

**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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**HEARING**

BEFORE THE

**COMMITTEE ON FINANCE  
UNITED STATES SENATE**

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

—————  
JUNE 27, 2007  
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**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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WEDNESDAY, JUNE 27, 2007

U.S. SENATE,  
COMMITTEE ON FINANCE,  
*Washington, DC.*

The hearing was convened, pursuant to notice, at 10:03 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Bingaman, Kerry, Wyden, Stabenow, Salazar, Grassley, and Roberts.

**OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR  
FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE**

The CHAIRMAN. The hearing will come to order.

It's like a bad horror movie. The unsuspecting victim thinks that everything is all right. She is going along without a care in the world. But a monster lurks around the corner; it is just waiting to pounce.

That monster, of course, is the Alternative Minimum Tax, also known as the AMT. It attacks more and more taxpayers every year, and most of its victims are middle-income Americans.

At the AMT's beginning, Congress tried to stop just 155 taxpayers with incomes above \$200,000 from completely avoiding taxes. It was an attempt to make sure that all taxpayers paid their fair share.

Now the AMT has morphed into a terrible beast. It snares American families who are just trying to get by; it besets families who are working hard and raising children.

The IRS reported that 3.6 million taxpayers paid the AMT in 2005. The Joint Committee on Taxation estimates that 4.2 million paid it in 2006.

Of these, 25,000 had adjusted gross incomes of less than \$20,000. That's right: less than \$20,000. Only 80,000 taxpayers made more than a million. More people making less than \$100,000 pay the AMT than people making more than a million. That does not make much sense.

On top of all that, 2001 IRS numbers show about 4,500 people with incomes of more than \$200,000 still did not pay either the regular income tax or the AMT. The AMT has strayed from its original purpose. And the number of taxpayers attacked by the AMT

would have been higher if Congress had not stepped in with a patch. This patch keeps the AMT somewhat at bay; it holds constant the number of taxpayers affected.

This patch expired at the end of 2006. Congress has not yet enacted a patch for 2007. Without the patch, the number of Americans affected by the AMT for 2007 will explode, from about 4 million to more than 23 million taxpayers.

Come April of next year, millions of taxpayers will get an unpleasant surprise if Congress does not act. In Montana, Congress's failure to enact a patch would mean that more than 6 times as many taxpayers would have that burden, and millions of those 23 million taxpayers would be middle-income Americans. The Joint Committee on Taxation projects that most of the 23 million taxpayers affected would earn between \$50,000 and \$200,000.

The problem of the AMT goes beyond just those paying the tax. The AMT affects a lot of other taxpayers, too. It forces many taxpayers to have to calculate their tax liability twice, first under the regular tax system, then again under the AMT.

The IRS guesses that the average taxpayer takes more than 30 hours filling out Form 1040, and that is more than one complete day every year out of the lives of each and every one of these taxpayers lost forever. The AMT only increases that loss.

The tax was enacted to make sure that upper-income taxpayers could not avoid paying any taxes at all. Now it is falling on middle-income families. We do not need two systems, we need just one—one that works.

The AMT monster attacks no new victims this year if we in Congress do what we should do, that is, enact legislation to make sure that it does not affect any new taxpayers for taxable year 2007.

Today's hearing will focus on this monster lurking around the corner, the individual AMT. We will try to figure out how to stop it from sneaking up on unsuspecting taxpayers, and we will try to figure out how we might even kill that monster once and for all. And who knows? With the time that taxpayers save in not having to calculate the AMT, they might even be able to get out and catch a good movie.\*

I will now turn to Senator Grassley.

**OPENING STATEMENT OF HON. CHUCK GRASSLEY,  
A U.S. SENATOR FROM IOWA**

Senator GRASSLEY. This hearing is especially important in light of my often-stated view that the Alternative Minimum Tax is generally not getting the attention it deserves in Congress.

The last increase in exemption amounts that Chairman Baucus and I worked to put in place has expired, and new taxpayers are being caught by the Alternative Minimum Tax right now.

Less than 2 weeks ago, taxpayers who make estimated tax payments made their 2nd-quarter payments.

Those taxpayers do not know if they are going to be protected by an increase in the exemption as we usually do, and that uncertainty is going to increase until something is done in this session.

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\*For additional information on this subject, *see also*, "Present Law and Background Relating to the Individual Alternative Minimum Tax," Joint Committee on Taxation staff report, June 25, 2007 (JCX-38-07).

The AMT has been a complete policy failure that was created with 155 taxpayers in mind in 1969, and could consume 23 million taxpayers this year. Moreover, the tax has not decreased the number of people who are able to legally eliminate all of their income tax liability.

The only thing that the Alternative Minimum Tax does successfully is pull in vast amounts of money for the Federal Government. This is especially ironic in that the Alternative Minimum Tax was conceived primarily to promote tax fairness, and not to raise revenue.

This tax is projected to balloon revenues by so much that the Congressional Budget Office has projected that total Federal revenues will push through their 30-year historical average and keep increasing.

The solution that I have advocated to the Alternative Minimum Tax is Senate bill 55, the Individual Alternative Minimum Tax Repeal Act. That solution is to permanently repeal the tax without offsetting the revenues that would not be collected as a result of the repeal.

Revenues projected to be collected by the Alternative Minimum Tax are revenues the tax was never meant to collect, hitting middle-income people who were never intended to pay it, and it would only be collected through error. To make offsetting a condition to repeal is to commit to reshape a problem without solving the problem.

However anyone seeks to approach the Alternative Minimum Tax, time is running out, and has already run out for millions of taxpayers. Anyone who seriously recognizes the Alternative Minimum Tax as a problem they actually intend to solve will see the need for immediate action.

I am going to be introducing legislation that will provide taxpayers a safe harbor from being punished for the fact that Congress has failed to deal with this issue. Right now, millions of Americans do not know whether they should be paying an estimated tax because Congress has not passed AMT relief for this year. In other words, there are many taxpayers who will be facing a big tax bill if we do not pass relief.

By law, many of these taxpayers should be paying estimated tax right now based on the fact, as the law is, that they are subject to the AMT. Under my proposal, in computing tax for the purposes of the penalties in the tax code dealing with estimated tax, a taxpayer would be permitted to disregard the Alternative Minimum Tax if the individual was not liable for the Alternative Minimum Tax for the preceding year.

So, if you did not have to pay the Alternative Minimum Tax last year, we are not going to penalize you if you do not file estimated taxes for AMT this year. Just because Congress cannot get its job done does not mean that taxpayers should be punished.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

I would like, now, to introduce the panel. The first witness is Mr. Frank Degen, a representative from the National Association of Enrolled Agents, who will discuss AMT from a practitioner's perspective.

Then Dr. Leonard Burman, the director of the Tax Policy Center, will discuss possible ways to fix the AMT and pay for it.

Next, Dr. Kevin Hassett, director of economic policy studies for the American Enterprise Institute for Policy Research, will discuss repealing the AMT.

Finally, Mr. Michael Graetz, a professor from Yale Law School, will discuss the timing of AMT reform. I think he wants to discuss AMT in the broader context of tax reform.

Thank you all for coming. And by the way, as you know, it is customary here to put all of your statements automatically in the record, and urge you to limit your remarks to about 5 minutes. I would just urge you to tell it like it is, say what is on your mind. Tomorrow is another day.

Mr. Degen, why don't you proceed?

**STATEMENT OF FRANK DEGEN, ENROLLED AGENT, NATIONAL ASSOCIATION OF ENROLLED AGENTS, SETAUKET, NY**

Mr. DEGEN. Thank you, Mr. Chairman and members of the committee, for inviting the National Association of Enrolled Agents to testify before you today.

My name is Frank Degen. I am an enrolled agent, and I speak on behalf of NAEA, the premier organization representing the interests of the 46,000 enrolled agents across the country.

The Internal Revenue Code requires a taxpayer to calculate his taxes twice, once under the regular tax calculation and then again under the AMT calculation. The taxpayer's liability then defaults to the larger of the two.

Given this process, one could argue that the AMT should more truthfully be termed the "mandatory maximum tax." Alternative Minimum Tax almost sounds benign, while "mandatory maximum tax" sounds so much closer to the truth.

The AMT's lack of inflation-indexed income exemptions presents Congress with an increasingly unpleasant trade-off. To minimize budget pain, Congress has passed 1- and 2-year patches instead of engineering a permanent fix. As a result, long-term tax planning is made virtually impossible for millions of taxpayers.

To further emphasize the disadvantages to taxpayers and tax practitioners resulting from the atmosphere of uncertainty and surprise surrounding the AMT, I would like to offer three real-life observations.

Bill and Liz are air traffic controllers. Their tax liability was increased an extra \$6,400 solely due to AMT. Why? Because the AMT calculation does not allow their five exemptions—Bill, Liz, and their three girls—and their Schedule A taxes. Bill said to me, "This is crazy. I don't have any tax loopholes."

Laura is a mid-level executive in New York City. Her income tax return is relatively straightforward: no K-1s, no passive activity bonds, no other tax preferences. When I told her that the AMT calculation on her return created a balance due of \$1,050 rather than refund of \$6,450, a net change of \$7,500, she asked me a question for which I had no answer: "Didn't Congress say it was lowering taxes?"

And Karen has four children. She files as head of household, claims the deduction, and has an AGI of \$75,000. Imagine her sur-



prise when I told her she has an AMT liability. Her only comment was, "I read in the papers the AMT was supposed to be for rich guys." I suspect few in the halls of Congress would argue that she is rich or that she is resorting to sophisticated tax planning to reduce her Federal income tax liability.

It is time Congress enacted a lasting solution to the AMT problem. We believe the best way to untie this Gordian knot is a complete repeal of the individual AMT. Chairman Baucus and Ranking Member Grassley have introduced a bill that would do just that.

I also commend Senator Schumer, from my home State of New York, for co-sponsoring the bill. Repealing the full AMT would be a huge step in simplifying the tax code.

Practically speaking, NAEA admits that full repeal of the AMT may be a bridge too far. At the same time, we believe that any proposal short of full repeal must satisfy three criteria. (1) It must limit the AMT's scope. It should affect only taxpayers Congress believes are engaging in the most egregious tax avoidance. (2) It must be permanent. One-, 2-, or even 5-year temporary fixes are not desirable. (3) It must be indexed. The lack of indexing is the root cause of the current AMT problems.

In closing, I would like to take a moment to make a broader point about tax return preparation, which is that producing an accurate return is often a complex exercise. A preparer must be able to properly interpret and apply the tax code, especially when AMT comes into play, and therefore the preparation of complex returns should not be left to amateurs. One wonders about the number of inaccuracies on tax returns that are a consequence of the AMT.

Congress could act to improve competence in the tax preparation industry by enacting S. 1219, the Taxpayer Protection Assistance Act introduced by Senator Bingaman. It appears reasonable to assume that greater accuracy in tax return preparation leads to greater taxpayer compliance.

As always, NAEA and its members stand ready to work closely with Congress in assessing the merits of various AMT proposals. I thank you once again, and stand ready to answer any questions later.

The CHAIRMAN. Thank you, Mr. Degen, very much.

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

The CHAIRMAN. Dr. Burman?

**STATEMENT OF DR. LEONARD BURMAN, DIRECTOR,  
TAX POLICY CENTER, URBAN INSTITUTE, WASHINGTON, DC**

Dr. BURMAN. Thank you, Mr. Chairman, Ranking Member Grassley, members of the committee, for inviting me to share my views on the individual Alternative Minimum Tax.

A few years ago, my colleagues and I wrote a paper titled "The AMT: Out of Control." It is really out of control now. If Congress does not act, virtually everyone in this room, along with 23 million Americans, will owe AMT next year. A lot of the AMT's victims are solidly middle-class, not the millionaires who were its originally intended target.

In my testimony I show that a family with four kids under age 17 earning \$75,000 with no itemized deductions will see their tax

double in 2007 because of the AMT. Their tax planning mistake in the AMT world was having four kids.

Last night, I checked the IRS website to see whether this family would have enough tax withheld to pay the AMT. No. Assuming one parent earns all the income, the IRS advises them to claim 11 exemptions on the W-4 form that employers use to set withholding, and promises that the family will get a \$25 refund at the end of the year.

Actually, under current law, that family would be under-withheld by almost \$2,000. Senator Grassley's proposal would help that family, or at least prevent them from paying penalties, but there would be a rude shock at tax time.

The smart money says that Congress will patch the AMT for another year or two to make sure that the hypothetical family will not be affected. The latest patch expired last year. This stop-gap approach leads to endless confusion. How much estimated tax and withholding should I pay? What is my tax bracket? Would I benefit from the tax credit for hybrid vehicles if I bought one? Is it safe to ignore the AMT, as the IRS does in its withholding calculator? Is the IRS prescient, or just clueless like the rest of us? We know the answer to that.

Why should 23 million Americans have to guess about their tax situation? Some people say that the AMT is not such a bad tax system so we should just let it take over. Actually, the AMT is a terrible tax system. The AMT exemption, which you deduct from income to calculate AMT, phases out at a 25-percent rate. This boosts the effective tax rates in the phase-out range by a quarter, so instead of the advertised 26- and 28-percent rates, many AMT taxpayers face effective rates of 32.5 or 35 percent. The AMT hits almost everyone with incomes between \$200,000 and \$500,000, but not so many millionaires, resulting in the highest rates not always applying to the highest-income people.

Unlike the regular income tax, the AMT is not indexed for inflation, so people's average tax bills can increase, even if their incomes do not grow at all in real terms. The AMT hammers married couples, and especially families with kids. In 2007, married couples will be 15 times as likely as singles to owe the AMT.

Some claim that software and paid preparers make AMT complexity no big deal, but there are at least three problems with this argument. First, as the AMT consumes the middle class, we will have more and more people who do their taxes by hand, or try. Second, even with software it is complex, as I explain in my written testimony. Third, you might want people to understand how the tax system affects them. With the AMT, the tax system becomes an inscrutable black box.

Some argue that the AMT is a blue State tax, only one party's problem. Although it is true that taxpayers in relatively high-income, high-tax coastal States were more likely to owe AMT than those in the interior, the AMT is going to hit people in all States hard if it is not fixed.

Even back in 2004, lots of red States had AMT hot spots, zip codes where 10 percent or more of the residents owed the tax. The AMT hits middle- and upper-income families with kids, soccer moms. It is in all of your interests to do something about it.

So what should we do? Well, some members of the committee have suggested the solution will be to repeal the AMT and not worry about the \$800 billion in revenues foregone. They argue that the AMT taxes people who were never its intended target, and thus AMT revenues should never have been counted on. The real baseline should assume no AMT.

Those members might have, but did not, raise that argument in 2001 when large projected AMT revenues greased the skids for the ensuing tax cuts. In fact, the AMT masked much of the cost of the tax cut, since people who pay it do not get the full income tax rate reductions. Eliminating the AMT after it has helped finance the largest tax cuts in history amounts to a major bait-and-switch if the lost revenue is not offset.

Fortunately, there are many options to reform or repeal the AMT that would not increase the deficit. My favorite option, and probably one shared by everyone on this panel, would be to eliminate the AMT as part of fundamental tax reform.

But given political reality, the best alternative may be a simple surtax of 4 percent of adjusted gross income over \$200,000 for joint returns, and \$100,000 for others, which would raise enough to offset the revenue lost from repealing AMT.

The surtax would be simple and progressive. The vast majority of AMT-paying taxpayers would pay lower taxes. Only the richest 1 percent would pay higher taxes, on average, and they would lose far less than they gain from the 2001 to 2006 tax cuts. Moreover, most of the taxpayers who lost a large share of their tax cut due to the AMT would now receive the full benefit.

Some critics have complained that the surtax would raise effective tax rates and discourage work and saving. But since the current AMT has even bigger implicit surtaxes built into it, most affected taxpayers would face lower rates under the alternative.

Many other fiscally responsible options are outlined in my written testimony. Repealing the State and local tax deduction would more than pay for repeal, although that raises other issues.

I understand that fixing the AMT is not easy. If it were, it would have been done a long time ago. I applaud the committee for taking the first steps towards what I hope will be a permanent solution.

The CHAIRMAN. Thank you very much, Dr. Burman.

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

The CHAIRMAN. Dr. Hassett?

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

Dr. HASSETT. Thank you, Mr. Chairman and Ranking Member Grassley. I would like to join my colleagues on the panel in commending Senator Grassley for looking for ways to protect taxpayers from the uncertainties caused by the AMT.

I think my testimony really has four parts. The first is a discussion of the uncertainty and the cost to taxpayers of that uncertainty. And I used the example that I drew from Dr. Burman's website that he included in his testimony, so I will not march everyone through that.

The three additional points in my testimony that I would like to march you through, if you would be so kind, are the following. First, I would like to address the question, is the AMT an efficient tax? Second, I would like to talk about, who pays the AMT, but also, who benefits from the exclusions and exemptions and so on that put people on the AMT? Three, how do I think we could fix it?

And on the third step, Mr. Chairman, rather than put a sort of partisan marker down on the field, what I really tried to do in my testimony was put all the bargaining chips on the table so that people could look at these chips and decide what they, themselves, might like to do. Hopefully this testimony will help foster a permanent reform that folks could work out together once they see these parameters.

So, first, 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. These people who argue this, however, forget, as Dr. Burman mentioned, that the exemption phases out, which creates a very broad range with very high marginal tax rates.

If you could turn to the first figure in my testimony, if you have it before you, I actually show, based on work from my colleague, Alan Viard at the American Enterprise Institute, a chart that shows the difference between the effective marginal tax rate for people on the AMT and the effective marginal tax rate for people in the ordinary code. You can see, from about \$50,000 in income up to around \$300,000 on the chart, for virtually everyone the AMT has a higher tax.

So if we were to switch to the AMT and repeal the ordinary code, as some have argued, then we would basically be passing a marginal tax rate hike on many, many Americans, which is, I think, undesirable, we would all agree.

Who pays the AMT? On this question, I think that the most important observation—and I will move you to that chart, the second chart in the section where I provide calculations that were performed for me by the Tax Foundation—is that the 1-year tax savings by decile from special tax provisions is very much loaded in the top decile.

So if you look at this chart, that top bar shows that probably maybe almost 70 percent of the revenue lost to the things that throw you on the AMT are benefits to the top decile.

Now, I think that that is interesting, because what it means is that, if you are considering a reform that is protecting those, say, protecting the State and local deduction rather than a permanent reform of the AMT that repeals it, then raising marginal rates on the top as my colleague, Dr. Burman, proposes, effectively is giving people money with your left hand and then taking it back with your right, which seems to me to be introducing needless complexity into the code.

So how do I think we should reform the AMT? I think the logical reform should eliminate or cap deductions and exclusions and then use the revenues gained from this to reduce marginal tax rates, or to leave them where they are, if that is the objective. This would

produce a simpler tax code and one that interferes with economic activity much less than today's convoluted code.

Now, the final table in my presentation is a chart that I prepared that provides some guidance to the kind of trade-offs that would be present if you were to pursue a strategy like this. The first measure to go in the chart 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—the total number of taxpayers on the AMT would stop growing—and does so with a slight revenue gain, allowing Congress, if they wanted to, to proportionately lower tax rates significantly.

Just as an example, I show that the top rate goes from 35 percent down to 33.5 percent. I do not think this committee, of course, has to decide to proportionately reduce everyone's tax rates. It is just that that seemed like an easy way to capture what you could buy from the elimination of it in an intuitively friendly way.

Next, if we cap mortgage interest deductions, and I just picked a number of \$100,000, we gain more revenue with which we could further reduce marginal rates. And as you read across the table, you can see that by eliminating these things we get marginal rates down tremendously.

In fact, in a revenue-neutral reform we could get the top rate all the way down to 26 percent and the bottom rate all the way down to 7 percent. Again, that is revenue-neutral.

Of course, this table is 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.

If you cap these things at some level, you will gain some revenue, a lot less than if you eliminate it, but that might be enough revenue so you could, for example, leave marginal rates where they are today but not lose any revenue.

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

The CHAIRMAN. Thank you very much, Dr. Hassett.

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

The CHAIRMAN. Mr. Graetz?

**STATEMENT OF MICHAEL J. GRAETZ, JUSTUS S. HOTCHKISS  
PROFESSOR OF LAW, YALE LAW SCHOOL, NEW HAVEN, CT**

Mr. GRAETZ. Thank you, Mr. Chairman, Senator Grassley, members of the committee.

I want to begin by just saying that I was a young staffer for the Treasury Department in 1969 when the Minimum Tax came into law, and I sat in the Ways and Means Committee room and in the Senate Finance Committee room as it was discussed.

And while those committees did pore over these famous 155 taxpayers, who were so highly publicized, everyone on the committee was aware that the kind of minimum tax they were talking about would indirectly cut back on itemized deductions. That is exactly what the minimum tax does today.

Now, its reach has grown far broader than anyone imagined. I agree with that entirely. It is true that this was a back-door way rather than a front-door way of cutting back on those deductions. But people did know that that is exactly what it was going to do.

I began my written statement with a thought experiment, and the thought experiment is this: let us assume that Congress, without changing anything else in the tax law, just renames the regular income tax the Alternative Maximum Tax and renames the AMT the regular tax. That is the way they work today. You pay the regular tax if it is higher than the AMT, and assume we do nothing else.

My question is, would we be sitting here talking about repealing the AMT under those circumstances or would we be sitting here talking about repealing the regular tax? The AMT, it is true, affects 25 to 30 million people if we do nothing. The regular tax, on the other hand, affects 150 million people, and we should also worry about them.

The essential point of this experiment is to make clear that whoever is under one of these taxes, this occurs because of the linkage between the two taxes. So in 2001, when we lowered tax rates under the regular tax but did not change the tax rates under the AMT, we moved people to the AMT.

In the 1980s, when we indexed the regular tax brackets for inflation but we failed to index the AMT tax bracket for inflation, we created the problem we are faced with today.

If we indexed the AMT for inflation, the exemption would be around \$70,000, which is just less than the patch has been over recent years. So, these two taxes are related. The problem that we are in today occurs because all of the tax cuts in the 2001 Act were focused on the regular tax side and not on the AMT side.

My point is this: in 2010 those tax cuts on the regular side all expire, and so do the ones that were enacted in 2003. So the question is, why should we be worrying about the AMT today when we have all of these questions about the regular tax going forward?

I use the example that everyone has used, because it is so important to the AMT, of State and local taxes to make the point that, under the regular tax you get a full deduction for State and local taxes, while under the AMT you get no deduction for State and local taxes.

The President's Tax Reform Commission recommended no deduction for State and local taxes. The Tax Reform bill that has been offered by Senator Wyden, a member of this committee, and Rahm Emanuel in the House limits drastically the amount of deductions for State and local taxes, and in fact changes the deduction to a 10-percent credit. There are real questions, real important policy questions—I go through some of these in my statement—as to whether there ought to be a deduction at the Federal level for State and local taxes or whether there should not, whether it subsidizes high-tax States at the cost of low-tax States.

I point out in my statement, Senator Baucus, that Montana ranks 46th in State and local taxes. I do not understand why you should want to put higher tax rates on the people in Montana in order to subsidize the high tax rates that Senator Kerry—to pick one who is not here—has in Massachusetts. Senator Grassley, your

State ranks 26th. So, there is a serious question about whether we should add tax rates, as Dr. Burman has suggested, rather than limiting the deduction for State and local taxes.

I want to be clear. Do not misunderstand me. I agree with many of the points that Senator Grassley made, that, Mr. Chairman, you made in your opening statement, that my colleagues on the panel have made. The minimum tax is horribly complex, it creates uncertainty. The people who have estimated tax problems really should be protected in the way Senator Grassley has suggested.

But I do not think that you can consider the AMT as if it is a stand-alone item apart from all of the other things that expire in 2010. It just does not make sense to me. And I am very skeptical of all of these charts that are showing current law versus AMT. They are assuming no patch on the AMT, although I would assume we are going to have a patch on the AMT. I would hope so.

And they are assuming that the tax rates are either extended or not extended, depending on which chart you look at. I think Dr. Burman's revenue estimates assume that the tax rates expire, all the changes expire in 2010, as current law provides. Dr. Hassett's charts, I think, assume the opposite.

So I think you have to be careful about these comparisons, because there is tremendous uncertainty in the regular tax today due to the sunsets that will be occurring in 2010.

I talk in my statement about other issues. I talk about the marriage penalties and the head of household issue under the Alternative Minimum Tax. In my statement, I talk about the home mortgage interest deduction. I believe the provision under the AMT is a better provision than the provision under the regular tax, which allows people to use home equity borrowing much more liberally than the AMT provision does.

My only point is that all of these issues are complex. They are going to all be on the table in 2010. I think that the best thing this committee could do in the interim is to extend the patch, index the patch for inflation through 2009 or 2010, depending on your judgment as to when you are going to have to take these issues on, protect the people who are not now on the AMT from coming into it, and support Senator Grassley's safe harbor for people who may otherwise have estimated tax penalties. Then in 2010 you will be in a position, or in 2009 with the new administration, with all the issues on the table, to ask questions of the sort that Dr. Burman has put forth about tax rates, and State and local taxes, and that Dr. Hassett has put forth about all of the itemized deductions, which are necessarily implicated when one thinks about the AMT.

Thank you, Mr. Chairman.

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

The CHAIRMAN. Thank you very much. That is very helpful.

I think we can all assume, and I think we can believe that we are going to find a patch here, as basically you have all said or implied, so that taxpayers who are not paying AMT in 2006 will not have to pay in 2007. I think that is pretty much a given.

I have a couple of questions, though. One is, how do we pay for it? We have these very rigid pay-go rules. I am going to ask, and I know some of your suggestions, but I would like you to give us some suggestions that are politically realistic, for this year and

next. I mean, we have to find ways that are realistic here, not that are unrealistic.

Second, I think it is wise, basically, considering the patch, to think about tax reform in 2009 and 2010, as you are doing. I would like you to kind of address some of the suggestions there that you also think are politically realistic, not just pure tax theory.

So I will start with you, Dr. Burman. I know your suggestion is the 4-percent surtax as the pay-for here, but if you could just give me, what is realistic here as we enact the patch? And then a couple of thoughts about 2009 and 2010. Get realistic.

Dr. BURMAN. Options that pay for just a 1- or 2-year patch?

The CHAIRMAN. Yes.

Dr. BURMAN. I am probably the least well-qualified person in this room to tell you what is politically realistic. I came up with the 4-percent surtax based on the cold reception that my proposal to repeal the State and local tax deductions got from the Ways and Means Committee.

The problem is, any kind of reform would involve winners and losers. You cannot replace an irrational tax with a rational one without changing the distribution of burdens, and the losers are always very vocal.

This committee has looked at options to close loopholes to improve the IRS's ability to enforce the tax. I think the proposal to require reporting on basis for sales of capital assets is a good one.

The CHAIRMAN. That does not raise much revenue.

Dr. BURMAN. Yes. It does not raise very much revenue. The hard thing is, the thing that would actually help both with compliance and enforcement would be to simplify the tax system. Right now we have a whole host of different tax benefits.

The CHAIRMAN. We are going to do that this year?

Dr. BURMAN. I guess the answer is, I do not have a simple solution to your question here.

The CHAIRMAN. All right.

Dr. Hassett?

Dr. HASSETT. Thank you, Mr. Chairman. I think that, if you are looking for revenue, you could look in the places where there is a lot of it sitting. There is already a cap on the mortgage interest deduction of \$1 million, and I do not think a marginal rate hike is something that you would call a politically easy lift this year.

But lowering the mortgage interest deduction cap some makes very good sense in terms of economic policy, and it could get you revenue. Depending on how far you went, it could get you a lot of revenue.

The CHAIRMAN. Do you think that is realistic?

Dr. HASSETT. Dr. Burman has a paper on his website that I think had 23—did I count it right?—different proposals to do this. And all we can do is explore the parameters that are there.

The CHAIRMAN. Mr. Graetz, we will let you get a whack at this.

Mr. GRAETZ. Mr. Chairman, I have to say I admire generally the reinstatement of the pay-go rules. I think this is a great improvement in our fiscal situation by the Congress.

The CHAIRMAN. I see all the panelists nodding their heads in agreement.



Mr. GRAETZ. Although I have to say, in this context, I am somewhat less concerned with it as is Senator Grassley, because no one really ever expected this revenue to be collected. You have this short window here of 2 or 3 years where you have to do something. There are no easy offsets.

You have been talking about compliance changes. I agree with the idea of reporting of basis. There are some credit card reporting options that have been suggested that may be more robust in terms of revenue, depending on how you go, and other compliance options. You have been talking about taxing high-income persons who get capital gains treatment rather than ordinary income treatment.

The CHAIRMAN. What do you think of that?

Mr. GRAETZ. Well, I think it is odd. I think there are some difficulties.

The CHAIRMAN. What is odd about it?

Mr. GRAETZ. I think it is odd that people who are making that much money off of essentially labor income should be paying lower rates than their secretaries are, to put it baldly. I think it is good that you are considering changing it. I think you have to be careful not to trap others in doing it.

I think you are also on the right track when you are thinking about whether publicly traded partnerships ought to be taxed as corporations, since the corporations they are competing with are certainly paying tax at the corporate level. There is some actual money in some of those areas.

I also think that Dr. Hassett and Dr. Burman are right, but none of Dr. Burman's suggestions are very pleasant politically. The suggestion of reducing the home mortgage interest deduction is not one I see people standing up and cheering about on the committee, although there are other ways to go.

I do think the AMT, by limiting the way in which you can use home equity interest, is a good solution. Perhaps limiting the deduction to one house instead of two might be a good idea, if one simply exempted members of Congress. [Laughter.]

The CHAIRMAN. Senator Grassley?

Senator GRASSLEY. Anybody who wants to answer my question may. Considering the fact that there are very wealthy people today—and I think my staff gave me a figure that I used in a speech—that there might be 2,300 people today who ought to be paying the Alternative Minimum Tax with high enough income, people who were intended to pay it who are not paying it, since we are ruining the middle-class, and since it is not working for the people it was intended to hit, why not just do away with it? Any one of you.

Dr. BURMAN. I would cheer if the AMT went away. I think it is terrible tax policy. The problem is that we did count on that revenue. The President says he is going to balance the budget by 2012, and he is assuming that there is going to be, on his baseline, something like 45 million people on the AMT producing revenues for the government.

In 2001, both the House and the Senate were well aware that the AMT was in the baseline. It was contributing revenues that made the budget situation look better—it was already good back then. In addition, it was known that the AMT was going to take back a sig-

nificant fraction of the tax cuts that were enacted because the cuts basically doubled the number of people on the AMT. That would have been a good time to raise the issue about whether this should have been counted, to revise the baseline and say, actually, the deficit situation—or surplus back then—was not as good as we expected, and, furthermore, the cost of the tax cuts is going to be about a third higher than we expected.

I think the problems now are more serious than they were then. In 2010, the baby boomers are going to start retiring. The demands on the government, as this committee well knows, are going to be enormous, and basically we need the revenue.

Senator GRASSLEY. What you just said is, regardless of the fact that today government revenues, as a percentage of gross national product, are 18.6 percent of the GNP, where they have been for 30 years—a level of taxation that we have accepted as something not hurting the economy, something that people will accept—are you suggesting we need to go way above 18.6 percent of GNP?

Dr. BURMAN. Actually, unless you can figure out something radical to do to control entitlement spending, you are going to have to.

Senator GRASSLEY. I cannot disagree with you on a statement about entitlement spending.

Go ahead, Dr. Hassett.

Dr. HASSETT. Yes. Senator Grassley, I am very sympathetic to your views. The one concern that I would have is, if we just repealed the AMT, more or less in defense of these itemized deductions that economists do not like that do not add to economic efficiency, that we are going to end up having higher marginal rates in the ordinary code than we want.

So I think that ultimately these heavy political lifts are going to have to be addressed. We are going to have to limit things like the mortgage interest deduction to get the revenue to keep marginal rates where you, Senator Grassley, I know, want them to be.

Senator GRASSLEY. Anybody else want to jump in before I go to my next question?

Mr. DEGEN. Senator Grassley, I do think I will make a comment. I view this a little bit differently. I am not part of academia. I see taxpayers, and I hear about reducing the mortgage interest deduction. The American dream is to own your own home.

The government, whether right or wrong, has made an implied promise to people that we will help you own this home by giving you a deduction for your mortgage interest. A \$100,000 mortgage is not very extreme in this day and age.

I am sure in Montana you see very high mortgages. I just happened to be out in Oregon a couple of weeks ago, and I could not believe the price of housing there. I live in New York on Long Island, where housing is very high. So a \$100,000 cap—I think we have to think about the taxpayer also.

I think part of, as I said, the American dream is to own your own house. Right now, people buy homes with the idea that the government is going to help them. So certainly, if you were ever going to introduce a cap, number one, it could not be retroactive, there would have to be some grandfathering or where you are.

But I seriously think \$100,000, if it ever came to pass that you decided to reduce the \$1 million level, you have to be realistic in

terms of, do you want to help the American dream survive where people can buy their own home?

I just wanted to say one more thing. You mentioned about the political thing. I think what you need to do, if you do not mind me saying this, is lock this committee and lock the Congress in a room, and you come out and you speak with one voice. It has to be bipartisan. The people do not see that enough. I do not have any answers.

I cannot advocate for Dr. Burman's position, though to me it sounds reasonable, this 4-percent surcharge. But I hope, though, that this committee, and the Congress in general, tries to act not in a "we got you" on the other side of the aisle, but in a sense of bipartisanship. Then people will appreciate whatever you do. If you do it together, they will accept it.

Mr. GRAETZ. Senator Grassley, if I could just respond to your question. I think that there are provisions under the Alternative Minimum Tax which we have talked about a lot today that are really bad provisions: the failure to index the exemption, the marriage penalties, and so forth. On the other hand, there are provisions under the regular income tax that are also really bad provisions.

The Joint Committee, in its pamphlet for the hearing today, points out that 62.7 percent of the revenues under the Alternative Minimum Tax relate to the disallowance of the State and local tax deduction.

I think an unlimited deduction for State and local taxes, frankly, is something that is not appropriate if the choice is to have higher tax rates, which is the choice that is going to be faced in 2010 when the rates under the regular tax will automatically go back up to nearly 40 percent.

And so, if you ask me, do I want a 40-percent rate with a full deduction for State and local taxes or a lower rate—it is even 35 percent in the phase-out range—without such a deduction, I actually prefer the AMT rule to the regular tax rule.

Now, I am not saying that this is an issue that you can deal with in the current context, but, because of the way the 2001 and 2003 legislation was structured to expire in 2010, you are going to have to address that issue, I think, in 2010. If you repeal the AMT today, you essentially pre-judge it in favor of higher rates, and that is what I am concerned about, frankly.

The CHAIRMAN. Thank you very much.

Senator Bingaman?

Senator BINGAMAN. Thank you all very much.

Sort of following on with your suggestion that, whatever we do, we should do it with a view toward a more significant reform of the tax code that is going to be essential as we approach 2010, is the right approach, as I understood you, Mr. Graetz, to enact another patch for a couple of years, index it, kick the can down the road in that way with the AMT, and then begin a more serious, in-depth look at how to restructure the entire tax code, hopefully to eliminate an AMT at that point?

Mr. GRAETZ. Senator Bingaman, that is exactly where I would urge the committee to go, and to do it in a way so that we do not

create this 1-year estimated tax problem that Senator Grassley talked about.

So go ahead and index it through 2009 or 2010 and begin looking at the provisions under both of these taxes and asking which ones of them are appropriate and which ones are not, in order to decide what to do when all of the 2010 legislation expires. I am agreeing with Dr. Burman to a large extent, that you cannot have a huge budget hole going forward, so you are going to have to do something in 2010 that is revenue-neutral. I am much less concerned, frankly, about the revenue to pay for the patch than I am about what happens in 2010.

I have argued before this committee and elsewhere in the past that we ought to be thinking more seriously about consumption taxes as a way to get people out of the income tax. I have had a proposal that we have a consumption tax that would allow us to finance a \$100,000 exemption from the income tax and eliminate 150 million people from the income tax altogether, which I think also should be on the table going forward. But it can only be done in the context of a 2010 look at this, or 2009.

Senator BINGAMAN. Let me ask Dr. Burman and Dr. Hassett if you have any thoughts about that course of action as sort of the least bad of the various options before us.

Dr. BURMAN. If I felt confident that there would be tax reform in the new few years, I think it would definitely be worth waiting for. Our tax system is broken, and the AMT is just one example of the things that are wrong with it. It is too complicated. The AMT is too complicated. We have a hodgepodge of tax credits, deductions, phase-ins, and phase-outs.

Kevin talked about the specific tax provisions that, in a lot of cases, do not satisfy their intended purpose. You could actually argue that the mortgage interest deduction has made it harder for low- and middle-income people to own their homes.

I understand the transition problems that Mr. Degen talked about. But the President's Tax Reform Panel made proposals, and, while I did not agree with every aspect of them, they would have made things a lot simpler and they dealt with a lot of fundamental problems in the tax system. I would love for this committee and for the country to engage on that issue.

Senator BINGAMAN. Dr. Hassett?

Dr. HASSETT. As an observer of this committee, Senator Bingaman, I would have to say that it is something of the gold standard of bipartisan cooperation, and I would trust your judgment on what is best to do and would not object at all to a patch until you felt that you had to deal with this, say, after the next general election. Economically, that would be acceptable, absolutely, because it would remove the uncertainty that I am so concerned about.

Senator BINGAMAN. All right. I will stop with that, Mr. Chairman.

The CHAIRMAN. Thank you very much.  
Senator Roberts?

Senator ROBERTS. Thank you, Mr. Chairman.

And Mr. Degen, thank you for your comments in regards to the mortgage interest deduction. I cannot think of anything that we need to mess with less than that during the recent housing slump

and the economy the way it is. But you make a very interesting point in regards to home building and being part of the American dream, which I think is entirely accurate.

Mr. Chairman, thank you very much for holding this hearing, what I call the ATM hearing, because you have to go to the ATM to pay the AMT. [Laughter.] This is such an unfair tax, very overly complicated, that does not even do what it was intended to do. My witnesses, in terms of my own hearings in Dodge City, my home town where I attend the coffee klatch, keep reminding me that I am sticking them with the Alternative Minimum Tax, so they try to stick it to me. That cost to me is much less than the AMT is to them.

In Kansas, if we do not do anything with a patch—which I think is a good recommendation, to do it for 2 years and then take a look at where we are in 2010—we are going to go from 22,000 to 140,000 people in Kansas who pay AMT. They are not going to be very happy, to say the least.

So I have joined the Chairman and the Ranking Member in what we call the Baucus-Grassley-Roberts bill in some sections of this committee, along with a lot of others, but what we call in Kansas the Roberts-Baucus-Grassley bill, to repeal the AMT. I really want to thank Senator Grassley for speaking to this in great detail on the Senate floor.

I take issue with those folks who think we need to offset a tax that was never intended to be collected at the level that is being collected today. Unfortunately, it is a revenue stream that we have gotten used to.

I want to thank all the witnesses for your views on how to deal with AMT. I think we can all agree that there needs to be a long-term solution, but I have serious concerns about some of the proposals that would impose newer and higher taxes on some taxpayers to pay for tax relief for other taxpayers.

That does not seem to me to be a very good idea, especially raising taxes on those who make the investments in our economy and are the job creators. That does not seem to be a very wise way to pay for a tax that was never intended to be imposed on the vast majority who are paying it now.

Just a couple of questions in the 2 minutes that I have. Mr. Degen, there are estimates that it takes the average taxpayer somewhere in the neighborhood of 63 hours to calculate their AMT liability. What does it cost taxpayers who have to calculate their income tax liability twice? Can you place a dollar amount in any way on the cost of this?

Mr. DEGEN. I really probably cannot, Senator, except to say it does cost. That is sort of a non-answer. But certainly, from a professional tax preparation standpoint, people typically charge by the complexity of the return. So I am just going to throw out a number. If it was an extra \$25 charge, I mean, considering all the people that have this, then the cost would be a large amount.

The other bad part about it is, often the AMT is not properly calculated because of all the loopholes. We talked about mortgage interest.

Senator ROBERTS. Right.

Mr. DEGEN. There are some add-backs on there that many, many people do not do properly, so there is cost to the Treasury on that. But I really cannot give you an exact dollar figure, except to say that it would be rather substantial.

Senator ROBERTS. Dr. Burman, in your testimony you advocate for what you call a surtax, but what I call a tax increase.

By the way, I do not call it "tax cuts," Mr. Chairman, because obviously we then get into, immediately the following words are "for the rich." But if you say "tax relief," that is a whole different connotation. So, my advice to all who would want to listen is to call it tax relief, although I am sure that will not be taken by every member.

But a tax hike of 4 percent to apply to families who earn over \$200,000 and individuals earning over \$100,000, 90 percent of small businesses who file their taxes as individuals would be hit by that. That is at least what we have indicated.

If you take the fact that small businesses actually create 60 percent of the jobs in this country, I am really worried about something like that. Do you have any comments that you would like to make about that?

Dr. BURMAN. First of all, for most people it would not be a tax increase because most people currently on the AMT would pay lower taxes. Most of them would face lower marginal tax rates as well. Dr. Hassett pointed out that marginal tax rates under the AMT can be quite high and it discourages work and saving, much more so than the 4-percent surtax that we are suggesting.

Senator ROBERTS. Right.

Dr. BURMAN. On the issue of small business—

Senator ROBERTS. I am not advocating that either. Do not misunderstand me.

Dr. BURMAN. I understand that, sir.

On the issue of small businesses, we have not looked at that specifically in this context, but in other contexts we looked at the distribution of, say, the 2001 to 2006 tax cuts and how they affected small businesses.

Senator ROBERTS. You mean tax relief? Pardon me. Go ahead.

Dr. BURMAN. Yes. The tax relief enacted from 2001 to 2006.

Senator ROBERTS. Right.

Dr. BURMAN. The vast majority of the small businesses, the ones actively involved in business and not just reporting a little bit of consulting income under Schedule C, were in lower brackets and were not affected by the tax rate cuts at the very, very top.

So overall, I would say that the surtax was our attempt to reflect something like political reality. It was in some sense a response to press reports—

Senator ROBERTS. I think you have that right, but not in the way you are advocating.

Dr. BURMAN [continuing]. About—considering the surtax proposal would actually lower marginal tax rates on most taxpayers.

Senator ROBERTS. My time has expired. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator.

Senator Kerry?

Senator KERRY. Mr. Chairman, thanks for having this hearing. I want to pick up on a couple things Senator Roberts said. But first of all, this is long overdue and it is sort of a classic procrastination of Washington, that we have been sitting around here for several years seeing this train wreck coming down the road and nobody has done anything.

This is a tax that was designed, in 1969, for 155 people—155 people—who earned more than \$200,000 a year and did not pay any taxes at all, and everybody was outraged. So there was a specific effort to try to make sure we had a fair tax system in America, that the wealthiest people did not walk away with larger amounts of money than seemed fair relative to what the average American was paying in their tax rate.

Now we are going to have 23 million Americans sucked into this unwittingly and inadvertently. I mean, it is just a no-brainer that we have to respond to this. Now, Senator Roberts is leaving. I regret that, because I think it is important to have a dialogue about this. That is all right. You can escape. [Laughter.]

Senator ROBERTS. There is a mark-up in the HELP Committee to help people in Massachusetts. [Laughter.]

Senator KERRY. Good. Well, we want you to do that.

The problem is that there has just been an unbelievable—I mean, I love this game that gets played with the word “relief” versus “cut” and how words have supplanted thinking around here, and they have also supplanted any fair standards of what we do.

In the 1980s, the top 1 percent of income earners in America earned somewhere in the vicinity of 10 percent of the income of our Nation. In the 1990s, it went up to about 16 percent. Now it is 22 percent. Twenty-two percent of the income of our country is earned by the top 1 percent, and they are walking away with larger and larger amounts of money.

Fifteen years ago, *Forbes* magazine, I think, had millionaires on the front. Now we have 400 billionaires. The spread between average working folks and what the rate is that they are paying, the rate of their taxation, the rate that a secretary pays versus the rate that a CEO pays, is obscene. Obviously, with much larger amounts of money, that rate is producing much larger income to people.

I do not know what the cut-off is now on 1 percent. What is a 1 percent income earner today? Above what level? What is the floor in that income now from 1 percent? Three hundred and fifty-thousand, something like that, and upwards.

I do know this. I do know that people earning more than \$1 million a year got at least \$32 billion worth of tax cuts last year. I also know that people like Warren Buffett and Bill Gates, who earn among the largest amounts of money in our Nation, did not think they should get that cut.

They believe deeply that tax relief ought to go more broadly to people in the economy, and they would make more money, in fact, if that happened because it would produce greater purchasing power, greater wealth, greater investment broadly into our economy.

So I look forward to this debate, Mr. Chairman, because we need to fix our tax code, which is seriously, seriously broken, whatever

27,000 pages and numbers of volumes it is now reaching. It is wrong.

So anyway, with respect to this fix, Dr. Burman, let me just ask you, to what degree is our thinking on the politics of this adversely and sort of strangely affected by the revenue stream created by the tax cuts themselves that have created this unfairness?

I mean, we are living in this vice of a tax cut structure where we see this revenue stream, and if you were to begin to focus on some of that, would you not have a much easier fix with respect to the AMT?

Dr. BURMAN. Well, it is certainly true that the tax cuts doubled the number of people on the AMT. They lowered regular tax rates and they did not do anything about the AMT but for a temporary fix, which has been extended a few times. So without the tax cuts, it would cost half as much to eliminate the AMT or to reform it.

Senator KERRY. So the tax cuts themselves had a perverse impact of pushing more Americans at the lower end. So the tax cut was not really a pure tax cut. It, in fact, was a tax increase for X number of Americans. Correct?

Dr. BURMAN. That is actually not true. I do not think anybody actually paid more tax as a result of the combination of the tax cuts and the AMT.

Senator KERRY. They still wound up with net less.

Dr. BURMAN. Yes. On net, just about everybody got at least something, at least until you account for how you are going to pay back the revenues lost.

Senator KERRY. So let me ask you, I think you already addressed the question of the replacement for the regular tax system. You stated that your favorite option is to replace it with the 4 percent.

Let me step beyond that for a minute. Would it be better to repeal the AMT than to try to reform it and exempt the middle class?

Dr. BURMAN. My preference would be to get rid of it. I do not think the AMT makes a lot of sense, as a matter of policy. There might be some elements to the AMT that should be in the regular income tax, but they should just be incorporated there. I do not think even millionaires should have to figure out their taxes under two different systems. I think people should be able to understand how the tax affects them.

Senator KERRY. Have one simple approach.

Dr. BURMAN. Yes.

Senator KERRY. And what would be the impact of repealing the State and local deduction? What would the impact be on State and local governments?

Dr. BURMAN. It would be a very progressive change, because right now the people who are getting the most benefit from the State and local tax deduction are very high income people. If you are on the AMT, you do not get the full benefit—or even sometimes any benefit—from the deduction.

It is kind of a funny way to help States because the States that get the most benefit are the ones that have the largest tax bases. High-income people are paying lots of tax. They get to deduct their State and local tax at 35-percent rates, while a lot of low- and middle-income people do not even itemize deductions and thus do not get any benefit from it at all.



There is a concern that, if you got rid of the State and local tax deduction, it would make it harder for States to raise enough revenues to finance their governments, so basically high-income people would want to leave. The evidence I have seen is not very convincing on that score, but the strongest argument made for the deduction is that it makes it easier for States to finance necessary services.

Senator KERRY. I have exceeded my time. I appreciate it, Mr. Chairman. I will come back.

The CHAIRMAN. Thank you. It is an interesting subject. In this very room, it was that issue which spurred the major efforts in this Congress to pass the 1986 tax changes. On that very issue, Senator Packwood was chairman, sitting right here, and he counted the votes before he asked for a recorded vote on whether to repeal the State and local tax deduction. He counted those votes. I was sitting right in this room.

He realized that he did not have the votes, so he banged the gavel down, he adjourned the committee, recessed it, went out and had that famous pitcher of beer with Bill Dieffenderfer, his top tax person, and they started thinking, "Now what? Now what are we going to do?"

And Joint Tax then pulled the basic 1986 tax reform off the shelf. For 2 or 3 days in this back room here, we started looking at the degree to which that made sense, and that was the basis of the 1986 law.

But it was that one issue, repeal of the State and local tax deduction, which was the catalyst to cause that major shift, and it resulted in the 1986 tax reform.

Senator Stabenow?

Senator STABENOW. Well, thank you, Mr. Chairman. Thank you very much for holding this hearing and giving us an opportunity to not only speak about what is happening with the AMT, but more broadly on tax reform. It has been very helpful. I think it makes sense.

We know we need to have some kind of a patch, but you have been able to connect the various issues together in a way that I think causes us to need to look at broader reform, and I appreciate that very much.

As a practical matter, I would just say that I come down on the side of feeling that the mortgage interest deduction has been very important. Mr. Degen, you spoke about that, in terms of home ownership. I think for the average person, home ownership may be the only way in which they gain substantial savings.

I mean, most people start in terms of retirement savings or building up resources through equity in a home, so that is an area that is of concern to me if we were to look at making changes.

But I am wondering, Mr. Degen. As a practitioner, just kind of take us back from the broad view in this important discussion on tax reform back to the practical realities of AMT. What do you think the average person thinks about the AMT?

Are they even really aware of it as they should be? I know in talking to my constituents, I do not think many people are even aware when they are bumping up into this, or how it works. From

a perspective of a majority of taxpayers, what is their view? What are people thinking about this?

Mr. DEGEN. I think the best comment I can give you is, there is a glaze over their eyes when I try to explain to them. You have all these very intelligent staffers sitting back there. If any of them can, in 25 words or less, explain to somebody what the AMT is, I am willing to listen.

Senator STABENOW. Right.

Mr. DEGEN. But I think it comes to a couple of things, Senator. Some people are simply unaware of it. As much as it is publicized in the political arena—newspapers in my area constantly do articles on it—a lot of folks—especially people who have professional tax preparers—are not doing it on their own, they ask you to do a service for them, so many people are still not aware of it.

We live in a very funny society with our tax system. Most taxpayers do not view your work as either good or bad because you saved them money or you knew all these things. “How much is my refund?” is the first question you get from somebody. So if they got a refund, similar to last year, maybe their refund should have been \$5,000 higher and they were subject to AMT, but they do not care. Do you know what I am saying? So there is that level.

You do try to explain to people. I try to be up front and tell people, this is what is happening. Some of them become quite angry. Many of them are just sort of frustrated. You know what would be nice? I would say to people, “Congress created the problem.” And I am not trying to blame you, but it is the reality.

I say, “Write to your Congressmen and let them know what your feelings are.” Very few of them do. I think some of them are exasperated. You cannot fight city hall, you know. It is just like, “no one will listen to me,” that kind of thing.

So, surprisingly, I think, to answer your question in a round-about manner, not as many people are fully aware of it, and fully aware of the impact on them if you do not explain it to them.

Just one more thing. Some preparers do not even bother to tell folks about it because, number one, they have to spend too much time trying to explain it, and number two, they do not want to irritate the taxpayer, so they just say, here is your bottom line, and let it ride like that.

Senator STABENOW. Could you talk a little bit more about what is most troubling to you in terms of the execution of the AMT and if there is any particular piece or way again that people find most troubling?

Mr. DEGEN. Well, I think people who prepare this on their own, certainly do not always do it accurately. We talked about the mortgage interest. In AMT, you are only entitled to certain of your mortgage interest as a deduction. You have to add back, and many people are not aware of that. They do not do it.

People refinance their homes for more than what we call acquisition debt and they are not entitled to take some of the AMT. Most folks, certainly self-prepared people, are unaware of it. And quite frankly, I am going to tell you the truth, I think many practitioners just sort of ignore it. So, I think there are a lot of errors in that way.

And then, of course, you do get problems with, say, legal settlements. Now, Congress did try to help on that, with the passage of the American Jobs Creation Act, with a discrimination suit where you could net attorney fees.

But still, in other types of legal settlements, you have to report the gross income, the gross settlement on the front of your tax return, and then on Schedule A you have to take a deduction, subject to the 2-percent "haircut," we call it, for the legal fees. Often if you have a large legal settlement, the miscellaneous deductions create this huge AMT liability.

There is a very famous story that many of you may have heard about, a policewoman, I think it was in the city of Detroit, actually, who filed a discrimination suit and she won, like, \$3 million or something, so the legal fees were \$1 million.

Then the judge reduced the reward to her—not the lawyer—and it turned out that after she calculated her income tax she had to pay more in income tax because of the AMT than she actually received as her portion of the settlement. That is insanity. I think she got \$300,000 finally and she paid \$400,000 in income tax. So those kinds of things are certainly frustrating.

Senator STABENOW. Yes.

Mr. DEGEN. While not many taxpayers, I will be honest with you, have that type of legal settlement, it just blows your mind when you hear those kinds of things.

Senator STABENOW. Yes.

The CHAIRMAN. Thank you very much, Senator.

Senator STABENOW. Thank you.

The CHAIRMAN. Senator Salazar?

Senator SALAZAR. Thank you very much, Chairman Baucus, for putting the spotlight on this important problem that affects so many people all over our country. For me, it is amazing when you look at some of the historical statistics and you realize this tax was put in place to deal with 155 people, and now we are talking about millions of people around our country.

I know that in my State, if we do not do something about the AMT problem going forward, that we are going to be having about 200,000 people in Colorado who are going to be ensnared by this tax that is very difficult to comprehend, and most people, frankly, do not comprehend it. So, I am hoping that we can do something about it.

I have a couple of questions for Dr. Burman, Dr. Hassett, and Mr. Graetz. I would like you to quickly respond to these two questions.

The first question is, if we do, as Senator Bingaman and others have suggested, a patch, how do we pay for it? The reality is, we are looking at \$115 billion, I think our staff has calculated.

We just went through a major debate here on energy relative to how we pay for incentives for our new energy package on the floor last week. It is tough to come up with the \$28 billion that we included in that package. So where do we come up with the \$115 billion that we need for this package, for this patch?

Second, with respect to the systemic problem that we have, which is essentially a tax system that is broken, you have lots of processes, lots of people who have talked about it. The President

has his commission. Everybody who is running for President is out there talking about how they are going to simplify our tax code, et cetera.

What process would you recommend for us to embark upon if we are really going to bring about some kind of systemic reform? So why don't each of you take about a minute to respond to each of those questions so each of you get a chance, starting with you, Dr. Burman. So, how do we pay for it? How do we fix the problem systemically?

Dr. BURMAN. I do not know that I have anything more than what we said earlier. It is not hard to come up with \$50 billion if you want to.

Senator SALAZAR. What is your recommendation, though? You are king for a day. How do you come up with \$50 billion? These guys struggle with it all the time. You come up with it.

Dr. BURMAN. You could turn the State and local tax deduction into a credit.

Senator SALAZAR. All right. I got your answer. Now, how about systemically? You have been around these issues a lot longer than I have. I am new to this committee. How do you fix the systemic issue?

Dr. BURMAN. I came to Washington to work on what became the Tax Reform Act of 1986, and that started with President Reagan asking the Treasury Department to put together a proposal and then leaving them alone. The Treasury Department has the expertise to do the analysis of the revenue cost.

Senator SALAZAR. Was the President involved in that, sleeves rolled up, trying to make that happen?

Dr. BURMAN. Actually, I think one of the things that made it effective was that the President really did not put a lot of restrictions on it. He wanted to cut marginal rates, as that is what had really bothered him when he was a young actor. This was President Reagan. Everything else was on the table. They actually proposed repealing the State and local tax deduction. It died in Congress because it had no political support.

Senator SALAZAR. Yes, but it started in the House. All right.

Dr. HASSETT, how about you? Two questions.

Dr. HASSETT. Yes. Thank you. I will be very quick. I agree with Dr. Burman, that I would go after the State and local tax deduction. Again, my rationale is something that I think should appeal to someone who says things like you did, Senator Kerry, that if you are concerned that the wealthy are not paying enough tax, given how much their incomes have gone up, it might be politically unfeasible to raise their marginal tax rates, and certainly the President would probably veto.

But economists say it is the marginal rate that matters, and if you do away with these base-narrowing things that throw people on the AMT, then that is all right with us. That is all right with us. So you can get revenue and increase the average tax of wealthy individuals without raising, necessarily, their marginal tax rates. That is what I would do.

Senator SALAZAR. How do we fix the systemic problem?

Dr. HASSETT. And I would fix the systemic problem by trying to recognize what I just said, and then sitting down together and

looking for a bipartisan agreement on it. So, for example, by capping, saying we are going to end deductions to these rich people, then you could leave the marginal rates where they are today.

Senator SALAZAR. Talk to me a little bit about process. We have had lots of processes that have ended up in no man's land in terms of solutions. So what process do you think might work for us to get our hands around this broken system?

Dr. HASSETT. I think the process should involve this committee, that you agree to go sit somewhere and work out a deal.

Senator SALAZAR. Mr. Graetz?

Mr. GRAETZ. I would agree with the basic pay-fors. I would cap the State and local tax deduction or do something to limit it. I would, as I said earlier, limit the home mortgage deduction to one home, except for members of Congress who have to have two, and those sorts of things. I think there are lots of things you can do, but they are not easy to do.

On the process, I think this is a really important question. The 1983 process for Social Security, which was a bipartisan group led by Mr. Greenspan and Senator Moynihan, was very successful. And I think the reason it was successful was that it had the support of the President—so I do not think there is any point in doing this until you have a new President in 2009, frankly—and it combined the expertise of people like Alan Greenspan and others along with politicians so that there was enough information for the politicians to see all of the options and enough political wisdom to go forward.

Senator SALAZAR. Thank you very much.

Mr. GRAETZ. I just want to say one more thing, if I may. I also participated in the 1990 budget negotiations which were held at Andrews Air Force Base and blew up, frankly, because of the abandonment of President Bush by some members of his own party in the House.

That process, for all of its failings, was also a very successful process because it included members of the administration, members of the Treasury Department, the key staff—CBO staff, Joint Committee staff, the Finance Committee staff and the like—and the leadership of both the House and Senate committees. That is another way to go.

Senator SALAZAR. Thank you very much. My time has expired. I would only make one request of you, and that is that if you have suggestions on process on how we make a systemic fix, I would appreciate it, and I am sure other members of this committee would as well.

It seems to me there are processes that end in failure, and we have a history of those, and we have processes that have led to successes, and we may be able to learn from that. Thank you very much. Thank you.

The CHAIRMAN. Thank you, Senator. I think, basically, Mr. Graetz, you put your finger on it about the only process that works. That model, I think, is the only successful model in recent times. But it had the added benefit, however, if I recall correctly, that the Social Security trust fund was going to go belly-up in 6 months.

So, that helped focus the mind and it helped both sides kind of work together, shake hands, both ends of Pennsylvania Avenue and

so forth, because we needed a fix. It was a combination, as you know, of lowering benefits and raising taxes.

Basically, Jim Baker called Tip O'Neal and said we Republicans will agree to raise taxes if you Democrats agree to lower benefits on Social Security. That was the handshake, with a 6-month gun at everyone's head, and we got it done.

I do not know that we need an emergency like that again. The tax code clearly is heading for collapse, but it is that general process, I think, that is about the only one in this town that works. Thank you very much.

Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman.

Just to pick up on the Chairman's remarks, I mean, the tax code is broken. There have been 14,000 changes since the last effort. It comes to three for every working day. I am going to ask you what I have asked 15 previous witnesses here and at the Budget Committee.

And just to give you some background on it, I have introduced the Fair Flat Tax Act, and it is essentially an updated version of what was done in 1986. We have a 1-page 1040 form, folks, with 30 lines. People at *Money* magazine completed their taxes on this in a half-hour.

And just so people understand the bipartisan prospects, the President's Commission calls for a form that is, like, 35 lines long. So for purposes of government work, we could work out a bipartisan agreement on simplification like this.

The legislation gets rid of the AMT and basically keeps progressivity and cleans out the clutter in order to hold down rates for everybody.

Now, I think I am at 15 unanimous votes for the 1986 kind of frame, and I hope to make it 19 after I ask this question of all of you.

But set aside my legislation. We are not talking about a specific bill. But for the basic concept of updating 1986, where you clean out the clutter, keep progressivity, hold down rates, and simplify the code, I have 15 witnesses on record, I think, in favor of that, and I would like to make it 19.

I am going to start with you, Professor Graetz, because I think you have already said favorable things about the Fair Flat Tax in the past, so I might get to 16 and that gives me a chance to warm up with the other three. Just on the question of, do you think the basic concept of 1986 ought to be updated as the basis for reforming the tax code?

Mr. GRAETZ. Senator Wyden, I am going to hedge a little bit, I am afraid. I believe that the Fair Flat Tax is a great improvement over current law, let me be clear about that, and that cleaning up the law would be a major improvement from where we are. I have to say that having watched the Tax Reform Act of 1986 unravel over the last 20 years—and I have written two pieces on this and have a book coming out in January which discusses the Fair Flat Tax and other alternatives in some detail—I really think that we need to be even more radical, frankly, than you are.

I have argued that we should enact a value added tax to get 150 million people out of the income tax altogether, and then the rates

would obviously be different, but something like the Fair Flat Tax at the top that was limited to people with over \$100,000 of income, really would return us to where the Nation was before the second world war when we relied more heavily on consumption taxes than we did on income taxes. It would allow much lower tax rates going forward under the income tax, which I have to say, in a globalized and technologically advancing economy, given the competition around the world, I think is extremely important.

Our corporate rate now is the highest rate among rates in Europe, and they are all coming down. We have a high corporate tax rate compared to other countries, and we simply cannot afford to fund our government going forward by just relying on the income tax. We are the only country in the OECD that does not have a broad-based national-level consumption tax. But I would combine that with what you are doing, and I think there is a lot of room for combination.

Senator WYDEN. I will count you as 15 and a half out of 16.

Mr. GRAETZ. You can certainly count me in that category.

Senator WYDEN. Thank you. And thank you for your scholarship. I have read a lot of your work.

Mr. GRAETZ. Thank you for your efforts.

Senator WYDEN. Dr. Hassett?

Dr. HASSETT. Senator Wyden, baseball fans remember the moment when Babe Ruth pointed at the stands and hit a home run, and tax geeks like Dr. Burman and myself remember the 1986 Act with similar relish. [Laughter.] It was the high point of tax policy, at least in my lifetime, but I can think of things that would be a lot better. Despite that, I will give you a vote.

Senator WYDEN. Great. And I will give you a commitment to work with you. I know you have spent a lot of time on this.

Look, clearly we can improve on this. Chairman Baucus and I have had a number of conversations about steps you can take if you can get to the Promised Land about how you keep from sliding back and allowing some of the special interest loopholes to be created. So I think your point about looking at ways to improve is something I am very receptive to.

Dr. Burman, you and I have talked about this subject as well, and I would appreciate your answer.

Dr. BURMAN. You can count me as a vote for a TRA 86-type approach. I applaud your leadership on this issue. Professor Graetz pointed out that TRA has unraveled to a large extent, but it has not completely. Rates are still lower than they were before the Act was enacted. The corporate tax, although there has been some backsliding, is not anywhere near as much of a mess as it was in 1986. We have learned a lot since then, so obviously focusing on the process is important. The other thing is, as Dr. Hassett has pointed out, bipartisanship is tremendously important.

One of the things that made the 1986 Act work was President Reagan, a Republican, Dan Rostenkowski, a Democrat, and Bob Packwood working together, and members of the committee, across party lines, working together.

We really need presidential leadership. Somebody is going to need to explain to people why shaking things up a lot and inevi-

tably raising some people's taxes is in their interests in the long term.

The reason for reform is that we need a tax system that works. If you look at the enormous revenue challenges we have facing us when the baby boomers retire, the current tax system just is not up to the challenge.

Senator WYDEN. Mr. Degen?

Mr. DEGEN. Senator, I come from New York, and we like to argue. I think the basic concept of what you said is absolutely correct. But we have to be careful. What a lot of ordinary taxpayers now perceive as tax planning, like the mortgage deduction we talked about—they view others as having tax loopholes—but, when it works for them, it is tax planning.

Senator WYDEN. We keep all of those. All of the middle-class breaks for saving, mortgage, charity, and health. All of that is kept.

Mr. DEGEN. Well, if that, in fact, is the case, then I would support it, with one caveat. I think you would have to write into the legislation that there can be no changes to this new Internal Revenue Code for X number of years, because what will happen is, like you said, three changes a day since 1986. Is that what you said, something to that effect?

Senator WYDEN. Fourteen thousand since the last time, three for every working day.

Mr. DEGEN. All right. So, three for every working day. So there is nothing to prohibit that again after your tax act passes—assuming it is ever enacted. So there has to be something in that legislation.

The CHAIRMAN. I would like to ask the witnesses the degree to which you agree with Mr. Graetz. I mean, he makes the basic point, if I understand him correctly, that the U.S. is the only OECD country without a significant consumption tax, and, in view of globalization and the immense pressures that American companies have and Americans have in facing the competition worldwide, that we as a country almost need to move to more of a consumption-based tax.

He pointed out, which I had not realized, that prior to World War II there was much more of a consumption element to our tax system than today. But if I may start with you, Dr. Hassett, and then go the other way. What do you think about that?

Dr. HASSETT. Yes. I absolutely agree.

The CHAIRMAN. And I would like to ask, when you agree, state why.

Dr. HASSETT. Alan Auerbach of Berkeley, who is a frequent advisor of Democrats, and I have a book we published where we reviewed the literature on fundamental tax reform. In our summary, we said our read of the literature was that if you switched wholesale to a consumption tax, it would buy you about 10 percent of GDP over 10 years, or GDP would be about a trillion dollars higher today if we had done it 10 years ago.

So I think that the economics literature is very decisive that a consumption tax is better. The problem, again, is that many of the decisions that you make when you introduce a consumption tax are politically difficult.

The CHAIRMAN. Right.



Dr. Burman?

Dr. BURMAN. Economists have always found the idea of a consumption tax attractive because it does not double-tax savings, so it encourages saving and theoretically makes the economy grow. There is a lot of debate, however, about the size of the effect.

The big concern about a consumption tax is it tends to be regressive. Low-income people consume more than their entire incomes. They actually get help from family members and others. High-income people only consume a tiny fraction, maybe 30 percent, of their income, so you would basically be exempting 70 percent of income from tax.

One question is, why are consumption taxes so popular in Europe? They are certainly not indifferent to the concerns of low- and middle-income people. An answer is, they do a lot more for low- and middle-income people through the spending side of the budget, so for example, people get free health care.

If you were to combine something like a value added tax with something that would make health care available to low- and middle-income people, that could be a progressive change overall. But I have concerns about the distributional effects of a stand-alone tax change—about whether you would be raising tax burdens on low-income people.

The CHAIRMAN. Mr. Degen?

Mr. DEGEN. Yes. I would agree with Dr. Burman. The regressive nature of the tax lends me to be against that type of thing. So you could build in some type of exemption or whatever. I do not know the particulars. But the regressiveness is not to my liking.

The CHAIRMAN. All right.

Mr. Graetz, you get a rebuttal.

Mr. GRAETZ. Thank you. I just want to make two comments. One is that you do have to deal with the regressiveness of a consumption tax at the bottom. The proposal that I have offered and that I am detailing in my forthcoming book does that. It does it in a number of ways I will not bother the committee with. But it actually responds to the regressivity at the bottom.

And you have to, in order to not give a big tax cut at the very top—which I agree this is not the moment for—also retain some small income tax at low rates on the very wealthy, but they are also going to pay consumption taxes and so, since they are paying a consumption tax and an income tax, you can keep those rates lower. And you can lower the corporate rate, which is borne, I think, in an open economy largely by consumers anyway, and it is a very bad tax and has the potential to really hurt the American economy going forward over the decades.

The CHAIRMAN. What about transition costs?

Mr. GRAETZ. By keeping the income tax at the very top, you really avoid the transition problems that exist when you go to a full consumption tax. There are a number of proposals that have been advanced, both in the political arena and in the academy for a full replacement of the income tax by the consumption tax. That creates major transitional problems. I do not urge that.

The CHAIRMAN. Now we have both consumption as well as income taxes. We have both.

Mr. GRAETZ. You would have both, but you only have the income tax, as we did before World War II, for the very highest-income Americans. If you have a \$100,000 exemption from the income tax, you basically only have the people who are now subject to the AMT at a high exemption level that we are talking about.

The CHAIRMAN. What were the consumption taxes prior to the war?

Mr. GRAETZ. Well, the consumption taxes prior to the war were tariffs, and they were very bad consumption taxes because they were tariffs. If you go through the history of the U.S., we raised most of our money through—

The CHAIRMAN. I know. Ninety-seven percent prior to the Civil War.

Mr. GRAETZ [continuing]. Through consumption taxes.

The CHAIRMAN. Correct.

Mr. GRAETZ. And the income tax did not come in until the second World War. The great development in thinking about taxing consumption is the invention of the value added tax, which was, I think, invented at Yale. Some people think it was invented in France. But if you go back to the work of Thomas Adams in the 1920s, I think he thought of the idea earlier.

But it is a kind of consumption tax that allows us to tax consumption in the United States; it does not tax exports. It taxes imports. It works. Its compliance costs are a third or less of what the income tax compliance costs are.

The businesses that are collecting it are collecting it throughout the world. You have to protect small businesses, you have to protect low-income people. You have to create a system that is appropriate to the United States and not borrow the system from abroad.

The CHAIRMAN. It also gives a boost to exports, rebates to exports. Is that correct?

Mr. GRAETZ. But I think it is a good tax.

The CHAIRMAN. Although it adds a tax, it allows a rebate for exports—

Dr. BURMAN. It does, but it basically just makes it neutral between exports and imports. It is actually one of the biggest misconceptions about a VAT, and it is shared by virtually everybody who is not an economist. But it is not an export subsidy, and that is why it is allowed under GATT.

The CHAIRMAN. Yes. That is why it is allowed.

Mr. GRAETZ. It is not a subsidy for exports, unlike the corporate income tax, which may be borne in part by consumers. If you use it to buy down the corporate income tax, putting aside exchange rates, which people say will adjust, you may get a benefit.

The CHAIRMAN. Senator Wyden, further questions?

Senator WYDEN. Thank you, Mr. Chairman. I thank you for all the time, too, Mr. Chairman.

Can I ask just one question about this consumption tax issue? Some of you may remember that Al Ullman from Oregon, who was chairman of the Ways and Means Committee for quite some time, arguably lost his seat as chairman of the Ways and Means Committee because he was for a consumption tax. The people of my terrific State have voted against sales taxes about 8,970 times, and that is just barely an exaggeration.

What I would be interested in, because I think the Chairman has asked you about a lot of important issues relating to this and sort of how it would evolve as actually implemented, but what has changed in your view since the time of Al Ullman?

Now, arguably that was more than a quarter-century ago when he first proposed it. What are the changes that have taken place that make it, in your view, more attractive today than it was 25 years ago?

Mr. GRAETZ. Senator Wyden, let me respond to that. I have to say, I think the history on Al Ullman's failure to win reelection had more to do with the fact that he did not even own a home in his district at the time and had lost touch with the people of Oregon than it did with the value added tax, so I think there is a little bit of urban myth about Al Ullman's failures.

But putting Al Ullman aside, the economy has changed dramatically. After the second world war, the United States had all the money there was in the world and our corporations and our economy were dominant in the world economy.

What you have today is a situation where income can move very quickly—all of the compliance issues that we have talked about, that you will talk about if you get into the private equity issues in more detail when you find out how they are really organized offshore. The way in which American capital is now organized is multinational and not domestic in the way that it was a quarter of a century ago when Al Ullman was talking about this issue.

This is due to a change in technology which allows money to move quickly and without a lot of paperwork around the world, and it is due to the globalization of the economy coming together at once. The income tax rates around the world, including the corporate rate, were much higher.

In 1986 when the Tax Reform Act was enacted, the U.S. went to the lowest income tax rate in the world. We are now second highest in the OECD because the other countries have moved to lower rates. If you look at what is going on in Europe today, they are lowering their corporate rates even more.

So given the choice, for example, of a company like Daimler-Chrysler to be headquartered in Germany or to be headquartered in the U.S., they have chosen, in many instances, to be headquartered abroad.

The question is whether we are going to own operations abroad or whether somebody else is going to own operations abroad, and whether we are going to attract capital from abroad or whether somebody else is going to attract that capital from abroad.

These were just not issues in the 1970s to anywhere near the same extent that they are today. In order to attract that capital, we need low income taxes, in my view, low income taxes on capital, which we can only pay for and only keep distributionally fair by having another revenue source.

I just want to say one more thing about this, because I think this is extremely important. We are a low-tax country, Senator. We are the second lowest-tax country in the OECD, but we do not take advantage of our low-tax status by having low income taxes because we rely entirely on income taxes and do not rely on consumption taxes in the way that the rest of the world does.

And so we basically have given ourselves a disadvantage by not taking advantage of our status as a low-tax country and taxing consumption, and thereby reducing taxes on capital, both capital invested here and, I think, capital invested by Americans abroad, because otherwise I think we are going to find our economy in great difficulty.

Senator WYDEN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, all of you. This has been a very thoughtful discussion. I deeply appreciate all four of you. You have contributed so much to this, and I suspect we are going to have a lot more conversations like this down the road. But this has been very helpful, very constructive, and I very much appreciate your help.

The hearing is adjourned.

[Whereupon, at 11:42 a.m., the hearing was concluded.]

# APPENDIX

## ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

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### Statement of Senator Jim Bunning June 27, 2007

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Thank you, Mr. Chairman.

The Alternative Minimum Tax (AMT) is a ticking time bomb, and I am glad we are taking time to talk about ways to defuse it before it causes one of the largest tax increases in U.S. history.

History has taught Americans to be wary when the tax man calls. When the 16th Amendment was ratified in 1913, members of Congress promised it would only apply to the very wealthy. Congress created the AMT in 1969 to force 155 wealthy individuals, who had previously escaped the income tax, to pay their taxes. In 2007, 6 million taxpayers were subject to the AMT. Next year, 26 million taxpayers will be subject to the AMT.

The AMT is a good example of what happens when tax writers target the rich: we end up hitting the middle class. How much will it cost to now patch the AMT? This year, the cost of extending the patch is in the tens of billions of dollars with that figure ballooning to hundreds of billions next year.

It is time for this Committee, and for the Senate as a whole, to examine whether this tax is serving its original purpose. I believe it is not.

I have been involved in AMT legislation for many years. I supported the Economic Growth and Tax Relief Reconciliation Act of 2001 which permanently allowed tax credits to be claimed against the full amount of a taxpayer's regular income tax and alternative minimum tax, and temporarily increased the AMT exemption amount. In May 2006, I supported the Tax Increase Prevention and Reconciliation Act of 2005 which included a one-year extension of both the AMT's personal-credit and increased-exemption provisions. More recently, I supported Ranking Member Grassley's efforts to include a full repeal of this unfair tax on the middle class during the debate on the budget, and I will continue to support efforts to scale back or repeal this tax.

I look forward to our witnesses' testimony.

Thank you.

Statement of

Leonard E. Burman<sup>1</sup>  
Director, Tax Policy Center  
Senior Fellow, the Urban Institute  
[www.taxpolicycenter.org](http://www.taxpolicycenter.org)

Before the  
United States Senate  
Committee on Finance

The Individual Alternative Minimum Tax

June 27, 2007

Chairman Baucus, Ranking Member Grassley, Members of the Committee: Thank you for inviting me to share my views on the individual alternative minimum tax.

A precursor to the current individual alternative minimum tax (AMT) was originally enacted in 1969 to limit the amount of tax sheltering that taxpayers could pursue and to ensure that high-income filers paid at least a minimal amount of tax.<sup>2</sup> The current AMT, however, has strayed far from those original goals. Under current law, the tax will affect more than 23 million taxpayers in 2007, mainly for reasons that have nothing to do with tax sheltering. The AMT is expected to generate more than \$800 billion in revenue over the next ten years under current law, a figure that rises to \$1.5 trillion if the 2001–2006 tax cuts are extended. In short, the AMT threatens to grow from a footnote in the tax code to a major scourge affecting tens of millions of taxpayers every year.

As you well know, the practice in recent years has been to patch the AMT every year or two on a temporary basis so that not too many people are affected. The latest patch expired at the end of 2006. This stopgap approach leads to endless confusion. How much estimated tax should I pay?

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<sup>1</sup> My testimony draws heavily on joint work with my Tax Policy Center colleagues, Jeff Rohaly, Greg Leiserson, and Bill Gale. Views expressed are my own and should not be attributed to the Urban Institute, its trustees, or its funders.

<sup>2</sup> The original minimum tax was an addition to regular income tax. The current AMT is a floor on total tax liability. For details, see Joint Committee on Taxation (2007) or Burman, Gale, and Rohaly (2005).

What is my tax bracket? Would I benefit from the tax credit for hybrid vehicles if I bought one? More than 23 million people don't know the answer to these questions.

I applaud this committee for seeking a permanent solution to the AMT's problems and hope that you will do it in a fiscally responsible manner. Some influential members have claimed that, since the AMT would hit millions of people it was never intended to affect, we should never have counted on AMT revenue and its loss need not be offset. With all due respect, that argument would have been more persuasive in 2001 when surging AMT revenues helped make the case for the affordability of the ensuing tax cuts. Moreover, the AMT has masked much of the cost of the tax cuts since people on the AMT do not get the full benefit of income tax rate reductions. Eliminating the AMT after its existence has enabled the largest tax cuts in history without offsetting the lost revenue would amount to a major bait and switch.

Fortunately, fiscally responsible alternatives to the AMT exist. In my testimony, I describe several such options. My favorite option is a 4 percent surtax on adjusted gross income (AGI) over \$200,000 for couples and \$100,000 for others. The surtax would be more in keeping with the AMT's original purpose—making sure that high-income people paid at least some tax—and it would be simple and progressive. The vast majority of taxpayers subject to the AMT would pay lower taxes. What's more, since the AMT includes very high implicit tax rates—disincentives to work and save—the surtax alternative would actually represent a cut in effective tax rates for most people.

My testimony outlines how the AMT works, whom it affects, why it demands attention, and why financing AMT repeal or reform is important. I lay out a number of fiscally responsible options to fix or eliminate the AMT and discuss their effects on the distribution of tax burdens, the number of AMT taxpayers, and marginal tax rates.

#### **How Does the AMT Work?**

The individual AMT operates parallel to the regular income tax with a different income definition, rate structure, and allowable deductions, exemptions, and credits. In short, after calculating regular tax liability, taxpayers must calculate their "tentative AMT" under the alternative rules and rates and pay whichever amount is larger. To calculate tentative AMT, taxpayers must first determine their alternative minimum taxable income (AMTI) and then subtract the applicable AMT exemption amount (which is subject to phase-out), calculate tax under the AMT rate schedule, and subtract any applicable credits. Technically, AMT liability is the excess, if any, of tentative AMT above the amount of taxes due under the regular income tax alone.

Alternative minimum taxable income is the sum of three components: regular taxable income for AMT purposes, AMT preferences, and AMT adjustments. Regular taxable income for AMT purposes is basically the same as taxable income used for regular tax purposes, except it is allowed to be negative if deductions exceed gross income.

An AMT preference is an item identified as a potential tax saving in the regular income tax that is not permitted in the AMT. An AMT adjustment is simply any other exclusion, exemption, deduction, credit, or other treatment (such as a method for computing depreciation) in the regular

income tax that is either restricted or disallowed in the AMT. Because there is generally no important economic distinction between preferences and adjustments, I will refer to both as preferences.

Interesting distinctions emerge among the various preferences themselves, however. Preferences are of two types: exemptions or deferrals. Exemption preferences broaden the AMT tax base and include the disallowance of personal exemptions, the standard deduction, and itemized deductions for miscellaneous expenses and state and local taxes. Deferral provisions change the timing of the recognition of income and deductions, typically to accelerate income and postpone deductions. Thus, they tend to raise the current-year tax base—and hence revenues—but only at the expense of future tax bases and tax collections.

Middle-income AMT taxpayers are primarily affected by the exemption preferences, which are added to taxable income. The exemption measures might be interpreted as an effort to reduce tax incentives generally and move toward an alternative tax base that is broader than the regular income tax base.

Deferral preferences outnumber exemption preferences, but they are used much less frequently, tend to be used by high-income taxpayers, and generate much less revenue. Deferral items tend to be complex; taxpayers generally need to recalculate income and costs using different schedules and keep separate books for regular tax and AMT purposes. Also, taxpayers may use AMT liability created by deferral provisions—but not by exemption provisions—as a credit against future years' regular tax liability in excess of the tentative AMT. The deferral provisions, coupled with the credit they create, are consistent with a policy goal of having every high-income filer pay some positive tax in each year, even if his or her overall multiyear tax liability does not change.

The Joint Committee on Taxation (2007) estimates that the three largest AMT preference items in 2006 were exemption preferences that few would consider to be aggressive tax shelters: deductions for state and local taxes (63 percent); personal exemptions, including exemptions for dependent children (22 percent); and miscellaneous itemized deductions, such as for unreimbursed business expenses (11 percent). As the AMT encroaches on more and more middle-income taxpayers, the share of the total accounted for by personal exemptions will rise to more than 40 percent as the share accounted for by the deduction for state and local taxes falls. The standard deduction will increase from 1 percent of the total in 2006 to 6 percent in 2007.

After adding back their preference items and determining alternative minimum taxable income, taxpayers may then subtract an AMT exemption amount of \$45,000 for couples or \$33,750 for singles and heads of household. That exemption is limited, however, for taxpayers filing joint returns with AMTI over \$150,000 (\$112,500 for singles and heads of household).<sup>3</sup> AMTI less any applicable exemption is taxed at two rates—26 percent on the first \$175,000 and 28 percent on any excess above that amount. As under the regular income tax, capital gains and dividends

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<sup>3</sup> The exemption is reduced by 25 percent of the amount that AMTI exceeds the relevant threshold. As a result, married couples filing joint returns can claim no exemption if their AMTI exceeds \$330,000; single filers and heads of household get no exemption if their AMTI is greater than \$247,500.



are subject to lower tax rates. If the resulting “tentative AMT” is greater than tax before credits calculated under the regular income tax, the difference is payable as AMT.<sup>4</sup>

That comparison means that anything that reduces the regular income tax relative to the AMT or that increases the tentative AMT relative to the regular income tax will move taxpayers onto the AMT. For example, a reduction in regular income tax rates not matched by a comparable change in the AMT would make more taxpayers subject to the AMT. The converse is also true: increasing regular income taxes or cutting AMT taxes would move some taxpayers off the AMT. If the 2001 and 2003 tax cuts are allowed to sunset after 2010 as scheduled, for example, fewer taxpayers will owe AMT, albeit only because their regular tax bills will have increased.

Congress has limited the AMT’s reach in recent years by temporarily increasing the AMT exemption and allowing the use of personal nonrefundable credits against the AMT.<sup>5</sup> For the 2006 tax year, for example, Congress raised the exemption from \$45,000 to \$62,550 for couples and from \$33,750 to \$42,500 for single filers and heads of household. Those changes kept 16.5 million taxpayers from falling into the AMT’s clutches. Because those adjustments were temporary, Congress will need to pass additional legislation to prevent a sharp rise in the number of taxpayers subject to the AMT, from about 4 million in 2006 to more than 23 million in 2007.

Box 1 shows the calculation of AMT for a married couple having four children and earning \$75,000 in 2007. It illustrates how the AMT will ensnare even middle-class families with very straightforward tax returns if Congress does not act.

#### **Whom Does the AMT Affect?**

Under current law, the AMT affected about 4 million taxpayers in 2006.<sup>6</sup> With the expiration of the temporary AMT “patch” at the end of last year, the number of AMT taxpayers will increase dramatically in 2007 to 23 million, and continue to grow through 2010, eventually reaching 32 million, or more than a third of all taxpayers. With the expiration of most of the 2001–2006 tax cuts in 2011, the number of AMT taxpayers will fall to 18.5 million, before again marching steadily upward to hit 39.1 million by 2017. If the 2001–2006 tax cuts are extended, 52.6 million taxpayers—almost half of all taxpayers—will pay the AMT by 2017.

<sup>4</sup> To be precise, the foreign tax credit is calculated before calculating the AMT and incorporated into the comparison between regular tax liability and AMT liability. Most credits, however, are calculated after both regular tax and AMT liability and do not affect the taxpayer’s direct AMT liability.

<sup>5</sup> Other personal credits, such as the earned income tax credit, were allowed against the AMT by tax law changes included in the Economic Growth and Tax Relief Reconciliation Act of 2001 and will remain in place through 2010.

<sup>6</sup> Unless otherwise noted, estimates in this testimony are based on the Urban–Brookings Tax Policy Center’s microsimulation model of the federal tax system. Taxpayers affected by the AMT include those with direct AMT liability, those whose credits are limited by the AMT, and those who choose to take itemized deductions that are lower than their standard deduction in order to reduce or eliminate their AMT liability. Our estimates differ slightly from those reported by the Joint Committee on Taxation (2007) because of differences in underlying data, assumptions about growth of income over time and other factors, and definitions of what it means to be affected by the AMT. (I present our estimates rather than the JCT’s simply for purposes of internal consistency, since the JCT did not report all of the statistics I refer to in my testimony.) See Leiserson and Rohaly (2006) for further details on the Tax Policy Center’s methodology.

**Box 1. Calculating the AMT in 2007**

A married couple with four children under age 17 has an income of \$75,000 from salaries and interest on their savings account. Under the regular income tax, the family can deduct \$20,400 in personal exemptions for themselves and their children. They can also claim a \$10,700 standard deduction. For the regular tax, their taxable income of \$43,900 places them in the 15 percent tax bracket, and they owe \$5,803 in taxes before calculating the AMT or tax credits. A child tax credit of \$4,000 (\$1,000 per child) is allowed against both the AMT and the regular income tax. Their regular income tax after credits would be \$1,803.

To calculate AMT liability, the couple adds preference items—personal exemptions of \$20,400 and the standard deduction of \$10,700—to taxable income and subtracts the married-couple exemption of \$45,000, yielding \$30,000 in income subject to AMT. That amount is taxed at the first AMT rate of 26 percent, for a tentative AMT liability of \$7,800. The AMT equals the difference between the couple's tentative AMT and their regular income tax, or \$1,997. Thus, the AMT more than doubles this couple's taxes—from \$1,803 to \$3,800.

Two points about this example are worth noting. First, the family is on the AMT because they have four children, not because they are rich or aggressive tax shelterers: the family has no deferral preferences, no itemized deductions, no capital gains, and no other complicating factors. Second, the couple received no benefit from the new 10 percent rate bracket or higher standard deduction for couples enacted in 2001, because their income tax liability is set by the AMT, not the regular income tax.

AMT Calculation  
Married couple filing jointly with four children, 2007

<b>Calculate Regular Tax</b>		<b>Calculate Tentative AMT</b>	
Gross income	\$75,000	Taxable income	\$43,900
<i>Subtract deductions</i>		<i>Add preference items</i>	
Personal exemptions (6 x \$3,400)	\$20,400	Personal exemptions	\$20,400
Standard deduction	\$10,700	Standard deduction	\$10,700
		<b>AMTI</b>	<b>\$75,000</b>
<b>Taxable income</b>	<b>\$43,900</b>	<i>Subtract AMT exemption</i>	
<b>Tax before credits</b>	<b>\$5,803</b>	AMT exemption	\$45,000
<b>Child tax credit</b>	<b>\$4,000</b>	<b>Taxable under AMT</b>	<b>\$30,000</b>
<b>Tax after credits</b>	<b>\$1,803</b>	<b>Tax (tentative AMT)</b>	<b>\$7,800</b>
<i>Tax bracket</i>	15%	<i>AMT bracket</i>	26%

**AMT = the excess of tentative AMT over regular income tax before credits**

$$\text{AMT} = \$7,800 - \$5,803 = \$1,997$$

$$\text{Tax after AMT and Credits} = \$1,803 + \$1,997 = 3,800$$

Although most AMT taxpayers are moderately well off, the tax is steadily encroaching on families that most would consider solidly middle-class. By 2010, half of all tax filers making between \$75,000 and \$100,000 will pay the AMT, up from 36 percent this year and less than 1 percent in 2006, when the temporary AMT fix was still in place (table 1).<sup>7</sup>

Although the AMT may have originally been intended to prevent high-income individuals from sheltering all of their income and paying no tax, it now affects more tax filers with moderately high incomes than it does at the very top of the income scale. Since the 35 percent top rate of the regular income tax exceeds the 28 percent top statutory rate of the AMT, individuals with very high incomes who do not shelter a substantial portion of it will end up in the regular tax system. In 2006, only 31 percent of filers with incomes above \$1 million were affected by the AMT, compared with 51 percent of those with incomes between \$200,000 and \$500,000. By 2010, the difference is even starker: only 39 percent of millionaires will pay the AMT, but 94 percent of those in the \$200,000 to \$500,000 income class will.

What's more, many tax shelters exploit the difference in tax rates between long-term capital gains, which face a maximum tax rate of 15 percent, and ordinary income, which can be taxed at rates as high as 35 percent under the regular income tax. However, the lower capital gains tax rate is not considered an AMT preference item, so high-income taxpayers who report a large amount of capital gains receive the same tax break under the AMT as under the regular income tax. In contrast, before 1987, the tax break on capital gains was considered a preference item and was, in fact, the largest one.

In addition to being in certain income classes, taxpayers with any of several common situations are more likely than others to find themselves on the AMT:

**Large Families.** Personal exemptions are allowed against the regular income tax, but not the AMT. Taxpayers with large families have many personal exemptions, which significantly reduce their regular income tax liability relative to tentative AMT. In 2006, taxpayers with three or more children were almost four times as likely to owe AMT as those with no children (table 1). By 2010, almost half of families with three or more children will find themselves on the AMT, compared with only 17 percent of those without children.

**High State and Local Taxes.** State and local taxes are deductible under the regular income tax, but not the AMT. Thus, high state and local taxes reduce regular tax liability relative to AMT, increasing the likelihood that a taxpayer will owe AMT. This helps explain why, in 2004, taxpayers in the New York area, the District of Columbia, and California were most likely to owe AMT (Burman and Rosenberg 2006). They not only faced higher-than-average state and local tax burdens, but they also had higher-than-average incomes, making them substantially more likely than the average taxpayer to be subject to AMT. In 2006, households in high-tax states were almost three times more likely to be on the AMT than those in low-tax jurisdictions (table 1). With the dramatic growth of the AMT over the rest of this decade, however, this

<sup>7</sup> Tax filers include all nondependent tax units filing an income tax return, regardless of whether they owe income tax. Taxpayers include all nondependent tax units with positive income tax liability after credits. The Joint Committee on Taxation (2007) reports estimates for "taxpayers," which they define as all tax-filing units, including those that do not file tax returns and dependent returns.

**Table 1**  
**AMT Participation Rate (percent) by Individual Characteristics**

Group	Current Law				Current Law Extended <sup>a</sup>	Pre-EGTRRA Law	
	2006	2007	2010	2017	2017	2007	2010
<b>All Taxpayers<sup>b</sup></b>	4.0	25.9	33.6	34.7	48.6	10.6	16.0
<b>All Tax Filers</b>	2.8	18.4	24.5	27.8	37.4	8.0	12.4
<b>Tax Filers by Cash Income (thousands of 2006\$)<sup>c</sup></b>							
Less than 30	*	*	*	0.1	0.1	*	*
30-50	*	1.3	3.0	12.2	13.0	1.4	2.9
50-75	0.2	9.0	17.1	30.1	38.8	6.9	13.1
75-100	0.7	36.2	49.9	53.7	67.2	18.1	26.1
100-200	4.8	70.8	80.4	61.7	92.3	23.4	32.0
200-500	50.9	89.7	94.3	77.7	96.8	41.3	54.2
500-1,000	49.3	57.2	72.2	27.0	73.8	22.0	22.6
1,000 and more	31.4	33.8	38.8	20.3	40.1	20.3	19.1
<b>Tax Filers by Number of Children<sup>d</sup></b>							
0	1.9	11.4	16.8	15.9	28.5	2.4	3.9
1	2.7	24.8	32.4	40.9	48.4	7.1	16.0
2	5.0	34.5	42.0	34.8	56.6	22.2	34.0
3 or more	7.4	39.6	48.4	65.3	64.4	39.8	50.3
<b>Tax Filers By State Tax Level</b>							
High	4.6	21.8	27.7	31.6	40.7	10.9	16.2
Middle	2.3	18.5	25.0	28.3	37.9	7.7	12.0
Low	1.6	15.3	21.1	23.8	33.9	5.7	9.2
<b>Tax Filers by Filing Status</b>							
Single	0.9	2.4	3.8	4.7	10.5	1.1	1.7
Married Filing Joint	5.1	36.7	47.9	49.7	67.2	14.5	22.2
Head of Household	1.3	10.4	17.0	33.1	35.0	8.3	14.5
Married Filing Separate	5.7	34.5	47.4	48.7	62.9	12.8	17.6
<b>Married Couple, 2+ Kids, 75k&lt;Cash Income&lt;100k</b>	0.2	59.1	73.6	92.3	92.8	57.5	74.3
<b>Married Couple, 2+ Kids, 75k&lt;AGI&lt;100k</b>	0.8	78.2	88.6	97.7	97.8	68.8	86.4

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1).

Notes:

Includes returns with AMT liability on Form 6251, with lost credits, and with reduced deductions. Tax units who are dependents of other tax units are excluded from the analysis.

\* Less than 0.05 percent.

(a) Includes all 2010 sunset provisions in current law.

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

(c) Tax units with negative cash income are excluded from the lowest income class. For a description of cash income, see <http://www.taxpolicycenter.org/TaxModel/income.cfm>.

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

differential is slated to fall dramatically. By 2010, residents of high-tax states will only be about 30 percent more likely to fall prey to the AMT than those in low-tax states (28 percent of households in high-tax states will face the AMT, compared with 21 percent in low-tax states.)

**Marriage.** Most married couples pay less tax under the regular income tax than they would if they were single. (That is, most “marriage penalties” have been eliminated and many couples receive “marriage bonuses.”) This is not true under the AMT. AMT tax rate thresholds are identical for married and single taxpayers and the AMT exemption is only 33 percent larger for couples than for singles (except for those for whom the exemption has been phased out). In

contrast, the standard deduction for couples under the regular income tax is twice that for singles. The combination of the AMT marriage penalties, the fact that married couples often have children, and the fact that married couples tend to have higher household incomes resulted in married couples being more than five times as likely to owe AMT as singles in 2006. In 2007, with expiration of the temporary AMT fix, married couples are 15 times more likely to owe AMT than singles (table 1).

Taxpayer characteristics can combine to create very high probabilities of falling prey to the AMT. For example, absent a change in law, the AMT will become the *de facto* tax system for upper-middle-class families with children. In 2006, the AMT affected less than 1 percent of married couples with two or more children and adjusted gross income between \$75,000 and \$100,000, but by 2010 that share will rise to 89 percent (table 1).

Other common situations that make a taxpayer more likely to incur the AMT include having high medical expenses or simply taking the standard deduction. Taxpayers may deduct medical expenses in excess of 7.5 percent of AGI under the regular income tax, but the threshold is 10 percent of AGI under the AMT. Thus, taxpayers with both high incomes and high medical expenses can be hit hard by the AMT. Even claiming the standard deduction can force an individual into AMT territory. Although most AMT taxpayers itemize deductions, the standard deduction under the AMT is worthless for the few who claim it: it reduces regular tax liability without affecting tentative AMT.

Finally, current AMT rules allow for the possibility of very perverse outcomes. Under the regular tax, filers may deduct legal fees incurred in cases that generate taxable damages (such as punitive damages or damages for nonphysical injuries) as miscellaneous itemized deductions to the extent that they exceed 2 percent of adjusted gross income. However, the AMT disallows miscellaneous deductions. As a result, a taxpayer with substantial legal fees will have much less taxable income under the regular tax than under the AMT. If the legal fees are high relative to the damage award, the taxpayer can actually owe more AMT than her net gain from a lawsuit (Johnston 2003).

The exercise of incentive stock options generally creates income that is immediately taxable under the AMT but is not taxable under the regular income tax until the stock is actually sold. Individuals must include in AMTI the excess of the fair market value of the stock over the purchase price of the stock at the date of exercise (JCT 2006). This can cause taxpayers with very modest cash incomes to owe substantial AMT. If the stock is ultimately sold at a profit, the AMT paid earlier can be taken as a credit against the regular income tax owed. But if the stock price falls, the taxpayer can end up with a substantial AMT liability even though no income is ever realized.<sup>8</sup>

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<sup>8</sup> The Tax Relief and Health Care Act of 2006 allows certain taxpayers to claim a refundable credit for 20 percent of their unused long-term alternative minimum tax credits (up to \$5,000) per year. The refundable credit phases out for high-income taxpayers. The refundable AMT credits can generally only be claimed for tax years 2007–2012 (JCT 2006 and personal communication from Jerry Tempalski).

### **Why Is the AMT Becoming a “Mass Tax”?**

Although the factors described above help explain why individual taxpayers are affected by the AMT, they do not explain the dramatic growth in the AMT. Two factors reduce regular income tax liabilities relative to tentative AMT over time and largely explain the explosive growth in AMT projected through 2010 and beyond.

Inflation. The AMT is not adjusted for inflation, whereas the regular income tax is. This means that if an individual’s income just keeps pace with inflation each year, his or her regular income tax would remain constant (in real terms) while AMT liability would rise. The Joint Committee on Taxation (2007) estimates that the number of AMT taxpayers in 2010 would be reduced by about 88 percent (27 million) if the exemption had been indexed for inflation since 1987.<sup>9</sup>

The 2001–2006 Tax Cuts. The tax cuts reduced regular income tax liability, but made only temporary changes to the AMT. As a result, regular income tax declined relative to AMT liability, dramatically increasing the number of taxpayers subject to the AMT. In 2007, about 23 million taxpayers will be subject to the AMT under current law, more than double the 10.2 million that would have been affected had the tax cuts not been enacted.

Lindsey (2000) attributes much of the AMT growth to the AMT changes made in 1993. In fact, however, the 1993 changes, which raised rates in both the regular income tax and the AMT, but also increased the AMT exemption, served on net to reduce the number of AMT taxpayers. While 23.4 million taxpayers will face the AMT in 2007 under current law, if the AMT rates and exemption had remained at their pre-1993 levels, we estimate that 26.6 million taxpayers would face the AMT.

### **Should We Care about the Dramatic Growth of the AMT?**

While many people decry the expanding reach of the AMT, others assert there is no cause for concern. Some argue that the complexity taxpayers face in calculating their taxes twice is not a reason to do away with the AMT, but rather cause to eliminate the regular tax. Others contend that the growing prevalence of tax preparation software negates any problems of complexity. In fact, both of those arguments have significant flaws.

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<sup>9</sup> Real income growth also causes more taxpayers to become subject to the AMT over time because *effective* AMT tax rates are much higher than regular income tax rates for most taxpayers. (See Burman, Gale, and Rohaly 2005 for a discussion.) Thus, in most cases, the more income that is subject to AMT, the more likely it is that tentative AMT will exceed regular income tax. This is especially a problem for taxpayers in the phase-out range for the AMT exemption who are effectively taxed at rates 25 percent higher than the statutory AMT rate. The 26 percent rate becomes 32.5 percent; the 28 percent rate becomes 35 percent. This explains why almost all taxpayers with incomes between \$200,000 and \$500,000 are affected by the AMT (table 1). Real income growth is a minor factor in projected AMT growth compared to the lack of indexation and the impact of the tax cuts, however. Only 777,000 taxpayers would be subject to the AMT in 2011 if the AMT were indexed back to 1987 levels, according to the Joint Committee on Taxation. If the tax cuts are extended, about five times as many people would be affected, even with indexation.

*Why not repeal the regular income tax?*

Some people, observing the complexity of having two parallel methods of calculating taxes, argue that the best solution is to repeal the regular income tax. This option would have several advantages according to its proponents. They claim that the AMT is nearly a flat-rate tax with only two statutory rates, 26 and 28 percent, both of which are significantly lower than the top statutory rate of 35 percent under the regular income tax. In addition, the AMT applies those lower rates to a broader income base, since it eliminates various special tax breaks that exist in the regular tax system. They therefore conclude that it is a more efficient way of raising revenue than the regular tax system.

This analysis is incorrect for several reasons.<sup>10</sup> First, the AMT actually imposes four marginal tax rates, not two. The phase-out of the AMT exemption creates higher phantom tax rates of 32.5 and 35 percent, the latter equal to the top rate under the regular income tax (table 2).<sup>11</sup> And in fact, significantly more taxpayers face higher effective marginal tax rates under the AMT than they would under the regular income tax. In 2006, 71 percent of AMT taxpayers faced a higher marginal rate under the AMT; that figure will rise to 89 percent by 2010 as the AMT ensnares more and more middle-income filers who would have faced statutory rates of 15 or 25 percent under the regular income tax (Leiserson and Rohaly 2006).

**Table 2. Effective Tax Rates on Ordinary Income and Capital Gains under the AMT, by Income, 2007**

Income (AMTI) in Dollars		Tax Rate (Percent)	
Single	Joint	Ordinary Income	Capital Gains
33,750–112,499	45,000–149,999	26	15
112,500–189,499	150,000–205,999	32.5	21.5
190,000–247,499	206,000–329,999	35	22
247,500 and over	330,000 and over	28	15

Second, as described above, some of the base broadeners in the AMT have questionable validity as policy. In addition, the relatively high AMT exemption means that the AMT tax base is often smaller than the regular income tax base because the AMT exemption is larger than the total of all preference items for most taxpayers. In 2006, 63 percent of AMT taxpayers had more income subject to tax under the regular tax than they did under the AMT. That number will rise to 87 percent by 2010 (Leiserson and Rohaly 2006).

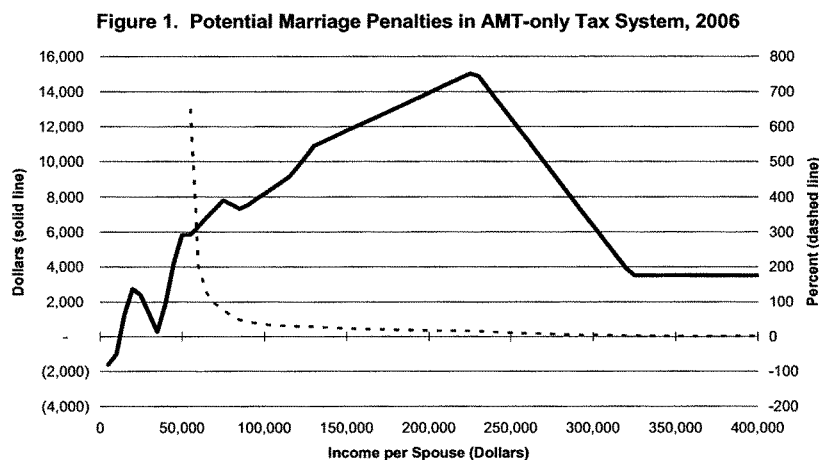
Thus, the conventional wisdom that the AMT applies a lower marginal tax rate to a broader income base and is therefore more efficient than the regular tax system is incorrect. In fact,

<sup>10</sup> For more detailed discussion, see Burman and Weiner (2005).

<sup>11</sup> Although the AMT generally preserves the lower statutory tax rates on capital gains and qualified dividends that exist under the regular tax system, the effect is diminished by the phase-out of the AMT exemption. Rather than the advertised 15 percent rate, taxpayers with incomes in the phase-out range can face effective marginal tax rates as high as 22 percent on gains and dividends. See Leiserson (2007) for details.

exactly the opposite is true. Most AMT taxpayers face a higher marginal rate applied to a more narrow tax base than they would if they were in the regular tax system.

As noted, the AMT also creates enormous marriage penalties. If the AMT were the only tax system, a married couple with two children earning \$100,000 split equally between the two spouses would pay \$5,837 more in taxes than they would if they were single and one spouse claimed custody of the children in 2006 (figure 1). At higher incomes, the marriage penalty would grow even larger, reaching a maximum of over \$15,000 for couples with incomes of about \$450,000 (although marriage penalties under current law are nearly as large at such high income levels).



Note: Chart assumes family of four with two children under age 17 (qualifying for child and earned income tax credit) in which each spouse has equal income. Itemized deductions allowed against AMT are assumed to be 12.6 percent of AGI. Marriage penalty calculated as the difference between the tax paid on a joint return and the sum of the tax paid on a head of household return with two children and a single return with no children.

Finally, if the AMT were the default tax system, the rightly reviled phenomenon of “bracket creep” would return with a vengeance. Since none of the AMT parameters are adjusted for inflation, people’s tax bills would increase as a share of their income even if their income just kept pace with inflation—because more and more income would be above the exemption threshold (and for high-income taxpayers, more would be subject to the exemption phaseout and the 28 percent tax brackets).

#### *Complexity*

Policy analysts sometimes assert that the complexity of calculating taxes under both the regular tax and the AMT does not pose a real problem. Relatively few taxpayers prepare their own tax returns, they argue, and instead rely on tax preparation software, which calculates the AMT



automatically, or paid tax preparers. It is true that the AMT is less complex for filers who use tax preparation software or a paid preparer, but at the cost of the income tax system's transparency. The fact that the tax system is a black box for so many people is something to regret, not champion.

In order to make informed decisions about work, saving, retirement, education, and other important matters, people should understand how the tax system affects those choices, but the AMT leads to endless confusion. Taxpayers will have a hard time predicting their marginal tax rate if they do not know whether they will be on the AMT. What's more, many people may be confused about what constitutes an AMT preference item. For example, *Consumer Reports* magazine reported in the February 2007 issue that the AMT is "snagging middle-income taxpayers with big families, people who pay lots of state tax, and those with high mortgage interest." Mortgage interest, of course, is not an AMT preference item (except on home equity lines and second mortgages used to pay for nonhousing expenses). And needless complexity contributes to public perceptions that the income tax system is unfair.

In any case, computer software has its limitations. For example, individuals who were on the AMT in the previous year must figure out the state tax deduction that would have been allowed on their prior-year tax return before they were subject to the AMT. This is necessary in order to figure out how much of their state tax refund in the current year is taxable. This calculation is so complex that my tax software doesn't do it. It recommends that I go back to my prior-year return, and keep refiguring my state tax deduction over and over until the AMT gets down to zero. This is complex even with software. Without it, the computation would be mind-numbing.

A second example involves the choice between itemizing and taking the standard deduction. Under the regular income tax, taxpayers claim the standard deduction as long as it exceeds the amount of itemized deductions. But taxpayers on the AMT should itemize even if their standard deduction is greater, as long as their non-preference itemized deductions exceed the portion of the standard deduction that makes their regular tax less than the AMT. Even though the AMT disallows the standard deduction, some taxpayers who do not owe much AMT (i.e., whose tentative AMT is not that much more than their tax under the regular system) get a partial benefit from the standard deduction. That is, they would not be on the AMT if they did not take the standard deduction. Does that sound complicated? It is. The last time I checked, my tax software did not deal with that issue either. Taxpayers should not have to figure this out for themselves.

#### *A "blue state" tax?*

Some partisans have suggested that the AMT is primarily the Democrats' problem because taxpayers in "blue states"—those who tend to vote for Democrats in national elections—are much more likely to owe AMT than those in "red states"—those who tend to vote Republican—to owe AMT. Although there has been an element of truth to this claim in the past, it is less relevant now. Absent a fix, the AMT will affect large numbers of taxpayers in all states starting this year. The tax especially affects middle- and upper-income families with children—the soccer moms and dads that both parties have courted in the past.

Even in 2004, when the AMT affected only about 2.5 percent of taxpayers nationwide, data from the IRS show that almost every state had hot spots with large percentages of taxpayers subject to the AMT (table 3). Almost half of states had at least one zip code with more than 20 percent of returns on the AMT. All but eight states had at least one zip code in which 10 percent or more returns were subject to the tax.

#### *Revenue*

Is there anything positive to say about the AMT? Over the long run, the AMT in its current form will become a more effective revenue generator than the regular income tax. The AMT will raise federal revenues by more than \$800 billion over the next 10 years under current law and by \$1.5 trillion if the 2001–2006 tax cuts are extended. Indeed, our estimates show that in 2007, it would cost less to eliminate the regular income tax than to eliminate the AMT. Over a longer time horizon, the Congressional Budget Office (2003) estimates that, primarily because of the AMT, federal taxes will claim 25 percent of GDP by 2050, compared with just under 19 percent today. That influx of revenue could help fund growing entitlement programs such as Social Security and Medicare as the baby boom generation retires.

But the AMT's power as a revenue generator stems entirely from the fact that its parameters are not indexed for inflation. In consequence, people whose incomes only just keep pace with inflation will face higher and higher average tax rates over time (a phenomenon sometimes referred to as bracket creep). And more and more people will find themselves in this situation as they become subject to the AMT over time.

Given this and all the other design flaws inherent in the AMT—marriage and family penalties, higher marginal tax rates likely to discourage working and saving and encourage inefficient tax avoidance behavior, and needless complexity—reforming or repealing the AMT in conjunction with reforming the regular income tax is far preferable to making the AMT the basis of our tax system.

#### **Drawbacks of the Patch**

I applaud the Chairman and Ranking Member for their commitment to finding a permanent solution to the AMT. The recent practice of temporarily increasing the exemption on a one- or two-year basis subjects taxpayers to tremendous uncertainty. They often do not know until late in the year whether they are going to be subject to the AMT and, if so, at what level. For example, in 2006, a patch was not enacted until May—after a substantial share of estimated tax payments and payroll withholding had been remitted for the year. Up until that point, taxpayers had to guess about whether they might owe as much as \$4,000 or more in additional tax if the patch legislation did not pass. If they had guessed wrong, some could have been subject to penalties and interest for underpayment of estimated tax.

Taxpayers face even greater uncertainty this year, as Mr. Grassley implied in his floor statement on June 13 as the second quarter estimated tax payment deadline approached. In addition to the expiration of the patch, a provision that allows taxpayers to claim nonrefundable tax credits against the AMT also expired. Thus, taxpayers not only have to guess about their tax liability,

**Table 3. AMT Hot Spots in Each State, 2004**

State	Location	Zip Code	Percent on AMT	Statewide Percent on AMT	Average AMT (Dollars)	Average AGI (Dollars)
AK	Anchorage	99516	2	0.7	2,843	80,502
AL	Mountain Brook	35223	12	0.7	5,644	193,831
AR	Little Rock	72222	11	1.1	6,143	122,837
AZ	Paradise Valley	85253	14	1.3	10,196	352,910
CA	downtown LA	90071	34	4.0	10,901	378,733
CO	Castle Rock	80108	9	1.5	3,705	138,780
CT	Weston	06883	28	4.8	4,965	289,891
DC	Washington	20015	19	4.2	4,109	162,845
DE	Wilmington	19890	32	1.6	15,571	280,474
FL	Boca Grande	33921	28	1.5	13,569	487,888
GA	Sea Island	31561	41	1.9	11,787	592,116
HI	Honolulu	96802	10	1.6	7,615	150,852
IA	Urbandale	50323	11	1.3	2,793	117,852
ID	Sun Valley	83353	10	1.4	8,134	124,317
IL	Peoria	61629	28	2.0	4,795	187,727
IN	Indianapolis	46285	22	1.0	4,582	221,153
KS	Overland Park	66224	18	1.6	3,301	160,686
KY	Glenview	40025	29	1.4	5,091	228,400
LA	around Tulane	70161	45	1.0	5,947	199,619
MA	Weston	02193	35	3.8	9,117	702,161
MD	Potomac	20854	23	3.9	5,925	230,205
ME	Cumberland County	04110	23	1.9	6,899	202,318
MI	Southfield	48086	31	1.5	1,420	241,130
MN	St. Paul	55144	41	2.4	6,088	282,581
MO	Saint Albans	63073	22	1.3	5,041	318,127
MS	Jackson	39205	7	0.7	5,650	112,828
MT	Sweet Grass	59484	15	1.4	200	21,742
NC	Charlotte	28207	22	1.9	6,609	245,834
ND	Milnor	58060	7	0.8	577	34,205
NE	Lincoln	68520	12	1.6	5,108	139,401
NH	Rye Beach	03871	13	1.7	5,114	251,862
NJ	Mountain Lakes	07046	32	5.6	5,720	259,019
NM	Albuquerque	87122	8	1.1	3,339	105,104
NV	Henderson	89011	19	1.2	12,073	889,783
NY	Park Ave.	10172	65	5.1	2,790	293,196
OH	Cincinnati	45201	25	2.2	3,425	140,391
OK	Oklahoma City	73151	11	1.1	2,490	133,344
OR	Beaverton	97076	34	2.3	2,176	191,760
PA	Delaware County	19085	22	2.0	7,097	346,724
RI	East Greenwich	02818	13	2.7	4,132	109,471
SC	Greenville	29603	20	1.4	4,929	144,479
SD	North Sioux City	57049	3	0.6	5,904	140,220
TN	Memphis	38130	10	0.7	8,424	106,169
TX	Houston	77210	30	1.3	4,972	214,026
UT	Salt Lake City	84150	14	1.4	2,867	103,827
VA	Clifton	22024	29	2.6	2,813	215,582
VT	Norwich	05055	13	1.9	4,331	85,503
WA	Medina	98039	16	1.2	9,090	561,909
WI	Elm Grove	53122	16	2.0	4,704	146,717
WV	Charleston	25314	6	0.8	3,897	82,566
WY	Wilson	83014	8	0.9	10,327	287,880

Source: Tax Policy Center analysis of ZIP Code tables provided by the Statistics of Income Division of the Internal Revenue Service.

but they also have to wonder whether they will get any benefit from education credits, the child and dependent care tax credit, and the tax credit for fuel efficient vehicles, to name just a few. This uncertainty undermines the effectiveness of these tax incentives.

The political appeal of temporary fixes for the AMT is obvious—it is a lot easier to pay for a \$50 billion temporary patch than for a permanent fix that could reduce tax revenues by hundreds of billions of dollars. But the retroactive nature of the patches amounts to playing a game of “chicken” with the American taxpayer, who should not have to guess.

#### **Financing AMT Reform or Repeal**

Reforming or repealing the AMT is costly and financing that cost is important. Outright repeal of the AMT, without any other offsetting changes, would reduce tax revenues by more than \$800 billion through fiscal year 2017, *assuming that the 2001–2006 tax cuts expire after 2010*. If the tax cuts are extended, the 11-year revenue loss nearly doubles to almost \$1.6 trillion.

Some have pointed out that the AMT would tax people who were never its intended target and thus AMT revenues should never have been counted on. The real baseline, they assert, should assume no AMT. But that argument had at least as much salience in 2001, when AMT revenues were counted on to mask the true cost of proposed tax cuts. What’s more, if the baseline should exclude the AMT, then projections should have recognized that the nation’s fiscal position was worse than advertised.

In 2001, legislators understood that the AMT would “take back” a significant portion of the tax cuts and therefore keep their estimated cost within the tax bill’s \$1.35 trillion target.<sup>12</sup> By 2010, the AMT will reclaim almost 28 percent of the individual income tax cuts, including more than 70 percent of the cut that would have gone to taxpayers making between \$200,000 and \$500,000 (Leiserson and Rohaly 2006).

Repeal of the AMT would be not only prohibitively expensive but also extremely regressive. Nearly 96 percent of the tax cut arising from AMT repeal in 2007 would go to the top fifth of income earners and 80 percent would go to the top tenth. More than half would go to taxpayers with incomes greater than \$200,000. After-tax incomes of taxpayers with incomes between \$200,000 and \$500,000 would rise by 2.7 percent, or an average of nearly \$6,000. In contrast, taxpayers in the middle quintile of the income distribution would receive less than 1 percent of the benefits and would see their after-tax income rise by an average of only \$5.

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<sup>12</sup> House Ways and Means Committee Democratic staffer, Al Davis (2000), pointed out the interaction of the president’s proposals with the AMT a year before the legislation was considered by Congress. Larry Lindsey (2000), who advised the Bush campaign and later became a top economic adviser to the president, said that the failure to reform or eliminate the AMT was a matter of priorities given budget constraints: “Should additional revenue become available, reductions in the AMT might well be desirable.” The logical corollary to that statement given the dramatic deterioration of budget projections since 2000—when large surpluses were anticipated—is that AMT reform should only occur in a fiscally responsible way.

## Revenue-Neutral Options to Repeal or Reform the AMT

### *Repeal Options*

There are numerous options to finance repeal of the AMT. The best one would be to do it in the context of broad-based tax reform that could finance the revenue loss with the elimination of loopholes, deductions, and credits while keeping income tax rates low. President Bush's advisory panel on federal income tax reform proposed one such plan, but the deafening silence with which that panel's report was met suggests that the nation may not yet be ready for a major tax overhaul.

There are many stand-alone options to finance AMT repeal that would be significant improvements over current law. Four are outlined below: (1) imposing a 4 percent of AGI surtax above \$200,000 for couples (\$100,000 for singles); (2) repealing the state and local tax deduction and *reducing* income tax rates by 2 percent, (3) increasing regular income tax rates in the 25 percent and higher brackets by 15 percent, and (4) increasing regular income tax rates in the 25 percent and higher brackets by 12 percent and repealing the 2003 tax cuts for capital gains and qualified dividends.

One attractive option would be to combine AMT repeal with a 4 percent tax on AGI in excess of \$200,000 for married couples or \$100,000 for other tax filers.<sup>13</sup> This would sharply reduce the number of high-income tax filers who pay no federal income tax. It would be approximately revenue-neutral over the 2007–2017 budget window. Through 2010, even with the 4 percent add-on tax, the top effective tax rates on ordinary income and capital gains would remain below the pre-EGTRRA levels of 39.6 and 20 percent.

Some commentators have complained that the surtax would be counterproductive because it would raise marginal tax rates and spur tax avoidance.<sup>14</sup> However, the modest surtax would replace the high marginal tax rates that already exist under the AMT. In 2007, about three times as many people would face a cut in marginal tax rates on ordinary income as would face higher rates under the option (table 4). The vast majority of affected taxpayers with incomes under \$200,000 and more than a third of those affected with incomes between \$200,000 and \$500,000 would face lower effective rates. About 90 percent of tax units would see no change in their effective capital gains tax rates. For those with a change, the majority would pay higher rates, but a significant number of taxpayers would see a cut because of the elimination of the AMT exemption phaseout. The bottom line is that, unlike a rate increase alone, which would reduce incentives to work and save, the proposal improves work incentives for most taxpayers and is a mixed bag in terms of saving.

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<sup>13</sup> See Burman and Leiserson (2007) for more discussion of this option.

<sup>14</sup> See, e.g., Viard (2007).

**Table 4. Distribution of Tax Units by Change in Marginal Tax Rate for Four Options to Repeal the AMT, 2007**

Cash Income Class (thousands of 2006 dollars) <sup>a</sup>	Change in Marginal Tax Rate On Wages			Change in Marginal Tax Rate On Capital Gains		
	Percent with Increase	Percent with Decrease	Percent with No Change	Percent with Increase	Percent with Decrease	Percent with No Change
<b>Repeal AMT</b>						
Less than 100	0.1	5.5	94.4	1.0	1.1	97.9
100-200	4.6	63.0	32.4	20.7	18.5	60.8
200-500	20.7	68.4	10.8	18.5	58.2	23.3
500-1,000	38.9	17.1	44.0	32.9	9.7	57.3
More than 1,000	20.5	12.0	67.5	20.1	4.3	75.7
All	1.4	13.9	84.7	3.9	4.8	91.3
<b>Repeal AMT &amp; Implement 4% Surtax on AGI Above 100/200K</b>						
Less than 100	0.1	5.5	94.4	0.9	1.1	98.0
100-200	15.2	59.8	25.0	25.6	16.2	58.2
200-500	59.6	34.6	5.8	27.8	48.7	23.5
500-1,000	83.9	11.0	5.1	65.3	4.7	30.0
More than 1,000	90.8	7.9	1.4	69.5	2.6	27.9
All	4.2	12.5	83.3	5.0	4.2	90.8
<b>Repeal AMT, Repeal State and Local Tax Deduction &amp; Reduce Tax Rates by 2%<sup>b</sup></b>						
Less than 100	2.5	60.2	37.3	2.8	10.8	86.4
100-200	10.6	88.4	1.0	20.6	23.1	56.3
200-500	24.3	74.0	1.8	11.8	63.0	25.1
500-1,000	41.2	57.0	1.8	26.7	31.8	41.4
More than 1,000	22.1	75.3	2.7	13.4	41.1	45.6
All	4.3	63.5	32.2	5.2	13.9	80.9
<b>Repeal AMT &amp; Increase Top Three Tax Rates by 15%</b>						
Less than 100	0.2	5.5	94.3	0.9	1.1	98.0
100-200	17.0	58.1	24.8	19.7	16.4	63.8
200-500	68.1	24.6	7.3	19.9	54.2	25.9
500-1,000	79.9	13.7	6.5	58.2	5.9	35.9
More than 1,000	85.8	10.4	3.8	56.6	3.4	39.9
All	4.7	12.0	83.3	4.0	4.4	91.6
<b>Repeal AMT, Roll Back Capital Gains Rates, &amp; Increase Top Three Tax Rates by 12%</b>						
Less than 100	1.4	5.6	93.0	60.0	0.4	39.6
100-200	16.0	61.6	22.4	81.2	9.5	9.2
200-500	50.6	44.7	4.7	35.9	46.8	17.3
500-1,000	82.3	12.4	5.3	70.7	4.2	25.0
More than 1,000	89.6	8.6	1.8	70.5	2.6	26.9
All	5.1	13.0	81.8	61.5	2.9	35.7

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1).

Notes:

Calendar year. Baseline is current law.

(a) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see <http://www.taxpolicycenter.org/TaxModel/income.cfm>

(b) The estimates in this table show marginal rates for federal taxes holding constant state taxes paid. A more complete consideration of marginal rates without this limitation would show somewhat different results.

This option is highly progressive. Taxpayers in the 60th through 99th percentiles would, on average, receive a tax cut from the proposal through 2010 (table 5). The proposal also has the advantage of returning the AMT to its original purpose—guaranteeing that high-income people pay at least some tax. Like the original minimum tax, the surtax is an addition to regular tax rather than an alternative tax system. It would be extremely simple to calculate. And it would significantly reduce the number of taxpayers who can avoid income tax altogether (although those with income only from public-purpose tax-exempt bonds could continue to avoid tax).

Table 5. Distributional Impact of AMT Reform Options, 2007 and 2010

Reform Option	Percent Change in After-Tax Income by Cash Income Percentiles <sup>a</sup>											
	2007					2010						
	40-60	60-80	80-90	90-95	95-99	99-100	40-60	60-80	80-90	90-95	95-99	99-100
<b>Repeal the AMT</b>												
With financing	0.0	0.2	0.9	1.4	2.6	1.1	0.0	0.4	1.5	2.1	3.6	1.4
Repeal, implement 4% of AGI add-on tax above 100K/200K	0.0	0.2	0.9	1.3	1.6	-2.8	0.0	0.4	1.4	1.8	2.5	-2.4
Repeal, repeal state and local tax deduction, reduce regular tax rates by 2% <sup>b</sup>	0.0	-0.1	0.2	0.3	1.0	-0.5	0.0	0.2	0.8	1.0	2.1	-0.3
Repeal, increase top three regular tax rates by 15%	0.0	0.2	0.9	1.3	1.4	-2.0	0.0	0.4	1.4	1.9	2.4	-1.7
Repeal, roll back rates on capital gains and qualifying dividends, increase top three regular tax rates by 12%	0.0	0.1	0.7	1.1	1.1	-3.4	0.0	0.4	1.4	1.8	1.6	-3.7
<b>Extend and index 2006 law</b>												
With financing	0.0	0.2	0.9	1.3	1.8	0.1	0.0	0.4	1.4	2.0	2.5	0.1
Increase top three regular tax rates by 12%	0.0	0.2	0.8	1.2	1.2	-2.1	0.0	0.4	1.4	1.8	2.0	-1.9
Increase AMT rates by 21%	0.0	0.2	0.8	0.8	-1.2	-2.4	0.0	0.4	1.3	1.2	-0.9	-2.8
Disallow pref. rates on capital gains and qualifying dividends, increase top three regular tax rates by 3%	0.0	0.2	0.9	1.2	0.9	-4.1	0.0	0.4	1.4	1.8	1.6	-3.7
<b>Broad reform: extend and index 2006 law; allow dependent exemptions; allow standard and itemized deductions<sup>c</sup></b>												
With financing	0.0	0.2	0.9	1.4	2.4	0.7	0.0	0.4	1.5	2.1	3.5	1.0
Increase top three regular tax rates by 14%	0.0	0.2	0.9	1.3	1.4	-2.1	0.0	0.4	1.4	1.9	2.3	-1.8
Disallow preferential rates on capital gains and qualifying dividends, increase top three regular tax rates by 7%	0.0	0.2	0.9	1.3	1.4	-4.0	0.0	0.4	1.4	1.9	2.4	-3.4

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1).

Notes:

(a) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes; and estate tax. For a description of cash income, see

<http://www.taxpolicycenter.org/TaxModel/income.cfm>.

(b) Increases and decreases in tax rates are applied to rates before and after the sunset of the 2001-2006 tax cuts separately.

(c) Includes state and local tax, miscellaneous, and medical deductions.

Instead of increasing effective tax rates, repeal could be financed by base broadening under the regular income tax. The president's tax reform panel proposed to eliminate the income tax deduction for state and local taxes (among many other measures) as a way to finance AMT repeal. The tax deduction is an inefficient instrument to help states—primarily benefiting states with high average incomes (since lower-income people usually do not itemize and, even when they do, the deduction is worth little to them because they are in low tax brackets).<sup>15</sup> Moreover, since the tax deduction is an AMT preference, over time, fewer and fewer taxpayers would be able to gain its full benefits under current law.

Assuming that the 2001–2006 tax cuts expire as scheduled at the end of 2010, repealing the state and local tax deduction would raise more than enough revenue to finance AMT repeal, allowing for a 2 percent reduction in income tax rates. The net effect of AMT repeal, state and local tax deduction repeal, and income tax rate reduction has very small effects on overall tax burdens by income group. This occurs because, although AMT repeal is regressive, repeal of the state and local income tax would be quite progressive. Most taxpayers in the bottom 60 percent of the income distribution take the standard deduction, so that the primary beneficiaries of the state and local tax deduction are those at the very top of the income scale who escape the AMT.

This option has significant effects on marginal tax rates. Almost 64 percent of households would face lower marginal rates on ordinary income, while almost 14 percent would pay lower rates on capital gains (table 4). The tax cut on wage income arises primarily because of the modest reduction in rates, and is generally small, but also because of eliminating the AMT. The tax cuts on capital gains also arise from AMT repeal and because the lower income tax rate means that the phaseout of itemized deductions creates a slightly (2 percent) smaller effective tax surcharge than it does under current law.<sup>16</sup> Interestingly, more people face marginal rate increases under this option than under repeal. This occurs because repeal of the deduction pushes some taxpayers with modest incomes into higher income tax brackets.

Since repealing the AMT primarily benefits higher-income taxpayers, it makes sense to offset the revenue losses by increasing top income tax rates. To finance repeal, statutory rates of 25 percent and above could be increased by 15 percent, resulting in top rates of 32.3, 38.0, and 40.3 percent through 2010 (from 28, 33, and 35 percent) and 35.7, 41.5, and 45.6 percent in 2011 and thereafter (from 31, 36, and 39.6 percent). Through 2010, only the top 1 percent of households would face an average tax increase, amounting to about 2 percent of after-tax income. This occurs because very high income earners are most affected by the rate increases and do not tend to benefit as much from repeal of the AMT since they tend not to be on the AMT in the first place. Through 2010, those in the 90th to 99th percentiles receive the largest average tax cuts

<sup>15</sup> See Rueben (2005) for a general discussion, or Burman and Gale (2005) in the context of the proposal made by the President's Advisory Panel on Tax Reform (2005).

<sup>16</sup> Under current law, itemized deductions phase out at a 2 percent rate for taxpayers with incomes above certain thresholds (\$156,400 for most taxpayers in 2007). Like the phaseout of the AMT exemption, the deduction phaseout implicitly creates a surtax, which in this case equals 2 percent of the statutory tax bracket. The surtax applies to capital gains as well as ordinary income. Thus, an increase in ordinary income tax rates increases the effective tax rate on capital gains and dividends for taxpayers affected by the phaseout. (Note that due to tax law changes in EGTRRA this provision is being phased out, but it will return at its original 3 percent rate in 2011 if the tax cuts are not extended.)



under this plan, between 1.3 and 1.4 percent of after-tax incomes in 2007, and between 1.9 and 2.4 percent in 2010.

Finally, AMT repeal could be an opportunity to rein in tax shelters in the regular income tax. For example, rolling back the 2003 tax cuts on dividends and capital gains would reduce the incentive to convert ordinary income into these tax-preferred forms. It would also raise some revenue to allow for a smaller increase in ordinary income tax rates. The top three income tax rates would increase by 12 percent under this option. The option would cut taxes by a modest amount for middle- and upper-middle-income taxpayers and increase taxes significantly for high-income taxpayers, especially through 2010, when current law allows for lower rates on capital gains and dividends. Taxpayers in the top 1 percent of the income distribution would, on average, pay additional taxes equal to 3.4 percent of after-tax income in 2007. These households lose out for three reasons—they are most affected by the income tax rate increases, they have a large amount of capital gains and dividends, and many taxpayers in this group do not owe AMT (and thus receive no benefit from repeal).

#### *Reforming the AMT to Spare the Middle Class*

Rather than outright repeal, the AMT could be reformed in order to shield middle- and upper-middle-income taxpayers from its effects.<sup>17</sup> The simplest reform would be to extend the exemption increase in place for 2006 and index the AMT for inflation. This would prevent inflation from increasing tentative AMT (in real terms) and conform the AMT treatment with that under the regular income tax.<sup>18</sup> If indexation were applied to rate brackets and the phase-out as well as the exemption, only 3.6 million taxpayers would be subject to the AMT in 2007, down from 23.4 million under current law (table 6). The number of AMT taxpayers with incomes less than \$100,000 would fall by more than 98 percent. By 2010, real income growth would increase the number of AMT taxpayers to 4.6 million, still significantly lower than the projected 32.4 million under current law.

A more comprehensive reform would also allow dependent exemptions, state and local tax deductions, the deductions for miscellaneous expenses and medical expenses, and the standard deduction for AMT purposes. This would reduce the number of AMT taxpayers to fewer than 500,000 in 2007 and would spare virtually all taxpayers with incomes below \$200,000 from the AMT.

These reforms would, however, substantially reduce federal tax revenues. We estimate that indexing the AMT for inflation from 2006 levels would reduce revenues by about \$0.6 trillion from 2007 to 2017, assuming the 2001–2006 tax cuts expire as scheduled. The comprehensive reform package would reduce revenues by \$0.8 trillion if the tax cuts expire.

<sup>17</sup> For more information on these options, and others, see Burman et al. (2007).

<sup>18</sup> The AMT exemption was increased between 2005 and 2006 as an ad hoc inflation adjustment, but it has never been formally indexed for inflation. The allowance of personal nonrefundable credits against both the regular tax and the AMT would also be extended under all reform options considered here.

Table 6. Effect of AMT Reform Options on Number of AMT Taxpayers (millions) by Cash Income Class, 2007

Reform Option	Cash Income Class (\$ thousands)				
	All	0-100	100-200	200-1,000	More than 1,000
<b>Extend and index 2006 law</b>					
With financing	3.6	0.1	0.1	2.6	0.1
Increase top three regular tax rates by 12% <sup>a</sup>	2.4	0.1	0.7	1.5	0.1
Increase AMT rates by 21%	9.6	0.4	4.2	4.5	0.4
Disallow preferential rates on capital gains and qualifying dividends in the AMT, increase top three regular tax rates by 3%	4.4	0.2	1.3	2.8	0.2
<b>Broad reform: extend and index 2006 law; allow dependent exemptions; allow standard and itemized deductions<sup>b</sup></b>	0.4	0.0	0.0	0.3	0.1
With financing					
Increase top three regular tax rates by 14%	0.3	0.0	0.0	0.2	0.0
Disallow preferential rates on capital gains and qualifying dividends in the AMT, increase top three regular tax rates by 7%	1.2	0.0	0.3	0.8	0.1
<b>Addendum: Current law baseline</b>	23.4	7.0	11.8	4.4	0.1

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1).

Notes:

Calendar years. Baseline is current law. Plans take effect 1/1/07. Excludes dependent returns. AMT taxpayers are defined as those with an AMT liability from form 6251, with lost credits, or with reduced deductions.

(a) Increases in tax rates are applied to rates before and after the sunset of the 2001-2006 tax cuts separately.

(b) Includes state and local tax, miscellaneous, and medical deductions.

*Offsetting the Revenue Cost of the Middle-Class Reforms*

The revenue cost of the reforms outlined above could be offset in a variety of ways. All the offset options described below are intended to be roughly revenue neutral over the 2007–2017 budget window, and assume that the 2001–2006 tax cuts expire as scheduled. If the tax cuts are extended, each of the options would generally lose substantial amounts of revenue over the budget window, and many more people would be subject to the AMT after 2010.

Although there are myriad ways in which the revenue cost of the reforms could be financed, I will discuss three illustrative options: (a) increasing the top three income tax rates under the regular tax; (b) increasing the AMT rates; or (c) combining (a) with disallowing the preferential rates on capital gains and dividends under the AMT.

Financing the reforms by increasing AMT rates rather than by raising regular income tax rates leaves more individuals subject to the AMT, particularly those with incomes over \$200,000. Since both of the reforms mentioned above involve substantial increases in the AMT exemption, they tend to shield those with incomes under \$100,000 from the AMT. In addition, raising regular income tax rates and thus regular income tax liability reduces the number of people for whom tentative AMT is greater than regular tax and thus further reduces the number of AMT taxpayers. In contrast, raising AMT rates tends to increase the number of people for whom tentative AMT is greater than regular tax.

Eliminating the preferential rates for capital gains and dividends under the AMT allows smaller increases in either regular or AMT tax rates. These options also tend to retarget the AMT toward those with very high incomes—since those taxpayers tend to have a higher share of their income in the form of capital gains—which is more consistent with the AMT’s original intent. Moreover, since many tax shelters exploit the lower tax rate on capital gains, eliminating preferential gains rates would likely do more to stem tax sheltering than any of the existing AMT preferences.<sup>19</sup>

Extending the exemption and indexing the AMT for inflation would require a 12 percent increase in the top three regular income tax rates. (We raise only the top rates because the AMT primarily affects taxpayers in the upper brackets.) Under this option, the top rate would increase from 35 to 39.1 percent through 2010 and from 39.6 to 44.3 percent for 2011 and thereafter. The number of AMT taxpayers would fall to 2.4 million in 2007; only 100,000 of them would have incomes below \$100,000. The change in tax burdens by income quintiles would be small, never more than 1 percent of income. The highest-income taxpayers, however, would pay more tax. By 2011, the top 1 percent pays additional tax equal to about 3 percent of income.

If AMT rates were raised instead, to 31.3 and 33.8 percent, the AMT would affect 9.6 million taxpayers in 2007; the number of AMT taxpayers with incomes of \$200,000 and

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<sup>19</sup> See Burman (1997) for a discussion of the connection between capital gains tax preferences and tax shelters.

over would actually rise relative to current law. AMT liabilities would also increase for higher-income households, and so they would pay higher taxes on average. Households in the 95th to 99th percentiles would experience a tax increase of about 1 percent of income through 2010, and those in the top 1 percent would pay additional taxes equal to almost 3 percent of income. After 2010, the tax increases are much smaller because the higher AMT exemption in combination with the pre-EGTRRA regular income tax rates results in fewer upper-income households owing AMT.

If the preferential rates on capital gains and dividends were disallowed for AMT purposes, the required increase in the top three regular income tax rates would be only 3 percent. The top rate, for example, would need to rise from 35 to 36 percent through 2010 and from 39.6 to 40.7 percent thereafter. This option would reduce the number of AMT taxpayers by more than 80 percent in 2007, to 4.4 million. The AMT would be much more targeted at those with high incomes; taxpayers with incomes greater than \$1 million would be more likely to owe AMT under this option than under current law. The tax change is significant for those at the very top, however. The top 1 percent would see an average tax increase of about 4 percent of after-tax income in 2007, although the size of that tax increase would decline over time.

Since broad reform of the AMT costs substantially more, financing it would require larger increases in either regular or AMT rates. The required increase in the top three regular rates would be 14 percent, resulting in a top rate of 39.9 percent through 2010 and 45.2 percent thereafter. This option reduces the number of AMT taxpayers to only 300,000 in 2007, including less than 100,000 with incomes less than \$200,000. Since this option reduces tax revenues in the first five years and increases it thereafter, the largest tax increases occur after 2010. The average tax increase is about 3 percent of income for those in the top 1 percent after 2010.

Finally, broad reform could be financed by disallowing the preferential rates on capital gains and dividends under the AMT combined with an increase in the top three regular income tax rates. The required rate increase would be 7 percent, resulting in a top rate of 37.5 percent through 2010 and 42.4 percent thereafter. This option would reduce the number of AMT taxpayers by about 95 percent in 2007, to just 1.2 million, with only 300,000 of them having incomes less than \$200,000. This option would have very small effects on the distribution of tax burdens by quintile. But disallowing the lower capital gains rates under the AMT, combined with the regular tax rate increases, results in significant tax increases for those at the very top of the income scale—over 3 percent of income for those in the top one percent before 2010.

### **Conclusions**

Lack of inflation indexing in the alternative minimum tax expands the reach of the tax each year. The 2001–2006 tax cuts have further exacerbated the problem by reducing regular income tax liabilities without corresponding permanent changes to the AMT. Caught amid these trends, one in three American taxpayers will soon face a tax that almost none of them were meant to pay. Although the goals of the AMT—ensuring high-income taxpayers pay at least some amount of tax each year and reducing inefficient tax

sheltering—may command public support, the AMT is a highly imperfect way of achieving those goals. In particular, under current law, the AMT will come to plague the middle- and upper-middle-income classes with undue complexity, a narrower tax base, and higher marginal tax rates than under the regular income tax.

As the AMT expands, the political benefits of achieving a solution increase as well. A number of sensible reform options are available. A significant barrier to AMT reform is the challenge of what to do about the lost revenues. Official budget estimates assume that the AMT will provide tax revenues of nearly \$1 trillion over the next 10 years. Even modest reforms, such as extending the AMT “patch” and indexing the AMT for inflation, would reduce tax revenues over that period by more than \$500 billion. Given our fiscal situation, making up that lost revenue would seem to be a necessary precondition for reform.

I have illustrated a number of options for repealing or reforming the AMT without increasing the deficit over the 10-year budget period. The options show that it would be feasible to repeal or sharply scale back the AMT in a fiscally responsible manner with relatively minor dislocations. All of the options produce winners and losers—it would be impossible to design a sensible revenue-neutral alternative to the AMT that didn’t—but many would cut taxes modestly on the middle class and have relatively small effects on those with higher incomes.

Many other fiscally responsible options exist, and some of them might be better politics or policy than the ones I discussed. For example, this Committee has explored options to improve tax compliance and collections as a way to raise revenue. To the extent that more of the tax that is due to the IRS could be collected, the revenue needs to finance AMT reform would be reduced. As a result, the options here could be implemented with smaller income tax rate increases or without the use of other offsets, such as elimination of the deduction for state and local taxes.

The ideal solution would be to address the AMT in the context of a complete overhaul of the income tax, such as the proposal made by the President’s Advisory Panel on Federal Income Tax Reform. Although the AMT is probably the best example of pointless complexity in the tax system, it is far from the only one. Addressing all of the sources of complexity, unfairness, and inefficiency in the tax system at the same time would strengthen the income tax—the major source of federal tax revenues—at a time when unprecedented demands are about to be placed on the federal government because of the impending retirement of the baby boomers.

That said, the perfect should not be the enemy of the good. Many of the incremental options I have outlined here would significantly improve our tax system.

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**Response to a Question for the Record From Dr. Leonard Burman  
June 27, 2007**

***From Senator Baucus***

*Question:* One of Mr. Degen's 3 criteria for a workable AMT fix is to limit the scope of the AMT to taxpayers that are engaging in the most egregious tax avoidance? Do you agree and how would it work?

I think it is best to eliminate the AMT, and use enforcement and law changes in the ordinary code to address egregious tax avoidance.



**Testimony of Frank Degen, EA**  
**Government Relations Committee Chair,**  
**National Association of Enrolled Agents'**  
**before the Senate Finance Committee**  
**June 27, 2007**

Thank you, Mr. Chairman and members of the Committee for inviting the National Association of Enrolled Agents (NAEA) to testify before you today on the alternative minimum tax (AMT). My name is Frank Degen. I am an enrolled agent and I am speaking on behalf of NAEA, the premier organization representing the interests of the 46,000 enrolled agents (EAs) across the country. As the only tax practitioners the IRS directly tests and regulates, enrolled agents are committed to increasing industry professionalism, improving the integrity of the nation's tax administration system, and protecting taxpayers' rights to representation. We believe that NAEA is well-positioned to offer an informed perspective on the real-world effects of the individual AMT.

The AMT as it exists today is a failed public policy, with few if any public—or private—defenders. Its history is well-known. In 1969, reports that 155 people with adjusted gross incomes (AGIs) over \$200,000 paid no federal income tax caused Congress to enact the AMT, which was intended to ensure that those with high incomes would pay at least some income tax. The AMT requires an additional calculation of tax (this calculation disallows many of the credits and deductions allowed under the regular income tax). An exemption amount is subtracted from alternative minimum taxable income (AMTI), and one of two rates (currently 26 or 28 percent) is applied to the taxable AMTI. The taxpayer pays the larger of the AMT or the regular income tax. *Given this process, one could argue that the AMT should more truthfully be termed the Mandatory Maximum Tax.*

Millions of people are subject to the AMT every year. In 2004, for instance, roughly three million taxpayers had AMT liability – including some with AGIs in the mid-\$50,000 range. Were it not for a temporary increase in the exemption, about 12 million taxpayers would have been ensnared. Interestingly, in the thirty-eight years since the AMT was enacted, while the reach of the AMT has so vastly expanded, the number of tax returns with AGIs over \$200,000 without any income tax liability has ballooned—to 2,420 in tax year 2004<sup>1</sup>. While we acknowledge that inflation and population growth distort the comparison between today and 1969, we believe the statistics demonstrate that the AMT has failed to accomplish Congress' clear intent. Most obviously, the AMT has not prevented all high-income taxpayers from avoiding federal income tax liability altogether. Further, and more alarmingly, the AMT's reach now includes millions of taxpayers it was never intended to touch.

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<sup>1</sup> Brian Balkovic. "High-Income Tax Returns for 2004." IRS Publication 1136, *Statement of Income Bulletin*, Spring 2007.

The AMT's lack of inflation-indexed income exemptions presents Congress with an increasingly unpleasant trade-off. If Congress leaves the income exemptions untouched, roughly ten million taxpayers would unexpectedly see their tax bills increase. If Congress adjusts the income exemptions upward, it necessarily forgoes significant tax revenues. In recent years, Congress has regularly renewed increased AMT exemption amounts. And to minimize the budget pain of these decisions, Congress has chosen to implement one and two year patches instead of engineering a permanent fix.

Enrolled agents and sophisticated taxpayers understand this to be a band-aid approach to dealing with the AMT, while the unsophisticated (both taxpayers and preparers) may not even be aware that they are dodging the AMT bullet. The net result, however, is that the current environment of temporary, short-term AMT fixes makes meaningful, long-term tax planning impossible for millions of taxpayers. Simply stated, the lack of a permanent AMT solution severely limits the ability of enrolled agents to help our clients. Without the certainty of a permanent fix, the AMT becomes nothing more than a perennial political football, with taxpayers, enrolled agents and IRS relegated to the sidelines as spectators. While most believe the broad result of the game is not in question (the AMT temporary fix will ultimately come to pass), the essential specifics (the exemption size and the timing of the decision) result in a lot of nail-biting.

To further emphasize the disadvantages to taxpayers and tax practitioners resulting from the atmosphere of uncertainty and surprise surrounding the AMT (exacerbated by the use of short-term patches), I want to offer some observations from the field. These are real-life examples of how the AMT can blindside and disillusion ordinary taxpayers as well as disrupt practical financial and tax planning:

- Bill and Liz are air traffic controllers. Because the AMT calculation doesn't allow their five exemptions (Bill, Liz and three children) and their Schedule A taxes, they owed an extra \$6,400 in tax due solely to the AMT. Bill exclaimed "This is crazy. I don't have **any** tax loopholes."
- Laura is a mid-level executive in New York City. Her income tax return was relatively straightforward—for instance, no Schedules K-1, no passive activity bonds (which cause their own AMT headaches), and no other tax preferences. When I told her the AMT calculation on her return created a balance due of \$1,050 rather than a refund of \$6,450 (an AMT tax liability increase of \$7,500), she asked me a question for which I had no answer. "Didn't Congress say it was lowering taxes?" And adding insult to injury, I was unable to calculate with certainty Laura's withholding schedule for 2007 because I did not know when I prepared her return (and do not know today) what the 2007 AMT patch would be and the extent to which she will be subject to AMT.

- Karen has four children, files as Head of Household, claims the standard deduction and has an AGI of \$75,000. Imagine her surprise when I told her she has an AMT liability. Her only comment was "I read in the papers the AMT was supposed to be for rich guys." I suspect few in the halls of Congress would argue that she is rich or that she is resorting to sophisticated tax planning to reduce her federal income tax liability.

It is time Congress enacted a substantive and lasting solution to the AMT problem. We believe that both taxpayers and tax practitioners would prefer a complete repeal of the individual AMT. Chairman Baucus and Ranking Member Grassley have introduced a bill that would do just that. We applaud their efforts and hope that Congress passes their legislation. Repealing the full AMT would be a huge step in the simplification of the tax code.

Practically, we admit that full repeal of the AMT may be a bridge too far. At the same time, we consider that any proposal short of full repeal must satisfy three criteria:

1. It must limit the AMT's scope. If the AMT persists, it should affect only taxpayers Congress believes are engaging in the most egregious tax avoidance. At a minimum, the personal exemptions and standard deductions allowed under the regular income tax should not be disallowed under the AMT, as they currently are. Further, Schedule A exclusion items, such as medical expenses, all taxes, and miscellaneous deductions, should also be permitted.
2. It must make the AMT permanent. One, two, and even five-year bills will not provide the necessary amount of certainty to taxpayers trying to plan their finances.
3. It must index any new income exemptions to inflation. The lack of indexing is the root cause of the current AMT troubles. Indexed exemptions would prevent the AMT from hitting those taxpayers whose real incomes stay constant. If Congress, in 1969, had indexed exemption amounts so that the AMT applied only to those 155 taxpayers with AGIs above \$200,000, today, the AMT would only affect those with AGIs over roughly \$1.1 million.

In closing, I would like to take a moment to make a broader point about tax return preparation: producing an accurate return is often a complex and non-intuitive exercise. A preparer must demonstrate his/her ability to interpret the tax code, especially when AMT comes into play, and therefore the preparation of complex returns, like those with the AMT, should not be left to amateurs. One wonders how many mistakes are made in preparing returns with the AMT.

A 2006 GAO study (*Paid Tax Return Preparers: In a Limited Study Chain Preparers Make Serious Errors*) estimated that more than half of individual income tax returns filed are prepared by a paid tax preparer. In the same study, GAO found several instances of incompetent preparation by chain preparers, often resulting in large refund overclaims. Congress could act to improve competence and

ethical standards in the tax preparation industry by enacting S. 1219, the Taxpayer Protection and Assistance Act. By requiring a) an initial competence examination of all unenrolled preparers, and b) continuing education for all paid tax preparers, Congress would bring more taxpayers into compliance by improving the accuracy of tax return preparation.

As always, the NAEA and its members stand ready to work closely with Congress in assessing the merits of various AMT proposals.

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<sup>1</sup> The **National Association of Enrolled Agents (NAEA)** is the professional society representing enrolled agents (EAs), which number some 46,000 nationwide. Its 12,000+ members are licensed by the U.S. Department of the Treasury to represent taxpayers before all administrative levels of the Internal Revenue Service (IRS), including examination, collection and appeals functions.

While the enrolled agent license was created in 1884 and has a long and storied past, today's EAs are the only tax professionals tested by IRS on their knowledge of tax law and regulations. They provide tax preparation, representation, tax planning and other financial services to millions of individual and business taxpayers. EAs adhere to a code of ethics and professional conduct and are required by IRS to take continuing professional education. Like attorneys and certified public accountants, enrolled agents are governed by Treasury Circular 230 in their practice before IRS.

Since its founding in 1972, NAEA has been the enrolled agents' primary advocate before Congress and IRS. NAEA has affiliates and chapters in 42 states. For additional information about NAEA, please go to our website at [www.naea.org](http://www.naea.org).

**Statement of Michael J. Graetz, Professor of Law, Yale Law School  
At a Hearing of the Senate Finance Committee  
on the Alternative Minimum Tax (AMT)  
June 27, 2007**

Mr Chairman and Members of the Committee--

Thank you for inviting me to testify here today on this important subject.

Let me begin with a thought experiment: Assume Congress -- without making any other substantive changes -- renamed the regular income tax the "Alternative *Maximum* Tax" (which people would no doubt call the "AMT") and, at the same time relabeled the current AMT the "regular" tax. Then, would we be here today talking about repealing or restructuring the AMT or the regular tax?

This is not a crazy question because going forward, if the law is not changed, the current AMT will raise more revenue than the regular tax -- and would do so generally by applying lower rates to a broader base--everyone's hallmark approach to fundamental tax reform.

My fundamental point in suggesting this thought experiment is simply this: The AMT does not exist in a vacuum separate from the rest of the tax code. Indeed, discontinuities between changes to the regular tax and the AMT have brought us to the unsatisfactory state of affairs we face here today. The number of taxpayers subject to the AMT depends on how its tax base and rates are linked to the regular income tax base and rates. If the AMT exemption had been indexed for inflation, similarly to the indexing of personal exemptions and rate brackets under the regular tax, and had the relationship between the AMT rates and the regular tax rates been maintained when the latter were reduced in 2001, we would not be here today worrying about a "stealth tax" that will affect "millions of unsuspecting taxpayers." But, as we all know, lowering the AMT rates in 2001 to maintain their relationship to the regular rates would have made it impossible to fit all of the 2001 cuts within the limits of that year's budget resolution--so the AMT problem was put off until another day.

The vast bulk of taxpayers recently affected by the AMT due to tax cuts enacted during the 2001-2006 period are not paying more tax than they would have without those cuts. Instead, the AMT has reduced the size of the tax cuts they would otherwise have received. (Having paid the AMT myself last year, I should probably say "we" rather than "they".) But since the AMT and the regular income tax were not considered together in fashioning the 2001 Act, the distribution of the AMT's claw backs of the 2001 tax cuts are rather haphazard, to put it gently. And the complexity and lack of transparency of running the two

systems simultaneously, to be sure, increases taxpayers' compliance costs and makes routine tax planning more difficult.

As you know well, Mr. Chairman, between 2003 and 2006 Congress has enacted short-term patches to increase the AMT exemption amounts and to allow nonrefundable personal credits to be used under the AMT. In so doing, you have held down the number of AMT taxpayers to less than there would have been under the pre-2001 law. The question now before you is whether to continue "patching" the AMT, to restructure it substantively, or to repeal it.

As much as I resist saying this, I believe the best course Congress can take now is to continue AMT patches through 2009 or 2010 and postpone dealing substantively with the AMT until then, when you will necessarily have to take up fundamental aspects of our income tax system. To do otherwise—to enact substantive reform of the AMT now before you know which aspects of the current regular tax structure enacted since the year 2000 you will extend and which you will let expire – would be to make the 2001 mistake in reverse: to treat the AMT as an issue separate from the basic issues of the regular income tax, issues that you will necessarily soon confront given the large number of important provisions that are currently scheduled to terminate in 2010. (All of the income tax provisions of the 2001 Act expire in 2010, along with reduced rates for capital gains and dividends, as well as the estate tax repeal enacted in 2001. A few of the most important expiring provisions are listed at the end of this statement in Table 1.)

Please do not misunderstand what I am saying here today. I agree with many of the points made by other witnesses who have pointed out defects in the AMT. It has numerous problems that should be fixed going forward –if it is to be retained. However, I do not think it is possible to answer the question what kind of minimum tax, if any, we should have without knowing what kind of regular income tax we have. And the uncertainties created by the vast number of expiring provisions simply do not allow us now to know the answer to the latter question. Let me use three important differences between the regular tax and the AMT to illustrate my point. (A list of the differences between the AMT and the regular tax is set forth at the end of this statement in Table 2.)

In recent years, the difference in treatment of deductions for state and local taxes has accounted for more than half the difference between regular taxable income and alternative minimum taxable income (AMTI) – 62.7% in 2006, according to the Staff of the Joint Committee on Taxation. Under the regular income tax, state and local income and property taxes are fully deductible, and recently taxpayers have been allowed to choose between deducting state and local sales and income taxes. Under the AMT, no deduction is allowed for state and local taxes. Thus, one of the major effects of moving people from the AMT to the regular tax would be to increase the allowance of state and local tax deductions in exchange for higher tax rates. Is this wise policy?

In policy and political circles, the appropriate treatment of state and local taxes is controversial. President Bush's tax reform panel, for example, recommended eliminating the deduction entirely on the grounds that such taxes were often payments for benefits received, that allowing a deduction advantaged public provision of services over private provision, and that allowing a federal deduction requires taxpayers in low-tax states to subsidize those who live in high-tax states. Presumably for similar reasons, the tax reform bill introduced by Senator Ron Wyden (D. OR) and Representative Rahm Emanuel (D. IL) would cut back substantially on the deduction for state and local taxes, especially for higher-income taxpayers, by substituting a refundable tax credit for 10% of state and local taxes for the unlimited deduction under the regular income tax.

I can readily understand why the Chairman of the House Ways and Means Committee, Mr. Rangel, prefers the regular tax treatment of state and local taxes to that of the AMT: New York ranks second (to California) in the amounts deducted for state and local taxes. But Mr. Chairman your state of Montana ranks 46<sup>th</sup>, so it is far less clear why you should be eager to improve the deductibility of state and local taxes in exchange for higher rates. Mr. Grassley, your home state of Iowa ranks 26<sup>th</sup>. By my count, only seven members of this committee, five Democrats and two Republicans, represent states that rank in the top half in the amounts of state and local taxes deducted on federal returns. (A complete list of these deductions by state is contained at the end of this statement in Table 3.) Needless to add, AMT burdens by state are highly correlated with the level of state and local taxes. Indeed, the top 23 states by aggregate state and local tax deductions are also the top 23 by aggregate AMT payments, although not precisely in the same order. (A state-by-state list of AMT payments is contained at the end of this statement in Table 4.)

The essential point is this: both Republican and Democratic tax reform proposals would restrict or eliminate the deduction for state and local taxes to achieve lower income tax rates. That is also the choice of the current AMT, but not of the regular tax. By 2010, when the tax rates of current law are scheduled to increase, this is a choice Congress will have to confront. Why prejudge that choice now when only the AMT is being considered?

A second difference between the AMT and the regular tax, although much less significant than the treatment of state and local taxes, is that the latter contains a separate rate schedule for unmarried taxpayers with dependents—the so-called head-of-household rate schedule—while the former distinguishes only between single and married taxpayers. Which is the better rule for the higher income taxpayers who are predominately now affected by the AMT? This is a difficult question. The head-of-household rate schedule was introduced into the income tax more than half a century ago in 1950, at a time when the demographics of our nation were very different than they are today, and decades

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\* It is not clear to me why the Wyden-Emanuel bill would make this particular credit refundable.

before Congress added to the Code a separate rate schedule for single persons and subsequently substantial tax credits for children. The head-of-household rate schedule provides important tax relief for many lower-income single parent households but also now contributes substantially to marriage penalties in the income tax. Even without a separate schedule for heads of households, the AMT exemption structure also imposes substantial marriage penalties. By 2010 Congress will have to reconsider both the rate schedules and expiring marriage penalty relief provisions under the regular tax. If an AMT is retained, its exemption levels, rate schedule and marriage penalties should be re-evaluated at the same time. Why is it sound to restructure the AMT now separately without knowing how those parameters will change under the regular tax?

Let me offer one final example. The AMT allows home mortgage interest to be deducted only if the borrowing is used to improve, buy or build the taxpayer's home, while the regular tax often allows deductions if the borrowing is secured by the taxpayer's home no matter what the loan proceeds are used for. Although others might disagree, in my view, the AMT rule is the better rule. The President's tax reform panel would have cut back the mortgage interest deduction even further. Again, the scope of the interest deduction is an issue that should be taken up in the broader context of considering all the provisions expiring in 2010. Shifting the balance now in favor of the rule under the regular income tax does not seem prudent or wise.

Mr. Chairman, at a minimum, the AMT needs restructuring, if not outright repeal. But one could say much the same about the regular income tax. Indeed, for many years, I have been urging that we greatly reduce our reliance on income taxation and that we enact a value added tax in order to eliminate all income taxes for the vast majority of Americans. A VAT at a rate of 10-14% could finance a \$100,000 income tax exemption, for example, and allow a low-rate income tax to apply to incomes above that amount. In any event, when the time comes to consider major income tax reform, as it soon will, either the AMT or the regular tax might serve as a starting point. Significant structural revisions will be necessary no matter where you start. Given the agenda-forcing nature of all the tax law provisions scheduled to expire in 2010, continuing to "patch" the AMT by retaining the current exemption levels and indexing them for inflation from 2007 through 2009 or 2010 in order to limit its reach in the meantime seems the wisest course for now.

Thank you. I would be happy to answer any questions.



**Table 1**  
**Selected Tax Sunsets in 2010**

	2007	2011
<b>Individual Income Tax Rates</b>	Rate brackets of 35, 33, 28, and 25%	Rates revert back to 39.6, 36, 31 & 28%
<b>10% Bracket</b>	10% bracket with upper level up to \$7K / \$14K for single/joint filers, subject to annual increases to reflect cost of living adjustment	Bracket eliminated; lowest bracket reverts to 15%
<b>15% Bracket for Joint Filers</b>	Top of bracket up to 200% of top of single filer bracket ("single filer")	Top of bracket reverts back to 167% of top of single filer bracket
<b>Capital Gains</b>	Tax rate is 5/15%	Tax rate reverts back to 10/20%
<b>Dividends</b>	Tax rate is 5/15%	Taxed at ordinary income rates
<b>Estate Taxes</b>	Top rate falls to 45%; \$2 million exemption	Reverts back to 55%; exempt amount declines back to \$1 million
<b>Standard Deduction for Joint Filers</b>	Up to 200% of standard deduction for single filer	Reverts back to 167% of single filer's deduction
<b>Child Credit</b>	\$1,000 per child	Back to \$500 per child

Table 2

## Regular Tax and Alternative Minimum Tax Provisions

Provisions	Treatment under regular tax	Treatment under AMT
<b>Marginal tax rates</b>	10%, 15%, 25%, 28%, 33%, and 35%. Brackets are indexed for inflation.	26% and 28% (32.5% and 35% for taxpayers in the phaseout range of exemptions). Not indexed for inflation.
<b>Standard deduction/exemption</b>	Deduction of \$10,300 for married taxpayers filing jointly, \$5,150 for single taxpayers, and \$7,550 for heads of households allowed in 2006 for those who do not itemize deductions. Indexed for inflation.	AMT exemption of \$62,500 for married taxpayers filing jointly and \$42,500 for single taxpayers and heads of household in 2006; \$45,000 and \$33,750 thereafter (not indexed for inflation). Exemption phases out at 25% rate for high-income taxpayers.
<b>Personal exemptions</b>	Deduction of \$3,300 per family member and dependent allowed against regular tax in 2006. Indexed for inflation. Phased out for high-income taxpayers.	Not allowed in addition to AMT exemption.
<b>Head of household status</b>	Single heads of household qualify for lower tax rates and larger standard deductions than singles.	Heads of household face the same tax rates and AMT exemption as singles.
<b>Itemized deductions</b>	Allowed under regular tax if standard deduction is not taken. Itemized deductions phase out at 3% rate for taxpayers with higher incomes (certain items do not phase out).	If deductions are itemized under regular tax, tax preference items are subtracted from the deductions for AMT purposes. No phaseout for higher-income taxpayers.

<b>State and local tax deductions</b>	Income and property taxes are allowed as itemized deductions. Sales taxes are allowed as an alternative to income taxes.	Not allowed.
<b>Miscellaneous deductions</b>	Miscellaneous expenses including tax preparation fees, unreimbursed employment expenses, and certain legal fees in excess of 2% of AGI are allowed as itemized deductions.	Not deductible.
<b>Home mortgage interest</b>	Mortgage interest for the first or second home and second mortgages and home equity lines are deductible subject to certain limits.	Only deductible if the proceeds are used to improve, buy, or build the taxpayer's home.
<b>Unreimbursed medical expenses</b>	Expenses in excess of 7.5% of AGI are allowed as itemized deductions.	Expenses in excess of 10% of AGI are allowed as itemized deductions.
<b>Treatment of capital gains and dividends</b>	Dividends and capital gains taxed at 5% and 15%; 0% and 15% in 2008. Capital gains taxed at 10% and 20% from 2011 onwards while dividends are taxed as regular income.	Same.
<b>Net operating loss</b>	Deducted from taxable income.	Not deductible, but may be carried forward to offset future income.
<b>Incentive stock options</b>	Exercising an ISO generates no tax liability. Selling the stock generates capital gains taxes on the difference of the sale price and the option price.	Exercising a stock option generates taxable income equal to the difference between the exercise price and the option price if the stock is not sold within the same year. Selling the stock generates capital gains taxes on the difference between the sale price and the exercise price.
<b>Other timing preferences</b>	Depreciation of equipment, oil depletion allowances, allowances for intangible drilling costs, or mining exploration and development costs are allowed under regular tax.	Deductions for timing preferences are allowed at a slower rate under the AMT. These preferences generate the AMT credit, which can be

		taken against regular tax liability in the future years. However, these credits cannot be used to lower regular tax liability below the tentative liability for that year.
<b>Child, adoption, and savers credits</b>	Allowed against regular tax.	Allowed against AMT until 2010.
<b>Refundable credits</b>	Allowed against regular tax.	Same.
<b>Foreign tax credit</b>	Allowed against regular tax.	Same.
<b>Nonrefundable personal credits other than above</b>	Allowed against regular tax.	Allowed against AMT through 2006. Not allowed thereafter.
<b>Business tax credits</b>	Allowed against regular tax.	Only certain ones allowed.

Leonard E. Burman and David Weiner, Suppose They Took the AM Out of the AMT? The Urban-Brookings Tax Policy Center Discussion Paper No. 25, August 2005, Table 2, updated.

Table 3

## State and Local Tax Deductions by State Tax Year 2002

Rank	State	Number of Returns (millions)	Percent of Returns Claiming Deduction	Percent of Returns In state	Amount (\$billions)	Percent of Amount Claimed	Average Amount	Percent of Federal Income Taxes Paid	State and Local Deduction as Share Of State AGI
1	California	5.9	13	39	52.3	17	\$6,884	13.2	6.8
2	New York	3.3	7.4	36.8	37.1	12	\$11,098	8.7	8.2
3	New Jersey	1.8	4	44.6	18.2	5.9	\$10,003	4.6	7.5
4	Illinois	2.1	4.6	36.3	13.5	4.4	\$6,475	5.1	4.7
5	Ohio	1.9	4.3	36.2	13	4.2	\$6,721	3.4	5.8
6	Pennsylvania	1.9	4.1	32.5	12.3	4	\$6,548	4.1	4.8
7	Massachusetts	1.2	2.7	40.5	10.8	3.5	\$8,655	3.3	6.2
8	Michigan	1.7	3.8	38	10.5	3.4	\$6,099	3.2	5.1
9	Maryland	1.3	2.8	48.7	10	3.2	\$7,944	2.3	7.2
10	Virginia	1.4	3	40.7	9.2	3	\$6,888	2.9	5.3
11	Texas	2	4.5	21.9	8.7	2.8	\$4,288	6.9	2.2
12	Georgia	1.4	3.2	39.1	8.5	2.8	\$5,960	2.6	5.2
13	North Carolina	1.4	3	37.4	8.5	2.8	\$6,252	2.2	5.6
14	Florida	2.1	4.7	27.5	7.9	2.6	\$3,707	6.1	2.3
15	Wisconsin	1	2.2	39.3	7.8	2.5	\$7,692	1.7	6.9
16	Connecticut	0.7	1.6	43.7	7.6	2.5	\$10,424	2.3	7
17	Minnesota	1	2.2	42.3	6.9	2.2	\$6,804	1.9	5.9
18	Oregon	0.7	1.5	42.2	4.8	1.6	\$7,222	0.9	7.2
19	Indiana	0.9	2	32.6	4.8	1.5	\$5,192	1.7	4.1
20	Missouri	0.8	1.8	32.1	4.7	1.5	\$5,768	1.6	4.5
21	Colorado	0.9	1.9	42.1	4.6	1.5	\$5,293	1.7	4.5
22	Arizona	0.9	1.9	39	4.2	1.4	\$4,816	1.5	4.3
23	South Carolina	0.6	1.3	33.4	3.4	1.1	\$5,629	0.9	4.9
24	Kentucky	0.6	1.2	32	3.4	1.1	\$6,028	0.9	5
25	Washington	1	2.1	34.3	3.1	1	\$3,262	2.4	2.3
26	Iowa	0.4	1	32.9	2.5	0.8	\$5,717	0.7	4.7
27	Kansas	0.4	0.9	31.8	2.4	0.8	\$6,230	0.8	4.7
28	Oklahoma	0.5	1	31	2.3	0.8	\$5,133	0.8	4.3
29	Alabama	0.6	1.3	30.9	2.1	0.7	\$3,624	1	2.9
30	Utah	0.4	0.9	41.5	2	0.7	\$5,089	0.5	5.1
31	Nebraska	0.2	0.5	30.8	1.6	0.5	\$6,591	0.5	5.1
32	Rhode Island	0.2	0.4	37.3	1.5	0.5	\$8,259	0.4	6.7
33	Maine	0.2	0.4	32.3	1.4	0.5	\$7,301	0.3	6

34 Louisiana	0.4	0.9	21.7	1.4	0.5	\$3,523	1	2.1
35 New Hampshire	0.2	0.5	36.1	1.4	0.5	\$6,126	0.5	4.4
36 Arkansas	0.3	0.6	25	1.4	0.4	\$4,883	0.5	3.4
37 Tennessee	0.6	1.3	22.4	1.2	0.4	\$2,161	1.6	1.2
38 New Mexico	0.2	0.5	27.3	1.1	0.4	\$5,078	0.4	3.9
39 Mississippi	0.3	0.6	23.4	1.1	0.4	\$3,968	0.5	2.8
40 Idaho	0.2	0.5	38.7	1.1	0.3	\$5,135	0.3	5
41 Nevada	0.4	0.8	35.7	1	0.3	\$2,904	0.9	2.2
42 Hawaii	0.2	0.4	33.6	1	0.3	\$5,299	0.3	4.3
43 District of Columbia	0.1	0.2	40.1	1	0.3	\$9,234	0.3	6.7
44 Delaware	0.1	0.3	37.5	0.8	0.3	\$5,492	0.3	4.3
45 West Virginia	0.1	0.3	18.9	0.8	0.2	\$5,325	0.3	2.9
46 Montana	0.1	0.3	32.1	0.7	0.2	\$5,296	0.2	5
47 Vermont	0.1	0.2	32.4	0.7	0.2	\$6,926	0.2	5.5
48 North Dakota	0.1	0.1	19.5	0.3	0.1	\$4,471	0.1	2.4
49 Alaska	0.1	0.2	24.5	0.2	0.1	\$2,864	0.2	1.6
50 South Dakota	0.1	0.1	16.4	0.2	0.1	\$2,778	0.2	1.3
51 Wyoming	0	0.1	20.4	0.1	0	\$2,761	0.2	1.3
United States	45.4	100	34.7	308.7	100		100	5.1

Source: Internal Revenue Service, Individual Tax Statistics — State Income for 2002 and 2003, Tax Year 2002: Unpublished Version.  
Available at <http://www.irs.gov/txstatst/article0,,id=103106,00.html>.

Source: Kim Rueben, The Impact of Repealing State And Local Tax Deductability, Tax Analysts Special Report, State Tax Notes, August 15, 2005, Table 1.

Table 4

## Alternative Minimum Tax by State, Tax Year 2004

State	Number of returns			AMT			Percent of Returns on AMT in State		
	All	Taxable	On AMT	Total (\$1,000s)	Average per Return (\$)	Percent of Income Tax	All Returns	Taxable Returns	Rank
United States	133,092,565	91,150,197	3,148,323	12,895,393	4,099	0.02	2.38	3.45	N/A
Alabama	1,910,403	1,200,871	14,056	56,239	4,001	0.65	0.74	1.17	46
Alaska	345,209	273,548	2,382	8,021	3,367	0.43	0.69	0.87	50
Arizona	2,372,519	1,609,749	30,907	129,576	4,192	0.96	1.30	1.92	35
Arkansas	1,136,031	710,996	12,403	41,750	3,366	0.93	1.09	1.74	37
California	15,327,238	10,385,782	606,578	2,908,043	4,794	2.55	3.98	5.84	4
Colorado	2,110,355	1,520,216	32,066	139,737	4,369	1.00	1.52	2.11	31
Connecticut	1,665,154	1,273,952	80,333	319,740	3,980	1.66	4.82	6.31	3
Delaware	395,657	293,062	6,468	28,985	4,466	1.11	1.63	2.21	24
District of Columbia	277,884	202,475	11,763	59,075	5,022	2.22	4.23	5.61	5
Florida	8,173,271	5,430,213	118,535	596,523	5,032	1.08	1.45	2.18	26
Georgia	3,782,867	2,443,152	73,066	271,859	3,721	1.31	1.93	2.99	13
Hawaii	606,129	432,887	9,748	42,105	4,319	1.35	1.81	2.25	23
Idaho	594,282	389,326	8,250	31,568	3,826	1.28	1.39	2.12	29
Illinois	5,782,889	4,010,524	112,129	381,265	3,400	0.94	1.95	2.80	15
Indiana	2,854,911	1,992,239	29,068	99,701	3,426	0.92	1.02	1.46	43
Iowa	1,334,499	959,238	17,047	53,578	3,143	0.70	1.28	1.78	36
Kansas	1,229,497	850,067	19,230	68,108	3,542	1.10	1.56	2.26	22
Kentucky	1,757,624	1,185,725	23,839	63,381	2,859	0.84	1.36	2.01	32
Louisiana	1,869,153	1,131,216	18,142	56,262	3,101	0.74	0.97	1.60	42
Maine	618,852	445,042	11,657	46,299	3,972	1.72	1.88	2.62	19
Maryland	2,635,590	1,964,764	102,793	359,570	3,498	1.80	3.90	5.23	6
Massachusetts	3,061,220	2,340,805	116,120	458,767	3,951	1.70	3.79	4.96	7
Michigan	4,561,087	3,191,038	69,421	213,634	3,077	0.85	1.52	2.18	27
Minnesota	2,407,792	1,800,407	57,474	219,750	3,823	1.42	2.39	3.19	11
Mississippi	1,165,951	675,030	7,855	23,045	2,934	0.60	0.67	1.16	47
Missouri	2,585,513	1,781,352	34,641	130,348	3,763	1.03	1.34	1.94	34
Montana	439,714	286,687	6,070	24,903	4,103	1.53	1.38	2.12	30
Nebraska	808,780	585,621	13,263	47,346	3,570	1.24	1.64	2.34	20
Nevada	1,092,600	783,790	13,525	68,883	5,093	0.81	1.24	1.73	38
New Hampshire	643,076	491,117	11,196	40,973	3,860	0.94	1.74	2.28	21
New Jersey	4,107,118	3,015,128	227,857	842,462	3,697	2.24	5.55	7.56	1
New Mexico	827,182	521,483	8,798	33,017	3,754	0.99	1.06	1.69	39
New York	8,625,432	5,929,874	436,985	2,137,635	4,892	2.96	5.07	7.37	2
North Carolina	3,789,920	2,487,478	69,635	283,896	3,790	1.44	1.85	2.80	14
North Dakota	305,030	217,199	2,355	8,664	2,830	0.53	0.77	1.08	48
Ohio	5,447,064	3,923,585	120,645	429,558	3,561	1.61	2.21	3.07	12
Oklahoma	1,476,128	949,554	15,914	59,242	3,723	0.91	1.08	1.68	41
Oregon	1,604,383	1,111,399	37,035	158,431	4,278	2.01	2.31	3.33	10
Pennsylvania	5,811,227	4,127,024	114,544	377,134	3,292	1.14	1.97	2.78	16
Rhode Island	500,314	368,702	13,478	52,556	3,899	1.71	2.69	3.66	8
South Carolina	1,844,497	1,189,004	26,054	92,914	3,566	1.19	1.41	2.19	25
South Dakota	362,240	246,473	2,141	8,120	3,793	0.49	0.59	0.87	51
Tennessee	2,606,931	1,735,014	17,623	76,882	4,351	0.58	0.68	1.02	49
Texas	9,431,995	5,915,840	118,352	414,662	3,504	0.74	1.25	2.00	33
Utah	996,414	645,503	13,765	47,781	3,471	1.09	1.38	2.13	28
Vermont	306,271	223,210	5,883	24,721	4,202	1.69	1.92	2.64	18
Virginia	3,491,196	2,580,266	89,067	298,749	3,354	1.21	2.55	3.45	9
Washington	2,860,940	2,101,597	35,311	150,265	4,255	0.78	1.23	1.68	40
West Virginia	747,838	502,407	6,169	20,440	3,313	0.75	0.82	1.23	44
Wisconsin	2,621,165	1,927,602	51,916	172,573	3,324	1.25	1.98	2.69	17
Wyoming	243,718	174,048	2,108	11,547	5,478	0.74	0.86	1.21	45
Other areas [1]	1,579,815	635,946	60,645	201,341	3,320	3.45	3.84	9.54	N/A

[1] Includes, for example, returns filed from Army Post Office and Fleet Post Office addresses by members of the armed forces stationed overseas; returns filed by other U.S. citizens abroad; and returns filed by residents of Puerto Rico with income from sources outside Puerto Rico or with income earned as U.S. Government employees.

NOTES: (a) This table presents aggregates of all returns filed and processed through the Individual Master File (IMF) system during Calendar Year 2005, including any returns filed for tax years preceding 2004.

(b) In general, during administrative or Master File processing, taxpayer reporting discrepancies are corrected only to the extent necessary to verify the income tax liability reported. Most of the other corrections to the taxpayer records used for these statistics could not be made because of time and resource constraints. The statistics in this table should, therefore, be used with the knowledge that some of the data have not been perfected or adjusted for statistical purposes.

(c) Classification by State was usually based on the taxpayer's home address. However, some taxpayers may have used the address of a tax lawyer, or accountant, or the address of a place of business; moreover, such addresses could each have been located in a State other than the State in which the taxpayer resided.

(d) For explanation of the tax law changes which could affect the year-to-year analysis of data, refer to the respective years' "Individual Income Tax Returns, Preliminary Data" article published in the SOI Winter Bulletin. For further explanation of the tax terms, refer to the "Individual Income Tax Returns," Publication 1304.

SOURCE: IRS, Statistics of Income Division, Individual Master File System, January 2006, and Tax Policy Center.

<http://www.taxpolicycenter.org/TaxFacts/TFDB/TFTemplate.cfm?Docid=536>

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”

June 27, 2007

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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.

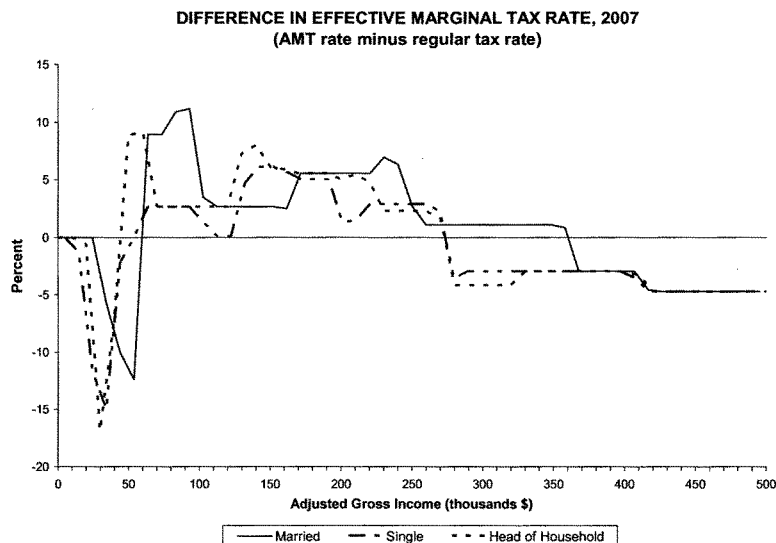
According to calculations by the Brookings-Urban Tax Policy Center, a family with an income of \$75,000 and four children would face almost \$2,000 in extra tax absent a patch. Individuals with higher incomes will generally face higher taxes from the AMT. These new taxes may well be high enough, and 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.



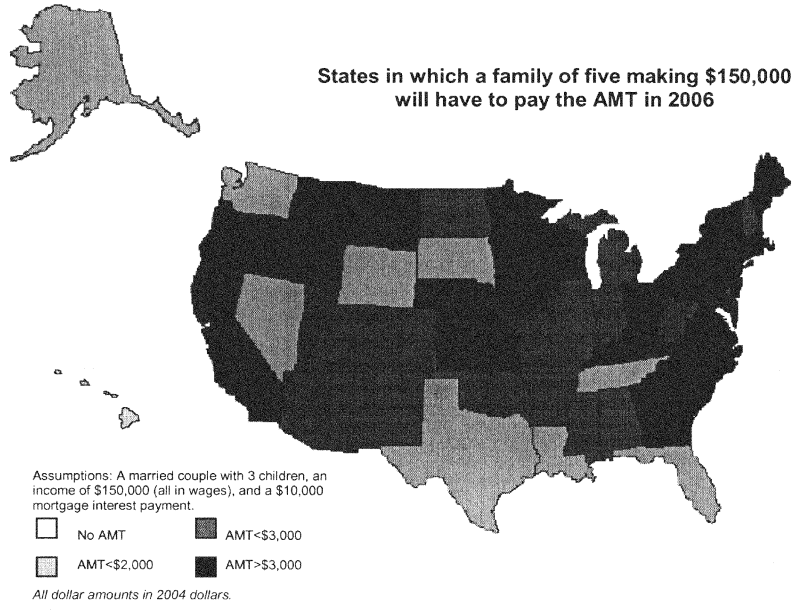
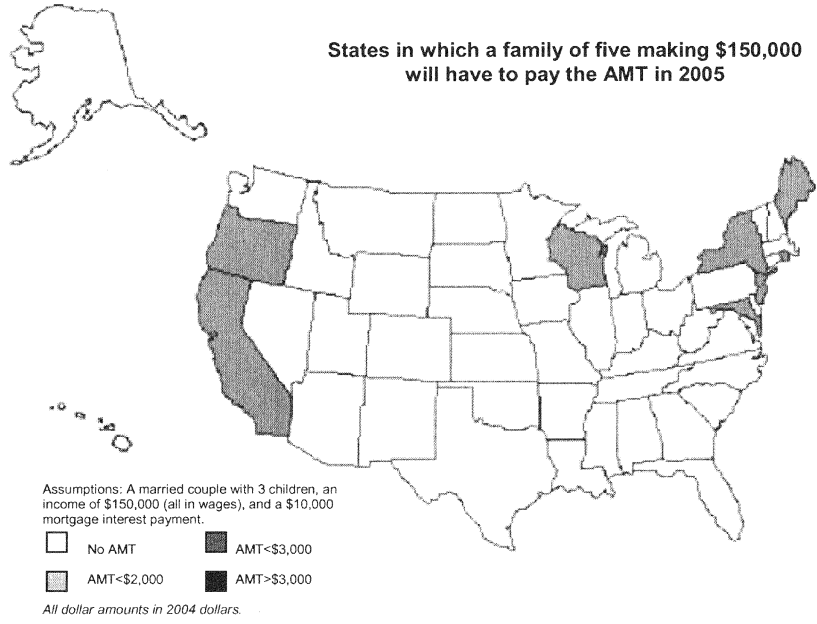
Source: Viard, A. "The Alternative Minimum Tax," AEI Tax Policy Outlook, November 2006, [www.aei.org/publication25110](http://www.aei.org/publication25110)

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.

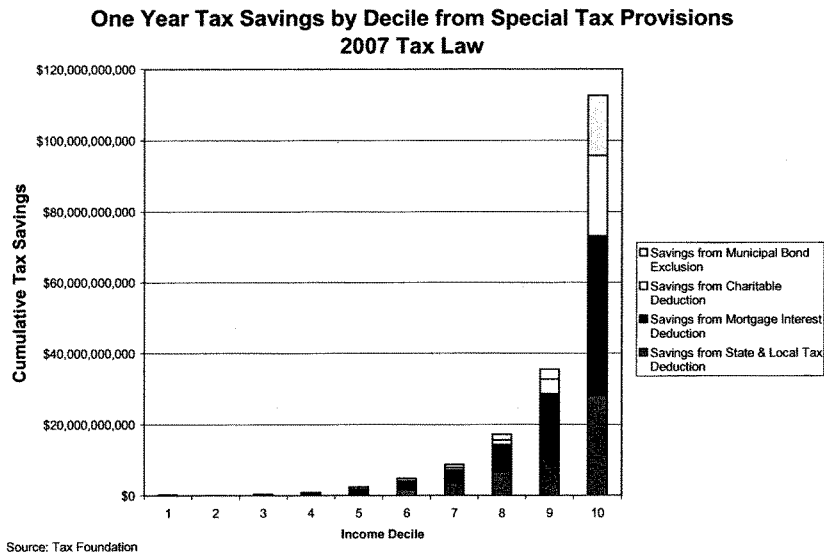
In addition to higher tax rates, the AMT also often imposes bizarre and confiscatory taxes on individuals who have received legal settlements, have stock options, or find themselves in other circumstances that are treated unfavorably by the AMT. Accordingly, repeal of the AMT seems the prudent course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



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.



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. By eliminating these deductions, the rapid expansion of the number of taxpayers paying the AMT can be halted while still lowering marginal tax rates.

**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%		9.5%	9%	7.5%	7%
15%		14%	13.5%	11.5%	11%
25%		23.5%	23%	21%	20%
28%		26.5%	26%	22.5%	22%
33%		31.5%	30%	26.5%	24%
35%		33.5%	32%	28.5%	26%

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 33.5 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 26 percent, and the bottom rate to 7 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, keeps middle income Americans off the 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.

**Responses to Questions for the Record From Dr. Kevin Hassett  
Senate Finance Committee Hearing of June 27, 2007**

*From Senator Baucus*

1. Dr. Hassett, your written testimony mentions the state and local income tax deduction several times. You state that the people that benefit from this deduction the most are wealthy taxpayers. You also provide that most of the revenue loss is from key deductions and exclusions taken by the top 10%. Why is that?

There are a variety of reasons why the state and local tax deduction is more heavily exploited by wealthy taxpayers. High-income taxpayers pay a higher marginal rate on their income, and consequently the tax deductions that they can take save them more money than low income taxpayers. Furthermore, high income taxpayers tend to live in areas with higher state and local tax rates, which are used to finance public spending on services and projects. Many of these services are not provided in low income areas, or provided with poorer funding (e.g. schools, hospitals, and even golf courses). Furthermore, the state and local tax exemptions [like all of the described tax exemptions] are biased towards high-income tax itemizers over low-income taxpayers that take the standard deduction.

2. Your testimony mentions capping the mortgage interest deduction. How would the cap work? Per year? Over the lifetime of the loan?

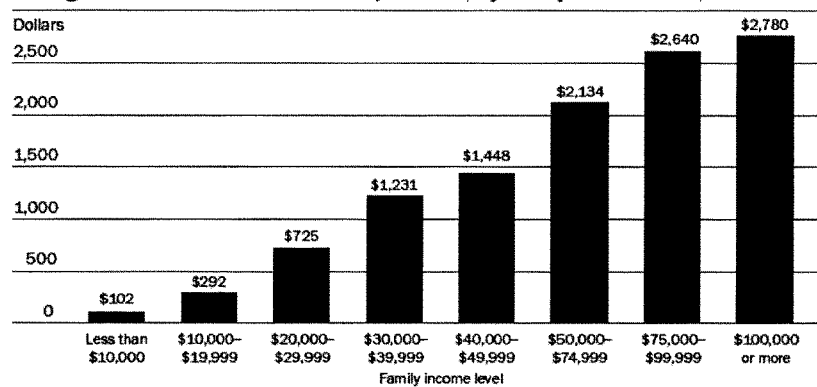
First of all, it is worthwhile to point out that the mortgage interest deduction is currently capped at \$1 million, so I am not proposing something completely new. My proposal would copy the current policy, but at a lower cap. Reducing the existing cap would raise revenue that could be used to fix the AMT and lower marginal rates.

3. You also refer to eliminating the health insurance exemption, the child tax credit, and the social security benefit exemptions. Wouldn't eliminating these benefits have more of a negative impact on lower and middle income taxpayers?

The answer changes depending on which item is changing. It is worth noting that marginal rate reductions could, in some cases, offset undesirable distributional consequences of any changes.

Health insurance exemption: The health insurance exemption is currently used by high income taxpayers far more often [and with greater magnitude] than low income taxpayers. The higher marginal tax rates of high income taxpayers means that they gain more savings from the deduction than low income earners. Furthermore, upper income families tend to buy more expensive healthcare programs than low income families, taking up a sizeable portion of the costs of the exemption.

**EXHIBIT 2**  
**Average Federal Health Benefit Tax Expenditure, By Family Income Level, 2004**



**SOURCE:** Lewin Group estimates using the Health Benefits Simulation Model (HBSM). Average per family is \$1,482.

[[http://content.healthaffairs.org/content/vol10/issue2004/images/data/hlthaff.w4.106v1/DC1/Sheils\\_Ex2.gif](http://content.healthaffairs.org/content/vol10/issue2004/images/data/hlthaff.w4.106v1/DC1/Sheils_Ex2.gif)]

**Child tax credit:** The CTC is a lesser benefit to low income families (below \$11,000), and is only a partial benefit to other low income families (below \$33,000 depending on the number of children in the family) due to the phased nature of the credit. However, as the credit begins to get phased out once adjusted gross income exceeds \$110,000, it would appear that the elimination of the benefit would harm lower and middle income taxpayers.

**Social Security benefit exemption:** Given that the exemption is phased out as income increases above \$25,000 for individuals and \$32,000 for couples, the repeal of the benefit would harm lower and middle income earners.

4. Your testimony also mentions reducing tax rates. Does eliminating some preferences and capping exclusions entirely cover the cost of AMT repeal and lower tax rates?

Eliminating the preferences that I discussed in my testimony would effectively halt the escalation in the number of taxpayers subject to the AMT. With different marginal rate adjustments, it is possible to completely eliminate the AMT in a revenue neutral manner.

Below is a chart of revenue neutral tax changes that can be implemented that keeps the number of taxpayers subject to the AMT about constant at current levels while lowering marginal tax rates:

**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%	9.5%	9%	7.5%	7%	
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28%	26.5%	26%	22.5%	22%	
33%	31.5%	30%	26.5%	24%	
35%	33.5%	32%	28.5%	26%	

Source: Tax Foundation

5. How does the individual AMT impact small businesses?

Small businesses that are registered S-corporations and limited liability partnerships pay their corporate taxes through their personal income tax forms. These corporations, through their special tax status, are punished by the diminished deductions allowable under the AMT. One big deduction disallowed under the AMT is the accelerated depreciation of new machinery or equipment.

6. What do you think about Mr. Graetz's proposal to hold off on any type of AMT reform and implementing a patch that goes to 2009 or 2010?

The sooner we get to AMT reform, the better. It is a political judgment not an economic one whether it is best to delay right now. I respect the opinions of the members of the committee on such matters more than my own.

7. Dr. Burman proposes to repeal the AMT. He also suggests several proposals to pay for repeal, with a main focus on imposing a \$5 surtax on taxpayers with adjusted gross income above \$100,000 for singles (\$200,000 for couples). Is this feasible and will it raise enough revenue to cover repeal? Who will benefit and who will be harmed?

While a 4 or 5 percent surtax is feasible, it seems as if we are sending mixed messages to the upper-class. On the one hand, we give them a variety of income tax exemptions—and then we hit them with a tax increase. It makes much more sense to eliminate those deductions.

The highest income Americans would have to pay the largest portion of the AMT repeal.



**Option 2: Repeal AMT & Increase Top Income Tax Rates**

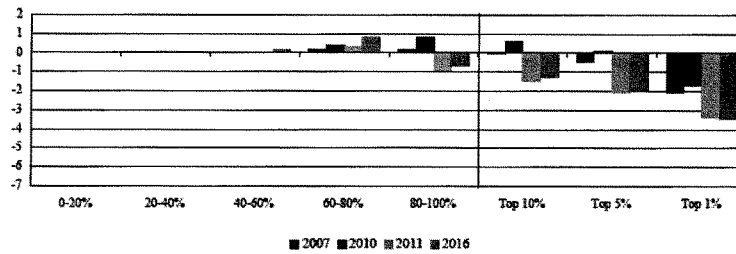
**Key Features**

- Repeal the AMT
- 15 percent increase in top three income tax rates

Income Tax Rates											
	2007-10						2011-2016				
Current Law	10.0	15.0	25.0	28.0	33.0	35.0	15.0	28.0	31.0	36.0	39.6
Option 2	10.0	15.0	25.0	32.3	38.1	40.4	15.0	28.0	35.8	41.5	45.7

Change in Tax Liability (Fiscal years, billions of dollars)												
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2007-11	2012-16
Option 2	-6.4	-21.5	-32.9	-44.4	-19.5	32.1	29.4	26.0	21.9	16.0	-124.6	125.4

**Percent Change in After-Tax Income, by Year and Cash Income Percentile**



[From Burman, "Options to save the AMT"]

8. One of Mr. Degen’s 3 criteria for a workable AMT fix is to limit the scope of the AMT to taxpayers that are engaging in the most egregious tax avoidance? Do you agree and how would it work?

I think it is best to eliminate the AMT, and use enforcement and law changes in the ordinary code to address egregious tax avoidance.

**STATEMENT OF SENATOR KEN SALAZAR**  
**FINANCE COMMITTEE HEARING**  
**“THE STEALTH TAX THAT’S NO LONGER A WEALTH TAX: HOW TO**  
**STOP THE AMT FROM SNEAKING UP ON UNSUSPECTING TAXPAYERS”**  
**JUNE 27, 2007**

Thank you, Chairman Baucus and Ranking Member Grassley, for holding this important hearing on how Congress should address the growing problem of the Alternative Minimum Tax.

We all know how pervasive the AMT has become since it was first enacted in 1969. Despite the fact that Congress originally intended for the AMT to restore fairness to our nation’s tax system by targeting wealthy taxpayers who had successfully worked the system to avoid any tax liability, the AMT now ensnares millions of honest taxpayers—over 4 million of them in tax year 2006—many of whom fall squarely in the middle class.

Just last month, this Committee held a hearing to examine the economic squeeze that many middle-class households are facing. As the cost of health care, education, and housing continue to rise, these households are seeing their pocketbooks challenged on all fronts. The last thing they need is for the federal government to burden them further with a tax that they were never intended to pay.

Today, married couples with children—not tax-sheltering millionaires—are the most likely taxpayers to owe the AMT, and as the number of Americans with AMT liability continues to rise, our tax system is becoming increasingly unfair. What’s more, the number of high-income families with no tax liability has actually grown—from 155 in 1969 to nearly 3,000 today.

4.2 million taxpayers are expected to face AMT liability in 2006. If Congress takes no action, that number will rise to 23 million—including approximately 200,000 additional taxpayers from my state of Colorado—in tax year 2007. Now more than ever, it is clear we need to take action to restore fairness to our tax code.

Short-term AMT “patches,” however, will not ultimately accomplish that goal. While these patches provide essential relief by temporarily raising the exemption for one or two years, the uncertainty associated with this stop-gap solution is inherently unfair to taxpayers. This year, for instance, millions of middle-income Americans are facing the grim possibility that Congress won’t enact a patch for the 2007 tax year—even though it is now June and well into the tax year.

We need a solution for the long term that is both fair and fiscally responsible. Given that the proposals offered by our panelists today—and the proposals of some of my Senate colleagues—vary greatly in terms of both complexity and cost, I believe it is very important to examine AMT reform in a broad, comprehensive context that is mindful of the effects such reform could have on our federal budget and the fundamental fairness of our tax system.

It is also worth taking a closer look at how AMT liability has increased for many taxpayers as a direct result of the Bush tax cuts. Because of the way our system is now structured, many of the taxpayers who could benefit the most from these cuts are instead hit with increased AMT liability. For many middle-income Americans, then, the recent tax cuts have turned into “phantom benefits” that serve only to increase their tax liability and their frustration with the tax system. As a supporter of many of these tax cuts, I find it disturbing that the AMT has rendered them meaningless.

I am also hopeful that we can find a solution that will help simplify our tax code and ease the tax filing burden on American taxpayers. Under the AMT system, taxpayers essentially have to calculate their taxes twice, and the IRS estimates that it takes the average taxpayer 63 hours to calculate his or her AMT liability. There has to be a way we can make the process simpler.

While taking on the AMT will require a great deal of cooperation and careful fiscal analysis, I believe that we can institute the sensible, workable AMT reform that American taxpayers deserve. I look forward to hearing from our witnesses on how we can go about doing just that.

Thank you.



COMMUNICATIONS

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**Statement of the  
American Farm Bureau Federation**

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**HEARING OF THE SENATE COMMITTEE ON FINANCE  
ON THE ALTERNATIVE MINIMUM TAX**

**JUNE 27, 2007**

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Farm Bureau supports repeal of the Alternative Minimum Tax (AMT) because its impact has expanded beyond preventing very high income earners from using highly specialized deductions, exemptions, and credits to minimize or eliminate their income tax liabilities. The AMT's parallel set of income tax rules now affects a growing number of middle income taxpayers who take advantage of widely used deductions, exemptions and credits, including farmers and ranchers.

When enacted several decades ago, the AMT targeted the top 1 percent of income earners, about 400,000 taxpayers by the start of the 1970s. Deductions, exemptions, and credits nullified by

AMT rules were highly specialized provisions that were not often used by the common taxpayer. The AMT has mutated into a broad-based middle income tax. Income thresholds that determine AMT liability (generally \$175,000 for a joint return) have not been changed to keep pace with inflation. Nor has the AMT exemption (\$49,000 for a joint return) been increased to reflect inflation.

As a result, both the number of people owing AMT and the amount of tax owed are increasing. In real dollars, the AMT threshold and exemption are essentially 17 percent lower now than they were just 5 years ago. As a result, up to 1 percent more people are subject to AMT each year simply because of inflation. Ten years ago the AMT collected \$2 billion from 720,000 taxpayers. In 2005, an estimated \$15 billion in AMT was collected from about 4 million tax payers. According to the Joint Economic Committee, 17 million returns will include an AMT payment in 2010.

**Farmers and ranchers pay more AMT than non-farm taxpayers because of farm income distribution.**

While average farm household income and non-farm household income are approximately equal, a greater share of farm households fall above the AMT threshold. USDA's farm household income statistics and IRS statistics indicate that about 4.5 percent of the general taxpayer population was liable for AMT in 2004-2005 while over 6 percent of farm households were liable. Until the threshold and exemption are increased and indexed for inflation, the AMT will impact more and more middle income taxpayers. While predictions are that one in four households will owe AMT by 2010, the affect on farmers and ranchers will be much greater with three or more out of ten owing the tax due to the distribution of farm household income.

**Farmers and ranchers pay more AMT than non-farm taxpayers because they lose the ability to deduct some of their state and local taxes.**

Farmers and ranchers pay more in state and local income and property taxes, even after Schedule F and Schedule A distinctions are made. This is because farmers and ranchers typically report more property tax under Schedule A that is not allowed in the AMT calculation than many other taxpayers. They also tend to itemize deductions more than many other taxpayers and hence lose the state income tax deduction under the AMT calculation. Farmers and ranchers above the AMT threshold currently claim over \$1 billion in state and local property tax deductions. Without the ability to deduct all state and local taxes, they will pay an added \$300 million in AMT.

**Farmers and ranchers pay more AMT than non-farm taxpayers because they lose the ability to deduct some farm and ranch operating losses.**

The deduction of farm and ranch operating losses by sole proprietorships, partnerships, and S corporations commonly used in agriculture is limited by the AMT calculation to 90 percent of pre-loss income. Because wide income swings are common in the farming and ranching business, the impact of the inability to take a full operating loss deduction is significant. For example in 2004-05, USDA farm income data indicated that over half of farmers and ranchers reported losses in one or more of their farm businesses. Hence, a significant proportion of AMT-liable farm and ranch operators have some business losses that are disallowed under the AMT. The problem is exacerbated by the fact that farmers are least able to pay added AMT following years with losses. The amount of additional AMT owed because of the inability to fully deduct farm operating losses is about the same as the amount owed from the denial of the state and local taxes deduction.

**Farmers and ranchers pay more AMT than non-farm taxpayers because they tend to have more capital gains tax income than taxpayers in general.**

Farming and ranching is a capital-intensive business, with IRS and USDA records suggesting that farmers and ranchers depend on capital gains earning for a larger portion of their lifetime income than non-farm households. Because AMT has higher capital gains effective rates than regular income tax rates, farmers and ranchers pay more AMT than the public at large. To make matters worse, the AMT often comes due in particularly sensitive years when farmers and ranchers have liquidated their operations and have moved into retirement when income is reduced and the tax more burdensome.

**Conclusion**

Farm Bureau supports repeal of the Alternative Minimum Tax because it no longer promotes tax equity. Because of the way the tax is calculated, the impact on farmers and ranchers is greater than on the public at large. Operating loss deductions, deductions for state and local taxes and favorable capital gains tax treatment were enacted by Congress for sound policy reasons. To deny them under the AMT, and thereby add to the farm and ranch tax burden, creates an unintended but real financial strain on agricultural producers. At the very least, the household income threshold and exemption amount should be increased and indexed for inflation. As a matter of fairness, changes should be made to allow farmers to take full advantage of the deductions for operating loss and for state and local taxes. Alterations also are needed so that capital-intensive businesses like farming are not disadvantaged by the tax.

June 22, 2007

Statement For The Record  
Mary Jane Spence  
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Ashburn, Virginia 20147

Please include this statement for inclusion in the record on the upcoming hearing : THE STEALTH TAX THAT'S NO LONGER A WEALTH TAX: HOW TO STOP AMT FROM SNEAKING UP ON UNSUSPECTING TAXPAYERS. Hearing June 27, 2007

#### STATEMENT

I am one of America's average citizens, who lives on a Federal pension. My husband also lives on a Federal pension. I don't believe Congress can associate any longer with the average citizen, due to all the lobbying that speaks for special interests and not those of the average American public. Congress has lost touch with the voters and I believe the upcoming elections will show this, and that many people will vote for a person, not a party in this election year and next year.

The actual cost of living, which far exceeds any small percentage a person receives in his/her pension check, is eroding the quality of life of Americans across this entire Country. Where ever I go, I hear the same complaints. Big businesses, and lobbyists are getting the ear of Congressmen and Congresswomen, and there are few who will stand up for us.

Having a lower income now, we still get hit with the AMT tax, which grows every more burdensome to us. Many of the baby boomers who are retiring or will retire in the near future will have to adjust to a much lower income stream, and will also be hit with a double Federal tax, the AMT tax.



I would hope that Congress will act this year, to adjust this AMT tax for those whom it was meant for - - - the very wealthy, who have yachts, planes, etc., and are above the \$300,000 income level. Each year, we give up more of our income to a double Federal tax, and to a Virginia State tax and to County property taxes, which leaves us with a smaller amount of funds to re-invest in our quality of life, and our ability to fuel the American economy.

I hope that you will listen to the average American's who are getting more and more burdened with this AMT tax, and adjust it downward for who it was originally intended.

Because the Federal Budget is increasing and spending is not being controlled, we see more and more pork barrel "special interest" spending, while others who are trying to live comfortably are suffering more and more each year.

I hope that Republicans and Democrats can come together to work across the table for the benefit of the American taxpayers, and revise the AMT tax tables for 2008 and beyond.



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