

**BLOWING THE COVER ON THE STEALTH TAX:  
EXPOSING THE INDIVIDUAL AMT**

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**HEARING**  
BEFORE THE  
SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT  
OF THE  
COMMITTEE ON FINANCE  
UNITED STATES SENATE  
ONE HUNDRED NINTH CONGRESS  
FIRST SESSION

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MAY 23, 2005  
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# CONTENTS

## OPENING STATEMENTS

	Page
Kyl, Hon. Jon, a U.S. Senator from Arizona, chairman, Subcommittee on Taxation and IRS Oversight, Committee on Finance .....	1
Jeffords, Hon. James M., a U.S. Senator from Vermont .....	3
Baucus, Hon. Max, a U.S. Senator from Montana .....	14

## WITNESSES

Carroll, Robert J., Deputy Assistant Secretary for Tax Analysis, U.S. Department of the Treasury, Washington, DC .....	3
Holtz-Eakin, Dr. Douglas, Director, Congressional Budget Office, Washington, DC .....	5
Olson, Nina E., National Taxpayer Advocate, Taxpayer Advocate Service, Washington, DC .....	7
Hassett, Dr. Kevin A., director of economic policy studies, American Enterprise Institute, Washington, DC .....	15
Markman, Carol C., CPA, president, National Conference of CPA Practitioners; and partner at Feldman, Meinberg and Company, LLP, Jericho, NY .....	17
Burman, Dr. Leonard E., senior fellow and co-director, Urban-Brookings Tax Policy Center, The Urban Institute, Washington, DC .....	18

## ALPHABETICAL LISTING AND APPENDIX MATERIAL

Baucus, Hon. Max: Opening statement .....	14
Burman, Dr. Leonard E.: Testimony .....	18
Prepared statement .....	21
Responses to questions from committee members .....	45
Carroll, Robert J.: Testimony .....	3
Prepared statement .....	50
Responses to questions from committee members .....	57
Grassley, Hon. Charles E.: Prepared statement .....	59
Hassett, Dr. Kevin A.: Testimony .....	15
Prepared statement .....	60
Responses to questions from committee members .....	73
Holtz-Eakin, Dr. Douglas: Testimony .....	5
Prepared statement .....	76
Responses to questions from committee members .....	87
Jeffords, Hon. James M.: Opening statement .....	3
Kyl, Hon. Jon: Opening statement .....	1
Prepared statement .....	90
Markman, Carol C.: Testimony .....	17
Prepared statement .....	92
Responses to questions from committee members .....	97

IV

	Page
Olson, Nina E.:	
Testimony .....	7
Prepared statement .....	98
Responses to questions from committee members .....	109
COMMUNICATIONS	
Capitol Tax Partners .....	115

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**MONDAY, MAY 23, 2005**

U.S. SENATE,  
SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT,  
COMMITTEE ON FINANCE,  
*Washington, DC.*

The hearing was convened, pursuant to notice, at 12:30 p.m., in room SD-628, Dirksen Senate Office Building, Hon. Jon Kyl (chairman of the subcommittee) presiding.

Also present: Senators Thomas, Crapo, Baucus, Jeffords, and Wyden.

**OPENING STATEMENT OF HON. JON KYL, A U.S. SENATOR  
FROM ARIZONA, CHAIRMAN, SUBCOMMITTEE ON TAXATION  
AND IRS OVERSIGHT**

Senator KYL. Good afternoon. This hearing of the Committee on Finance, Subcommittee on Taxation and IRS Oversight, will begin.

I am expecting that Senator Jeffords will be here momentarily, but we may be on a very tight time schedule today, and as a result we want to move along as quickly as possible.

I will have an announcement to make in about 45 minutes or so, but it is possible that there will be an effort to close this hearing after 1 hour. So what I am going to do is to ask all of the witnesses if they could try to stick with the 5-minute timeframe that we have for oral testimony.

I know you have submitted testimony for the record, which we will, of course, accept, and we will try to get through both of the panels here, at least during the formal part of our discussion.

I will be exceedingly brief with some opening remarks. And Senator Jeffords, now that you are here, I will feel free to proceed with that.

Let me just say, Senator Grassley is intending to be here as well a little bit later.

I think we all know that one of the President's top priorities is tax reform, an effort that he began earlier this year when he reported a special panel, led by two former members of the Finance Committee.

It is widely anticipated that, in its July 31st report to the Treasury Secretary, in addition to other proposals, this panel will make recommendations on how to address the Alternative Minimum Tax, or AMT.

With that July 31st deadline fast approaching, our committee now begins laying the groundwork for tax reform in the Senate by holding today's hearing on the Individual AMT.

Our goal for tax reform and simplification, in my view, must be to create a tax system that supports continued economic growth and prosperity by encouraging work, savings, and investment, and that does not waste taxpayers' time and effort with needless complexity.

To achieve these goals, Congress must make the individual rates, the dividend and capital gains rates, and repeal of the estate tax permanent, and we must repeal the AMT.

Now, the problem with the AMT is, in my view, that it was misguided from the beginning as an attempt to tax the rich, to make sure that very wealthy taxpayers could not zero out their tax liability by claiming otherwise legitimate deductions and exemptions.

But, as frequently happens, what was originally aimed at the rich quickly began to affect everyone else. As a result, according to one report, by the end of the decade, the AMT will reach 35 million taxpayers, the majority of whom will have incomes below \$100,000.\* Clearly, this is something we have to deal with.

Now, the primary reason the AMT has begun invading the middle class is because its parameters—namely, the exemptions, rate brackets, and phase-out levels—were not indexed for inflation.

But I do not think we should fool ourselves into thinking that we can adjust the AMT in that way, and therefore solve the problem. As I said, its real fundamental fallacy is that it attempts to impose a special tax only on the wealthy, which inevitably ends up discouraging work and hurting economic growth.

So the hearing today is not intended to resolve the debate about whether to reform AMT or repeal it, whether to offset the cost of reform or repeal the tax increases or spending cuts, or whether the costs need not be offset at all, but rather is to begin the process of educating Senators and the public about the mind-boggling complexity of the AMT and about how the AMT amounts to a stealth tax that traps many unsuspecting taxpayers.

Today we are going to learn the exact nature of the problem, including the numbers and types of taxpayers who most often fall into the AMT.

We will learn what taxpayer situations most often trigger the AMT, including the extent to which it imposes a marriage penalty and hits families with children particularly hard.

We will hear how the AMT affects otherwise similarly situated taxpayers who just happen to live in different States very differently, and how much it might cost the Treasury in static terms to reform or repeal the AMT.

But, most important, we will learn how costly the AMT is currently to the economy in terms of taking productive resources out of the private sector, in terms of reducing incentives to work and save, and in terms of administrative complexity imposed on taxpayers as a result of the AMT.

Senator Jeffords?

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\*For more information on this subject, *see also*, "Present Law and Background Relating to the Individual Alternative Minimum Tax," Joint Committee on Taxation staff report, May 20, 2005 (JCX-37-05).

**OPENING STATEMENT OF HON. JAMES M. JEFFORDS,  
A U.S. SENATOR FROM VERMONT**

Senator JEFFORDS. Mr. Chairman, I want to commend you for having this hearing today, and I want to thank today's witnesses for giving us their time and expertise.

It looks like our time will be limited, so I will keep my remarks brief.

Almost 40 years ago, a handful of wealthy taxpayers escaped paying taxes, and the minimum tax was born. It has grown like the weeds since then, today snaring some 3 million taxpayers, with another 30 million filers trapped in the next few years if we do not act. We need to confront the problems created by the AMT directly rather than applying a succession of Band-Aids.

The problems are many. Millions and millions of Americans are wasting time and money in calculating a second tax liability. These people have not engaged in exotic schemes to lessen their tax burden.

No wonder, then, there is a tremendous frustration from ordinary taxpayers who find that they have additional liability simply because they have several children or substantial State and local tax bills. I look forward to the testimony of today's witnesses. I am very interested in their ideas on how we should reform this tax once and for all.

While the AMT should certainly be examined by the President's Advisory Panel on Tax Reform, this is just the latest in 5 years' worth of administrative justifications for doing little or nothing.

Again, I commend Senator Kyl, and I appreciate the witnesses joining us today to share their expertise. Thank you, Mr. Chairman.

Senator KYL. Thank you very much, Senator Jeffords.

I am going to turn to the panel, next. Our three panelists are: Mr. Robert Carroll, Deputy Assistant Secretary for Tax Analysis, U.S. Department of the Treasury; Dr. Douglas Holtz-Eakin, Director, Congressional Budget Office, Washington, DC; and Ms. Nina E. Olson, National Taxpayer Advocate, Taxpayer Advocate Service in Washington.

Thank you, lady and gentlemen. We will start with you, Mr. Carroll.

**STATEMENT OF ROBERT J. CARROLL, DEPUTY ASSISTANT  
SECRETARY FOR TAX ANALYSIS, U.S. DEPARTMENT OF THE  
TREASURY, WASHINGTON, DC**

Mr. CARROLL. Thank you very much, Mr. Chairman, Senator Jeffords, and distinguished members of the committee. Thank you for inviting me to appear before your subcommittee to discuss the Individual Alternative Minimum Tax.

When first enacted, the AMT was intended to address a relatively small, targeted problem. Unfortunately, it has had unintended consequences, grown far beyond its original purpose, and created a far larger problem than it was ever intended to address.

The AMT is intertwined with the rest of the income tax in complex ways. Thus, a long-term solution to the AMT needs to be considered in the context of broader reform of the entire income tax.

Originally, in an attempt to address the concern that a small group of high-income individuals had managed to avoid paying any income tax, Congress enacted a minimum tax in 1969. At the time, 155 taxpayers with incomes over \$200,000 paid no Federal income tax. But by 2015, the AMT is projected to affect more than 50 million taxpayers under the President's policy baseline.

Moreover, the AMT has been unsuccessful in ensuring that all high-income taxpayers pay at least some tax. Several thousand high-income taxpayers continue to avoid tax liability each year, in spite of the AMT.

Simply put, the AMT is a second income tax system that runs parallel to the regular income tax. It is complex, it is unfair, it discourages economic growth. It requires millions of taxpayers to understand and comply with both tax systems, even if they ultimately have no AMT liability.

Yet, still many taxpayers become unsuspecting and unintended victims of the AMT, unaware that they will be affected by the tax until they complete their tax returns.

The major reason the AMT has become such a growing problem is that, unlike the regular tax, this parallel tax system is not indexed for inflation. Over time, this steadily increases the size and the scope of the AMT relative to the regular tax.

A higher AMT exemption and the provision to allow all personal credits to be claimed against the AMT, the so-called AMT patch, has generally kept the vast majority of taxpayers free from the reach of the AMT over the past several years, and through the end of 2005. Indeed, to prevent a large increase in the number of AMT taxpayers in the near term, the AMT patch has been included in the major tax cuts enacted in the last several years.

However, the AMT patch, as I mentioned, expires at the end of this year. The number of taxpayers affected by the AMT will rise sharply, from 3.8 million in 2005, to 20.5 million in 2006, increasingly affecting middle-income taxpayers when filing their tax returns in the spring of 2007.

By 2015, 51.3 million, or 45 percent of all taxpayers with income tax, are projected to be subject to the AMT under the President's policy baseline. The AMT also increasingly affects families with children because it does not allow deductions for personal exemptions.

Moreover, because of the phase-out of the AMT exemption, many unsuspecting AMT taxpayers are subject to an effective marginal tax rate of 35 percent, even though the maximum statutory AMT rate is only 28 percent.

The AMT is, in many respects, a poster child for tax reform. It fails to meet all three of the criteria the President laid out when creating the advisory panel for reform of the Federal tax system. It adds significant complexity to this tax system, it restrains economic growth, and it is unfair.

Because the AMT is intertwined with the regular tax, and because budgetary constraints preclude simple AMT repeal, a long-term solution to the AMT problem must be considered in the context of reform of the entire income tax system.



This provides us with an opportunity. The current tax system imposes large costs on our economy by distorting the economic decisions of households and businesses.

Reducing these distortions can encourage economic growth and improve living standards. Complexity undermines our system of voluntary compliance, leaving many taxpayers with the sense that the system is unfair because others use special provisions to pay less tax. This leads taxpayers to believe that they, too, should seek out tax-minimizing strategies.

The U.S. tax system also imposes a compliance burden on our economy, estimated at \$130 billion annually, reflecting both direct out-of-pocket costs and the opportunity costs of taxpayers' time spent to learn about the tax laws, to keep and assemble necessary records, and prepare and submit tax returns. This translates into 6 billion hours per year, and is equivalent to 1.5 million workers each working 2,000 hours per year. Certainly a simpler tax system could decrease these burdens and put these resources to more productive uses. The President has made reforming our tax system a key priority. The President's Advisory Panel on Federal Tax Reform is developing options to reform our tax system to make it simpler, fairer, and more pro-growth. The panel brings a fresh perspective to tax reform, and the members are not wedded to particular approaches to tax reform. We look forward to the panel's final report to the Secretary of the Treasury, due by July 31st. The options developed by the panel will provide critical input for the recommendations on reform, including recommendations to address the AMT problem. The Secretary will then make recommendations to the President, and the President to the Congress.

Thank you again, Mr. Chairman, for the opportunity to appear before you today. We look forward to working together with this committee on the AMT issue, and on tax reform in general. I would be pleased to answer any questions.

Senator KYL. Thank you, Mr. Carroll. I should have noted that this first panel has a very difficult job, especially with a time limit of 5 minutes, to provide us all the information we need about the history, the background, the scope, and expected impact of the AMT problem.

So, I really appreciate all of you trying to tackle that within the tight timeframes. Mr. Carroll, thank you for your testimony.

[The prepared statement of Mr. Carroll appears in the appendix.]

**STATEMENT OF DR. DOUGLAS HOLTZ-EAKIN, DIRECTOR,  
CONGRESSIONAL BUDGET OFFICE, WASHINGTON, DC**

Dr. HOLTZ-EAKIN. Mr. Chairman, Senator Jeffords, members of the committee, the CBO is pleased to be here today. Given the tight timeframe, I will not even try to tackle that. Instead, I will direct you to the written testimony, and I will make five points, quickly.

The first, is that, as has been noted, the AMT is growing quite rapidly, whether viewed as affecting a certain number of taxpayers or its importance in the revenue scheme.

The chart on my left shows you the rising importance of the AMT in the CBO baseline, where it rises from under 5 million taxpayers

now to 29 million taxpayers in 2010. It grows to raise \$95 billion in that year.

What is, I think, less appreciated, if we show the next chart, is that if one allows this particular construct to evolve over a long, long time—and I will show you a chart that goes out to 2050 that was in a 2003 report we did—the AMT begins to affect 70 percent of taxpayers by 2050 and raise 20 percent of all income taxes.

Now, the source of this growth has been commented upon. Over the long term, it is the fact that the tax is not indexed for inflation. Over the near term, it is intertwined with decisions that the Congress will make about the projected rise in the regular income tax under current law with the sunset of the tax legislation of the past 3 years.

Now, who will pay this tax? Increasingly, it will be paid by the middle-income taxpayer. The most striking rise over the 10-year baseline is among those taxpayers who have between \$50,000 and \$100,000 of income.

They are more likely to be married and they are more likely to have children. Cut differently, it turns out that it is most likely to affect those who deduct their State and local income taxes and use personal exemptions.

Now, from a budgetary perspective, we outlined a couple of potential options that the Congress might consider in thinking about reducing the impact of the AMT.

At the most extreme, one could repeal the AMT, eliminate its impact on 29 million taxpayers in 2010. That would come at a cost of about \$611 billion, in our estimates, which are done with the help of the Joint Committee on Taxation.

Moving down in order of less extensive impacts, 22 million taxpayers would be removed simply by indexing the AMT for inflation. That would cost, in revenue terms, \$385 billion.

Allowing personal exemptions to be used under the AMT would remove 18 million taxpayers in 2010, at a cost of \$343 billion. Twelve million taxpayers would no longer pay the AMT if they were permitted to deduct their State and local income taxes and sales taxes. That would cost \$423 billion.

Finally, if one were to permit a standard deduction under the AMT, it would remove from the rolls 6 million taxpayers at a cost of \$64 billion over the 10-year horizon.

Now, I want to emphasize that these are estimates that are done relatively to the CBO current law baseline, so those assume that the regular income tax provisions sunset in 2010 and go back to their 2000 configuration in 2011. If you were to do the estimates relative to, for example, the President's policy baseline, the numbers would be considerably different.

Let me close with a few thoughts on the AMT as tax policy, not as a budgetary phenomenon. The question often arises about whether the AMT is a problem. I think there has been great testimony, both in its growing extent of use and the complexity it imposes on individual taxpayers, that it may be useful to address it from a tax policy perspective. Sometimes it is promoted that perhaps the AMT by itself would be a better tax than would be the regular individual income tax.

There, two claims are typically made. One, that it is a relatively flat tax, and for that reason does not have a progressive structure that would interfere with economic decisions for tax purposes.

That is usually an over-statement of the case. There are, in fact, four marginal tax rates imbedded in the Alternative Minimum Tax, from 26 to 32.5 percent, rising to 35 percent, and then dropping back down to 28. So in practice, the AMT is far less flat than it might appear on paper.

The second claim is typically that the AMT has a nice, broad base, but it is useful for the committee to remember that that base was designed in conjunction with the regular income tax.

As a stand-alone tax, it is neither as broad as would be one under comprehensive tax reform, and in some cases it is broad in a fashion that would probably be viewed by the Congress and most tax policy experts as undesirable. For example, the absence of the ability to use personal exemptions means that the tax is not adjusted for family size in any way.

I am happy for the chance to be here, and look forward to answering your questions.

Senator KYL. Thank you very much. You do have a lot to cover, and I appreciate that very much.

[The prepared statement of Dr. Holtz-Eakin appears in the appendix.]

Senator KYL. Ms. Olson?

**STATEMENT OF NINA E. OLSON, NATIONAL TAXPAYER  
ADVOCATE, TAXPAYER ADVOCATE SERVICE, WASHINGTON, DC**

Ms. OLSON. Mr. Chairman, Senator Jeffords, and distinguished members of the subcommittee, thank you for inviting me today to testify at this hearing, which is intriguingly titled, "Blowing the Cover on the Stealth Tax: Exposing the Individual AMT."

Since I became the National Taxpayer Advocate 4 years ago, I have tried to further this mission by repeatedly calling attention to the deficiencies in the Individual AMT. If I were given the opportunity to make just one change to the Internal Revenue Code, I would use it to eliminate the Individual AMT.

When the concept of a minimum tax first came into the Internal Revenue Code in 1969, after the Treasury Department reported that 155 taxpayers with adjusted gross incomes above \$200,000 had paid no tax in 1966, the intent was to prevent wealthy taxpayers from using tax preferences, generally available only to them, to avoid paying their fair share of taxes.

However, Congress has changed the tax laws many times since the inception of the AMT and it has long since shut down many of the tax-avoidance opportunities that existed in the 1960s and 1970s.

Today, the AMT affects millions of taxpayers with no tax-avoidance motives at all, unless one considers choosing to live in a high-tax State or choosing to have children to be a tax-avoidance motive.

For 2002, the Treasury Department found that fully 51 percent of aggregate AMT tax preference dollars are attributable to the disallowance of State and local tax deductions under the AMT, and 22 percent of the aggregate AMT tax preference dollars are attributable to the disallowance of personal exemptions.

Thus, nearly three-quarters of the increase in income subject to taxation under the AMT results simply because of the taxpayer's place of residence or family composition.

Moreover, the AMT is now affecting increasing numbers of middle-income taxpayers because the amount of income exempt from the AMT, referred to as the AMT exemption amount, is not indexed for inflation.

When Congress first enacted a minimum tax in 1969, the exemption amount was \$30,000 for all taxpayers. If Congress had indexed that amount, it would be equal to \$157,400 today. Instead, the exemption amount, after a temporary increase that will expire after 2005, is \$45,000 for married taxpayers and \$33,750 for most others.

At the same time, many of the so-called tax preferences claimed by middle-income taxpayers, which are added back into income under the AMT, are indexed for inflation.

As a result of these diverging trends, more income becomes subject to the AMT each year. It is now projected that in 2010, 34.8 million individual taxpayers, or 34 percent of individual filers who pay income tax, will be subject to the AMT.

Among the categories of taxpayers hardest hit are 94 percent of married couples with adjusted gross income between \$75,000 and \$100,000 and two or more children that will owe the AMT. That is 94 percent. Heaven forbid you should be the Brady Bunch, with six kids.

The burden that the AMT imposes is substantial. In dollar terms, it is estimated that the average AMT taxpayer owed an additional \$6,000 in tax in 2004. In terms of complexity and time, taxpayers often must complete a 12-line worksheet, read 8 pages of instructions, and complete a 55-line form simply to determine whether they are subject to the AMT. Thus, it is hardly surprising that 75 percent of AMT taxpayers hire practitioners to prepare their returns.

At some point in the next few years, we will reach a point where it will cost more for Congress to repeal the AMT than to repeal the regular income tax and leave the AMT intact. In a very real sense, then, the AMT is ceasing to fulfill its intended mission to prevent tax avoidance by the wealthy, and is instead becoming the de facto tax system for millions of Americans.

The obvious challenge in repealing the AMT is that its increasing revenue stream has been built into revenue estimates, so if it is repealed, either Congress will have to raise tax receipts in other ways or budget deficits will balloon.

These alternatives admittedly are not appealing, but I have no doubt that there are solutions that are far preferable to the status quo. Significantly, the longer Congress waits to act, the more dependent the government will become on AMT revenue and the harder it will be to repeal it.

Clearly, there are many practical policy and political challenges to repealing the AMT, but these challenges will continue to grow over time as the government, absent Congressional action, becomes increasingly dependent on revenue.

With all of the problems inherent in the AMT, I do not think taxpayers will stand for it when the AMT begins to hit tens of millions

of taxpayers within the next few years. The AMT is a time bomb with a short fuse. Although munitions experts may say that such a device is an impossibility, I think it accurately depicts what will happen in the next few years. In the short run, we will have a blow-up at the end of next year when the lowered exemption amount expires and the lower exemption amount pulls about 21 million taxpayers into the AMT. In the long run, the AMT is set to detonate within the next 5 years. I strongly urge Congress to act before the AMT explosion occurs.

Thank you, and good luck.

Senator KYL. Thank you very much.

[The prepared statement of Ms. Olson appears in the appendix.]

Senator KYL. As I indicated at the beginning, if the so-called 2-hour rule is invoked, precluding this committee from meeting beyond the hour of 1:30, we really will not have an opportunity to finish our business with this hearing today.

But given the fact that that is a possibility, what I would like to try to do is to at least leave enough time in the schedule to hear from the next panel, which means that we have no more than about 15 minutes.

By my calculation, if each of us take a couple of minutes instead of our usual 10, we could at least each get an opportunity to question each of these witnesses. So, I am going to voluntarily take 2 minutes, myself, to begin, and see if everyone else will fall in line with that so that we can then get to the next panel.

Ms. OLSON, how can significant medical expenses trigger AMT liability?

Ms. OLSON. Well, if they fall within a certain range, they get added back into the AMT taxable income. It is one of the tax preferences that are added back in. There is a member of a governing body that I have personal knowledge of every year who says to me, what are you doing about the AMT? He is paying AMT on his medical expenses.

Senator KYL. And these are, for the most part, unforeseen expenses, which can, therefore, substantially increase your tax liability under the AMT.

Ms. OLSON. As a result of catastrophic illness or disabilities.

Senator KYL. All right.

Let me ask you—and perhaps Mr. Carroll knows the answer to this as well—how many taxpayers each year fall into the AMT without knowing about it until they hear from the IRS? Do you have any idea?

Mr. CARROLL. It is a little bit difficult to say. But certainly, in the last several years, there probably have not been very many, meaning fewer than several million. There are only 3.8 million taxpayers subject to the AMT that we project for 2005. So over the last several years, it might be on the order of several hundred thousand, maybe a bit more than that.

Senator KYL. All right.

Mr. CARROLL. The real issue is going from 2005 to 2006, when we have this very large increase in the number of people.

Senator KYL. And my understanding is, it increases from 3.8 million to over 20 million next year who will be required to pay.

Mr. CARROLL. Exactly.

Senator KYL. Is that correct?

Mr. CARROLL. Exactly. So going from 2005 to 2006, it will number 16.7 million.

Senator KYL. It will catch a lot of people who have no idea they are going to be caught by it.

Anybody have an estimate real quickly?

Ms. OLSON. We know that, in tax year 2001, 176,000 taxpayers who faced AMT also had to pay \$103 million in estimated tax penalties, which means they did not know.

Senator KYL. Which means they did not anticipate it.

Ms. OLSON. Right.

Senator KYL. All right. Thanks very much.

Senator Jeffords?

Senator JEFFORDS. Mr. Carroll, you note that Congress has included, in each of the major tax cuts, protections against large increases in AMT filers. But surely it would have been possible in the 2001 Act to have done this for the entire decade. Can you explain why Treasury did not urge greater and longer-term AMT protections in 2001, or any budget year since?

Mr. CARROLL. I should point out, as you also pointed out, what has been done over the last several years. The President, working with Congress, has ensured that in the near term the AMT problem has not touched millions and millions and millions of taxpayers.

It is the case that, in the longer term, the number of taxpayers affected by the AMT will grow very, very rapidly. I had mentioned the 50 million, over 50 million taxpayers under the President's policy baseline. Doug Holtz-Eakin had mentioned what those numbers were under the current-law baseline.

It is the President's view that the AMT patch, as it is called, will get us through 2005. It is very important that we develop a long-term solution to this problem, and it is something that the Tax Panel is very much focused on.

It is something that, when the Secretary first met with the panel back in January, he specifically asked them to include solutions to the AMT problem in their options that they are working on.

I just should point out that when we have this large increase in the number of taxpayers who will become subject to the AMT between tax year 2005 and tax year 2006, it is in the spring of 2007—I think Ms. Olson made a reference to this point—when those additional 16.7 million individuals who become subject to the AMT file their tax returns in 2007 when this is really a particular problem.

So, it is certainly the President's hope and the administration's hope that a long-term solution can be developed, together with tax reform, before then.

Senator JEFFORDS. Ms. Olson, as you know, the administration's budget proposal this year did not recommend even an extension of the current AMT. Deferring to the work of the Tax Reform Panel, what do you think would happen to taxpayers if we did not extend that by the end of the year, but maybe did so sometime next year?

Ms. OLSON. So that there was a gap or they would be filing 1 year and paying the tax and then seeking a refund? I am not sure I understand the question. Or that there is a year where they

would be pulled in and then a year that they would be pulled out? Either circumstance would be a disaster.

Senator JEFFORDS. Let us take them one at a time.

Ms. OLSON. Yes. Well, either circumstance would be a disaster. Taxpayers do not do well when we are changing rules in mid-stream. The IRS does not do well. We would probably be flooded with letters over and over again, and people would be confused, and the IRS might have to waive penalties. It would just be a disaster.

Senator JEFFORDS. Thank you, Mr. Chairman.

Senator KYL. Thank you, Senator Jeffords.

Incidentally, I will simply announce, unless there is objection, that members will have until close of business tomorrow to submit additional questions to these witnesses, since we clearly will not have time to get them all asked today.

Without objection, it is ordered.

Senator Thomas?

Senator THOMAS. Just very briefly, what is the impact on unincorporated small businesses, Ms. Olson?

Ms. OLSON. Well, one example that we give is that Congress has enacted a very liberal Section 179 depreciation, where up to \$100,000 in equipment purchases can be written off.

In general, the difference between accelerated and straight-line depreciation is considered a tax preference and gets added back in. So, small business owners may go ahead and make an investment, only to find out that they are owing more tax as a result of that investment, even though they calculate it in another way.

Senator THOMAS. Thank you.

This will be very difficult for 15 seconds each, but what would be your solution? Would you eliminate it? Would you alter it? What do you think? In general terms, what would you do?

Mr. CARROLL. The administration is very much focused on tax reform, broad reform of the tax system. We are waiting to hear back from the tax panel. We are of the view that really the only long-term solution to the AMT problem needs to be dealt with in the context of broad reform of the tax system, because it is in such an intimate way intertwined with the regular tax.

Senator THOMAS. I see.

Dr. HOLTZ-EAKIN. I think most tax policy experts would say that you have to address the AMT and the regular tax simultaneously, that the existence of the AMT is evidence to some extent that the regular tax itself has problems.

Senator THOMAS. So you all both would see that it remains, but in a different context, apparently.

Ms. Olson?

Ms. OLSON. Oh, I think you need to repeal it and deal with the impact that it has on the tax system in a mature and reasonable fashion. It is silly to have two systems.

Senator THOMAS. All right. Thank you.

Senator KYL. You are succinct. Thank you very much, Senator Thomas.

Now, Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman. I am very pleased, Mr. Chairman, to be with you and Chairman Grassley and Senator

Baucus on the legislation we are introducing now to repeal this tax. I would just say to the panel and to colleagues, this is the worst of all worlds, the current situation.

What was supposed to be a targeted provision to make sure that the most affluent would have to pay something has resulted in a situation where now more affluent people pay no taxes at all than when this whole debate began with respect to the AMT, and I think we have also seen the kind of bureaucratic water torture that middle-class people are pushed through, through the questions that we have already established. So, I am very pleased to be part of a bipartisan effort to turn this around.

Mr. Carroll, my question for you is, the administration wants to lower tax rates right now for the most affluent in our country and also give them more itemized deductions, while at the same time saying that AMT reform has to wait. How is that fair?

Mr. CARROLL. What the administration has put a priority on is permanence, repeal of the sunsets. That will help encourage economic growth, put the right incentives in place, give taxpayers more certainty as households and businesses arrange their affairs. Stability of the tax system is certainly one of the things that is important to allow taxpayers, individuals and businesses, to make decisions.

Another thing on the permanence provisions, the repeal of the sunsets achieves——

Senator WYDEN. No. I just would like to get an answer to the question. Tax rates under the administration's proposal would get acted on immediately. The deductions would get acted on immediately, but the whole debate about AMT would have to wait. How is that fair?

Mr. CARROLL. If I just might finish the thought. Another thing that the permanence provisions attain is, they lower the fraction. They basically keep the fraction of Federal Government revenues relative to GDP a little above 18 percent, which is about their historic norm over the last 20, 30, 40, 50 years. So, that is one of the things that they achieve.

It is the administration's view that reform of the income tax, as directed to the Tax Panel, should be revenue-neutral and that therefore the long-term solution to the AMT problem should be dealt with in a revenue-neutral way, keeping in line with the 18 percent of GDP.

Senator WYDEN. I will not try a third time to get an answer to my question, but it seems to me that the administration is raising taxes on middle-class families now by not addressing the AMT.

Can you tell me why that analysis would be incorrect? Because I am talking to middle-class families in Oregon who come to town meetings, and they tell me that they would like to see tax relief here, because they are getting clobbered now. They got clobbered April 15th. It seems to me that the administration is raising taxes on all those people by not addressing it now. Now, how would that analysis be incorrect?

Mr. CARROLL. Well, one thing that the administration has done, working with Congress, is it has passed the AMT patch, or provisions related to it, in pretty much each of the major tax bills that have worked their way through Congress in the last 4 years. That



AMT patch has prevented a large number of individuals becoming subject to the AMT.

So one thing I would observe is that, through 2005, we have not had a large increase in the number of taxpayers subject to the AMT because the President has worked with the Congress to achieve that result. It is the hope of the administration that the AMT problem can be solved, if you will, in the context of tax reform, through broad reform of the income tax.

That can occur prior to certainly the spring of 2007, when we have this very large increase in the number of folks who will be subject to the AMT, when those folks are filing their tax returns.

Senator WYDEN. My time is up, Mr. Chairman.

Senator KYL. Thank you, Senator Wyden.

I would now like to turn to Senator Baucus. With the committee's concurrence, when Senator Baucus has concluded his questioning, then we will turn to the second panel.

Senator CRAPO. Mr. Chairman?

Senator KYL. Oh, I am sorry. I forgot Senator Crapo. My apologies. Senator Crapo, then Senator Baucus.

Senator CRAPO. I do not mind letting Senator Baucus go first.

Senator BAUCUS. No, no, no. You were here first. Go ahead.

Senator CRAPO. Thank you, Mr. Chairman.

I would just like to say, in comment to Senator Wyden, I do not think it is accurate to portray the President's position as one of wanting the AMT to be left alone.

In fact, as was indicated, the AMT has been handled by the administration in each of the tax proposals that it has put before Congress, and the administration is proposing to handle AMT today in terms of overall tax reform.

The question that I have is, first of all, how many tax returns are there? Do we have a broad, general number to that?

Mr. CARROLL. Roughly 130 million.

Senator CRAPO. One hundred and thirty million.

And in the 2006 tax year, 1 year from now, 16.7 million of the 130 million tax returns are going to be included in AMT coverage. Is that correct?

Mr. CARROLL. It is actually higher. In tax year 2006, we project 20.5 million taxpayers will be subject to the AMT. The 16.7 is the increase relative to 2005, sir.

Senator CRAPO. That is the additional amount. There is 3.8 million now.

Mr. CARROLL. Right.

Senator CRAPO. And then another 16.7 million. I believe it was you, Ms. Olson, who said that the average tax increase for those now covered was \$6,000.

Ms. OLSON. In 2004. Additionally, yes.

Senator CRAPO. For 2004. The question I want to get to in my remaining time—and maybe you know the answer to this, Ms. Olson, but whoever could answer this—is for those 16.7 million, who 12 months from today, or in the tax year starting next year, are going to get covered, do we have an idea about the amount of taxes that they are going to pay? If we do not have any specific numbers, are we talking a couple of hundred dollars more in taxes or are we talking thousands of more dollars of taxes per return?

Ms. OLSON. I do not know. I would have to go back and work on that.

Dr. HOLTZ-EAKIN. The total that it would cost to extend the 2005 treatment to 2006, unless stopped, would be about \$30 billion in the aggregate.

Senator CRAPO. So if you divided 16.7 million into \$30 billion, you get an average for the cost.

Dr. HOLTZ-EAKIN. You get an average for the cost.

Senator CRAPO. All right. Thank you very much.

Senator KYL. Senator Baucus?

**OPENING STATEMENT OF HON. MAX BAUCUS,  
A U.S. SENATOR FROM MONTANA**

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Chairman, I want to thank you and Senator Jeffords for calling this hearing today on the Alternative Minimum Tax. This weekend, millions of Americans watched in suspense as Anakin Skywalker was lured to the dark side and became Darth Vader. What millions of those same Americans may not be aware of is another Darth Vader lurking in our tax code, and that is the Alternative Minimum Tax, otherwise known as the AMT.

The AMT has many of the same qualities as Anakin Skywalker. The AMT was supposed to bring order and fairness to the tax world, but it eventually got off on the wrong path and became a threat to middle-income taxpayers. Both Skywalker and the AMT started off with great intentions, but eventually went astray.

Now we have the Darth Vader of the tax code bearing down on millions of unsuspecting families. If we do not act, the Congressional Research Service estimates that in 2006 the family-unfriendly AMT will hit middle-income families earning \$63,000 with three children.

What was once meant to ensure a handful of millionaires did not eliminate all taxes through excessive deductions is now meaning millions of working families, including thousands in my home State of Montana, are subject to a higher stealth tax. It is truly bizarre.

Mr. Chairman, we designed a tax saying more children are excessive deductions and duly paying your State taxes a bad thing. Not only is the AMT unfair and poorly targeted, it is an awful mess to figure out.

We have heard testimony today from our National Taxpayer Advocate who has singled out this item as causing the most complexity for individual taxpayers, but also from a tax practitioner who has seen first-hand how difficult it is for her clients.

I look forward to hearing from our other witnesses, Mr. Chairman. They have many good ideas for reform or repeal of the AMT. I do look forward to working with my colleagues on the committee to craft a bill that will put an end to the Darth Vader of the tax code without any sequels.

Mr. Chairman, thank you very much. As you know, myself and the Chairman of the committee are introducing a bill to repeal AMT, along with yourself and Senator Wyden, and soon others, as co-sponsors. I think it is about time we do something.

Senator KYL. We will let you write the opening paragraph on the statement on it. That would be great. [Laughter.] Thank you very

much, Senator Baucus. I really do appreciate the indulgence of the members of the committee here, and especially the panelists. We will leave the record open for submission of questions, and appreciate your cooperation very, very much.

Now let me call to the dais the second panel, which is our private sector panel. Dr. Kevin Hassett is director of economic policy studies at the American Enterprise Institute here in Washington, DC; Ms. Carol Markman is a CPA and president of the National Conference of CPA Practitioners, and is a partner at Feldman, Meinerberg and Company, LLP, from Jericho, NY; and Dr. Leonard Burman is a senior fellow and co-director of the Urban-Brookings Tax Policy Center at The Urban Institute, Washington, DC.

We thank all three of you for being here. If you can keep to 5 minutes, we can get all of your testimony in before the bottom of the hour. I appreciate all of you being here.

Dr. Hassett, let me begin with you, please.

**STATEMENT OF DR. KEVIN A. HASSETT, DIRECTOR OF ECONOMIC POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, DC**

Dr. HASSETT. Thank you very much, Mr. Chairman, Senators Baucus, Jeffords, and the rest. It is an honor and pleasure to be here. I regret not having brought my light saber after hearing Mr. Baucus's introduction. [Laughter.]

I think that every professional agrees that the Alternative Minimum Tax is an abomination. My first recommendation to this panel is that reliance on stop-gap measures, or patches, as Mr. Carroll referred to them, be abandoned.

This is because current long-run forecasts include ever more significant amounts of revenues from the AMT that will not be realized if successive temporary stop-gaps are adopted. Elected officials will base their decisions on highly misleading revenue forecasts if they rely on these misleading baseline projections.

We are also very, very close, as you mentioned, to the precipice on the AMT. I prepared in my testimony a simple example of exactly how close we are. Figures 1 and 2 in my testimony indicate in which State a family with three children and two adults, with an income of \$150,000 and normal State deductions, will be on the AMT.

The top panel, Figure 1, shows there are very few States where that is the case. But next year, where the exemption goes back down or the patch is removed, you can see that this very milquetoast family is on the AMT in virtually every State.

I also, in the second chart, used shading to indicate the big variation in AMT liability, depending on which State that you are in. So, I think that action on the AMT is urgent, and I think giving up stop-gap measures is important as well.

Now, why do we need to fix this AMT? Well, I think there are two reasons. First, as has been mentioned, the AMT increases tax complexity and compliance costs for the millions of taxpayers who must calculate their taxes twice.

But, second, and I believe more important, the AMT raises marginal tax rates on individuals who are put on to the AMT more often than not. In my testimony, I review a recent paper by Jim

Poterba and Dan Feenberg that calculates specifically how those rates are changing.

I think that current forecasts assume that significant AMT revenue will be realized. Indeed, if you let the AMT run forward, then tax revenues rise as a share of GDP to a level significantly above the historical average over the next 10 years.

Beyond that, even more, by 2050, tax receipts will increase to 24.7 percent of GDP as the AMT gobbles up more and more taxpayers with a code that is not indexed to inflation.

Senator KYL. By what year is that?

Dr. HASSETT. 2050.

Senator KYL. Thanks.

Dr. HASSETT. These are CBO numbers referenced in my testimony.

Accordingly, I would have to disagree with some of the statements that I heard on the last panel, that it might be advisable to have a revenue-neutral tax reform. Exactly where you stop with the neutrality is certainly a judgment call, and in the near term these pressures are significantly weaker, of course. But in the long run, revenue neutrality would push revenue to GDP to an unprecedented height.

In the near term, if the committee wishes to consider offsets to reduce the fiscal impact of the AMT, certainly they will refer to both possible tax changes and spending changes. In the remainder of my testimony, I just wanted to highlight the fact that I think that the case for spending changes is pretty strong, as you can see in the charts in my testimony.

Figures 4 and 5 help illustrate how much spending has skyrocketed. They compare current baseline spending and revenue to what was projected to occur in the 2000 CBO budget outlook. Figure 4 documents that the difference in projected revenue is \$180 billion in 2006, shrinking to only \$65 billion by 2009.

This can be seen in Figure 5. The difference in spending is much larger: a striking \$425 billion in 2006, climbing to \$535 billion in 2009.

From this comparison, it appears that spending increases that were unanticipated in 2000, more than lower taxes, explain the transition from projected budget surpluses to budget deficits.

If these pictures suggest that spending is an important additional source of the fiscal deterioration, then one might wish to explore what changes to spending would be required if one wanted to repeal the AMT. I did that in my testimony as well.

Because spending is projected to increase over the next 10 years, the cost of eliminating the AMT could plausibly be offset with relatively small reductions in spending growth, without actually reducing spending itself. The numbers, again, are in my testimony.

While these cuts may seem politically impossible, it is worth noting that spending would be extraordinarily higher than it was forecast to be a little more than 5 years ago, even after these reductions.

Now, I would seek to reduce spending while repealing the AMT. I understand that others would prefer alternative approaches to reaching fiscal balance in the near term.

The AMT is such a terrible tax, however, that I hope strategies for achieving AMT reform in a responsible manner will receive the careful scrutiny of this committee, and that disagreement concerning the merits of the different approaches does not become an obstacle to the reform that is necessary and urgently needed.

Thank you.

Senator KYL. Thank you. Thank you, Dr. Hassett.

[The prepared statement of Dr. Hassett appears in the appendix.]

Senator KYL. Ms. Markman?

**STATEMENT OF CAROL C. MARKMAN, CPA, PRESIDENT, NATIONAL CONFERENCE OF CPA PRACTITIONERS; AND PARTNER AT FELDMAN, MEINBERG AND COMPANY, LLP, JERICO, NY**

Ms. MARKMAN. Yes. Good afternoon.

I am a CPA, and I have been in practice for over 25 years. As you mentioned, I am president of an organization that represents CPAs in public practice. The members of NCCPAP own and operate local and regional practice units ranging in size from sole proprietors to organizations with many CPA owners. We estimate that our members serve more than a half a million businesses and individual clients in every State.

I have been asked to provide anecdotal information about how the AMT affects our members' clients, the taxpayers of America. The NCCPAP Tax Committee collected individual tax returns from our members where the taxpayer was required to pay AMT. We analyzed these returns to determine the reasons for the presence of the AMT.

The most common reasons we saw were the large individual itemized deductions, such as the State and local tax, and miscellaneous itemized deductions. However, a colleague told me about a Federal income tax return of a single father with three children. He earned a little over \$70,000. He had no other income and he claimed the standard deduction.

The taxpayer was required to pay \$100 in AMT on his 2002 return. The trigger for the AMT was the exemption for his three children. A taxpayer who is otherwise eligible to file a 1040-EZ should not have to be concerned about the AMT.

One of the other tax returns we reviewed concerned a retired single woman with no dependents. Her 2003 adjusted gross income was about \$76,000. It consisted mostly of Social Security, interest, dividends, and net rental income.

She paid almost \$2,700 in AMT, which was almost 30 percent of her Federal tax liability, because of her relatively large real estate taxes and her income from some tax-exempt private activity bonds. She was quite annoyed and could not believe that she was in the target group for this tax.

Another tax return concerned a married couple with four children. Both spouses worked outside the home. They earned a total of about \$152,000. They had less than \$1,000 of interest and dividend income in 2004, but their State and local taxes were almost \$17,000. They had to pay almost \$1,000 in AMT. They had one child in college and one who will begin college next year. They are not like the 155 taxpayers who paid no tax in 1969.

One of the most difficult AMT add-backs to explain to our clients is the one for employee business expenses. One tax return we reviewed was for a single taxpayer with about \$90,000 worth of income. He was an outside salesman and had about \$20,000 of miscellaneous itemized deductions, travel, meals, et cetera. He was subject to over \$2,000 in AMT, 16 percent of his tax liability.

One of the issues that we dealt with was a taxpayer who loses the tax benefit of the cost of producing income. If the taxpayer receives an award for damages from a lawsuit and the attorney is paid legal fees from the settlement, those legal fees are not permitted for the AMT.

For the tax return that I want to bring to your attention, the taxpayer received a settlement because a stockbroker churned the taxpayers' investment accounts. The taxpayers, who suffered capital losses, were able to offset the settlement against capital gains for regular tax purposes.

The taxpayers were retired and they had no taxable income for the year of the settlement. However, they were subject to almost \$20,000 of Alternative Minimum Tax because the legal fees were not an allowable deduction for AMT purposes.

The AMT has been called the "acutely messy tax," and it is a perfect example of the tax law giving with one hand and taking away with the other. The regular tax rates have been lowered significantly, but the AMT rates have not changed in recent times and the exemption amounts have not been indexed for inflation. If nothing is done to change the tax law, as you have heard, more than a third of taxpayers will be subject to the AMT by 2010.

Although NCCPAP's position is that the AMT should be repealed, there may, in fact, be a place for the AMT in the Tax Code. However, the AMT certainly should not affect those taxpayers with moderate income, a few children, and real estate taxes on their principal residence, wherever they may live.

Thank you for the opportunity. NCCPAP stands ready to supply you with additional anecdotal information if that would be helpful. Thank you.

Senator KYL. It has been very helpful. Thank you, Ms. Markman.

[The prepared statement of Ms. Markman appears in the appendix.]

Senator KYL. Dr. Burman?

**STATEMENT OF DR. LEONARD E. BURMAN, SENIOR FELLOW  
AND CO-DIRECTOR, URBAN-BROOKINGS TAX POLICY CENTER,  
THE URBAN INSTITUTE, WASHINGTON, DC**

Dr. BURMAN. Thank you, Mr. Chairman, Ranking Member Jeffords, and members of the subcommittee.

I hope you will indulge me, but I am going to try to skip over things that people have already said.

I do have one point. Actually, I can answer the question from Mr. Crapo. According to our estimates, AMT revenue, per taxpayer, in 2006, would be about \$3,000. It is actually coming down over time as more and more middle-income taxpayers get subject to the tax. Though it sounds like it might be good news, it is actually an indication of how bad the tax is.

Now, this issue has been understood for years. The Treasury Department, CBO, and others have been doing great analysis on this. The question is, why is it so hard to fix?

I have one prop, although not as big as CBO's. It is kind of like the old horror movie, "The Blob." This poster says, "Indescribable, indestructible, nothing can stop it."

Well, the AMT makes the tax system indescribable for many ordinary taxpayers, and even the Tax Reform Act of 1986 could not destroy it, and the Tax Acts of 2001, 2003, and 2004 actually ended up feeding the beast. So far, even though temporary patches have slowed it down, nothing has stopped it.

The problem is that the AMT will bring in a lot of revenue over the next 10 years, which would have to be made up somewhere else if the AMT were eliminated or restrained. Kevin suggests spending cuts. Given Congress' recent history, I might suggest that you might also need to raise taxes as well.

Politically, it would be hard to do those things. But extracting from political concerns, one of the great luxuries of being in my job is that it is actually not that hard to fix or eliminate the AMT, and you do not need to wait for fundamental tax reform to do it. So, I will discuss some options to accomplish that.

Just a couple of points before. One issue that Ms. Olson brought up was AMT preference items. They are mostly middle-class tax preferences. State and local tax deductions are half of the total. Personal exemptions are a little bit more than a fifth, and so are miscellaneous itemized deductions.

That is, 90 percent of the AMT tax preference items have nothing to do with tax sheltering. Well, why has the AMT grown so much over time? There are really two major factors. One is the failure to index the AMT for inflation. Second is the 2001–2004 tax cuts. Those lowered regular income tax rates, but except for a temporary fix, they did not do anything about the AMT.

If the 2001–2004 tax cuts had not been enacted, the number of people on the AMT by 2010 would fall from 30.9 million to 14.4 million. If the AMT had been indexed for inflation all along, there would be 400,000 people on the AMT.

A perverse effect of those tax cuts is that the AMT actually takes back almost a third of the 2001–2004 tax cuts, so a lot of people thought they were getting a big cut when their rates were reduced, and will be surprised to find that the AMT rate is what prevails.

Another factor. This sort of relates to Mr. Carroll's testimony. Part of the administration's revenue projections are counting on a lot of AMT revenue. I think Kevin also made this point. By 2015, AMT revenues are supposed to represent 1 percent of GDP. It is not going to happen, but it means that we are sort of budgeting in a kind of fantasy world here.

I am going to skip over the demographics and go to some solutions.

So what could you do about it? CBO options show a number of ways to reduce the number of AMT taxpayers, but as Doug pointed out, they would add to the deficit significantly.

There are ways to fix the AMT without adding to the deficit. One way would be to repeal the tax and raise ordinary income tax rates.

This sounds like a bad option because the rate increases would be fairly significant.

In 2010, you would need a 9 percent across-the-board tax increase. That is, the top rate would go from 35 percent to 38 percent. If you actually targeted those rate increases to the people who are likely to pay the AMT, the top rate would go from 35 percent to 44 percent. It sounds like a lot, but it is actually an indicator of how much revenue the AMT is bringing in.

Senator KYL. Dr. Burman, excuse me. There are rules and I must stop you right now. I am going to ask you to continue in just a second.

But first let me say, without objection, I am going to insert in the record a statement of the chairman of the committee, Senator Chuck Grassley.

[The prepared statement of Senator Grassley appears in the appendix.]

Senator KYL. Second, I have to advise the witnesses and members of the committee that, because Rule 5A of the Standing Rule 26 of the Senate has been invoked by Senator Reid, the Senate having convened at 11:30 this morning, this committee cannot meet past the hour of 1:30 p.m.

And even though it would be rare that such an objection would be lodged against the Finance Committee meeting, especially on a bipartisan matter like the AMT, it has been invoked and therefore we have no option but to adjourn the meeting at this time.

It would be my intention that, after adjournment, the microphones are not cut off so we can continue to talk, but strictly in an informal fashion. The hearing will have to adjourn. Unfortunately, we are about 10 seconds over.

So at this point, this hearing of the subcommittee of the Finance Committee is adjourned.

[Whereupon, at 1:30 p.m., the hearing was concluded.]



# APPENDIX

## ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

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Leonard E. Burman  
The Urban Institute  
Tax Policy Center  
Georgetown Public Policy Institute

Chairman Kyl, Ranking Member Jeffords, and Members of the Subcommittee:

Thank you for inviting me to testify today on the individual alternative minimum tax. I submit as my testimony an updated version of an article I wrote with my colleagues, William G. Gale and Jeffrey Rohaly, titled "The Expanding Reach of the Individual Alternative Minimum Tax," which was originally published in the spring 2003 issue of the *Journal of Economic Perspectives*. The article has been updated to reflect the effects of major individual income tax legislation passed through 2004, including the temporary deduction for state and local sales taxes (the newest AMT preference item), and the latest CBO economic projections.

### **The Expanding Reach of the Individual Alternative Minimum Tax**

Updated May 2005

Leonard E. Burman, William G. Gale, and Jeffrey Rohaly

Leonard E. Burman is a senior fellow at the Urban Institute, Washington, D.C., co-director of the Tax Policy Center, and visiting professor at Georgetown University Public Policy Institute. William G. Gale is Arjay and Frances Fearing Miller Chair at the Brookings Institution, Washington, D.C., and co-director of the Tax Policy Center. Jeffrey Rohaly is a research associate at the Urban Institute, Washington, D.C., and director of tax modeling at the Tax Policy Center. This paper is an updated and revised version of Leonard E. Burman, William G. Gale, and Jeffrey Rohaly, "The Expanding Reach of the Individual Alternative Minimum Tax," *Journal of Economic Perspectives* 17 (2): 173-86 (Spring 2003). The authors gratefully acknowledge research assistance from Mohammed Adeel Saleem, helpful discussions with Jerry Tempalski and David Weiner, and comments and editorial assistance from the editors of the *Journal of Economic Perspectives*. Views expressed are those of the authors alone and do not necessarily represent the views of the Urban Institute, the Brookings Institution, their trustees, or their funders. The authors may be contacted at [feedback@taxpolicycenter.org](mailto:feedback@taxpolicycenter.org).

### A. Introduction

In January 1969, Treasury Secretary Joseph W. Barr informed Congress that 155 individual taxpayers with incomes exceeding \$200,000 had paid no federal income tax in 1966. The news created a political firestorm. In 1969, members of Congress received more constituent letters about the 155 taxpayers than about the Vietnam war. Later that year, Congress created a minimum tax to prevent wealthy individuals from taking advantage of tax laws to eliminate their federal income tax liability.

Both the original minimum tax and its successor, the individual alternative minimum tax (AMT), have applied in the past to a small minority of high-income households.<sup>1</sup> But barring a change in law, this “class tax” will soon be a “mass tax.” Current projections show the number of AMT taxpayers skyrocketing from one million in 1999 to almost 31 million in 2010.<sup>2</sup> Without reform, virtually all upper-middle-class families with two or more children will be paying the AMT by decade’s end. The AMT is notoriously complex, and its record on fairness and efficiency is mixed at best. But because of its widening reach, fixing the AMT will be expensive. By the end of the decade, repealing the AMT will cost more than repealing the regular income tax. This paper explains how a tax originally designed to target 155 taxpayers

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<sup>1</sup> A separate alternative minimum tax applies to corporations. See Lyon (1997).

<sup>2</sup> Throughout this paper, we compare current or recent data to projections for 2010. By the end of that year, all of the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), and the Working Families Tax Relief Act of 2004 (WFTRA) will have expired under current law. The resulting uncertainty about the course of tax policy means that every post-2010 projection would have to be predicated on some assumption about whether the tax rules are extended or not. If the tax cuts are extended, 46 million taxpayers will face the AMT in 2015. If, instead, they are allowed to expire as scheduled, 28.5 million taxpayers will be on the AMT in 2015. And AMT revenue will be nearly \$500 billion greater over the ten-year budget window assuming the tax cuts are extended than if they expire in 2010.

could grow to cover 31 million, discusses economic issues related to the alternative minimum tax, and examines options for reform.<sup>3</sup>

#### **B. How the Alternative Minimum Tax Works**

Taxpayers who may be subject to the alternative minimum tax must calculate their tax liability twice: once under regular income tax rules and again under AMT rules. If liability under the AMT proves higher, taxpayers pay the difference as a surcharge to the regular tax. Technically, the difference paid is their AMT.

To calculate the alternative minimum tax, taxpayers add to their regular taxable income various items that are paradoxically called “AMT preferences,” and that fall into two categories. *Exemption preferences* allow taxpayers a variety of deductions, exclusions or credits in the regular tax, but are not allowed in the AMT. These items include personal exemptions, the standard deduction, and itemized deductions for state taxes and miscellaneous expenses. Middle-income taxpayers are the most likely to be hit by exemption preferences, which have little to do with tax sheltering. As a result, these adjustments are difficult to justify.

*Deferral preferences* allow taxpayers to postpone regular income tax payments or shelter income by hastening deductions or delaying income recognition. The AMT rules limit the extent to which taxpayers can use deferrals by, for example, allowing less generous depreciation deductions. Compared with exemption preferences, deferral preferences are more complex, have a greater tendency to affect high-income filers, and generate less AMT revenue.

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<sup>3</sup> This paper draws from Burman et al. (2002); Burman, Gale, and Rohaly (2003); and Burman et al. (2004). The interested reader might also read Graetz and Sunley (1988), Harvey and Tempalski (1997), JCT (1970, 2001a), JEC (2001) Karlinsky (1995), Kiefer et al. (2002), Rebelein and Tempalski (2000), Shaviro (2001), and Tempalski (1996).

Once a taxpayer adds in all applicable preferences and tallies income, the next step is to subtract the alternative minimum tax exemption—currently \$58,000 for married couples and \$40,250 for singles. The remaining income level is then taxed at flatter rates than under the regular income tax. The statutory AMT tax rate of 26 percent applies to the first \$175,000 of net income above the exemption. For income over that level, a 28 percent tax rate applies. Under the regular income tax (in 2005), the same income would be taxed at rates ranging from 10 percent to 35 percent. Many taxpayers' effective AMT rate, however, is significantly higher than the top statutory AMT rate of 28 percent, because the AMT exemption itself phases out at a 25 percent rate over higher income ranges. Thus, effective marginal tax rates under the AMT can be as high as 35 percent (1.25 times 28 percent). The AMT exemptions and tax brackets are not indexed for inflation.<sup>4</sup>

### **C. Class Tax to Mass Tax**

Under current law, about 31 million people will be paying the alternative minimum tax by 2010, almost 9 times as many as in 2005, as shown in table 1.<sup>5</sup> The increase in coverage will

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<sup>4</sup> The alternative minimum tax generally preserves the lower tax rates on capital gains and dividends in the regular tax. Current law limits tax rates on long-term capital gains and qualifying dividends to 5 percent for low- and moderate-income taxpayers and 15 percent for others. Those limits apply to both the regular income tax and the AMT and are scheduled to expire at the end of 2008 under current law. Unless provisions in JGTRRA are extended, dividends will revert to being taxed as ordinary income and the rate on long-term capital gains will return to 20 percent (10 percent for lower-income taxpayers) in 2009.

<sup>5</sup> Unless otherwise noted, all of the projections in this paper derive from the Tax Policy Center (TPC) Microsimulation Model. The model is based on data from the 2001 public-use file produced by the Statistics of Income Division of the Internal Revenue Service. The file contains about 143,000 records with detailed information from federal individual income tax returns filed in the 2001 calendar year. A constrained statistical match with the March 2002 Current Population Survey provides demographic and other information to supplement the tax data. The tax model has two components: a statistical routine that uses forecasts from the Congressional Budget Office to "age" or extrapolate the 2001 data to create representative samples of the population for future years; and a detailed tax calculator that computes the regular income tax and AMT liability for all tax units in the sample under current law and under alternative policy proposals. For details on the model's methodology, see Rohaly, Carasso, and Saleem (2005).

occur in all but the very lowest income classes. In 2005, for example, 1 percent of filers with income between \$75,000 and \$100,000 (in 2005 dollars) face the AMT; by 2010, 49 percent of filers in that income range will pay the AMT. The AMT will become the de facto tax system for filers in the income range of \$200,000 to \$500,000, 94 percent of whom will face the tax in 2010. At very high income levels, the share of taxpayers on the AMT falls, because the top AMT rate is lower than the top marginal tax rate in the regular income tax. As a result, as income rises, eventually regular income tax liability overtakes AMT liability. Even so, in 2010 more than one-third of tax filers with incomes above \$1 million will pay the AMT, up from 25 percent in 2005.

Because the alternative minimum tax does not allow exemptions for dependents or deductions for state taxes, it will impose particularly high burdens on taxpayers with children and those in high-tax states.<sup>6</sup> Because the AMT exemption for couples is less than double the exemption for singles and because the tax brackets are not adjusted for marital status, the AMT imposes significant marriage penalties. In combination, these issues can raise AMT participation rates dramatically, as spelled out in table 2. By 2010, among married couples with two or more children and income between \$75,000 and \$100,000, 89 percent will face the AMT.

More generally, the expansion of the AMT implies that by 2010 more than half of all tax filers will be unaffected by marginal tax rate changes in the regular income tax—45 percent of those because they are on the AMT and 55 percent because their incomes are too low to owe

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<sup>6</sup> The American Jobs Creation Act of 2004 provided a deduction for state and local general sales taxes that is incorporated in the TPC microsimulation model. As with the deductions for state and local income and property taxes, the deduction for sales taxes is an AMT preference item. Under current law, the sales tax deduction is scheduled to expire at the end of 2005.

regular income tax. Sixty-two percent of married couples will find themselves in that situation—almost three-quarters of them because of the AMT.

Perhaps the most striking illustration of the growing scope of the AMT is that by 2010, almost half of all income will be taxed under the AMT and repealing the regular income tax would reduce tax revenues by less than repealing the AMT. In 2010, total income tax revenues are projected to be \$1,291 billion -- \$1,179 billion from the regular income tax and \$112 billion from the AMT (defined as the amount owed above and beyond regular tax liability). AMT repeal would thus reduce revenues by \$112 billion in 2010. If the regular income tax were repealed, AMT revenues would increase dramatically to \$1,240 billion, so the net revenue loss would be only \$51 billion (= \$1,291 billion – \$1,240 billion). The number of AMT taxpayers would more than double to 70 million as even moderate-income taxpayers would face AMT liability.

Determining the causes of the expanding reach of the AMT is tricky. For example, the AMT might have been repealed in 1979, but it wasn't. Thus, in some sense, failure to repeal the AMT in 1979 could be viewed as the cause of projected AMT growth. Despite this underlying ambiguity, we believe it makes the most sense to focus on two factors: the lack of inflation indexing in the AMT and the 2001-2004 tax cuts. As a general rule, most major tax legislation since 1980 has included changes in the AMT that broadly conform to the reforms made in the regular income tax--the 1986 act, for example, broadened the base of both taxes; the 1993 act raised marginal rates under both taxes. There are four major exceptions to the general rule, though. The Economic Recovery Tax Act of 1981 cut taxes and indexed the regular tax system for inflation but did not index the AMT. More recently, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the Jobs and Growth Tax Relief Reconciliation Act of

2003 (JGTRRA), and the Working Families Tax Relief Act of 2004 (WFTRA) cut the regular income tax, but did not make significant, lasting changes to the AMT.<sup>7</sup> Our simulations show that if the AMT had been indexed for inflation along with the regular income tax in 1985, and if the 2001-2004 tax cuts had not been enacted, the number of AMT taxpayers would have remained between 300,000 and 400,000 through 2010, rather than rising to 31 million.

The 2001-2004 tax acts more than doubled the projected number of those who face the alternative minimum tax in 2010, as shown in the third column of table 1. Before this legislation, 14 percent of taxpayers were slated to pay the AMT in 2010 (with the rise over time due primarily to the lack of inflation indexing); afterwards, 31 percent will pay the AMT. In addition, by 2010, the recent tax cuts will more than double the share of adjusted gross income (AGI) subject to the AMT from 22 percent to 50 percent, and the laws will almost triple the cost of eliminating the AMT from \$40 billion to \$112 billion.

Ironically, just as the tax cuts made the AMT problem worse, the AMT will undo some of the effects of the 2001-2004 acts. By 2010, the AMT will “take back” about 29 percent of the overall income tax cut, including more than 71 percent of the cut targeted to taxpayers with income between \$200,000 and \$500,000, as shown in table 1.<sup>8</sup>

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<sup>7</sup> Lindsey (2001) blames the 1993 tax measures for much of the growth in AMT participation, but our estimates suggest that those effects were much smaller than those attributable to EGTRRA, in large part because the 1993 act raised the highest income tax rates whereas EGTRRA reduced marginal tax rates.

<sup>8</sup> Policymakers understood these effects at the time. Some have claimed that the AMT was left unadjusted precisely in order to reduce artificially the revenue costs and mitigate the reported distributional effects of the tax. Gale and Potter (2002) discuss these issues further.

**D. Equity**

The alternative minimum tax was originally motivated by a minimalist notion of vertical equity—that high-income people should pay at least some income tax each year. The logic of such a goal is questionable on purely economic grounds, but it commands substantial public support, as the 1969 letter-writing campaign suggests.

The alternative minimum tax has succeeded in holding down the number of high income tax filers who pay no federal income tax. We estimate that in 2005, roughly 1,600 tax filers with incomes above \$1 million will pay no federal income tax, but at least 7,600 high-income tax filers would owe no income tax without the AMT. If the existence of the AMT also discourages taxpayers from attempting to shelter income, the number paying no income taxes without an AMT could be much higher. Nevertheless, it is unclear why a few million people need to pay the tax currently in order to stop a few thousand from paying no tax.

Moreover, although the AMT is more progressive than the income tax, it will become less progressive over time as it comes to affect millions of middle-class families. Filers with income under \$100,000 (in 2005 dollars) will account for 37 percent of AMT taxpayers in 2010, up from 6 percent in 2005. Those filers will account for 11 percent of AMT revenues, compared with less than one percent in 2005. Only 18 percent of AMT revenues will come from taxpayers with incomes above \$500,000 in 2010, compared with 31 percent in 2005. That income group will account for 34 percent of income tax revenues in 2005 and 31 percent in 2010. Thus, the AMT's ability to boost the progressivity of the income tax will erode in the future.

The alternative minimum tax also raises horizontal equity issues. On the one hand, to the extent that it reins in tax shelters, the AMT reduces the variance of average effective tax rates among taxpayers with similar incomes. On the other hand, the AMT affects taxpayers with



similar incomes but different family circumstances or different state of residence differently, raising the variance of after-tax income. Our calculations show that, on balance, the AMT actually increases the variance by four percent for taxpayers with incomes between \$200,000 and \$500,000 in 2005. By 2010, the AMT will increase the variance of effective tax rates by over 17 percent for such taxpayers, although it will reduce the variance slightly for those earning between \$50,000 and \$75,000. Moreover, a full measure of horizontal equity must adjust for differences in ability to pay tax created by factors other than income; specifically, it might include adjustments for factors like charitable contributions or extraordinary medical expenses that are now written into the regular tax code. The AMT allows some of these adjustments, such as deductions for charitable contributions and casualty losses, but disallows others, such as child exemptions and deductions for certain medical expenses. It also significantly increases marriage penalties. Thus, a judgment on how the AMT affects horizontal equity will necessarily involve considering which elements of the current tax code are necessary to reflect ability to pay.

#### **E. Efficiency**

The most plausible economic rationale for a minimum tax of some sort is that it could be a second-best backstop for a porous income tax. By reining in unwarranted tax shelters that lawmakers for some reason could not address directly, the tax might reduce distortions and limit tax sheltering. For example, by taxing interest income from bonds that state and local governments issue to support private activities like shopping centers or stadiums, income that is exempt from the regular income tax, the AMT reduces the subsidy afforded such investments (Leonard 1998). Under certain assumptions, this could make the tax system more efficient.

Although the notion of the AMT as a base-broadening, rate-lowering tax was plausible in the past, it is not today. In the early years of the alternative minimum tax, shelters were booming. Shelters served to reduce or eliminate taxes for many high-income filers and typically worked by combining assets that generated capital gains and expenses that were deductible.

Tax on capital gains could be deferred for years and faced a low statutory rate when recognized. Deductions included highly accelerated depreciation, generous oil depletion allowances, and interest payments that largely represented inflation rather than the real cost of funds (Graetz 1997). Thus an investment that would lose money before tax—because the income including capital gains was less than the expense—could be profitable after tax because expenses were overstated for tax purposes and capital gains were only partially taxed. The AMT likely limited those shelters and arguably improved economic neutrality in large part by reducing the generosity of the deductions and taxing capital gains at the same rate as other income. Prior to 1985, about 85 percent of AMT preferences related to capital gains.

The alternative minimum tax, however, no longer focuses mainly on tax shelters. A much larger share of its revenue now comes from run-of-the-mill provisions like the disallowance of personal exemptions and standard deductions.<sup>9</sup> The Tax Reform Act of 1986 combined with the near-elimination of inflation sharply curtailed tax shelter activity (Samwick, 1995). Because the 1986 tax reform taxed capital gains at the same rate as ordinary income, capital gains were eliminated as an AMT preference item. When tax preferences for capital gains were re-established in 1990 and expanded in 1997, the role of capital gains in sheltering income rose, but capital gains were not reinstated as an AMT preference item. Thus, the

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<sup>9</sup> Burman and Weiner (2005) provide a breakdown of the relative importance of the different AMT adjustments and preferences in reconciling taxable income under the regular tax and the AMT. In 2002, personal exemptions alone accounted for more than 20 percent of the difference.

preferential treatment of capital gains, the linchpin of many sheltering schemes, is not addressed at all in the AMT.

Finally, one of the enduring bits of conventional wisdom about the alternative minimum tax is that, whatever its other faults, it taxes a broader base of income at lower marginal rates than the regular income tax. The facts are almost exactly reversed; that is, the AMT often results in less income subject to tax but at higher marginal rates than under the regular income tax. For example, a couple earning \$85,000 with six children would have \$49,400 of taxable income under the regular tax in 2005, assuming that they took the standard deduction.<sup>10</sup> Neither the personal exemptions nor standard deduction would be allowed against the AMT, but the couple would be entitled to an AMT exemption of \$58,000, yielding income subject to the AMT of \$27,000—less than the taxable income under the regular tax. They would nevertheless owe AMT because their marginal tax rate under the AMT—26 percent—is much higher than their regular income tax bracket of 15 percent. Over time, more and more taxpayers will find themselves in a similar position. The share of AMT taxpayers with less income taxed in the AMT than in the regular income tax is projected to rise from 70 percent in 2005 to 87 percent in 2010. The share with higher marginal tax rates under the AMT than under the regular tax will rise from 71 percent in 2005 to more than 92 percent in 2010.

#### **F. Complexity**

The National Taxpayer Advocate (2001) and the Internal Revenue Service (2000) have called the alternative minimum tax one of the most difficult and complex areas of tax law. Many

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<sup>10</sup> Taxable income would equal \$85,000 minus \$25,600 in personal exemptions (8 times \$3,200 per person) minus a standard deduction of \$10,000, which equals \$49,400.

taxpayers must keep two separate sets of books because of the deferral preferences--the AMT rules on the timing of income recognition and deductions that differ from regular income tax rules. These rules reduce the number of high-income tax filers that pay no income tax and thus serve an identifiable goal. The same goal could be advanced much more simply, however, by scaling back deferral preferences in the regular tax, rather than requiring taxpayers to juggle two separate, complicated calculations.

Much of the rest of AMT complexity appears to be completely pointless. Most people who must currently fill out the AMT forms end up owing no additional tax. Increasingly, the tax will impose greater compliance burdens on middle-class taxpayers, a group that was never the tax's main target. Moreover, the complexity also makes predicting marginal tax rates and understanding tax rules much more difficult.

#### **G. Options for Reform**

The underlying goals of the AMT—requiring high-income people to pay some tax, deterring the aggressive use of tax shelters, and ensuring progressivity—have widespread popular appeal, but the tax itself is replete with problems. A variety of reform options could, to varying degrees, keep the baby but throw out the bathwater.

##### *Reducing the AMT*

Merely indexing the AMT for inflation would reduce the number of AMT taxpayers in 2010 by 82.5 percent overall and by 98 percent for middle-class taxpayers, defined as those with cash income between \$50,000 and \$75,000. Indexing would reduce revenues by \$431.5 billion through 2015 under current law (table 3).

The middle class could be almost entirely removed from the AMT by also allowing dependent personal exemptions and nonrefundable credits, such as the tax credits for child care and education. In conjunction with indexing, these reforms would reduce the number of AMT taxpayers in 2010 by 86.5 percent overall and by more than 99 percent among those with incomes between \$50,000 and \$75,000.

Combining these reforms with two additional steps -- repealing the phaseout of the AMT exemption and allowing deductions for state and local taxes, miscellaneous expenses, and medical expenses allowed under the regular tax -- would eliminate all of the major exemption preferences and virtually end the AMT for all but very high-income tax filers. The number of AMT taxpayers would fall by more than 99 percent relative to current law. The additional steps primarily benefit high-income households; for example, they would reduce the number of AMT taxpayers with income between \$500,000 and \$1 million by almost 94 percent. The additional measures are also expensive. The ten-year revenue cost would be \$614 billion, more than 40 percent greater than indexing alone.

From here, outright repeal of the AMT is a small step, consisting mainly of the elimination of the deferral preferences. Relative to the plan above, repeal would cost just \$56 billion more over the decade and reduce the number of AMT payers in 2010 by an additional 0.3 million. Repeal of the deferral preferences would be significantly regressive, however, with very large tax cuts going to the highest-income households (Burman et al. 2004).

Repealing the deferral preferences would also significantly increase the number of high-income filers who pay no income tax. The number of filers with income above \$1 million who

would pay no income tax would rise from 3,700 under the plan above to 9,100 under repeal.<sup>11</sup> These figures show the power of the deferral preferences in reducing the number of high-income filers who pay no tax. Even more nontaxpayers would exist (and the revenue costs would be larger) if AMT repeal unleashed a rash of new tax shelters.

*Revenue neutral reform*

All of the plans noted above would significantly reduce revenues over the next decade and by increasing amounts beyond that.<sup>12</sup> In the current budgetary environment, such changes may be neither feasible nor desirable (See Auerbach et al. 2003). AMT reform could be financed by retargeting the tax or by coupling AMT repeal with income tax changes.

One way to retarget the AMT at very high-income taxpayers and aggressive tax shelterers would be to allow dependent exemptions and personal nonrefundable tax credits, eliminate the AMT exemption phaseout, and index the exemption from its 2005 level starting in 2006. These reforms could be paid for by increasing the 28 percent AMT bracket to 33.5 percent (which would increase taxes only for those with incomes above the AMT exemption phaseout, an income level of \$330,000 for couples after 2005) and eliminating the preferential rates for capital gains and dividends under the AMT.

As shown in table 3, under current law, the proposal would raise about \$9 billion over the next ten years. The proposal would be highly progressive, cutting overall taxes on those with incomes under \$500,000 and raising taxes on higher income filers. It would reduce the number

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<sup>11</sup> The number of filers with income above \$200,000 who pay no income tax would rise from 51,300 under the plan above to 105,700 with repeal.

<sup>12</sup> If the 2001-2004 tax cuts were made permanent, the revenue losses due to AMT reform would rise. Indexing and repeal would reduce revenues by about \$747 billion and \$1.11 trillion, respectively, through 2015. These estimates omit the added debt service costs that the government would owe if revenue fell.

of AMT taxpayers in 2010 by 90 percent—99 percent for those with incomes between \$50,000 and \$75,000. But it would decrease the number of AMT taxpayers among those with incomes between \$500,000 and \$1 million by only 8 percent. Although not shown in the table, it would more than double the number of taxpayers with incomes over \$1 million subject to the tax.

If there is to be an alternative minimum tax, this option has much to recommend it. Allowing preferential capital gains tax rates under the AMT is also a major source of complexity and sheltering. Many individual tax shelters are designed to exploit the difference between the tax rates on capital gains and the tax rates on other income and expense—most notably the higher effective tax rate on interest expense (Burman 1999). The deduction for investment interest is the most important factor explaining the nontaxation of high-income returns (Balkovic 2002). Thus, taxing capital gains the same as other income under the AMT could arguably enhance efficiency, equity, and simplicity, and raise revenue that could be used to reduce the number of AMT taxpayers.

Instead, if legislators could find the revenue and resolve to finance AMT repeal, the best option would be to incorporate directly into the regular income tax whatever AMT provisions are deemed good tax policy, while adjusting the rates and tax in the regular income tax to achieve revenue neutrality and distributional neutrality. For example, if the regular income tax deductions for state and local taxes and the depreciation rules are too generous, reformers could eliminate these provisions for all taxpayers, not just for those paying the AMT.<sup>13</sup> Inevitably, many taxpayers would face higher marginal and average tax rates under a revenue-neutral

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<sup>13</sup> In fact, eliminating the regular income tax deduction for state and local taxes would more than pay for repealing the AMT, if the 2001-2004 tax cuts expire as scheduled, although the option would lose revenue if the tax cuts are extended.

package. But replacing the hodge-podge of implicit taxes created by the AMT with well-designed explicit taxes under the regular income tax would make the tax system fairer, simpler, and more efficient without spawning shelters or sacrificing tax revenues.

Table 4 shows the tax rates that would be necessary in the regular income tax to finance a revenue-neutral repeal of the AMT in 2010. Raising all statutory tax rates by the same proportion would require an increase of more than 9 percent, bringing the top rate to 38.3 percent compared to its current-law value of 35 percent. Raising only the top three rates would require a 15 percent increase and a top rate of 44 percent. Although these changes would be revenue neutral, they would involve shifting tax burdens across income classes. Alternatively, it would be possible to mimic the distribution of average tax burdens under current law without the AMT. If taxpayers in each bracket were to make the same aggregate tax payment in 2010 after the elimination of the AMT as they would under current law, the 10 percent tax rate would have to be raised to 10.1 percent, the 15 percent tax rate to 16.3 percent, the 25 percent tax rate to 28.3 percent, the 28 percent tax rate to 34 percent, the 33 percent rate to 42.3 percent, and the 35 percent tax rate would be *lowered* to 33.8 percent. That is, the statutory regular income tax rate would have to rise for those in the bottom five brackets and fall in the highest income group.

#### **H. Why Not Repeal the Regular Tax?**

By 2010, it would cost more to repeal the alternative minimum tax than to repeal the regular income tax. Some commentators have suggested, with varying degrees of seriousness,



that the regular tax be repealed and the AMT kept on. We believe this would be a major mistake.<sup>14</sup>

If the alternative minimum tax were to become the only income tax, it is unlikely that it could (or should) remain in its current structure. The tax is not indexed for inflation. It is laced with marriage penalties and child penalties. A tax based on ability to pay should have an adjustment for family size, which suggests that personal exemptions should be allowed.

Those who favor a flat tax should be clear that the alternative minimum tax is not a shortcut to that goal. After all, the AMT includes all the aspects of the regular income tax that are not explicitly erased by the adjustments under the AMT. The alternative minimum tax includes four different tax brackets (including the effect of the phaseout of the exemption) at rates of 26, 32.5, 35, and 28 percent. And it would certainly not be simple.

#### **I. Conclusion**

Lack of inflation indexing in the alternative minimum tax expands the reach of the tax each year. Meanwhile, the 2001-2004 tax cuts reduce regular income tax burdens over time. Caught amid these trends, one in three American taxpayers will soon be squeezed by a problematic tax that almost none of them were ever meant to pay. To date, neither political party has been willing to shoulder the responsibility for addressing the problem. But as the reach of the alternative minimum tax expands to encompass ever more taxpayers, the political benefits of seeking out a solution will expand as well.

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<sup>14</sup> The issues in replacing the regular tax with the AMT are discussed in Burman and Weiner (2005).

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Table 1. Aggregate AMT Projections

	AMT participation				Percent of 2001-2004 income tax cuts taken back by AMT, 2010
	Current law			Pre-EGTRRA law	
	2005	2006	2010	2010	
<b>AMT taxpayers<sup>1</sup></b>					
Number (in millions)	3.5	18.9	30.9	14.4	-
As percent of all taxpayers <sup>2</sup>	4.1	21.1	30.6	13.7	-
As percent of all tax filers	2.9	15.0	22.9	10.7	29.0
As percent of filers, by cash income (thousands of 2005\$)					
0-30	*	*	*	*	*
30-50	*	1.1	2.9	2.9	*
50-75	0.3	6.3	16.8	12.1	2.9
75-100	1.1	29.8	49.1	23.1	21.4
100-200	6.9	63.7	79.2	28.2	47.1
200-500	53.3	87.1	93.8	49.5	71.3
500-1,000	37.0	51.3	66.8	19.7	24.3
1,000+	25.2	30.8	34.5	17.4	9.2
<b>AMT revenue</b>					
Dollars (billions)	20.3	55.3	112.1	39.8	-
As percent of income tax revenue	2.4	5.9	8.7	2.7	-
<b>Percent of AGI on AMT returns</b>	13.7	37.8	49.7	21.8	-
<b>Cost of income tax repeal (\$ billions)</b>	169.7	64.0	51.1	221.8	-

Source : Urban-Brookings Tax Policy Center Microsimulation Model (version 0305-3).

Notes : AGI = adjusted gross income; AMT = alternative minimum tax; EGTRRA = Economic Growth and Tax Relief Reconciliation Act of 2001; \* = less than 0.05 percent; - = not applicable

(1) AMT taxpayers include those with AMT liability on Form 6251 and those with lost credits.

(2) Taxpayers are defined as returns with positive income tax liability net of refundable credits.

**Table 2. AMT Projections by Individual Characteristics**

	AMT participation			
	Current law			Pre-EGTRRA law
	2005	2006	2010	2010
<b>Percent of filers on AMT by:<sup>1</sup></b>				
<b>Number of children<sup>2</sup></b>				
0	1.9	8.9	15.8	3.3
1	2.7	18.8	30.1	12.6
2	5.2	29.9	39.3	30.5
3 or more	8.3	34.5	46.5	47.8
<b>State tax level<sup>3</sup></b>				
Low	0.9	10.9	18.4	7.5
Middle	1.2	13.3	22.3	9.8
High	2.8	16.9	24.7	13.5
<b>Filing status</b>				
Single	0.8	1.9	3.5	1.5
Married filing joint	5.2	30.0	45.2	19.0
Head of household	1.4	7.4	15.1	12.4
<b>Married filers with income between \$75,000 and \$100,000<sup>4</sup></b>				
0 kids	0.6	39.1	63.6	4.8
1 kid	0.5	51.8	82.2	21.9
2+ kids	1.8	73.4	89.4	83.6

*Source* : Urban-Brookings Tax Policy Center Microsimulation Model (version 0305-3).

*Notes* : (1) Includes those with direct AMT liability on Form 6251 and those with lost credits.

(2) Number of children is defined as number of exemptions taken for children living at home.

(3) State codes are not provided on the Statistics of Income public-use file for individuals with 2001 adjusted gross income (AGI) above \$200,000. Figures include only those filers for which we have state-of-residence information.

(4) Income refers to AGI in 2005 dollars.

Table 3. Reform Options

	AMT taxpayers, 2010 (millions)	Percentage change in AMT taxpayers, by cash income (2005\$)			Change in revenue, 2006- 2015 (\$ billions)	High-income filers owing no tax, 2010 <sup>1</sup>
		All	50k-75k	500k - 1 million		
<b>Index the AMT after 2005</b>	5.4	-82.5	-97.8	-12.0	-431	2,000
+ Remove middle-class exemption preferences <sup>2</sup>	4.2	-86.5	-99.4	-15.9	-457	2,000
+ Remove other major exemption preferences <sup>3</sup>	0.3	-99.2	-99.8	-93.6	-614	3,700
Repeal	0.0	-100.0	-100.0	-100.0	-670	9,100
<b>Revenue-neutral retargeting<sup>4</sup></b>	3.1	-90.1	-99.3	-8.1	9	2,000

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0305-3).

Notes: Change in revenue in fiscal years, other tabulations in calendar years. All plans are effective January 1, 2006. Baseline is current law.

(1) High-income filers are defined as having cash income greater than \$1 million in 2005 dollars. Numbers of returns have been rounded to the nearest hundred.

(2) Indexes and allows dependent exemptions and personal nonrefundable credits.

(3) Takes steps in the previous plan, repeals the AMT exemption phaseout, and allows deductions for miscellaneous expenses, medical expenses allowed under the regular tax, and state and local taxes.

(4) Allows dependent exemptions and personal nonrefundable credits. The preferential rates for capital gains and dividends under the AMT would be repealed; the 28 percent AMT rate would be increased to 33.5 percent; and the AMT exemption phaseout would be repealed. The sunset of the AMT exemption increase would be repealed and the exemption and rate-bracket threshold would be indexed after 2005.

**Table 4. Required Statutory Income Tax Rates for Revenue-Neutral AMT Repeal, 2010**

Individual income tax reform	Statutory individual income tax rates that preserve revenue neutrality			
<b>Current law baseline</b>	<b>10.0</b>	<b>15.0</b>	<b>25.0</b>	<b>35.0</b>
Proportional rate increase	10.9	16.4	27.4	38.3
Proportional rate increase for tax rates above 25 percent	10.0	15.0	25.0	44.0
Distributionally neutral rate increase <sup>1</sup>	10.1	16.3	28.3	42.3

*Source* : Urban-Brookings Tax Policy Center Microsimulation Model (version 0305-3).

*Notes* : Rates are for calendar year 2010.

(1) Rates are adjusted so that the aggregate amount of income tax paid by individuals in each taxable income bracket is the same after AMT repeal as it is under current law.



**Responses to Questions for the Record from Dr. Leonard E. Burman  
Subcommittee on Taxation and IRS Oversight Hearing of May 23, 2005**

*From Senator Grassley*

*Question:* We're talking about an unintended tax, the AMT, which balloons Federal revenue as a percentage of GDP. My question is this. Is it appropriate to assume that the Federal revenue windfall from the AMT must be offset with other tax increases? Put another way, if we're assuming all of the revenue from the AMT must be replaced, aren't we assuming historically high levels of Federal tax as a percentage of GDP?

*Answer:* I'd like to answer the question in two parts: (1) Should we *ever* have counted on the AMT revenues in budget projections? (2) Won't the AMT produce historically high levels of Federal income tax revenues if left unchecked? I agree that one could make a case that most of the AMT revenue should never have been counted upon. It seems highly unlikely that Congress and the President would allow 31 million households to become subject to this pointlessly complex surtax by 2010. But the official rules that CBO and OMB must follow require a number of unrealistic assumptions, such as that expiring tax provisions—including those with broad bipartisan appeal like the research and experimentation tax credit—will be allowed to expire. Although I do not think Congress would want to ask the CBO to make judgments about the political prospects of existing and expiring provisions, the unfortunate effect of most of these conventions is that they produce an overly optimistic picture of the budget. Arguably, those over-optimistic projections have fueled the proliferation of tax cuts and spending increases that threaten our fiscal health. Had Congress anticipated that projected AMT revenues would not materialize, it might have judged the tax cuts to be unaffordable. In any event, I believe that it would be fiscally reckless to adjust the baseline rules to make AMT repeal seem costless, unless at the same time Congress were to reconsider the earlier tax cuts in light of the new paradigm and make offsetting adjustments.

As for (2), CBO has projected that Federal tax revenues will grow to almost 25 percent of GDP by the year 2050 if the AMT is allowed to continue on its current trajectory. (Only part of this growth is due to the AMT. Part arises from the fact that, under a progressive income tax, revenues increase as a share of income as real incomes grow as more and more income becomes subject to higher tax brackets over time.) Given that the historical norm for revenues is about 18 percent of GDP, and the record was about 21 percent, this would indeed be unprecedented, but expenditures are on track to grow far more according to the CBO because of the retirement of the baby boomers and growth in health care costs. Thus, even the unprecedented revenue yield might prove insufficient to prevent an explosion of public debt over the long run. My view is that the AMT is not the best way to meet current or future revenue needs, but, at least over the long run, the revenue attributable to the AMT needs to be offset either by other taxes, by spending cuts, or some combination.

*From Senator Kyl*

*Question:* Your written testimony pins much of the blame for the exploding AMT problem on the 2001 and 2003 tax cuts, in addition to the fact that the parameters of the AMT are not indexed for inflation. While it's indisputable that more taxpayers fell into the AMT as their regular tax liability was reduced when regular income tax rates were reduced, isn't this really a problem with the AMT and not with the concept of reducing tax rates?

*Answer:* My testimony addressed your point:

Determining the causes of the expanding reach of the AMT is tricky. For example, the AMT might have been repealed in 1979, but it wasn't. Thus, in some sense, failure to repeal the AMT in 1979 could be viewed as the cause of projected AMT growth. Despite this underlying ambiguity, we believe it makes the most sense to focus on two factors: the lack of inflation indexing in the AMT and the 2001–2004 tax cuts. As a general rule, most major tax legislation since 1980 has included changes in the AMT that broadly conform to the reforms made in the regular income tax—the 1986 act, for example, broadened the base of both taxes; the 1993 act raised marginal rates under both taxes. . . . [But ] the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), and the Working Families Tax Relief Act of 2004 (WFTRA) cut the regular income tax, but did not make significant, lasting changes to the AMT.  
(p. 5)

The problem is not with marginal income tax rate cuts, *per se*, but with cutting those rates without making a conforming adjustment to the AMT tax structure. If those conforming changes had been made, millions fewer people would be affected by the AMT in future years. But those changes would also have significantly increased the revenue loss associated with the tax cuts, which might have forced policymakers to scale them back.

*Question:* Does any taxpayer who fell into the AMT because of the 2001 and 2003 tax cuts have higher tax liability in the AMT than they would have had under the regular system if the 2001–2004 tax cuts had never been enacted?

*Answer:* As far as I know, no one ended up paying more in total income taxes because of the interaction between the AMT and the 2001 to 2004 tax cuts. (Since AMT is technically the difference between tax owed under the regular income tax rules and tax owed under the AMT rules, many taxpayers' AMT liability went up, but the increase was fully offset by a reduction in regular income tax liability.)

However, it should also be noted that a significant fraction of tax units will end up with no tax cut as a result of the AMT. In 2010, 12 percent of tax units with incomes between \$100,000 and \$200,000, 27 percent of units with incomes between \$200,000 and \$500,000, and 10 percent of units with incomes between \$500,000 and \$1 million will receive no tax benefit from the individual income tax cuts enacted between 2001 and 2004 because of the AMT.

*Question:* On this same point, your testimony says, "Our simulations show that if the AMT had been indexed for inflation along with the regular income tax in 1985, and if the

*2001–2004 tax cuts had not been enacted*, the number of AMT taxpayers would have remained between 300,000 and 400,000 through 2010, rather than rising to 31 million” (emphasis added). Did you run a simulation to see what would be the result if the parameters had been indexed for inflation in 1985, and the 2001 and 2003 tax cuts *were* enacted?

*Answer:* In response to your question, we simulated the effect of the tax cuts assuming that the AMT had been indexed since 1985. Under that scenario, we project that 1 million people would be subject to the AMT in 2010 (although that is still roughly 250 percent of the number absent the tax cuts).

Here are some other relevant findings: Had the AMT been indexed in 1985, pre-EGTRRA baseline income tax revenues would have been reduced by about \$139 billion for the 10-year budget window, 2001–2010, and the revenue loss attributable to the 2001–2004 tax cuts would have been \$226 billion higher over the original budget window. In 2010, the revenue loss attributable to the income tax cuts would be 36 percent higher than under current law. As a result, the tax cuts as enacted could not have fit in the budget reconciliation targets, and the cost of extending the tax cuts beyond 2010 would be much higher than currently projected.

#### ***From Senators Baucus and Jeffords***

*Question:* We have heard from several witnesses that AMT repeal makes the most sense. The big question, however, is how to pay for it. The committee heard testimony that a reversal of the recent tax cuts would not be an appropriate offset, but rather Congress should rely on spending cuts. Do you agree?

*Answer:* I think that is a question for Congress to decide. I will note that, according to OMB, income tax revenues in 2004 were 7 percent of GDP—the lowest level since the Truman administration, which was a time when the Federal Government was much smaller. Revenues are projected to grow somewhat as a result of the AMT and real income growth, but stay far below historical norms for quite some time. Eliminating the AMT without making up the tax revenue elsewhere (rolling back the recent tax cuts is one of several options) is unsustainable without draconian cuts in spending programs. My colleague, Gene Steuerle, has calculated under a similar scenario that, even if all discretionary programs other than defense and homeland security were eliminated, the government would be running growing deficits after 2014. In other words, even if Congress could muster the will to eliminate funding for highways, national parks, monuments, schools, the environment, health care and food stamps for poor families, and even the White House, Congress, and the courts (and much more), the government would still be running deficits as the baby boomers start to retire. Thus, unless Congress can also slash programs such as Social Security, Medicare, and national defense, additional tax revenues will be needed.

*Question:* In your written testimony, you stated that before 1985, capital gains preferences were a major item in the AMT. Can you describe how that worked, the reasoning behind it, and what happened to it? What would be the revenue implications of returning to such a system?

*Answer:* Prior to enactment of the Tax Reform Act of 1986, the preferential rate on long-term capital gains was the single largest preference item under the AMT. In short, capital gains and other income, such as wages, interest, and dividends, were taxed at the same rates under the AMT. The logic behind taxing capital gains at the same rate as other income is that a rate differential provides huge incentives for inefficient tax sheltering. Wealthy individuals invest in schemes that make otherwise highly taxed compensation appear to be lightly taxed capital gains. At the top income tax rate of 50 percent that applied in 1986, and the top capital gains rate of 20 percent, such schemes would save 30 cents in tax for every dollar of income thus sheltered.

Tax lawyers say that the capital gains differential is the engine behind the vast majority of tax shelter schemes. And those schemes are highly inefficient. People make investments for tax purposes that they would not make based simply on the underlying economics, starving other potentially worthwhile investments for capital. Since the original purpose of the AMT was to discourage such tax sheltering, it made sense to treat the capital gains differential as a preference item.

Under current law, capital gains and dividends are taxed at lower rates than other income under both the regular income tax and the AMT. The differential between the top ordinary income tax rate (35 percent) and the top capital gains rate (15 percent) is now 20 percentage points, providing a substantial incentive for tax sheltering. It is also a significant source of complexity; an entire page of Form 6251 (used to calculate AMT liability) is devoted to implementing the alternative tax rates on capital gains and dividends. Taxing gains and dividends at the same rate as other income under the AMT would eliminate this complication, reduce the incentive for tax shelters, and raise substantial revenue—primarily from people with incomes over \$200,000.

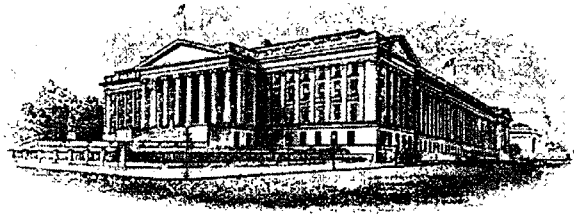
In one simulation, titled “revenue neutral retargeting” in Table 3 of my testimony, we estimated that the number of AMT taxpayers could be reduced by 90 percent (from 31 million to 3.1 million) in 2010 without increasing the deficit over the budget window if capital gains and dividends were taxed the same as other income under the AMT, the exemption and rates were indexed for inflation, personal credits allowed against the AMT, and the four implicit AMT rates of 26, 32.5, 35, and 28 percent were replaced with two rates: 26 percent and 33.5 percent (where the higher rate takes effect where the 28 percent rate applies under current law, so most AMT taxpayers get a rate cut). That scenario would virtually eliminate the AMT for taxpayers with incomes under \$75,000, and cut the participation rate in every income class up to \$1 million. Taxpayers with incomes over \$1 million, in contrast, would be twice as likely to owe AMT as under current law. In other words, the AMT would fall more heavily on those who were its original target.

***From Senator Crapo***

*Question:* Of your proposed solutions, you said one option would be to repeal the AMT for all except the high-income individuals. At what level do you define “high income?”

*Answer:* I was referring to taxpayers with cash incomes over \$200,000.

The revenue-neutral retargeting option described in my previous answer would cut the number of AMT taxpayers in 2010 by 90 percent and eliminate it for almost all households with incomes under \$200,000. Less than 1 percent of tax filers with incomes under \$100,000 would owe the tax, and only 4.4 percent of those with incomes between \$100,000 and \$200,000 would be subject to the AMT. In contrast, under current law, 49 percent of filers with incomes between \$75,000 and \$100,000, and 79 percent of filers with incomes between \$100,000 and \$200,000 will be subject to the tax. Under the retargeted option, most of the tax would be paid by households with incomes over \$200,000.



**DEPARTMENT OF THE TREASURY  
OFFICE OF PUBLIC AFFAIRS**

**Testimony of Deputy Assistant Secretary (Tax Analysis) of Treasury  
Robert J. Carroll before the Senate Finance Subcommittee on  
Taxation and IRS Oversight**

Mr. Chairman, Senator Jeffords, and Distinguished Members of the Committee.

Thank you for the opportunity to discuss the individual alternative minimum tax. The alternative minimum tax, or AMT, is an example of a tax provision that was intended to address a relatively small, targeted problem that has had unintended consequences, grown far beyond its original purpose, and created a far larger problem than it was ever intended to address. Unfortunately, because of the way the AMT is now intertwined with the rest of the individual income tax, a long-term solution to the AMT problem needs to be considered in the broader context of reform of the income tax.

**History of the AMT**

The predecessor of the AMT -- the minimum tax -- was first enacted in 1969 in an attempt to insure that a small group of high-income individuals who had managed to avoid paying any income tax would pay at least a minimum amount of tax. Then Treasury Secretary Barr noted in his testimony before the Joint Economic Committee of Congress in 1969 that 155 taxpayers with incomes over \$200,000 paid no tax in 1966. The AMT we have today is projected to affect over 50 million taxpayers by 2015.

Moreover, even though the minimum tax and later the AMT did reduce the number of high-income taxpayers who otherwise would have paid no income tax, neither provision has been

successful in attaining the original goal of ensuring that all high-income taxpayers pay at least some tax. Each year several thousand high-income taxpayers continue to be nontaxable, generally for various combinations of legitimate reasons and in spite of the AMT.

Several major and many minor changes since 1969 have transformed the original minimum tax into the current alternative minimum tax which, for too many taxpayers, is now a second income tax that runs parallel to the regular individual income tax. The broad reach and design flaws of the AMT result in a tax system that is complex, unfair, and discourages economic growth. Taxpayers must comply with two parallel tax systems – even for the many millions who do the calculations but ultimately have no AMT liability.

### **The AMT: A Looming Problem**

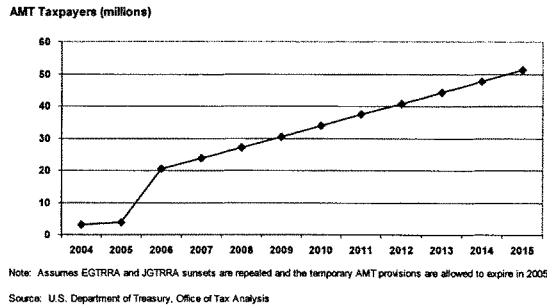
The AMT is a parallel tax system with its own tax base, exemption amounts, tax rates, and usable tax credits. A taxpayer's AMT liability is essentially the difference between the liability calculated under the AMT and the liability calculated under the regular income tax. The AMT itself is not an especially complex tax. It is the requirement that taxpayers understand and comply with two parallel tax systems makes the AMT complex. Moreover, because many taxpayers become subject to the AMT for reasons that are not the result of tax-motivated planning, many taxpayers are not aware that they will be affected by the AMT until they complete their tax returns. They become unsuspecting – and unintended – victims of the AMT.

The major reason the AMT has become such a growing problem is that, unlike the regular tax, this parallel tax system is not indexed for inflation. The AMT tax rate thresholds, the AMT exemption, and its phase-out are all fixed in nominal terms. Consequently, the passage of time and the erosive effects of inflation have steadily increased the size and scope of the AMT. Because of budgetary constraints and the large and ever-increasing amount of revenue from the AMT, solving the AMT problem in isolation would be extremely difficult.

The large AMT exemption has generally kept the vast majority of taxpayers free from the reach of the AMT. Indeed, each of the major tax cuts enacted by the Congress in the last several years have included provisions to increase the AMT exemption or other provisions to prevent a large increase in the number of AMT taxpayers. The higher AMT exemption and the provision to allow all personal credits to be claimed against the AMT – the so-called “AMT patch” – both remain in effect through 2005.

Chart 1: Number of AMT Taxpayers

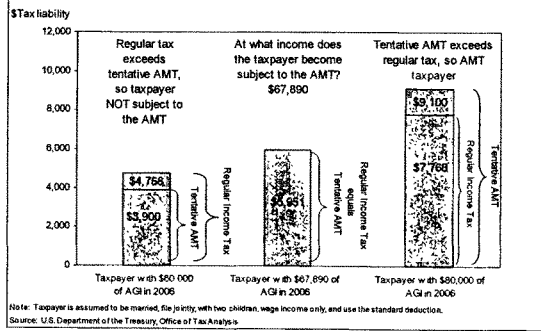
Beginning in tax year 2006, after the temporary AMT provisions expire, the number of taxpayers projected to be affected by the AMT rises sharply, from 3.8 million in 2005 to 20.5 million in 2006 (Chart 1). By 2015, 51.3 million or 45 percent of all taxpayers with income tax are projected to be subject to the AMT.



The AMT will increasingly affect middle-income taxpayers. In tax year 2005, about 13 percent of taxpayers with incomes between \$100,000 and \$200,000 will be subject to the AMT. But, when taxpayers file their tax returns in the spring of 2007 for tax year 2006, over 75 percent of taxpayers in this income group will be subject to the AMT.

To put this into perspective, consider how the AMT will affect a hypothetical joint filer with two children in tax year 2006 (see Chart 2). The taxpayer calculates tax liability under both the regular tax and the AMT and pays whichever is larger. The illustration reveals that in 2006 the hypothetical taxpayer becomes subject to the AMT when his income exceeds \$67,890. The AMT is no longer a tax that applies only to the high income.

Chart 2: An illustration for a joint filer with two children in 2006





The AMT also increasingly affects families with children because it does not allow deductions for personal exemptions. Nearly all AMT taxpayers will lose at least part of the benefit of the 2001 through 2004 tax cuts, including some who will lose all the benefit. And many unsuspecting AMT taxpayers are subject to an effective marginal tax rate of 35 percent even though the maximum statutory AMT rate is only 28 percent because of the phase-out of the AMT exemption.

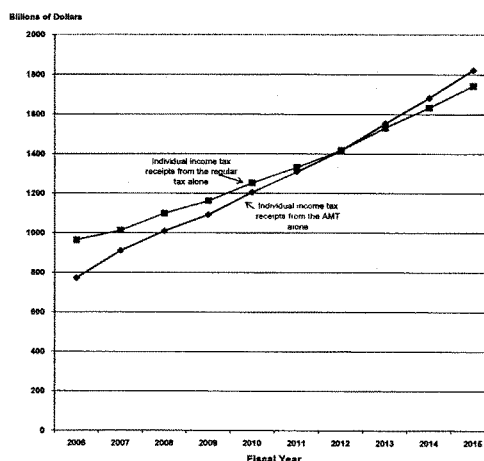
The increases in the number of AMT taxpayers over the next decade will be accompanied by dramatic increases in tax revenues from the AMT. AMT revenue will increase from \$18 billion in 2005 to \$210 billion in 2015 (roughly 11 percent of total individual income tax revenue). In fact, by 2013 the revenue raised by the AMT alone actually exceeds the revenues from the regular tax (Chart 3). Both the large numbers of taxpayers affected and the large amount of revenue suggest that the AMT problem will have to be addressed in the context of broader changes to the tax system.

#### Tax Reform and the AMT

In many respects, the AMT is a poster child for the need to reform the tax system. The AMT fails to meet all three of the criteria the President laid out when creating the Advisory Panel for Reform of the Federal Tax System. First, the AMT is not simple. The AMT requires taxpayers to comply with two parallel tax systems, often does not warn taxpayers that they have to deal with the second system, and the second system itself is unnecessarily complicated. Second, the AMT does not promote economic growth. In fact, the extra compliance costs and for many taxpayers the higher marginal tax rates imposed by the AMT discourages economic growth. And, third, the AMT is not fair. It disproportionately affects large families. It disallows some legitimate expenses incurred by taxpayers in order to earn income. It affects many middle-income and upper-middle-income taxpayers, but does not affect many taxpayers with the highest incomes.

Given the large revenue impact of the AMT and the extent to which the AMT is closely related and intertwined with the regular income tax, we need to consider broader solutions that will involve changes to the regular income tax. Thus, it is both inevitable and timely that the long-term solution to the AMT problem will be through broad reform of the income tax. Inevitable, because budgetary constraints preclude simple AMT repeal. Timely, because our overly

Chart 3: Revenue from the Regular Tax Versus the AMT



Note: Assumes EOTMRA and JOTIRRA sunsets are repealed and the temporary AMT provisions expire in 2005.  
Source: U.S. Department of Treasury, Office of Tax Analysis

complicated tax system, which distorts economic decision-making and discourages economic growth, is in dire need of reform.

The current tax system imposes large costs on our economy by distorting the economic decisions of households and businesses, and tax reform that reduces those costs would encourage economic growth and improve living standards. Fundamental tax reform could increase our capital stock by 10 to 15 percent and ultimately increase real GDP by as much as 2 to 6 percent. More uniform treatment of different types of income, businesses and individuals could also produce significant economic gains by improving the allocation of economic resources and reducing economic waste.

The complexity of the income tax leaves many taxpayers with the sense that the system is unfair because others use special provisions to pay less tax. This sense of unfairness undermines voluntary compliance. It also encourages taxpayers to believe that they, too, should seek out tax minimizing strategies and behavior. In turn, that behavior only increases the economic costs and inefficiencies of our tax system.

Major revisions to our tax code occur every few years, with minor changes almost every year. Frequent changes in the tax code and uncertainty about the future make it difficult for individuals and businesses to make economic decisions. One goal of tax reform is a more stable tax system. Taxpayers should be able to plan without having to gamble about the future of the tax system.

The U.S. tax system not only imposes a cost to the economy by distorting households' and businesses' economic decisions and slowing economic growth, but it also imposes direct costs on taxpayers measured by the value of the time and resources devoted to complying with the tax system that could be put to more productive uses. According to the IRS, business and individual taxpayers spend more than 6 billion hours per year to comply with the tax system. To put this in perspective, this translates into a million and a half additional IRS agents. The total compliance costs of the income tax are estimated to be roughly \$130 billion annually – about 13 cents for every dollar in income tax revenues collected.<sup>1</sup> These compliance costs include both out-of-pocket costs and the time taxpayers spend to learn about the tax laws, keep and assemble necessary records, and prepare and submit tax returns.

Recent estimates are that individual taxpayers (including sole proprietors) spent roughly 3.5 billion hours annually complying with the tax system. According to a recent study based on IRS data, compliance costs for individuals – including the value of taxpayers' time – are roughly \$90 billion a year. On average, individuals spent 26 hours a year on their federal income taxes and spent an average of \$157 on out-of-pocket costs for the services of tax professionals, filing fees, software purchases, etc., in tax year 2002. Although taxpayers with self-employment income tend to have more complex affairs and spend more time and money on their taxes, even taxpayers without any self-employment income spend an average of 15 hours and \$76 in out-of-pocket costs each year determining their tax obligations.

IRS estimates that businesses spend over 3 billion hours a year complying with the tax system. One analyst estimates the total cost to be about \$40 billion annually. Recent academic research indicates that compliance costs are the highest for the very largest businesses. Those with over \$5 million in assets reported compliance costs of nearly \$25 billion per year.

Certainly, a simpler tax system could decrease these burdens substantially and put these resources to more productive uses.

#### **Criteria of a Well-Functioning Tax System**

We suggest five criteria for evaluating proposals for tax reform: simplicity; pro-growth; fairness; fiscal responsibility; and stability.

A tax system should be easy to understand, have reasonable filing and record keeping requirements, including reduction or elimination of return filing, if possible, and have low cost and non-intrusive tax administration.

A tax system should be consistent with a strong economy. Business and household decisions should not be based on the tax code as little as possible. The tax code should promote economic growth by removing tax distortions and should maintain U.S. international competitiveness.

A tax system should be fair. It should provide equal tax treatment of similarly situated taxpayers (horizontal equity) and a reasonable degree of progressivity, imposing higher taxes on those with a greater ability to pay (vertical equity).

A tax system should be fiscally sound. It should raise sufficient revenue to fund the federal programs that government chooses to provide.

A tax system should be stable. It should be resistant to frequent changes, especially those that change taxpayers' legitimate expectations.

#### **The President's Tax Reform Panel**

The President has made reforming our tax system a key priority. The President's Advisory Panel on Federal Tax Reform, named by the President earlier this year, is developing options to reform our tax system to make it simpler, fairer and more pro-growth. The Tax Panel brings a fresh perspective to tax reform. The members of the Panel are both independent and open-minded and are not wedded to particular approaches to tax reform. The Panel has a mandate to consider all options. The only constraints in the Panel's mandate are that its proposals should be revenue neutral, they should recognize the importance of housing and charitable giving to our American society, and that one of its options must include reform of the current income tax.

The Panel has been holding public hearings here in Washington, DC, and across the country to obtain the views of a wide range of knowledgeable and interested individuals about the problems with the current tax system and the merits of alternative ways to improve or reform the current system.

We are looking forward to the Panel's final report to the Secretary of the Treasury due by July 31. The options developed by the Panel will provide critical input for the recommendations on tax reform – including recommendations to address the AMT problem – the Secretary will then make to the President and the President will then make to the Congress.

Thank you again, Mr. Chairman, Senator Jeffords, and Members of the Committee for the opportunity to appear before you today. We look forward to working together with this Committee and others in the Congress on the AMT issue, on tax reform in general, and on other issues. I would be pleased to answer questions from the Committee.

**Responses to Questions for the Record From Robert J. Carroll  
Subcommittee on Taxation and IRS Oversight Hearing of May 23, 2005**

*From Senator Grassley*

*Question:* We're talking about an unintended tax, the AMT, which balloons Federal revenue as a percentage of GDP. My question is this. Is it appropriate to assume that the Federal revenue windfall from the AMT must be offset with other tax increases? Put another way, if we're assuming that all of the revenue from the AMT must be replaced, aren't we assuming historically high levels of Federal tax as a percentage of GDP?

*Answer:* Under current law, we estimate that the Federal receipts-to-GDP ratio will be below the 50-year average through 2010. If the recommendations in the President's 2006 budget are enacted, the receipts-to-GDP ratio will remain below its long-term average until the second half of the budget window. Both of these estimates assume no changes to the AMT, which is equivalent to assuming that AMT revenue would be fully replaced if the AMT were repealed. So, if all AMT revenue were replaced, the ratio of receipts to GDP would rise above historical levels by the end of the 10-year budget period.

*From Senator Kyl*

*Question:* Does the administration believe that reforming or repealing the AMT must be done in a revenue-neutral manner?

*Answer:* The President has appointed an Advisory Panel on Federal Tax Reform, which will offer options in a report to the Secretary later this summer. In his Executive Order establishing the panel, the President directed that the panel's options should be revenue neutral. The Treasury Department will rely on these options in developing its recommendations to the President later this year. We fully expect the panel to address the AMT in its options. Since any changes to the AMT will be included in revenue-neutral options, they effectively will be paid for.

*Question:* Please explain why the President did not include an extension of the AMT "patch" in his FY 2006 budget.

*Answer:* In the fall of 2004, the Working Families Tax Relief Act extended the higher AMT exemption amounts through calendar year 2005. That extension has kept the impact of the AMT from increasing dramatically for 2005 and has provided time for the administration and the Congress to address the AMT issue.

Because of the complexity of our tax system and the interrelations between many of its provisions, issues involving the AMT should not be dealt with in isolation. Any solution to the AMT issue is likely to be in the context of overall changes to the entire Federal tax system. The President's Advisory Panel on Federal Tax Reform is currently developing reform options that we fully expect will address the AMT.

*From Senator Baucus*

*Question:* Dr. Burman in his testimony presented estimates (based on data that is publicly available) as to the number of high-income taxpayers who would pay no Federal income tax in the absence of the AMT. Do you agree with these estimates or have other relevant data, and

could you describe the principal reasons that such high-income taxpayers would owe no income tax?

*Answer:* Less than two-tenths of one percent of high-income returns have been nontaxable over the past quarter-century, and the reasons for their nontaxability vary widely. While we agree with Dr. Burman's projection that repeal of the AMT would increase the number of nontaxable high-income returns, our projections are lower than Dr. Burman's. Further, if other changes were made to the individual income tax when the AMT was repealed, the number of remaining high-income nontaxable returns could be substantially reduced (or increased), depending on these other changes. Thus, looking at the effect of AMT repeal in isolation may not provide insights into the effects of actual policy proposals.

The high-income returns that would become nontaxable if the AMT were repealed generally would be paying taxes at very low average rates even with the AMT. Absent the AMT, miscellaneous deductions such as the deduction for State and local income and property taxes and for miscellaneous items subject to the 2 percent of AGI floor could combine with other deductions which are not considered preferences under the AMT to completely offset a taxpayer's adjusted gross income, producing zero or negative taxable income, and hence no ordinary income tax.

*Question:* The last budget proposal from the prior administration proposed allowing the personal exemption and the standard deduction against the AMT. At the time, that proposal was estimated to cost \$38 billion over 10 years, but now the same proposal would cost almost ten times as much because of the tax cuts and inflation. Do you know if this proposal was debated within the new Treasury, and if so, why was it not re-proposed in 2001?

*Answer:* Allowing personal exemptions and the standard deduction for AMT purposes would alleviate the AMT problem, but would fall far short from solving it. Further, the cost of this change would be the same today even if the proposal had been enacted in 2001. In 2001, the primary focus was on reducing tax rates and lessening other disincentives in our tax system. That effort and subsequent legislation have been very successful in responding to the economic slowdown in 2001 and the economic repercussions of 9-11. The administration's tax priorities now are to ensure permanence of this legislation and to fundamentally reform the Federal tax system. We fully expect that the AMT will be addressed in the context of fundamental tax reform.

*Question 3:* We have heard testimony advocating spending cuts over tax increases in order to pay for repeal of the AMT. Assuming extension of the 2001 cuts, full repeal would cost over \$1 trillion. Does the administration believe that spending cuts, while politically difficult, are the appropriate revenue source if the AMT is to be repealed? If so, would you identify these cuts?

*Answer:* The extension of the higher AMT exemption amounts through calendar year 2005 has kept the impact of the AMT from increasing dramatically for 2005 and has provided time to address the AMT issue. Because of the interrelations between many of the provisions of the Federal tax system, the AMT issue is likely to be addressed in the context of overall changes to the entire Federal tax system. The President's Advisory Panel on Federal Tax Reform is currently developing revenue-neutral reform options that we fully expect will address the AMT.

*Question 4:* If the administration is of the opinion that AMT repeal should be offset by spending cuts, please explain why the administration's FY 2006 revenue proposals, which would result in approximately twice as much revenue loss, should not also be offset by spending cuts?

*Answer:* As noted in the answer to the preceding question, we fully expect the AMT to be addressed in the context of a revenue-neutral tax reform.



U.S. SENATE COMMITTEE ON

# Finance

SENATOR CHUCK GRASSLEY, OF IOWA - CHAIRMAN

<http://finance.senate.gov>

Statement of Senator Chuck Grassley  
 Taxation and Oversight Subcommittee Hearing:  
 "Blowing the Cover on the Stealth Tax: Exposing the Individual AMT"  
 Monday, May 23, 2005

First off, thank you to Senators Kyl and Jeffords for your work on putting together this hearing on the Alternative Minimum Tax. I'd like to take a few minutes, make a short statement, and ask the witnesses to answer a couple of questions. The AMT penalizes married taxpayers and taxpayers with children because the AMT prohibits deductions for dependents, and by 2010, about 6 million taxpayers will face the AMT simply because they have children. Among married taxpayers with two or more children, 85 percent will face the AMT in 2010. Eighty five percent! To me, that's an incredible figure. We can't let that happen. Mr. Chairman, let me repeat it. We cannot let 85 percent of families with two or more children face the AMT. Those families have enough of a tax burden already. Asking them to deal with the AMT as well is just plain wrong.

As I see it, we have two tasks in front of us on the AMT. The first is to make sure we continue to stop the damage with the AMT hold harmless, or "patch." There is room in the reconciliation bill to cover the patch, and I intend to use it when we get to that bill this fall. I hope we'll have bipartisan support for that effort. Keep in mind that, at least from my standpoint, \$30 billion of the reconciled tax relief is supposed to go for the AMT hold harmless. Together with other bipartisan expiring tax relief policy, like college tuition deductibility, small business expensing, and the research and development ("R&D") tax credit, the reconciliation bill should be supported be most on this committee.

The second task deals with the long-term solution for the AMT problem. From my standpoint, AMT can be resolved in tax reform, but tax reform should not be the only avenue for a resolution. I'll be looking for the earliest legislative opportunity to reform the AMT. When we were wrapping up the budget resolution conference report, I responded to the criticism that the budget resolution didn't cover the AMT problem. In fact, as I discussed a moment ago, there is room for the hold harmless provision. In that statement, I also challenged the critics, primarily the Democratic leadership, to stop complaining and come up with an AMT reform plan. I'm pleased to say that, as is typical with this committee, the challenge is being taken up by Finance Committee Democrats. Senator Baucus and Senator Wyden are joining with Senator Kyl and me in this effort. As always, the Finance Committee, on a bipartisan basis, is trying to solve a key problem affecting millions of American families. So, I say to the Democratic leadership, get out of the way. Quit complaining about the AMT. Let the Finance Committee, on a bipartisan basis, do something about the problem. I couldn't be more pleased, Mr. Chairman, that this committee, as it did in 1999 and 2001, is once again, taking the lead on fixing the AMT.

We will be introducing a bill shortly. The bill will call for repeal of the AMT. Now, some will note that the revenue loss is over \$600 billion for repeal. It is still higher if the bipartisan tax relief is extended past 2010. We all recognize that is a high number. We will need to get it to a reasonable level. I'd remind my colleagues that if we extend current law AMT relief provisions, we're looking at a revenue loss of \$385 billion. It appears the Congress, on a bipartisan basis, has already accepted that figure. Who would argue that we shouldn't extend the hold harmless because it is not offset? I'd like the panel to answer a couple of questions. We're talking about an unintended tax which balloons federal revenue as a percentage of GDP. My question is this. Is it appropriate to assume that the federal revenue windfall from the AMT must be offset with other tax increases? Put another way, if we're assuming all of the revenue from the AMT must be replaced, aren't we assuming historically high levels of federal tax as a percentage of GDP?

Testimony before the Subcommittee on Subcommittee on Taxation and IRS Oversight

Senate Finance Committee

“Blowing the Cover on the Stealth Tax: Exposing the Individual AMT”

Monday, May 23, 2005

Kevin A. Hassett

Director of Economic Policy Studies

American Enterprise Institute



Almost every professional analysis of the Alternative Minimum Tax (AMT) of which I am aware takes a highly critical view of this misguided tax. Extensive research has revealed that it has undesirable incentive effects, and often accounts for tax liabilities that are unreasonable and even at times indefensible. Until recently, the AMT was something of a footnote in the tax code. However, as my colleague on this panel Len Burman has demonstrated in a series of important papers with various coauthors, taxpayers are affected by the AMT more and more each year.<sup>1</sup>

Since I feel safe in presuming that Mr. Burman can more competently convey his research findings than I can, I will focus my remarks on parts of the academic literature that complement his work. Before I do that, however, let me stipulate that Mr. Burman's work accurately and exhaustively characterizes the state of the AMT problem today. He has carefully documented the economic harm that the AMT causes. His estimates of the costs of various reforms in the updated version of his *Journal of Economic Perspectives* piece appear to be accurate, as does his estimate of the proportion of taxpayers who have become subject to the AMT by the EGTRRA. The question, I believe, is not whether this tax needs to be reformed, but rather, how best to do it. This is where my testimony will focus most of its attention.

My first recommendation is that reliance on stopgap measures be abandoned. To date, the AMT problem has been delayed by stopgaps. One measure that has been used to soften the blow is a temporary increase in the AMT exclusion. The use of this stopgap is effective in the short run, but it is likely harmful to future policy as a whole. This is

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<sup>1</sup> Burman, Leonard E., William G. Gale, and Jeffrey Rohaly (2003) "The AMT: Projections and Problems," *Tax Notes*, Vol. 100, No. 1, pp. 105-117. Burman, Leonard E., William G. Gale, and Jeffrey Rohaly. (2003) "The Expanding Reach of the Alternative Minimum Tax." *Journal of Economic Perspectives*, Vol. 17, No. 2, pp. 173-86

because current long run forecasts include ever more significant amounts of revenue from the AMT that will not be realized if successive temporary stopgaps are adopted. Elected officials will base their decisions on highly misleading revenue forecasts if they rely on them.

Future stopgap measures might continue to reduce actual AMT revenue, but there are no guarantees. The AMT is acquiring such a big footprint that these temporary measures will soon become quite costly, and politically more challenging. This will make uncertainty concerning AMT reform a key factor for tax planners. Mr. Burman has indicated in his work how serious the aggregate problem is becoming. A specific example will help illustrate how close we are to the AMT precipice under current law. For Figures 1 and 2, I used data on state and local income taxes to estimate whether a married couple with an income of \$150,000, three children, and normal state and local deductions would be on the AMT. Under current law, with the temporarily high \$58,000 AMT exemption, taxpayers in only eight states face the AMT. Next year, when the exemption is reduced to \$45,000, this changes dramatically. This family would face the AMT regardless of what state it lived in. Note, however, how uneven the liability is. Individuals in states that are the darkest will bear a much higher AMT burden than individuals in the lighter shaded states. A family in New York would pay the most, \$4,058, while the same family in Tennessee would pay the least, \$1,243.

This latter point is one key problem with the AMT that has been highlighted in the literature. While it was originally motivated as a tax to ensure social justice, it likely does the opposite. It taxes individuals across states in a hodgepodge way, hitting similar individuals quite differently. Mr. Burman has also demonstrated that it

disproportionately harms families with children, and married couples. Such harm is an unintended consequence of bad tax design, having no conceivable philosophical justification.

**What economic impact would the AMT tax hike likely have?**

This uneven and unjust tax has significant economic consequences. The AMT causes economic harm for at least two reasons. First, it increases tax complexity and compliance costs for the many millions of taxpayers who must calculate their taxes according to two different sets of rules each year. Second, the AMT often increases marginal tax rates for those who fall under it. A recent study of these marginal tax rate increases found that they were very uneven, increasing marginal rates sharply for some taxpayers, and only slightly for others.<sup>2</sup> The authors found that for 81 percent of taxpayers, wages face a higher marginal tax rate under the AMT, with 18.6 percent of taxpayers experiencing an increase of 10 percent or more. The increase occurs because the lowest AMT bracket rate is higher than the income tax rate of middle income Americans who are swept onto the AMT, especially in future years. On average across all taxpayers, the AMT is projected to increase average marginal income tax rates by 1.5 percentage points by 2010, though the increment to the marginal tax rate is lower in earlier years.<sup>3</sup>

These higher marginal tax rates likely will suppress economic activity, and do so unevenly, hitting some states much harder than others. Although the scale of this effect

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<sup>2</sup> Feenberg, Daniel R. and James M Poterba. (2003) "The Alternative Minimum Tax and Effective Marginal Tax Rates." MIT Department of Economics Working Paper No. 03-37, pp. 28

<sup>3</sup> *Ibid.*, page 16

is the subject of intense academic debate, recent research suggests that marginal tax rates have large effects over longer time horizons.<sup>4</sup>

### **Reform options**

The complexity, high marginal rates, and uneven reach of the AMT make repeal the best reform option. The key factor justifying this recommendation in my mind is the absence of unambiguous logical justification for the current view that it is “just” to punish taxpayers for taking advantage of tax preferences that are perfectly legal. For example, capital market equilibrium may equalize after-tax returns of assets with different tax attributes. This means that if the tax rate were 50 percent, one would expect to observe, to use bonds as an example, that tax free bonds would pay 2.5 percentage points interest if taxable bonds paid 5 percentage points. Now, one millionaire might purchase taxable bonds and pay healthy tax on that interest, while another might buy tax free bonds and not do so, but each of them derives the same welfare. If an unexpected penalty is imposed on the individual purchasing the tax free bonds because they failed to pay tax, then one in fact diminishes social justice by increasing after tax inequality. If the tax penalty is anticipated, it will simply change the interest rate on the “tax free” instrument in a manner that leaves both investors with the same after tax income. Other tax preferences are folded into our complex economy in a similar way. Thus, there are two possible outcomes. The penalty accomplishes a bad thing, or nothing at all. It is hard to imagine why a rational individual would want to keep it, or even amend it to make it “better”.

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<sup>4</sup>See Prescott, Edward (2002) “Prosperity and Depression,” *American Economic Review*, Vol. 92, No. 2, pp. 1-15. Prescott, Edward (2003) “Why Do Americans Work So Much More than Europeans?” Federal Reserve Bank of Minneapolis Staff Report 321. Davis, Steven J., and Magnus Henrekson. (2004) “Tax Effects on Work Activity, Industry Mix and Shadow Economy Size: Evidence from Rich-Country Comparisons.” NBER Working Paper 10509

If the AMT were repealed, a natural question, given the current difficult fiscal situation, would be whether the repeal should be revenue neutral.

The current forecasts assume that significant AMT revenue will be realized. Tax revenues rise as a share of GDP to a level significantly above the historical average (Figure 3) over the next 10 years. Outside of the budget window, the revenue gains associated with the AMT are even more impressive. If policymakers do not modify the AMT or any other provisions of current tax law, revenues relative to GDP will rise to virtually unprecedented levels. By 2050, tax receipts would be 24.7 percent of GDP, compared to 18.4 percent if they remained at their historical average.<sup>5</sup>

If we abstract from the problem with entitlements, the AMT could easily yield enough revenue to push the budget from deficit back into surplus, assuming that the revenues are not spent. Since the government should, in present value, try to align tax revenues and spending, this could be viewed as a positive step, at least until revenues start to skyrocket in the out years. It may be a stretch however, to assume that the new revenues from such an approach would be used for deficit reduction since higher revenues are sometimes found to lead to higher spending.<sup>6</sup>

If these tax receipts are spent, it would have a significant and negative impact on growth forecasts. Robert Barro (1991)<sup>7</sup> and others following his influential work have used cross-country regressions to measure the effect of public sector size on economic growth. Barro (1991) studied the effect of government spending (excluding spending on education and national defense, which can be viewed as investment) on economic growth

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<sup>5</sup> Congressional Budget Office, *The Long-Term Budget Outlook*, December 2003.

<sup>6</sup> Calomiris, Charles W. and Kevin A. Hassett. (2002) "Marginal Tax Rate Cuts and the Public Tax Debate." *National Tax Journal*, Vol. 55, No. 1, pp. 119-131.

<sup>7</sup> Barro, Robert J. (1991) "Economic Growth in a Cross Section of Countries." *The Quarterly Journal of Economics*. Vol. 106, No. 2, pp. 407-443.

for a sample of 98 countries, and found that every percentage point of government expenditure per GDP is associated with a slower annual growth rate of between 0.1 and 0.18 percent for the period of 1960 to 1985. Engen and Skinner (1992)<sup>8</sup> had similar results and found that a percentage point increase in government expenditure per GDP is associated with an annual growth rate that is 0.108 percentage points lower for their sample of 107 countries over the period from 1970 to 1985.

Over the very long run, projected AMT revenues increase so much that revenue neutrality seems inadvisable. Strict adherence to revenue neutrality would push revenues and spending as a share of GDP to unprecedented heights, knocking perhaps as much as a percent a year off of expected long run growth. Achieving long-run revenue neutrality would require income tax rates to rise to very high levels as well.

In the nearer term, however, this Committee may wish to consider different offsets to reduce the fiscal impact of AMT repeal. Some may argue that the current fiscal situation is the result of reduced revenue associated with the tax cuts from 2001 through 2004, and hence, that any offset to AMT repeal should come from a reversal of these tax reductions. However, analysis of the sources of change in the long run fiscal outlook does not support this view unambiguously, even before one considers the possibility that the tax reductions provided a stimulus to economic growth. In particular, conclusions about the relative importance of spending and revenue revisions in explaining the change in the overall fiscal outlook depend on what year one chooses to construct the base case comparison.

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<sup>8</sup> Engen, Eric and Jonathan Skinner. (1992) "Fiscal Policy and Economic Growth." NBER Working Paper No. 4223.

Figures 4 and 5 help illustrate this point. They compare current baseline spending and revenue to what was projected to occur in the 2000 CBO budget outlook. Figure 4 documents that the difference in projected revenue is \$180 billion in 2006, shrinking to only \$65 billion by 2009. As can be seen in Figure 5, the difference in spending is much larger, a striking \$425 billion in 2006, climbing to \$535 billion in 2009. From this comparison, it appears that spending increases that were unanticipated in 2000, more than lower tax revenues, explain the transition from projected budget surpluses to budget deficits.

It is worth noting that as one uses more recent CBO projections, the relative importance of spending diminishes (but does not disappear) as an explanation for deficits. This is because the CBO incorrectly (in retrospect) ratcheted up revenue and growth forecasts just after the forecasts included in these charts. Even with the recession, the 2000 forecast underestimated the level of GDP that would occur today by a significant amount, which reduced its revenue forecast as well. Forecasts that were made later erred in the opposite direction on both GDP and revenue. While it is difficult to choose which error should be the basis of comparison, it is interesting to note that we would be in a dramatically better fiscal situation today if the 2000 forecast for spending had been correct, even with today's revenues. If a CBO analyst from late 1999 were transported in a time machine to today, she would find the level of spending to be far more surprising than the level of revenues. It is simply incorrect to assert that the lion's share of the fiscal deterioration is unambiguously attributable to EGTRRA, even before one allows for revenue feedbacks from lower tax rates.

If these pictures suggest that spending is an important additional source of the fiscal deterioration, then one might wish to explore what changes to spending would be required if one wanted to repeal the AMT and leave the deficit unaffected in the near term.

The CBO estimates that, relative to baseline budget projections, repealing the AMT would cause tax revenues to decline by approximately \$600 billion over the next ten years. If the EGTRRA tax provisions are made permanent, the projected revenue reduction jumps to about \$900 billion.<sup>9</sup>

Because spending is projected to increase over the next ten years, the cost of eliminating the AMT could plausibly be offset with reductions in spending growth, without actually reducing spending itself. The current projected annual growth in total outlays from 2005 to 2014 is 4.5%; if that growth rate were decreased by 0.37 percentage points, the resulting savings would offset the decline in revenues from repealing the AMT. Focusing on discretionary spending only, the projected 1.9% annual growth rate would have to be decreased by 1.15 percentage points. To pay for AMT repeal if EGTRRA is made permanent, those figures would have to change to 0.55 and 1.75 percentage points, respectively.

While these cuts may seem politically impossible, it is worth noting that spending would be extraordinarily higher than it was forecast to be a little more than five years ago, even after these reductions.

I would seek to reduce spending while repealing the AMT. I understand that others would prefer alternative approaches. The AMT is such a terrible tax, however,

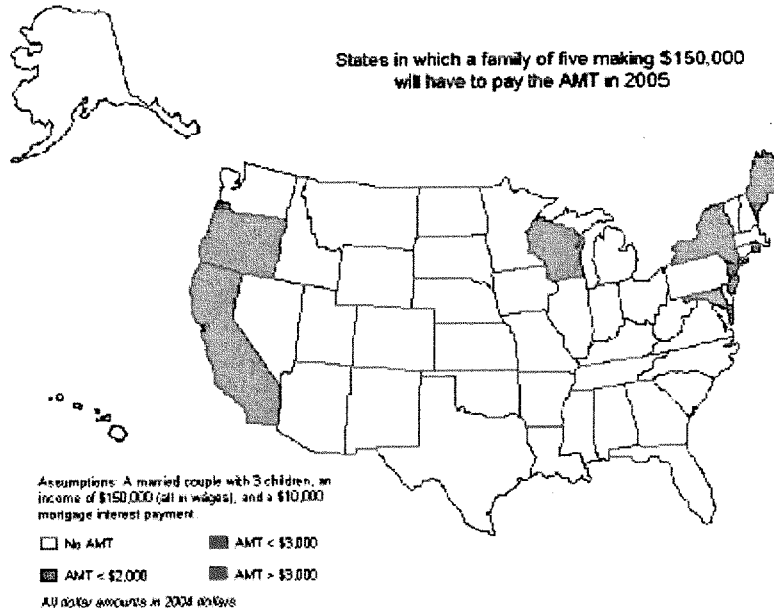
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<sup>9</sup> "Revenue and Tax Policy Brief: The Alternative Minimum Tax", Congressional Budget Office, April 15, 2004. As budget windows change, these estimates increase.



that I hope strategies for achieving AMT reform in a responsible manner will receive the careful scrutiny of this Committee, and that disagreement concerning the merits of the different approaches does not become an obstacle to a reform that is necessary and urgently needed.

**Figure 1**



**Figure 2**

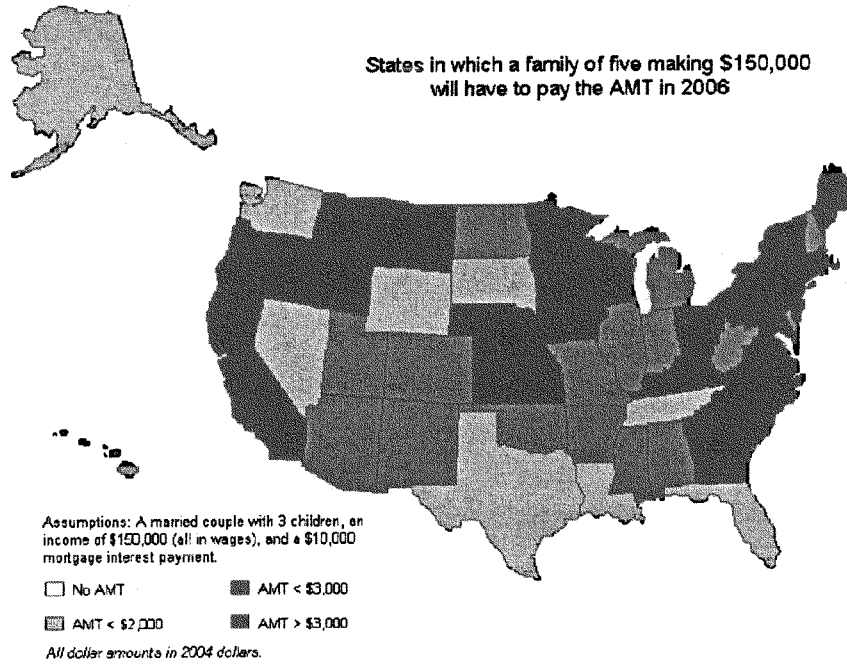
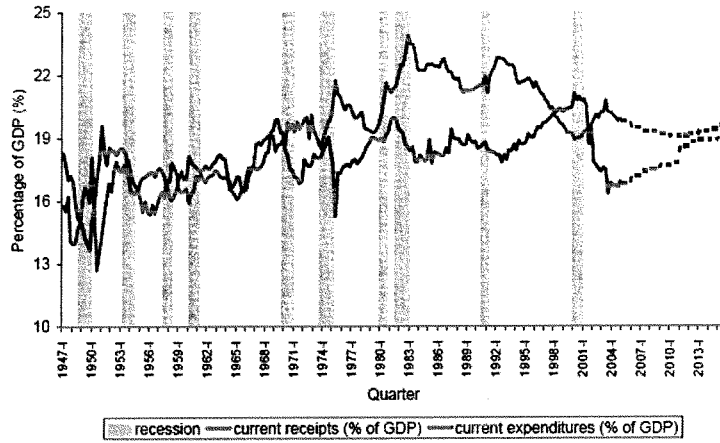


Figure 3

Receipts and Expenditures in Postwar U.S.



Source: Current receipts, expenditures, and GDP from NIPA Tables; business cycle dates from NBER; forecasts from CBO.

Figure 4

Comparison of CBO Budget Projections for Total Revenues

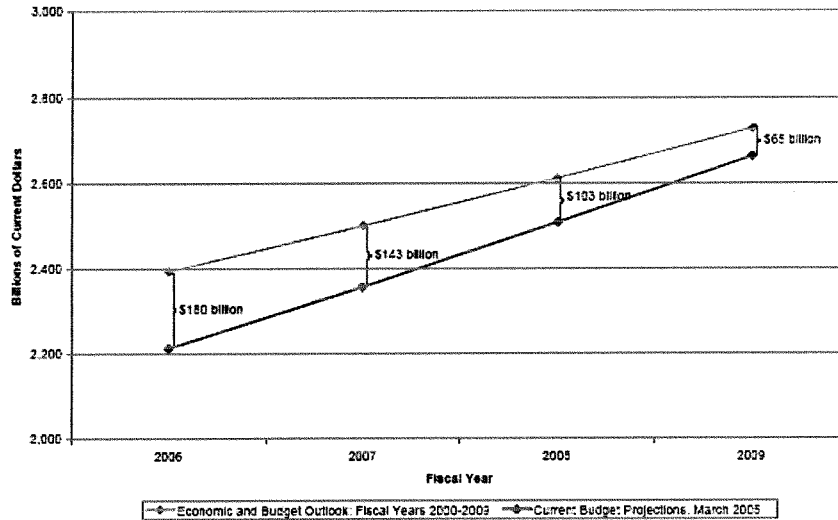
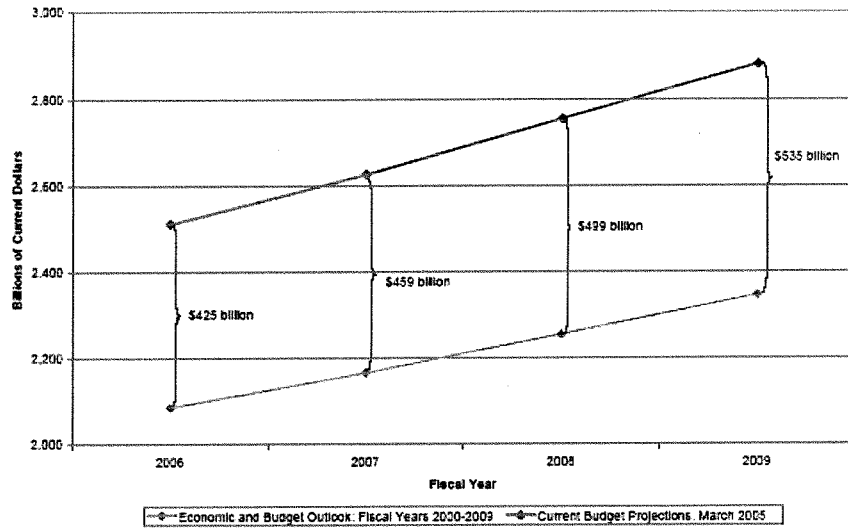


Figure 5

Comparison of CBO Budget Projections for Total Outlays



**Responses to Questions for the Record From Dr. Kevin A. Hassett  
Subcommittee on Taxation and IRS Oversight Hearing of May 23, 2005**

*From Senator Grassley*

*Question:* We're talking about an unintended tax, the AMT, which balloons Federal revenue as a percentage of GDP. My question is this. Is it appropriate to assume that the Federal revenue windfall from the AMT must be offset with other tax increases? Put another way, if we're assuming all of the revenue from the AMT must be replaced, aren't we assuming historically high levels of Federal tax as a percentage of GDP?

*Answer:* Over the next 10 years, tax revenues as a share of GDP rise to a level significantly above the long-run average, partly due to ballooning AMT revenues. Over the very long run, if the tax laws are not changed, tax revenues relative to GDP will rise to record levels. By 2050, tax receipts will be 24.7 percent of GDP, compared to a historical average of 18.4 percent.<sup>1</sup> Therefore, if all of the revenue lost by repealing the AMT is replaced by raising taxes, it will help cause tax revenues as a percentage of GDP to rise to an unprecedented level.

*From Senator Kyl*

*Question:* You suggest that Congress could reduce the rate of growth in discretionary spending by 1.75 percentage points to offset the cost of repealing the AMT even assuming the 2001 and 2003 tax cuts are made permanent (\$900 billion/10 years). How much of an increase would this still allow for above the CBO 2000 baseline projection for spending?

*Answer:* Relative to the CBO's latest baseline budget projections, if discretionary spending growth were reduced by 1.75 percentage points in each year from 2005 to 2014, total discretionary spending over that period would equal \$8.9 trillion. Even with the reduction in spending growth, this total is still \$2.0 trillion greater than the CBO's 2000 baseline projection for discretionary spending from 2005 to 2014.<sup>2</sup>

*Question:* I want to ask you to give your opinion of a proposal in Dr. Burman's testimony. He suggests that various AMT reforms (indexing, eliminating the phase-out, and so forth) could be "paid for" by "eliminating the preferential rates for capital gains and dividends under the AMT." As a strong supporter of making the current rates for dividends and long-term capital gains permanent, I believe Dr. Burman's proposal would have a detrimental effect on our growing economy. Such income has already been taxed at least twice—once at the corporate level and again when it is distributed to the individual, which adds up to a tax rate of nearly 45 percent. Subjecting investment

<sup>1</sup> "The Long-Term Budget Outlook," Congressional Budget Office, December 2003.

<sup>2</sup> "Economic and Budget Outlook: Fiscal Years 2000–2009," Congressional Budget Office, January 1999. The spending projections can be extended to 2014 by assuming that spending grows at the projected rate of inflation—the same rule that the CBO follows to project discretionary spending.

income, which is responsible for much of our economic activity, to substantially higher marginal rates will certainly diminish economic activity.

*Answer:* Optimal tax theory tells us that the optimal tax rate on capital is zero. Anything higher raises the cost of capital, which discourages investment. Decreased investment will, as you correctly point out, certainly diminish economic activity.

***From Senators Baucus and Jeffords***

*Question:* While you prefer spending cuts as a means of offsetting the cost of repealing the AMT, let's assume that near-term revenue neutrality within the tax code is necessary. If so, would you agree with Dr. Burman that we should make the implicit taxes of the AMT explicit in the regular tax rates? Wouldn't that be more fair and transparent to taxpayers?

*Answer:* My first choice is to offset the cost of repealing the AMT with spending reductions instead of tax increases. If taxes must be increased, however, then I agree with Dr. Burman that we should make the implicit taxes of the AMT explicit. The AMT is a complex tax that is difficult to calculate. Consequently, it is very difficult for taxpayers to anticipate if they will have to pay the AMT; as National Taxpayer Advocate Nina Olson testified, many are not aware of their AMT liability until they receive a notice from the IRS demanding payment. Making the AMT a transparent part of regular tax rates, as Dr. Burman suggests, would be fairer to taxpayers. It would greatly reduce their tax compliance burden and it would allow taxpayers to plan their finances with greater certainty and accuracy.

*Question:* In your written testimony, you stated that it may seem "politically impossible" to reduce government spending, but you believe that is a better way to pay for the AMT repeal than a reversal of the 2001–2004 tax cuts. If we assume that the tax cuts are made permanent and AMT repeal would cost close to \$1 trillion, can you identify which Federal spending programs you would target for reduction or elimination in order to pay for the repeal?

*Answer:* My preference is to reduce all spending proportionally. This approach distributes the reduction in a manner that is less likely to cause significant disruptions. If one were to pursue the cancellation of programs, then one must perform a detailed cost-benefit analysis of said elimination in order to establish its advisability. I have not performed such analyses, as this is not my particular area of expertise. However, a number of efforts by others have alerted me to a long list of reasonable candidates for elimination.

- 1) In 2003, under the initiative of House Budget Committee Chairman Jim Nussle, congressional committees identified Federal waste in mandatory spending programs that totaled \$80–100 billion over 10 years.<sup>3</sup> This waste has not yet been eliminated.
- 2) According to Citizens Against Government Waste, in FY 2005, Congress spent a record \$27.3 billion on 13,997 pork projects. While pork is in the eye of the beholder, many of these projects seem to have poor cost-benefit rationales.

<sup>3</sup> Susan Davis, "Panels Find \$80 Billion to \$100 Billion in Federal Waste," *National Journal's Congressional Daily*, 10/2/03.

- 3) In FY 2006, the Federal Government will pay out over \$435.7 billion in grants to State and local governments for transportation, education, housing, environmental, and other programs. It is not obvious that it is efficient for the Federal Government to collect money from taxpayers, pass it through DC's costly bureaucratic maze, and then send it back to the States in the form of grants. By transferring just a fraction of these programs to the States, Congress could easily pay for repealing the AMT.
- 4) President Bush's FY 2006 budget includes a number of proposals to terminate or reduce discretionary spending that is duplicative, ineffective, or non-essential. Programs targeted for elimination include the Emergency Steel Guarantee Loan Program, the Forest Service Economic Action Program, and the Advanced Technology Program. Enacting all of the President's discretionary spending proposals would save \$17.2 billion in 2006. Further savings of more than \$150 billion over the next decade could come from the President's recommended mandatory spending reforms and increased reliance on user fees.

# **CBO TESTIMONY**

**Statement of  
Douglas Holtz-Eakin  
Director**

## **The Individual Alternative Minimum Tax**

**before the  
Subcommittee on Taxation and IRS Oversight  
Committee on Finance  
United States Senate**

**May 23, 2005**

*This statement is embargoed until 12:30 p.m. (EDT) on Monday, May 23, 2005. The contents may not be published, transmitted, or otherwise communicated by any print, broadcast, or electronic media before that time.*



**CONGRESSIONAL BUDGET OFFICE  
SECOND AND D STREETS, S.W.  
WASHINGTON, D.C. 20515**



Mr. Chairman and Members of the Subcommittee, thank you for inviting the Congressional Budget Office (CBO) to testify about the individual alternative minimum tax (AMT). The AMT was originally designed to limit the use of tax preferences (exclusions or deductions from a comprehensive measure of income) by high-income taxpayers to ensure that they paid at least some income tax. Under the AMT, a parallel tax system was established with a more limited set of tax preferences than those that apply under the regular income tax and with its own set of exemptions and tax-rate schedule. Taxpayers are required to pay whichever is greater—the tax they owe under the AMT or the tax they owe under the regular income tax.

### **The Growing Significance of the AMT**

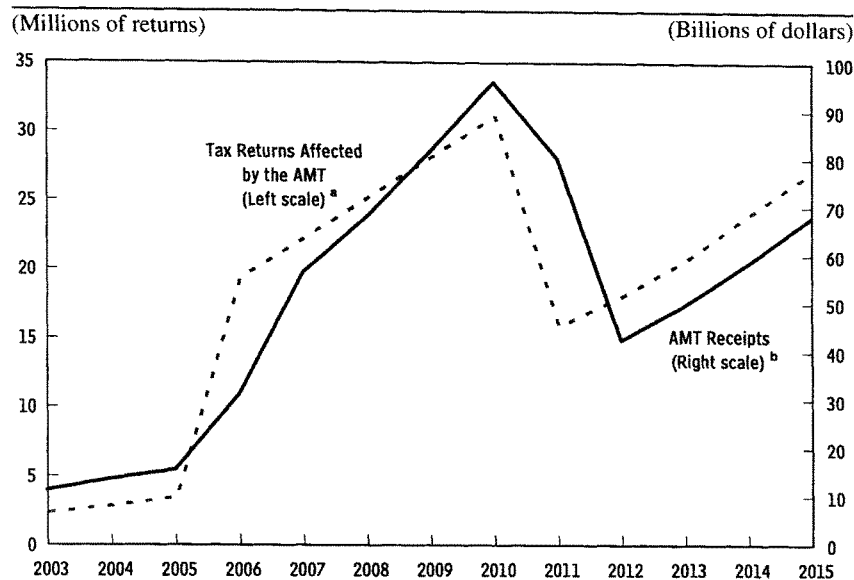
The number of taxpayers who are affected by the AMT and the revenues that are collected as a result of it have been growing over time. Thus far, the share of tax filers who are subject to the AMT has been small, reaching 1 percent of filers for the first time in tax year 2000. Under current law, however, the AMT is expected to extend its reach (see Figure 1). In 2002, about 2 million taxpayers paid additional taxes as a result of the AMT; in 2010, roughly 30 million taxpayers are expected to owe more because of it. And those figures do not include the even greater number of filers who are required to calculate their taxes under both the AMT and the regular tax to determine whether they owe more under the alternative tax.

Revenues from the AMT will make up a growing share of individual income tax receipts over the next 10 years. In CBO's estimation, the federal government received an additional \$14 billion in fiscal year 2004 from the AMT, and those added revenues are expected to grow to about \$95 billion in fiscal year 2010. Over the 2005-2015 period, CBO's baseline includes about \$645 billion in revenues from the AMT, or roughly 4 percent of personal income tax receipts.

### **Why Is the Impact of the AMT Increasing Over Time?**

Two factors are spurring the growth that is occurring in the number of taxpayers affected by the AMT. First, unlike the parameters of the regular tax, the parameters of the AMT are not indexed for inflation. Under the regular tax, the personal exemption, standard deduction, and rate brackets are all indexed, which prevents tax rates from rising when incomes just keep pace with inflation. By contrast, the parameters of the AMT—the exemption and rate brackets—are not indexed. Over time, taxpayers face higher tax rates under the AMT, even if their incomes grow only at the pace of overall price rises. Because inflation boosts tax rates under the AMT but does not raise rates under the regular income tax, as prices rise, a greater number of taxpayers will owe more under the AMT than under the regular tax. In addition, the effects of inflation on the AMT accumulate over time. CBO estimates that if current law remained in effect, 70 percent of taxpayers in 2050 would be affected by the AMT, and the additional revenues

**Figure 1.**  
**Projected Effects of the Individual Alternative Minimum Tax**



Source: Congressional Budget Office.

a. Calendar year basis.

b. Fiscal year basis.

from it would account for 20 percent of the personal income taxes collected by the government (see Figure 2).<sup>1</sup>

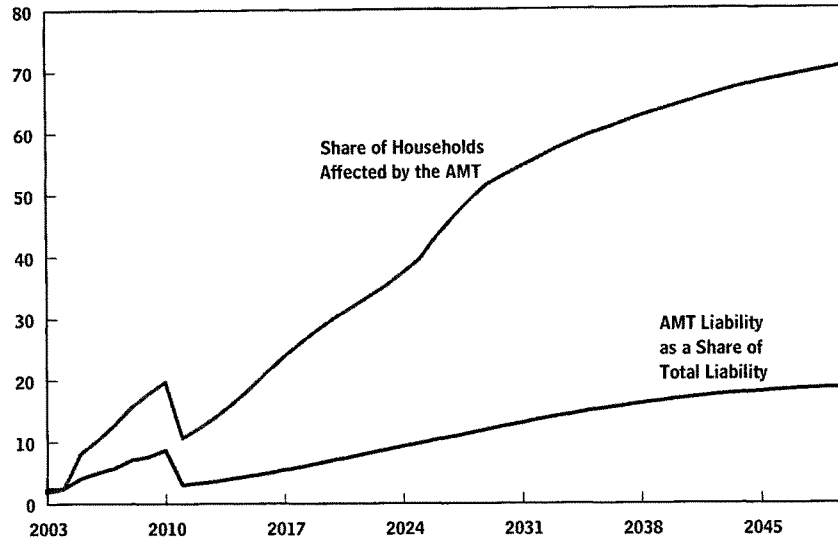
The second factor that may cause more taxpayers to be affected by the AMT in the next few years is reductions in regular income taxes. The tax cuts enacted in 2001, 2003, and 2004 resulted in more taxpayers becoming subject to the alternative tax, although that effect was mitigated somewhat by a temporary increase in the AMT exemption that is scheduled to expire after 2005.<sup>2</sup> The interaction of the AMT and

1. See Congressional Budget Office, *The Long-Term Budget Outlook* (December 2003). In its calculations, CBO assumed that inflation would be 2.5 percent through 2050.

2. The recent laws that reduced regular income taxes are the Economic Growth and Tax Relief Reconciliation Act of 2001, the Jobs and Growth Tax Relief Reconciliation Act of 2003, and the Working Families Tax Relief Act of 2004.

**Figure 2.**  
**The AMT's Impact on Individual Income Tax Liabilities**  
**Under Current Law, 2003 to 2050**

(Percent)



Source: Congressional Budget Office.

Note: AMT = alternative minimum tax.

those tax law changes is illustrated by the expected drop after 2010 in the number of taxpayers that the AMT affects (see Figure 1). That number falls from about 30 million to 16 million between 2010 and 2011, when the 2001 changes are scheduled to expire, and then begins to increase again after 2011 as a result of inflation.

### Who Is Affected by the AMT?

The types of taxpayers who are affected by the AMT are changing over time. Historically, many of those subject to it were the relatively small number of filers who used a narrow set of tax preferences that were not allowed under the alternative tax. (For example, relatively few taxpayers are eligible for incentive stock options, which receive less favorable treatment under the AMT than under the regular income tax.) In the years to come, however, the preferences that are not allowed under the AMT and that will move taxpayers within its sphere are some of the more widely used features of the regular tax, such as the personal exemption (which is used by all taxpayers) and the standard deduction (which is

used by roughly two-thirds of filers). The AMT potentially affects almost all filers who itemize because they generally claim a deduction for state and local taxes, which is not allowed under the AMT. That broad reach of the tax suggests that taxpayers in larger families (who have a greater number of personal exemptions) and taxpayers with larger deductions for state and local taxes will tend to be more affected by the AMT than will other taxpayers.

Also likely to experience more of an effect will be married couples—relative to unmarried taxpayers with similar incomes. Married couples are treated more generously under the regular tax than under the AMT. In 2005, for example, the standard deduction for married couples under the regular tax is twice that for single filers, whereas the exemption amount for married couples under the AMT is only 37 percent larger. That relatively favorable treatment of married filers under the regular income tax means that they are more likely to become subject to the AMT. Married couples also tend to have larger families and are therefore more affected by the elimination of personal exemptions under the alternative tax. In 2010, only 5 percent of unmarried taxpayers will be subject to the AMT, CBO estimates, whereas the number of married taxpayers affected will be almost 40 percent. Among married taxpayers, about 30 percent of those without children are expected to be within the AMT's reach, and over half of those with at least two children will owe more as a result of the alternative tax (see Figure 3).

The impact of the AMT varies among taxpayers with different incomes (see Figure 4). The share of taxpayers affected by it is projected to grow through 2010 for all income groups, although the share is expected to expand the most for taxpayers with incomes between \$50,000 and \$500,000.<sup>3</sup> Under current law, in 2010 (the year of the AMT's peak effect during CBO's current baseline projection period), two-thirds of the 26 million taxpayers with adjusted gross income (AGI) between \$50,000 and \$100,000 will owe more tax as a result of the AMT. Among the 9 million taxpayers with AGI between \$100,000 and \$500,000, more than 85 percent will owe more tax.

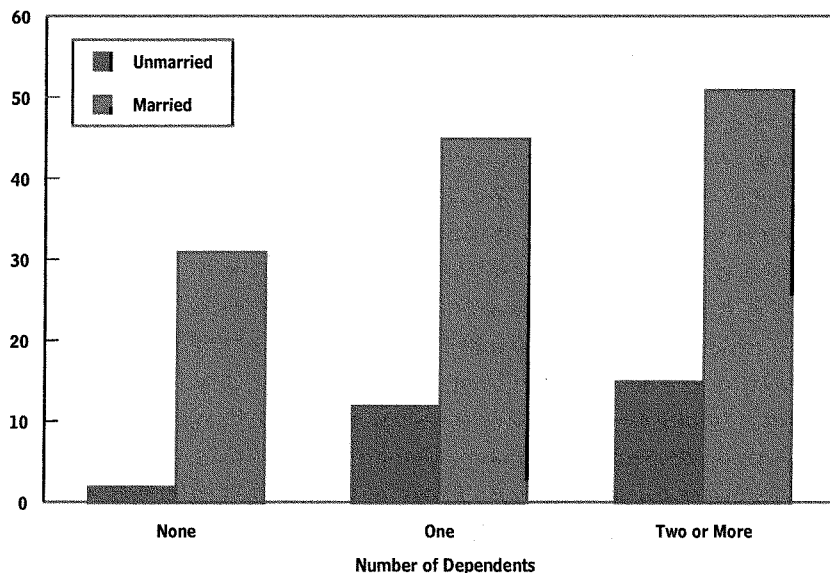
A smaller portion of the highest-income taxpayers—less than one-third—will be affected by the AMT in 2010, and relatively few taxpayers with incomes of less than \$50,000 will feel an impact. The highest-income taxpayers are less affected by the AMT because the top rate under the regular tax (35 percent) is higher than the top rate under the AMT (28 percent). Therefore, most of the highest-income taxpayers will owe more under the regular tax than under the AMT. The lowest-income taxpayers (those whose incomes are less than \$50,000) remain largely

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3. Income figures are in 2005 dollars.

**Figure 3.****Percentage of Taxpayers Projected to Pay the AMT in 2010, by Marital Status and Number of Dependents**

(Percent)



Source: Congressional Budget Office.

Notes: CBO projects that in 2010, there will be 100 million unmarried and 60 million married taxpayers.

AMT = alternative minimum tax.

unaffected by the tax in 2010 because the AMT's exemption prevents much of their income from becoming subject to the AMT.

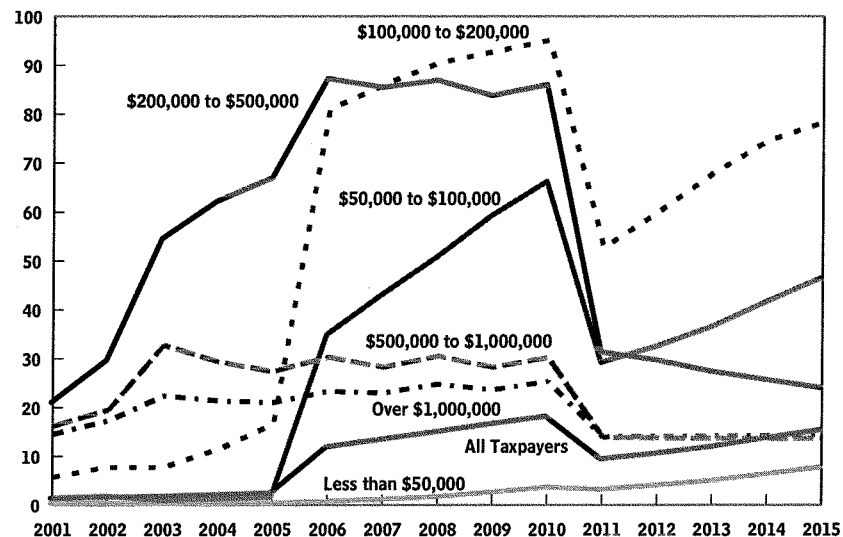
**Is the Growing Reach of the AMT a Problem?**

The AMT imposes multiple costs on taxpayers and the economy. Most directly, it increases individual tax liabilities and adds complexity to the calculation of taxes. But it may also impose indirect costs—for example, by affecting people's behavior in ways that can have an adverse economic impact. Both kinds of costs must be taken into account in evaluating the alternative minimum tax.

Although the basic calculation for the AMT appears simple, it is actually complex in a variety of ways. For example, it complicates one of the most basic of tax-filing questions: whether to itemize deductions. Under the regular income tax, the decisionmaking process is relatively easy: sum up all deductions that may be

**Figure 4.****Taxpayers with AMT Liability, by Adjusted Gross Income in 2005 Dollars, Calendar Years 2001 to 2014**

(Percentage of taxpayers)



Source: Congressional Budget Office.

Note: AMT = alternative minimum tax.

itemized; adjust for the phaseout, if it is applicable; compare the result with the appropriate standard deduction; and claim the larger of the two amounts. In calculating their tax liability under the AMT, taxpayers must make the same decision about deductions that they would make for the regular tax: whether to either itemize or claim the standard deduction. Taxpayers who claim the standard deduction under the regular tax cannot itemize their deductions under the AMT. However, because some itemized deductions may be claimed under the alternative tax, some taxpayers who are subject to it will have a smaller total tax liability if they claim itemized deductions that total less than their standard deduction. That factor increases to four the number of potential liabilities that a taxpayer must calculate to determine first, whether he or she is liable for the AMT, and second, how to pay the smallest amount of tax.

Much of the complexity created by the AMT can be lessened by using computer software to prepare tax-filing forms. Programs available on the Internet or for installation on individual computers automatically determine whether taxpayers have AMT liability and create the required paperwork. But not all taxpayers have

access to computers; furthermore, use of the software can raise the costs of tax preparation for many people. In addition, some taxpayers move on and off the AMT over time. As a result, they are subject to a set of continually changing tax rules and rates.

The alternative tax may cause taxpayers to change their behavior—at least to the extent that they know that the AMT may affect them—which could reduce economic efficiency. Under the AMT, taxpayers may be subject to higher marginal tax rates (the tax on an additional dollar of income), which in turn may influence their decisions about how much to work and save. Many taxpayers face higher marginal rates under the AMT than they would under the regular tax. Changes in the structure of the alternative tax could help lower those rates, but how those changes affected the economy would depend on whether other tax rates were raised to make up for the lost revenues.

### **Options for Changing the AMT**

The increasing impact of the AMT has generated interest in changing or repealing it. The most straightforward approach to curtailing the growth of the AMT would be to eliminate the tax entirely, which would reduce revenues by roughly \$600 billion over the next decade (see Table 1). Eliminating the AMT would free many taxpayers from having to make a second set of tax calculations and would lower taxes for nearly everyone who is now subject to the AMT. The repeal approach, however, might raise concerns that some high-income individuals would pay little or no tax through the use of various tax preferences and so undermine the original purpose of the alternative levy.

Short of repeal, there are several options that could limit the AMT's expected growth. Over the longer run, the reach of the tax will expand primarily because in nominal terms, its parameters are fixed, whereas the parameters of the regular income tax are adjusted annually to take account of inflation. The current AMT exemption is \$58,000 for married couples filing jointly and \$40,250 for unmarried filers. After 2005, however, those amounts are scheduled to revert to their pre-2001 levels of \$45,000 and \$33,750, respectively. Extending the current exemption levels just for 2006 would keep about 14 million taxpayers from incurring AMT liability for that year and reduce the tax burden of others—at a cost of about \$30 billion in forgone revenues. If the 2005 exemptions were made permanent and, along with other AMT parameters, indexed for inflation after 2006, most of the increase over the coming decade in the number of taxpayers with AMT liability would disappear. Under that option, about 7 million taxpayers would incur such a liability in 2010, a reduction of more than 75 percent from the estimated 29 million taxpayers who would otherwise owe the alternative tax in that year. The option would reduce federal revenues by about \$385 billion over the 2006-2015 period.

**Table 1.****How the AMT Options Affect Revenues and Taxpayers**

	Reduced Receipts, Fiscal Years 2006 to 2015 <sup>a</sup> (Billions of dollars)	Number of Taxpayers Subject to the AMT in 2010 <sup>b</sup> (Millions)
Repeal the AMT	611	0
Extend the 2005 Exemption to 2006 and Index All Parameters Thereafter	385	7
Allow Personal Exemptions Under the AMT	343	11
Allow State and Local Tax Deductions Under the AMT	423	17
Allow the Standard Deduction Under the AMT	64	23

Sources: Congressional Budget Office; Joint Committee on Taxation.

a. The effective date for the options is assumed to be January 2006.

b. The number of taxpayers subject to the AMT in 2010 under current law is 29 million.

Another alternative for mitigating the impact of the AMT would be to allow certain preferences under it that are expected to affect a growing number of taxpayers. Permitting the same personal and dependent exemptions under the AMT as under the regular income tax would remove about 18 million tax units from the AMT's reach in 2010, or more than 60 percent of all taxpayers who would owe the alternative tax under current law in that year. The option would reduce federal revenues by about \$343 billion between 2006 and 2015. Alternatively, allowing taxpayers to deduct state and local taxes for the purposes of the AMT would eliminate its impact for about 12 million taxpayers in 2010 (roughly 40 percent of those who would pay the tax in that year under current law) and reduce federal revenues by about \$423 billion during the 2006-2015 period.

Allowing the standard deduction under the AMT would have the smallest effect on revenues of any option discussed here other than the one-year extension of the higher exemption amount. If the standard deduction was allowed, revenues would be reduced by about \$64 billion between 2006 and 2015, and the AMT's effect would be eliminated for 6 million taxpayers in 2010.



### **Is the AMT a Good Alternative to the Regular Tax?**

Some commentators have suggested that instead of repealing the AMT, it would be preferable to repeal the regular tax and rely on the AMT's broader base and lower rates. That option, according to its proponents, would have several advantages. The AMT is nearly a flat-rate tax. It eliminates a variety of special tax breaks in the regular tax system—that is, it applies to a broader base of income and over the long run generates more revenue than the regular income tax.

However, in practice, the AMT is less “flat” than it might appear. First, in addition to the tax's statutory rates of 26 percent and 28 percent, the AMT has additional effective marginal rates equal to 32.5 percent and 35 percent—which are caused by the phasing out of the tax's exempt amount (for 2005, \$58,000 for married taxpayers and \$40,250 for unmarried taxpayers). Thus, the AMT's effective rate structure is 26 percent, 32.5 percent, 35 percent, and 28 percent, the last being the rate that applies to the highest incomes.

Second, the tax base of the AMT was designed as a companion to that of the regular income tax. Consequently, the AMT's base might not make as much sense if the tax were recast as a stand-alone levy. For example, under the regular income tax, as a family's size increases, personal exemptions reduce its taxes, but as more and more families were affected by the AMT, that adjustment for family size would disappear. Moreover, although the elimination of some preferences under the AMT would simplify the tax system, for most taxpayers the main difference between the AMT and the regular income tax is in the rate schedule and not in the definition of income and deductions. Put differently, the AMT's tax base is not as broad as that of a truly comprehensive tax; at the same time, it is broader than the base of the regular tax in ways that may not be desirable for the tax system as a whole.

Third, revenues would grow more quickly under the AMT than under the regular tax, but much of that extra growth would stem from the fact that the AMT is not indexed for inflation. As a result, for the same level of real (inflation-adjusted) income, tax rates would rise over time.

**Related CBO Publications**

*The Budget and Economic Outlook: Fiscal Years 2006 to 2015* (January 2005).

*The Alternative Minimum Tax*, Revenue and Tax Policy Brief No. 4 (April 15, 2004).

*The Long-Term Budget Outlook* (December 2003).

**Responses to Questions for the Record From Dr. Douglas Holtz-Eakin  
Subcommittee on Taxation and IRS Oversight Hearing of May 23, 2005**

*From Senator Grassley*

*Question:* We're talking about an unintended tax, the AMT, which balloons Federal revenue as a percentage of GDP. My question is this. Is it appropriate to assume that the Federal revenue windfall from the AMT must be offset with other tax increases? Put another way, if we're assuming all of the revenue from the AMT must be replaced, aren't we assuming historically high levels of Federal tax as a percentage of GDP?

*Answer:* Over the 1946-2004 period, Federal revenues averaged 18 percent of GDP. In contrast, CBO's baseline for total revenues is 16.8 percent of GDP in 2005 but will rise above the historic average to 19.6 percent of GDP in 2015. The AMT contributes to that rise, growing from 0.1 percent of GDP in 2005 to 0.3 percent of GDP in 2015. The AMT will continue to rise thereafter. Under current law, by 2025, AMT revenues will be just over 1 percent of GDP, CBO estimates, and that amount grows to almost 3 percent of GDP by 2050.

If no other changes are made to tax laws, eliminating the AMT would bring revenues a little closer to their historical average at the end of the baseline period and thereafter. Revenue-neutral changes that eliminate the AMT would leave Federal revenues above the historic average.

*From Senator Kyl*

*Question:* While the economy has clearly responded to the reduced tax rates enacted in 2001 and 2003, the AMT has robbed the economy of some of the effectiveness of tax relief. Charts depicting the number of taxpayers with AMT liability seem to indicate that the problem of the AMT would diminish if we allowed the lower tax rates to expire. Isn't it true, however, that while this would indeed shift many taxpayers back into the regular system, their tax liability would be significantly higher than if we made the current rate structure permanent, regardless of what happens to the AMT?

*Answer:* If the Congress allows the 2001 and 2003 tax laws to expire, taxpayers' liability under the regular tax will rise and their AMT liability will decline—for some of them to zero. In that sense, the "AMT problem" would diminish as fewer taxpayers would be liable for the AMT and the AMT would raise less revenue. CBO's baseline shows the aggregate implications of that approach. Total Federal revenues rise from 16.8 percent of GDP in 2005 to 19.6 percent of GDP in 2015. The AMT contributes to that rise, growing from 0.1 percent of GDP in 2005 to 0.3 percent of GDP in 2015. In contrast, the sunset of the 2001 and 2003 tax laws (all provisions, not just tax rates) contributes about 1.5 percentage points to the rise in revenues as percentage of GDP. Thus, while fewer taxpayers are liable for the AMT after 2010, total liabilities—regular income tax plus the AMT—are projected to rise under current law.

*From Senators Baucus and Jeffords*

*Question:* Dr. Burman in his testimony presented estimates (based on data that is publicly available) as to the number of high-income taxpayers who would pay no Federal income tax in the absence of the AMT. Do you agree with these estimates, or do you have other relevant data, and could you describe the principal reasons that such high-income taxpayers would owe no income tax? Do you have any recommendations for the committee as to what measures we could take to ensure these individuals would pay some tax in the absence of the AMT?

*Answer:* Dr. Burman's estimates are reasonable. Despite the presence of the AMT, some taxpayers with high income still pay no income tax. For example, in 2002, the IRS Statistics of Income indicate that there were 168,967 taxpayers with adjusted gross income greater than one million dollars; among those, 717 owed no ordinary income tax for that year, and 446 owed tax as a result of the AMT. The remaining 271 taxpayers owed no tax in 2002 even with the AMT in place.

It is not clear, however, that the objective of ensuring that individuals with high income pay some Federal income tax is either desirable or easy to achieve. For example, among the 271 returns for which no tax was owed in 2002, some of those taxpayers had in fact paid taxes on their income. For example, some paid taxes to foreign governments on income earned overseas and had their U.S. taxes reduced on that income by the foreign tax credit. Others had paid taxes in prior years because they had been subject to the AMT and used AMT credits from those payments to reduce their 2002 taxes. Others have used deductions that reflect the costs of earning income. It is difficult to define what constitutes an excessive use of tax deductions or exclusions and for whom deductions or exclusions should be eliminated.

*Question:* As you know, the State sales tax deduction is relatively new. But many are already advocating it be made permanent or extended. Does your analysis of the number of taxpayers hit by the AMT and affected States take this new deduction into account? If this provision is made permanent, how would that affect your estimates as to the number of taxpayers hit by the AMT and the cost to repeal the AMT?

*Answer:* CBO's baseline estimates of Federal revenues incorporate the deductibility of sales taxes in 2004 and 2005 and the interaction with the AMT. CBO does not yet have estimates of the number of taxpayers affected by the AMT as a result of the sales tax deduction. On the basis of preliminary work, CBO believes that the deductibility of State sales taxes would increase the number of taxpayers affected by the AMT by at most a few hundred thousand. Similarly, CBO has not estimated how extending the deduction would affect the cost of repealing the AMT.

*Question:* Can you contrast the amount of revenue we collect from the AMT today with 2010, and perhaps how much we have historically collected from the AMT?

*Answer:* In its baseline, CBO estimates that the AMT will raise about \$15 billion, under 2 percent of personal income tax revenues in 2005. That amount is expected to grow to \$96 billion by 2010, or 7 percent of personal income tax revenues. Actual AMT revenues have never been

greater than 2 percent of personal income tax revenues but, under current law, are expected to first exceed that threshold in 2006.

*Question:* You have identified a number of options to reform or repeal the AMT and the revenue losses associated with each option. Can you provide an estimate of the cost for repeal of the AMT, assuming that the 2001 and 2003 tax cuts are made permanent? What would be the long-term fiscal impact on the budget if full repeal of AMT is enacted without an offset?

*Answer:* The Joint Committee on Taxation estimates that the cost of repealing the AMT after making permanent the 2001 and 2003 tax laws would be \$1,028 billion over the baseline period from 2006 to 2015. The cost grows significantly after the end of the baseline period. CBO estimates that under current law, AMT revenues will be just over 1 percent of GDP by 2025 and almost 3 percent of GDP by 2050.

**Statement by Senator Kyl**  
**Chairman, Senate Finance Subcommittee on Taxation and IRS Oversight**  
**Hearing on the Individual AMT**  
**May 23, 2005**

Tax reform is one of the President's top priorities. He began the effort earlier this year when he appointed a tax reform panel led by two former members of the Finance Committee. It is widely anticipated that in its July 31 report to the Treasury Secretary, in addition to other proposals, the panel will make recommendations on how to address the Alternative Minimum Tax (AMT).

With that July 31 deadline fast approaching, the Finance Committee begins laying the groundwork for tax reform in the Senate by holding today's hearing on the individual AMT.

Our goal for tax reform and simplification must be to create a tax system that supports continued economic growth and prosperity by encouraging work, savings and investment, and that does not waste taxpayers' time and effort with needless complexity. To achieve these goals, Congress must make the individual rates, the dividend and capital gains rates, and repeal of the death tax permanent, and we must repeal the AMT.

The individual AMT was intended to make sure very wealthy taxpayers could not zero-out their tax liability by claiming otherwise legitimate deductions and exemptions.

What started out as a misguided attempt to tax the "rich" has become a significant added tax burden on millions of middle-income Americans.

While the primary reason the AMT has begun invading the middle-class is the fact that its parameters—the exemptions, rate brackets, and phase-out levels—were not indexed for inflation, we should not fool ourselves that making these few adjustments would solve the AMT problem. The real problem of the AMT is that it tries to impose a special tax only on the "wealthy." And such attempts almost always end up discouraging work and hurting economic growth.

This hearing is not intended to resolve the debate about whether to reform the AMT or repeal it; whether to "offset" the cost of reform or repeal with tax increases or spending cuts; or whether the costs need not be offset at all.

Rather, this hearing begins the process of educating Senators and the public about the mind-boggling complexity of the AMT and about how the AMT amounts to a "stealth" tax that traps many unsuspecting taxpayers.

Today we will learn the exact nature of the problem, including the numbers and types of taxpayers who most often fall into the AMT.

We will learn what taxpayer situations most often trigger the AMT, including the extent to which the AMT imposes a “marriage penalty” and hits families with children particularly hard.

We will hear how the AMT affects otherwise similarly situated taxpayers, who happen to live in different states, very differently.

We will learn how much it might cost the Treasury, in static terms, to reform or repeal the AMT.

And—most important—we will learn how costly the AMT is currently to the economy in terms of taking productive resources out of the private sector, in terms of reducing incentives to work and save, and in terms of administrative complexity imposed on taxpayers by the AMT.

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### Opening Comments

#### **Blowing the Cover on the Stealth Tax: Exposing the Individual AMT Subcommittee on Taxation and IRS Oversight Senate Committee on Finance Hearing - May 23, 2005**

My name is Carol Markman. I am a Certified Public Accountant and have been in practice for over 25 years. I am currently a partner of Feldman, Meinberg & Co. LLP of Syosset, New York. I am the President of NCCPAP, the National Conference of CPA Practitioners, the only national professional organization representing only Certified Public Accountants in Public Practice. Our membership is by firm and all of the owners of member firms are Certified Public Accountants in public practice. The members of NCCPAP own and operate local and regional practice units ranging in size from sole proprietorships to organizations with many CPA partners and large professional staff. We represent practitioners all across the country that have clients in all 50 states. Most of the members of NCCPAP deal with the Internal Revenue Code on a daily basis in their work with taxpayers. We live the Internal Revenue Code every day and sort through its complexities constantly. We estimate that our members serve more than 500,000 businesses and individual clients in every state. We appreciate the invitation to participate in this hearing.

I have been asked to provide anecdotal information about how the Individual Alternative Minimum Tax ("AMT") affects our members' clients, the taxpayers of America. The AMT first became part of the Internal Revenue Code in 1969, after the then Treasury Secretary testified that there were 155 people with incomes over \$200,000 who had not paid any income taxes for 1967. In today's economy, this would be a person with income of \$1.1 million and paying no Federal Income Tax. The highest individual income tax rate in 1969 was 77 percent when Congress added a 10 percent AMT to the tax code. Until 2000, less than one percent of individual taxpayers were required to pay AMT tax in any given year. This was the situation even though the highest individual income tax rate had been reduced to 39.6 percent. For 2004, the highest individual Federal income tax rate was 33 percent and the highest AMT tax rate was 28 percent. It is estimated that 3.8 million taxpayers will pay additional tax due to the AMT.

The NCCPAP Tax Committee collected redacted individual income tax returns from our members where the taxpayer was required to pay AMT. The returns we assembled do not constitute a statistically valid sample of AMT tax returns. They are just the returns we collected from our members. We have analyzed these returns to determine the reasons for the presence of AMT on the actual tax returns. Two types of "adjustments"



NCCPAP - AMT Hearing  
May 23, 2005  
Page 2

are required in order to calculate Alternative Minimum Taxable Income: (1) "permanent adjustments", that is tax benefits that are lost forever, such as state and local income taxes; and (2) "tax preference items", which are mostly timing differences, such as the adjustment for post 1986 depreciation. The tax preference items are tax benefits that are **postponed** due to the AMT. These timing differences usually benefit the taxpayer in future years due to either basis adjustments or AMT Credits. The timing difference adjustments create a current cash flow problem for the taxpayer but they are the more fortunate victims of the AMT because they have the potential opportunity to recover the AMT tax paid at some point in the future.

The most common reasons our clients are subject to AMT are large itemized deductions for state and local taxes, (state and local income tax or sales tax, real property tax, personal property tax) and miscellaneous itemized deductions. However, a colleague told me about a Federal income tax return of a single father with three children who earned \$70,483 at his job. He had no other income and claimed the standard deduction. This taxpayer was required to pay \$100 in AMT on his 2002 income tax return. The trigger for the AMT was the exemptions he claimed for his three children. Surely this is not a taxpayer who should be subject to this additional tax. My colleague said he performed some modeling with this taxpayer's information and determined that the taxpayer would not be subject to AMT in 2004 on the same salary because of the increase in the AMT exemption included in the 2004 Tax Act, but this change in the AMT exemption is for 2004 only. As a result, a taxpayer with this fact pattern will again be subject to AMT in 2005, unless the law is changed. A taxpayer with wages of \$115,483 and the same fact pattern would be subject to \$174 of AMT for 2004. While these AMT tax amounts are small, the requirement that a taxpayer whose only income is wages needs to calculate his tax two ways is expensive, time consuming, wasteful and unfair. A taxpayer who is otherwise eligible to file a Form 1040EZ should not have to be concerned about the AMT.

One of the tax returns we received concerned a single, retired woman with no dependents. Her 2003 adjusted gross income of \$ 76,014 consisted of mostly Social Security, interest, dividends and net rental income. She paid \$2,697 of AMT, which was almost 30 percent of her Federal Tax liability because of her relatively large real estate taxes and her income from tax-exempt private activity bonds that were generated from a municipal trust. She was quite annoyed when told that she was subject to the AMT. She could not believe that she was in the target group for this tax.

Another tax return concerned a married couple with four children. Both spouses work outside the home earning a total of \$152,549 and they had less than \$1,000 in interest and dividend income in 2004. Their state and local income and real estate taxes were \$16,820 and they had to pay \$937 in AMT. They have one child in college and one

NCCPAP - AMT Hearing  
May 23, 2005  
Page 3

who will begin college next year. They are not like any of the 155 taxpayers who paid no Federal income tax in 1969. When asked, the taxpayers indicated that they would have used the funds to pay for the school expenses for their children.

Another one of our members recently told me about a letter he sent to a client explaining that she was subject to the AMT in part because of the interest income from the private activity bonds she held. She told the CPA that if he was a better tax preparer this would not have happened and he lost the client. We wonder whether her *new* tax preparer properly reported the income from the private activity bonds, since the payer is not required to report private activity bond income to the IRS.

One of the most difficult AMT add-backs to explain to clients is the one for employee business expenses. The Internal Revenue Code requires an employee, who incurs ordinary and necessary business expenses in the performance of his/her employment that are not reimbursed by his/her employer, to include those expenses with other miscellaneous itemized deductions. These expenses are required to be reduced by two percent of the taxpayer's adjusted gross income and can be further reduced by the phase out of itemized deductions. "Statutory Employees" and businesses in all forms, i.e., corporations, partnerships, LLC's, LLP's and sole proprietorships, are allowed to deduct all business expenses in full against gross income (subject to limitations such as 50% of meals). The only business expenses that are not allowed to be deducted in full are those incurred by employees. In addition, these expenses are an add-back for AMT tax calculation purposes. Expenses related to the production of income are disallowed for AMT purposes on an individual tax return, but not on a business tax return. One tax return we received was for a single taxpayer with adjusted gross income of \$89,544 and \$20,018 of miscellaneous itemized deductions. He was subject to \$2,039 of AMT in 2004, 16 percent of his Federal income tax liability.

The taxpayer also loses the tax benefit of the costs of producing income if the taxpayer receives an award for damages from a lawsuit and the attorney is paid the legal fees from the settlement. The taxpayer must include the full amount of the award in income but the legal fees are deductible as a miscellaneous itemized deduction subject to the 2 percent floor and phase-out based on AGI. The legal fees are an add-back in determining alternative minimum taxable income. It is, therefore, possible for the attorney fees and the tax liability to consume the majority of the damage award the taxpayer actually receives. One colleague described a case in which a lawsuit was settled for a payment of \$850,000. The taxpayer had incurred attorney fees of \$650,000. The full amount of the settlement was required to be reported by the taxpayer even though she received only \$200,000 for herself. The AMT tax exceeded the \$200,000 she received.

NCCPAP - AMT Hearing  
May 23, 2005  
Page 4

The Civil Rights Tax Relief Act, which became law in October 2004, provides that, with respect to all prospective employment related and certain other settlements, only the amount payable to the taxpayer needs to be included in income so there is no AMT issue. The Code needs to be changed so that all legal settlements are reported net of legal fees.

Another colleague told me about a tax return where the taxpayer received a settlement because the stockbroker churned the taxpayer's investment accounts. The taxpayers, who suffered terrible capital losses, were able to offset the settlement against capital gains for regular tax purposes. The taxpayers, who are both retired, had no taxable income for the year of the settlement. However, they were subject to \$19,222 in AMT because the legal fees were not an allowable deduction for AMT purposes.

Other miscellaneous itemized deductions on some of the tax returns we collected where the taxpayer was subject to the AMT are investment advisory fees, IRA fees and other investment related expenses, legal fees related to the production of income, the costs of tax return preparation and representation fees in connection with IRS audits.

One of our members described a situation involving a 2002 tax return for a widow who had inherited a group of securities that were not appropriate for her circumstances. She wanted to rearrange the portfolio but was concerned about the capital gains tax since there were significant unrealized capital gains. The CPA told her about the possible consequences of the AMT where a taxpayer has significant capital gain income. He prepared tax projections for her in order to determine the maximum amount of long-term capital gain income that the taxpayer would be able to have and not be subject to the AMT. She subsequently sold only enough of the securities to stay out of the AMT. Although the current AMT calculations have nothing to do with capital gains, increasing capital gain income subjects the taxpayer to AMT because of the phase-out of the AMT exemption.

I was unable to locate actual Federal Income Tax forms for 1969. However, I found some tax returns from 1979. The form used to calculate the AMT in 1979 and the related instructions were each *one* page long. A taxpayer was permitted to reduce Adjusted Gross Income by a varying amount (\$1,700 to \$3,400) based on filing status and by \$1,000 per dependent. There were two lines for tax preference items, adjusted itemized deductions and capital gain deductions. The 1979 adjustments to itemized deductions did not include miscellaneous itemized deductions or private activity bond income. Also itemized deductions were not subject to phase-out for regular tax purposes in 1979. There was an add-back for the capital gains deduction that was excluded for regular taxes. The exemption amount for individuals was \$20,000 except if married filing separately. The AMT tax rate varied from 10 to 25 percent and the highest marginal income tax rate for regular tax was 70 percent.

NCCPAP - AMT Hearing  
May 23, 2005  
Page 5

By comparison, the form used to calculate the AMT in 2004 consists of two full pages and the related instructions are eight pages long. There are 26 lines of adjustments; no reduction is permitted based on filing status and no amount per dependent. The exemption amount for individuals was \$40,250 for single, \$58,000 for married filing jointly and \$29,000 for married filing separately. The AMT tax rate for 2004 varies from 25 to 28 percent and the highest marginal tax rate for regular tax is 35 percent.

The AMT has been called the "acutely messy tax" and is a perfect example of the tax law giving with one hand and taking away with the other. The regular tax rates have been lowered significantly but the AMT rates have not changed and the exemption amounts have not been indexed for inflation. If nothing is done to change the Tax Code, more than one third of American taxpayers will be subject to AMT by 2010. Although NCCPAP's position is that the AMT should be repealed, there may, in fact, be a place for the AMT in the tax code. The AMT certainly should not affect those taxpayers with moderate income, a few children and real estate taxes on their principal residence, wherever they may live.

Thank you very much for this opportunity. NCCPAP stands ready to supply you with additional anecdotal information you may need.

Respectfully submitted,



Carol Markman, CPA  
on behalf of the National Conference of CPA Practitioners

**Responses to Questions for the Record From Carol C. Markman  
Subcommittee on Taxation and IRS Oversight Hearing of May 23, 2005**

*From Senator Kyl*

*Question:* Have you seen clients change their economic behavior to avoid—or attempt to avoid—the AMT?

*Answer:* Yes.

I have clients who carefully avoid investing in Tax Exempt Private Activity Bonds.

I have had clients who have sold securities up to the amount of proceeds that will not subject them to AMT.

I have advised clients to postpone the payment of estimated State tax to the subsequent year to avoid AMT.

I have clients who requested that their employer reduce the taxpayer's wages and have the employer pay business expenses directly.

Some taxpayers decline to purchase property such as a second home with a mortgage because they will not get a tax deduction for the interest under AMT.

*From Senators Baucus and Jeffords*

*Question:* According to your testimony, your organization believes the AMT should be repealed, but you also feel there may be some value to the AMT. What parts of the AMT should be retained? Are there parts that should be incorporated into the regular income tax?

*Answer:* The “value” of the AMT is in its goal of creating “fairness” in the tax code. However, as the AMT is now calculated, many wealthy taxpayers still do not pay any Federal income tax. Some of these individuals will never pay income tax as long as they can keep their assets in tax-exempt bonds or structure their business in ways that avoid income tax. I have a few widowed clients who are tax-adverse, and most of their substantial assets are invested in tax-exempt bonds. When the AMT was first introduced, it was an add-on tax, not an alternative tax. Perhaps you need to consider the concept of an add-on tax or surtax for certain kinds of income that are not currently taxed, such as tax-exempt income above a certain threshold.

**STATEMENT OF NINA E. OLSON  
NATIONAL TAXPAYER ADVOCATE**

**BEFORE THE**

**SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT  
COMMITTEE ON FINANCE  
UNITED STATES SENATE**

**MAY 23, 2005**

Mr. Chairman and distinguished Members of the Subcommittee:

Thank you for inviting me to testify today at this hearing, which is intriguingly titled, "Blowing the Cover on the Stealth Tax: Exposing the Individual AMT." I have tried to further this mission by repeatedly calling attention to the deficiencies in the individual alternative minimum tax (AMT).<sup>1</sup> Indeed, if I were given the opportunity to make just one change to the Internal Revenue Code, I would use it to eliminate the individual AMT.<sup>2</sup>

**Overview**

The AMT was originally designed to prevent wealthy taxpayers from using tax shelters to avoid paying their fair share of taxes. However, Congress has changed the tax laws many times since the inception of the AMT and shut down many of the tax-avoidance opportunities that existed in the 1960s and 1970s. Today, the AMT affects millions of taxpayers with no tax-avoidance motives at all – unless one considers choosing to live in a high-tax state or choosing to have children to be a tax-avoidance motive. For 2002, the Treasury Department found that fully 51 percent of aggregate AMT tax preference dollars are attributable to the disallowance of the state and local tax deduction under the AMT, and 22 percent of aggregate AMT tax preference dollars are attributable to the

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<sup>1</sup> In my 2001 Annual Report to Congress, I recommended that the AMT be repealed or, at a minimum, substantially revamped to accomplish its original objective of preventing high-income taxpayers from escaping taxation through the use of tax-avoidance techniques. National Taxpayer Advocate 2001 Annual Report to Congress 166-177. In my 2003 Annual Report to Congress, I designated the AMT as the most serious problem facing taxpayers. National Taxpayer Advocate 2003 Annual Report to Congress 5-19. This report was recently cited by the American Bar Association in presenting its recommendation that Congress repeal the individual AMT. Report of the American Bar Association Section of Taxation to the American Bar Association House of Delegates (Aug. 2004) (transmitted with Letter from Kenneth W. Gideon, Chair, American Bar Association Section of Taxation, to Senators Grassley and Baucus and Congressmen Thomas and Rangel (Nov. 29, 2004)). In my 2004 Annual Report to Congress, I reiterated my recommendation that the AMT be repealed. National Taxpayer Advocate 2004 Annual Report to Congress 383-385.

<sup>2</sup> As a matter of fairness, the repeal of the AMT would require that Congress address the treatment of unused prior-year minimum tax credits, perhaps simply by retaining section 53 of the Code.

disallowance of personal exemptions.<sup>3</sup> Thus, nearly three-quarters of the increase in income subject to taxation under the AMT results simply because of taxpayers' place of residence or family composition.

Moreover, the AMT is now affecting increasing numbers of middle-income taxpayers, because the amount of income exempt from the AMT (the AMT "exemption amount") is not indexed for inflation. When Congress first enacted a minimum tax in 1969, the exemption amount was \$30,000 for all taxpayers. If Congress had indexed that amount, it would be equal to about \$157,400 today.<sup>4</sup> Instead, the exemption amount, after a temporary increase that will expire after 2005, is \$45,000 for married taxpayers and \$33,750 for most other taxpayers.<sup>5</sup> As a result, it is now projected that in 2010, 34.8 million individual taxpayers – or 34 percent of individual filers who pay income tax – will be subject to the AMT.<sup>6</sup> Among the categories of taxpayers hardest hit, 94 percent of married couples with adjusted gross income (AGI) between \$75,000 and \$100,000 and two or more children will owe AMT.<sup>7</sup>

The burden that the AMT imposes is substantial. In dollar terms, it is estimated that the average AMT taxpayer owed an *additional* \$6,000 in tax in 2004.<sup>8</sup> In terms of complexity and time, taxpayers often must complete a 12-line worksheet,<sup>9</sup> read eight pages of instructions,<sup>10</sup> and complete a 55-line form<sup>11</sup> simply to determine whether they

<sup>3</sup> Department of the Treasury, Office of Tax Analysis (unpublished tabulation) *cited in* Leonard E. Burman & David Weiner, *Suppose they took the AM out of the AMT?* (Nov. 13, 2004) (available at [www.taxpolicycenter.org](http://www.taxpolicycenter.org)).

<sup>4</sup> Department of Labor, Bureau of Labor Statistics, *Consumer Price Index – All Urban Consumers (CPI-U)* (April 30, 2005). Congress acted after hearing testimony that 155 taxpayers with adjusted gross incomes above \$200,000 had paid no federal income tax for the 1966 tax year. See *The 1969 Economic Report of the President: Hearings before the Joint Economic Comm.*, 91<sup>st</sup> Cong., pt. 1, p. 46 (1969) (statement of Joseph W. Barr, Secretary of the Treasury). The consumer price index has more than quintupled since 1966, so the kinds of taxpayers who caught Congress' attention back then would be making over \$1.19 million today. See Department of Labor, Bureau of Labor Statistics, *Consumer Price Index – All Urban Consumers (CPI-U)* (April 30, 2005). Yet the AMT today is not primarily affecting taxpayers with incomes over \$1.19 million. By 2010, it has been estimated that 83 percent of all taxpayers affected by the AMT will have incomes under \$200,000 – and 37 percent will have incomes under \$100,000. See Leonard E. Burman et al., *The Individual Alternative Minimum Tax: A Data Update*, table 4 (Aug. 30, 2004) (available at [www.taxpolicycenter.org](http://www.taxpolicycenter.org) and at 2004 TNT 175-15).

<sup>5</sup> IRC § 55(d).

<sup>6</sup> Department of the Treasury, Office of Tax Analysis (unpublished data furnished on Dec. 3, 2004).

<sup>7</sup> Leonard E. Burman et al., *The Individual Alternative Minimum Tax: A Data Update*, table 2 (Aug. 30, 2004) (available at [www.taxpolicycenter.org](http://www.taxpolicycenter.org) and at 2004 TNT 175-15).

<sup>8</sup> Leonard E. Burman et al., *The Individual Alternative Minimum Tax: A Data Update*, table 3 (Aug. 30, 2004) (available at [www.taxpolicycenter.org](http://www.taxpolicycenter.org) and at 2004 TNT 175-15). Final IRS data for 2004 is not yet available.

<sup>9</sup> 2004 Form 1040 Instructions, at 35.

<sup>10</sup> 2004 Instructions for Form 6251.

<sup>11</sup> 2004 Form 6251, *Alternative Minimum Tax – Individuals*.

are subject to the AMT. Thus, it is hardly surprising that 75 percent of AMT taxpayers hire practitioners to prepare their returns.<sup>12</sup>

Perhaps most disturbingly, it is often very difficult for taxpayers to determine in advance whether they will be hit by the AMT. As a result, many taxpayers are unaware that the AMT applies to them until they receive a notice from the IRS, and some discover they have AMT liabilities that they did not anticipate and cannot pay. To make matters worse, the difficulty of projecting AMT tax liability in advance makes it challenging for taxpayers to compute and make required estimated tax payments, which often results in these taxpayers being subject to penalties.

At some point in the next few years, we will reach a point where it will cost more for Congress to repeal the AMT than to repeal the regular tax and leave the AMT intact.<sup>13</sup> In a very real sense, then, the AMT is ceasing to fulfill its intended mission to prevent tax avoidance by the wealthy and is instead becoming the *de facto* tax system for millions of Americans. The obvious challenge in repealing the AMT is that its increasing revenue stream has been built into revenue estimates, so if it is repealed, either Congress will have to raise tax receipts in other ways or budget deficits will balloon. These alternatives admittedly are not appealing, but I have no doubt there are solutions that are far preferable to the status quo. Significantly, the longer Congress waits to act, the more dependent the government will become on AMT revenue and the harder it therefore will become to repeal it.

While the concept of a minimum tax is not unreasonable, the AMT as currently structured has morphed into something that was never intended: It is penalizing taxpayers for such nontax-driven behavior as having children or selecting a state of residence; it is hitting taxpayers it was never intended to hit because its exemption amount has not been indexed for inflation; it is taking large numbers of taxpayers by surprise – and subjecting them to penalties to boot; it is imposing onerous compliance burdens; it is altering the distribution of the tax burden that exists under the regular tax system; it is changing the tax incentives built into the regular tax system; and it is neutralizing the effects of changes to tax rates imposed under the regular tax system.

### **Background of the AMT**

The concept of a minimum tax was initially developed in response to reports that a small, wealthy group of taxpayers was avoiding taxes altogether through the use of tax avoidance techniques.<sup>14</sup> In 1969, the House of Representatives adopted

<sup>12</sup> Tax Year 2002, IRS Compliance Data Warehouse, Individual Returns Transaction File (IRTF).

<sup>13</sup> While estimates of when this crossover point will occur vary slightly, the most recent modeling by the Tax Policy Center, a joint venture of the Urban Institute and Brookings Institution, projects it will occur by 2008. See Leonard E. Burman, *The Individual Alternative Minimum Tax: A Presentation to the President's Advisory Panel on Federal Tax Reform* (March 3, 2005) (available at [www.taxpolicycenter.org](http://www.taxpolicycenter.org)).

<sup>14</sup> *The 1969 Economic Report of the President: Hearings before the Joint Economic Comm.*, 91<sup>st</sup> Cong., pt. 1, p. 46 (1969) (statement of Joseph W. Barr, Secretary of the Treasury); Committee on Ways and



recommendations of the Treasury Department and passed a bill to impose a minimum tax by limiting certain tax preference items, in the aggregate, to 50 percent of gross income.<sup>15</sup> This approach required the use of a complex formula designed to allocate itemized deductions between taxable income and non-taxable income and to disallow those deductions allocated to non-taxable income.<sup>16</sup>

The Senate changed the bill, adopting instead a tax on specified preference items in excess of a \$30,000 exemption amount.<sup>17</sup> The final bill followed the Senate's approach and imposed an add-on tax of 10 percent on nine specific tax preference items when the sum of the preference items exceeded \$30,000.<sup>18</sup>

The Tax Reform Act of 1976 and the Revenue Act of 1978 both made modifications to the add-on tax. The 1976 Act, among other things, increased the add-on tax rate to 15 percent and lowered the exemption amount from \$30,000 to \$10,000.<sup>19</sup> The 1978 Act went a step further, restructuring the tax into two components. The add-on tax was retained for all tax preferences except the capital gains deduction and excess itemized deductions, and a new alternative minimum tax was established to adjust the taxpayer's income for these two items of tax preference. This new alternative minimum tax (AMT) imposed a progressive three-tiered rate structure on AMT: 10 percent on AMT income between \$20,001 and \$60,000; 20 percent on AMT income between \$60,001 and \$100,000; and 25 percent on AMT income over \$100,000.<sup>20</sup>

In 1982, Congress repealed the add-on tax and replaced it with the alternative minimum tax (AMT).<sup>21</sup> Although Congress has enacted many technical changes over the past two decades, the basic structure of the AMT rules has remained intact.

#### **How the AMT Is Computed**

The AMT's method of calculation vividly demonstrates its complexity. The AMT requires a separate set of computations from the regular income tax, with unique rules governing the recognition of income and the timing of deductions and credits.

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Means of the U.S. House of Representatives and Committee on Finance of the U.S. Senate, 91<sup>st</sup> Cong., *Tax Reform Studies and Proposals*, U.S. Treasury Department, pt. 1, p. 132 (Comm. Print 1969).

<sup>15</sup> H.R. 13270, § 301(a) (version passed by the House of Representatives on Aug. 8, 1969).

<sup>16</sup> See H.R. Conf. Rep. No. 91-782, p. 301 (1969).

<sup>17</sup> H.R. 13270 (substituted version passed by the Senate on Dec. 11, 1969).

<sup>18</sup> Tax Reform Act, Pub. L. No. 91-172, § 301 (1969). The nine specified tax preference items were (1) excess investment interest income, (2) accelerated depreciation on personal property, (3) accelerated depreciation on real property, (4) amortization of certified pollution control facilities, (5) amortization of railroad rolling stock, (6) tax benefits from stock options, (7) bad debt deductions of financial institutions, (8) depletion, and (9) the deduction for capital gains.

<sup>19</sup> Tax Reform Act, Pub. L. No. 94-455, § 301 (1976).

<sup>20</sup> Revenue Act, Pub. L. No. 95-600, § 421 (1978).

<sup>21</sup> Tax Equity and Fiscal Responsibility Act, Pub. L. No. 97-248, § 402(a) (1982).

Taxpayers are often required to maintain two sets of records – one for regular income tax purposes and one for AMT purposes.

The determination of AMT liability, if any, involves an eight-step process:

1. The taxpayer must calculate his regular tax liability. The regular income tax rules provide preferred treatment for certain types of income and allow taxpayers to claim certain exemptions, deductions, exclusions and credits.
2. The taxpayer must determine whether he is subject to additional tax under the AMT regime. The IRS provides a 12-line worksheet (Worksheet To See if You Should Fill in Form 6251)<sup>22</sup> to help taxpayers determine whether they may be subject to the AMT. If the worksheet indicates that a taxpayer is *potentially* subject to the AMT, the taxpayer must complete Form 6251 (Alternative Minimum Tax – Individuals), which contains 55 lines. Many taxpayers are required to complete Form 6251 – only to find that they do not have an AMT liability.
3. The taxpayer must compute his alternative minimum taxable income (AMTI) on Form 6251. This computation generally requires taxpayers to give up the benefit of tax preference items to which they are entitled under the regular tax system (e.g., dependency exemptions, a standard deduction, and itemized deductions for state and local taxes, employee business expenses and legal fees).<sup>23</sup>
4. The taxpayer must determine an “exemption amount” to which he is entitled based on filing status. The AMT exemption amounts are temporarily boosted to \$58,000 for married taxpayers<sup>24</sup> and \$40,250 for most other taxpayers.<sup>25</sup> After 2005, however, the exemption amounts are scheduled to drop back to \$45,000 for married taxpayers and \$33,750 for most other taxpayers.<sup>26</sup> The exemption amount is phased out for married taxpayers with AMTI exceeding \$150,000 and non-married taxpayers with AMTI exceeding \$112,500.<sup>27</sup>

<sup>22</sup> 2004 Form 1040 Instructions, p. 35.

<sup>23</sup> Required adjustments listed on Form 6251 include adjustments for medical and dental expenses, state and local taxes, certain non-allowable home mortgage interest, miscellaneous itemized deductions, tax refunds, investment interest, depletion, certain net operating losses, interest from specified private activity bonds, qualified small business stock, the exercise of incentive stock options, estates and trusts, electing large partnerships, property dispositions, depreciation on certain assets, passive activities, loss limitations, circulation costs, long-term contracts, mining costs, research and experimental costs, income from pre-1987 installment sales, intangible drilling costs, certain other adjustments and alternative tax net operating loss deductions. See IRC §§ 56 and 57; IRS Form 6251 (Alternative Minimum Tax – Individuals), Part I.

<sup>24</sup> In cases where married persons file separate returns, each taxpayer is entitled to 50 percent of the exemption amount allowable to married taxpayers who file joint returns.

<sup>25</sup> Working Families Tax Relief Act, Pub. L. No. 108-311, § 103 (2004).

<sup>26</sup> IRC § 55(d).

<sup>27</sup> IRC § 55(d)(3).

5. The taxpayer must compute his "taxable excess" by subtracting the exemption amount from his AMTI.
6. A taxpayer with a positive "taxable excess" must compute his "tentative minimum tax." A "taxable excess" of \$175,000 or less is taxed at a 26 percent rate and any additional "taxable excess" is taxed at a 28 percent rate. The sum of the two amounts is the "tentative minimum tax."<sup>28</sup>
7. The taxpayer must compute his "alternative minimum tax" or "AMT." The AMT is equal to the excess of the taxpayer's tentative minimum tax, if any, over his regular tax liability (reduced by any tax from Form 4972 (Tax on Lump Sum Distributions) and any foreign tax credit from Form 1040). If the net result is a negative number or zero, the taxpayer does not owe AMT.
8. If the taxpayer owes AMT, he computes his final tax liability by adding his regular tax liability and his AMT liability.<sup>29</sup>

A taxpayer who is subject to the AMT accrues AMT credits.<sup>30</sup> These credits may be used in the future when the taxpayer's regular tax liability, reduced by other nonrefundable credits, exceeds the taxpayer's tentative minimum tax for the year. However, these credits may be applied only to "deferral" items -- not to "exclusion" items. Deferral items are those that are accounted for in different tax years in the regular tax and AMT systems. For example, the AMT in some instances requires taxpayers to depreciate property over a longer period of time. Exclusion items are adjustments and tax preference items that result in the permanent disallowance of certain tax benefits such as the standard deduction, personal exemptions and certain itemized deductions. Thus, many individual taxpayers will never be able to use their AMT credits.

#### **Problems with the AMT**

At the risk of some redundancy, the following is a concise list of the most significant problems arising from AMT:

- Impact on "Wrong" Taxpayers. The AMT no longer targets just wealthy taxpayers engaged in tax avoidance. As noted above, the number of AMT filers is projected to grow to nearly 35 million by 2010.<sup>31</sup> Of that total, a staggering

<sup>28</sup> IRC § 55(b)(1)(A).

<sup>29</sup> In most cases, the taxpayer's final tax liability is simply the greater of his regular tax liability or his tentative minimum tax liability. But because the Code requires adjustments for tax from Form 4972 (Tax on Lump Sum Distributions) and any foreign tax credit from Form 1040, the Seventh and Eighth steps are required to ensure that taxpayers with these tax items obtain the correct result.

<sup>30</sup> IRC § 53.

<sup>31</sup> Department of the Treasury, Office of Tax Analysis (unpublished data furnished on Dec. 3, 2004).

81 percent of taxpayers with incomes between \$100,000 and \$200,000 will be subject to the AMT.<sup>32</sup>

- Lack of AMT Knowledge. As noted above, taxpayers often file their returns not knowing about the AMT or expecting to be subject to it, but then receive bills relating to the AMT that they are not prepared to pay. In fiscal year 2004, the IRS closed nearly 23,000 examinations that were initiated because of suspected AMT liabilities. These examinations resulted in additional tax assessments of over \$39 million – more than \$1,700 per return.<sup>33</sup>
- Complexity. The individual AMT computations are completely separate from the regular income tax computations. As described above, taxpayers may need to fill out a 12-line worksheet and then a 55-line form (IRS Form 6251, Alternative Minimum Tax – Individuals) just to determine whether they are subject to AMT. Other complexities of the AMT include the re-computation of the foreign tax credit,<sup>34</sup> its effects on incentive stock options<sup>35</sup> and capital gains rates,<sup>36</sup> and the treatment of income of minor children (the so-called kiddie tax).<sup>37</sup>
- Failure to Index AMT Exemptions for Inflation. Regular income tax standard deductions, exemptions and filing thresholds are all adjusted for inflation. As discussed above, however, the AMT exemption amounts are not. The absence of an AMT indexing provision is largely responsible for the increasing numbers of middle-class taxpayers who are subject to the AMT regime.<sup>38</sup>
- Adverse Impact on Families. Married taxpayers will be almost 20 times as likely as single taxpayers to pay AMT in tax year 2010. One study projected that approximately 5.7 million taxpayers will pay AMT in 2010 simply because they lose the benefit of personal exemptions under the AMT.<sup>39</sup>
- Loss of Itemized Deductions. An individual taxpayer must add back certain itemized deductions when computing AMT.<sup>40</sup> This adjustment causes particular

<sup>32</sup> See Leonard E. Burman, *The Individual Alternative Minimum Tax: A Presentation to the President's Advisory Panel on Federal Tax Reform* (March 3, 2005) (available at [www.taxpolicycenter.org](http://www.taxpolicycenter.org)).

<sup>33</sup> IRS Wage & Investment Operating Division, Audit Information Management System (FY 2004 data).

<sup>34</sup> IRC § 59(a).

<sup>35</sup> IRC § 56(b)(3).

<sup>36</sup> IRC § 55(b)(3).

<sup>37</sup> IRC § 59(j).

<sup>38</sup> The effect of the absence of AMT-exemption indexing is compounded by the fact that key tax preference items that are included in AMTI – e.g., the standard deduction and personal exemptions – are indexed annually.

<sup>39</sup> Leonard E. Burman, William G. Gale & Jeffery Rohaly, *The AMT: Projections and Problems*, Tax Notes, July 7, 2003, pp. 105-106 (available at [www.taxpolicycenter.org](http://www.taxpolicycenter.org)).

<sup>40</sup> IRC § 56(b) & (e). Common itemized deductions that must be added back to income include, but are not limited to, state and local taxes, real estate and personal property taxes, mortgage interest not used

difficulties for taxpayers with large expenditures such as medical bills, legal fees in court settlements, state and local taxes, or employee business expenses.

- Unpredictability of Estimated Tax Payments. Because the law is so complicated, it is difficult, if not impossible, to predict whether an individual will be subject to the AMT. This uncertainty causes problems in paying the correct estimated tax for the year and can result in penalties for underpayment. In tax year 2001, for example, more than 176,000 taxpayers facing AMT were also required to pay nearly \$103 million in estimated tax penalties.<sup>41</sup>
- Taxation of Incentive Stock Options. A taxpayer's exercise of incentive stock options creates a paper (phantom) gain in the year the stock is purchased (the option exercise). This gain is not taxed under the regular tax rules but is taxed for AMT purposes. The gain is the difference between the option price and the market value of the stock on the date the option is exercised to purchase the shares.
- Limitation on Availability of General Business Credits. General business tax credits are not denied for purposes of computing AMTI but are limited by the taxpayer's tentative minimum tax.<sup>42</sup> To illustrate, assume a taxpayer has a regular tax liability of \$10,000 prior to credits, tentative minimum tax of \$9,000, and a \$2,000 credit under IRC § 44 for constructing an access ramp to his business for disabled individuals. Absent the credit, the AMT has no effect on this taxpayer because his regular tax liability exceeds his tentative minimum tax. However, the disabled access credit would reduce the taxpayer's regular tax liability to \$8,000, which is below his tentative minimum tax. Therefore, the taxpayer is only entitled to a credit amount of \$1,000 and must carry back or carry forward the \$1,000 credit balance. Under these circumstances, the taxpayer is required to complete Form 6251 and attach it to his return – even though the taxpayer does not have an AMT liability – to substantiate his entitlement to a portion of the credit. A 2000 Treasury analysis estimated that taxpayers will lose nearly 12 billion dollars in tax credits, mostly business credits, in 2010 because of the AMT.<sup>43</sup>
- Timing Issues Resulting from AMT Tax Credit Regime. The portion of AMT attributable to timing items reflects the difference between when certain deductions are allowable under the AMT and when the same deductions are

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for the purchase or improvement of a personal residence, medical expenses exceeding 7.5 percent but less than 10 percent of adjusted gross income, and certain miscellaneous itemized deductions such as employee business expenses and legal fees.

<sup>41</sup> Tax Year 2001, Compliance Research Information System, Model IFM 2003.

<sup>42</sup> IRC § 38(c)(1).

<sup>43</sup> Department of the Treasury, Office of Tax Analysis, Paper 87, table 1 at p. 19, June 2000; IRC § 55(c)(2).

allowable under the regular income tax. The taxpayer can claim an AMT credit only in subsequent years when the regular tax exceeds the AMT.

- Requirement of Two Sets of Records. Taxpayers often must keep separate records for regular tax and AMT purposes. For example, assume a taxpayer placed an office building into service prior to 1999 and is claiming straight-line depreciation on the building. The taxpayer must depreciate the building over a 39-year period for regular tax purposes,<sup>44</sup> but for AMT purposes the depreciation period is 40 years.<sup>45</sup>
- Inconsistent Treatment of Carryover Items. When a taxpayer loses a tax benefit because of the AMT, the taxpayer may or may not be entitled to carry the benefit to another tax year, and the carryover periods vary from item to item. For example, an unused credit otherwise allowable for placing a qualified electric vehicle into service may not be carried over.<sup>46</sup> If the credit cannot be used in the year in which the vehicle is placed into service, it is permanently lost. Unused general business credits, on the other hand, generally may be carried back one year and carried forward 20 years.<sup>47</sup> Unused foreign tax credits generally may be carried back two years and forward five years.<sup>48</sup>
- Two Computations of Capital Gains Tax. Capital gains are taxed for regular tax purposes at lower rates than the AMT rates. Because Congress wanted to preserve tax-favored capital gains treatment under the AMT regime, a taxpayer with capital gains who owes AMT must complete 20 lines on Form 6251 after having already completed a Schedule D (Capital Gains and Losses) for regular tax purposes.
- Increased Use of Paid Preparers. Approximately 55 percent of taxpayers without AMT liabilities pay to have their returns prepared. Where a taxpayer has an AMT liability, the use of paid preparers jumps to 75 percent.<sup>49</sup>
- High AMT Marginal Tax Rates Due to Phase-out of AMT Exemption. As described above, the AMT rules impose tax at a rate of 26 percent on a "taxable excess" (*i.e.*, AMTI reduced by the applicable AMT exemption amount) up to \$175,000 and 28 percent on higher amounts. However, the AMT exemptions phase out at a 25 percent rate for married taxpayers with AMTI exceeding

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<sup>44</sup> IRC § 168(c).

<sup>45</sup> IRC § 56(a)(1)(A)(i) (referencing IRC § 168(g)).

<sup>46</sup> A credit may be carried to another taxable year only if the Code expressly provides for it. In the case of the credit for placing a qualified electric vehicle into service, carryovers are not authorized. See IRC § 30(a).

<sup>47</sup> IRC § 39(a).

<sup>48</sup> IRC § 904(c).

<sup>49</sup> Tax Year 2002, IRS Compliance Data Warehouse, Individual Returns Transaction File (IRTF).

\$150,000 and non-married taxpayers with AMTI exceeding \$112,500.<sup>50</sup>  
Therefore, the AMT marginal tax rate can reach 35 percent.

### Examples of AMT Impact

The following examples illustrate the impact of the AMT in three situations:<sup>51</sup>

AMT Penalty for Having Children: The (modified) Brady Bunch. Mr. and Mrs. Brady live in California in a rented home with their six children ages 5-16. They claim the "married filing jointly" filing status and take the \$9,700 standard deduction in 2004. Mr. Brady, an architect, made \$73,160. Mrs. Brady worked part-time as a teacher and earned \$25,000. The Bradys owe \$3,394 in taxes under the regular tax system, but their tax bill rises to \$4,442 with the AMT because the tax benefits of the personal exemptions for their children are lost under the AMT.

AMT Marriage Penalty. Assume the same facts as in the prior example except that Mr. and Mrs. Brady did not marry. If each used the "Head of Household" filing status and claimed their own three children, the AMT would not apply to either of them and their combined tax bill would be lower. Mrs. Brady would pay no tax and get \$4,125 in refundable credits (a \$1,987 EITC credit and a \$2,138 child tax credit), and Mr. Brady would pay tax of \$6,006. Their combined tax liability would be \$1,881 (*i.e.*, \$6,006 minus \$4,125) – or \$2,561 less than their tax liability if they were married. Part of the difference in tax in these two examples is attributable to the general marriage penalty, but a significant portion is attributable solely to the AMT.

AMT Penalty for High State and Local Taxes. A taxpayer filed a joint return claiming two exemptions for 2003. The taxpayer had an adjusted gross income (AGI) of \$185,000 and paid state income and property taxes totaling \$27,000. The taxpayer had 90 percent of his regular tax liability withheld from his paycheck. When the taxpayer prepared his return, he discovered that he had an additional AMT tax liability of \$3,908 because the tax benefits of the deduction for state and local taxes are lost under the AMT. Because of the additional AMT tax liability, he also owed a penalty for failure to pay estimated tax in the amount of \$101.

AMT Penalty for Combination of Having Children and Requirement to Use "Married Filing Separately" Filing Status. A mother of five earned \$55,000 in 2003. She was separated from her husband during the last five months of the year and thus claimed "married filing separately" filing status. Because of the child tax credit, she had no tax liability under the regular tax rules. She therefore did not have any tax withheld from her paychecks. When she prepared her tax return, however, she discovered that she had a tax liability of \$1,760 due to the AMT. Because of the AMT tax liability, she also owed a penalty for failure to pay estimated tax in the amount of \$45.

<sup>50</sup> IRC § 55(d)(3).

<sup>51</sup> These examples illustrate common AMT issues we have seen in the Taxpayer Advocate Service, but they do not represent the facts of any particular case.

**Conclusion**

To be viewed as fair, a tax system must be transparent. Yet the complexity of the AMT is such that many if not most taxpayers who owe the AMT do not realize it until they prepare their returns. It adds insult to injury when many of these taxpayers discover that they also owe a penalty for failure to pay sufficient estimated tax because they did not factor in the AMT when they computed their withholding exemptions or estimated tax payments. Taxpayers subjected to this treatment may wonder whether their government is dealing fairly with them. To say the least, "gotcha" taxation is not good for taxpayers or the tax system.

Clearly, there are many practical, policy, and political challenges to repealing the individual AMT. But these challenges will continue to grow over time as the government, absent congressional action, becomes increasingly dependent on AMT revenue. With all the problems inherent in the AMT, I don't think taxpayers will stand for it when the AMT begins to hit tens of millions of taxpayers within the next few years. The AMT is a time bomb, and it is set to detonate within the next five years. I strongly urge Congress to act before the AMT explosion.



**Responses to Questions for the Record From Nina E. Olson  
Subcommittee on Taxation and IRS Oversight Hearing of May 23, 2005**

*From Senators Baucus and Jeffords*

*Question:* Many committee members have heard from taxpayers back home about the incentive stock option problem in the AMT. Can you provide a description of this problem?

*Answer:* Section 422 of the Internal Revenue Code permits companies to issue a limited number of Incentive Stock Options (ISOs) to employees as a financial inducement to share in the employer's long-term growth.<sup>1</sup> Under the regular tax system, employees who hold the stock received upon the exercise of an ISO for the requisite period (at least 2 years from grant and 1 year from exercise) receive a tax benefit. IRC § 421(a). Specifically, they are not treated as receiving any income when they exercise the option. *Id.*<sup>2</sup> Instead, they are taxed at capital gains rates on the eventual sale of the underlying stock. IRC § 1221(a). On the other hand, when employees receive options that do not qualify as ISOs, they are generally treated as receiving ordinary income in the year the option is exercised. IRC § 83(a). The amount that they must include in income is the difference between the value of the stock and the option exercise price (called the "spread"). *Id.*

The spread on an ISO is subject to the AMT in the year the option is exercised. IRC §§ 55(b), 56(b)(3). A limited exception applies if the stock is disposed of at a loss in the same taxable year as the year in which the option is exercised. *Id.*; IRC § 422(c)(2). Employees, however, sometimes fail to sell stock received upon the exercise of an ISO before the end of the year, even if the stock has significantly declined in value. This situation may occur because employees are discouraged by their employer from selling the stock or because of various legal, contractual or practical limitations. Such limitations may include:

- (a) contractual "lock up" periods imposed by underwriters after an initial public offering,
- (b) the potential that a sale of stock would subject the employee to liability under Rule 10b-5 of the Securities Exchange Act of 1934 because he or she is in possession of material nonpublic information about his or her employer,

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<sup>1</sup> See S. Rep. No. 144, 97th Cong. 1st Sess., 1981 U.S.C.C.A.N. 105, 202 (noting that ISOs were intended to be an "incentive device for corporations to attract new management and retain services of executives who might otherwise leave . . . [and] an important incentive to expand and improve the profit position of the companies involved").

<sup>2</sup> However, the granting corporation is not entitled to a deduction in connection with ISOs. *Id.*

- (c) a compliance policy that allows employees to sell employer stock only during limited periods, or
- (d) misinformation about the potential tax consequences of holding the stock.<sup>3</sup>

If the employee does not sell the stock before the end of the year, the AMT may exceed the value ultimately received by the employee on the sale of the stock. Thus, the employee can be “penalized” for exercising ISOs and failing to sell the underlying stock rapidly.

A taxpayer subject to AMT on the exercise of an ISO receives AMT credits that can only be used in future years to the extent the taxpayer’s regular tax liability exceeds his or her “tentative minimum tax” for the year. IRC § 53. Accordingly, a taxpayer can use AMT credits to reduce her regular tax to her AMT in future years. The sale of ISO stock can produce a capital loss under the AMT without producing a loss under the regular tax rules. Thus, AMT capital losses resulting from the sale of ISO stock could reduce a taxpayer’s tentative minimum tax below her regular tax liability so that she could use her AMT credits. AMT capital losses are most useful in reducing a taxpayer’s tentative minimum tax if they can be used to offset AMT capital gains.

Taxpayers with diversified stock holdings may be able to use their AMT losses to offset other AMT gains so that they can rapidly recover their AMT credits. However, for many employees and entrepreneurs receiving ISOs, employer stock is their only significant capital asset that could produce an AMT capital gain. As a result, any AMT capital losses are of limited value to them because the IRS takes the position that such losses can only be offset against AMT capital gains plus \$3,000 of ordinary AMT income per year.<sup>4</sup> In a recent survey of its members, [ReformAMT.org](http://ReformAMT.org), an organization formed in response to the ISO/AMT problem, found that its average member owes or owed \$322,428 in AMT and has an outstanding AMT credit of \$213,620.<sup>5</sup> The organization noted that it would take 71.2 years for its members to recoup \$213,620 in AMT credits, assuming they could recoup them at a rate of \$3,000 per year.<sup>6</sup>

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<sup>3</sup> None of these restrictions will prevent an employee from recognizing taxable income upon the exercise of an option. See, e.g., IRC § 83; Rev. Rul. 2005-48, 2005-23 IRB 1; TAM 200338010 (May 22, 2003).

<sup>4</sup> See Instructions for Form 6251, *Alternative Minimum Tax—Individuals*, 3 (March 2004). However, at least one commentator has suggested that the \$3,000 per year capital loss limitation applicable to individuals under section 1211(b) may not apply for AMT purposes. See Joe Mikrut and Jonathan Talisman, *Capitol Tax Partners Urge Treasury to Address AMT Issues*, 2004 TNT 166-29, n.7 (Aug. 26, 2004).

<sup>5</sup> Memo from ReformAMT to the President’s Advisory Panel on Tax Reform (April 29, 2005), available at <http://comments.taxreformpanel.gov/files/ReformAMTReformProposalTaxPanel42905final.pdf>.

<sup>6</sup> This assumption may be optimistic because the taxpayer’s regular tax must exceed her tentative minimum tax by \$3,000 in order to use \$3,000 in AMT credits. The ability to apply AMT capital loss carryforwards to offset \$3,000 of ordinary AMT income each year does not ensure that the taxpayer’s regular tax will exceed her tentative minimum tax by \$3,000.

**Example:** On January 1, 1997, Tom received ISOs to buy 10,000 shares of employer stock for \$10,000. He exercised the ISOs on March 15, 2000, paying \$10,000 for the stock at a time when stock was worth \$900,000. Because of Tom's position as an executive of his employer with access to material nonpublic information, he would risk liability under Rule 10b-5 if he sold the stock. For the year 2000, Tom was subject to AMT on \$890,000 (\$900,000 value of stock at time of exercise – \$10,000 exercise price) of phantom income resulting from the exercise of his ISOs on March 15, 2000. Tom's AMT basis in the ISO stock was \$900,000, but his regular tax basis in the ISO stock was \$10,000. His 2000 AMT liability, due on April 15, 2001, was \$249,200. The value of the stock subsequently fell. By April 1, 2001 the stock was worth \$10,000, leaving Tom with no significant assets to pay his \$249,200 year 2000 AMT liability.

Assuming that Tom was able to sell his stock in April 2001 for \$10,000, he would have no gain or loss for regular tax purposes in tax year 2001 (\$10,000 regular tax basis – \$10,000 sale price), but would have \$890,000 in AMT capital losses (\$900,000 AMT basis – \$10,000 sale price). His 2001 AMT capital losses could *not* be used to offset his \$890,000 in ordinary AMT income that he reported in 2000. Assuming Tom had no AMT capital gains in 2001, his AMT capital loss from the sale of the stock would only offset \$3,000 of AMT ordinary income and therefore would not significantly reduce his tentative minimum tax. The AMT capital loss might allow him to use some of his AMT credit in 2001 if it reduced his tentative minimum tax below his regular tax. Any unused AMT capital losses and AMT credits would carry over to later years. However, Tom may never be able to fully utilize his AMT credits.

The crux of the ISO/AMT problem is that losses on the sale of stock received upon the exercise of an ISO do not offset phantom gains previously recognized on the exercise of the ISO. The complexity of the AMT also obscures the tax treatment of ISOs and sets a trap for the unwary. This situation is compounded by the fact that the ISO/AMT problem is counterintuitive and at odds with the purpose of the AMT and the ISO rules as commonly understood by the public. The AMT was originally aimed at the very wealthy who received the bulk of their income from capital gains rather than from services.<sup>7</sup> Employees without sufficient capital gains to offset the AMT losses on the sale of their ISO stock who are subject to the ISO/AMT problem, by definition, get the bulk of their income from personal services rather than from capital gain. Thus, the purpose of the AMT is not served in connection with ISO exercises by employees who receive most, if not all, of their income from services and, thus, are unable to use their AMT capital losses or AMT credits rapidly.

<sup>7</sup> S. Rep. No. 552, 91st Cong., 1st Sess., 1969 U.S.C.C.A.N. 2027, 2143 (noting that reason for enacting the AMT was to correct the problem that "In general, high-income individuals, who get the bulk of their income from personal services, are taxed at high rates. On the other hand, those who get the bulk of their income from such sources as capital gains or who can benefit from accelerated depreciation on real estate pay relatively low rates of tax.").

*Question:* If the AMT is repealed, how will these taxpayers fare?

*Answer:* Repealing the AMT would allow taxpayers exercising ISOs after the effective date of the repeal to avoid the ISO/AMT problem. However, unless the legislation also allows taxpayers that currently have AMT credits to use those credits, it will not help taxpayers subject to the ISO/AMT problem who exercised their ISOs during the technology stock decline that occurred in the years 2000 and 2001. Any such legislation would need to have transition rules that allow taxpayers to use existing AMT credits.

*Question:* Do you have any recommendations to fix it?

*Answer:* In my last few Annual Reports to Congress, I presented a number of recommendations that would ameliorate the effect of the AMT for middle-income taxpayers, including those facing the ISO/AMT problem, as follows.<sup>8</sup>

Establish a gross income threshold (indexed for inflation) for individual AMT. Congress could exempt from the AMT married taxpayers with gross incomes (under the regular tax system) under \$150,000 and other taxpayers with gross incomes under \$75,000 from the AMT. This threshold could be indexed for inflation. This approach would be a simple way of reducing the AMT burden for taxpayers exercising ISOs.<sup>9</sup> Since the exercise of an ISO does not produce gross income under the regular tax system, income from the exercise of an ISO would be ignored for purposes of the threshold. Thus, this proposal would eliminate the ISO/AMT problem for taxpayers with regular gross income below the threshold and limit the ISO/AMT to high-income taxpayers, as originally intended. However, unless such legislation is retroactive, it would not help taxpayers currently facing the ISO/AMT problem.

Increase the individual AMT exemptions and index them for inflation. Increasing the individual AMT exemptions will reduce the number of middle-income taxpayers subject to the AMT and prevent the AMT from affecting more taxpayers each year solely because of the effects of inflation. This approach will also help taxpayers facing the ISO/AMT problem use their AMT credits.<sup>10</sup> The \$30,000 AMT exemption amount enacted in 1969 would be worth about \$150,000 today if it had been indexed for inflation.<sup>11</sup> Increasing the exemption amount would help to ameliorate the ISO/AMT

<sup>8</sup> See National Taxpayer Advocate, 2003 Annual Report to Congress 5; National Taxpayer Advocate, FY 2001 Annual Report to Congress, 172. See also National Taxpayer Advocate, 2004 Annual Report to Congress 433.

<sup>9</sup> The proposal has the additional advantage of allowing the taxpayer to determine his or her eligibility for the AMT by looking at a specific line on Form 1040, rather than completing a worksheet or the actual AMT form.

<sup>10</sup> See National Taxpayer Advocate, 2003 Annual Report to Congress 5. The exemption amount on a joint return is currently \$58,000, but this amount begins to phase out when alternative minimum taxable income exceeds \$150,000. IRC § 55(d). The phase-out may also need to be adjusted or eliminated.

<sup>11</sup> See National Taxpayer Advocate, 2003 Annual Report to Congress 18.

problem for some taxpayers who exercise their options after the effective date of the legislation. It would also help some taxpayers with existing AMT credits use the credits more rapidly, because a higher exemption amount would make it more likely that their regular tax would exceed their tentative minimum tax.

Eliminate personal exemptions, the standard deduction, State and local taxes, and miscellaneous itemized deductions as adjustment items for AMT purposes. This recommendation would reduce or eliminate the AMT burden for many middle-income taxpayers with large families, many taxpayers who live in areas with high State and local taxes, and many taxpayers who incur high miscellaneous itemized deductions. Like the recommendation to increase the AMT exemption amount, this proposal would also help middle-income taxpayers use their AMT credits by making it more likely that their regular tax would exceed their tentative minimum tax.

Clarify the IRS's authority under section 7122 of the Code to compromise liabilities resulting from so-called "tax traps," such as the ISO/AMT problem.<sup>12</sup> In the extraordinary circumstance where the AMT on an ISO exercise exceeds the value ultimately received (or likely to be received) by a taxpayer on the sale of the stock, my proposal would allow the IRS to compromise such liabilities.<sup>13</sup> This would provide a solution to the ISO/AMT problem for some of the most egregious cases where taxpayers with outstanding tax liabilities would otherwise be forced to pay more in tax than they ultimately received on the sale of the ISO stock. It would also help taxpayers who have already exercised their ISOs.

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<sup>12</sup> See National Taxpayer Advocate, 2004 Annual Report to Congress 433.

<sup>13</sup> IRM § 5.8.11.2.2(3) (May 15, 2004). To date, the IRS has declined to use its discretion to compromise on this basis. See, e.g., *Speltz v. Commissioner*, 124 T.C. No. 9 (May 23, 2005).



## COMMUNICATIONS

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### CAPITOL TAX P A R T N E R S

**For a Hearing Before the  
Subcommittee on Taxation and IRS Oversight of the Committee on Finance**

**“Blowing the Cover on the Stealth Tax: Exposing the Individual AMT”  
--May 23, 2005--**

**A Proposed Legislative Solution to Address an Alternative Minimum Tax Problem  
Unique to S Corporation Shareholders**

#### **Present Law**

A corporation described in subchapter C of the Internal Revenue Code of 1986 (Code) is subject to tax on its income as it is earned and its shareholders are subject to tax when the earnings and profits of the corporation are distributed to them as dividends. The shareholders of certain small business corporations can elect, under subchapter S of the Code, to have the income of the corporation (an S corporation) taxed directly to the shareholders as such income is earned. Distributions of such income from an S corporation are not then subject to another level of tax at the shareholder level. Thus, the income of a C corporation generally is subject to two levels of tax while the income of an S corporation generally is subject to one level of tax.

In the case of a corporation that converts from C to S corporation status, subchapter S employs certain mechanisms to account for the different treatment of income earned before and after the conversion. Specifically, an S corporation with accumulated earnings and profits (AEP, i.e., income earned while a C corporation, but undistributed to shareholders as of the date of conversion) must maintain an accumulated adjustments account (AAA). The AAA generally is increased by the taxable income of the S corporation (which flows through to the S corporation's shareholders) and is reduced by the losses of the S corporation and actual distributions to the shareholders. Distributions by the S corporation not in excess of the AAA are not taxable to the shareholders. Distributions in excess of the AAA are taxable dividends to the shareholders to the extent of the S corporation's AEP.

The taxable income of an S corporation generally is computed in the same manner as in the case of an individual. The items of income, loss, deduction and credit of an S corporation flow through and are taken into account by the corporation's shareholders. Where the separate treatment of an item could affect the tax liability of a shareholder, such item flows through separately to, and is taken into account appropriately by, the shareholder. Examples of such separately stated items include capital gains and losses and the preferences and adjustments of the alternative minimum tax described below.

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An individual is subject to an alternative minimum tax (AMT) for a taxable year to the extent the taxpayer's tentative minimum tax exceeds his or her regular tax liability for the year. A taxpayer's tentative minimum tax is determined by applying the AMT rates to the taxpayer's alternative minimum taxable income in excess of his or her exemption amount. The AMT rates are 26 percent to the extent such taxable amount does not exceed \$175,000 and 28 percent on the excess over \$175,000. Alternative minimum taxable income is the taxpayer's regular taxable income increased by certain preference items and adjusted for certain other items.<sup>1</sup>

#### **Discontinuities for S Corporation Shareholders under Present Law**

A shareholder of an S corporation that has significant AMT preferences and adjustments relative to its income may become subject to the AMT through his or her share of S corporation earnings for the year. If the S corporation does not have a sufficiently large AAA, but does have AEP, any distribution from the corporation to fund the shareholder's AMT liability will further increase that liability.

**Example 1.** An S corporation that was formerly a C corporation has \$100 of AEP from its C corporation years and a sole individual shareholder. In its first year as an S corporation, the S corporation has \$100 of investment income and \$100 of investment expenses that are deductible for regular tax, but not AMT, purposes. For regular tax purposes, the S corporation reports zero taxable income and has a zero AAA. Accordingly, the shareholder has zero regular taxable income from the S corporation. For AMT purposes, the shareholder has \$100 of alternative minimum taxable income from the S corporation. The shareholder thus owes up to \$28 of AMT because investment expenses are not deductible for AMT purposes.

In order for the shareholder to pay his AMT liability, the S corporation distributes \$28 to him. For regular tax purposes, that distribution is treated as a dividend because the S corporation's AAA is zero and the S corporation has AEP. Although unclear,<sup>2</sup> it appears that the distribution may cause the shareholder to have \$28 of additional alternative minimum taxable income, resulting in additional AMT liability. To enable the shareholder to pay the additional AMT, the S corporation must

<sup>1</sup> Among the items that increase the alternative minimum taxable income of an individual is the disallowance of the deduction allowed for regular tax purposes under Code section 212 for ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income; for the management, conservation, or maintenance of property held for the production of income; or in connection with the determination, collection, or refund of any tax (generally known as investment expenses).

<sup>2</sup> It is unclear whether the corporation has a separately computed AAA for AMT purpose. The Internal Revenue Code and applicable regulations are silent and no other sources of administrative guidance or case law have addressed the issue. In addition, even if an S corporation was allowed to separately compute an AAA for AMT purposes under present law, sections 1367(a)(2)(D) and 1368(e)(1)(A) may cause the AAA to be reduced by the amount of the deductions not allowed for AMT purposes.



“gross up” the distribution to \$39.<sup>3</sup> Thus, the shareholder receives a total distribution of \$39 and ends up paying AMT of \$39 on \$139 of alternative minimum taxable income, rather than paying only \$28 of AMT on the \$100 of investment income that triggered the AMT liability.

The example above raises several policy issues. First, it is problematic that section 212 expenses are treated as an adjustment for AMT purposes. Section 212 expenses include those ordinary and necessary expenses paid or incurred in the production of income. Treating section 212 expenses as an AMT adjustment converts the nature of the taxpayer’s liability from a net income tax under the regular tax to a gross income tax under the AMT.

Second, the shareholder in the example must fund his AMT liability that arises from S corporation items with a distribution from the S corporation. The distribution, in turn, may give rise to additional AMT if the S corporation is not deemed to have sufficient AAA for AMT purposes. This would increase the effective tax rate of the original transaction that gave rise to the AMT from 28 percent to (the top statutory AMT rate) to 39 percent. The shareholder would have an AMT liability in excess of a tax on gross income. This issue may arise with respect to any number of AMT preferences and adjustments.

#### **Proposed Legislative Solution**

The proposal would clarify that the S corporation adjustments that are made for regular tax purposes should be made separately for AMT purposes. Thus, a shareholder’s stock basis in his or her S corporation stock and debt, an S corporation’s AAA and AEP, and other similar items will be adjusted separately for regular tax and AMT purposes.

Example 2. Assume the same facts in Example 1 above. Under the proposal, the S corporation would continue to have zero regular taxable income and zero AAA. The shareholder would continue to have a \$28 AMT liability with respect to the S corporation adjustment relating to the investment expenses. However, under the proposal, because the S corporation generated \$100 of alternative minimum taxable income, it would have an AAA of \$100 for AMT purposes before the distribution is taken into account. The \$28 distribution from the S corporation would be a dividend for regular tax, but not AMT, purposes, and the shareholder would not have additional AMT as a result of the distribution. There would not be a need to make the additional “gross up” distribution. At year end, the S corporation has a zero AAA and \$72 AEP for regular tax purposes and a \$72 AAA and \$100 AEP for AMT purposes.

<sup>3</sup> Determined as:  $\text{Income} / (1 \text{ minus tax rate}) \text{ minus Income}$  or, in the example,  $\$100 / (1 - .28) \text{ minus } \$100$ , or \$38.89. Note that for taxable years beginning before December 31, 2008, the maximum tax rate generally applicable to dividend income is 15 percent. Thus, in such years, the amount of the “gross up” distribution would be \$32.94 (computed as  $\$28 / (1 - .15)$ ).

**Rationale for the Proposal**

Congress intended the AMT to be a separate, yet parallel, system from the regular tax system.<sup>4</sup> For example, the basis of property subject to AMT depreciation adjustments and net operating losses specifically are adjusted to reflect AMT rules. To preserve the integrity of the AMT as a separate tax system, similar rules should operate with respect to the various adjustments required under subchapter S. The proposed clarification provides such rules.

The AAA mechanism of subchapter S is designed to maintain the single level of taxation on S corporation earnings. The AAA is increased by the taxable income of the S corporation so that subsequent distributions of such earnings are not treated as taxable dividends. This mechanism should operate for AMT purposes as well so that items of S corporation income that shareholders include in their alternative minimum taxable income are not subject to AMT again when distributed to the shareholders.

The effect of some AMT adjustments (and the adjustment for section 212 investment expenses, in particular) is to create a tax on gross income. Typically, shareholders of an S corporation receive distributions from the corporation to pay for their tax liabilities attributable to the S corporation. Shareholders that receive distributions from an S corporation to pay AMT that arises from activities of the corporation may incur additional AMT liabilities if the S corporation has AEP and insufficient AAA. This creates a tax liability in excess of a tax on gross investment income.

Some may argue that the AMT treatment of certain preferences or adjustments (such as section 212 investment expenses) affects many different types of individual taxpayers and that crafting a legislative solution only for S corporation shareholders provides an unfair advantage to those taxpayers. This argument misinterprets the proposal. The proposal does not relieve S corporation shareholders of AMT liability with respect to such items; the items of preference and adjustment would still apply to them. Rather, the proposed clarification would ensure that an S corporation shareholder's AMT liability would not be increased by reason of distributions to pay the AMT related to such corporate-level preferences and adjustments.

The tax-on-tax issue described above is unique to S corporation shareholders. Partnerships may generate preferences and adjustments that result in an AMT liability, but distributions from the partnership to pay such tax generally will not compound the AMT liability. Similarly, a shareholder in a closely-held C corporation may incur additional AMT liability by withdrawing dividends from the corporation. However, the shareholder's original AMT liability must be from items unrelated to the C corporation because AMT preferences and adjustments do not flow through from C corporations to shareholders. It is only with respect to S corporations where individuals may incur additional AMT by withdrawing funds from an entity or vehicle to pay an AMT liability that originated from the entity or vehicle itself. The proposed solution is narrowly crafted to address only these unique aspects presented by S corporations.

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<sup>4</sup> See, Staff of the Joint Committee on Taxation, 99th Cong., General Explanation of the Tax Reform Act of 1986 438 (Comm. Print 1987).

CAPITOL TAX  
P A R T N E R S

**For a Hearing Before the  
Subcommittee on Taxation and IRS Oversight of the Committee on Finance**

**“Blowing the Cover on the Stealth Tax: Exposing the Individual AMT”  
--May 23, 2005--**

**A Proposal to Provide Fair Treatment of Incentive Stock Options under  
the Alternative Minimum Tax**

**Executive Summary**

The issue of the ever-increasing reach of the individual alternative minimum tax (AMT) clearly is worthy of consideration by the Senate Finance Committee. Any such analysis undoubtedly would include an examination of the scope and operation of the AMT, the historical and current policy justifications for the AMT, and the revenue raised by the AMT. The purposes of this submission is to highlight the need to address one particularly egregious feature of the AMT – the treatment of the disposition of stock acquired through the exercise of incentive stock options (ISOs) in a falling stock market.

As explained in detail in the attached submission, ISOs are stock options issued to broad classes of employees to encourage participation in the growth of the issuing corporation. Present law provides favorable regular tax rules that allow the deferral of the recognition of income upon the exercise of an ISO. The AMT negates this favorable tax rule by requiring taxpayers to recognize income upon the exercise of the ISOs. In a steady or rising stock market, the AMT liability effectively “pre-paid” upon the exercise of the ISO is refunded to the taxpayer when he or she disposes of his or her ISO shares.

A discontinuity arises in the case of a declining stock market. As illustrated in greater detail in the submission, in such cases the refund mechanism may not operate properly and taxpayers are subject to significant AMT liabilities despite the absence of economic income. Real life cases have resulted in severe economic hardship as affected taxpayers have been forced to declare bankruptcy or sell their homes, retirement security assets, or dependents’ education funds in order to pay this unfair tax.

A relatively easy fix can remedy this situation – clarify that any AMT loss on the disposition of ISO shares has the same character as any AMT income recognized upon the exercise of the ISO. This solution results in the taxation of economic income, prevents taxpayer whipsaw, encourages broad employee participation in the growth of their employers, and is consistent with fundamental concepts underlying the AMT. In addition, this clarification would simplify compliance and reduce recordkeeping for individual taxpayers by “closing out” all the AMT effects of an ISO transaction upon the disposition of the stock while presenting no opportunity for abuse or tax avoidance.

Thank you for the opportunity to express this concern and for your consideration of this matter. If you have any questions, please do not hesitate to contact Joseph M. Mikrut or Jonathan Talisman of Capitol Tax Partners, Washington, D.C.

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### **Introduction**

We are writing to request that you consider a legislative clarification to the tax treatment of incentive stock options (ISOs) under the individual alternative minimum tax (AMT).<sup>1</sup> During the “exuberant” stock market, many taxpayers exercised their ISOs at substantial discounts and incurred large AMT liabilities. Subsequent downturns in the market, however, have caused those discounts to be “ephemeral” and the gain recognized for AMT purposes to be “illusory.” Thus, upon a subsequent sale of the stock, these taxpayers typically have had (or will have) a significant negative AMT adjustment. The character of this negative AMT adjustment presently is unclear.

We propose that the character of any negative AMT adjustment upon sale of the ISO stock should be the same as the character of any corresponding prior positive AMT adjustment upon exercise of the ISO. This simple clarification treatment results in the taxation of economic income, prevents taxpayer whipsaw, and is consistent with fundamental concepts underlying the AMT. In addition, this clarification would simplify compliance and reduce recordkeeping for individual taxpayers by “closing out” all the AMT effects of an ISO transaction upon the disposition of the stock.

### **Incentive Stock Options – Current Law**

Congress provided favorable tax treatment to employees who receive ISOs in order to “provide an important incentive device for corporations to attract new management and to retain the service of executives who might otherwise leave.”<sup>2</sup> This favorable tax treatment includes no regular tax consequences to an employee when an ISO is granted or the option is exercised. In addition, provided certain holding periods are met, the employee is taxed at capital gains rates on any gain realized from the sale of stock acquired pursuant to an ISO. Employers forego a deduction for ISOs. The regular tax ISO rules thus provide employees with the benefits of income tax deferral and preferential capital gains treatment if the applicable requirements are met.

Congress provided the ISO tax incentives under present law on the premise that the stock in the ISO plan will continue to increase in value over time. In order to qualify for favorable regular tax treatment, the strike price of the ISO cannot be less than the fair market value of the stock at the time the option is granted (sec. 422(b)(4)). Thus, an employee will not exercise an ISO unless the value of the stock has risen since the date of grant. In addition, the ISO rules require an employee to hold the stock for at least two years from the date of grant and one year from the date of exercise (sec. 422(a)(1)).

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<sup>1</sup> We understand that the AMT presents broad policy issues. We take no position in that debate; rather, we seek to point out one of the more egregious elements of the present-law AMT.

<sup>2</sup> See, S. Rep. 97-144, p. 98, (July 6, 1981).

The favorable regular tax treatment for ISOs, however, does not apply for AMT purposes. Under the AMT, the spread between a stock's fair market value on the date of the ISO exercise and the exercise price generally is a positive AMT adjustment<sup>3</sup> and will result in AMT liability for an employee in the year of exercise. The employee will have an AMT credit (which can be used to offset regular tax liability in future years) to the extent of such AMT liability. The positive AMT adjustment generated in the year the ISO is exercised reverses as a negative adjustment and is taken into account for AMT purposes in the year the stock is sold. The AMT credit generated in the year of the positive AMT adjustment can be used to offset regular tax liability in a subsequent taxable year to the extent the employee's regular tax liability for such year exceeds his or her tentative minimum tax (which generally will be the year of the disposition of the ISO stock because the taxpayer will have a relatively low basis in his or her ISO shares for regular tax purposes and a negative AMT adjustment).

The AMT ISO rules thus negate the tax deferral benefits provided under the regular tax by requiring an employee to take into account the bargain purchase element of an ISO in the year of exercise rather than in the year of the disposition of the stock. This acceleration of income recognition should completely reverse, however, in the year in which the employee recognizes this income for regular tax purposes with respect to the ISO stock (i.e., in the year of disposition). Such reversal is consistent with the intended operation of the AMT as a separate tax system, as amended by the Tax Reform Act of 1986 (as discussed in detail below). Thus, in the case of a steady or rising stock market, the AMT acts as a pre-paid tax that is effectively refunded when the taxpayer disposes of his or her ISO shares.

The operation and interplay of the regular tax and AMT rules with respect to ISOs can be best illustrated in the following example.

**Example 1—Rising market.** Assume a taxpayer was granted an ISO to purchase 10,000 shares for \$10 each when the shares were worth \$10 each. Over a year later, the taxpayer exercised the ISO when the fair market value of the stock was \$50 per share. As a result of the exercise, the taxpayer had a positive AMT adjustment of \$400,000 and a significant AMT liability. This AMT liability provides the taxpayer with an AMT credit that may be used to offset regular tax liability on sale of the ISO shares in a later year.

Over a year after the date of exercise, the stock has retained its value of \$50 a share and the taxpayer sells her shares. Because she paid \$10 for each of the shares, the taxpayer has a regular tax gain of \$400,000 on the sale. Because she has already taken this \$400,000 amount into account for AMT purposes, she will not have any AMT gain in the year of the sale. Rather, the taxpayer's income for regular tax purposes will exceed her AMTI (i.e., she will have a negative AMT adjustment). Similarly, her regular tax liability will exceed her tentative minimum tax and the taxpayer is allowed to use her AMT credits to offset her regular tax liability to the extent of such excess. Use of the AMT credit in the year of disposition effectively refunds to the taxpayer the AMT she paid in the year of exercise.

<sup>3</sup> A taxpayer generally determines his or her alternative minimum taxable income (AMTI) by starting with regular taxable income and making adjustments. Positive adjustments increase the taxpayer's AMTI relative to his or her regular taxable income. Negative AMT adjustments decrease the taxpayer's AMTI.

**Potential for Whipsaw**

Declines in the stock market have highlighted a potential whipsaw under the AMT for taxpayers who exercised ISOs. The following example illustrates the problem.

**Example 2—Falling market.** Assume a taxpayer was granted an ISO to purchase 10,000 shares for \$10 each when the shares were worth \$10 each. Over a year later, the taxpayer exercised the ISO when the fair market value of the stock was \$50 per share. As a result of the exercise, the taxpayer had a positive AMT adjustment of \$400,000 and a significant AMT liability. This AMT liability provides the taxpayer with an AMT credit that ostensibly may be used to offset future regular tax liability on sale of the shares.

Over a year after the date of exercise, the stock has declined in value to \$10 a share. The taxpayer, seeking to avoid further investment loss, sells her shares. Because she paid \$10 for each of the shares (and has a \$10 basis in each share), the taxpayer does not have an economic gain from exercising the ISO and owning the shares (and does not have a regular tax gain on the sale). For AMT purposes, she has already recognized \$400,000 in income in the year of the exercise which must be reversed.

At issue is how the \$400,000 positive AMT adjustment generated in the year of exercise in Example 2 should reverse in the year of disposition. The employee paid AMT on \$400,000 of income in the year of the exercise of the ISO. Such “income” was lost when the market retreated and she sold her shares. **To make the taxpayer whole, her AMT liability should be refunded. To accomplish this result, the law should clarify that the character of the negative AMT adjustment is the same as the prior positive AMT adjustment.**

**Policy Considerations**

The advocated treatment of the negative ISO adjustment is strongly supported by general tax principles as well as the policies underlying the individual AMT.

**General tax principles**

It is well-settled tax policy, embodied by the Arrowsmith doctrine and the tax benefit rule, that a transaction that is integrally related to a prior transaction has the same character and should be accorded the same tax treatment as the earlier transaction. In Arrowsmith,<sup>4</sup> two shareholders liquidated a corporation, realizing a capital gain. In a subsequent taxable year, the shareholders were required to satisfy a judgment against the corporation. One shareholder tried to assert that he was entitled to an ordinary deduction on payment of the judgment. The Supreme Court, however, disagreed holding that the payment of the judgment was a capital loss. In reaching its holding, the Court found that the shareholders’ “liability as transferees was not based on any ordinary business transaction of theirs apart from the liquidation proceeding.” Moreover, the court found it important that the loss would have been capital (i.e., reduced the amount of

<sup>4</sup> 344 U.S. 6 (1952).

capital gain) had it occurred in the same year as the liquidation.<sup>5</sup> Legislation should clarify the application of the Arrowsmith doctrine to the AMT treatment of ISOs.

The tax benefit rule generally provides that gross income should not include income from the recovery of an item deducted in a prior year that did not result in a tax benefit in such prior year.<sup>6</sup> According to the Supreme Court, the tax benefit rule is intended to protect both taxpayers and the government from “transactional inequities” that may arise from adherence to an annual accounting system. The proposed treatment for ISOs under the AMT would eliminate the “transactional inequities” discussed in this submission by ensuring that a taxpayer who has already experienced a tax detriment (the inclusion of the ISO bargain element in AMTI in the year of exercise) equitably receives the related tax benefit (the negative AMT adjustment) in the year of disposition of the ISO stock.

#### **Policies underlying the individual AMT**

The advocated treatment of the negative ISO adjustment is consistent with the policies underlying the individual AMT. The AMT originally was enacted, and subsequently significantly modified by the Tax Reform Act of 1986, to ensure that individuals with significant economic income did not escape taxation on such items of income. To accomplish this goal, the AMT disallows the use of certain permanent items of tax preference (such as tax-exempt interest on certain private activity bonds and certain itemized deductions) and negates the benefit inherent in certain timing items (such as accelerated depreciation and the special ISO rules). The taxpayer in Example 1 above has \$400,000 of economic income with respect to her ISO stock over the term of the ISO transactions and is subject to tax on such amount. The taxpayer in Example 2 above has no economic income with respect to her ISO stock. If the negative AMT adjustment is treated as a capital loss, the taxpayer will have AMTI, but no economic income, with respect to her ISO shares. Stated another way, if the negative AMT adjustment is treated as a capital adjustment, the taxpayers in Examples 1 and 2 will have the same amount of income subject to tax over the course of their ISO transaction (\$400,000), even though they do not have the same amount of economic income. Clarifying that the negative adjustment has the same AMT character as the prior positive adjustment ensures that the taxpayers’ taxable incomes match their economic incomes and that both taxpayers are treated fairly under the AMT.

<sup>5</sup> Since Arrowsmith, many courts and the IRS have invoked the doctrine to require the character of a transaction to have the same character as a prior related event. See, United States v. Skelly Oil Co., 394 U.S. 678 (1969) (deduction for repayment of income that was eligible for oil depletion allowance was limited by amount of income previously recognized); Anderson v. Commissioner, 480 F.2d 1304 (1973) (repayment of short-swing profits had same character as gain on prior sale); Bresler v. Commissioner, 65 T.C. 182 (1975) (gain had same character as “integrally related” prior loss); Rev. Rul. 79-278, 1979-2 C.B. 302 (receipt of payment to settle stock loss suit had same character as prior loss).

<sup>6</sup> The tax benefit rule is codified in section 111 and section 59(g) specifically authorizes the Secretary to issue regulations under which differently treated items shall be properly adjusted pursuant to the tax benefit rule for AMT purposes. Regulations issued pursuant to this authority do not address ISOs. Thus, it is unclear whether sections 59(g) and 111 specifically apply to the AMT ISO situation.

Another fundamental notion underlying the AMT is the prepayment concept with respect to timing items. The AMT negates the benefit inherent in certain timing items by slowing down the ability of taxpayers to claim deductions (as in the case of accelerated depreciation) or accelerating the recognition of taxable income (as in the case of ISOs). The AMT, particularly as modified by the Tax Reform Act of 1986, provides several mechanisms that ensure that the elimination of these deferral benefits does not create permanent differences between a taxpayer's regular taxable income and AMTI. First, the AMT is treated as a separate, parallel tax system under which positive AMT adjustments create tax attributes that "turn around" to reduce subsequent year AMTI. Second, and in conjunction with the reversal of positive AMT adjustments, the AMT paid with respect to the timing differences of an individual give rise to an AMT credit that can be used to reduce regular tax liability in a subsequent taxable year to the extent such liability exceeds the taxpayer's tentative minimum tax. A taxpayer whose AMT adjustments relate to timing differences will pay AMT in the early years of a transaction that gives rise to the adjustments, but will offset the entire amount of such AMT against regular tax liability by the end of the transaction via the credit mechanism. Thus, with respect to timing items, the AMT is a prepayment of regular tax liability that is intended merely to accelerate income recognition, rather than create it. Example 1 illustrates the operation of the AMT as a prepaid tax with respect to timing items. The taxpayer paid AMT in the year of the exercise of her ISO, but may use such amount as an offset against regular tax in the year of disposition of her ISO shares. Over the course of the ISO transaction, the taxpayer pays no net AMT. The taxpayer in Example 2 (who in fact had no economic income) should not be treated less favorably by not taking the negative adjustment into account at the close of the ISO transaction. In order to ensure that the AMT operates as a prepaid tax as intended with respect to ISO transactions, legislation should clarify that the negative ISO adjustment has the same character as the prior positive adjustment.

Third, section 56(b)(3) contemplates, by its operation, that the negative ISO adjustment should have the same AMT character as the prior positive adjustment. Section 56(b)(3) provides that, if a disposition of ISO stock occurs in the same year in which the option is exercised, the AMT adjustment is limited to the gain on the disposition of the stock.<sup>7</sup> Thus, section 56(b)(3) provides that the negative and positive adjustments may be netted. Netting the tax effects of two separate transactions, even within a taxable year, is only appropriate where the effects have the same character. Thus, Congress must have believed that the positive and negative AMT adjustments applicable to ISOs have the same character for AMT purposes. Stated another way, the two adjustments cannot have the same character if taken into account in the same year, but different characters if taken into account in different years.<sup>8</sup> Providing that the negative and positive ISO adjustments have the same character and can be netted if the exercise of the ISO and the disposition of the shares occur in the same year, but that the taxpayers have worse tax consequences if the transactions occur in different years, would be inconsistent with the policies underlying the AMT ISO rules and with Congress' intention for providing incentives to

<sup>7</sup> Such rule generally follows the rule of section 422(c)(2). The application of section 422(c)(2) is naturally limited for AMT purposes to cases where the exercise and the disposition occur in the same year because the multiple holding periods required under section 422(a) for regular tax purposes are irrelevant for AMT purposes.

<sup>8</sup> See, also, the discussion of the Supreme Court decision in Arrowsmith, above.



encourage taxpayers to hold investments long-term.<sup>9</sup> Legislation should clarify that negative and positive ISO adjustments taken into account in different years have the same character for AMT purposes.

Fourth, clarifying that the negative ISO adjustment has the same AMT character as the prior positive adjustment will simplify tax compliance. For many individuals, the ISO adjustments will be the only significant AMT adjustments they will experience. Clarifying that all the AMT effects of an ISO transaction end in the taxable year that the ISO stock is disposed of will reduce recordkeeping and the need to enter into transactions to ensure the utilization of AMT credits. Conversely, requiring the negative AMT adjustment and AMT credits to be carried forward will necessitate taxpayers having to keep additional records, calculate tentative minimum tax even in years where it is clear that the taxpayer's regular tax liability will exceed AMT (in order to determine the amount of AMT credit capacity) and potentially engage in complicated tax planning strategies.

Finally, the advocated proposal does not create any loopholes or potential for abuse. As noted above, the taxpayer in Example 2 has AMTI but no economic income upon the disposition of her ISO shares if the negative adjustment is treated as a capital loss and the capital loss limitation of section 1211(b) applies. Capital loss limitations ensure that taxpayers cannot reduce their tax liabilities by "cherry picking" their loss positions while retaining their built-in gain positions. Clarifying that the negative AMT adjustment has the same character as the positive adjustment does not frustrate the intent of section 1211(b). Claiming a loss with respect to ISO shares is not "cherry picking" because such loss directly corresponds to, and may not exceed, the AMTI previously recognized upon the exercise of the ISO shares. Capital loss treatment would still apply to the extent the loss incurred on the disposition of the stock exceeded the prior positive AMT adjustment. In Example 2 above, if the employee had sold her ISO stock for \$8 rather than \$10 a share, she would have a negative adjustment of \$400,000 that has the same AMT character as the prior positive adjustment and a \$20,000 capital loss for AMT purposes. This is the proper result because the taxpayer has invested \$10 per share in the stock and amounts realized below the \$10 cost basis represent an investment (i.e., capital) loss.

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<sup>9</sup> A technical correction included in the Technical and Miscellaneous Revenue Act of 1988 modified the ISO provisions of the AMT regime from what was included in the Tax Reform Act of 1986 to what currently appears in section 56(b)(3). The changes made by the technical correction further support the position that the negative adjustment incurred when taxpayers sell ISO stock should have the same character as the prior positive adjustment. Specifically, the technical correction supports the view that the AMT ISO provisions are in the nature of a timing rather than "add-on" adjustments, that gains and losses occurring in the same year can be netted and thus must have the same character, and that the treatment of negative adjustments should be consistent with the purposes of the AMT.