and increasing investment. This simple relationship between the cost of capital and investment makes the cost of capital a useful index of the relative incentive to invest.

The AMT affects the cost of capital by changing the tax treatment of the returns to an investment. In general, deductions for investment projects are taken at a slower rate under the AMT. As a result, more of a project's income is subject to taxation "up front." By itself, the slower recovery of the cost of the investment increases the cost of capital. Income generated by the project, however, is taxed at a 20 percent rate under the AMT rather than the 34 percent rate under the regular tax. The reduced rate of taxation on additional income works to reduce the cost of capital. The net effect on the firm's cost of capital is ambiguous without a detailed calculation of the magnitude of these two effects.

It is important at this point to distinguish between two effects of the AMT: an effect on tax liability and an effect on investment incentives. By definition, a firm on the AMT pays higher total taxes. The AMT increases the average tax rate of the firm. But the higher average tax rate does not provide any information on the profitability of undertaking investment. This second effect, the incentive to undertake new investment, is determined by the firm's cost of capital. The cost of capital is based on the tax treatment of new investment. Theoretically, it is possible for the AMT to increase a firm's total tax bill, yet increase the incentive to undertake new investment. This could occur, for instance, if AMT liability resulted from the disallowance of deductions associated with past investments, but deductions for contemplated new investment were not as severely curtailed.

Calculations of the effects of the AMT on the cost of capital for representative investments are presented below. The cost of capital presented here is defined as the required pretax return on an investment net of depreciation. (The basic methodology of these calculations is explained in greater detail in my paper "Investment Incentives under the Alternative Minimum Tax," *National Tax Journal,* December 1990, pp. 451–465.)

For simplicity, the model ignores the effects of uncertainty. Firms are assumed to know in advance whether they will be subject to the AMT in any given year. Some critics of the AMT have argued that a great deal of the difficulties created by the AMT are precisely due to the uncertainty facing a firm of whether or not it will be subject to the tax. This model cannot evaluate the separate costs of this uncertainty. If these costs exist, they should be considered in addition to the changes in the cost of capital reported here.

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[2] Assistant Professor of Economics at the University of Maryland, College Park, Maryland and Faculty Research Fellow at the National Bureau of Economic Research. The views expressed in this testimony are my own and do not represent those of any organization.

Table 1 presents estimates of the cost of capital under the regular tax system and under the AMT for a variety of assets. The cost of capital under the AMT depends on the length of time the firm is subject to the AMT. Generally, the longer a firm is subject to the AMT the higher is the cost of capital.

The table shows that the cost of capital for equipment used in the manufacture of computer equipment (and similar electronic devices) has a cost of capital nearly one percentage point higher for a firm subject to the AMT for five years than for a regular tax firm. In general, shorter-lived equipment is more adversely affected by the AMT. For the first six assets shown in the table, all of which would be recovered over five or seven years Under the regular tax, the cost of capital is more than ten percent higher for a firm subject to the AMT for five or more years than for regular tax firms.

The effect of current proposals to reform the AMT are shown in Figures 1 and 2. Under current law, the Adjusted Current Earnings (ACE) provision reduces depreciation allowances available to firms on the AMT for recently purchased assets. In addition to its effect on the cost of capital, it is frequently cited as a source of complexity since it requires firms to keep track of three different depreciation schedules for a single asset. Repeal of the ACE provision reduces the cost of capital for AMT firms. Repeal reduces the cost of capital by 0.14 percentage points for equipment used to manufacture computers for a firm on the AMT for five years. Even with repeal of ACE, however, the cost of capital under the AMT would remain ignificantly higher than under the regular tax.

The President's budget proposal also proposes enactment of a temporary 15 percent Investment Tax Allowance (ITA) that could be used by both regular tax and AMT firms. In Figures 1 and 2 its effect only for AMT firms is estimated together with repeal of ACE. The ITA further lowers the cost of capital. The ITA is shown to reduce the cost of capital by an additional 0.24 percentage points for equipment used to manufacture computer equipment for firms subject to the AMT for five years. For firms in the AMT for extended periods of time, however, AMT depreciation combined with the ITA still results in a cost of capital higher than under the regular tax system under current law. Also, because the ITA would be available for regular tax firms as well, AMT firms would continue to face a relative disadvantage when competing against firms on the regular tax system.

Although many of the reforms of the 1986 Tax Reform Act were an attempt to "level the playing field," I do not believe the AMT was helpful in this regard. As the cost of capital analysis indicates, the AMT results in different firms facing different incentives to invest in the identical asset. For firms currently subject to the AMT, investment incentives are generally diminished relative to firms that will remain permanently on the regular tax. Another set of incentives is faced by firms currently paying regular tax that anticipate future AMT liability. These firms may have a greater incentive to invest immediately, before they become subject to the AMT. Although the intent of the AMT may have been to diminish tax planning from the investment decision, ironically the AMT may have the opposite effect in practice.

The AMT was also motivated on grounds of tax fairness. In the early 1980s hundreds of major corporations were reported to have little or no corporate income tax liability in at least a single year. bile the AMT has reduced the number of firms paying zero taxes, few economists believe this increases the actual fairness of the tax system. Investment is allocated in the economy to those sectors which offer the highest after-tax returns. If certain sectors of the economy receive preferential tax treatment, the flow of investment into these sectors will drive down the available pre-tax return. In equilibrium, the after-tax return to an additional unit of investment in any sector of the economy is equalized, although pre-tax returns may differ. Since each unit of investment in the different sectors receives the same after-tax return, it is difficult to argue that the outcome is unfair.

The AMT does increase the total tax burden of capital income, and this increase may be regarded by some as increasing tax fairness. It is a very cumbersome mechanism however to increase tax revenues and very small changes to the regular tax system can achieve the same outcome with greater reliability.

Differing pre-tax returns in the different sectors of the economy do potentially create an inefficiency. Under common economic assumptions more equal taxation of different sectors can increase economic output. It should be recognized, however, that differing pre-tax returns are due to the rules of the regular tax system. The minimum tax does not necessarily result in more equal taxation of different sectors. If one wishes to bring about more equal taxation of different types of capital, then appropriate changes could be made to the regular tax system.

While the desire for a minimum tax may be motivated on the basis of both equity and efficiency concerns, there is no guarantee that either objective will be attained. The minimum tax may create production inefficiencies by imposing widely divergent

investment incentives across firms and across assets. A minimum tax has a number of other drawbacks. Administrative costs per dollar of tax revenue are higher than those resulting from many possible changes to the regular tax system. The minimum tax decreases the automatic stabilizing force of the income tax. Finally, the AMT increases the uncertainty firms face in undertaking investment. I believe legislation that lessens the discrepancies between the AMT and the regular tax provisions would be beneficial.

Table 1—COST OF CAPITAL FOR SPECIFIC TYPES OF EQUIPMENT

Asset	Permanent regular tax	Years on AMT			
		1 year	2 years	5 years	10 years
Assets used to manufacture computer chips [1]	7.26	7.41	7.65	8.07	8.05
Assets used to manufacture computer equipment [2]	6.93	7.07	7.33	7.95	8.04
Assets used to manufacture factory robots [3]	6.77	6.84	7.00	7.52	7.95
Assets used to manufacture automobile engine blocks [4]	6.55	6.62	6.77	7.32	7.88
Continuous-casting equipment for the manufacture of steel [5]	6.33	6.40	6.55	7.10	7.75
Chemical industry wastewater treatment plants [6]	6.32	6.45	6.70	7.49	7.96
Certified pollution control facilities [7]	6.02	6.05	6.14	6.64	7.36
Scrubbers for the removal of air pollution in the electric utility industry [8]	7.39	7.40	7.42	7.49	7.62

[1] ADR asset class 36.1. [2] ADR asset class 36.0. [3] ADR asset class 35.0. [4] ADR asset class 37.11. [5] ADR asset class 33.4. [6] ADR asset class 28.0.
[7] Section 169 facilities: under regular tax, 60 percent recovered through 5-year amortization, remainder recovered over 20 years; under AMT, recovered over 28 years, straight-line.
[8] ADR asset class 49.13 (not qualifying for sec. 169 amortization). All assets are assumed to be financed 50 percent with debt, 50 percent with equity.

Figure I

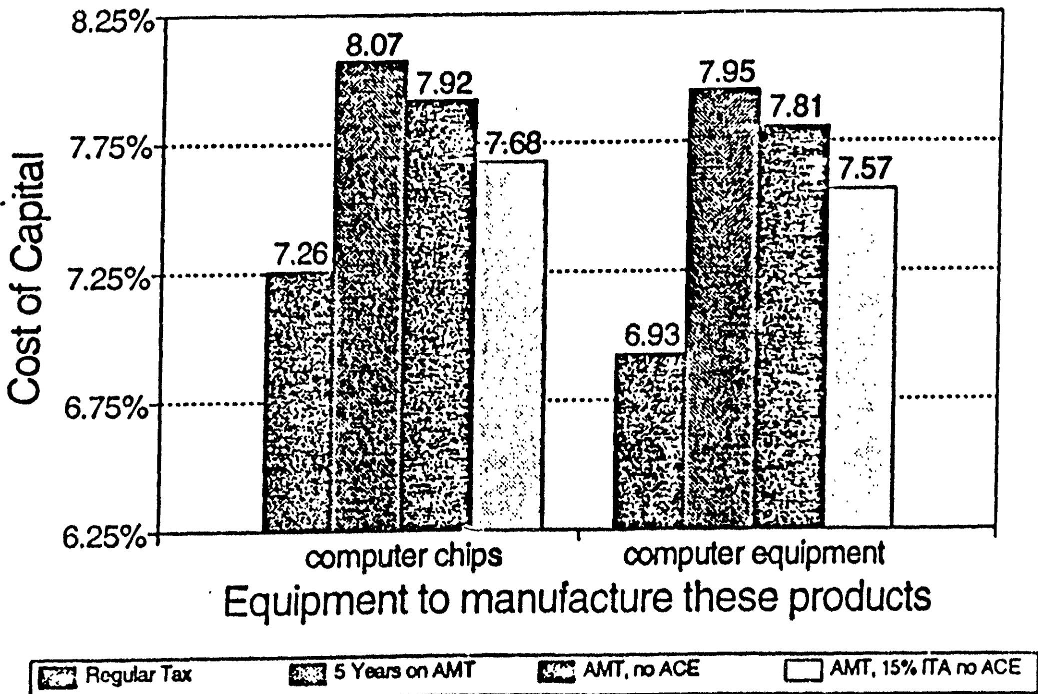
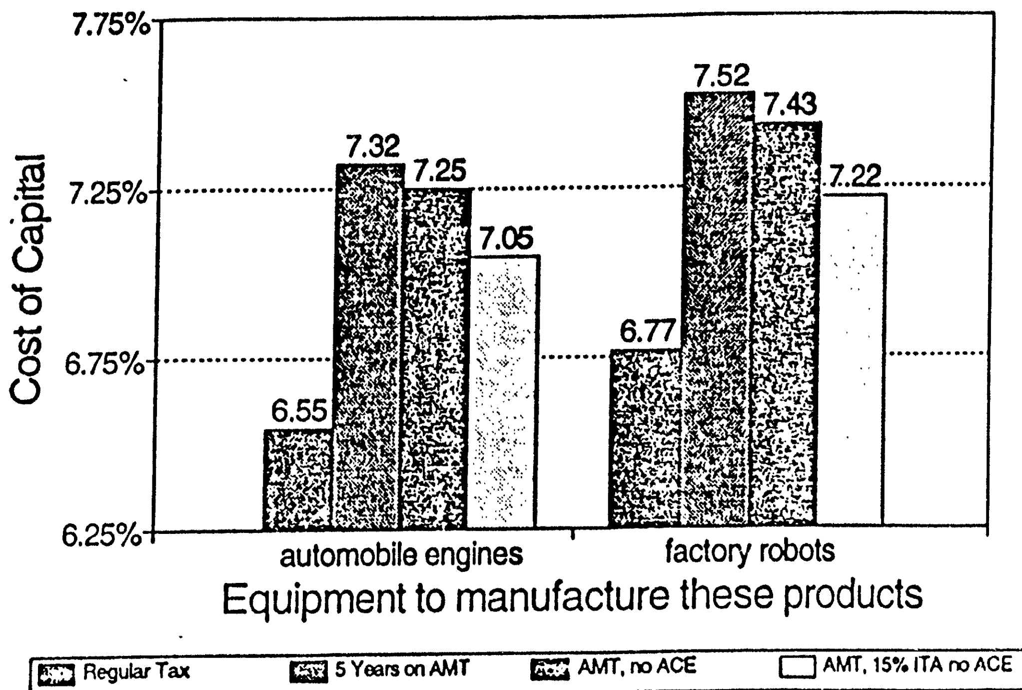


Figure 2

AMT COST OF CAPITAL
Current Law and Proposals



PREPARED STATEMENT OF ROBERT S. MCINTYRE

I appreciate the opportunity to testify before the Committee on behalf of Citizens for Tax Justice. Our coalition of labor, public interest and grassroots citizens groups represents tens of millions of middle- and low-income Americans, who have a vital stake in fair, economically sound tax and budget policies.

The issue before the Subcommittee today involves the corporate Alternative Minimum Tax, which was adopted in 1986 to try to put an end to the spectacle of highly profitable corporations paying little or nothing in federal income taxes. Recently, however, several proposals, from the Bush administration and others, have been made to weaken the Alternative Minimum Tax. We urge the Congress to reject these proposals and instead to strengthen the minimum tax by broadening its base and raising its rate.

WHY THE CORPORATE ALTERNATIVE MINIMUM TAX WAS ADOPTED

A 1986 CTJ survey of 250 of the nation's largest and most profitable corporations found that 130-more than half the total-managed to pay absolutely nothing in federal income taxes in at least one of the five years from 1981 to 1985.[1]

These 130 companies, ranging alphabetically from Aetna Life & Casualty to Xerox, earned a combined total of $72.9 billion in pretax domestic profits in the years they did not pay federal income taxes. But instead of paying $33.5 billion in income taxes, as the 46 percent statutory federal corporate tax rate purportedly required, they received $6.1 billion in *tax rebates*—for a "negative" tax rate of -8.3 percent.

- Of this group of 130 corporate tax freeloaders, 73 had at least two years of paying nothing in federal income taxes from 1981 to 1985.

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[1] Citizens for Tax Justice, *130 Reasons Why We Need Tax Reform* (July 1986).

- 42 of these companies paid nothing-or less-in total federal income taxes over the entire five years.

Congress rightly found this situation intolerable.

"The committee believes the tax system is nearing a crisis point," said the December 1985 House Ways and Means Committee Report on what became the Tax Reform Act of 1986. "Many firms have made use of tax provisions to reduce their tax liability to zero, and, in some cases corporations with substantial book income obtain tax refunds."

Likewise, the Senate Finance Committee's May 1986 report on the same bill stated "The committee finds it unjustifiable for some corporations to report large earnings and pay significant dividends to their shareholders, yet pay little or no taxes on that income to the government."

In response to the egregious level of corporate tax avoidance, the Tax Reform Act of 1986 closed many business loopholes and adopted the Alternative Minimum Tax. The AMT was designed to assure that all profitable corporations pay at least some reasonable amount in federal income tax. The official summary of the Tax Reform Act of 1986 states:

> Congress concluded that the minimum tax should serve one overriding objective: to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits. . . . It is inherently unfair for high-income taxpayers to pay little or no tax due to their ability to utilize tax preferences."

THE STRUCTURE OF THE ALTERNATIVE MINIMUM TAX

The "alternative" feature of the AMT works like this. Most companies pay the 34 percent regular corporate tax rate on their profits less amounts sheltered by various remaining tax preferences, such as super-accelerated depreciation (200%-declining-balance over very short periods) and special breaks for oil, gas and mining. Alternatively, companies must pay the 20 percent minimum tax on profits computed without some loopholes-if the AMT is higher.

Minimum taxable income is usually higher than regular taxable income for several reasons. Depreciation write-offs, for example, are less accelerated under the AMT Investments in mining exploration and development must be amortized over 10 years rather than deducted immediately. And tax "losses" (NOLs) left over from prior years that are attributable to certain tax preferences (such as accelerated depreciation and a portion of certain oil tax breaks) cannot be used to offset the AMT.

In addition, if "adjusted current earnings" exceeds minimum taxable income as otherwise defined, then the AMT applies to three-quarters of the difference. In computing adjusted current earnings, excessive depreciation write-offs are further scaled back, oil companies must use cost depletion and write off their "intangible drilling costs" over 5 years (rather than deduct them immediately), and tax "losses" from previous years are not allowed.[2]

HOW THE MINIMUM TAX HAS WORKED IN PRACTICE

Since its adoption, the 1986 reforms, including the corporate Alternative Minimum Tax, have curbed some of the worst corporate tax avoidance problems. In fact, the number of no-tax giant corporations in CTJ's most recent survey dropped sharply—to only seven in 1988.[3] Although not all firms disclose in their annual reports whether they paid the minimum tax, in our 1987 corporate tax survey we were able to identify 11 profitable companies that would have paid no tax at all without the minimum tax.[4]

As a 1991 IRS paper noted, "in the case of large companies with regular deferrals of tax liability, AMT may cause them to experience a new phenomenon: paying taxes."[5]

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[2] The "adjusted current earnings" rule replaced a similar rule that tried to relate alternative minimum taxable income to a portion of the profits that companies report to their shareholders ("book income").

[3] *See* Citizens for Tax Justice, *It's Working, but . . ., The Resurgence of Business Investment & Corporate Income Taxes* (Oct. 1989).

[4] *See* Citizens for Tax Justice, *The Corporate Tax Comeback* (Sept. 1988). The 11 companies were: Englehard, General Re, Harris Bancorp, Merrill Lynch, Middle South Utilities, Pennsylvania Power & Light, Philadelphia Electric Co., St. Paul Companies, Sun Company, Suntrust Banks and Xerox.

[5] Patrice Treubert & Amy Pavelko, Internal Revenue Service, "The Alternative Minimum Tax: An Analysis of Its Effect on Corporations in 1987" (1991).

REGULAR & ALTERNATIVE MINIMUM TAXES FOR ALL CORPORATIONS IN 1988

Industry	Total No. of returns	No. with AMT	Percent with AMT	Tax w/o AMT	Net AMT	Percent change from AMT
All Active Corporations	**2,299,896**	**25,193**	**1.1**	**$93.0**	**$2.9**	**+3.1**
Mining, Oil & Gas	27,735	918	3.3	0.9	0.2	+24.2
Manufacturing	205,143	4,488	2.2	40.6	1.3	+3.2
Transp. & Public Utilities	92,465	1,795	1.9	15.0	0.4	+2.7
Construction	258,948	4,663	1.8	2.2	0.1	+3.2
Fin., Insur. & Real Estate	381,028	5,583	1.5	17.3	0.6	+3.5
Agriculture, For. & Fish.	70,141	848	1.2	0.5	0.0	+2.3
Services	621,475	3,567	0.6	4.0	0.1	+3.3
Wholesale & Retail Trade	629,262	3,323	0.5	12.6	0.1	+1.1
Other	13,699	8	0.1	0.0	0.0	+1.8

Note: Total number of corporations excludes Sub S corporations, REITS and RICS. Dollar figures are in billions.

Source: Internal Revenue Service, 1988 Corporation Income Tax Returns (Nov. 1991).

That's not to say, however that the Alternative Minimum Tax affects very many corporations. According to the IRS, in 1988 the corporate AMT was paid by only 25,193 corporations –1.1 percent of all active corporate filers. By industry, the percentage of corporations paying the AMT ranged from 3.3 percent in mining down to 0.5 percent in wholesale and retail trade.

Overall in 1988, the AMT increased total corporate income tax payments by a net $2.9 billion. That's 3.1 percent above what would have been paid in the absence of the AMT The biggest percentage tax increase from the AMT was in the historically low-tax mining industry, where the AMT added 24 percent to the taxes that would have been paid without the AMT.

Some 78 percent of the total 1988 AMT was paid by corporations with assets greater than $250 million. This is slightly above the 71 percent of total corporate income taxes (after credits) paid by these giant companies. (The AMT increased taxes on giant companies by 3.4 percent.) Without the AMT those corporations that paid it would have had very low effective tax rates. Overall, the AMT increased taxes on the 25,193 corporations that paid it by 114 percent over what they would have owed without the AMT. According to IRS data for selected industries in 1987, the "book income" preference (since changed to "adjusted current earnings") played a central role in the effectiveness of the AMT in 1987in four of the five industries examined.

CORPORATIONS PAYING THE ALTERNATIVE MINIMUM TAX IN 1988

Industry	No. with AMT	Percent tax increase from AMT
All	25,193	+114
Agriculture, For. & Fish.	848	+85
Construction	4,663	+119
Fin., Ins. & Real Estate	5,583	+850
Manufacturing	4,488	+192
Mining, Oil & Gas	918	+163
Services	3,567	+88
Trans. & Public Utilities	1,795	+67
Wholesale & Retail Trade	3,323	+100
Other	8	+39

Source: IRS, 1988 Corporation Income Tax Returns (Nov. 1991).

FACTORS MAKING UP ALTERNATIVE MINIMUM TAXABLE INCOME IN 1987 FOR COMPANIES PAYING THE AMT IN SELECTED INDUSTRIES

Industry	Taxable income before NOLs	Book income preference	Other factors
Electric, Gas & Sanitary Utilities	27.2%	68.1%	4.7%
Banking	52.9	42.5	4.6
Insurance	56.6	40.0	3.4

FACTORS MAKING UP ALTERNATIVE MINIMUM TAXABLE INCOME IN 1987 FOR COMPANIES PAYING THE AMT IN SELECTED INDUSTRIES—Continued

Industry	Taxable income before NOLs	Book income preference	Other factors
Transportation	58.3	31.0	10.7
Non-Electrical Machinery	81.4	12.9	5.7

Source: Patrice Treubert & Amy Pavelko, Internal Revenue Service, "The Alternative Minimum Tax: An Analysis of Its Effect on Corporations in 1987" (1991).

REFORMING—OR DEFORMING—THE ALTERNATIVE MINIMUM TAX

Tax Reforms Options

Although adoption of the corporate Alternative Minimum Tax was an important step in the direction of tax fairness, further reforms are still needed.

To make the Alternative Minimum Tax more effective, more loopholes and tax preferences should be disallowed in computing Alternative Minimum Taxable Income. Examples of changes that could be made to strengthen the corporate Alternative Minimum Tax include:

- Change accelerated AMT equipment depreciation to straight line over ADR lives.
- Treat all oil & gas intangible drilling cost deductions in excess of 6-year amortization as a tax preference.
- Disallow AMT deductions for business meals & entertainment.
- Disallow write-offs for "company cars" (with minor exceptions).
- Disallow interest deductions for payments to foreign lenders in tax havens. (This is a back-door compliance reform).

In addition, we believe that the corporate AMT rate should be increased from the current 20 percent rate to the same level as the individual AMT rate: 24 percent.

Tax Deform Proposals

Unfortunately, the Bush administration, some in Congress and apparently most of the corporate representatives appearing before the Subcommittee today want to move in exactly the opposite direction, toward weakening the minimum tax.

The House Ways and Means Committee tax proposal now pending would cut the AMT rate from 20 percent to 19 percent. Others have suggested gutting the minimum tax as it applies to the oil and gas industry. For its part, the administration seeks to allow companies reporting profits to shareholders to use faster depreciation in determining their minimum taxable income under the adjusted current earnings test.

Those who favor weakening the AMT argue that it has caused dire problems for the companies affected, raising their "cost of capital" and hurting their ability to compete internationally. But this argument is silly. The AMT rate is only 20 percent-far below the corporate tax rate in any other major Western nation. Indeed, the regular U.S. corporate tax rate is only 34 percent, also below the rate in most other countries. How can paying taxes at a 20 percent rate (or a 34 percent rate, for that matter) put American companies at a disadvantage compared to foreign corporations that generally pay much higher tax rates?

The United States already has very low corporate income taxes by international standards. In fact, at only 2.1 percent of gross domestic product, U.S. federal and state corporate income taxes are less than half the 4.5 percent of GDP weighted average for the 22 other OECD nations. Japan's corporate income taxes, for example, were 7.4 percent of GDP in 1988, the United Kingdom's were 4.1 percent of GDP, and Canada's were 2.9 percent.

It's very hard to believe that a low-rate tax that affects only one percent of all corporations and raises only a few billion dollars a year could possibly be guilty of the crimes it is alleged to perpetrate. Instead, the AMT actually works to level the business playing field, avoiding the inevitable economic distortions that result when certain industries and companies enjoy low-tax status, while others must pay significant taxes.

Notably, after the 1986 Tax Reform Act was adopted, business investment picked up markedly from its weak performance over the 1981–86 loophole era. Real business investment grew by 2.7 percent a year from 1986 to 1989, 42 percent faster than the meager 1.9 percent annual growth rate from 1981 to 1986. Leading the way was a resurgence in investment in industrial plant and equipment, which grew rapidly after actually falling from 1981 to 1986.

At bottom, the real purpose of various proposals to weaken the minimum tax has nothing to do with sound economics. As Rep. Bill Archer (R-Tex.) has happily admitted, the result of the Bush alternative minimum tax plan, for example, would be to allow some highly profitable companies "to pay no tax." He's right. If Congress weakens the minimum tax by restoring tax preferences, it can be confidently predicted that the specter of large, profitable "no-tax corporate freeloaders" will return.

In particular, the companies that are represented before the Subcommittee today for which I happened to have recent annual reports on hand paid very low-or no-federal income taxes prior to adoption of the Alternative Minimum Tax, and even today they pay low effective rates.

- Mitchell Energy Corporation, for example, had a negative overall federal effective tax rate from fiscal 1982 through fiscal 1987, and in fiscal 1990 paid only 3.3 percent of its profits in federal income taxes.
- Likewise Champion International paid only about 2 percent of its profits in federal income taxes from 1981 to 1987, and paid at rates of only 16.1 percent and 11.2 percent in 1990 and 1989, respectively.
- LTV Corporation paid a 14.6 percent effective federal tax rate in 1990 and only 4.1 percent in 1989, most or all of which, according to LTV's annual report, was the Alternative Minimum Tax.

[Dollars in millions]

	U.S. Pretax profit	Federal income tax	Effective tax rate (percent)
Mitchell Energy Corp.:			
Fiscal year 1990	$46.1	$1.5	3.3
Fiscal year 1989	7.3	0.8	10.9
Fiscal year 1988	14.1	0.3	1.9
Fiscal year 1987	13.3		0.0
Fiscal year 1982–86	538.8	–41.1	–7.6
Champion International:			
1990	286.4	46.2	16.1
1989	471.9	53.0	11.2
1988	510.0	41.7	8.2
1987	436.2	6.9	1.6
1986	189.4	2.8	1.5
981–85	377.4	9.1	2.4
LTV Corporation:			
1990	86.8	12.7	14.6
1989	279.3	11.4	4.1

Source: Corporate Annual Reports.

We don't need to lower taxes even further on these companies or others that pay the AMT in order to compete in world markets. On the contrary, the fact that these and other companies pay such low effect tax rates suggests that the AMT needs to be strengthened, not weakened.

If the abuses that the minimum tax was designed to stop are recreated, the direct cost to the Treasury will be substantial, and taxpayer confidence in the integrity of the federal tax system will be undermined. It will then become even more difficult to raise the revenue the government needs to reduce the budget deficit and address our nation's social and public investment problems. And if Congress fails to deal with the deficit and fails to move to repair our decaying infrastructure, the damage to American business and our ability to compete internationally will be severe.

We urge the Congress to reject all efforts to weaken the corporate Alternative Minimum Tax, and instead to take steps to strengthen this important feature of our tax law.

Prepared Statement of Senator Don Nickles

Mr. Chairman, today I want to talk about the Alternative Minimum Tax and the impact it is having on the oil and gas industry. As you know, current provisions in the tax code treat intangible drilling costs and percentage depletion as preference items for purposes of calculating a taxpayer's Alternative Minimum Tax obligation.

These provisions are causing irreparable harm to an industry that is vital to our national security.

At the end of January, the national rig count stood at 65% active drilling rigs. A rig count of 653 indicates that the industry has entered a period of accelerated decline. The nation's domestic oil production is falling at an annual rate of 300,000 barrels a day, and foreign imports are rapidly approaching fifty percent of our domestic needs. We have lost 326,000 jobs, almost half of the oil field worker jobs since the peak in 1982 when the rig count was 3,105.

Independent producers have been devastated by a combination of low oil and gas prices and high tees. Every rig that shuts down means jobs that are lost and increased dependency upon foreign oil for our energy needs. I strongly believe that relief is needed to save the domestic industry from collapse.

The time to act is now. The independent producers say that unless tax relief is provided, the industry will collapse. With the energy bill on the floor of the Senate and the President's budget before Congress, it is time to act and act decisively.

I am convinced that the Alternative Minimum Tax relief is the single most important agenda item for the oil and gas industry. It does little good to talk about extending incentives unless we remove Alternative Minimum Tax impediments.

When a recession coincides with sustained low oil and gas prices, the Alternative Minimum Tax works like a severe penalty that gets progressively worse the longer the taxpayer falls under it. The longer prices are low and profits thin, the harsher is the Alternative Minimum Tax's impact.

According to a preliminary report prepared by the University of Oklahoma on the impact of the Alternative Minimum Tax on the Petroleum industry, a "more favorable AMT treatment would result in 17–25 percent increase in exploratory drilling." The report concludes that the AMT is a regressive tax structure producing noncompetitive and punitive effects on taxpayers undertaking drilling investments.

Under current law, when percentage depletion and intangible drilling costs are added back to income in calculating Alternative Minimum Tax tax liability it can result in a 70 to 80 percent effective tax rate for some producers. The result is indisputedly punitive, if not confiscatory. It is for these reasons that I have introduced legislation with Chairman Boren calling for the removal of intangible drilling costs and percentage depletion as preference items under the Alternative Minimum Tax.

Including intangible drilling costs and percentage depletion as preference items in 1986 was a mistake. It has been referred to by some Americans trying to increase oil production here in the United States as a drilling penalty tax for independents. In the fall of 1990, Congress made a change to these provisions by reducing the amount of intangible drilling costs that independents must include in the alternative minimum tax by 75 percent for exploratory wells and 15 percent for nonexploratory wells. But the penalty is still 25 percent for exploratory wells, including all developmental wells. We need to eliminate IDC's entirely from the alternative minimum tax.

IDC's are the only out-of-pocket business expense in any industry or profession that are treated as a preference item in the alternative minimum tax. Inclusion of IDC's was unfair, and another example of treating the domestic industry as a cash cow to be milked every time revenue is needed.

Taking IDC's and percentage depletion out of the alternative minimum tax is appropriate not simply because they are a unique penalty on oil and gas producers but because in practice these provisions have been both anticompetitive and regressive, and have had the effect of significantly reducing drilling activity in the United States. As I mentioned, the rig count is at the lowest level of drilling activity since records were begun in the 1940's.

In summary, the Independent oil and gas producers are being unfairly penalized by the 1986 tax amendments. If these tax provisions are not eliminated the results will be a continued decapitalization of a strategic sector of our industrial economic base, a continued loss of jobs and a continued risk to our Nation's ability to respond to requirements for domestic oil and gas production. Treatment of IDC's and percentage depletion as preference items in the Alternative Minimum Tax must be eliminated immediately if this industry is to survive and the national security of this Nation be preserved from further reliance on foreign energy sources.

PREPARED STATEMENT OF JOSEPH W. O'TOOLE

Good afternoon. My name is Joseph O'Toole. I am Vice President and General Tax Officer of Phillips Petroleum Company, Bartlesville, Oklahoma. I serve as the principal officer responsible for the Company's tax matters. Phillips is most appreciative

of this opportunity to share with the Committee our thoughts and experiences regarding the alternative minimum tax. Unfortunately, it is a topic that we know all too well.

Phillips Petroleum Company is headquartered in Bartlesville, Oklahoma. Phillips currently employees approximately 22,000 people across the United States with a heavy concentration in Oklahoma, Texas and the Southwest. We are an integrated oil and gas company with substantial investments—over $18 billion—in exploration and production, gas and gas liquids operations, petroleum products and chemicals. More than two thirds of our assets are located within the United States. Phillips is generally regarded by the financial community as an integrated domestic company although we do have sizable international investments.

Today, I would like to address the following topics:

1. How the AMT burden impacts Phillips and related companies
2. Generic problems with the AMT, and
3. Comments on pending legislative proposals and recommendations.

AMT TIMING AND BURDEN

Phillips Petroleum Company's business lines are very capital intensive. Our recent capital budgets have been approximately $1.5 billion per year. The capital planning associated with such sums involves long time horizons. It typically takes several years to develop our investments in oil and gas fields and to build the large associated infrastructure (plants, etc.) which our businesses require. We cannot expect to see a return on these investments until many years after the capital expenditures are made. The businesses in which we are engaged are, generally, commodity oriented including such products as crude oil, natural gas, gasoline, ethylene and a host of other materials used in plastics and chemicals manufacturing. Such products make our revenues very susceptible to the drastic swings caused by the cycles of the United States and world economies. This combination of commodity based revenues and a large investment base along with its fixed costs results in Phillips' cash flow, financial earnings and tax liabilities also experiencing wide fluctuations. Long range planning, including tax planning, becomes particularly important in view of these factors.

Phillips and its employees are suffering in the current economic environment. Our 1991 earnings were down 66.7 percent from 1990. In attempting to adjust our operations to stay competitive, the company is currently in the process of closely scrutinizing and reducing costs. Our goal is to improve cash flow by $200 million. Unfortunately, in order to adjust to the present economic situation, we anticipate that substantial layoffs will occur, primarily at our headquarters in Bartlesville. We are also anticipating targeted asset sales as a means of raising needed capital.

With the above as background, let me now turn to how the alternative minimum tax has affected Phillips.

Phillips has found itself in an alternative minimum tax status for four of the five years since the current AMT was enacted. Despite the fact that our domestic operations have had regular taxable and economic losses in recent years, we have still paid about $ 100 million of alternative minimum tax in the past three years, alone. The inability to take advantage of legitimate deductions such as depreciation and intangible drilling costs gives our competitors who are in a regular tax paying status a significant edge. Nor does the AMT allow us to currently utilize legitimate tax incentive enacted by Congress such as the Section 29 and enhanced oil recovery (EOR) credits despite the fact that we have undertaken such projects. In essence, a company must be profitable and in a regular tax paying mode in order to take advantage of such incentives. This situation reminds me of the old saying that one must be able to show that he or she does not need money in order to get a loan.

The "cash drain" from our alternative minimum tax payments has aggravated the Company's difficulties caused by current national economic conditions. The AMT as it is presently applied does, in fact, "kick a company while it is down" and discourages new capital investment. The employee layoffs and asset sales which we are undertaking are certainly related to the impacts which the AMT has on cash flow.

Examples of specific areas of impact to our company are as follow:

First, in order to preserve for the future the benefits of incentive items provided by the Congress, like Section 29 credits, Phillips has delayed deductions available for regular tax purposes and, perversely, increased its AMT liability in the process.

Second, Phillips must make significant capital expenditures at its plants to protect the environment. Over twenty percent of our current budget is dedicated to environmental compliance. These investments do not produce economic return; yet they still produce an AMT burden.

Third, alternative minimum tax has a strong chilling effect on the economics of domestic oil and gas drilling. Phillips' oil and gas investments in the United States, while still significant, have been reduced below where they would have been if the AMT were not a factor. Some sectors of our industry like to say that the major integrated companies have abandoned the United States. Nothing could be further from the truth, particularly in Phillips' case. The withdrawal of much of the OCS, the apparent unlikelihood that Congress will open the Arctic National Wildlife Refuge, the closing of much of the West to onshore oil and gas development and the implementation of burdensome regulatory requirements—all of these factors—have drawn Phillips to the conclusion that the United States has abandoned our industry. When the AMT factor is added to these restraints, the result is a domestic environment which discourages domestic investment and invites exploration elsewhere. The New York Times on January 27, implied that Phillips' strong domestic presence was a handicap. The Times article reported that Phillips had sharply lower earnings in 1991 and that the earnings decline was steeper than those of oil companies with broader international operations.

GENERIC PROBLEMS WITH THE AMT

Phillips is not likely to generate much sympathy from our colleagues in the business community over our experience with the alternative minimum tax. Many other companies have their own negative experiences with the AMT to relate. In fact, contrary to the popular opinion that the AMT only affects a company here and there, its impact is very widespread. By some estimates, as much as sixty percent of the business community is subject to the AMT. There is general agreement that the AMT is affecting over one-half of business, large and small. Furthermore, few industries are exempt. The most severe impact has been on capital intensive industries such as airlines, steel, chemicals, paper, automotives, and energy where large capital investments are required to modernize and remain competitive.

When Congress enacted the AMT in 1986, its overriding objective was to ensure that no taxpayer with substantial economic income should be permitted to avoid significant tax liability by using exclusions, deductions and credits. Taxpayers generally believed that to be inequitable and the AMT was enacted to prevent such situations from occurring. We accept the policy rationale underlying the AMT. But after five years of experience with the alternative minimum tax, I would suggest that its impact reaches far beyond that original policy rationale and is contributing to the current economic woes which the Country finds itself facing. We are now vividly aware of the chilling effects which the AMT can have on investments by capital intensive and cyclical industries. We can also see examples of businesses who have found themselves paying the AMT, despite having made no profits in a given tax year, as the USX Corporation pointed out before this Committee two weeks ago. We can also tell you of other severe, negative effects from the alternative minimum tax which were unforeseen by Congress and the business community and which we believe that Congress did not intend.

A major negative impact which the AMT brings to business is that it effectively repeals investment incentives for companies which are chronically in an AMT position. Capital intensive companies subject to AMT must assume that AMT depreciation rates govern their economics. Therefore, the investments which Congress intended to foster by the regular tax depreciation rates are less likely to occur.

The alternative minimum tax has also resulted in the tax code playing an enhanced role in determining whether a given investment is economic or uneconomic. This is causing investment patterns within industries and from industry to industry to become distorted. In other words, if a given AMT paying company and a regular tax paying company in the same industry are reviewing the same investment, their respective tax paying status may very well be the key determining factor in whether the investment with the same pre-tax economics is deemed attractive after tax. The company in the AMT position would likely find a plant investment, for example, to be uneconomic whereas a non-AMT company could find the same investment desirable.

This anti-competitive feature of the AMT runs counter to fundamental U.S. economic policy. The anti-trust laws, small business statutes and many other provisions were enacted during this century with the goals of fostering—not eliminating—competition. Those statutes seek to protect and provide opportunities for businesses which are relatively less well off than their competitors. In contrast, the AMT effectively reduces competition by making some investments by the large group of companies in AMT positions uneconomic and, therefore, not feasible. This will decrease the number of suppliers who provide goods for the American consumer. As a consequence, the consumer will ultimately suffer the effects of di-

minished competition caused by the AMT through reduced choices and higher prices.

THE AMT AND DOMESTIC FOCUSED ENERGY COMPANIES

The domestic oil and gas exploration and production business particularly gets singled out and penalized under the alternative minimum tax statute. Intangible drilling costs are considered as preferences for purposes of the AMT calculation. IDCs are considered the heart of oil and gas operations when it comes to costs because these include the majority of expenses involved in actually drilling oil and gas wells. Obviously, these costs are very legitimate business expenses and should be allowed to offset AMT liability as is the case for similar costs in other industries. It is a known fact that the inability to deduct IDCs has dampened drilling in this Country. Phillips has had a number of domestic producers tell us that they watch their AMT status carefully and will elect to not undertake additional projects that will throw them into the AMT when they are at the margin of entering AMT liability. This, of course, impacts jobs, additional tax revenues, domestic energy supplies and has many other negative effects on the economy.

Phillips would urge this Committee, however, not to consider limiting AMT relief on IDCs to only one sector of the oil and gas industry. If IDCs are a legitimate expense, which they are, the costs born by a larger company cannot be differentiated from those born by a smaller company. It is often stated that larger integrated companies have other profitable business lines on which to rely. In today's economic climate that is not the case, at least for Phillips. In a recent meeting of the so-called large multi-national oil companies, for example, two-thirds of the eighteen companies present indicated that they pay the AMT and consider it as a priority issue. All sectors of Industry operations are experiencing hardships. A large number of the 300,000 plus jobs which are often cited as being lost in the extraction side of our business have come from our ranks. Unfortunately, that number grows as I speak. There is no difference between an unemployed oil field worker in Texas, a broke independent in New Mexico, a laid off employee of an integrated oil company in Bartlesville, Oklahoma or a marketing representative in any of the other forty-seven states across the Country. They all have mortgages, bills to pay and families to feed. They also all contribute in bringing oil and gas reserves and associated products to the domestic marketplace. To treat one's legitimate business expenses differently from the identical expenses of another is unfair. We would urge that any IDC relief given be given to the industry at large.

A last area of the AMT which I would like to mention, Mr. Chairman, concerns the role which this tax plays at the international competitiveness level. Many of the incentives in the Tax Code are needed in order to make domestic investments competitive with foreign investments. The AMT actually causes these incentives to not be available to many taxpayers, thus, making domestic investments less competitive than those made abroad. The impact of the AMT on the worldwide flow of capital will, of course, vary depending upon the investment and other factors. However, if all other factors are considered equal, the AMT liability can become the determining factor in weakening the competitive position of U.S. investments.

PENDING LEGISLATIVE PROPOSALS

While there are numerous pending proposals which would change the AMT, I would like to address Senate Bill 2159, introduced by Senator Boren, and the AMT proposals introduced as part of President Bush's package as well as an approach to AMT which appears to be emerging from the House Ways and Means Committee.

Senate Bill 2159 would substantially mitigate the adverse effects on taxpayers who have been in a chronic AMT position. The bill would also cap AMT liabilities for taxpayers who have been subject to AMT for three out of the past five years. It would allow a credit of accumulated AMT against up to ninety percent of the current year's AMT. S. 2159 would also eliminate AMT liability for depreciation on assets acquired to meet Congressionally mandated environmental control standards. We like these provisions and believe they would be major improvements.

The AMT credit provision provides AMT relief without discriminating between the various sectors of the business community which are faced with economic hardships. We believe that AMT relief must be broad and not targeted if the intent is to free up extensive capital to help jump start the economy. The Boren proposal also prevents the AMT from becoming so watered down that it fails to serve its original intent; to require profitable taxpayers to pay some tax and not be able to zero out by taking generous advantage of numerous incentives. Under S. 2159, any credits allowed against AMT liability would only apply up to ninety percent of the current year's liability.

President Bush's proposals recognized the dampening effects which the AMT has on the investment outlook in the United States. Relief from AMT depreciation rates and the ACE provisions for future investments is welcome. Those proposals, alone, however, are not bold enough in the context of the cash flow and cost of capital difficulties which the AMT has imposed on cyclical, domestic industries. While we believe the Administration has taken a step in the right direction, we would urge the Committee to consider broader AMT relief such as contained in the Boren proposal.

The House Ways and Means Committee is said to be considering a one percent drop in the corporate AMT rates as part of their package. While, again, this is a step in the right direction it fails to address the many inequities cited by witnesses before this Committee and will provide minimal relief to those suffering under the AMT.

CONCLUSIONS/OBSERVATIONS

The Finance Committee has had a number of witnesses today and over the past few weeks, giving their version of how to address economic recovery. As you have probably already concluded, there is no one magical fix. Having said that I would only reiterate that the factor brought to the table by the alternative minimum tax is a factor that has not had to be dealt with in past debates over tax reform and economic stimulus. Take for example, the investment tax credit, a possible incentive which has significant support and which has had a commendable track record when implemented in the past. This time around, if an ITC is enacted, it will be useless to that large sector of the business community paying the AMT unless the credit can be used to offset AMT liability. In general, if Congress considers any incentives as part of the economic recovery debate, an AMT offset must be included.

It is clear that the AMT deals harshly with companies which have a domestic focus and which are in capital intensive, cyclical industries. The AMT also promotes inequity between these companies compared to those which not in an AMT status. Adjustments are called for. Companies in chronic AMT positions due to worsening economic conditions have paid their dues. They have experienced handicaps to their investment intentions and they have been forced to contribute to the Nation's unemployment figures. Because of the AMT, these companies will be greatly hindered in contributing to the goal of economic recovery.

Five years of experience have taught us that the alternative minimum tax needs fine tuning. We are not calling for repeal. AMT relief certainly fits into the economic recovery debate as a legitimate topic and we urge the Committee to give it due consideration as you tackle the tough task ahead of you.

Again, on behalf of Phillips, I thank the Committee for the invitation to appear here today to offer our thoughts on this most important matter.

COMMUNICATIONS

STATEMENT OF THE AMERICAN GAS ASSOCIATION

I. INTRODUCTION AND SUMMARY

The American Gas Association (A.G.A.) is a national trade association comprising approximately 250 natural gas distribution and transmission companies located throughout the United States. Collectively, 90 percent of the gas consumers in this country are served by A.G.A.'s members. Several A.G.A. member companies are alternative minimum taxpayers and some are leaders in the production of natural gas from nonconventional sources. A.G.A. is pleased to present its views on the effect alternative minimum taxes (AMT) have upon taxpayers utilizing the nonconventional fuels production credit under Section 29 of the Internal Revenue Code (Code) as well as the President's bill to eliminate the depreciation component of "adjusted current earnings" (ACE) for AMT purposes.

While Congress enacted the Section 29 credit to provide an incentive for producers to drill wells from domestic nonconventional sources, many producers have not been able to utilize the credit primarily because of restrictions imposed on carryovers and by the AMT. Many producers incur AMT, as opposed to regular tax, as a result of many factors; *e.g.*, level of earnings, capital investments, depreciation and tax preferences incurred.

A.G.A. urges that legislation be enacted to: (1) allow the Section 29 credit to be credited against AMT; (2) allow taxpayers to carry forward against future year's regular tax any portion of the Section 29 credit that is permanently lost under current law; and, (3) eliminate the depreciation component of ACE for determining AMT. Passage of our recommendations will help producers utilize the Section 29 credit as originally intended by Congress for spurring production and ensuring an adequate supply of natural gas. Such supply will help enable end-users to meet new environmental standards and reduce the nation's reliance on imported oil. In addition, enactment of the President's bill regarding ACE computations will help simplify the AMT calculation and the recordkeeping burden of using more than one depreciation methods. A.G.A. believes its recommendations regarding the Section 29 credit will have a revenue neutral effect since they would allow taxpayers to use the credit as originally intended by Congress.

II. PURPOSE AND HISTORY OF THE SECTION 29 CREDIT

Congress created the credit for the production of fuel from a nonconventional source as part of the "Windfall Profit Tax Act of 1980." The credit was part of the nation's response to the OPEC oil embargo and the gas shortage crises of the 1970's. Congress felt that development of our vast nonconventional gas resources as well as other nonconventional domestic energy sources should be stimulated through a production credit which would reduce dependence on imported oil. The credit was also designed to provide an incentive for domestic oil and gas producers to invest time and capital in the exploration and production of oil and gas from deposits that would be uneconomical to develop without the credit.

The "Omnibus Budget Reconciliation Act of 1990" extended the credit for drilling a well or placing a qualifying facility in service until January 1, 1993, and selling fuel from a qualifying well or facility by January 1, 2003.

III. DESCRIPTION OF THE SECTION 29 CREDIT

The Section 29 credit applies to "qualified fuels" produced from domestic wells drilled before January 1, 1993 and sold before January 1, 2003. Qualified fuels include natural gas produced from geopressurized brine, Devonian shale, coal seams, tight formations or biomass. The amount of the credit is $3 per barrel-of-oil equiva-

lent of qualified fuels produced by the taxpayer and sold to an unrelated person. This amount is adjusted for inflation for all qualified gas except for a tight formation. That is, the current value of the credit is approximately $.52 per MMBTU for tight formation gas and about $.92 per MMBtu for gas from other nonconventional sources.

Gas produced from tight formations is also subject to a special rule. See 29 I.R.C. (c)(2)(B). The credit is available for such gas only if it was dedicated to interstate commerce as of April 20, 1977 or is produced from a well drilled after October 27, 1990. If the special rule is met, the credit is available only for gas produced after December 31, 1990.

The Section 29 credit phases out as the market price of gas increases.[1] For the last several years, general market conditions have been far below the $4.05 to $5.08 per million British Thermal unit (MMBtu) equivalent phase out levels for the Section 29 credit. These conditions are expected to persist into the foreseeable future. The recent wellhead price offered for new gas has fallen so low such that many producers who are subject to the AMT will not have economic margin to develop nonconventional gas sources. Thus, a large amount of our nation's undeveloped reserves will be rendered unavailable to consumer markets.

IV. NEED FOR AMT REFORM AND CARRY-FORWARD RELIEF

The changes made by the "Tax Reform Act of 1986" created a system that exists separately from, but parallel to, the regular tax system. The AMT was designed to ensure that all taxpayers pay some minimum level of tax. Taxpayers usually get into an AMT situation because of: (1) a high level of investment in capital assets (such as drilling equipment) generating depreciation deductions; and (2) low taxable income.

Under present law, AMT is payable, in addition to other tax liabilities, to the extent tentative minimum tax (TMT) exceeds the taxpayer's regular income tax liability. For example, if a taxpayer's TMT for a tax year is $100 while its regular tax is $75, the taxpayer must pay an AMT of $25 and an overall tax of $100. Under the AMT system, regular taxable income is modified by a series of adjustments and tax "preference items," such as accelerated depreciation, percentage depletion and intangible drilling costs (IDCs), to arrive at alternative minimum taxable income (AMTI). AMT is calculated on the basis of AMTI. In addition, depreciation allowances for taxpayers subject to AMT are generally much less favorable than that of taxpayers paying regular income tax.

Many producers of gas from nonconventional sources are presently subject to AMT. This is expected to continue into the foreseeable future. As a result, they are not able to take full advantage of the Section 29 credit because it may not be applied against regular tax liability. The amount of Section 29 credit that may be used in any tax year is *limited* to the taxpayer's regular income tax liability in excess of its TMT. Any Section 29 credit not utilized in a tax year because of TMT limitations may be carried forward and used to the extent regular tax exceeds TMT in future years, which may never occur. Moreover, to the extent the Section 29 credit exceeds the taxpayer's regular income tax liability, such excess may not be carried forward and is permanently lost. For example, if the taxpayer's regular tax liability for 1991 before credits is $300, TMT is $200 and the Section 29 credit generated equals $350, then $100 of the Section 29 credit may be utilized in 1991, since the regular income tax liability exceeds TMT by this amount. Of the remaining $250 of Section 29 credit not currently utilized, $200 may be carried forward indefinitely and $50 is lost permanently. If the taxpayer's regular tax liability was zero, the full $350 of Section 29 credit would be lost permanently. To the extent Section 29 credits have to be carried forward, the net present value of those credits for purposes of determining project economics is reduced. Further, the value of the credit would be reduced by inflation.

Without the full credit, many producers are not able to recover the costs expended to drill and produce a well and to make the project economically feasible. Thus, some producers have sought unsuccessfully to obtain partners who have high taxable incomes and are not in an AMT situation to share the costs of drilling and producing fuel from a nonconventional source. The end result is that the Section 29 credit has not achieved its intended legislative purpose because of the AMT.

A.G.A. urges Congress to provide relief to allow taxpayers to use the Section 29 credit against AMT. This would encourage producers to drill and develop this na-

[1] The credit is designed to phase out as the price per barrel of oil rises above $23.50 and terminates completely at $29.50, adjusted for inflation. On a Btu equivalent basis, these phaseout thresholds equate to $4.05 and $5.08 per MMBtu, respectively.

tion's nonconventional gas reserves as originally intended by Congress. A.G.A. also urges Congress to enact legislation to enable taxpayers to carry-forward any portion of the credit generated, but not used, in a particular tax year so that the benefit cannot be lost.

V. MODIFY ACE DEPRECIATION

A.G.A. supports that part of the President's legislation[2] to simplify the AMT depreciation rules. The Administration's bill would eliminate the separate depreciation component of ACE for corporate AMT purposes for property placed in service on or after February 1, 1992. Presently, ACE depreciation is determined using the straight-line method over the class life of the property. According to the bill, the corporate taxpayer would use the same depreciation method to compute AMTI and ACE. Namely, the 150 percent declining balance method is used for tangible personal property, with a switch to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

The ACE adjustment helps determine the size of AMT. A corporation's AMTI is increased by 75 percent of the amount by which its ACE exceeds AMTI, computed without the adjustments for either the ACE preference or alternative tax net operating losses. If, however, the corporation's ACE is less than its AMTI, then ACE may reduce AMTI by 75 percent of the amount by which AMTI exceeds ACE. In general, the ACE computation includes the AMTI as its base, plus certain adjustments computed in accordance to rules for determining earnings and profits (E&P), including some of the principles for calculating the E&P figure used to determine the taxation of dividend distributions to shareholders.

Since the excess of ACE over AMTI can increase AMT, the size of the ACE adjustment can have a significant effect upon the amount of taxes paid and the cost of capital. The AMT significantly extends the time required to recover the depreciable equipment and increases the after-tax cost of capital of investments. Recent research by Arthur Andersen and Co. shows that U.S. firms paying the AMT recover their investment costs for new equipment much more slowly than companies in major competitive nations.[3]

The AMT also imposes an enormous burden upon the corporate taxpayer in computing taxes. The AMT depreciation computation reflects a complicated set of calculations requiring corporate taxpayers to keep two or three separate sets of depreciation records. For example, the AMT taxpayer may use an accelerated method or straight-line depreciation for regular tax purposes, 150 percent declining balance for determining AMTI, and straight-line for computing ACE. The Administration's bill would enable these taxpayers to eliminate one of these complex and burdensome calculations.

A.G.A. urges Congress to enact legislation to eliminate the separate depreciation calculation for ACE.

VI. BENEFITS OF PERMITTING AMT AND CARRY-FORWARD RELIEF

There are several benefits in enacting legislation that will enable taxpayers to use the Section 29 credit against AMT, to preserve any portion of the credit that otherwise would be permanently lost under current law and to calculate AMTI and ACE using one depreciation method

First, and foremost, producers would be able to use the credit as intended by Congress for domestic production. A.G.A. believes AMT relief and carry-forward reform would have a revenue neutral effect since reform would allow the credit to be used as originally intended.

Second, since nonconventional gas development is often a less attractive investment due to the higher costs and lower well production rates involved, the credit makes the project economically feasible only for those taxpayers who are able to take full advantage of the credit. The wells typically require expensive fracturing techniques and other technology to stimulate production to commercial levels. Further, it can take 30 years or more to deplete the recoverable gas reserve. For example, the initial investment for gas produced from coal seams can run 10 to 20% more than that for a conventional well. This is due to the higher costs of stimulating and

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[2] The President's proposal was introduced in the Senate on February 5, 1992 by Robert Doe (R-KS) as S. 2195, the "Economic Growth Acceleration Act of 1992," and in the House on February 4, 1994 by Reps. Robert Michel (R-IL) and Bill Archer (R-TX) as H.R. 4200, "Economic Growth and Job Creation Act of 1992."

[3] Stephen R. Corrick and Gerald M. Godshaw, "AMT Depreciation: How Bad Is Bad?" ECONOMIC EFFECTS OF THE CORPORATE ALTERNATIVE MINIMUM TAX (ACCF Center for Policy Research, Washington, D.C.), pp. 1–31.

completing multiple seams, additional compression and production equipment and facilities for the disposal of the water produced with this gas. In addition, monthly well operating costs can run 300 to 400 percent more. Nonconventional resources require environmental measures that are extremely costly and are not required with conventional production, such as the facilities to dispose of water from coalbed methane gas.

Beyond that, geological factors increase the effect of price volatility risks to these wells. Hydrostatic pressure, which exists in most coal seam gas wells, eliminates the options" Of temporarily shutting in a well or reducing its gas flow rate in response to changing market conditions. Such options are available to conventional well operators. Similarly, the limited flow rates of tight formation wells make recovery of cash flow disruptions virtually impossible. These and other factors differentiate risks inherent in nonconventional wells as compared to conventional wells.

Third, the credit encourages production from a substantial portion of known, yet untapped domestic energy reserves. Much of the resource base consists of well known, shallower reservoirs found in proximity to existing pipelines. According to a U.S. Department of Energy study, a sizable amount of proven reserves lie in nonconventional sources.[4] In figures taken from the report, nonconventional gas reserves comprise approximately 259 trillion cubic feet (Tcf) or about one-fourth of estimated remaining reserves in the lower 48 states. The gas could be produced for the marketplace, thus benefitting consumers and enhancing industry competitiveness through increased supplies of gas.

Fourth, the credit is also a cost-effective mechanism based on the amount of production actually sold into the market during the initial phase of a well's life. If the well is unsuccessful, no credit is available, and all the risk of drilling stays with the producer. Fifth, the credit is stimulating the development of technology. The development of nonconventional resources includes "learn-as-you-go" technology which would cease to advance if production does not continue because producers are unable to utilize the credit.

Finally, elimination of the depreciation component of ACE will simplify the calculation of AMT and reduce the burden of recordkeeping for different depreciation systems.

VI. CONCLUSION

Many taxpayers are unable to use the Section 29 credit because of current law restrictions. A.G.A. urges Congress to remove barriers that prevent taxpayers from utilizing the Section 29 credit to the extent it exceeds the difference between regular tax liability and TMT. Moreover, the taxpayer should be allowed to carry-forward any portion of the Section 29 credit that is permanently lost under current law. Allowing the credit to be used to stimulate domestic production is consistent with Congressional intent. Allowing corporate taxpayers to use the same depreciation method for computing ACE and AMTI will simplify and reduce the burden of preparing AMT calculations.

STATEMENT OF THE AMERICAN PAPER INSTITUTE

The American Paper Institute, the national trade association of companies that manufacture pulp, paper and paperboard, represents an industry that is extremely capital intensive.

The Alternative Minimum Tax (AMT) has had a particularly significant impact on capital intensive industries such as the paper industry. In fact, in a recent paper industry survey an overwhelming majority of companies indicated that they are currently paying AMT rather than the regular corporate tax rate. This situation has arisen in large part because of the AMT's treatment of accelerated depreciation, which penalizes those companies which have continued to make significant capital investments in new and improved plants and equipment even during the recent period when cash flow and profits have been sharply lowered.

It is precisely because of the long-term pattern of sustained capital investment that the paper industry has been able to maintain a strong competitive position in markets throughout the world. However, the AMT, by reducing the benefit of accelerated depreciation, increases the cost of capital and discourages investment at the same time that these firms are already suffering from a temporary reduction in earnings.

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[4] U.S. Department of Energy, an Assessment of the Natural Gas Resource Base of the United States (May, 1988).

The paper industry supports reform of the Alternative Minimum Tax, and would particularly favor meaningful reform that addresses the treatment of depreciation. The industry is encouraged that President Bush in his State of the Union message and Senator Boren in introducing S. 2159 have recognized that the Alternative Minimum Tax impedes long-term economic growth and needs to be changed. Reform of the AMT would in fact have a positive impact on capital formation and work to enhance the global competitiveness of American industry.

The Alternative Minimum Tax should not act as a deterrent to capital investment, and in today's economy the needs of the nation and its workers can best be served through a modification of the IT which reduces this unwarranted penalty on investment.

STATEMENT OF THE CHEMICAL MANUFACTURERS ASSOCIATION

The Chemical Manufacturers Association ("CMA") applauds the efforts of Senator Boren and the Subcommittee on Taxation in holding this hearing to focus attention on the serious economic problems created by the Corporate Alternative Minimum Tax (AMT). CMA appreciates the opportunity to join you in this important effort by making this statement.

CMA is a nonprofit trade association. The chemical industry now provides almost 1.1 million jobs for American workers and our member companies represent more than 90 percent of the productive capacity for basic industrial chemicals in the United States. Over the past decade the industry's overall employment level has remained constant even though the U.S. chemical industry has changed dramatically to remain competitive in world markets. Today the chemical industry is the leading U.S. exporter with total exports of $43.5 billion in 1991, producing a net trade surplus in that year of $19.5 billion.

Despite this strong export performance, income and profits in the chemical industry are down because of weak sales in the United States during the current recession and because of intense worldwide competition. The chemical industry is highly capital intensive and industry fixed costs—principally depreciation on its equipment—remain high even though income has declined. In addition, the industry must make the new capital expenditures Congressionally mandated environmental standards require. Thus, many CMA member companies are now subject to the AMT precisely when their cash needs are greatest. This problem is being replicated across American industry and is helping to extend the duration of the present recession.

Today's recession is really only a symptom of a much larger problem which is the continuing decline in U.S. international competitiveness. CMA believes the solution to both problems cannot be found in any short-term economic fix, but will only be achieved through broad changes in the governmental policies that balance short and long-term national economic growth.

Of all the specific tax policies needed for sustained long-term national growth, CMA stresses first and foremost that the income tax rates enacted in the 1986 Tax Reform Act must be retained. Real fairness means continuing the present tax rates for everyone. New policies and programs for economic stimulus should not be paid for by increasing income tax rates.

Second, the Subcommittee on Taxation is wisely focusing attention on the alternative minimum tax (AMT). CMA believes that a majority of large corporations—particularly manufacturing and industrial corporations that have large fixed investments in plant and equipment—are now in a minimum tax position. In considering any tax stimulus to the economy, we must recognize that most traditional tax incentives such as the R&E tax credit cannot be used to reduce the AMT burden. Thus, any incentive they might provide would have little current utility for corporations that are paying the AMT.

CMA submits that without fundamental structural change the principal effect of the AMT will be to continue to punish America's basic heavy industries during periods of economic slowdown. These industries will find it increasingly more difficult to compete internationally. CMA commends President Bush for recommending a fundamental change in the structure of the AMT by permanently repealing the ACE depreciation adjustment. It should be noted that the President's proposal provides only limited relief, but it represents a beginning of needed structural reform of the AMT.

The AMT burden is especially painful when depreciation on congressionally mandated and voluntary environmental expenditures that do not produce income act to increase AMT liability. The added AMT liability that our members will incur as they act to meet these new environmental standards is illustrative of the problems now faced by most industrial taxpayers. CMA commends Senator Boren for his in-

troduction of S. 2159 which seeks to eliminate this basic inequity. Sound public policy dictates that taxpayers who must invest in environmental control assets to meet Congressional mandates should not also incur increased tax liability because of those investments.

There are serious misconceptions about why and under what circumstances corporate taxpayers pay the minimum tax. Most misunderstood is the pernicious effect of the AMT in an economic downturn. Congress enacted the AMT in 1986 to assure that firms with substantial economic income could not avoid paying any Federal taxes. In a recession, however, the AMT in fact becomes the "maximum tax" that corporations will pay. Then most American manufacturers must pay the AMT when their cash needs for economic survival are greatest. It is not uncommon in today's economic climate to hear of companies that must borrow cash to pay corporate AMT liabilities. This was clearly not a result Congress intended when it enacted the AMT.

CMA and its member companies wish to work with Congress and the Administration to correct the AMT, not to permit tax avoidance, but to eliminate its discouraging effects on capital investment and the added costs it imposes in meeting Congressionally mandated environmental standards. CMA has several specific suggestions on how to improve the AMT and would welcome the opportunity to assist the Subcommittee and its staff in this critical area.

In summary, CMA commends Senator Boren and the Subcommittee for reviewing the AMT at this critical time. We support the President's initiative for structural revision of the AMT in calling for the prospective repeal of the ACE depreciation adjustment in the AMT calculation. We applaud Senator Boren's efforts in S. 2159 to eliminate AMT liability for depreciation on assets acquired to meet Congressionally mandated environmental control standards. CMA strongly urges, however, that more fundamental structural revision of the AMT is needed if U.S. manufacturing is to be internationally competitive in future years.

We would be happy to discuss our comments and specific recommendations for structural reform of the AMT with the Subcommittee and its staff. To arrange a mutually convenient meeting, please call Robert B. Hill, Associate Director-Taxation, at (202) 887–1128, or Claude Boudrias, Legislative Representative-Trade and Taxation, at (202) 887–1138.

Statement of the Coalbed Methane Association of Alabama

The Coalbed Methane Association of Alabama (CMAA) is an association of coalbed methane well operators, service companies, equipment suppliers, and other companies who participate in the exploration, development, and production of coalbed methane in the state of Alabama. Alabama is recognized nationally and internationally as the seat of technical leadership in the development of coalbed methane. Increasingly, Alabama firms are becoming involved in transferring this technology to many other states and countries.

Methane is the major component of conventional natural gas. Methane produced from coal in Alabama is pipeline-quality gas and is used directly in homes, businesses and industry. Today there are almost 3,000 wells on production in Alabama producing 7 billion cubic feet of natural gas per month. The University of Alabama estimated that at the peak of exploration in Alabama (late 1990) the coalbed methane industry was responsible for almost 13,000 direct and indirect jobs. The industry is recognized as making a major contribution to enlarging the economy of West Alabama during a time when most of the rest of the state and nation were experiencing a shrinking economy. This economic boost will continue after the drilling and development phase as coalbed operators pay state, local and federal taxes in addition to the employment of thousands of our citizens. Capital investments by the industry is estimated at about $2 billion.

Even with the significant advances in methane extraction technologies in the last few years, it is not economically feasible at today's market prices without the benefit of the Nonconventional Fuels Tax Credit under section 29 of the Internal Revenue Code (IRC). Congress created the credit for the production of fuel from a nonconventional source as a part of the Windfall Profit Tax Act of 1980. The credit was designed to provide an incentive for domestic oil and gas producers to invest time and capital in exploration for and production of oil and gas from deposits and formations, the development of which would be otherwise uneconomical.

However, many producers of coalbed methane in the Black Warrior Basin are not able to take full advantage of the section 29 tax credit because of the alternative minimum tax (AMT) provisions of the IRC. Under section 29, the credit could be used to reduce the producer's tax liability to the extent of the excess of its regular

tax over its tentative minimum tax (TMT). TMT is the minimum amount of taxes that must be paid regardless of credits. Any section 29 credits not used in a particular year because of the TMT limitation may be carried forward. However, it cannot be used until regular tax exceeds TMT, which may never occur. Since the cost differential from drilling nonconventional sources must still be recovered to maintain the economics of the well, producers need to be allowed to use section 29 to offset a portion of TMT.

Although abundant gas reserves do exist in the lower 48 United States, this should not preclude the continued development of these reserves for the future. Perhaps as important as developing the resources is developing the technology. Developing nonconventional resources has included "learn as you go" technology which will likely cease to advance if producers are not allowed to use section 29 to offset a portion of TMT.

The Board of Directors of the Coalbed Methane Association of Alabama supports legislation to allow credits generated from section 29 to offset a portion of TMT. Utilizing the section 29 credit in this manner would help operators bring production online to help ensure adequate supplies of natural gas, provide an alternative to imported oil and furnish end-users options for cleaner burning fuels. This would be consistent with Congressional intent.

Statement of E.M. Warburg Pincus & Co., Inc.

We appreciate the opportunity to submit this statement in connection with the hearing on the alternative minimum tax (AMT). This statement is submitted on behalf of E.M. Warburg Pincus & Co., Inc., which is in the business of investment counseling and of managing venture banning funds.

As part of the Subcommittee's examination of the impact the AMT has on business, we want to call your attention to a feature of the individual AMT that inhibits venture capital investments. Specifically, an amendment to the Internal Revenue Code is necessary to correct an inequity in the individual AMT provisions which effectively imposes a tax on gross investment income. This flaw in the AMT hampers the formation of venture capital necessary to finance start-up companies.

In the case of individuals subject to the alternative minimum tax, no deduction is currently allowed, for AMT purposes, for costs of earning investment income, such as investment advisory and management fees. This imposes an unwarranted tax impediment to venture capital investments. The impact is particularly severe in the case of individual partners in venture capital partnerships that invest in the stock of start-up and other small enterprises.

CURRENT DEDUCTIBILITY OF INVESTMENT EXPENSES

Our system of taxation rests on the fundamental principle that it is appropriate to tax an individual's business or investment income net of expenses, rather than to levy a tax on gross income. Thus, section 212 of the Internal Revenue Code provides a deduction for expenses incurred by a taxpayer "for the production or collection of income." These expenses include fees for services of investment counsel, custodial fees, clerical help, office rent and similar expenses paid or incurred by a taxpayer in connection with that taxpayer's investments.

Since the 1986 Tax Reform Act, section 212 investment expenses are allowable in computing taxable income only to the extent that these deductions, along with the taxpayer's other miscellaneous itemized deductions, exceed 2 percent of adjusted gross income. Congress enacted the 2 percent floor as a simplification measure to eliminate burdensome recordkeeping requirements for taxpayers and to reduce the Internal Revenue Service's auditing costs. In addition, Congress was concerned that many miscellaneous itemized deductions were for expenses sufficiently personal in nature that they would have been incurred apart from any business or investment activity. This rationale, of course, does not extend to section 212 expenses such as investment advisory or management fees. Thus, Congress established a floor, rather than eliminate these deductions, so that taxpayers with sufficiently large investment expenses would be able to continue to deduct them, at least in part.

THE ALTERNATIVE MINIMUM TAX

The individual alternative minimum tax was first enacted in 1969 to ensure that high-income individuals paid at least some Under the AMT, no deduction is allowed for any miscellaneous itemized deductions (including section 212 investment expenses). For an individual subject to the minimum tax, this provision imposes a permanent denial of any deduction for expenses that represent costs of earning invest-

ment income. Such individuals may not deduct their investment expenses, even though their investment income is includable in full in gross income.

The legislative history to the AMT provisions suggests that treating miscellaneous itemized deductions as a tax preference was intended to reach those itemized deductions that represented personal expenditures. S. Rep. No. 494, 97th Cong., 2d Sess. 108(1982).

At the same time, Congress recognized that costs of earning income not in the nature of personal expenditures should not be treated as preference items for AMT purposes. Thus, investment interest expense is not treated as an item of tax preference; rather, it is fully deductible for AMT and regular tax purposes to the extent of the taxpayer's net investment income. Further, because Congress recognized that it is inappropriate to deny a deduction altogether for expenses which are costs of producing taxable income, Congress provided an indefinite carryforward for investment interest in excess of investment income.

SECTION 212 EXPENSES SHOULD BE DEDUCTIBLE FOR MINIMUM TAX PURPOSES

The nondeductibility of section 212 investment expenses for minimum tax purposes is inconsistent with the policy underlying the federal income tax laws that an individual should not be taxed on gross investment income. Indeed, the express policy underlying the AMT is that a deduction should be permitted, for both regular tax and AMT purposes, for costs of earning income.

Section 212 investment expenses, unlike the other miscellaneous itemized deductions which often represent personal expenses, are by definition costs of earning income. As such, these costs are not analogous to the kinds of preference items that the AMT is intended to capture. Rather, they are analogous to investment interest, which is deductible to the extent of the taxpayer's investment income for the taxable year for purposes of both the regular tax and the AMT. Parallel treatment should be provided for section 212 investment expenses.

PROPOSED AMENDMENT

In computing the AMT, individuals should be allowed to deduct those investment expenses which are deductible in computing the regular tax (i.e., which exceed the 2 percent floor), to the extent the expenses do not exceed the individual's net investment income.

This proposal would effectuate the fundamental principle that net, and not gross, income should be taxed. By limiting the deduction to section 212 investment expenses in excess of the 2 percent floor (the amount allowable for regular tax purposes), the proposal would not undercut the distinct policies underlying the 2 percent floor. And by limiting the deduction to net investment income, the proposal furthers the policy behind the AMT because it prevents an individual from using section 212 investment expenses to shelter or reduce tax on other, non-investment income.

Correcting this flaw in the minimum tax has received significant Congressional attention. Representatives Raymond McGrath (R–NY) and Ed Jenkins (D–GA) have introduced proposed legislation to this effect in the House of Representatives (H.R. 4001, introduced Nov. 26, 1991). Senator Dale Bumpers has also spoken in support of this provision. In his remarks in connection with the introduction of S. 1932, the Enterprise Capital Formation Act, on November 7, 1991, Senator Bumpers expressly acknowledged the detrimental impact on capital formation of taxing income from venture capital investments on a gross rather than on a net basis, and indicated that a change is needed to the AMT to correct this problem.

The Treasury Department also has recognized the appropriateness of this change. In hearings before the House Ways and Means Subcommittee on Select Revenue Measures on October 26, 1989, Kenneth W. Gideon, then Assistant Secretary of the Treasury for Tax Policy, stated that "[i]t is appropriate, in the context of the AMT, to allow deductions for investment expenses as an offset to the investment income to which such costs relate."

We believe it is time for Congress to correct the inequity created for investors in venture capital funds under the individual AMT by amending the Code to permit an AMT deduction for investment expenses, to the extent they are deductible for regular tax purposes, and limited to the individual's net investment income for the taxable year. This modest change makes sense both as a matter of good tax policy and as a matter of fundamental fairness.

STATEMENT OF THE PUBLIC SECURITIES ASSOCIATION

The Public Securities Association (PSA) welcomes the opportunity to comment on the effects of the alternative minimum tax on the market for tax-exempt municipal bonds. PSA is the international trade organization of banks and securities firms that underwrite and trade municipal securities, U.S. Government and Federal Agency securities, mortgage-related securities and money market instruments. PSA members account for about 95 percent of the nation's municipal securities activity.

BACKGROUND

The alternative minimum tax (AMT) was set in place by the Tax Reform Act of 1986. The purpose of the tax is to ensure that all taxpayers pay a minimum level of income or corporate tax regardless of exemptions, deductions or other tax preferences. Because of its structure, the AMT has greatly decreased demand for municipal bonds, which are issued by states and localities to finance roads, bridges, schools and other important economic infrastructure. PSA objects not to the underlying purpose of the AMT—to ensure that all taxpayers pay a minimum level of federal income tax—but to its means of implementation: the taxation of interest on otherwise tax-exempt municipal bonds.

The AMT applies to tax-exempt interest in two ways. First, all of the interest on tax-exempt private-activity bonds, i.e., bonds issued by states and localities for the benefit of private parties, is subject to both individual and corporate AMTs. As a result, yields on these AMT bonds are currently between 25 and 30 basis points (0.25 to 0.30 percentage points) higher than yields on other, similar bonds. The higher cost to the issuer of AMT bonds does not necessarily correspond with substantial revenue gains to the Federal government. Investors subject to the AMT simply avoid such bonds, and they are instead purchased by investors not exposed to the AMT who enjoy a higher tax-free yield.

In addition to subjecting the interest on private-activity bonds to the AMT, the 1986 Act also subjected a portion of interest on public purpose tax-exempt bonds and on tax-exempt bonds issued on behalf of tax-exempt 501(c)(3) organizations to the corporate AMT. Until 1990, 50 percent of the interest on public purpose and 501(c)(3) bonds was subject to the AMT. Beginning on January 1, 1990, 75 percent of the interest on these bonds is subject to the AMT. Since the corporate AMT is 20 percent, this means that corporations affected by the AMT effectively pay a tax rate of 15 percent on tax-exempt interest on public purpose and 501(c)(3) bonds.

THE AMT AND CORPORATE DEMAND FOR BONDS

The application of the corporate AMT to public purpose bonds, and the increase in the percentage of interest taxed, have had a negative impact on corporate demand for municipal bonds. The AMT has had a particularly strong effect on the one remaining strong corporate source of demand for bonds, property and casualty insurance companies (P&Cs). As a result of the 1990 increase in the percentage of interest taxed under the AMT, P&Cs have begun to shy away from the market. P&C holdings of municipal bonds have shrunk from 14.3 percent of all bonds outstanding in 1987 to 13.0 percent in the third quarter of 1991.

The corporate AMT has also affected remaining commercial bank demand for municipal bonds. As a result of an interest deductibility provision contained in the Tax Reform Act of 1986, commercial banks, once the predominant sector of corporate demand for municipal bonds, have largely divested their municipal holdings. Today, banks confine their purchases of bonds to those issued by small communities that issue $10 million or less per year, known as bank-qualified bonds. However, since the 1990 increase in the corporate AMT for municipal bonds, banks that would otherwise purchase bank-qualified bonds have been driven from the market.

The 1990 corporate AMT provision, combined with the loss of bank investment in tax-exempt bonds, has left the municipal market dangerously dependent on a single source of demand, individual investors, who today own over two-thirds of all outstanding municipal debt. While individuals have demonstrated strong support for municipal bonds over the years, any market so dependent on a single sector of demand remains dangerously sensitive and potentially volatile.

If P&Cs depart from the municipal market entirely as a result of the Tax Code—much the same way commercial banks have done—it could mean that states and localities will have a harder time finding buyers for their securities. Their cost of borrowing would rise, and public investment that is vital to our economy would become more expensive. Fewer investment projects would be undertaken, and the ones that were would cost more.

SUMMARY

By dampening corporate demand for tax-exempt debt, the 1990 increase in the corporate AMT for municipal bonds has increased borrowing costs for many state and local governments. Moreover, when combined with the loss of bank deductibility for municipal bond portfolios, the AMT threatens to hurt the borrowing ability of small communities especially. Currently, 75 percent of the interest on public purpose and 501(c)(3) bonds is subject to the AMT. In order to enhance the desirability of bonds issued by small communities and to retain some diversity in the base of demand for municipal bonds, PSA urges Members of the Subcommittee to restore taxation of municipal bond interest to the pre-1990 level of 50 percent.

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