

Testimony Submitted
To
The United States Senate
Committee on Finance

“The Stealth Tax that’s No Longer a Wealth Tax: How to Stop the AMT from Sneaking
up on Unsuspecting Taxpayers”

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Kevin A. Hassett
American Enterprise Institute

Dr. Kevin A. Hassett is Director of Economic Policy Studies at the American Enterprise Institute. The views expressed in this testimony are solely his own and do not reflect the views of the American Enterprise Institute or any other institution.

Chairman Baucus, Ranking Member Grassley, Members of the Committee, it is an honor to appear before you today to discuss the reform of the Alternative Minimum Tax (AMT).

As everyone on this committee knows, the AMT is a bizarre feature of the tax code that is affecting the lives of more and more Americans each year. Because fixes for the AMT are so costly and ambitious, Congress has chosen to pare the AMT back by adopting a sequence of patches. These patches, however, simply delay the inevitable; the AMT reappears the following year, larger than ever. This year, if the patch is not passed, projections suggest that 23 million taxpayers will be swallowed up by the AMT.

Before addressing the incidence and economic efficiency effects of the AMT, I should note at the outset that uncertainty concerning the likelihood of passing a patch each year creates significant costs for taxpayers. If a patch is not passed, then a taxpayer runs the risk of facing a steep tax bill next April if he is captured by the AMT, and the prudent will plan ahead.

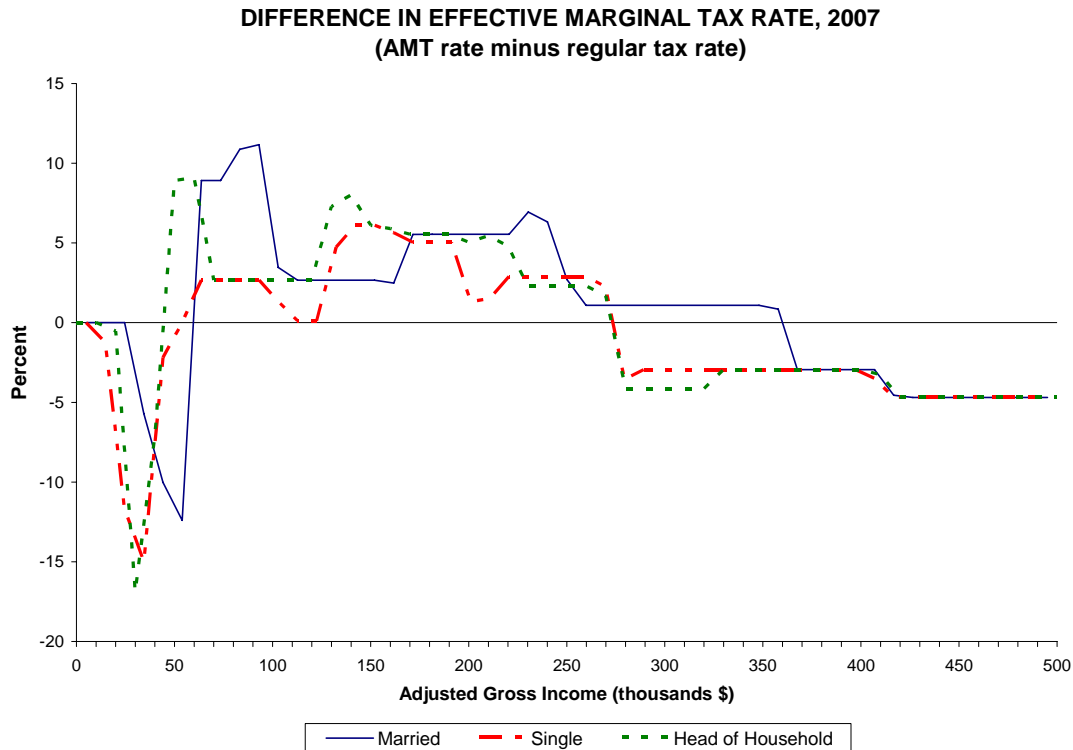
According to calculations by the Brookings-Urban Tax Policy Center, a family with an income of \$75,000 and four children would face almost \$2,000 in extra tax absent a patch. Individuals with higher incomes will generally face higher taxes from the AMT. These new taxes may well be high enough, and surprisingly, that taxpayer could face an IRS penalty for insufficient withholding as well. Accordingly, taxpayers today must choose between two undesirable options. They can amend their withholding in a manner that eliminates the risk of penalty, thereby sending too much money to the government if a patch is passed. Or, they can accept the uncomfortable risk that the patch will not be passed, and hope for the best.

It is unfortunate that the political difficulty of fixing the AMT exposes Americans to these costs and risks each year. At some point soon, members of this Committee are going to face the difficult task of reforming the AMT. For the remainder of my testimony, I will focus on providing guidance for such a reform.

Is the AMT an Efficient Tax?

Some have argued that it is actually desirable to move more taxpayers onto the AMT, as it is a tax that has lower rates and a broader base. According to this view, one could move the U.S. toward a fundamental tax reform simply by failing to pass patches to the AMT.

This is, however, a terribly naïve view. Provisions such as the deductibility of state and local income taxes reduce disincentives to work, and hence, eliminating these preferences can increase disincentives, all else equal. My colleague at AEI, Alan Viard, has performed a comparison of marginal rates under the normal code and the AMT under particular assumptions. Here I reproduce his figure that demonstrates that marginal rates would actually be higher for many people if the AMT replaced the regular tax.



Source: Viard, A. "The Alternative Minimum Tax," AEI Tax Policy Outlook, November 2006, www.aei.org/publication25110

The figure shows the difference between the AMT marginal tax rate and the rate under the regular code for people of different incomes and family situations. When the AMT tax rate is higher than that in the normal code, this difference is positive. AMT rates are higher, and often significantly so, for taxpayers with incomes between about \$50,000 and about \$300,000.

In addition to higher tax rates, the AMT also often imposes bizarre and confiscatory taxes on individuals who have received legal settlements, have stock options, or find themselves in other circumstances that are treated unfavorably by the AMT. Accordingly, repeal of the AMT seems the prudent course to take when considering reform.

Who Pays the AMT?

A couple of years ago, I performed an exercise to identify the geographic distribution of the AMT. In that exercise, I assumed that Congress did not pass a patch for the 2006 tax year, and then indicated the AMT liability by state. The next two charts show that failing to patch the AMT will hit families hard in all states, but be especially painful in states that have high state and local taxes, such as New York and California. The pattern would be similar this year.

States in which a family of five making \$150,000 will have to pay the AMT in 2005

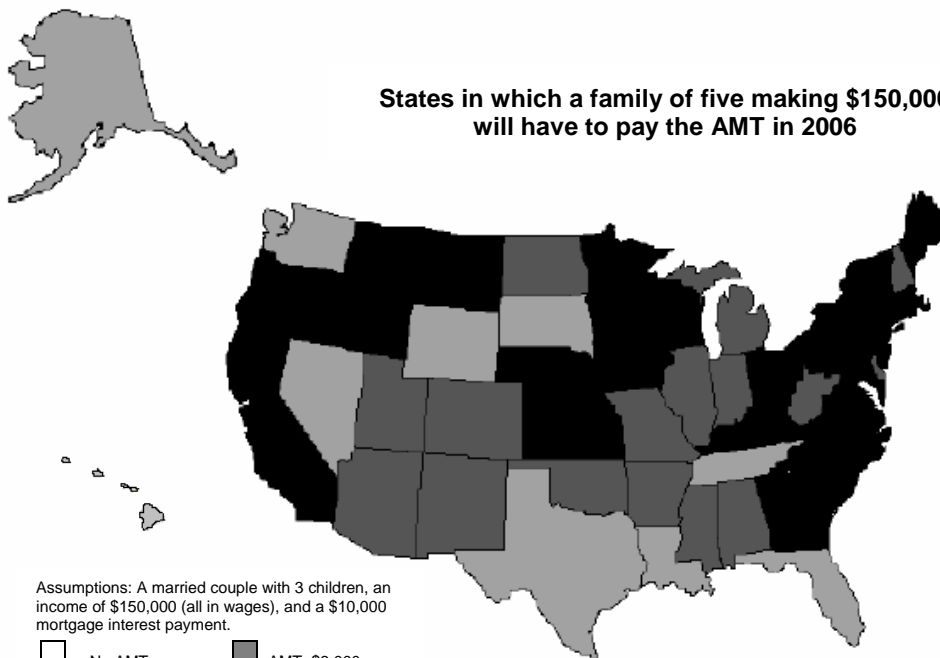


Assumptions: A married couple with 3 children, an income of \$150,000 (all in wages), and a \$10,000 mortgage interest payment.

- No AMT
- AMT < \$2,000
- AMT < \$3,000
- AMT > \$3,000

All dollar amounts in 2004 dollars.

States in which a family of five making \$150,000 will have to pay the AMT in 2006



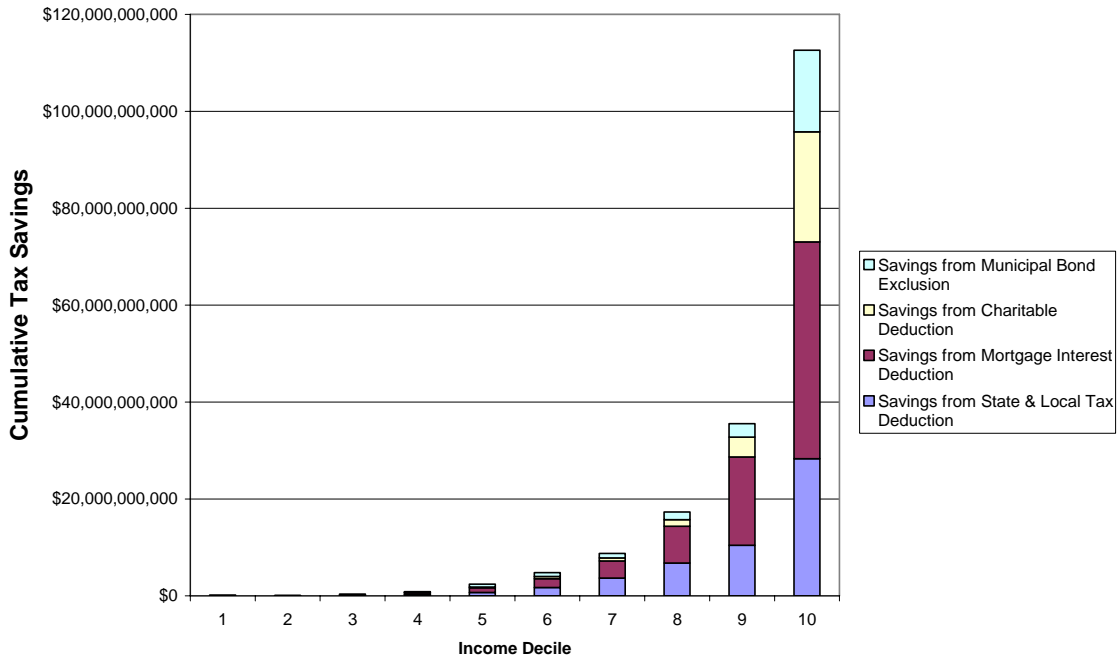
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Interestingly, it is base-narrowing measures such as the state and local income tax deduction that put people on the AMT. These measures disproportionately benefit wealthy taxpayers. As can be seen in the next chart, which was provided to me by the Tax Foundation, an enormous percentage of the revenue loss from key deductions and exclusions comes from the top decile.

**One Year Tax Savings by Decile from Special Tax Provisions
2007 Tax Law**



This suggests that it would be needlessly complex to reform the AMT by keeping the current state of the income tax, but raising marginal rates on the top decile to pay for the AMT repeal, as my colleague on this panel has proposed. In this case, government would be giving wealthy taxpayers a benefit with one hand, and then taking the benefit away with the other, all the while driving up marginal rates.

How to Reform the AMT

Thus, the logical reform should eliminate or cap deductions and exclusions, and then use the revenues gained from this to reduce marginal tax rates. This would produce a simpler tax code, and one that interferes with economic activity much less than today's convoluted code.

To provide guidance as to the possibility of such an approach, please refer to my final table, which was constructed again with the help of economists at the Tax Foundation. In this table, I perform a simplification exercise. I successively eliminate the key revenue-losing, base-narrowing measures such as the state and local income tax deduction, and

then use that revenue to provide Americans with an across the board proportional tax rate reduction.

Revenue Neutral Tax Changes made possible by Base Broadening – 2007 law

Marginal Tax Rate	Base-Narrower				
	Current Law	State and Local Deductions	Mortgage Interest Deduction	Health Insurance Exemption	Child Tax Credit and Social Security Benefits Exemption
10%	9.37%	8.78%	7.43%	6.86%	
15%	14.05%	13.17%	11.15%	10.29%	
25%	23.42%	21.95%	18.58%	17.15%	
28%	26.23%	24.59%	20.80%	19.215	
33%	30.92%	28.98%	24.52%	22.64%	
35%	32.79%	30.74%	26.01%	24.01%	

Source: Tax Foundation

The first measure to go is the state and local tax deduction, and the special treatment of state and municipal interest payments. Eliminating these measures effectively solves the AMT problem, and does so with a slight revenue gain, allowing Congress to lower the tax rates from 35 percent to 32.79 percent and so on.

Next, if we cap mortgage interest deductions at \$100,000, we gain more revenue with which we could further reduce marginal rates. Subsequent measures, such as repealing the health insurance exemption, and child tax credit and social security benefit exemptions, have enormous impacts on the base. All told, elimination of all of these base-narrowing measures would allow a revenue neutral reduction in rates all the way to those listed in the final column. The top rate drops all the way to about 24 percent, and the bottom rate to 6.86 percent.

This table is, of course, not meant to be a blanket policy recommendation. Rather, it is a guide to the trade-offs that this Committee should consider while reforming the AMT. By capping and reducing these deductions and exemptions, one gains revenue that could then be fed back into lower marginal rates. If you are less aggressive in the design of your cap, then the revenue you gain will be smaller. Once one has the extra revenue, then marginal rate reductions are feasible. For those concerned about the progressivity of the system, remember that just about any pattern of marginal rate reductions would be possible.

Perhaps the biggest lesson from this table is that designing a tax system that raises the same amount of money as the current system, does not have an AMT, and does not have higher marginal rates than we face today is really child's play. I would urge this committee to work together to make such a reform a reality.