

Point and Counterpoint: Should the Individual AMT Be Repealed?

By Linda M. Beale and Yoram Keinan

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Introduction

The President's Advisory Panel on Federal Tax Reform has been charged with advising on options to make the Code "simpler, fairer, and more pro-growth." It does so as Congress considers a variety of tax-related topics, including funding for Social Security, making the 2001 and 2003 tax reductions permanent, and using a VAT to replace or supplement the federal income tax. Among the topics that the Panel and Congress may consider is the individual Alternative Minimum Tax (AMT), which was enacted in 1969 in response to reports of high-income taxpayers who paid little or no income tax. Over time, Congress expanded the AMT but failed to index its provisions. As a result, the AMT now affects a significant number of middle-class taxpayers and is often criticized. Although the Joint Committee on Taxation has called for repeal of the AMT, repealing the AMT will soon be more costly than repealing the income tax itself. In this Point/Counterpoint debate Professor Linda Beale of the University of Illinois makes the case for retaining the AMT with modifications, while Yoram Keinan of Ernst & Young argues that the AMT should just be repealed, the sooner the better. In reaching their conclusions each considers topics assigned to the Advisory Panel: simplicity, fairness, and growth.

— Gail L. Richmond, Fort Lauderdale, FL

Point:

The Individual AMT Should Not Be Repealed (But Should Be Reformed)

by Linda M. Beale, Champaign, IL

Although the AMT was originally enacted to target the superwealthy, various changes in the early years reflected Congress' goal of limiting the ability of any taxpayer to reduce his or her federal tax burden by aggregating preferences. The current AMT thus acts as a secondary tax system with flatter rate brackets and a broader tax base that applies whenever a taxpayer's

accumulated preferences under the regular tax result in a tax liability below that demanded by the AMT. There are genuine concerns about its complexity, its potential reach into lower-income ranks, and its lessened effectiveness in ensuring that the wealthy pay at least a minimum level of tax on their economic income. Nevertheless, several factors outweigh these concerns. These factors include the country's current fiscal situation, efficiency arguments that recognize the AMT's reinforcement of policies underlying certain preferences, fairness arguments favoring the AMT as an existing mechanism for targeting high-income taxpayers in ways that remain politically palatable, and the potential for pragmatic reforms to ensure that the AMT retains its role as a supplemental rather than a primary tax system.

Current Fiscal Situation

No discussion of potential AMT repeal can take place without considering the current fiscal context. Although the broadening reach of the AMT is undeniable, outright AMT repeal would even further burden ordinary taxpayers with future tax increases or spending reductions if 2001-2003 tax cuts are not substantially rolled back. Those tax cuts (including estate tax repeal) decreased progressivity and disproportionately benefited the super-rich. Fiscal pressures to reduce the federal deficit — more than \$400 billion in 2004 and likely to soar to a record proportion of GDP in 2005 and beyond — hurt poorer Americans most, since programs that invest in human capital and welfare are targeted for reduction but spending related to the United States' expanded global military presence and concerns about terrorist activity is not. Related increases in federal borrowing, at \$7.6 trillion and rising, affect currency exchange, foreign trade and interest rates, with the greatest impact on prices of ordinary consumer goods and availability of credit for middle- and lower-income Americans. One study confirmed: "[o]nce the financing is included, the 2001 and 2003 'tax cuts' are best seen as net tax cuts for about 20-25 percent of households, financed by net tax increases or benefit reductions for the remaining 75-80 percent of households." William G. Gale, Peter R. Orszag, and Isaac Shapiro, "Distribution of the 2001 and 2003 Tax Cuts and Their Financing", 103 *Tax Notes* 1539, 1539 (June 21, 2004).

Efficiency Revisited

Arguing from efficiency, critics suggest that it is counterproductive to step back preferences in the alternative system when those preferences operate as economic growth incentives in the regular system. Those arguments gloss over the polycentric and shifting rationales for preferences in the regular tax system — a provision that is proposed to reduce a surplus may be enacted to spur growth, or one that is originally enacted to spur growth may be retained even though it has been shown to have little or no effect on growth. Indirect reduction of

COMMENTARY / CURRENT AND QUOTABLE

subsidies *in the aggregate* through the AMT may be politically palatable when direct elimination of *particular* subsidies would not be possible.

Furthermore, if the AMT is retained but restructured so that ordinary taxpayers are exempt, the straightforward availability of preferences in the regular tax system, coupled with the limitations on preferences in the AMT system, can reinforce rather than undermine preferences that are designed to help ordinary taxpayers. For example, the mortgage interest deduction was intended to allow ordinary Americans to realize their dream of owning a home. If they are assured of a mortgage interest deduction unaffected by the AMT clawback, the preference would encourage the purchase of modest homes as intended. At the same time, a change to the AMT treating all or part of the deduction as an AMT preference would appropriately lessen its incentive effect on the wealthy, since purchases of large homes (or purchases of second homes) would not be as likely to benefit. That result is not distortive of, but in fact consistent with, the original goal of the mortgage interest deduction to increase the percentage of Americans owning a home. The legislative history of AMT expansion reflects Congress' general understanding of this mechanism, noting the problem of wealthy taxpayers who benefit from provisions that were intended "to aid some limited segment of the economy." *Committee on Ways and Means Report on the Tax Reform Act of 1969*, H. Rep. No. 91-413 (Aug. 2, 1969), at 1.

Fairness Demands

The recent changes to the overall federal tax system have significantly reduced its progressivity. The estate tax, a major redistributive mechanism, has been substantially reduced and may even be eliminated. The failure of Congress, in enacting the recent tax cuts, to limit major preference items that disproportionately benefit high-income taxpayers makes it even easier for them to avoid tax on their economic income during their lifetimes, unless the AMT is retained as a backstop.

Wealthy taxpayers, as noted, receive generous benefits from the mortgage interest deduction applicable to first and second homes. They also can afford to purchase luxury health care and take advantage of the tax deduction for medically necessary facilities, such as swimming pools, that are beyond the reach of most. This different response to incentives is heightened because the majority of lower-income taxpayers do not itemize and therefore cannot take many regular tax deductions that significantly reduce tax bills for the wealthy. Moreover, the recent tax changes have extended additional regular tax preferences, including lower rates on capital gains that disproportionately accrue to the super-rich and a new sales tax deduction that reduces the cost in low income-tax states of luxury consumer purchases such as yachts, diamonds, and designer appliances. Changes that provide tax-favored treatment of savings beyond the amount ordinary Americans can set aside may yet be implemented. Without some mechanism such as the AMT to re-balance the allocation of the tax burden, working Americans will bear the full cost of government, and wealthy Americans will essentially have a free ride.

The AMT provides such a mechanism, by recalculating the tax burden when the cumulative preferences

under the regular tax reach a critical threshold. It does not reach every wealthy American who is not otherwise paying taxes at the highest regular tax rates, but it reaches a substantial number of the wealthiest Americans. Although without some reforms the AMT will extend into the \$75,000 income bracket in 10 years, the average income is still substantially below that amount, so that the AMT, even without realistically possible structural reforms, still increases overall progressivity.

AMT critics suggest that fairness benefits are not sufficient to support the AMT, yet offer no realistic solution in the current political climate to halt the slide towards regressivity. Neither AMT repeal coupled with retention of the current regular tax nor retention of the current AMT coupled with repeal of the regular tax would satisfy distributive justice goals. The revenue cost of AMT repeal would require that the regular tax be restructured to eliminate most changes made in the last four years. Given the investment of the current Congress and Administration in those changes, reversal is highly unlikely in the near future. A possible alternative to AMT retention would be to install phase-outs on all regular tax preferences, but most commentators disfavor phase-outs in the regular tax system as a major source of complexity for all taxpayers. Furthermore, phaseouts require Congress to determine an income ceiling for benefits. If that ceiling is different for different types of benefits, complexity mushrooms; yet a single ceiling for every type of preference may be inappropriate. If ordinary taxpayers can be exempted from the AMT, the AMT may actually provide a means of removing complexity from the system applicable to ordinary taxpayers while permitting AMT liability to be based on the cumulative preferences utilized by each taxpayer.

Appropriate Reforms

A simple reform, suggested by the National Taxpayer Advocate and other commentators, could eliminate two of the most significant AMT concerns — the complexity of AMT determinations for ordinary taxpayers and the expanding AMT reach into middle-income brackets. By establishing an income threshold, indexed to inflation, that would eliminate AMT liability for those with approximately twice the national average income or less, most Americans would have no need to be informed about the AMT or to do any complex AMT calculations.

That reform must be paid for through tax increases elsewhere in the system or substantial reduction of programs. In order to ensure that the AMT remains targeted towards higher-income taxpayers, these changes should include treating additional deductions and exclusions typically enjoyed by wealthy taxpayers as AMT preferences and repealing the recent rate cuts for the highest regular tax brackets.

Conclusion

In the current political environment, fairness concerns strongly favor retention of the "back-up" AMT system to ensure that taxpayers who have substantial preferences incur at least some tax liability. Concerns about complexity and continuing encroachment on middle-income brackets can be addressed by simple reforms such as instituting a reasonable gross income threshold for AMT liability that is indexed for inflation. Revenues for these

reforms can be raised by the addition of new preferences tailored to ensure that the AMT targets high-income taxpayers and those who aggregate preferences to avoid taxation and by eliminating the regular tax rate cuts for taxpayers in the highest income brackets.

Counterpoint: The Individual AMT Should Be Repealed

by Yoram Keinan, Washington, DC

The minimum tax, the predecessor to the current AMT, was enacted in 1969 to prevent "higher income individuals from substantially eliminating income tax liability through the excessive use of preferences." Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, JCS-10-87, at 7. Congress reiterated that objective when it replaced the minimum tax with the AMT in 1978 and when it strengthened and expanded the AMT in the Tax Reform Act of 1986. Thus, the AMT was expected to enhance horizontal and vertical equity. It could also make the income tax system more efficient by limiting the use of preferences. Although administrability and revenue were not primary concerns when the tax was first enacted, the pendulum has now shifted, so that there are now calls for retaining the AMT for revenue considerations, and the difficulties of administering the tax have become a major drawback. This essay explores the AMT from these policy perspectives and concludes that the AMT hardly serves the purpose that originally justified its enactment. It should therefore be repealed. While some commentators call for retaining the AMT while fixing its current flaws, as discussed below, it will be more efficient to repeal the AMT and fix the current flaws in the regular income tax system.

Revenue

Since the scope of the AMT has significantly expanded, AMT revenue has increased. In the near future, most of the revenue from the AMT will come from "ability to pay" preferences. A recent estimate provides that over the next ten years, the revenue loss from repealing the AMT could reach \$800 billion. Dep't of the Treasury, *Fact Sheet: The Toll of Two Taxes: The Regular Individual Income Tax and the AMT*, (JS-1293) (April 2, 2004). Nevertheless, this loss could be significantly reduced if AMT repeal is combined with the imposition of phase-outs on preferences. In any event, the sooner the AMT is repealed, the lower the costs of repealing it will be.

Efficiency/Neutrality

Some commentators believe that a tax is efficient if it promotes economic growth. Congress uses the regular tax to achieve social and economic objectives by providing preferences, including investment incentives. Nevertheless, the Joint Committee on Taxation explained that such preferences "become counterproductive when taxpayers are allowed to use them to avoid virtually all tax liability." Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, JCS-10-87, at 432-433. Taxing such preferences (which is equal to limiting them if the AMT and regular tax rates are equal, as is almost the case today) frustrates the purpose for enacting them.

Thus, to the extent that it limits the use of preferences whose purpose is to encourage economic growth, the AMT is inefficient.

By contrast, a tax is viewed as efficient (neutral) if it does not interfere with a taxpayer's economic behavior. A neutral tax, therefore, is one without preferences. Prior to enacting the AMT, Congress considered limiting the use of certain preferences as an alternative to imposing a separate tax. Ultimately, Congress chose to achieve its equity objective by imposing a second level of tax on the sum of such preferences over an exemption amount. Having separate systems allows Congress to retain various preferences within the regular tax system while ensuring that the AMT limits their use. Such a dual system is even less neutral than the limitation method originally proposed.

In a dual system, one must question what types of preferences ought to be taxed in order to create a more efficient system. Under an all-inclusive regime, a preference would be any deduction, credit or exemption that reduces tax liability. Such a regime would create a tax base free from preferences, so taxpayers pay tax on their economic income. Under a narrower approach, only preferences that violate neutrality in a taxpayer's decisionmaking (tax-motivated activities) ought to be taxed.

The AMT has never had a tax base that approximates true economic income, largely because the AMT is subject to the same political pressures as the regular tax. The AMT has always targeted only selected preferences. In other words, it has discouraged activities that give rise to preferences on a limited basis. The original preferences generally included items related to investment activities. Subjecting such preferences to the AMT caused taxpayers to change their investment behavior solely to avoid the AMT. Thus, even in its original form, the AMT was inefficient. Attempts in 1986 to move the AMT closer to its intended purpose, with the addition of the book income preference, basically failed. In conclusion, Congress ought to focus on how to make the regular income tax more efficient rather than trying to keep two parallel systems, each of which is inefficient.

Equity

A study conducted in the late 1960s revealed that in 1967, 155 individuals with income above \$200,000 paid no income tax. See Hearings on the 1969 Economic Report of the President before the J. Comm., 91st Cong. 46 (Govt. Printing Office 1969). Congress reacted quickly to this perceived unfairness by enacting the minimum tax. Congress assumed that the percentage of taxpayers subject to the tax would increase as income increased, thereby creating a more equitable tax system. In 1970, Alan Schenk observed that "[t]he net effect of this new tax thus makes the entire tax structure more progressive." Alan Schenk, "Minimum Tax for Tax Preferences", 48 *Taxes* 201 (1970).

In 1986, Congress's stated objective in strengthening and expanding the AMT's scope, continued to be equity: "[T]he minimum tax should serve one overriding objective: to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using

COMMENTARY / CURRENT AND QUOTABLE

exclusions, deductions and credits." Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, JCS-10-87, at 7.)

Nevertheless, the term "minimum tax" implies that Congress did not intend to enhance progressivity significantly and expected only some minimum achievement. In fact, the AMT added very few wealthy taxpayers to the income tax payment pool. Despite its presence, some wealthy taxpayers continue not to pay tax, and many others pay insignificant amounts.

Additionally, the AMT's burden has shifted to middle-class taxpayers. This shift is attributable to: (i) the significant expansion of the AMT base; (ii) the failure to index the AMT exemption for inflation; and (iii) the recent reductions in regular income tax rates. Due to the latter two factors, the pattern of more middle-class taxpayers being subject to the AMT will continue. As to the AMT base expansion, the targeted preferences in 1969 included excess investment interest, accelerated depreciation on real property and personal property subject to a net lease, rapid amortization of certified pollution control facilities, the exercise of certain stock options, percentage depletion, and capital gains.

Congress has since expanded the AMT base to include such "ability to pay" amounts as personal exemptions and the standard and certain miscellaneous itemized deductions. Additionally, several regular income tax credits, such as those for education, are limited to the difference between AMT and regular tax liability, the effect of which is to partially establish that such credits are subject to the AMT. Finally, some preferences, which in 1969 were available to wealthy people, are available today to middle-income taxpayers; stock options are an example of this phenomenon. In 1969, stock options were generally limited to high-level executives; since then, their use as a compensation tool has broadened considerably.

Clearly, Congress's intention in enacting the AMT was not to impose a surtax on the middle class. The preferences that trigger the AMT today do not correspond to its original objective for two reasons: (i) Congress expanded the scope of the targeted preferences significantly; and (ii) Congress did not anticipate that preferences originally available only to wealthy taxpayers would become available to more taxpayers.

To conclude, as one commentator observed, the AMT has changed from a "class tax," to a "mass tax." Leonard Burman, William Gale, Jeffrey Rohaly and Benjamin Harris, "The Individual AMT: Problems and Potential Solutions," 55 *Nat'l Tax J.* 555 (2002). Daniel Shaviro has stated that despite this shift, "the AMT unmistakably increases the overall progressivity of the fiscal system." Daniel Shaviro, "Tax Simplification and the Alternative Minimum Tax," 91 *Tax Notes* 1455, 1460-61 (May 28, 2001). He agrees, however, that in the long-run, repealing the AMT would not create a more regressive tax system. In my view, although the AMT still prevents certain taxpayers from paying no tax, that equitable feature is insufficient to justify retaining it. A major motivation for the original minimum tax was to remove the most visible form of inequity — wealthy taxpayers paying no tax. Now that the AMT has become a "mass tax," it has precisely the opposite effect. Instead of giving middle

class taxpayers comfort that wealthy individuals cannot avoid paying their fair share of tax, it subjects them to a complex tax that they don't understand and perceive as unfair. It is true that the regular income tax system has become less progressive in recent years. In my view, however, this development further supports repealing the AMT and focusing on retaining progressivity in the regular income tax system.

Administrability

A complex tax regime is undesirable because it creates "deadweight loss." The original minimum tax was relatively easy to calculate. Numerous structural changes, particularly the shift from a minimum tax to an "alternative" minimum tax, have resulted in a more complex calculation scheme. Simply stated, taxpayers are now required, in addition to calculating regular tax liability, to determine if they are subject to the AMT, to calculate their AMT liability (if applicable), to compare their regular tax and AMT liabilities, and to pay the greater amount.

Opponents of the AMT state that its complexity should be a predominant factor in determining whether to repeal it. The National Taxpayer Advocate identified complexity as the most serious problem affecting individual taxpayers today and continues to recommend AMT repeal. While the increasing use of tax software simplifies the AMT calculation for tax return purposes, AMT planning is very difficult for most individuals. Repealing the AMT, therefore, will promote simplicity in the tax system. In contrast, retaining the AMT and trying to fix its current flaws will result, in my view, in even more complexity. Finally, the President's call for simplicity in the tax system further signals that administrability will play a greater role in tax policy in the near future.

Conclusion

Ideally, taxable preferences ought to be preferences used primarily by wealthy people and preferences that arise from tax-motivated activities. A system that taxed such preferences would be equitable and efficient. Nevertheless, the current AMT base includes as preferences items not reasonably classified as tax-motivated and preferences that may be used by middle-class taxpayers. Thus, the current AMT is not only inefficient; it fails to serve its original equity objective. It also imposes enormous compliance costs. While eliminating the AMT it would create a significant revenue loss, that should not prevent the repeal of the AMT.