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Time To Repeal A Miserable Tax — The AMT

For the second year in a row, the Internal Revenue Service's National Taxpayer Advocate has called for repeal of the Alternative Minimum Tax (AMT) for individuals. The IRS's Taxpayer Advocate deplores the AMT's "complex and burdensome calculations" and warns that "although originally aimed at the very wealthy", the AMT now has "a growing number of middle-income taxpayers" in its sights. (Internal Revenue Service, *National Taxpayer Advocate's Annual Report To Congress, FY 2000*, accessed on the Internet at www.irs.gov.)

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The AMT has been a disaster from day one. It is based on an inaccurate and unreasonable misdefinition of income. It is a complicated, arbitrary, wholly unjustified tax that should never have been enacted. It should have been repealed years ago.

Today, however, repeal of the AMT has taken on even greater urgency as the tax is poised to strike millions of additional taxpayers, mostly with middle-class incomes. The number of individual taxpayers owing the AMT jumped by 38% in 1998 alone (from about 620,000 to about 850,000). The IRS Taxpayer Advocate projects that unless the law is changed, "Over 17 million taxpayers will be subject to the Alternative Minimum Tax by the year 2010. [And by that year] taxpayers with an adjusted gross income of less than $100,000 will owe "60% of the nation's Alternative Minimum Tax..."

Action is also imperative because it appears likely that President Bush and Congress will approve significant regular income tax relief this year. Due to the peculiar nature of the AMT, reducing regular income tax liabilities could throw millions more taxpayers into the AMT unless there is also AMT relief.

A Tax at Odds with Principles. The AMT is a second income tax. In a heads-the-government-wins-and-tails-you-lose game, you must pay either the regular income tax or the AMT, whichever is larger. (The way this appears on tax forms is that you must pay regular income tax, prepare a separate schedule computing the AMT, and if the AMT exceeds regular income tax, tack on that extra amount to the check you send Washington.)

The AMT was originally enacted in 1969 following reports that a few wealthy people were obeying all laws but paying little or no income tax. Mostly absent from the discussion was an examination of why these people owed little income tax. Income, properly measured, is receipts minus the expenses incurred in generating income. In many cases, people with low incomes, properly measured, were falsely categorized as having high incomes by arbitrarily ignoring legitimate income-related expenses recognized by the regular income tax.

In many other cases, people had low explicit federal taxes because they derived much of their

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income from tax-exempt bonds, which are exempt from the regular federal income tax. The exemption is a federal subsidy to states and localities, and it induces private lenders to charge much lower interest rates to state and local government borrowers than otherwise. In effect, lenders pay tax implicitly, through reduced interest rates. If state and local bond interest or any other provision in the regular income tax is deemed to be a problem, the principled approach is to reexamine the regular income tax provision, not to impose a complex parallel income tax with rules different from and at odds with those in the regular income tax.

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The questionable rationale for the AMT is further undercut by changes Congress made to the regular income tax during the 1980s and early 1990s. In aggressively seeking added tax revenues, Congress curtailed or abolished many of the regular income tax provisions (generally investment-related deductions and credits) that critics had most often accused of being loopholes. Some of these were, in fact, legitimate expenses that are now disallowed under both tax systems.

There is also an AMT for corporate taxpayers. It too is badly flawed. Fortunately, it no longer applies to small corporations, thanks to the leadership of former chairman of the House Ways and Means Committee Bill Archer. It, too, should be repealed — a subject for another paper.

These Are Loopholes? Looking at the so-called "adjustments and preferences" which the individual AMT adds back to taxable income exposes its lack of a principled foundation. The AMT entirely disallows personal exemptions, which means that, other things equal, a large family whose regular income tax is reduced by many personal exemptions is more likely to be caught by the AMT than a small family. The AMT also disallows the standard deduction. One of the AMT's biggest additions to income compared to the regular income tax is that the AMT allows no deduction for state and local taxes. Consequently, although the federal tax deduction for income lost to state and local taxes is not usually regarded as a tax loophole, the AMT treats it that way and makes it one of the factors most likely to push people into the AMT. To cite one more example among many, the AMT permits no deduction for the miscellaneous business expenses that the regular income tax recognizes as legitimate costs incurred in the production of income.

The Inflation Tax Is Alive and Well in the AMT. Following rate increases made by the 1990 and 1993 tax acts, the AMT now has two de jure rates: a base rate of 26% and a higher rate of 28%. The AMT also has two hidden rates — 32.5% and 35% — due to the loss of an exempt amount with rising income.

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The ad hoc exempt amount is all that keeps most people from owing the AMT. (With the AMT's base rate almost twice as high as that of the regular income tax, most lower- and middle-income people would owe the AMT if not for the exempt amount.) But the AMT exempt amount is not indexed for inflation, so its real (inflation adjusted) value is steadily shrinking. Also, the income level at which the government begins taking away the exempt amount is not adjusted for inflation. In the regular income tax, by contrast, rate brackets, personal exemptions, and the standard deduction are all indexed for inflation, and many itemized deductions rise with the price level. The combination of the AMT's high base tax rate and the AMT's lack of inflation indexing explains why the number of AMT taxpayers is soaring and why even more taxpayers must go through arduous AMT calculations to be sure they do not owe the tax.

Conclusion. It is time to repeal **A M**iserable **T**ax. Short of repeal, the individual AMT could be eased by raising the exempt amount and indexing it for inflation, increasing the threshold at which the phaseout of the exempt amount begins and indexing the threshold for inflation, lowering the AMT's rates, and removing from AMT taxable income some of the "adjustments and preferences" mentioned above. However, the most principled AMT reform would be to admit that the individual AMT does not belong in the tax code at all and repeal it outright.

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Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.