IRET *Congressional Advisory*

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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HOUSE TO VOTE ON AMT PATCH

The House of Representatives is about to act on an Alternative Minimum Tax (AMT) patch for 2007 (H.R. 3996 - Temporary Tax Relief Act on 2007). It would prevent 21 million additional taxpayers from falling under the AMT. The House would replace the additional revenue that is forecast to come from the rising AMT burden by enacting several "offsets" (tax hikes). The Senate will have to consider the issue after the House acts. The Senate appears to be less inclined to require offsets. Reaching an agreement between the two chambers may take until December. The tax forms for 2008 will have to be printed with instructions that follow old law, and will have to be revised once the compromise becomes law. This could lead to considerable confusion in the filing of 2007 tax returns.

The House bill

The House bill would raise the AMT exempt amount for a couple filing jointly to $66,250 for 2007 (from $62,550 in 2006 - an inflation adjustment from last year's "patched" level). If no action were taken, the exempt amount would revert to the permanent, unindexed level of $45,000, set in 1993 when the AMT underwent a major expansion. (Corresponding figures for a single filer are $44,350 for 2007, up from $42,500 in 2006 and a base amount of $33,750.) Reversion to the permanent levels would entrap about 21 million additional taxpayers in the AMT, costing them an average of about $2,000 in higher tax.

The bill would also extend a number of expiring business, education, and charity-related tax provisions (labeled "extenders"). Some of these (such as the R&E credit) have been part of the tax code on a "temporary" basis for years if not decades. Minor provisions assisting some of the homeowners caught up in the subprime credit mess are also included.

House Pay-Go rules require offsetting tax hikes.

The House is expected to propose several tax increases to offset the revenue loss from the 2007 AMT patch and the extenders. The object is to conform the bill to the so-called "Pay-Go" rule that the House has adopted. Under Pay-Go, any change in tax law that results in a projected loss of revenue from current-law "baseline" forecasts must be offset by a rise in other taxes or a cut in entitlement spending.

Preventing one tax increase by enacting another is no favor to the taxpayers.

A true tax baseline would consist of tax revenues that remain roughly stable over time as a share of national income. The tax structure, rates, and rules should not drift in reaction to inflation or other trends in the economic or social environment.

Unfortunately, current law contains features that will generate automatic tax increases on a rising number of taxpayers over time, and will command a rising share of national income without any further votes by the Congress. These stealth tax rate increases may please Congress, but they will harm taxpayers and damage the economy. Current law is not an honest baseline. Preventing those stealth tax increases should not be regarded as a tax reduction, and should not require an offsetting tax increase.

Allowing long-time deductions and credits to expire must be felt as a tax increase by those affected. In addition, the AMT will impose tax increases year after year as far as the eye can see, about $850 billion over ten years. Again, these are tax increases, and are not needed to keep revenues or sustain spending at their current levels as a percent of GDP.

The AMT disallows a number of exemptions and deductions found in the regular income tax, replacing them with a fixed exempt amount, and with a different rate structure of two brackets with rates of 26% and 28%. The exempt amount was not indexed to inflation when it was first introduced. In addition, the exempt amount is phased out with rising income, and the income threshold at which the phase-out begins is not indexed for inflation either. During the phase-out, which occurs at a rate of $0.25 per dollar of additional income, the effective tax rates become 32.5% and 35%, and the effective tax rates on capital gains and dividends, now normally 15%, become effective rates of 21.5% and 22%.

Over time, many more taxpayers have run afoul of the AMT, and with increasing tax consequences from doing so, due to increases in income and increases in such AMT-disallowed items as the personal exemptions (which rise with inflation), property taxes, and state and local income taxes. (Under the ordinary income tax, the personal exemptions, standard deductions, and tax brackets are indexed for inflation. Even with the inflation adjustments, the progressive tax rate schedule of the ordinary income tax will collect a rising share of income over time as real incomes grow, but not as much as with the unindexed AMT.)

Trading one year of tax relief for a permanent tax increase.

The major revenue raising offsets in the bill are permanent tax increases. Their ten year revenue take would offset the one-year AMT fix, and cover the effects of the one-year extension of expiring provisions (some of whose revenue losses spill over into later years). When another AMT patch is needed next year, what additional permanent tax increase will be proposed? This process is a hidden way of ratcheting up the tax burden.

Three main revenue raisers proposed in the bill relate to international income flows or the treatment of hedge funds. They could reduce competitiveness of American firms operating abroad, or raise taxes on saving and capital formation. We should not rush into them. A fourth revenue source is a ludicrous example of budget gimmickry. These are:

• Elimination of deferral of compensation for services performed by foreign firms in non-treaty jurisdictions. This may be the first shot in an ill-considered general assault on deferral of foreign source income.

• Taxing income of partners for investment management services as ordinary income, instead of capital gains, even when that income is invested in the partnership ventures. This may be the "pure" income tax treatment, but there is concern that it may lead to reduced incentives for taking risk in a variety of markets. Note that in an ideal, unbiased saving-consumption neutral tax system, such investment by the partners would be treated as tax-deferred saving (akin to pension or IRA treatment), reducing the effective tax rate. Capital gains treatment could be viewed as a crude approximation of that treatment.

• Postponing worldwide allocation of interest expense (enacted in 2004, effective for tax years after 2008) until 2017. This would defer a very legitimate reform of the foreign tax credit limitation for multinational firms. U.S. firms would be penalized for operating globally, making them less competitive and costing the U.S. significant exports.

• A brazen gimmick of forcing companies to shift much of their estimated tax payment for the fourth quarter of 2012 to the third quarter (to move it from the 2013 to the 2012 federal fiscal year) to meet the remaining Pay-Go gap. Why not just admit that Pay-Go is an inappropriate constraint in the case of the AMT and extenders situation, and waive it entirely?

What should be done?

- Make the expiring provisions permanent.

- Eliminate the AMT, or at least make the current exempt amount the new base and index it permanently for inflation.

- Do not offset the so-called revenue losses with other tax increases; these offsets are not needed to maintain current levels of spending.

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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.