IRET Congressional Advisory

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TIME TO REPEAL THE AMT

Representative Bill Archer, the new Chairman of the House Ways and Means Committee, has added an important tax reform provision to H.R. 1215, the "Contract With America Tax Relief Act of 1995". The Archer proposal would immediately scale back the "alternative minimum tax" (AMT) imposed by current law on certain individuals and businesses, and repeal the AMT entirely for businesses in 2001. Scaling back and eliminating the AMT is a step in the correct direction because the AMT is complicated, inconsistent with regular tax policies, harmful to economic growth, and unfair.

> ***The AMTs violate the rules laid out in the regular tax system, which puts many taxpayers in a heads-they-lose, tails-the-government-wins position.***

Under the ordinary income tax, individuals and corporations calculate their gross income and next subtract specified exemptions and deductions to determine net taxable income. They then compute their tax and deduct allowable tax credits. The AMT is an entirely separate tax calculation, under which taxpayers must omit many of the normal exemptions, deductions, and credits, and calculate a second tax liability on an expanded version of taxable income under a lower tax rate. They must then pay whichever tax bill is greater.

The exemptions, deductions, and credits related to business activity under the ordinary income tax consist overwhelmingly of legitimate adjustments to income, or to the tax on income. These adjustments are made to reflect (sometimes inadequately) the cost of producing goods and services for sale or other costs of earning income, because, until a taxpayer's revenues exceed his or her costs, no real income or profit can be said to exist, and no income tax should be due.

The AMT's broader tax base almost always exceeds the real incomes of the affected individuals and businesses, and, even at lower AMT tax rates, may result in higher effective tax rates on the real earnings of the taxpayers involved than does the ordinary income tax. Consequently, the AMT discourages economic activity and retards economic growth.

Rep. Archer's plan would remove from the corporate and individual AMT bases many items that are not included in the regular tax base, thereby reducing the tax liabilities of many firms and individuals now in the alternative tax system and returning many others to the regular tax system. Further, Rep. Archer's plan would repeal the corporate AMT in 2001. Congress's Joint Committee on Taxation estimates the 1995-2000 revenue cost at $16.6 billion. Of course, that is a static estimate. In the real world, the cost would probably be much lower because a reduced AMT would be less of a hindrance to economic growth.

The individual AMT originated in the 1960s after it was publicized that some individuals with high "incomes" paid little or no tax. What was seldom reported is why these people paid little tax.

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Many had low taxable incomes after subtracting legitimate deductions reflecting real business costs. Thus, the problem was not that these people paid too little tax but that the reports exaggerated their taxable incomes and, therefore, what they should have paid in tax by ignoring their legitimate tax deductions and, therefore, looking at their gross incomes instead of their net incomes. The AMT removes these so-called "loopholes" by arbitrarily restricting various deductions and credits and making other adjustments, effectively imposing taxes on gross rather than net earnings.

A corporate AMT was added in 1986. Many corporations, particularly in manufacturing, now find themselves in the AMT system on a virtually permanent basis. Year after year, they must pay the corporate AMT instead of the regular corporate income tax. For these companies, the AMT makes irrelevant many of the standard provisions of the tax code.

The corporate AMT, which Rep. Archer seeks to abolish, mainly affects companies that are investing heavily or are encountering financial difficulties. Companies with large capital expenditures often have low taxable incomes and, therefore, low ordinary income tax liabilities because their deductions are high. They are apt to run afoul of the corporate AMT because that alternative system requires much slower write offs of capital expenditures. Companies that are doing poorly usually have low ordinary income tax liabilities because their revenues are weak relative to their expenses. The corporate AMT's many limitations and adjustments tends to make them look artificially healthy, thereby subjecting them to the corporate AMT. To a large extent, then, the corporate AMT is a penalty tax on companies that are increasing future productivity and employment or are experiencing low earnings and even losses. The AMT's effective targeting of growing or weak companies for punitive taxation is a stunning example of perverse tax policy.

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Perhaps the most obvious burden the AMT inflicts on individual and corporate taxpayers is increased administrative costs. It forces many taxpayers, especially corporations and higher-income individuals, to prepare an additional set of tax calculations under different rules, often just to verify that the AMT is no larger than their regular tax. The regular tax is already too complicated, and the AMT compounds the damage.

Further, the AMT is unprincipled in that it contradicts rules laid out elsewhere in the tax code. If the rules of the regular tax system are correct, the AMT should not override those rules. Conversely, if the AMT's rules are correct, the regular tax system's rules should be changed. The combination of two inconsistent sets of rules, with taxpayers forced to obey whichever hands the government more taxes, loads the dice in the government's favor.

From the perspective of sound tax policy, both the regular tax base and the AMT base leave much to be desired, but the AMT base is worse. For instance, the regular tax often requires producers to write off current investment costs over a multi-year period, and the AMT substitutes still longer write-off periods. In contrast, an economically correct tax treatment of investments is to allow producers to write off, or expense, investment costs in the year they incur those costs.

The individual and corporate AMTs should both be repealed immediately. Their complexity increases taxpayers' compliance costs. The AMTs violate the rules laid out in the regular tax system, which puts many taxpayers in a heads-they-lose, tails-the-government-wins position. The corporate

AMT penalizes many companies attempting to lift productivity through vigorous investment and adds to the woes of many other companies suffering business reverses.

Rep. Archer's proposal to scale back the corporate and individual AMTs next year and to abolish the corporate AMT several years later moves very much in the correct direction. If any objection is raised, it ought to be that the plan does not go far enough, fast enough.

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Note: Nothing written 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 Congress.