

# **Columbia Law School**

## **Tax Policy Colloquium**

“The Political Economy of Tax Reform: The  
Case for Retaining the AMT”

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A copy of this paper is available at  
<http://www2.law.columbia.edu/taxcolloquium>

[Note: This is obviously a work in progress. In some sections I have only sketched out the argument and one section is unwritten. I welcome your comments.]

## The Political Economy of Tax Reform: The Case for Retaining the AMT

Deborah H. Schenk<sup>1</sup>

### I. Introduction

Three significant issues in tax and fiscal policy have been running on parallel tracks for the last decade, engendering their own debate, largely in isolation. Talk of fundamental tax reform rarely leaves the national rhetorical agenda, particularly during election years. Concerns about the burgeoning costs of entitlement programs, especially Medicare, Medicaid and Social Security, are voiced frequently often accompanying the release of gloomy long-term fiscal projections. The alternative minimum tax is everyone's favorite punching bag, widely reviled as a major tax policy mistake. Yet, seldom are connections drawn between the three issues. This paper fills that gap.

This paper is largely about the politics of tax policy even though it is ostensibly about one feature of the income tax. In the usual case tax scholars debate the wisdom of a tax provision as a first-best response, evaluating it from their ivory tower, far above the mud-slinging, give and take of the political arena. This paper takes it all as a given—perhaps even more unusual it uses the reality of the political process as an argument for a particular action. It is a description of the political processes that got us where we are today with respect to tax policy and how the future of a specific tax provision should be viewed through that lens.

The paper first explores the failure of both tax reform and the entitlement reform, especially the need to address revenue concerns. It offers similar political economy explanations for both. It concludes that these political issues—at least in the short term—show no signs of dissipating. It then looks at the remarkable growth of the AMT and its projected future, which is almost uniformly viewed as a crisis in the making. The standard assumption is that repealing the AMT is a good idea.<sup>2</sup> That assumption is wrong. I argue instead that given the political

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<sup>2</sup> See, e.g., Allen Kenney, Former Commissioners Say It's Time to Scrap AMT, 103 Tax Notes 1466 (June 21, 2004) (Fred Goldberg, Sheldon Cohen, Donald Alexander and Mortimer Caplin recommend eliminating the AMT); Tax Sec. ABA et al., Tax Simplification Recommendations from ABA, AICPA, and TEI, 2000 TNT 39-82 (Feb. 25, 2000) (joint recommendation for repeal).

economy problems of tax reform, that the AMT should be retained.<sup>3</sup> No one could seriously argue that the AMT is a first-best or even a second-best fiscal tool and I do not. In a perhaps tenth-best world, where Congress' ability to reform its chief fiscal tool is severely constrained and the government has worked itself into a position where raising additional revenue is extraordinarily difficult, retaining a feature that is projected to raise significant revenue and contributes to base broadening and progressivity is a plausible tenth-best solution. Let me emphasize: I am *not* arguing that the AMT is a good idea or even a good second-best idea. My approach is more pragmatic: Given where we are, repeal is a mistake.

Even so, while the concept of an AMT may be a good tenth-best solution, the actual embodiment of the concept may be so fatally flawed that it should be rejected. Thus, the paper also considers whether this is the case and concludes it is not. While there are both minor and major refinements that have some appeal and that could be made, the paper cautions against major changes. Putting reform of AMT on the legislative agenda will only run the risk of eliminating the base-broadening aspects of the tax and even worse, would substantially reduce the projected revenue. If the argument for retaining the AMT is its political viability as a solution to the failure of tax reform and revenue enhancement, it should largely be left alone.

## II. The Politics of Tax Reform

The Part explores the current political economy barriers to substantive tax reform.<sup>4</sup> It is obvious that people will not agree on an ideal tax system, regardless of their criteria. It is equally

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<sup>3</sup> There are those who argue in favor of repealing the income tax and retaining the AMT as the substitute. See Wall St. J., Dec. 6, 2006 editorial; Michael Kinsley, In Defense of the AMT, Wash. Post, Oct. 20, 2007, at A15 available at <http://www.washingtonpost.com/wp-dyn/content/article/2007/10/19/AR2007101901577.html>. For a good explanation of why repealing the regular tax and keeping the AMT is not a particularly good idea, see Burman & Weiner. Two decades ago Michael Graetz argued in favor viewing the AMT as a transition to a flat tax. Michael Graetz, "The 1982 Minimum Tax Amendments as a First Step in the Transition to a 'Flat Rate' Tax," 56 S. Cal. L. Rev. 527 (1983). Subsequently he has argued that the income tax should be repealed and replaced with a VAT and a modified AMT. See Michael J. Graetz, 100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System, 112 Yale L. J. 261 (2002). This should be considered fundamental tax reform and my argument is that such reform is not on the horizon—for political economy reasons no major reform proposal, including Graetz's, is likely to be adopted. Unlike Graetz I argue that as a second-best approach, *both* the income tax and the AMT should be retained.

<sup>4</sup> By tax reform, I will use a consensus definition stated by Dan Shaviro: "the approach that ... aims to tax different types of economic income more equally and to prevent high-income taxpayer from entirely avoiding significant tax liability." Daniel Shaviro, Beyond Public Choice and Public Interest: A study of the Legislative Process as Illustrated by Tax Legislation in the 1980s," 139 U. Pa. L. Rev. 1, 4 (1990). The term fundamental tax reform has come to mean a more dramatic shift—for example to a consumption tax or a flat tax or a truly comprehensive income tax.

clear that no one thinks that the current tax system satisfies his or her test. For the purposes of this paper, I do not have to settle on a first-best tax system—we must only agree that the current one is not it and that we would prefer something else.<sup>5</sup> If we take that as a given, what’s important for this paper is that we cannot get there easily. Political constraints at this time in our history prevent any serious attempt to do what collectively we want to do.<sup>6</sup> This section describes why that is so.

Most political economy literature with respect to tax attempts to provide a positive account of why particular tax legislation was passed. My goal is somewhat different. In this Part, I seek to explain why a certain kind of tax legislation—tax reform—is not really on either the public or the legislative agenda, i.e. why this type of tax legislation is *not* being passed. Despite the disparity between those two goals, there are sufficient similarities that it is worth examining the literature on enacted legislation for insights that may be valuable in analyzing unenacted legislation. Thus I start with this scholarship.

#### A. Drawing on the Past

The political economy literature with respect to tax legislation is somewhat sparse. Little attention was paid to tax legislation during the heyday of public interest theory. Under this approach, the government is assumed to be motivated to improve general welfare by financing public goods and correcting for market failure. Those who hew to this explanation emphasize ideology—legislators have a desire to enact good policy that will improve society.<sup>7</sup> No one seems to ever have suggested that tax legislation could be completely explained by public interest theory. [true?] This approach was subject to a good deal of criticism and ultimately was supplanted in the academic literature. The dominant and standard view of politics for the last several decades has been public choice theory, which is usually taken to mean interest group politics.<sup>8</sup> That approach treats the government as an actor in what is essentially a market

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<sup>5</sup> Eric Posner, “The Political Economy of the Bankruptcy Reform Act of 1978,” 96 Mich. L. Rev. 47 (1997) (“In public choice studies it is standard to describe the optimal version of the law in question and use interest group theory to explain the observed deviations. This approach raises difficulties because the optimal version of a particular law may be controversial.”).

<sup>6</sup> This assumes that some type of tax reform is desirable. While there is a consensus that the current tax system is probably not good, there is no consensus on what radical reform should look like and there are even reasons to reject radical reform. For a nice summary of what’s wrong with the current tax and why radical reform may not be a panacea, see Joel Slemrod & Jon Bakija, *Taxing Ourselves: A Citizen’s Guide to the Great Debate Over Tax Reform* 1-13 (1996).

<sup>7</sup> For a concise explanation of this theory, see Shaviro (1990) at 11-13.

<sup>8</sup> This approach is traced to Mancur Olson, *The Logic of Collective Action* (1965) and has been prominent ever since. ADD CITES.

transaction, providing goods and services (via legislation) to interest groups that want to maximize the income of their members. Interest groups bid for legislation and pay for it with campaign contributions, votes in elections and the like.<sup>9</sup>

The originator of this approach, Mancur Olson, argued that two conditions could predict when effective interest groups would emerge and the policies that they would be interested in. The first is that the groups must be small. Although every member of a group stands to benefit from the results obtained, formation and coordination costs are high and they increase as the group grows in size. The second is free-riders. The desired legislation may affect a significantly larger group and this creates an incentive to free-ride, i.e. not to shoulder any of the burden of obtaining the legislation. Smaller groups lessen the coordination problem and narrower policy objectives lessen the free-rider problem. Thus, one would expect to see small groups who will gain a lot from very narrow objectives controlling legislation.

In the tax area, there is a fairly long history of examining interest group politics.<sup>10</sup> There have been several prominent attempts to explain tax legislation from a public choice perspective. Richard Doernberg and Fred McChesney argued that the increasing rate of federal tax legislation that proved to be unstable could be explained by Congress' responding to well-organized groups who paid for benefits that maximized their wealth.<sup>11</sup> They contend that business groups that lobby to obtain tax favors for themselves or their constituents are the primary "public" participants in the tax legislative process in which tax legislation is delivered to the highest bidder. These groups are interested only in short-term contracts rather than long-term deals because there is a turnover in the players on Capital Hill. Politicians are also more interested in short-term deals because they can extract more benefit each time the process begins. [add more

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<sup>9</sup> See, e.g., Jonathan Macey, "Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model," 86 Colum. L. Rev. 223 (1986).

<sup>10</sup> See, e.g., William L. Cary, Pressure Groups and the Revenue Code: A Requiem in Honor of the Departing Uniformity of the Tax Laws, 68 Harv. L. Rev. 745, 747-73 (1955) (identifying sources of pressure on Congress to create special tax rules); Stanley S. Surrey, The Congress and the Tax Lobbyist - How Special Tax Provisions Get Enacted, 70 Harv. L. Rev. 1145, 1149-81 (1957) (attempting to enumerate reasons why tax lobbyists seek "loopholes"); Michael J. Graetz, Reflections on the Tax Legislative Process: Prelude to Reform, 58 Va. L. Rev. 1389 (1972); Jeffrey H. Birnbaum & Alan S. Murray, Showdown at Gucci Gulch: Lawmakers, Lobbyists, and the Unlikely Triumph of Tax Reform (1987); Timothy J. Conlan et al., Taxing Choices: The Politics of Tax Reform (1990) (analyzing the processes behind the passage of the Tax Reform Act of 1986); Thomas J. Reese, The Politics of Taxation (1980) (explaining the difficulty in passing meaningful tax reform legislation). Rebecca M. Kysar, The Sun Also Rises: The Political Economy of Sunset Provisions in the Tax Code.

<sup>11</sup> Richard Doernberg & Fred McChesney, On the Accelerating Rate and Decreasing Durability of Tax Reform, 71 Minn. L. Rev. 913, 926 (1987); Richard Doernberg & Fred McChesney, "Doing Good or Doing Well?: Congress and the Tax Reform Act of 1986, 62 NYU L. Rev. 891 (1987).

detail about their arguments]. Standard public choice theory posits that public interest or public opposition to interest groups will be diffuse and ineffective. In the tax arena, that opposition historically has come from the Treasury Department, the Joint Committee on Taxation and certain public interest tax lobbying organizations.

Public choice theory is not without its critics.<sup>12</sup> Some of its detractors take the flaws they find with the theory generally or as applied to specific types of legislation to be proof that public interest theory is more viable.<sup>13</sup> Others find that the theory has some explanatory power but cannot provide a complete explanation. With respect to tax, one notable critic is Daniel Shaviro who demonstrated that public choice theory could not explain the passage of the notable Tax Reform Act of 1986. While clearly interest groups played a role in that tax legislation, other factors were at work. He pointed to other institutional forces that shaped legislation that had been overlooked by pure public choice accounts, which focused solely on wealth maximization. His key insights were two: First that the act of proposing and enacting legislation was a means of symbolic communication with the general public, which influenced their views of the politician without having to benefit individuals in a tangible way. This could promote reelection. Second he argued that legislation was a method for a politician to exercise and demonstrate power in ways that “promote self-interest goals apart from reelection.”<sup>14</sup>

Another exception is a contrary approach developed by Ed McCaffery and Linda Cohen, which they dub *ex ante* rent extraction.<sup>15</sup> McCaffery and Cohen concede that interest-group politics plays a major role in the development of legislation, but argue that it cannot explain all tax legislation. In brief, under this approach because Congress is addicted to the money received in the form of campaign contributions, it creates special interest groups from which it hopes to subsequently extract contributions. The difference between this mode of analysis and standard interest group analysis is that the politicians themselves solve the coordination problems. The politicians who are “rent-extracting” precede the interest groups that are “rent-seeking.” They focus on tax provisions that apply to very few people but those who are affected face high stakes. In a sense they threaten to eliminate the rent by imposing higher taxes or eliminating a tax incentive. This is most effective when the group affected has the ability to organize and be politically effective. McCaffery and Cohen list five properties of rent-extraction: (1) the issue

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<sup>12</sup> See, e.g., Cass Sunstein, “Interest Groups in American Public Law,” 38 *Stan. L. Rev.* 29, 48-49 (1985); Mark Kelman, “Why Public Ideas Matter,” in *The Power of Public Ideas* 31 (R. Reich ed. 1988) [add more cites]

<sup>13</sup> See, e.g., Kelman.

<sup>14</sup> Shaviro (1990) at 9.

<sup>15</sup> Edward J. McCaffery & Linda R. Cohen, *Shakedown at Gucci Gulch: The New Logic of Collective Action*, 84 *N.C. L. Rev.* 1159 (2006); see also Fred S. McChesney, *Money for Nothing: Politicians, Rent Extraction, and Political Extortion* 45 (1997). For an example applying the rent extraction model, see Rebecca M. Kysar, *The Sun Also Rises: The Political Economy of Sunset Provisions in the Tax Code*.

will be one of high stakes to a small group with a narrow policy focus that matters to the group (these are also the two conditions identified by Olson); (2) the issue will not be of much importance to most voters and therefore is not likely to be that important in election politics; (3) the issue should be two-sided, i.e. groups on both sides will be willing to pay so that legislators can gain no matter what their position is; (4) there must be plausible action that Congress can undertake; (5) the issue should be such that the legislation will be reasonably long-lived so that Congress cannot immediately undo it, thus negating an incentive for interest groups to pay.<sup>16</sup> One result, according to McCaffery and Cohen, is that there is little incentive to actually solve the problem since stringing along all the interest groups creates more opportunities to pay.<sup>17</sup>

One final bit of history is also relevant. In the not-too-distant past we have an example of what was widely regarded as successful tax reform.<sup>18</sup> It was also regarded as a once-in-a-lifetime event.<sup>19</sup> It is very tempting to conclude that when the stars are aligned exactly as they were in 1985-1986, we will again have tax reform. That would be misguided. Much about the formation of tax policy and congressional politics in general has changed in the last two decades. Thus it is far too simplistic to argue that tax reform is not on the horizon because things are different from 1986.

## B. Why Tax Reform is not on the Horizon

In this section, I draw on the insights of interest group politics with respect to the passage of legislation to explain why there will be no tax reform in the near future. But as Shaviro argues, it is too simplistic an approach to explain all tax legislation and it is too simplistic to explain why there will be no legislation. McCaffery and Cohen make a persuasive case that the ex ante rent extraction model can better explain some legislation. As to why tax reform is not forthcoming, my argument is that both models have some explanatory value. Thus the description that follows relies in part on both approaches as well as clues from the 1986 experience. While every actual tax reform effort is different because it responds to different conditions,<sup>20</sup> there are similarities that suggest why reform may not be forthcoming. The next

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<sup>16</sup> McCaffery & Cohen, at 1177-78.

<sup>17</sup> Id. at 1179.

<sup>18</sup> See, e.g. John F. Witte, *The Tax Reform Act of 1986: A New Era in Tax Politics*, 19 Am. Pol. Q. 438, 441 (Oct. 1991) (“TRA can only be viewed as a remarkable legislative accomplishment and by far the most radical example of peacetime tax reform in history.”); Shaviro, Penn at (“The 1986 Act was the all-time leading example of tax reform.”).

<sup>19</sup> See, e.g., Conlan, Wrightson & Beam at 1 (“Especially in political terms, the TRA was little less than a modern miracle.”).

<sup>20</sup> See Jonathan Z. Ackerman & Rosanne Altshuler, *Constrained Tax Reform: How Political and Economic Constraints Affect the Formation of Tax Policy Proposals*, 59 Nat’l Tax J. 165 (2006).

section also argues that there are other political factors at work that explain the failure.<sup>21</sup> No one factor is solely responsible for the failure of tax reform; together, however, they get the job done.

[I have not fully flushed out each factor but have sketched out below the political factors that I think preclude tax reform in the short-term and possibly longer]

*Tax reform is a ballot box issue and neither rent-seeking interest groups nor rent-extracting politicians are interested in ballot box issues.*

The rent extraction model would predict that Congress would avoid a ballot-box issue, that is one that is likely to have much appeal to voters generally, particularly in elections. On the surface, this seems incorrect with respect to tax reform. The evidence is that politicians devote a good deal of attention to tax reform in election years. Presidential candidates especially often include comments about the tax system in their standard stump speeches and reform of the tax system is a perennial question in presidential debates.<sup>22</sup> Yes, presidents seldom act on their rhetoric. The notable exception is Ronald Reagan and his leadership was a major factor in the Tax Reform Act of 1986.<sup>23</sup>

Legislators also talk about tax reform in election campaigns but interest group politics helps to explain why in fact they do not act on their expressed concern. Many congressional politicians are no longer concerned about re-election—they are assured of retaining their seats.<sup>24</sup>

On the other hand legislators do have an interest in floating specific tax reform proposals that in keeping with the rent-extraction model might attract small groups facing large stakes. For example, the mere mention that any tax reform might jeopardize the state and local tax deduction, the mortgage interest deduction, or the charitable deduction, will mobilize groups that have much to lose from the repeal of these deductions. They will not, however, be interested in tax reform, qua tax reform, but only in insuring that if there is tax reform, it will not eliminate the incentive from which they benefit.

*Lack of small groups*

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<sup>21</sup> A recent effort addressed to the failure of tax reform is George Yin's exploration of legislative process obstacles to tax reform. George K. Yin, *Is the Tax System Beyond Reform*, Dunwoody Distinguished Lecture in Law, University of Florida School of Law, in 58 Fla. L. Rev. 977 (2006). Yin appears to ignore the role of interest group politics in arguing that there are two evolving features of the process that makes passage of a tax reform bill "daunting." Those features are internal changes in the Congress that result in "top-down" organizational structure and a fracturing and external focus of Congress. These are discussed further below.

<sup>22</sup> Get cites

<sup>23</sup> Shaviro at . . .

<sup>24</sup> Get statistics about incumbents in the last elections.

Both the rent-seeking and the rent extraction models predict that small groups with high stakes will emerge to control legislation, specifically legislation with concentrated specific benefits and costs to the groups. Conversely groups will have less interest in legislation with diffuse benefits and significant costs. One implication is that special interest groups largely will have no interest in tax reform due to both coordination problems and free-riding. While there may be particular aspects of fundamental tax reform that might cause interest groups to form, reform qua reform is not likely to spark the formation of such groups. Individuals will have widely-differing interests in fundamental reform (if they have any interest at all) and it will be difficult to organize a group whose members are enough in sync to bear the costs of pressuring Congress for a given result. Tax reform almost always arises from one issue and the particular pieces of tax reform cannot be considered in a vacuum.<sup>25</sup> Furthermore reform of the federal income tax presents the classic example of free-riding. If in fact legislation were passed that provided benefits of any kind, all of us would benefit in some way.

*Many small windows of opportunity are better for interest groups than one big one*

Public choice theory suggests that interest groups prefer repeat opportunities to bargain and legislators also prefer recurring opportunities to extract rent. Therefore those interest groups who are in fact lobbying for tangible benefits for their members are likely not to be interested in tax reform that might block future opportunities for bargaining.

*Tax issues must be politically prominent and there must be consensus for diffuse groups to have an impact*

Interest group politics can be offset by diffuse unorganized interests provided there is a strong consensus. Public opinion can act as a constraint on the legislative process.<sup>26</sup> Thus if an overwhelming consensus developed among the American public for example for a broad base with a flat rate, Congress might respond. But even where there is a consensus, it would not only have to be at the top of the political agenda to expect action, but there must also be consensus on how to solve the problem. For example, it seems likely that almost every taxpayer in the United States agrees that the current tax law is too complex, but since there is no consensus as to how to eliminate complexity, Congress takes no action. Most Americans have only the vaguest idea of what might make a tax system equitable or efficient. Some people believe in progressivity and some do not. Even among those who believe in progressivity, some believe that a flat tax would promote progressivity and many do not. Some believe that there can never be too many tax

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<sup>25</sup> See William G. Gale, "The Kemp Commission and the Future of Tax Reform," 70 Tax Notes 717 (1996) ("An essential element of tax reform is how particular policies combine to create a tax system. In particular, many interesting implications of the recommendations cannot be understood in isolation.")

<sup>26</sup> See, e.g., William N. Eskridge, Jr., Politics without Romance: Implications of Public Choice Theory for Statutory Interpretation, 74 Va. L. Rev. 275, 287 ("unorganized interest may still have an impact if their preferences are strong and commonly held, for public opinion itself works as an important constraint on legislative action.").

incentives and others are concerned about their distortions. Without some agreement about fundamental policy concerns, there can be no consensus on tax reform.

*The public is remarkably uninformed about fiscal policy and taxation's role.*

Almost all of the public discussion focuses on the revenue side and very little on the spending side. Most taxpayers do not seem to object to pronouncements about the need to end big government but it is clear that they do not want to terminate any spending program of which they are a beneficiary. What motivates taxpayers has been remarkably constant over the last several decades: to pay as little tax as possible but to receive as large public benefits as possible.<sup>27</sup> This is entirely consistent with public choice theory since taxpayers are looking for their own self-interest.

*Role of television and internet*

Pervasiveness of television and the internet as content providers. The increase of sound bites and yelling. If there is no civil discourse about tax reform on Fox Notes or on USA Today, voters know nothing about it. What they do hear over and over is the evil of taxes, the pledges not to raise taxes, etc.

*Rhetoric*

Politicians fan the hostility to taxes, both the rates and the idea that our income tax system is truly awful.<sup>28</sup> Although the severity of the rhetoric appears to be aimed at goading taxpayers into supporting reform, the effect may be just the opposite. Much of the rhetoric misleads the public about tax reform. It may imply the there is far more support for tax reform than there actually is.<sup>29</sup> Or it holds out that hope that the income tax will be repealed.<sup>30</sup> Most Americans are likely to assume that means there will be no substitute, that the time they will stop having to pay taxes is near.

*Lack of Policy Entrepreneurship*

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<sup>27</sup> See Shaviro (1990) at 57.

<sup>28</sup> See Marvin A. Chirelstein, Taxes and Public Understanding, 29 Conn. L. Rev. 9 (1996) (noting public hostility to federal income tax, both paying taxes and the system itself).

<sup>29</sup> Examples: Senate Majority Leader Dole & Speaker Gingrich, Forward to the Kemp Commission Report on Tax Reform, Unleashing America's Potential 3 (1996) ("As we approach the 21<sup>st</sup> century, the crescendo for tax reform continues to build, year after year, election after election.").

<sup>30</sup> Replacing the Federal Income Tax: Hearings Before the H. Comm. on Ways and Means, 104<sup>th</sup> Cong. 4 (1995) (statement of Rep. Bill Archer, Chairman, House Comm. on Ways and Means) ("[The current system] is too broken to be fixed. . . . In my opinion, our challenge is to do no less than pull the current Income Tax Code out by its roots and throw it away so that it can never grow back.

Shaviro attributes the rise of policy entrepreneurship as one factor that offsets a narrow reading of interest group politics as the only explanatory fact. By policy entrepreneurship he means “the investment of personal resources in promoting a particular policy, with the anticipated ‘return’ often depending on the enactment of legislation.”<sup>31</sup> He notes that the personal investment of President Reagan and congressional leaders in the 1986 legislation was key to its enactment. To date, however, despite the rhetoric there has been no policy entrepreneurship with respect to tax reform. Presidential candidates speak often about tax reform in the most general system—“we must reform our terrible tax system” [get an actual quote]—but no one is invested in an actual proposal. (Of course that is true of all presidential politics). The same is true on Capital Hill. When President Bush abandoned any pretense of interest in tax reform, the Republic majority in Congress followed suit.

### *The Permanent Campaign*<sup>32</sup>

The necessity for Congress to be constantly involved in a re-election campaign that requires huge amounts of fundraising has resulted in an external focus that does not permit time for working as a collaborative body for the public good.<sup>33</sup> The economics of campaign financing are such that House members especially must spend virtually all their time raising money usually far away from Washington.<sup>34</sup> Because members are often in very safe seats,<sup>35</sup> they are not worried about ballot box issues, that is those issues that might help them secure votes. Instead they are most interested in raising money. Yin also notes that the external focus arising from the permanent campaign makes it difficult to mount a successful legislative effort such a huge undertaking as tax reform; there is time only for symbolic efforts.<sup>36</sup>

### *Weakness of Congressional leaders*

Shaviro notes that congressional leaders have stronger prestige and ideological incentives than rank and file member and tend to be less subject to interest group influence.<sup>37</sup> When

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<sup>31</sup> Shaviro (1990) at 93-94.

<sup>32</sup> The term comes from *The Permanent Campaign and its Future* (Norman J. Ornstein & Thomas E. Mann, eds. 2000). The book’s thesis is essentially that there is no longer any distinction between governance and campaigning.

<sup>33</sup> See Yin at 1025.

<sup>34</sup> See Shaviro (1990) at 101-102 (discussing the effects of campaign financing).

<sup>35</sup> Get statistics

<sup>36</sup> See Yin at 1029. Yin gives as an example of the lack of seriousness with which Congress addresses tax reform, the perennial introduction of the Tax Code Termination bill which would repeal the entire code to be followed by a unspecified simple and fair tax. *Id.* & n.203.

<sup>37</sup> Shaviro (1990) at 102

congressional leaders control the legislative process, interest groups are less likely to influence legislation. This creates the opportunity for policy entrepreneurs among the leadership. If that leadership was interested in tax reform, they would have an opportunity to move it to the legislative agenda. But congressional leadership today is not nearly as strong as it previously was. One take-away from this evolution is that interest group politics becomes more important. But another take-away is that this congressional leadership has been displaced by party control. In either case tax reform is less likely.

Yin argues that over the last several decades there has been a strengthening of the party system and a corresponding decrease in committee leadership, especially in the House. A number of events have created this situation. They include the repeal of the automatic seniority system for choosing the committee chair as well as curtailment of the chair's power, reduction in committee staffs. At the same time the party assumed more control over legislation, including setting the agenda and providing language. While this was happening on the Hill, historically neutral tax policy advisors in the Treasury Department became less important as tax policy analysis shifted to the political office in the White House. Yin argues that the affect on tax reform is ambiguous. A top-down organizational structure can offset the possibility that various committees acting independently can produce legislation that is not favored by anyone. Party leaders can require committees to commit to support legislation favored by the party. If the party has no interest in tax reform, therefore, the committees will not either. Also contributing to the lack of interest in real tax policy, Yin argues, is the loss of specialization benefits provided by strong committees and the decline in the committee's ability to provide good information. This factor is important, however, only if the parties are not interested in tax reform. Here other conditions indicate that this is so [return to this.]

Loss of House Speakers, changing of political party. Insert more about this] Instead for a long time the political party has been more important. In periods where parties exercise less control, interest groups hold sway.<sup>38</sup> Over the last \_\_ years until the mid-term elections of 2006, the Republican party had good control of its congressional delegation and there was very little defection. Since the Republican party had made a determination that talking about tax reform was important but enacting it was not, most representatives and Senators followed that course

The last time we had tax reform it was led by a President who staked his political reputation in part on tax reform, both by campaigning for reform<sup>39</sup> and by providing legislative leadership. He was soon joined by legislative leaders on both sides of the aisle—bipartisan support was critical to success. Both a Republican proposal (Kemp-Roth) and a Democratic proposal (Bradley-Gephardt) were precursors to the ultimate legislation, which was shepherded

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<sup>38</sup> add cites

<sup>39</sup> See, e.g., President Ronald Reagan, Remarks to Citizens of Bloomfield, New Jersey (June 13, 1985), released by the White House, Office of the Press Secretary ("Our current [income tax] system is neither admired nor respected. It encourages cheating; it is inherently unjust; it is tottering on an unsound foundation; and it's time we simply tore it down and built a better one.")

through the process by the Republican chairman of the Senate Finance Committee (Robert Packwood) and the Democratic chairman of the House Ways and Means Committee (Dan Rostenkowski).

At this juncture in our political history, there is little sign of bipartisan agreement on tax reform or political leadership. We are all looking for leaders.<sup>40</sup>

### *Lack of Bipartisanship Support*

The rise in the power of the party has also been accompanied by inter-party polarization. The last decade has witnessed virtually no bipartisan efforts in Congress. And yet almost everyone agrees that a bipartisan effort is necessary to enact tax reform<sup>41</sup> or perhaps any major legislative action.<sup>42</sup>

### *Maintaining the Status Quo*

“The ex ante rent-extraction model suggests that payments to politicians might be needed simply to maintain the status quo.”<sup>43</sup> Fundamental tax reform obviously completely upsets the status quo. It throws out most, if not all, of the old deals. While there might be winners in fundamental tax reform, it is highly unlikely that they would be interest groups. By definition, fundamental reform involves broadening (or perhaps completely changing) the base. The winners in base broadening are diffuse. There is very little way for Congress to extract money out of tax reform; thus it has very little interest in doing so. On the other hand, it is relatively simple for Congress to extract money in order to keep the status quo.

### *Legal Rules and Structures that Impose Constraints*

(a) The budget and PAYGO rules. [expand and include explanations—the important point is that budget policy is not exogenous to tax policy and that there are features of budget policy that make tax reform quite difficult. The literature generally addresses how budget policy shapes tax policy. My argument is that it also puts up roadblocks that make major policy changes (as opposed to incremental changes) very unlikely]

Earlier this year, Congress re-adopted pay-as-you-go budget rules (PAYGO) in the House and Senate. These rules require that any legislation to lower revenues or expand entitlement spending

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<sup>40</sup> See, e.g., Michael J. Graetz, *Taxes That Work: A Simple American Plan*, 58 Fla. L. Rev. 1043 (2006).

<sup>41</sup> See, e.g. Yin at 1030.

<sup>42</sup> See Sarah A. Binder, *Stalemate: Causes and Consequences of Legislative Gridlock* 68 (2003) (finding that polarization increases legislative stalemate and is “counterproductive to major policy change”).

<sup>43</sup> McCaffery & Cohen, at 1174.

-- relative to current law projections (i.e., the "baseline") -- be offset with corresponding revenue increases or spending cuts.

(b) Current law is riddled with expiring provisions and phase-outs that make it very difficult to compare any reform proposal to current law. Taxpayers must believe that reform is better than current law but if they do not understand current law because of these provisions, the benefits are less obvious.<sup>44</sup>

(c) Revenue Neutrality. Both Treasury I and the recent tax reform panel operated under a revenue neutrality constraint, that is reform must raise no more and no less than current revenue raised by the income tax. It seems very likely that future reform efforts would labor under the same constraint. Given the extreme difficulty of raising revenue (see below), the political way to make sure that does not happen is to impose a revenue neutrality requirement. That and the fact that it was difficult to even determine whether a proposal was revenue neutral because the choice of a revenue baseline is so controversial imposed significant constraints on the President's Tax Reform Panel<sup>45</sup> that made it impossible to propose real fundamental tax reform that was revenue neutral.

The need to produce revenue neutral legislation is a significant impediment to tax reform. It is widely acknowledged that it is extremely difficult to produce reliable revenue estimates even for a one-off proposal.<sup>46</sup> Producing an estimate for fundamental tax reform would be even more difficult because of the many parts of the legislation that would affect the revenue stream. The usefulness of static revenue estimates is always in doubt but would be particularly so with respect to fundamental reform. To take a simple example, one would expect dramatic changes in investment behavior on the adoption of a consumption tax. One would expect these estimates to dominate the legislative process because the estimate would determine whether or not offsets were needed. In fact, revenue estimates would likely dictate the form of the reform. For example, repeal of taxation of an item that raised significant revenue would inevitably fall to the bottom of the wish list and conversely a revenue-raising item would move to the top. Thus a politically acceptable revenue-raiser would have more cachet than a revenue-neutral provision that was better tax policy. These kinds of trade-offs might not prevent legislation but they might prevent anything that we could realistically call tax reform.

(d) Distributional Neutrality. Any near-term fundamental reform effort is also likely to be saddled with a distributional neutrality constraint. Although defining what is meant by distributional neutrality is itself complex, whatever it is it makes real change extremely difficult

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<sup>44</sup> See Ackerman & Altshuler at 171 ("The temporary nature of many recently enacted tax cuts also makes it more politically challenging to demonstrate the benefits of tax reform.").

<sup>45</sup> See Ackerman & Altshuler at 175-76.

<sup>46</sup> The uncertainty and manipulation of revenue estimates has been documented elsewhere. See Linda A. Schwartzstein, *Smoke and Mirrors: Tax Legislation, Uncertainty and Entrepreneurship*, 6 *Cornell J. L. & Public Pol'y* 61 (1996); Graetz, *Paint by Numbers*.

### *Lack of Consensus of the Experts*

As David Bradford has noted, “experts inevitably shape the crucial details of economic regulatory systems.”<sup>47</sup> Tax reform is not likely to happen without a consensus of the experts. And currently there is no real consensus. There has been no shortage of blue ribbon reports about tax reform.<sup>48</sup> There also has been no shortage of actual tax reform proposals.<sup>49</sup> While there may be consensus about some very broad principles of tax reform,<sup>50</sup> there is little agreement about the details, even including such major items as to whether there should be a separate tax on corporations or whether capital should be subject to tax.

### *Lack of parties on the other side*

Often where interest group politics holds sway, there are those who have an interest in passing the legislation and those who have an interest in defeating it. There is no obvious group opposing tax reform. Unlike, for example, the case of estate tax repeal,<sup>51</sup> where armies of estate planners stand to lose, accountants, lawyers, and the like, have no fear that a broad-based federal revenue-raising tax will disappear (they may not even have much reason to fear that the *income* tax will disappear).

### *Nature of US tax*

As is well known, the U.S. income tax serves two purposes: it raises revenue to fund the costs of government and it is used as an instrument to regulate (both incentivize and penalize) behavior. Thus any effort to reform the federal income tax will spark contentious debate about how to distribute the costs of government and the extent to which and how the tax should affect economic and social policy. These are issues that often are of interest to presidential candidates and even Presidents or to the major parties, but their preferences often do get enacted by Congress. Congress has been very good at passing legislation aimed at specific groups via tax preferences—this happens on an annual basis, often in conjunction with other “larger goals.” Congress has also been able to pass legislation that changes tax rates. But it has been far less

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<sup>47</sup> David F. Bradford, *Tax Reform: Waiting for a New Consensus of the Experts*, 79 *Tax Notes* 899, 899 (May 18, 1998).

<sup>48</sup> *Unleashing America’s Potential: A Pro-Growth, Pro-Family Tax System for the 21<sup>st</sup> Century*, “The National Commission on Economic Growth and Tax Reform (1996) (the Kemp Commission).

<sup>49</sup> See, e.g., Nunn-Domenici USA Tax, Hall-Rabushka Flat Tax; Neal Boortz & John Linder, *The FairTax Book: Saying Goodbye to the Income Tax and the IRS* (2005).

<sup>50</sup> For example, there is something approaching a consensus among academics for a consumption tax and a clear group of politicians who prefer a flat tax.

<sup>51</sup> McCaffery & Cohen, at 1165.

successful with respect to fundamental reform issues. Because large, difficult issues are put on the table with tax reform—distribution, incentives, form of tax, etc.—inevitably there will be significant conflicts. So long as Congress stays with the status quo, some of these issues can be avoided. For example, the basic issue of whether capital should be taxed is largely avoided even if the legislation proposes to change the rate of tax on capital, but it cannot be avoided if Congress is considering changing the base. A decision whether the preferences system should be dismantled or enlarged can also be avoided so long as Congress only tinkers around the edges. There is deep disagreement about these fundamental policy issues and until a consensus develops, it probably makes the most political sense to Congress to not revisit the disagreements.

### *Transition Problems—We Can't Get There From Here*

While almost everyone agrees that something should be done about the tax system, almost everyone also agrees that radical tax reform would cause “administrative, legislative, and economic upheavals.”<sup>52</sup> There is a widespread sense that an old law is a good law. People are familiar with it and know how to deal with it. Decades of interpretative law has been built up that would have to be jettisoned. Economic decisions have been made based on the current tax system and in any transition there would be winners and losers, not all of which are easily identifiable.

### *Use of fiscal illusion.*<sup>53</sup>

By using budgetary tricks and other fiscal gimmicks Congress is able to raise taxes or cut back on preferences without angering the public, which fails to understand the magic or even that they are witnessing magic. Examples include: failing to index, the AMT, deficit spending, attacks on the corporate tax (possible because of a limited understanding about incidence)

Even the no new taxes pledge and subsequent events can be seen as an instance of fiscal illusion: so long as the public did not believe a revenue raising measure was not a tax, it could be engaged in.<sup>54</sup> This explains the little noticed success of user fees, for example.

### *Obsession with Marginal tax rates*

Another problem is the focus on *marginal* rather than effective tax rates. The rate bubble created by the phase-out of the exemptions or the haircut in itemized deductions or even the

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<sup>52</sup> William G. Gale, Tax Reform Options in the Real World, in *Toward Fundamental Tax Reform* 34-38 (Alan Auerbach & Kevin Hassett eds 2005); Ronald A. Pearlman, A Tax Reform Caveat: In the Real World, There Is no Perfect Tax System, in *Toward Fundamental Reform* 106, 107 (“change is traumatic and unpredictable” and no one can predict “fiscal, economic, social, compliance and other effects”).

<sup>53</sup> For coinage of the term, see Susan Hansen, *The Politics of Taxation: Revenue Without Representation* 22-23 (1983); see also [cite Dan]

<sup>54</sup> Bennett, “A Pledge, a Wink, and a Jump into the Unknown,” 47 *Tax Notes* 107-08 (1990).

AMT were rate hikes but so long as they could not be easily described as “increasing taxes” or “increased tax rates” the public accepted them. The same is true for a limited amount of base broadening. If the entire tax reform dog is tied to the tail of lowering marginal rates, it probably is a nonstarter.

*Concern about a budget deficit* could prompt concern but that concern must be immediate. For example, the deficit that arose after the Economic Recovery Tax Act of 1981 prompted tax increases in 1982 and 1984. But those deficits were current, not years in the future.

*Some Interest Groups are Interested in Principle*<sup>55</sup>

The no new taxes groups [fill in]

### *Summary*

In summary, there are a wide variety of factors that lead to the conclusion that tax reform is unlikely to happen in the near future. [write]

## III The Politics of a Fiscal Crisis

[I haven't written this section. Will cover the following things:

The politics of raising revenue—no new taxes the read my lips effect.

A long-term trend is the willingness of politicians to provide more political goods than citizens are willing to pay for via the tax system,<sup>56</sup> opting instead for debt financing.

Tax revenues historically have been between 16% and 20% of GDP. Government spending is projected to rise to 27% of GDP by 2030.<sup>57</sup> This is attributable mainly to entitlement spending—Medicaid, Medicare and Social Security. This currently cannot be funded by government revenues.

A reduction in revenues via tax cuts coupled with the expansion of entitlements leads to deficits that may impede long-term economic growth.

If we cannot cut spending, then we have to raise revenue.]

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<sup>55</sup> Shaviro (1990) at 98 (nothing that ideas matter a great deal; politicians pursue ideological ends and ideas sway people in masse).

<sup>56</sup> See Sheldon D. Pollack, A New Dynamics in Tax Policy, 12 Am. J. Tax Pol'y 61, 62 (1995).

<sup>57</sup> Rivlin & Sawhill (2005).

## IV. The Alternative Minimum Tax

### A. A Brief History of the AMT

From its humble beginning in the Tax Reform Act of 1969,<sup>58</sup> the AMT has grown from a “class tax to a mass tax.”<sup>59</sup> The original purpose of the AMT was to insure that high income individuals paid at least some income tax. Congress was apparently outraged by 154 individuals with incomes of over \$200,000, who paid no tax in 1966.<sup>60</sup> In addition, many individuals with high incomes were paying tax at a relatively low effective rate due to a variety of tax preferences, even to the point where the tax rates were regressive at the top end.<sup>61</sup>

The goal of the first minimum tax was to respond to these two concerns by increasing the effective tax rate on capital gains and nine other items of “preference income.”<sup>62</sup> The minimum tax imposed a 10% tax rate on the sum of these preference items to the extent it exceeded a \$30,000 exemption amount.<sup>63</sup> The Joint Committee estimated that the minimum tax would increase revenue by \$590 million in 1970 and \$635 million “in the long run.”<sup>64</sup> This

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<sup>58</sup> Pub. L. No. 91-172, 1969 U.S.C.C.A.N. 509.

<sup>59</sup> Leonard E. Burman, William G. Gale & Jeffrey Rohaly, *The AMT: Projections and Problems*, Tax Notes 105, 105 (July 7, 2003).

<sup>60</sup> H. Ways and Means Committee, *T ax reform Act of 1969*, H. Rep. No. 91-413 (1969) *reprinted in* 1969 U.S.C.C.A.N. 1645.

<sup>61</sup> Joint Committee on Taxation, 91st Cong., *General Explanation of The Tax Reform Act of 1969* (Comm. Print 1969).

<sup>62</sup> *Id.*

<sup>63</sup> Pub. L. No. 91-172, §301, 1969 U.S.C.C.A.N. 509, 623. The targeted preference items were: (1) Excess investment interest (the amount by which the investment interest expense exceeds the net investment income); (2) accelerated depreciation on real property. (the amount by which accelerated depreciation exceeded straight-line depreciation); (3) accelerated depreciation on personal property subject to a net lease; (4) amortization of certified pollution control facilities (the amount by which the amortization allowances exceeded the accelerated depreciation that would otherwise be allowable); (5) amortization of railroad rolling stock (the amount by which amortization allowances exceeded the accelerated depreciation which would otherwise be allowable); (6) stock options (the amount by which the fair market value of a share of stock exceeded the strike price at the time of exercise); (7) depletion (the excess of the depletion allowance for over the adjusted basis of the property at the end of the taxable year; (8) Capital gains. Pub. L. No. 91-172, §301, 1969 U.S.C.C.A.N. 509, 624-26.

<sup>64</sup> Joint Committee on Taxation, 91st Cong., *General Explanation of the Tax Reform Act of 1969* (Comm. Print 1969).

prediction proved extremely optimistic; in 1974, for example, the minimum tax on individuals raised a mere \$130 million.<sup>65</sup> In addition, the revenue was largely attributable to capital gains.<sup>66</sup> The Tax Reform Act of 1976 sought to rectify the shortcomings of the minimum tax by adding two preference items, raising the minimum tax rate, and altering the exemption levels.<sup>67</sup> Importantly it brought back in some itemized deductions for the first time. The Joint Committee estimated that income tax revenue from individuals would increase by \$2.1 billion total in 1977 and 1978 as a result of the changes to the minimum tax.<sup>68</sup>

The Revenue Act of 1978,<sup>69</sup> which was enacted principally to provide tax relief, responded to congressional concern that the minimum tax was not tied to the amount of regular tax liability, so that some taxpayers already paying regular taxes at high rates were substantially burdened.<sup>70</sup> On the other hand, many individuals who used tax preferences to avoid most or all regular taxes, were relatively unburdened by an effective tax rate close to 15 percent when the top bracket was 70 percent.<sup>71</sup> The '78 Act for the first time provided for an *alternative* minimum tax for individuals.<sup>72</sup> Under the new section 55, an individual taxpayer would first have to calculate his regular tax liability, including the minimum tax liability on certain preference items (but not the capital gains preference or the adjusted itemized deduction preference), and then calculate the AMT, and pay whichever was greater.<sup>73</sup> Alternative minimum taxable income (AMTI) was calculated by reducing gross income by allowable deductions, and increasing it by two preferences: the capital gains preference and the adjusted itemized deduction preference.<sup>74</sup>

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<sup>65</sup> Joint Committee on Taxation, 94th Cong., General Explanation of the Tax Reform Act of 1976 (Comm. Print 1976).

<sup>66</sup> *Id.*

<sup>67</sup> Pub. L. No. 94-455, 1976 U.S.C.C.A.N. (90 Stat.) 1520. Preferences now included intangible drilling costs and excess itemized deductions. In addition the preference for accelerated depreciation now covered all personal property. *Id.* at §301, 1976 U.S.C.C.A.N. (90 Stat.) 1520, 1550.

<sup>68</sup> Joint Committee on Taxation, 94th Cong., General Explanation of the Tax Reform Act of 1976 (Comm. Print 1976).

<sup>69</sup> Pub. L. No. 95-600, 92 Stat. 2763 (1978).

<sup>70</sup> S. Finance Comm., Revenue Act of 1978, S. Rep. No. 95-1263, at 201 (1978), *reprinted in* 1978 U.S.C.C.A.N. 6761, 6964.

<sup>71</sup> *Id.*

<sup>72</sup> Pub. L. No. 95-600, §421, 92 Stat. 2763, 2871-72 (1978).

<sup>73</sup> *Id.*; 92 Stat. 2763, 2872-74 (1978).

<sup>74</sup> *Id.*;

The AMT rate was 10% on AMTI greater than \$20,000 and less than \$60,000, 20% on AMTI greater than \$60,000 and less than \$100,000, and 25% on AMTI greater than \$100,000.<sup>75</sup> If this tax exceeded the regular tax liability, the taxpayer had to pay the excess amount.<sup>76</sup>

The Tax Equity and Fiscal Responsibility Act of 1982<sup>77</sup> repealed the add-on minimum tax for individuals altogether, and replaced it with an alternative minimum tax—essentially the same one that is in effect today. Once again the motive was to eliminate the possibility of individuals avoiding all tax liability.<sup>78</sup> The exemption amount was set at \$40,000 for a joint return/surviving spouse, \$30,000 for taxpayer who is not married/not surviving spouse, and \$20,000 for taxpayer who is married filing separately.<sup>79</sup> A rate of 20% was imposed on AMTI in excess of the exemption amount.<sup>80</sup> A taxpayer was liable for the excess of the tentative AMT over regular tax liability.<sup>81</sup> In determining AMTI, the deduction for state and local taxes, personal exemptions, the standard deduction, and the deduction for interest on home equity loans were not allowed. Incentive stock option gain was included in AMTI. These remain the principal preferences and adjustments under current law.”<sup>82</sup>

In 1986 Congress eliminated the preference for capital gains in the regular tax, thereby deleting it as an AMT preference, a move that was to have substantial effect several years later. The Tax Reform Act of 1986<sup>83</sup> also increased the AMT tax rate to 21%,<sup>84</sup> and added a minimum

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<sup>75</sup> Id;

<sup>76</sup> Id. The '78 Act also made slight modifications to the list of tax preferences: capital gains from the sale of a principal residence was excluded from the capital gains preference, and the calculation of the itemized deduction preference was altered. Pub. L. No. 95-600, §421, 92 Stat. 2763, 2874 (1978).

<sup>77</sup> Pub. L. No. 97-248, 96 Stat. 324 (1982).

<sup>78</sup> S. Finance Comm., Tax Equity and Fiscal Responsibility Act of 1982, S. Rep. No. 97-248, at 108 (1982), *reprinted in* 1982 U.S.C.C.A.N. 781, 876. The original House bill did not contain any provisions related to the minimum tax. *See* H.R. REP. NO. 97-248, at 473 (1982) (Conf. Rep.) *reprinted in* 1982 U.S.C.C.A.N. 1191, 1253.

<sup>79</sup> Pub. L. No. 97-248, 96 Stat. 324, 416 (1982).

<sup>80</sup> Pub. L. No. 97-248, 96 Stat. 324, 411 (1982).

<sup>81</sup> Pub. L. No. 97-248, 96 Stat. 324, 411 (1982).

<sup>82</sup> Joint Committee on Taxation, 110th Cong., Present Law and Background Relating to the Individual Alternative Minimum Tax (Comm. Print 2007).

<sup>83</sup> Pub. L. No. 99-514, 1986 U.S.C.C.A.N. (100 Stat.) 2085.

<sup>84</sup> Id, §701, 1986 U.S.C.C.A.N. (100 Stat.) 2085, 2321.

tax credit—still in effect today—which allows a taxpayer who pays AMT in a given year to reduce taxes by a certain amount in a subsequent year in which he does not have AMT liability.<sup>85</sup> For the first time the exemption amounts were phased out.<sup>86</sup> In 1990, Congress raised the AMT rate from 21 percent to 24 percent.<sup>87</sup>

In 1993, Congress raised the rates again and created the two-tier rates still in effect today. AMTI (in excess of the exemption amounts) up to \$175,000 was taxed at 26 percent; income above \$175,000 was taxed at 28 percent.<sup>88</sup> The exemption amounts were also raised to \$45,000 for a joint return/surviving spouse; \$33,750 for taxpayer who is not married/not surviving spouse; and \$22,500 for taxpayer who is married filing separately.<sup>89</sup>

Beginning in 1997 Congress began to be aware of the discontinuity between the rates and exemptions of the regular tax and the AMT due to the failure to index the AMT exemptions. Although several attempts were made to index the exemption or to raise it, the bills failed to pass.<sup>90</sup> The 1997 Act also made it clear that the lower capital gains rates for the regular tax rate applied as well to the AMT.<sup>91</sup>

The Economic Growth and Tax Relief Reconciliation Act of 2001<sup>92</sup> increased the exemptions to \$49,000 for married taxpayers filing jointly and surviving spouses and to \$35,750 for single taxpayers.<sup>93</sup> These increases were to be in effect for the years 2001-2004.<sup>94</sup> Two

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<sup>85</sup> Id; 1986 U.S.C.C.A.N. (100 Stat.) 2085, 2339-2341. The deferral preferences were adjusted, and a preference item for private activity bonds was added.

<sup>86</sup> Id.; 1986 U.S.C.C.A.N. (100 Stat.) 2085, 2322. Exemptions were reduced (but not below zero) by 25% of ATMI above \$150,000 for a joint return/surviving spouse; \$112,500 for an individual taxpayer who is not married/not surviving spouse, and \$75,000 for taxpayer who is married filing separately

<sup>87</sup> Pub. L. No. 101-508, §11102, 1990 U.S.C.C.A.N. (104 Stat.) 1388-1, 1388-406.

<sup>88</sup> Pub. L. No. 103-66, §13203, 1993 U.S.C.C.A.N. (107 Stat.) 312, 461-62.

<sup>89</sup> Id; 1993 U.S.C.C.A.N. (107 Stat.) 312, 462.

<sup>90</sup> A House bill provided for increases in the exemption amounts for the years 1999, 2001, 2003, 2005, and 2007. H. Budget Comm., Taxpayer Relief Act of 1997, H. Rep. 105-148, at 350 (1997), *reprinted in* 1997 U.S.C.C.A.N. 679, 744. The Senate bill provided for increases in 2001 and each subsequent year. H.R. REP. NO. 105-220, at 389-390 (1997) (Conf. Rep.). The bill that came out of conference and ultimately passed contained neither House nor the Senate proposals for increasing the exemptions. Id.

<sup>91</sup> Pub. L. No. 105-34, §311, 1997 U.S.C.C.A.N. (111 Stat.) 788, 835.

<sup>92</sup> Pub. L. No. 107-16, 2001 U.S.C.C.A.N. (115 Stat.) 38.

<sup>93</sup> Pub. L. No. 107-16, §701, 2001 U.S.C.C.A.N. (115 Stat.) 38, 148.

years later, Congress raised the exemption amounts again—this time to \$58,000 for taxpayers who are married filing jointly or surviving spouses, and to \$40,250 for single taxpayers.<sup>95</sup> These exemption amounts were effective in 2003 and 2004.<sup>96</sup> The 2003 act also aligned the dividend tax rate under the AMT with the 15 percent rate imposed for regular tax purposes.

For the last several years, Congress has tinkered with the AMT by adding a so-called “patch.” Alarmed by the increasing number of taxpayers subject to the AMT and terrified by the political fallout that would follow if the numbers increased, Congress kept raising the exemption in order to keep the number of AMT taxpayers manageable. The Tax Increase Prevention and Reconciliation Act of 2005, raised the exemption to \$62,500 for married taxpayers filing jointly or surviving spouses, and \$42,500 for other individuals, but only for taxable years beginning in 2006.<sup>97</sup> For 2007 and beyond, current law provides for exemption amounts of \$45,000 and \$33,750.<sup>98</sup> No one actually expects Congress to fail to pass a patch again.

The '05 Act also extended through 2006 taxpayers' ability to use nonrefundable credits (e.g., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit, the HOPE Scholarship and Lifetime Learning credits, etc.) to offset both their regular tax liability and their AMT tax liability.<sup>99</sup> Although in 2007, the nonrefundable personal credits (except for the adoption credit,<sup>100</sup> child credit,<sup>101</sup> and saver's credit<sup>102</sup>) are allowed only to the extent that the taxpayer's regular tax exceeds her tentative minimum tax (determined without regard to the minimum tax foreign tax credit),<sup>103</sup> This too may change.

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<sup>94</sup> Id.

<sup>95</sup> Pub. L. No. 108-27, §106, 2003 U.S.C.C.A.N. (117 Stat.) 752, 755.

<sup>96</sup> Id.

<sup>97</sup> Pub. L. No. 109-222, §301, 2006 U.S.C.C.A.N. (120 Stat.) 345, 353.

<sup>98</sup> IRC 55(d). The exemption for 2000 and 2007 and beyond assuming nothing further is done is \$45,000. The exemption was \$49,000 in 2001 and 2002, \$58,000 in 2003-2005, and \$62,550 in 2006.

<sup>99</sup> Pub. L. No. 109-222, §302, 2006 U.S.C.C.A.N. (120 Stat.) 345, 353.

<sup>100</sup> IRC 23.

<sup>101</sup> IRC 24.

<sup>102</sup> IRC 25B.

<sup>103</sup> IRC. 26.

Today, AMT is calculated in essentially the same manner as it has been calculated since 1982. AMTI is reduced by the exemption amounts—which are phased out—to calculate ‘taxable excess.’<sup>104</sup> The tentative minimum tax is calculated by summing: (1) 26% of taxable excess less than \$175,000, plus (2) 28% of taxable excess greater than \$175,000.<sup>105</sup> If the tentative minimum tax is greater than the regular tax, the taxpayer owes the difference.<sup>106</sup> AMTI is calculated by adjusting income according to section 56 and section 58, and adding the tax preference items in section 57. The adjustments and preferences that individuals must take into account for AMTI purposes are (1) depreciation is calculated to eliminate much of accelerated depreciation; (2) Mining exploration and development costs are capitalized and amortized over a 10-year period; (3) Taxable income from long-term contracts is computed using the percentage of completion method of accounting; (4) Amortization for pollution control facilities is calculated using the regular tax recovery periods and the straight-line method; (5) Miscellaneous itemized deductions are not allowed; (6) Deductions for state, local, and foreign real property taxes, state and local personal property taxes, state, local, and foreign income, war profits, and excess profits taxes; and state and local sales taxes are not allowed; (7) Medical expenses are allowed only to the extent they exceed ten percent of the taxpayer's adjusted gross income; (8) The standard deduction and personal exemptions are not allowed; (9) The amount allowable as a deduction for circulation expenditures is capitalized and amortized over a three-year period; (10) Expenditures for research and experimentation from passive activities are capitalized and amortized over a 10-year period; (11) The regular tax rules relating to incentive stock options do not apply; (12) The excess of the deduction for percentage depletion over the adjusted basis of each mineral property (other than oil and gas properties) is not allowed; (13) The amount by which excess intangible drilling costs exceed 65 percent of the net income from oil, gas, and geothermal properties is not allowed; (14) Tax-exempt interest income on private activity bonds (other than qualified 501(c)(3) bonds) is included in AMTI; (15) Seven percent of the amount excluded from income under section 1202 (relating to gains on the sale of certain small business stock) is included in AMTI; (17) Losses from any tax shelter farm activity or passive activities are not taken into account in computing AMTI.<sup>107</sup>

There are four current effective AMT rates (due to phase-out of the exemption), which are 26, 28, 32.5 and 35 percent. The top AMT rates do not apply to the highest-income taxpayers, however, because they occur because of the phase-out of the AMT exemption. Once the phase-out range is passed, the marginal tax rate is 28 percent.

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<sup>104</sup> IRC 55(a).

<sup>105</sup> IRC 55(b)

<sup>106</sup> IRC 55(a).

<sup>107</sup> Beginning in 2007, the nonrefundable personal credits (except for the adoption credit, child credit, and saver's credit) are allowed only to the extent that the taxpayer's regular tax exceeds her tentative minimum tax (determined without regard to the minimum tax foreign tax credit). There is an AMT foreign tax credit, provided for in section 59.

What this brief summary makes clear is that although the AMT has retained some of its initial characterization as a vehicle to insure that all taxpayers paid a minimum amount of tax on income, it has strayed far from that purpose. It is no longer targeted simply at the top 100 tax avoiders, but applies far down the income scale. It increasingly is an important part of the overall income tax system. Three historical events are particularly important for the argument that the AMT should be retained in a second-best world. The first was the decision not to index the exemption when other features of the regular income tax were indexed. This meant that over time the number of taxpayers whose AMTI exceeded the exemption would increase. The current threshold for AMT liability (\$45,000 for married couples, ignoring the patches, which expire) is not much more than the \$40,000 threshold in effect in 1982. According to the President's Tax Reform Report, if this figure had been indexed for inflation, the exemption would have been \$82,000 in 2005. The second was the decision to enact tax cuts in 2001 and 2003 that were not coordinated with the AMT. Rate reductions resulted in many more taxpayers being subject to the AMT because the difference between the regular and AMT rates decreased. This had the effect of cutting back substantially on the revenue loss from the tax cuts.

## B. Growth of the AMT—Revenue Implications

This section briefly reviews projections about the number of taxpayers who are and will be subject to the AMT and the revenue that it will raise. This revenue will not be collected if the AMT is repealed and thus this section also looks at the cost of repeal.

A number of organizations have developed projections of the growth of the AMT. These projections vary somewhat in part based on the modeling technique but there are three other factors that affect them. The first is the time when they are done. The more recent projections are able to project the AMT farther in the future. The second is that as time passes, the information about the AMT exemption changes. For example, projections that were calculated in 2003 would assume that the exemption would return to lower levels since the "patch" only extended for a year or two. Projections done this year know that the exemption level stayed high at least through 2006. Third, the projections all require some assumption about the 2001 and the 2003 tax cuts, which are, under current law, due to expire at the end of 2010. Thus, in most cases there are two sets of projections—those that assume that the tax cuts sunset in 2010 and those that assume that they do not. Because a large cause of the increase in the AMT is attributable to the tax cuts, 2010 is the year with the most taxpayers subject to the AMT and the largest revenue if one assumes that the tax cuts sunset. Under the opposite assumption, the numbers keep growing. Despite the differences, the projections are remarkably consistent and for my purposes, the differences are unimportant--all that matters is that significant revenue is projected to be raised by the AMT.

The Tax Policy Center estimates that the AMT will affect 32.4 million taxpayers in 2010 and 39.1 million taxpayers in 2017 if the tax cuts are extended and will affect 16.5 million (2010) and 39.2 million (2017) if they are not. The percentage of AMT filers is projected to be 33.6% (2010), or 48% (2017) if the tax cuts are extended and 16% (2010) or 34.5% (2017) if they are not.<sup>108</sup> This large growth is largely attributable to two factors: the failure to index the

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<sup>108</sup> <http://www.taxpolicycenter.org/taxtopics/AMT.cfm>

AMT for inflation and the 2001 tax cuts.<sup>109</sup> Burman et al calculate that if the AMT had been indexed when the regular tax was indexed in 1981 and if the 2001 tax cuts had not been adopted only 268,000 households would face the AMT (less than 1 percent of the current projection for 2010).<sup>110</sup>

The TPC projects that if the tax cuts are not repealed AMT revenue will be \$117.4 billion (2010), \$265.2 billion (2017) and \$43.4 billion (2010), 114.9 billion (2017) if they are not. This represents 9.4% of income tax revenue in 2010 and 13.4% in 2017 if the tax cuts are not repealed and 3% of income tax revenue in 2010 and 5.2% in 2017 if they are.<sup>111</sup>

These numbers are reasonably close to Treasury estimates. Treasury's projects that fewer taxpayers but more revenue will occur in 2017 if the tax cuts do not sunset. If the tax cuts remain in place, it projects 56 million taxpayers will be subject to the AMT in 2017, raising \$250 billion in revenue.<sup>112</sup> The President's tax reform panel estimated that 50 million taxpayers would be subject to the AMT in 2015.<sup>113</sup>

The estimates by the Joint Committee, however, are much lower. That is because the JCT assumes current law remains in place, most importantly that the 2001 and 2003 tax cuts actually sunset at the end of 2010. The Joint Committee predicts that in 2007, 13.8 percent of taxpayers will be affected by the AMT, up sharply from the 2.5% affected in 2006. The percentage climbs each year, reaching 17.9% in 2010, but decreases to 10.4% in 2011 when the tax cuts expire.<sup>114</sup> JCT estimates that revenue collected under the AMT will also rise sharply, from an estimated \$20 billion in 2006 (equivalent to 2.5% of total individual income tax liability), to \$70 billion in 2007 (7% of total liability), to \$107 billion in 2010 (9% of total liability).<sup>115</sup>

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<sup>109</sup> See Greg Leiserson and Jeffrey Rohaly, "What is Responsible for the Growth of the AMT?" (Mar. 2007), available at [http://www.taxpolicycenter.org/UploadedPDF/901053\\_Responsible\\_AMT.pdf](http://www.taxpolicycenter.org/UploadedPDF/901053_Responsible_AMT.pdf)

<sup>110</sup> Burman et al at 108 (2003)

<sup>111</sup> <http://www.taxpolicycenter.org/taxtopics/AMT.cfm>

<sup>112</sup> <sup>2</sup>Office of Tax Pol'y, U.S. Treas. Dep't, Tax Relief Kit 2 (Mar. 2007), available at [http://www.treas.gov/offices/tax-policy/fact-sheet/TaxReliefKit2007\\_web\\_.pdf](http://www.treas.gov/offices/tax-policy/fact-sheet/TaxReliefKit2007_web_.pdf)

<sup>113</sup> President's Tax Reform Panel ch .4, available at : <http://www.taxreformpanel.gov/final-report>.

<sup>114</sup> Joint Committee on Taxation, 110th Cong., Present Law and Background Relating to the Individual Alternative Minimum Tax (Comm. Print 2007).

<sup>115</sup>Id. Other previous projections are in the same ballpark. See, e.g., Daniel R. Feenberg & James M. Poterba, The Alternative Minimum Tax and Effective Marginal Tax Rates (MIT Dept of Econ Working Paper Series 03-37, Oct. 2003 (ssrn) (estimating that **Error! Main Document**

Of additional importance is the extent to which the AMT affects various classes of taxpayers. According to the TPC, those with AGI of less than \$30,000 are unlikely to be affected by the AMT. The overwhelming majority will not be subject to the AMT because of the size of its exemption. In 2017 if the tax cuts are extended, the AMT is projected to affect 38.8% of taxpayers with AGI of \$50,000-\$75,000, 67.2% of taxpayers with AGI of \$75,000-\$100,000, 92.3% of taxpayers will AGI of \$100,000-\$200,000, and 96.8% of taxpayers with AGI of \$200-\$500,000. At higher incomes, the percentage is less because the regular tax rate is higher. However, even 73.8% of those with incomes of \$500,000-\$1M and 40.1% of those with income over \$1 million will be affected.<sup>116</sup>

Finally, it is important to focus on the aggregate cost of repealing the AMT, i.e. the revenue that the government loses if the AMT were no longer imposed.<sup>117</sup> In April 2004 the Congressional Budget Office projected the cost of repeal was “\$600 billion over the next decade under current law.”<sup>118</sup> In 2005 they estimated the cost of repeal would be \$611 billion for FY2006-2015.<sup>119</sup> The Tax Policy Center projected that the total revenue attributable to the AMT from 2007-2017 is estimated to be \$1.7 trillion if the tax cuts are extended and \$850 billion if they are not. In fact, by 2008 they project that it would cost less to repeal the regular tax than the AMT because the total revenue loss from repealing the regular income tax for 2008-2017 is \$1.6 trillion.<sup>120</sup> This is in part because although the revenue from the regular tax would be lost, the amount of revenue from the AMT would soar since many more taxpayers would owe AMT. The President’s tax reform panel estimated that \$1.2 trillion would be lost if the AMT were repealed.<sup>121</sup>

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**Only**.37 million taxpayers (nearly one in four) will pay the AMT in 2010 and that revenue from the AMT will be \$125.53 billion); Leonard E. Burman, William G. Gale & Jeffrey Rohaly, *The AMT: Projections and Problems*, Tax Notes, July 7, 2003, at 5 (projecting there will be 33.1 million AMT filers in 2010 and \$124 billion in revenue).

<sup>116</sup> Tax Policy Center. These numbers are generally consistent with those calculated by the Congressional Budget Office. See <http://www.cbo.gov/ftpdocs/53xx/doc5386/04-15-AMT.pdf>. The differences are not important to the point I making.

<sup>117</sup> There would be other nonrevenue costs. For example, taxpayers would save time and any marginal costs incurred because they had to calculate taxes twice. While not trivial, it is insignificant compared to the revenue loss.

<sup>118</sup> <http://www.cbo.gov/ftpdocs/53xx/doc5386/04-15-AMT.pdf>, p. 7.

<sup>119</sup> <http://www.cbo.gov/ftpdocs/63xx/doc6370/05-23-AMT-testimony.pdf>, p. 10.

<sup>120</sup> Tax Policy Center, *Repealing the AMT: Costly and Regressive*, available at [http://www.taxpolicycenter.org/taxtopics/amt\\_repeal.cfm](http://www.taxpolicycenter.org/taxtopics/amt_repeal.cfm); See also CBO, *The AMT (4/25/04)*, available at [www.cbo.gov/shoedoc.cfm?index=5386](http://www.cbo.gov/shoedoc.cfm?index=5386) (cost of repeal will be more than cost of repealing the rest of the income tax).

<sup>121</sup> President’s Tax Reform Panel ch. 4

Congress decreases the revenue from the AMT without repealing it by enacting one- or two-year patches. It does this by keeping the higher exemption amount in place instead of letting it return to its \$45,000 level. For example CBO found that the cost of extending the 2004 level exemptions into 2005 would be \$18 billion, and would continue to rise to a peak of \$58 billion in 2010 and then fall to \$42 billion in 2014.<sup>122</sup> The Tax Policy Center provides a static estimate of \$90 billion as the cost of extending the 2006 patch for two years.<sup>123</sup> Treasury estimated in 2005 that extending and indexing the AMT patch would cost \$866 billion over the next ten decade.<sup>124</sup> Budget projections made by OMB in January 2007 estimated that extending the 2006 exemption and indexing it for inflation would cost \$569 billion for the period 2008-2017.<sup>125</sup>

Finally, assuming revenue neutrality is required, consider how repeal of the AMT could be paid for. The President's Tax Reform Advisory Panel estimated that replacing the AMT revenue by raising current tax rates requires an 11% across-the-board rate increase, raising the top rate from 35% to 39%). Raising the top four brackets only would require an 18% increase in each rate bracket (raising the top rate from 35% to 41%).<sup>126</sup> Another possibility is to impose a 4% surtax on incomes exceeding \$100,000 (\$200,000 for couples).<sup>127</sup> As the authors note, this option is highly progressive because it shifts the burden of the AMT upward and can be made to be revenue neutral over a ten-year budget window.

## V. The Argument for Retaining the AMT

### A. The Rationale

The political economy of the tax reform provides certain lessons in stark relief: (1) There is no political consensus for significant reform, including base broadening, for equity or efficiency reasons. (2) It is currently impossible to raise effective tax rates either through direct changes to the marginal rates in the regular tax or through base broadening. (3) Congress is more concerned with short-term political goals than long-term fiscal policy even in the face of encroaching deficits or fiscal crisis that are surely know but also ignored. (4) Congress is enamored with fiscal illusion; transparency is a victim of politics. (5) Interest groups have significant control and then gain little from tax reform and politicians are not able to extract rents from successful tax reform.

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<sup>122</sup> <http://www.cbo.gov/ftpdocs/53xx/doc5386/04-15-AMT.pdf>

<sup>123</sup> <http://www.taxpolicycenter.org/numbers/Content/PDF/T07-0121.pdf>

<sup>124</sup> President's Tax Reform panel

<sup>125</sup> <http://www.cbo.gov/ftpdocs/77xx/doc7731/01-24-BudgetOutlook.pdf> at p. 16.

<sup>126</sup> President Tax Reform Panel

<sup>127</sup> Len Burman and Greg Leiserson A Simple, Progressive Replacement for the AMT, Tax Notes (June 4, 2007) at 945.

The rationale for retaining the AMT is wholly dependent on the arguments sketched out above: that tax reform is currently not viable and that Congress will not reduce entitlement spending to a level where revenue is not a concern. If it were possible to broaden the base and/or raise rates, the argument would have little merit.<sup>128</sup> Clearly a more transparent, less complex approach would be to scrap the AMT and incorporate its functions by directly repealing the tax preferences and raising rates. There is support for this proposition.<sup>129</sup> This ignores the political economy of both the AMT and base-broadening reform. Thus I argue that the AMT can be justified as a backdoor approach to reform and revenue raising. Furthermore, absent accompanying base-broadening and rate changes, repeal of the AMT is worse than retention. I develop the various rationales for retaining the AMT below.

### *The AMT is a Solution to Future Revenue Problems*

The problem with the AMT is not that it is so complex, nontransparent, and lacking in sound policy as many, many commentators have asserted. The “problem” with the AMT is that it raises (or is predicted to raise) too much revenue. There are numerous reasons to repeal the AMT and they are all very good. The problem is that there is one huge problem with repealing the AMT that trumps all the other reasons—it’s a money machine.<sup>130</sup> The time to repeal the AMT is rapidly disappearing if it is not gone altogether. The time to repeal it was when it was producing very little money. The primary argument for retaining the AMT given current political constraints is that it produces a significant amount of revenue and that revenue will increase over time.<sup>131</sup>

Of course refusing to repeal the AMT is pretty much the same as raising rates on the regular income tax but Congress apparently thinks that the public does not understand that (and apparently they are right). If you cannot raise revenue directly by broadening the base or increasing marginal rates, then retaining the AMT is another way of getting there, particularly if it is the top rate that is critical.

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<sup>128</sup> This is the converse of the argument made in Treasury I in connection with repealing the AMT, which Treasury supported only if the other base-broadening proposals in the report were implemented. Add cite.

<sup>129</sup> Daniel S. Goldberg, *To Praise the AMT or to Bury It*, 24 Va. Tax Rev. 835, 837 (2004).

<sup>130</sup> The President’s Advisory Panel on Tax Reform recommended repealing the AMT. Once that decision had been made, the constraint that the report be revenue neutral required the panel to find significant alternative sources of revenue. Sacred cows came into its crosshairs and this more than anything else probably killed any interest in its version of tax reform. ADD RANGEL PLAN

<sup>131</sup> Daniel R. Feenberg & James M. Poterba, *The Alternative Minimum Tax and Effective Marginal Tax Rates* (MIT Dept of Econ Working Paper Series 03-37, Oct. 2003 (ssrn) (“The potential revenue cost of AMT repeal is a substantial impediment to systematic reform.”))

### *Real of the AMT Would Narrow the Base*

Repeal would reinstate the full use of tax preferences now ensconced in the AMT and that is clearly a step backwards, assuming that the preferences are undesirable.<sup>132</sup> Even if the preferences were initially desirable, it is likely that Congress did not intend for them to be used so extensively and they produce inefficient allocate effects. There is little empirical evidence that any of the incentive provisions clawed back by the AMT do a particularly good job of reallocating resources in an optimal way. Assuming that it is politically impossible to attack preferences directly through the regular tax and that the preferences are objectionable, then the AMT may reduce the undesirable allocative effects of the preferences.<sup>133</sup> Concededly, the AMT itself, like any tax, has efficiency effects: The AMT may affect the behavior of those whose behavior is affected by taxes. Certainly in making the decision to work or save in calculating the after-tax benefit, taxes must be taken into account, including the AMT.<sup>134</sup> In fact, it is the marginal tax rate (after taking the AMT into account) that matters. But it should not *change* the efficiency effects by splitting the tax into two pieces, assuming those affected by taxes understand the effect of the AMT.<sup>135 136</sup>

### *The AMT Makes a Major Contribution to Progressivity*

This is not the place to argue for the propriety of progressivity in the income tax or whether any measure of distributive justice supports progressivity. Assuming that our system incorporates some measure of progressivity as a means of correlating taxes with an ability to bear a tax burden or as a way to redistribute wealth, the AMT is one tool we use to make the tax system progressive because it imposes some or a larger tax on wealthier individuals.<sup>137</sup> There is no question that it a significant factor contributing to progressivity.

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<sup>132</sup> Burman et al at 115 (“The most plausible economic rationale for a minimum tax or some sort is that it could be a second-best backstop for a porous income tax.”).

<sup>133</sup> Shaviro, Tax Notes, at 1461.

<sup>134</sup> See CBO Report at 7.

<sup>135</sup> One additional efficiency consideration is that everyone may not know or be able to calculate the accurate marginal tax rate either because they are unaware of the AMT or because they are uncertain about its effect.

<sup>136</sup> See Goldberg at 859 (arguing that the AMT should not be abandoned without securing simultaneous base broadening because tax reform cause would be set back); Gale (Toward Fundamental Reform) at 43 argues for repeal *if* anti-sheltering provisions are brought into the regular tax, the corporate and individual tax is integrated, and it is revenue neutral. As a second-best proposal he would retain the AMT but raise the AMT exemption to remove the middle class and make capital gains a preference.

<sup>137</sup> Beale at 877 argues that although flawed the AMT can play a role in making sure that higher-income tps pay some tax.

Although commentators often point to the fact that the AMT is regressive at the top (because the regular tax kicks in rather than the AMT), that is the wrong way to measure progressivity. One must take into account the *overall* progressivity of the system; looking at the AMT in isolation is misleading for two reasons. First, the AMT serves to broaden the base of the federal income tax by clawing back various preferences that are largely used by the wealthy. Conversely, the AMT also removes “preferences” used by those who are not wealthy, such as the exemptions. That too must be taken into account but only to the extent that individuals actually have a higher effective tax rate.<sup>138</sup> Second, the AMT raises the effective tax rate for individuals who are subject to it and effective rates take into account both systems.

It is important to recognize that the benefit of repeal would be directed to taxpayers at the top of the income distribution. Almost 96 % of the tax cut resulting from repeal would go to the top quintile and 80% would go to the top tenth.<sup>139</sup> More than half would go to taxpayers with income in excess of \$200,000.<sup>140</sup> After-tax incomes of taxpayers with incomes between \$200,000 and \$500,000 would rise by 2.7 percent, or nearly \$6,000. In 2010 repeal of the AMT would cut taxes on 18% of tax units, by an average of about \$3,400. This tax cut would average \$628 (slightly more than 1% of gross income. But most relevant for progressivity is that the biggest beneficiaries in dollars would be those with incomes in excess of \$1 million. Those with incomes between \$200,000 and \$500,000 would have the largest gains as a percentage of income. More than 97% of those in that income cohort would receive tax cuts, averaging 3.3% of income. More than 82% of the cohort with income between \$100,000 and \$200,000 would have taxes cut, averaging \$2,622, averaging about 1.6%<sup>141</sup> Conversely, the taxes of the lowest quintile (below \$30,000) would not change at all and the second and third quintiles in the aggregate would experience only a .3% change (up to \$50,000 of income). Those with income of \$50-\$100,000 would enjoy 9.2% of the change.<sup>142</sup>

This raises a political economy argument against repeal: It is inconceivable that Congress would adopt such a huge tax cut for the wealthy, particularly on top of the 2001 and 2003 changes. If repeal of the AMT would take a serious toll on the progressivity of the income tax system, one obvious response would be to raise marginal rates under the regular tax or to cut

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<sup>138</sup> For example, if individuals who would lose the dependency exemption have income that is less than the AMT exemption and therefore are not subject to the alternative rate structure, there is no effect on progressivity.

<sup>139</sup> Tax Policy Center, Repealing the AMT: Costly and Regressive, at tbl. T07-0007.

<sup>140</sup> Id. at tbl. T07-006.

<sup>141</sup> Leonard E. Burman & David Weiner, Suppose They Took the AM Out of the AMT? (Tax Pol’y Ctr. Discussion Paper No. 25, August 2005, available at [http://www.taxpolicycenter.org/UploadedPDF/311212\\_TPC\\_DiscussionPaper\\_25.pdf](http://www.taxpolicycenter.org/UploadedPDF/311212_TPC_DiscussionPaper_25.pdf)

<sup>142</sup> Tax Policy Center, Repealing the AMT: Costly and Regressive, at tbl. T07-0007.

back on preferences in the regular tax that are mainly used by the wealthy. Neither of those solutions, but particularly the first, is politically plausible.

*The AMT is a Way to Deal with the Possible Permanence of the 2001 and 2003 Tax Cuts*

There is every reason to believe that it may be too politically difficult for Congress to allow the 2001 and 2003 tax cuts to sunset. It is inevitable that sunsetting them will be characterized as a tax increase, and in truth, it is not implausible to describe them as an increase rather than a temporary tax reduction given the time they will have been in place by 2010. If Congress ends up being unable to sunset the earlier tax cut, it can effectively do so by not amending the AMT.<sup>143</sup> The Tax Policy Center shows that about one-fifth of the tax deductions attributable to the cuts will be reclaimed by the AMT in 2007. Specifically they estimate the following percentages of tax cuts are clawed back by income class: \$30-\$50,000 (.3%), \$50-\$75,000 (1.8%), \$75,000-\$100,000 (11.1%), \$100-200,000 (34%), \$200-\$500,000 (55.3%), \$500,000-\$1M (16.3%), over \$1M (4.6%).

It is entirely possible that the Bush administration itself used the AMT to camouflage or hold down the revenue estimates for the tax cuts. By not reducing the AMT rates (or by not indexing the exemption) at the same time as the regular rates were cut, some portion of the tax cuts were eliminated through the AMT. This may have made the revenue estimates more politically attractive than they would have been if everyone had actually received the announced tax cut.<sup>144</sup> Retaining the AMT would continue that process.

*We Can't Pay for AMT Repeal in Any Event*

Here the political economy argument is telling as well. There is no obvious answer how to pay for reform. One possibility, calculated by the Tax Policy Center, would be to let the tax cuts and rate reductions on capital gains and dividends sunset and repeal the deduction for state and local taxes.<sup>145</sup> That will surely be controversial. [fill in with recent suggestions for how to treat repeal. Also deal with the argument that revenue neutrality is not necessary.]

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<sup>143</sup> See Alan Auerbach, Willam G. Gale & Peter Orszag, Bush Administration Tax Policy: Introduction and Background, 104 Tax Notes 1291, 1294 (Sept. 13, 2004) (failure to amend the AMT will “eventually erase all of the income tax cuts provided in the 2001 and 2003 legislation”).

<sup>144</sup> See Lawrence Zelenak, Framing the Distributional Effects of the Bush Tax Cuts, 105 Tax Notes 83, 90 (Oct. 4, 2004). The revenue savings is the difference between the AMT raises after the tax cut and the amount the AMT would have raised had their been no tax reductions in the regular tax. An even more cynical view would be that proponents of the tax cuts actually understood that middle class taxpayers, but not wealthy taxpayers would lose their tax cuts through the AMT and did not care.

<sup>145</sup> Burman, Koch

## B. Responding to Criticism

Given the general dislike of the AMT<sup>146</sup> one would expect significant criticism to be levied at the suggestion to retain it, even as a second-best (or tenth-best) suggestion. It is easy to predict what will be said. One would expect opponents of the AMT to argue that its flaws are so numerous and so egregious that they swamp any argument to be for retaining it on either revenue, base-broadening or progressivity grounds. Briefly I describe these expected criticisms and explain why I do not think any of them alone or in the aggregate is critical.

### *It Doesn't Get Much More Complex than the AMT*

It is a truism that the tax law is too complex for taxpayers and policymakers to understand and in the abstract that is a very bad thing. The AMT is often cited as a prime example of complexity run amok. Computation of the AMT requires a separate calculation of the AMTI, which requires many ancillary calculations. This obviously adds a layer of complexity to the current tax system, both for the taxpayer and for the IRS. The AMT affects those who ultimately have an AMT liability, those for whom a portion of nonrefundable credits are disallowed, and those who must calculate the AMT only to discover that they are not affected by the AMT after all.

The chief complexity complaint against the AMT is that taxpayers are required to file their taxes under two regimes.<sup>147</sup> Another complaint is that taxpayers would need to keep two sets of records, especially for preference items where deferral is being scaled back. Thus, any suggestion that the AMT be retained is arguably moving in the wrong direction since repeal would remove a significant amount of complexity.

While the underlying assumption about two regimes is correct, the criticism is overblown. At the margin the AMT creates additional complexity, but overall compliance complexity is not high. Taxpayers do not need to keep two sets of records other than calculating depreciation twice for example. All of the calculations are automatic if tax preparation software is used; in fact the taxpayer may not even know that she is subject to the AMT.<sup>148</sup> According to

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<sup>146</sup> See, e.g., Nina E. Olson, 2004 National Taxpayer Advocate Ann. Rep. to Cong. 2-3 (Dec. 31, 2004) (AMT one of the most serious problems taxpayers face); Sheryl Stratton, "Overson Speaks Out on Tax Code Complexity," Tax Notes at 1199 (Sept. 4, 2000) (National Taxpayer Advocate Val Overson in calling for repeal referred to AMT as "absolutely, asininely stupid."); Martin A. Sullivan, "Tax Simplification: Can the Dream Become a Reality," Tax Notes 1528, 1529 (Mar. 13, 2000) (calling AMT an "abomination")

<sup>147</sup> Examples of those who think that the complexity problem is significant include Beale at 854-57, Burman et al at p. 115, Burman, Koch ("The AMT is notoriously and pointlessly complex. ")

<sup>148</sup> Feenberg & Poterba at 5 ("For most taxpayers who will face AMT liability, the AMT calculation is not particularly burdensome."); CBO, The Alternative Minimum Tax (Apr. 15, 2004), available at <http://www.cbo.gov/ftpdocs/53xx/doc5386/04-15-AMT.pdf> ("The required

the Joint Committee, there are no studies available that measure the compliance costs for taxpayers.<sup>149</sup> To be clear this is not an argument for retaining the AMT for the sake of complexity. Rather the argument is that the specific marginal complexity added by the AMT is not so onerous a burden that it outweighs the current benefits of retaining the AMT.

### *The AMT Hides the Ball and Messes Up Fiscal Discipline*

Transparency is an important desideratum in a democracy. It is generally agreed that laws should be transparent and people should understand how to comply with them. Transparency also makes it easier to monitor the tax system both by taxpayers and by policymakers on the Hill or in Treasury. When the ball is hidden it is more difficult to figure out the implications of a statutory change. One criticism often leveled at the AMT and suggested as a reason for its repeal is that the AMT makes the income tax system less transparent than it should be since it is not obvious what rate of tax one is paying or how the tax burden is allocated.<sup>150</sup> If it is difficult for taxpayers and those who monitor the system to understand changes to the tax system, it skews political debate.

In addition Burman argues that this lack of transparency undermines fiscal discipline because, for example, the AMT can hide expensive programs. The 2001 and 2003 tax cuts are a good example. There was almost no public comment about the interaction between the tax cuts and the AMT. Although it seems clear that the Bush administration was well aware of the interaction,<sup>151</sup> there was little public understanding that over time the AMT would remove the benefit of the tax cuts for many taxpayers. Clearly this confused the discussion over the distributional implications of the cuts. Burman also argues that since Congress is afraid of adding all those new taxpayers to the AMT rolls each year, it knows it has to pass a patch and that is an opportunity to add pork barrel items and of course they cost a lot of money.<sup>152</sup>

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calculations increase both the complexity and time required to comply with tax laws, although computer software may mitigate those costs.”); Joint Committee on Taxation, 110th Cong., Present Law and Background Relating to the Individual Alternative Minimum Tax (Comm. Print 2007) (off-the-shelf software significantly reduces complexity).

<sup>149</sup> Joint Committee on Taxation, 110th Cong., Present Law and Background Relating to the Individual Alternative Minimum Tax (Comm. Print 2007).

<sup>150</sup> See, e.g., Linda M. Beale, Congress Fiddles While Middle American Burns: Amending the AMT (And Regular Tax), 6 Fla. Tax Rev. 811, 824-25 (2004).; Burman et al at p. 116.

<sup>151</sup> Len E. Burman, The Alternative Minimum Tax: Assault on the Middle Class, Milliken Inst. Rev. (4<sup>th</sup> Q. 2007) at 18-19, available at [http://www.milkeninstitute.org/publications/review/2007\\_10/12-23mr36.pdf](http://www.milkeninstitute.org/publications/review/2007_10/12-23mr36.pdf).

<sup>152</sup> <sup>1</sup>Len E. Burman, The Alternative Minimum Tax: Assault on the Middle Class, Milliken Inst. Rev. (4<sup>th</sup> Q. 2007) at 18-19, available at [http://www.milkeninstitute.org/publications/review/2007\\_10/12-23mr36.pdf](http://www.milkeninstitute.org/publications/review/2007_10/12-23mr36.pdf).

There is no question that commentators are right about the lack of transparency in the AMT but they miss the political economy benefit of nontransparency. Nontransparency may be a virtue because it permits Congress to do important things that for political reasons it otherwise may be unable to do. While transparency is generally important, the politics are such that there are other more important values—the need to maintain the progressivity of the income tax, the need to curb tax preferences, as well as the need for additional revenue—that trump the desire for transparency.<sup>153</sup> Transparency is critical in a first-best world; it is much less important in a tenth-best world and it can never trump other more important values.

### *The AMT Will Get Less Progressive over Time*

The AMT is currently highly progressive. It was estimated that in 2006, 47% of the tax would be paid by those with income exceeding \$500,000.<sup>154</sup> But over time the progressivity of the AMT will decrease. Burman et al posit that the progressivity of the AMT will decline over time as more middle income taxpayers are swept into its maw.<sup>155</sup> For example, they note that those with income of less than \$100,000 will constitute 52% of AMT taxpayers in 2010 and will account for 23% of the AMT revenue compared to 5% in 2003 whereas only 10% of revenues will come from those with income over \$500,000 compared to 36% in 2003. It is undoubtedly true that the progressivity of the AMT standing alone will decrease over time as more taxpayers at the lower end of the income scale are subject to the AMT because the exemption is not indexed. But that is not the appropriate perspective—the important measure is the overall progressivity of the federal tax system. Thus, the issue is whether the AMT continues to contribute to progressivity. If we focus solely on the contribution of the AMT, the failure to index the exemption may decrease overall complexity over time as taxpayers move to the AMT [is that in fact true?], but as compared to the current regular tax without the AMT, there would be less progressivity over time.

It is possible that the AMT could result in too much progressivity if it increased the effective tax rate to the point where it had a strong negative effect on the incentive to work.<sup>156</sup> But none of the projected effective marginal tax rates taking into account the AMT exceed the highest nominal marginal tax rate even in 2010.<sup>157</sup> What is troubling, however, is that the

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<sup>153</sup> See, e.g., Daniel Shaviro, Tax Simplification and the Alternative Minimum Tax, Tax Notes at 1455, 1458 (May 28, 2001) (“[T]ransparency need not be a supreme value if ... obfuscation permits well-meaning policymakers to choose better policies.”).

<sup>154</sup> Leonard E. Burman, Juliana Koch & Greg Leiserman, The Individual Alternative Minimum Tax (AMT): 11 Key Facts and Projections (Dec. 2006), available at [http://www.taxpolicycenter.org/UploadedPDF/1001046\\_AMT11facts.pdf](http://www.taxpolicycenter.org/UploadedPDF/1001046_AMT11facts.pdf).

<sup>155</sup> Burman et al at 114 (2003).

<sup>156</sup> See Burman, Koch & Leiserman (nothing that AMT raises effective marginal tax rates, which affect the incentive to work).

<sup>157</sup> See Tax Policy Center tbl. T06-0271, at <http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=1353>.

effective marginal tax rates appear almost random. For example, in 2010 the average effective marginal tax rate for those with income of less than \$30,000 (27.6%) is higher than the average rate for those with income exceeding \$1 million. [see discussion under finetuning]

### *We can Deal with Preferences if we Repeal the AMT*

A number of commentators assert that repealing the AMT would be an opportunity to limit or even eliminate overused tax preferences and thus the AMT is not needed as a base-broadening tool. Even if an attempt was made to rein in preferences as a part of AMT repeal, we should anticipate that the process would be hijacked by those interested in keeping various preferences. One would expect to see a political economy asymmetry play out. Each group with a vested interest in a preference has a good deal to gain by keeping it in the Code whereas all of those not affected by the incentive directly have little to lose by its repeal (other than the diffuse possibility of higher taxes and higher prices on goods and services affected by the incentive). Political models predict that the former will be active in the debate and the latter will be passive. Those with vested interests in incentives tend to be politically well-connected and have much experience in protecting their interests.

Under the current PAYGO system, repeal requires offsets and every year that passes the needed offsets increase in size. As the recent introduction of repeal by Rangel makes clear, there are no obvious offsets with overwhelming political support. By definition someone's ox is going to be gored and it is unlikely that various interest groups can coalesce around one solution

### *The Goal of the AMT was to tax those 144 taxpayers and that's all it should do.*

This criticism rejects the possibility that the AMT may currently play an important role in the structure of the income tax because that is not why the AMT was adopted. It should not be too difficult to accept that the original goal of the AMT has changed. It is counterproductive to argue that since the AMT no longer serves the original goal, it must be repealed. It is possible, and even likely that it now serves different goals.

### *The AMT does not Even Do the Job It was Adopted to Do*

A corollary argument is that the AMT is not even accomplishing its original goal of preventing high income taxpayers from paying no tax. Treasury estimated that in 2006 more than 6600 taxpayers with income greater than \$200,000 and more than 1,300 taxpayers with income greater than \$700,000 will pay no tax through "legitimate tax avoidance."<sup>158</sup> The obvious answer is to strengthen the AMT, not repeal it. If this is really a concern, then additional preferences should be added to the base.

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<sup>158</sup> President's Advisory Panel on Tax Reform (2005).

### C. Is Fine Tuning Possible?

While none of the criticisms described in the previous section is convincing, support for retaining the AMT is not the same as saying that the AMT is perfect. This section considers some possible adjustments to the AMT that might make it more palatable to retain. It should be kept in mind that it is very costly to make any changes in the AMT. Just to give a flavor of the costs, it has been estimated that extending the 2006 AMT exemption relief and indexing it would more than \$900 billion (assuming no sunset of the tax cuts). Also permitting exemptions would raise the price to \$1 trillion, and removing state and local tax deductions as a preference pushes it to \$1.2 trillion.<sup>159</sup> If one of the key arguments for retaining the AMT is its revenue potential, the base cannot be gutted.

#### *State and local tax deduction*

Whether the state and local tax deduction should be part of the AMT is a complicated question that depends on whether one believes that such a deduction is normative. There is no consensus on whether that is true,<sup>160</sup> although the lack of a definitive argument for requiring the deduction eases the case. Excluding the deduction from the AMT complicates the argument that the AMT can be used to raise revenue because the provision is the largest AMT tax preference<sup>161</sup> and is a very large tax expenditure.<sup>162</sup> If one did not accept the arguments in favor of the deduction, then repealing the deductions out right would be the first-best choice,<sup>163</sup> and leaving it as an AMT preference item is a good second choice option. On the other hand, if the case can be made for the deduction, then it is a mistake for it to be swept into the AMT.

One suggestion that has been made is to repeal both the AMT and the state and local tax deductions.<sup>164</sup> This may have distributional problems [look for info on this] but it clearly has political problems. There is a huge constituency for this tax preference and most taxpayers believe that state and local income and property taxes are deductible in full. Very few understand the extent to which they are clawed back by the AMT. While some people

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<sup>159</sup> Leonard E. Burman, William G. Gale, Gregory Leiserson & Jeffrey Rohaly, Options to Fix the AMT, (Jan. 19, 2007), available at [http://www.taxpolicycenter.org/UploadedPDF/411408\\_fix\\_AMT.pdf](http://www.taxpolicycenter.org/UploadedPDF/411408_fix_AMT.pdf).

<sup>160</sup> For thoughtful discussions of the arguments, see Brian Galle, SALT in Their Wounds?: Irrationality, Unfunded Mandates, and the AMT (SSRN); Beale at 861-66.

<sup>161</sup> Find authority

<sup>162</sup> Get most recent tax exp. Budget

<sup>163</sup> The President's Tax Reform Panel called for its repeal. Report of the President's Advisory Panel on Federal Tax Reform 70, 83-84, available at [www.taxreformpanel.gov/final-report/Tax-Reform.pdf](http://www.taxreformpanel.gov/final-report/Tax-Reform.pdf)

<sup>164</sup> Get cite

understand the fact that they live in a high tax state subjects them to the AMT (or even more specifically that high state income and real estate taxes subject them to the AMT), they fail to understand that their deduction has been largely stripped away. But they would clearly understand an attempt to repeal the deduction outright. Voters' perceptions of preferences are much starker than their perceptions of other ways of cutting taxes, such as raising the threshold for a rate bracket.<sup>165</sup> Assuming the case for a normative deduction is not strong, political economy and revenue constraints argue for retaining state and local taxes as a preference.

#### *Miscellaneous itemized deductions above the 2% floor*

The 2% floor can only be justified as a rough justice way to exclude “business consumption” (the Wall Street Journal) from the base, as well as on administrative grounds. Otherwise the expenses of producing taxable income should be deductible. Absent strong administrative advantages, the 2% floor should be removed from the regular tax and that automatically solves the AMT problem. On the other hand, if the consumption and administrative arguments are compelling, the cleaner answer is to prevent any deduction for the business expenses of employee. (As it is very few taxpayers actually have such business expenses that exceed 2% of AGI.) (get figures). Furthermore, the additional revenue obtained from taking back the excess deduction is hardly worth it and only exacerbates the normative problem. This preference should be removed.

#### *The deduction for personal and dependency exemptions and the standard deduction*

Although dependency exemptions and the standard deduction can be said to be a deduction of personal consumption, that is entirely appropriate assuming one accepts some ability-to-pay notion applicable to the tax. If there is a subsistence level of income below which we as a society do not believe it is possible or morally acceptable to live, then no part of the dollars available for subsistence consumption are available to pay taxes. Our rate structure reflects this--the standard deduction and exemptions are used to create a zero bracket for those who income reflects no ability to pay.

How does this relate to the AMT exemption? First there is a discrepancy because the AMT exemption is larger than the standard deduction and the exemptions (unless it is a very large family). Second a taxpayer who itemizes can take itemized deductions for the regular tax (and some for purposes of the AMT) as well as the exemption amount.

A better effort needs to be made to align these numbers. The function of both the standard deduction and exemptions as well as the AMT exemption should be to exclude from the taxpaying universe those who have no ability to pay. The real problem is not that the AMT exemption is larger than the standard deduction and the exemptions; the problem is that it is not coordinated and in a limited number of cases is not large enough. This arises because it fails to take family size into account—the flat exemption applies to everyone. Yet historically we have construed ability to pay to be constrained by family size. [Of course if you view the dependency exemption as a subsidy to families, then it might seem appropriate to take this away as a

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<sup>165</sup> See Shaviro (1990) at 61-62.

preference. But that view is misguided unless we believe that the exemption affects behavior, i.e. that it creates an incentive to have more children.] Accepting that the dependency exemption merely excludes subsistence amounts from tax (so much for each individual) it should not be treated as a preference and there should be some alignment.

While the argument that excluding the personal exemption and the standard deduction sounds quite persuasive, it actually is not as important as it sounds. That is because the AMT exemption is quite large. The current amount is \$62,500 for a married couple. If we believed that all other preferences included in the AMT base *should be subject to tax*, then the exemption is too low in all but a few cases. It takes a fairly extreme example to show that the exemption is not high enough. Suppose we had a couple with five dependent children and wage income of \$100,000. If the family took the standard deduction in 1006, the taxable income would be \$65,900 and the tax liability under the regular tax would be \$9322. Under the AMT, however, the AMTI, assuming no preferences other than the standard deduction and exemptions would be \$37,500 [ $\$100,000 - \$62,500$ ], which would be subject to a 26% tax or a tax liability of \$9750. That clearly is a little too high—the only reason this person is subject to the higher amount if because of the fifth child. With four children or less income, the AMT would not kick in. Just raising the AMT exemption is not the right answer. Raising the exemption to \$70,000 would do the trick, but it would exclude taxpayers without a lot of children who had preferences. Now consider the case where the taxpayer does not take the standard deduction but instead itemizes and the only itemized deduction is state and local taxes. If the deduction is close to the same amount as the standard deduction, the result will be the same. But suppose as income increases, it gets much larger. If we believe that the deduction is a preference and should not be allowed, then that person should be in roughly the same position after the AMT if they had not taken the deduction but instead had taken the standard deduction. But the bottom line is *if* the state and local deduction is not viewed as a tax preference, this the failure to index the exemption and the failure to include the standard deduction or dependency exemptions is just not that big a deal. Perhaps if for optics only, it might make sense to vary the exemption a little by the number of dependents.

Furthermore keeping the current AMT exemption as well as removing the standard deduction and personal exemptions would be a significant revenue hit. Feenberg & Poterba estimate that if personal exemptions could be subtracted in defining AMTI then in 2010 there would be only 12 million filers and \$48 billion in revenue. Furthermore the probability of being an AMT filer drops from 77.2% to 15.8% for those with AGI \$75,000-\$100000. CBO estimates that if dependency exemptions were permitted about one-fifth of all taxpayers who would otherwise owe AMT would be removed and it would cost \$175 billion over the period 2005-2015.

Another obvious discontinuity in that the AMT brackets, exemption amounts are not indexed for inflation whereas the brackets and the exemption in the regular tax are. But that is not per say bad. If we view the two taxes in tandem, it does not necessarily matter if one is indexed and the other is not so long as on an annual basis, we get the right rates and the right exemption. The main point is that they do not have to be identical in any or every respect so long as together we are taxing the right people at the right level.

[I have not worked out the numbers yet, but would suggest some alignment and the possibility: of adjusting for family size.]

One obvious proposal is to at least peg the exemption at the 2006 level and index it for inflation. That essentially is what the legislative patch has done on a year-to-year basis. Why don't I suggest that? The simple reason is revenue. It would be extraordinarily expensive to do that and essentially defeats the purpose of letting the AMT be the Trojan horse for tax reform and revenue raising.<sup>166</sup>

### *The consumption tax features of the AMT*

Our current income tax has features that that would be appropriate in a consumption tax. It is common wisdom that we have neither an income tax nor a consumption tax but rather a hybrid. One way to view these provisions is as tax expenditures--incentives for certain activities, such as saving. Another way is to view them as normative in the sense that they are appropriate as part of a conscious move towards a consumption tax.

First assume that they are incentives, designed to encourage or subsidize certain activities. That characterization does not resolve how they should be treated in a retained AMT. If Congress continues to be of the mind that they are worthwhile federal subsidies [elaborate], and their amount is calibrated correctly, then inclusion in the AMT is wrong. If Congress would like to end the subsidy but simply does not have the will to do so, they should remain as tax preferences. On the other hand, if they are "normative" in a hybrid tax (by which I mean that they would be appropriate in a consumption tax), then they should be removed from the AMT.

### *Medical expense deduction*

If medical expenses are personal consumption expenses, then they should not be deductible under the regular tax and the extra limit on the deduction via the AMT can be viewed as a way to reach the correct result given political constraints. Another way of reaching the same result is through the argument that the medical deduction is not only unnecessary if private insurance markets operate well and may in fact result in over-insurance. The AMT is operating properly in the sense of responding to the political economy argument (can't do it directly)—meaning Congress would really like to limit the deduction to expenses that exceed 10% of AGI but politically cannot do so. This is a complicated question, however, given the current treatment of employer provided medical insurance—the deduction for medical expenses cannot be viewed in a vacuum.

Additionally there is an argument that the medical deduction is necessary to measure income when the expenses are extraordinary.<sup>167</sup> If that amount is fixed by 7% then the AMT

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<sup>166</sup> Feenberg & Poterba project that if the exclusion is indexed there would be 14M filers in 2010 and 48B in revenues (reducing revenue by 60%). CBO estimated in 2004 that making the current exemption permanent and indexing it for inflation would cost \$370b from 2005-2014.

<sup>167</sup> For the classic exposition of this argument, see William D. Andrews, "Personal Deductions in an Ideal Income Tax," 86 Harv. L. Rev. 309 (1972).

may in fact be skewing progressivity and the base because it is aimed at the wrong people.<sup>168</sup> For example, an uninsured person with reasonably low income and high medical expenses would lose at least a portion of the deduction by virtue of the AMT.

While it might be better to more carefully craft the medical deduction or to simply raise the cut-off, this is a politically acceptable second-best choice and it does not affect many people. [need to check statistics and think more about this]

### *Marriage Penalty*

The AMT exclusion for married couples filing jointly is less than twice the single exclusion. In addition the tax rates and exemption phase-out apply at the same level of AMTI regardless of filing status. This creates a marriage penalty (two singles with income who marry could owe additional AMT because they marry) that are larger than they would be under the regular income tax. On the other hand, if the exemption is doubled, there is a marriage bonus for couples with a non-working spouse. Solving the marriage penalty/bonus is impossible, but whatever decision is made for the regular tax should be made for the AMT. There is no good reason to treat marriage or the lack thereof as a preference.

The AMT also has no head of household status—that status can be considered an AMT preference. That too makes no sense.

### *Complexity*

It's true that there are aspects of the AMT that so mind-blowing complex that almost no one can figure them out. Two stand out: Taxpayers must include in gross income a state income tax refund attributable to the previous year's taxes but may exclude any amount that was not actually deductible in the prior year. If a taxpayer was subject to the AMT in the prior year, in order to determine the portion of the refund that is taxable, one has to figure out what amount of state income tax would have been deductible in the previous year if the AMT had not applied. The other notable complexity is particularly perverse: deciding whether to itemize; it may be better to itemize even if the deductions are less than the standard deduction if you are subject to the AMT [figure out how to solve this]

### *Need for Additional Revenue*

If the AMT is changed to eliminate some inconsistencies, particularly with respect to the exemption, filing status and the marriage penalty, then additional revenue needs to be raised to keep it revenue neutral. AMT can continue to be used to limit incentives or to broaden the base where that cannot be done directly. So items could be added to the AMT.

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<sup>168</sup> Beale argues that the limitations should be the same for the AMT and the regular tax. Beale at 869.

My first choice is capital gains. The preferences for this item are not added back in AMT. Capital gains were originally in the AMT but the preferences for capital gains were repealed in 1986. When rate differentials came back, the AMT preference was not restored. Although AMT does not include LTCG as a preference, they are indirectly affected when a taxpayer becomes subject to the AMT. If a taxpayer who otherwise would not be subject to the AMT, garners sufficient LTCG so that he has positive AMTI after the exemption, he will be subject to additional tax, raising the effective tax rate on the additional income, that is, the capital gains.<sup>169</sup> I propose to cover the revenue losses that would occur through the finetuning described above by making capital gains and dividends a preference item again.<sup>170</sup> This could be done at the time that the rates on capital gains and dividends are to phase out. That would be less politically challenging.

Another possibility is to treat the appreciation on property contributed to charity as an item of tax preference.<sup>171</sup>

Cut back on other tax preferences. Perhaps make the interest deduction on home equity indebtedness a preference. Or make the interest on debt exceeding \$500,000 (rather than \$1 million) on a home mortgage a preference.

## VI Conclusion

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<sup>169</sup> For an explanation of this see Yvonne L. Hinson & Ralph B. Tower, Influence of Long-term Capital Gains on Individual AMT, 102 Tax Notes 403 (Jan. 19, 2004).

<sup>170</sup> See Linda Sugin, Sustaining Progressivity in the Budget Process: A Commentary on Gale & Orszag's *An Economic Assessment of Tax Policy in the Bush Administration, 2001-2004*, 45 B.C. L. Rev. 1259, 1273 (2003); Beale at 892 (both suggesting this).

<sup>171</sup> See Beale at 885 who suggests adding the untaxed appreciation on charitable contributions as a preference; Pearlman