PROJECTED TAX EXPENSE: CAN IT BE COMPUTED ON THE BACK OF AN ENVELOPE?

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Tags
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BACKGROUND

Before making an investment, a potential investor often asks a tax adviser about the expected U.S. tax on projected profits. This seems like an easy question, but a reliable answer is anything but straightforward when a structure is significantly leveraged, takes into account depreciation determined on the basis of a cost segregation study, and the project generates revenue that may benefit from credits and the domestic production activities deduction. The computation may provide inaccurate results if management simply applies the regular Federal and state tax rates to projected income for financial statement purposes. In such a case, the projection ignores the effect of the alternative minimum tax ("A.M.T."), which may be material. The A.M.T. is a tax that is imposed at a lower rate but on a broader tax base, so that the taxation of corporations will be more in line with their economic income. As a result, projections of tax liability may be grossly underestimated in the absence of a detailed *pro forma* tax return.

The giant U.S. retailer Wal-Mart encountered this type of understatement in Puerto Rico when the local A.M.T. rules were materially changed in 2015. The balance of this article provides a general description of the A.M.T. in the U.S. and the terrible effect the Puerto Rican version had on Wal-Mart in Puerto Rico when the law was changed.

THE ALTERNATIVE MINIMUM TAX

Under Federal tax laws, a corporation must pay the A.M.T. if its "tentative minimum tax" is more than its regular tax. The tentative tax calculation starts with the taxable income and applies significant adjustments. Recognition of income is accelerated, depreciation is slowed by the use of longer cost recovery periods, various items of income that are exempt for the regular tax are added back for A.M.T. purposes, and deductions for items such as dividends received and net operating loss carryovers may be limited. The adjusted taxable income used for the calculation of the tentative liability is increased by a further adjustment based on the corporation's adjusted current earnings. The adjusted current earnings ("A.C.E.") are calculated and 75% of the excess of the A.C.E. over the interim adjusted taxable income is added. After all computations and adjustments are made, a corporation benefits from a $40,000 exemption, and the balance is subject to tax at a flat rate of 20%.

If the tentative tax liability calculated exceeds the regular tax liability, the excess, which is the A.M.T., is added to the regular tax liability. Any A.M.T. reported during a current year may be used as a credit in future years when the regular tax liability is lower than the tentative tax liability. However, the A.M.T. credit can only reduce

regular tax liability to the extent of the tentative tax liability, but any excess A.M.T. credit can be carried forward indefinitely. As can be seen, these computations go far beyond applying statutory tax rates to projected book income.

EXCEPTIONS

Small corporations having average annual gross receipts of less than $5 million for the corporation's first three years are exempt from the A.M.T. Following the first three years, A.M.T. exemption is allowed for corporations having average annual gross receipts for the preceding three-year period that does not exceed $7.5 million. For the first year in existence, all corporations are exempt from the A.M.T. regardless of gross receipts for the year.

IN THE NEWS

Wal-Mart Puerto Rico, Inc. v. Juan C. Zaragoza-Gomez[1] illustrates how a short-form tax projection can be problematic.

The case involved the A.M.T. in effect in Puerto Rico. The Commonwealth of Puerto Rico was in dire financial straits. Its public debt was larger than its gross national product and its annual budget was running a structural deficit in excess of $1 billion.

Against this backdrop, the Puerto Rican legislature amended the A.M.T. in an effort to raise more tax revenue. Like the A.M.T. in the U.S., the Puerto Rican A.M.T. is a tax equal to the amount by which a corporate taxpayer's tentative minimum tax exceeds its regular tax on taxable income. Two A.M.T. computations were made, and the one that produced the greater tax was the one that was used. The first computation adjusted the computation of income, much like the rules in the U.S. The second computation contained two components: an expense tax and a tangible property tax. The expense tax was a 20% tax on services provided to the corporate taxpayer by a related party or home office outside of Puerto Rico. The tangible property tax was a tax on the goods sold or transferred to the corporate taxpayer by a related party or home office outside of Puerto Rico. Prior to the 2015 amendment, the tangible property tax was a 2% flat tax. The 2015 amendment provided new graduated rates for the A.M.T.'s tangible property tax, with a top rate of 6.5% for corporate taxpayers with $2.75 billion or more in gross sales in Puerto Rico.

Initially, the purpose of the expenses and tangible property taxes was to prevent multistate corporations doing business in Puerto Rico from shifting profits off the island by purchasing goods and services from related mainland entities at artificially inflated prices. The concern was that by manipulating prices for transactions between related entities, a multistate taxpayer could shift profits to another jurisdiction with a lower tax rate, thereby artificially deflating its Puerto Rican income tax burden. Reflecting that purpose, the A.M.T. statute initially provided that the tax authorities in Puerto Rico could tax a related-party transaction at a lower rate if the transfer price paid by the taxpayer to the related entity was equal or substantially similar to the price at which the related party sold the property to others. The 2015 A.M.T. amendment eliminated this exemption.

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[1] *Wal-Mart Puerto Rico, Inc. v. Juan C. Zaragoza-Gomez*, 1st Cir., August 24, 2016, Docket Nos. 16-1370 and 16-1406.

Wal-Mart was the only corporation to meet the sales threshold for the top tangible property tax rate of 6.5%. As a result, its Puerto Rican tax increased from close to $20 million in prior years to approximately $46.5 million, of which approximately $32.9 million was attributable to the A.M.T. This amounted to a tax rate of 132% of its total annual income. Ultimately, Wal-Mart obtained an injunction preventing the application of the 2015 amendments and the Court of Appeals for the First Circuit affirmed the lower court.

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CONCLUSION

The rationale for the decision in *Wal-Mart* is not material to this article. What is material is that a projection of expected tax expense by applying statutory income tax rates to simple projections of book income may yield results that materially underestimate actual tax. The interplay of normal tax and A.M.T. requires the preparation of a complete *pro forma* tax return. Of equal importance is the need to revise projections as tax laws are amended throughout the year.

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