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A MISERABLE TAX (THE AMT) MAY BECOME WORSE

The individual alternative minimum tax (AMT) is a parallel income tax with complicated rules that differ from those of the regular income tax. To compute the AMT, one calculates the regular income tax and then the AMT. If the AMT exceeds the regular income tax, one must pay the government the difference, on top of the normal income tax.

Many people are unaware of the AMT or assume it does not apply to them. Millions have learned otherwise only when their tax-preparation software or paid preparer told them they owed the AMT, or they received an official notice from the IRS dunning them for extra taxes, along with interest and penalty.

A poorly conceived tax based on envy now hits millions of ordinary taxpayers.

Congress enacted the first version of what became the AMT in 1969, following Congressional testimony by the Treasury Secretary that 155 high-income tax filers had not owed any federal individual income tax in 1967.[1] This disclosure fed into the urban legend that the wealthy pay little income tax. In fact, higher income individuals pay a disproportionately large income tax share. In 2004 (the last year for which tax-share data are available), the top 1% of filers with positive incomes paid 36.9% of total income taxes, the top 50% paid 96.7%, and the bottom 50% paid just 3.3%.[2]

The 155 high-income filers who did not owe the individual income tax in 1967 were not accused of having violated the law but of having claimed deductions, credits, and exemptions that the law specifically permitted. For those troubled because 155 high-income filers (less than 1% of high-income filers that year) did not owe the individual income tax, the proper response would have been to reexamine the tax code's deductions, credits, and exemptions, not to slap on a strange and arbitrary parallel tax.

Although the AMT was advertized as targeting a very small number of very wealthy individuals, it now hits millions of taxpayers, mostly middle class and upper-middle class, because it is not indexed for inflation and its rates have increased over the years. (The key rate hikes occurred in 1990 and 1993.) The normal income tax, in contrast, is partially indexed for inflation and its statutory rates have been reduced on several occasions.

Among its special features, the AMT differs from the normal income tax in that it does not allow filers to claim personal exemptions, the standard deduction, any deduction for state and local taxes, or the miscellaneous expense deduction. (The last applies to certain unreimbursed employee expenses and certain expenses relating to producing and managing income.) In effect, the AMT treats these items as tax loopholes These are controversial changes from normal tax treatment, but they slid through with little debate because, politically, the AMT was created as a soak-the-rich tax and Congress gave little concern to the means used to soak the rich. As a result, some of the primary risk factors today for middle income and upper-middle income tax filers with regard to owing the AMT are having several children, living in high-tax states, and having miscellaneous expenses.

In tax year 2004, the AMT caught 3.1 million tax filers, and 90% percent of them had adjusted gross incomes between $75,000 and $500,000.[3] For filers with positive adjusted gross incomes between $200,000 and $500,000, 65% owed the AMT.[4] Millions of addition filers needed to fill out the complicated AMT form in order to determine that they did not owe the tax. Preliminary data indicates that the AMT snared over 4 million tax filers in tax year 2005.[5]

Since 2001, Congress has enacted a series of temporary patches to prevent the number of AMT taxpayers from skyrocketing even higher. The last temporary patch expired at the end of 2006. If Congress does not act, it is estimated that the number of AMT taxpayers will mushroom to over 23 million this year.[6] For many of these 23 million tax filers, the extra – and unexpected – tax liability will be several thousand dollars.

Because the complicated, arbitrary individual AMT is inconsistent with sound tax principles, it should be repealed.[7] (The corporate AMT is not the subject of this paper, but it too is complicated and unprincipled and should be repealed.) A second best approach would be at least to index the AMT for inflation. A third best approach would be to adopt another temporary patch.

Congress took the right action in 1999 when it passed legislation to repeal the AMT (the Taxpayer Refund and Relief Act of 1999, H.R. 2488, 106th Congress, First Session). Regrettably, President Clinton vetoed that bill.

The government wants your money.

The main barrier to fixing the AMT or even applying another temporary patch is that in the peculiar world of federal government budgeting, a soaring AMT counts as the baseline. In other words, without the knowledge of most Americans, Washington has promised itself huge revenue increases through the AMT, largely because the AMT is not indexed for inflation. In its official budget scoring, Washington claims, in a fiction worthy of George Orwell, that any action to prevent or ameliorate what most people would regard as a massive, inflation-fueled tax increase would actually be a tax cut.

For the last several years, Congress recognized the deceptive nature of official budget scoring, at least in this case, and patched the AMT without seeking revenue offsets. To his credit, Sen. Charles Grassley (R-IA), the ranking member of the Senate Finance Committee, calls for repealing the AMT without using that as an excuse to raise other taxes, "We must repeal the AMT ... without offsetting any revenue the AMT is expected to collect in the future... The AMT was never intended to be a significant source of revenue. Despite this, the AMT will balloon federal revenues to historically high levels if something isn't done."[8]

Congress's Democratic majority, however, is demanding tax increases elsewhere as the price for an AMT fix. They have backed this up by passing a budget resolution that leaves no room for an AMT fix except through offsetting tax increases. President Bush also calls for "revenue neutrality" – large offsetting tax increases – when fixing the AMT. Because the AMT is growing so quickly, even a one-year patch would be very expensive, with a revenue cost of about $50 billion according to official budget scoring.

Some would defend the approach of Congress and the Administration by saying that Congress has very expensive spending plans and needs a lot more money from taxpayers. According to this view, it would be fiscally irresponsible not to let the AMT push up tax collections to historic highs or otherwise increase taxes.

However, a counterargument is that taxes are already at their historic average as a share of national output, and any further revenue increases should be done openly rather than through a hidden tax hike. Many observers would also argue that much government spending is wasteful and that Washington would not need any additional revenue if it used greater care when spending taxpayers'

money. Furthermore, if the AMT or other revenue raisers increase marginal tax rates, they will discourage work effort and saving, which will hurt the economy.

A look at one possible revenue raiser.

One of the proposals being floated is to repeal the AMT and replace it with a 4 percentage point surtax on adjusted gross incomes (AGI) in excess of $100,000 for singles and $200,000 for couples. The proposal was developed by the Tax Policy Center, a joint undertaking of the Urban Institute and Brookings Institution.[9] Although this idea is still in the talking stage, it is worth examining what the economic effects would be if the 4 percentage point surtax were adopted.

First, it should be realized that to a considerable extent the surtax would be the AMT in disguise. The surtax would be pegged to AGI, and AGI is measured before subtracting personal exemptions, the standard deduction, itemized deductions, and tax credits. Hence, like the AMT, the surtax would not allow for personal exemptions, the standard deduction, state and local taxes, or miscellaneous expenses. Indeed, the surtax would go farther than the AMT because it would include more deductions and credits in the tax base than does the AMT, and it would hit *all* tax filers with AGIs above $100,00 for singles and $200,000 for couples, regardless of how much regular income tax they pay. As noted above, if one believes that certain deductions, credits, and exemptions are excessive or unjustified, the principled and transparent approach is to reexamine those features of the tax code and modify them directly, not partially undo them through a stealth tax.

In promoting a strong, growing, efficient economy, the most effective portions of the Bush tax cuts of 2001 - 2003 are the marginal rate cuts: lower statutory tax rates in the various tax brackets, and a lower top tax rate on capital gains and dividends. In particular, the 15% cap on the tax rate on dividends and capital gains reduces the impact of the double taxation of corporate income, and makes possible a larger capital stock. The proposed 4 percentage point surtax would effectively repeal most of the marginal rate reductions for singles with AGIs above $100,000 and couples with AGIs above $200,000.

For affected taxpayers now in the 25% rate bracket, the surtax would raise their marginal rate to 29%, which is actually higher than the 28% rate prior to the Bush tax cuts.[10] Affected taxpayers in the 28% bracket would see their marginal tax rate jump to 32%, which is higher than the pre-Bush 31% bracket. For the 33% bracket, the increase would be to 37%, which is higher than the pre-Bush 36% bracket. For affected taxpayers in the 35% income tax bracket, the marginal rate increase would be to 39%, which is almost as high as the pre-Bush 39.6%. The rate on long-term capital gains, which was reduced from 20% to 15% in 2003, would go back up to 19% for taxpayers subject to the surtax. Only the marginal rate on qualified dividends, which would rise from 15% to 19%, would remain appreciably below what it was pre-Bush (when dividends were taxed at ordinary tax rates). If Congress also allows the Bush rate cuts to expire in 2010, which is a real possibility, taxpayers subject to the surtax will face marginal tax rates 4 percentage points higher than under prior law.

Moreover, because the surtax would be based on AGI instead of taxable income, it would start biting surprisingly far down the income ladder. For a single filer with itemized deductions equal to 20% of AGI, the 4% surtax would begin at a taxable income of $76,600, which is in the regular tax's 25% bracket. For a couple with two children who claim itemized deductions equal to 20% of AGI, it would begin at a taxable income of about $147,000, which is in the regular tax's 28% bracket.

Far from being an add-on levy confined to the super-wealthy, the surtax would also apply to millions of hard-working, middle- and upper-income professionals and small business people. Most of these people have considerable discretion in the hours they work, how much they save, and the forms in which they claim income. Predictable consequences of the surtax are that work effort would decrease

because taxable earnings from work would become less attractive relative to nontaxed leisure, saving and investment would drop because the tax bias against saving and investment and in favor of immediate consumption would become stronger, and tax avoidance and evasion would grow because the payoff from minimizing reported, taxable income would become larger. The economic damage would be especially serious because the millions of people that the surtax would target are among the most productive and economically dynamic people in society, and they perform outsized shares of saving and investment.

Ironically, the surtax or any other revenue raiser that Washington supposedly needs in order to be able to fix the AMT would collect much less revenue than official revenue estimates would predict. Official revenue scoring models intentionally and incorrectly assume tax increases have no ill effects whatsoever on important macroeconomic variables like employment, investment, productivity, output, and growth. By ignoring the negative feedbacks due to steep increases in marginal tax rates, static scoring models consistently overestimate the added revenues that can be expected from tax changes that boost marginal tax rates.

For example, the authors of the Tax Reform Act of 1986 expected a large gain in revenue when they raised the top tax rate on long-term capital gains from 20% to 28%. Instead, the stock market crashed in 1987, and capital gains realizations plummeted: from 1987 to 1996, realizations as a share of GDP were below what they had been in 1985, the year before the tax hike.[11] The 1986 tax rate increase on capital gains definitely collected less revenue than the government's static revenue estimates had predicted, and probably lost money. This result should not have been a surprise. Treasury studies done in the mid-1980s indicated that the reduction in the capital gains rate from 28% to 20% in the Economic Recovery Tax Act of 1981 had increased revenues, at least in the near term, just by spurring realizations (as had the previous reduction from 35% to 28% after the Stieger Amendment of 1978).[12] Additional revenue gains from a higher stock market and from additional investment, and higher productivity and wages, would have added even more to the total, but were not considered in the studies. They do occur in the real world.

The revenue maximizing capital gains tax rate is almost certainly below 20%. Following the enactment of the 15% cap on the tax rates for long-term capital gains and qualified dividends, capital gains realizations have been strong, and many firms have either increased their dividend payouts or begun paying dividends. Consequently, there has been a surge in taxes from non-withheld sources, including capital gains and dividends. It is likely that the 15% tax caps have cost the Treasury very little, and may have raised revenue once the economic effects from reducing the double taxation of corporate income and spurring capital formation are factored in.

Reversing these rate reductions – such as by enacting a 4 percentage point surtax – would at least partially undo the positive behavior changes, and would raise little revenue. It might do sufficient economic damage to result in a revenue loss. The surtax might not have quite so dramatic an effect on other types of income, but is would surely collect less revenue than the estimators predict. Certainly, if the economic harm to the public from the rate increases is taken into account, and not just the change in revenue for the Federal Government, a rate increase is a clear loser for the country.

The best that can be said for the 4 percentage point surtax or some other large tax increase is that it does not look quite so bad if it is assumed to be the only alternative to the out-of-control AMT. Happily, though, the United States need not limit itself to a choice among these bad policies. A better option would be to repeal the AMT and not replace it with another damaging tax increase.

Leonard Burman and Gregory Leiserson, of the Tax Policy Center, do correctly note that the 4 percentage point surtax would be simpler than the complex AMT. They write, "The proposed add-on tax would be extremely simple: subtract the threshold ($100,000 or $200,000) from AGI and multiply the

difference (if any) by 4 percent. Add that to income tax."[13] The surtax attains its simplicity, however, by being even more guilty than the AMT of using an overly broad tax base that summarily disallows many of the adjustments to income and tax found in the normal income tax. While economists are often critical of some adjustments in the regular income tax, such as the mortgage interest deduction, others have greater merit, such as personal exemptions, the charitable deduction, and the distinction between capital gains and ordinary income. The surtax would toss out all of them. A better way to simplify the tax system would be to eliminate the AMT and not replace it with an add-on surtax or some other revenue raiser.

Another argument on behalf of the surtax is that it would supposedly be equitable because it would increase the income tax burden on individuals with above average incomes. Given that the income tax is already very progressive, however, it is debatable whether greater progressivity would make the income tax more fair or less fair. In addition, the history of the AMT offers the caution that a tax initially billed as applying only to the rich may quickly extend its reach far down into the middle class.

A more subtle point is that when a tax on upper-income individuals causes them to work and save less, part of the tax burden is shifted to the rest of the population, including lower-income individuals. As high-productivity, upper-income people cut the time and intensity of their work effort due to a higher tax rate on their labor effort, they employ fewer people to work with them, and their reduced presence in the workplace lowers the productivity and incomes of other workers. As upper-income individuals save and invest less due to a higher tax rate on their capital income (the higher tax rate can be at the corporate level, the shareholder level, or on income from non-corporate businesses), capital formation drops, which reduces the amounts of plant, equipment, buildings, and other structures. The smaller capital stock decreases the productivity of labor, thereby reducing jobs and wages. Because of these tax-induced effects, middle- and lower-income workers indirectly bear a significant part of the burden of the taxes on higher-income individuals. Middle- and lower-income also suffer from a lower stock market if they own shares directly or through pension funds. Middle- and lower-income additionally bear some of the tax as consumers, because output is reduced, and consumers of all income levels must make do with fewer, higher-priced goods and services.[14]

Conclusion.

The individual AMT is arbitrary, complicated, distorts people's economic behavior, and is unfair to the millions of taxpayers who follow the rules in paying the regular income tax and are then hit by the AMT on top of that. Unfortunately, the unprincipled AMT, which is not indexed for inflation, is rapidly growing. Many people in Washington look forward to the deluge of money it is slated to take from taxpayers and send to the federal government. Much of the talk in Washington this year about slowing the AMT's rate of growth or enacting a permanent solution is to only take action if some large, alternative tax increase can be found. A better policy would be to admit that the AMT has been a mistake from day one, and that the mistake is made worse by the AMT's growing reach. On grounds of tax efficiency, simplicity, and fairness, the AMT should be repealed immediately and not replaced with some other, massive tax hike.

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Endnotes

1. For a more in-depth discussion and analysis of the AMT, see Kurt Schuler, "The Alternative Minimum Tax For Individuals: A Growing Burden," Joint Economic Committee, U.S. Congress, May 2001, accessed at http://www.house.gov/jec/tax/amt.pdf. For a recent and concise overview, see Chris Edwards, "The Alternative Minimum

Tax: Repeal Not Reform," *Tax & Budget Bulletin*, No. 45, Cato Institute, May 2007, accessed at http://www.cato.org/pubs/tbb/tbb_0507_45.pdf.

2. Kyle Mudry and Justin Bryan, U.S. Internal Revenue Service, "Individual Income Tax Rates and Shares, 2004" *SOI Bulletin*, Winter 2006-2007, pp. 21-60, accessed at http://www.irs.gov/pub/irs-soi/04inrate.pdf.

3. Michael Parisi and Scott Hollenbeck, U.S. Internal Revenue Service, "Individual Income Tax Returns, 2004," *SOI Bulletin*, Fall 2006, pp. 8-46, accessed at http://www.irs.gov/pub/irs-soi/04indtr.pdf.

4. *Ibid.*

5. Internal Revenue Service, "Individual Income Tax Returns, Preliminary Data, 2005" *SOI Bulletin*, Winter 2006-2007, accessed at http://www.irs.gov/pub/irs-soi/05inplim.pdf.

6. Leonard E. Burman, William G. Gale, Gregory Leiserson, and Jeffrey Rohaly, "Options to Fix the AMT," Tax Policy Center, Urban Institute and Brookings Institution, January 19, 2007, accessed at http://www.urban.org/UploadedPDF/411408_fix_AMT.pdf.

7. Anticipating the AMT's exploding reach and its conflict with basic tax principles, an earlier IRET paper, issued in 2001, had also recommended AMT repeal. See Michael Schuyler, "Time To Repeal A Miserable Tax – The AMT," *IRET Congressional Advisory*, No. 111, February 21, 2001, available at ftp://ftp.iret.org/pub/ADVS-111.PDF.

8. Charles Grassley, "Floor Statement of U.S. Senator Chuck Grassley of Iowa, Ranking Member of the Committee on Finance; The Alternative Minimum Tax, Part 3," February 15, 2007, accessed at http://www.senate.gov/~finance/press/Gpress/2007/prg021507.pdf.

9. Len Burman and Greg Leiserson, "A Simple, Progressive Replacement for the AMT," Tax Policy Center, Urban Institute and Brookings Institution, May 23, 2007, accessed at http://www.urban.org/UploadedPDF/411472_amt_replacement.pdf. Also see Heather M. Rothman, "AMT-Fix Proposals Abound, But No Sign Of Unity In Congress," *Daily Tax Report*, May 23, 2007, pp. G-5/G-6.

10. For expositional simplicity, the numbers here do not include phase-outs in the tax code of various deductions, exemptions, and credits with rising income. These phase-outs push up many individuals' true marginal tax rates, often by a lot, and make tax computations even more complicated than they would be otherwise.

11. See U.S. Treasury, "Capital Gains and Taxes Paid on Capital Gains for Returns with Positive Net Capital Gains,1954-2004," February 9,2007, accessed at http://www.treas.gov/offices/tax-policy/library/capgain2-2006.pdf.

12. See the following Treasury Department studies: the panel study in "Report to Congress on the Capital Gains Tax Reduction of 1978", Office of Tax Analysis, September, 1985; Michael R. Darby, Robert Gillingham, and John S. Greenlees, "The Direct Revenue Effects of Capital Gains Taxation: A Reconsideration of the Time Series Evidence", Research Paper 8801, Office of the Assistant Secretary for Economic Policy, May 24, 1988; Gillingham, Greenlees, and Kimberly D. Zieschang, "New Estimates of Capital Gains Realization Behavior: Evidence from Pooled Cross-Section Data", OTA Paper 66, May 1989, and Gerald E. Auten, Leonard E. Burman, and William C. Randolph, "Estimation and Interpretation of Capital Gains Realization Behavior: Evidence from Panel Data", OTA Paper 67, May 1989, both from the Assistant Secretary for Tax Policy, Office of Tax Analysis; Gillingham and Greenlees, "Evaluating Recent Evidence on Capital Gains Realization Behavior", August 4, 1989; and "The Effect of Marginal Tax Rates on Capital Gains Revenue, Another Look at the Evidence", Research Paper 9003, Dec. 1, 1990, both from the Office of Economic Policy. Also see Gillingham, Greenlees, and Zieschang, "An Econometric Model of Capital Gains Realization Behavior", presented at the 65th Annual Conference of the Western Economic Association, July 1, 1990.

13. Burman and Leiserson, *op. cit.*

14. For a fuller discussion of how a tax on one group often hurts other groups also, see Stephen J. Entin, "Tax Incidence, Tax Burden, And Tax Shifting: Who Really Pays The Tax?" *IRET Policy Bulletin*, No. 88, September 10, 2004, available at ftp://ftp.iret.org/pub/BLTN-88.PDF.

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.