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RSC Policy Brief:
Repealing the AMT: Two Contrasting Approaches

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Context: Consensus is building around the need to repeal the Alternative Minimum Tax (AMT) for individuals, which is a mandatory recalculation of the tax bill of certain taxpayers that always leads to higher taxes for these taxpayers. Repealing the AMT would save taxpayers billions of dollars immediately. One significant point of controversy is whether the repeal of the AMT should be "offset" by tax increases or spending cuts elsewhere. This policy brief examines the two schools of thought—to offset or not to offset.

Background on the Individual AMT: As the Congressional Research Service notes, the "individual income tax has been used as a vehicle to promote various social and economic goals." This means that it is possible for two taxpayers to have similar incomes but dramatically different tax bills. Instead of changing and simplifying the tax code, the AMT was created in 1969 as a mandatory add-on to the existing tax code to prevent 155 of the very wealthiest taxpayers from lowering their tax bills using the available deductions and credits. The AMT's reach has since grown dramatically through bracket creep.

The AMT has a two-tiered rate structure, 26% and 28%, and an exemption, so that most people have not had to pay the AMT (which is always a higher tax than the tax calculated under the regular tax system).

Unlike other exemptions in the tax code, the AMT exemption (currently $45,000 for joint returns in tax-year 2007) is not adjusted for inflation. As a result, though meant for the wealthiest of taxpayers, 3.5 million taxpayers were subject to the AMT in 2006, and tax organizations estimate that **23 million taxpayers may be subject to the AMT in 2007**.

Another important reason the AMT is negatively impacting more and more taxpayers is the 1993 tax increase, written by a Democrat Congress and signed into law by President Clinton. The Democrats raised the then-24% rate to 26% on the first $175,000 of AMT-taxable income above the exemption and 28% on the AMT-taxable income in excess of $175,000.

In 1999, the Republican Congress sent legislation to the President fully repealing the AMT. President Clinton vetoed that bill.

The Offset Approach: In short, the offset approach is based on the notion that the government *is entitled to* the increasingly higher tax revenues from the AMT (even though these higher revenues were never intended to be collected). That is, this approach is based on the philosophy that the correction of tax mistakes should be offset with tax increases so that there is no net loss of revenue to the federal government, even if the tax increases apply to different people than do the tax mistakes. The offset approach takes a government-first perspective; it views revenues from the vantage point of the federal government, rather than from the individual taxpayer.

The leading proposal embodying the offset approach is Ways & Means Chairman Charles Rangel's (D-NY) Tax Reduction and Reform Act (often called "The Mother of All Tax Bills" by Rep. Rangel and the "Mother of All Tax Hikes" by critics). Highlights of this legislation, introduced as H.R. 3970 are as follows:

Tax Increases in the Tax Reduction and Reform Act:

NET TOTAL OF $1.331 TRILLION IN TAX INCREASES OVER TEN YEARS

- Surtaxes. Imposes a 4% surtax on joint filers with adjusted gross incomes (minus interest paid on investments) above $200,000 (or a higher amount set by the Treasury to recapture the required amount of money from full AMT repeal) and a 4.6% surtax on joint income above $500,000. The thresholds for the 4% surtax for singles would be $150,000 and for married filing separately would be $100,000. Notably, the plan imposes a large marriage penalty, since the threshold for married couples filing jointly is not double that for singles). The surtax would be applied to adjusted gross income, which includes SOME deductions—like retirement savings, business deductions, and health savings accounts—but not all deductions. The surtax would be calculated on income BEFORE all of a taxpayer's deductions (like state and local sales taxes, mortgage interest, charitable contributions, etc.) have been applied and thus would dilute the value of such deductions. ***Costs taxpayers $831.70 billion over ten years.***

- Limits on Itemized Deductions. Restores the overall limitation on itemized deductions and the phase-out of the deduction for personal exemptions to pre-Bush-tax-cut levels for taxpayers with adjusted gross incomes above $250,000 (for singles; $500,000 for joint). ***Costs taxpayers $28.58 billion over ten years.***

- Miscellaneous Itemized Deductions. Raises the trigger level at which miscellaneous itemized deductions may be taken. ***Costs taxpayers $7.13 billion over ten years.***

- Carried Interest. Requires investment fund managers to treat carried interest as ordinary income (and thus be taxed at a higher rate). Currently, carried interest is taxed at the capital gains rate since carried interest is a capital gain. Carried interest is the name give to the compensation that fund managers earn based on the performance of the fund which they manage. This compensation is the main performance incentive driving fund managers to do better—but such compensation only comes from capital gains. It is by no means "ordinary" income. In fact, this capital gain revenue is already subject to the 35 percent corporate tax rate before it is distributed to investors as capital gains or dividends, meaning that it is already double-taxed when the manager receives it, even at the 15 percent capital gains rate. ***Costs taxpayers $25.66 billion over ten years.***

- Deferred Compensation. Prevents hedge fund managers from using foreign corporations to defer taxes on compensation. Thus, deferred compensation would be taxed as it accrues, rather than when it's actually paid. ***Costs taxpayers $22.64 billion over ten years.***

- Gains from Related People. Treats the gain on sales between related parties as ordinary income (not as capital gains with its lower tax rates). ***Costs taxpayers $135.0 million over ten years.***

- S Corporation Taxes. Subjects the profits of S Corporations distributed as profits to shareholder-employees to self-employment taxes. ***Costs taxpayers $9.41 billion over ten years.***

- Cost Basis Reporting. Mandates cost basis reporting by brokers for transactions involving publicly traded securities, beginning on securities acquired in 2009 (and on all other financial instruments acquired in 2011 and thereafter). Assesses penalties for failing to provide the broker the required information for certain transfers. ***Costs taxpayers $4.27 billion over ten years.***

- Domestic Production Activities Deduction. Repeals the Section 199 domestic production activities deduction. ***Costs taxpayers $114.93 billion over ten years.***

- Repatriation of Foreign Income. Denies the deduction to corporations who defer taxation on foreign income. ***Costs taxpayers $106.39 billion over ten years.***

- Worldwide Allocation of Interest. Repeals the provision allowing U.S. corporations to elect special interest allocation rules for foreign assets. ***Costs taxpayers $26.20 billion over ten years.***

- Treaty Benefits. Limits the ability of corporations incorporated in certain countries that have tax treaties with the United States from taking certain deductions on U.S. income. ***Costs taxpayers $6.40 billion over ten years.***

- LIFO. Repeals the Last-In, First-Out (LIFO) accounting method, which is a method used by companies with large inventories (like energy and automobile companies). Allows taxpayers to allocate any tax increases from this accounting adjustment over eight years. ***Costs taxpayers $106.51 billion over ten years.***

- Cost or Market Method. Repeals the lower of cost or market method of valuing inventories, thus requiring taxpayers to value inventories at cost (rather than at market value). Allows taxpayers to allocate any tax increases from this accounting adjustment over eight years. ***Costs taxpayers $7.15 billion over ten years.***

- C Corporation Accrual Method. Prohibits the special rule for service providers on the accrual method of accounting from applying to C Corporations. Allows taxpayers to allocate any tax increases from this accounting adjustment over eight years. ***Costs taxpayers $225.0 million over ten years.***

- Section 197 Amortization. Extends from 15 to 20 years the amortization period for Section 197 intangibles (such as a copyright, design, operating system, etc.). ***Costs taxpayers $20.70 billion over ten years.***

- Economic Substance Doctrine. Codifies the "economic substance doctrine," which prohibits businesses from making certain free-market business decisions (and from taking the related tax benefits) based solely on tax-lowering motives. The bill would also impose a 20% penalty on understatements attributable to a transaction lacking economic substance (40% in cases where certain facts are not disclosed). ***Costs taxpayers $3.79 billion over ten years.***

- Dividends-Received Deduction. Reduces by 10 percentage-points the deduction that companies can claim for dividends received. ***Costs taxpayers $4.60 billion over ten years.***

- Stock Options. Taxes as ordinary income the exercising of stock options in S Corporations that have shareholders that are exempt employee stock ownership plans. ***Costs taxpayers $606.0 million over ten years.***

- Domestic International Sales Corporations. Prohibits dividends received on or after September 29, 2006 from domestic international sales corporations from qualifying as dividend income. ***Costs taxpayers $881.0 million over ten years.***

- Spin-Off Transactions. Treats distributions of debt securities in a tax-free spin-off transaction the same as distributions of property or cash. ***Costs taxpayers $235.0 million over ten years.***

NOTE: The revenue estimates for this legislation assume that the Bush tax cuts of 2001 and 2003 will be allowed to expire.

Tax Relief and Tax-Expenditures in the Tax Reduction and Reform Act:

NET TOTAL OF $1.338 TRILLION IN TAX RELIEF AND TAX EXPENDITURES OVER TEN YEARS.

- Standard Deduction. Increases the standard deduction for married couples filing jointly by $850 ($425 for singles and married filing separately; $625 for heads of

- Earned Income Tax Credit. Doubles the earned income tax credit for individuals with no qualifying children and increases the phase-out amount for the ability to claim the credit. ***Gives individuals $29.14 billion over ten years.***

- Refundable Child Tax Credit. Reduces the amount above which the portion of a taxpayer's income is refundable under the child tax credit from about $11,000 to $8,500 and eliminates any inflation adjustments. ***Gives individuals $9.12 billion over ten years.***

- AMT "Patch". Provides for a $64,950 AMT exemption amount for married couples in 2007 (it was $62,550 in 2006 and would drop to $45,000 without a "patch"), for a $44,150 exemption amount for singles (it was $42,500 in 2006 and would drop to $33,750 without a "patch"), and the current-law relief for nonrefundable personal AMT credits. ***Saves taxpayers $49.56 billion over ten years.***

- AMT Repeal. Fully repeals the AMT for individuals beginning with tax-year 2008. ***Saves taxpayers $795.66 billion over ten years.***

- Unrelated Business Income Tax. Allows pension plans, universities, and other tax-exempt entities to directly invest in hedge funds and other investment funds without triggering the unrelated business income tax. ***Saves taxpayers $1.34 billion over ten years.***

- One-Year Extenders. Extends the following tax credits and deductions for one year *(ten-year savings numbers indicated below because some of the one-year extenders have revenue implications beyond the first year):*
  - --Research and Development Credit. ***Saves taxpayers $9.00 billion over ten years.***
  - --Indian Employment Credit. ***Saves taxpayers $59.0 million over ten years.***
  - --New Markets Credit. ***Saves taxpayers $1.32 billion over ten years.***
  - --Railroad Track Maintenance Credit. ***Saves taxpayers $165.0 million over ten years.***
  - --Mortgage Insurance Premiums Deduction. ***Saves taxpayers $17.0 million over ten years.***
  - --State and Local Sales Tax Deduction. ***Saves taxpayers $3.58 billion over ten years.***
  - --15-Year Depreciation for Leasehold and Restaurant Improvements. ***Saves taxpayers $3.47 billion over ten years.***
  - --7-Year Depreciation for Motorsports Entertainment Complex Improvements. ***Saves taxpayers $27.0 million over ten years.***
  - --Accelerated Depreciation for Indian Reservation Business Property. ***Saves taxpayers $148.0 million over ten years.***
  - --Brownfields Expensing. ***Saves taxpayers $192.0 million over ten years.***

--Puerto Rico Domestic Production Deduction. ***Saves taxpayers $116.0 million over ten years.***
--Tuition Expenses Deduction. ***Saves taxpayers $1.39 billion over ten years.***
--Special Tax Treatment for Payments to Tax-Exempt Entities. ***Saves taxpayers $23.0 million over ten years.***
--Special Rules for Foreign Shareholders Who Invest in Regulated Investment Companies. ***Saves taxpayers $67.0 million over ten years.***
--Qualified Zone Academy Bonds. ***Saves taxpayers $156.0 million over ten years.***
--DC Investment Tax Incentives (such as the first-time homebuyer credit). ***Saves taxpayers $158.0 million over ten years.***
--Increase in Cover-Over of Rum Excise Tax Revenues to Puerto Rico and the Virgin Islands. ***Saves taxpayers $93.0 million over ten years.***
--American Samoa Economic Development Credit. ***Saves taxpayers $16.0 million over ten years.***
--Incentive to Contribute Property for Conservation Purposes. ***Saves taxpayers $52.0 million over ten years.***
--Deduction for Contributions of Food Inventory. ***Saves taxpayers $72.0 million over ten years.***
--Deduction for Contributions of Books to Public Schools. ***Saves taxpayers $31.0 million over ten years.***
--Deduction for Corporate Contributions of Computer Equipment. ***Saves taxpayers $218.0 million over ten years.***
--Tax-Free IRA Distributions for Charitable Purposes. ***Saves taxpayers $452.0 million over ten years.***
--Special Allowance for S Corporations Donating Property. ***Saves taxpayers $54.0 million over ten years.***
--Deduction for School Teacher Expenses. ***Saves taxpayers $191.0 million over ten years.***
--Election to Include Combat Pay in Income for the Earned Income Tax Credit. ***Saves taxpayers $19.0 million over ten years.***
--Special Rules for Qualified Mortgage Bonds for Veterans. ***Saves taxpayers $159.0 million over ten years.***
--Allowance for Active Duty Reservists to Make Penalty-Free Withdrawals from Retirement Plans. ***Saves taxpayers $1.0 million over ten years.***
--Special Rules for Non-Residents Investing in Regulated Investment Companies. ***Negligible revenue effect.***
--Mental Health Parity. Extends for one year the $100 per day excise tax on group health plans that impose limits on mental health benefits that are not imposed on medical and surgical benefits. ***Saves taxpayers $25.0 million over ten years.*** *(Although this provision looks like a tax increase on its face, the Joint Committee on Taxation scores this as inducing group health plans to increase their mental health coverage and thus increase tax deductible health care expenditures.)*

- Corporate Tax Rate. Reduces the top corporate marginal tax rate from 35% to 30.5%, beginning with tax-year 2009. ***Saves taxpayers $363.84 billion over ten years.***

- Small Business Expensing. Makes permanent the current-law increased Section 179 small business expensing thresholds. ***Saves taxpayers $20.55 billion over ten years.***

NOTE: According to the Joint Committee on Taxation, the Tax Reduction and Reform Act would have the **net** affect of saving taxpayers $7.48 billion over ten years.

The Non-Offset Approach: In short, the non-offset approach is based on the notion that the government does NOT deserve the increasingly higher tax revenues from the AMT (since such revenues were never intended to be collected). That is, this approach is based on the philosophy that the correction of tax mistakes should NOT be offset with tax increases, especially when the tax increases apply to different people than do the tax mistakes. The non-offset approach takes a taxpayer-first perspective; it views revenues from the vantage point of the individual taxpayer, rather than from the federal government.

There are two leading proposals that embody the non-offset approach: the RSC's Taxpayer Choice Act (H.R. 3818, introduced by Reps. Paul Ryan, Jeb Hensarling, John Campbell, and Michele Bachmann) and Rep. Phil English's Individual AMT Repeal Act (H.R. 1366). Highlights of both proposals are as follows:

Taxpayer Choice Act: H.R. 3818 would permanently and completely eliminate the AMT on individual taxpayers for tax-years beginning after 2006. Additionally, the bill would make permanent the current tax rates on capital gains and dividends. Lastly, the bill would create a voluntary Simplified Tax that would give individuals the option of paying under a highly simplified income tax system or under the regular income tax as it is structured now.

The Simplified Tax would have no special deductions or exemptions—except for a $25,000 standard deduction for couples ($12,500 for individuals) and a $3,500 per-family-member exemption. In other words, a family of four earning $39,000 a year would owe zero federal tax under the Simplified Tax. The Simplified Tax would have two rates: 10% on all income up to and including $100,000 and 25% on all income above $100,000 (all dollar figures adjusted for inflation).

Taxpayers would have until tax-year 2016 to decide which tax system under which they want to file and would be allowed one subsequent chance to change their minds with no questions asked. Taxpayers could also change their tax systems any time a life event—like marriage, divorce, or death—forces a change in tax filing status.

In sum, the Taxpayer Choice Act would give taxpayers the choice of paying either higher tax rates with more available deductions (the regular tax structure in current law) or lower tax rates with no special deductions (the Simplified Tax).

The bill would not increase taxes on anyone, anywhere, anytime.

Individual AMT Repeal Act: H.R. 1366 would permanently and completely eliminate the AMT on individual taxpayers for tax-years beginning after 2006. The bill would not increase taxes on anyone, anywhere, anytime.

Conservative Concerns with Offset Approach: Most conservatives have grave concerns with the offset approach, i.e. the tax-increase approach, and specifically about the Democrats' Tax Reduction and Reform Act summarized above. Some such concerns include, but are not limited to, the following:

- No Offsets on Principle. Some conservatives believe on principle that no tax relief, especially income tax relief, *needs* to be offset, since tax relief is savings to taxpayers. Most tax relief allows taxpayers to keep more of their own money; it does not "cost" the government anything. If, however, tax relief must be offset, it should be offset with spending reductions, not tax increases.

- No Offsets for Government Mistakes. Most conservatives would argue that the principled opposition to offsetting tax relief *especially* applies in instances where the tax relief is being provided to correct a mistake or oversight by the federal government, as it does in the case of the AMT. The correction of tax mistakes applicable to one set of people should never be offset with tax increases on a different set of people, as would be the case under the Democrats' Tax Reduction and Reform Act. That is, most conservatives believe that it is improper for the federal government to punish some people and businesses with higher taxes just because of a government tax mistake on other people.

- No Accelerated Increase of the Tax Burden. Under current law, the Congressional Budget Office projects that federal revenues will increase faster than economic growth. In other words, the tax burden (measured as a percentage of Gross Domestic Product) is expected to increase. This would still be true, just to a smaller extent, if the AMT were reduced or even eliminated. Thus, the only rationale for "paying" for an AMT reduction with any offsetting tax increase is the belief that the tax burden should be *higher* than it currently is or than what it has historically been.

- Attack on Small Business. Many people fail to realize that millions of small businesses file individual, not corporate, tax returns—thus any tax increase on more-well-off individuals will also apply to millions of small businesses. In this legislation, small businesses would be hit with the surtax on some of their income and would lose the domestic manufacturing deduction, all while incorporated businesses get an across-the-board rate cut, making it even harder for many small businesses to compete.

- Objections to Particular Tax Increases. Many conservatives have strong objections to some of the particular tax increases included in the Democrats' Tax Reduction and Reform Act, including, but not limited to (in no particular order):

--Surtax: Small businesses and well-off individuals and families should not be punished with an additional tax for being more well-off. Is it not the American dream to improve one's financial situation? Plus, this surtax would be calculated on income BEFORE all of a taxpayer's deductions (like state and local sales taxes, mortgage interest, charitable contributions, etc.) have been applied and thus would dilute the value of such deductions.

--Marriage Penalty: The surtax contains a large marriage penalty (since the threshold for married couples filing jointly is not double that for singles), as does the AMT "patch."

--Carried Interest: "Carried interest" is just another phrase for gains made from investments. It is by no means "ordinary" income since it is incentive compensation based solely on capital gains that may or may not be realized. Should capital gains not be taxed at the capital gains rate? Changing the carried interest taxation rates would both remove a huge incentive for investment fund managers to make their funds more profitable to investors and force partners to offer high pre-tax compensation to fund managers, thereby lowering returns for millions of investors who rely on capital gains or dividend income.

--Domestic Production Activities Deduction: Repealing this deduction will dilute the benefit of reducing the corporate marginal tax rate. Furthermore, at a time when moving business activities to a foreign country has become easier than ever, does Congress want to discourage companies from maintaining their production operations in the United States?

--LIFO: Repealing LIFO will force a recalculation of tax liability so that businesses pay more in taxes on the same amount of economic activity (akin to how the AMT is a forced recalculation to get more taxes from the same level of income). Furthermore, repealing the LIFO accounting method would particularly hurt energy companies. With energy prices increasing and domestic energy supplies artificially limited for a variety of reasons, is it helpful to American consumers to worsen the financial situation of energy companies?

--Economic Substance Doctrine: Businesses should not be punished for making market-driven, legal business decisions aimed solely at reducing their tax liabilities. Reducing one's tax bill should not be something worthy of prohibition or penalty.

--One-Year Extenders: Many tax deductions and credits that conservatives support, such as the research and development tax credit and the mortgage insurance deduction, would be extended for just one year, whereas the tax increases in the bill would be permanent. This inequity demonstrates a preference for tax increases over tax relief.

--Refundable Tax Credits: Two of the leading refundable tax credits, the earned income tax credit and the child tax credit, would be greatly expanded by this bill. Many conservatives regard refundable tax credits as tax expenditures, no different than a direct appropriation from the Treasury to individuals who have not paid taxes that year. Many conservatives may see this refundable credit expansion as particularly offensive in this legislation, since it is paired with numerous provisions increasing taxes on businesses and people that do have a net tax liability.

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