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The Study of the Individual Alternative Minimum Tax: Past, Present, and Reform

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A STUDY OF THE INDIVIDUAL ALTERNATIVE MINIMUM TAX: PAST, PRESENT, AND REFORM

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CHAPTER ONE - INTRODUCTION

1.1 Brief background

The individual Alternative Minimum Tax (AMT) imposed on individuals was originally created to ensure that the wealthiest Americans do not avoid paying income tax by taking advantage of certain deductions and exemptions. AMT was not indexed for inflation and when coupled with other inequities, many more Americans are now subject to AMT than ever before. By studying the past and present tax laws surrounding individual AMT, I will present a reformed approach of the AMT tax system for individuals.

According to IRS Filing Statistics, the number of AMT returns in 1990 was a little over 130,000. By 2000, this number was around 1.3 million. By 2007, that number had jumped to over 4.1 million. The number of returns that had AMT versus the total amount of returns filed jumped from 0.12% to 1.01% to 2.87%, respectively. Also during that time, AMT revenues as a percentage of total tax revenues collected went from 0.18% in 1990 to 0.94% in 2000 and finally in 2007 ended up at 2.05% (Internal Revenue Service, 2010). If not for temporary fixes ("patches"), these numbers would be even worse, as the current AMT is not indexed for inflation and is currently set at 1986 levels.

Therefore, AMT has become common conversation amongst many middle-class families. Politicians have caught onto this and despite vowing to reform or repeal AMT, nothing to date has been accomplished. In the summer of 2011, when the budget deficit came into the public light and the debt ceiling talks intensified, many Americans realized something needed to be done with the tax system for the betterment of the country going forward. The only questions that now remain are when and how tax reform will happen.

1.2 Research questions to be answered

Many people have ideas as to if and when AMT should be reformed. There are political, economic, and social implications to all ideas and proposals. It is also possible that the best solution is the status quo and that doing nothing might be the easiest thing to do from a political perspective. Therefore, the first research question I investigate is:

RQ 1: Should the Individual Alternative Minimum Tax be reformed?

In evaluating alternatives, I will assess the political feasibility of such proposals. I will also consider the difference in tax revenue collected and how to best potentially offset that to achieve a revenue neutral solution that does not plunge the United States into further debt and deficit. Thirdly, I want to keep the original intentions of AMT intact. The idea for AMT in 1969 had widespread popular appeal. However, the specific details and execution of the AMT has many taxpayers unhappy with it. With this in mind, the second research question I will attempt to answer is:

RQ 2: If the Alternative Minimum Tax should be reformed, what reform alternative would work best to keep the original intentions of the tax intact and not be a burden to our increasing national debt?

With this in mind, I will look at many different AMT reform and repeal options as previously proposed. I will then incorporate them into my own proposed solution for the future of the Alternative Minimum Tax system.

CHAPTER TWO - LITERATURE REVIEW

2.1 Alternative Minimum Tax (AMT) Background

In 1969, more letters were received by Congressmen related to the perceived tax inequities of 155 Americans who made more than $200,000 than about the Vietnam War. The reason for this is because in 1969, Treasury Secretary Joseph Barr notified Congress that those 155 individual taxpayers did not pay any federal income tax in 1966 (Burman, Gale, & Rohaly, 2003). On elevated public support, a federal minimum tax was created to prevent the wealthiest Americans from taking advantage of certain deductions and exemptions to eliminate their tax liability. According to IRS Topic 556 (2011), the goal of a federal minimum tax is "to ensure that anyone who benefits from [certain] tax advantages pays at least a minimum amount of tax" (n.p.). See Exhibit 1 for a summary of important tax legislation from 1969-2010 impacting AMT.

According to Burman, Gale, Leiserson, and Harris (2002), the original 1969 tax, an "add-on" tax, did not run parallel to the regular income tax system and was imposed separately. This was aimed at high income taxpayers because of the perceived inequalities of a tax system in which some high income taxpayers paid no tax. An add-on of 10% of certain tax preferences over an exemption amount of $30,000 was the fundamental tenet of the bill. The major preference item taxed differently by this minimum tax was capital gains, but also preferences for accelerated depreciation and stock options, among others were included. Capital gains at the time were taxed at 25% instead of the maximum individual tax rate of 50% (Urban-Brookings Tax Policy Center, 2010). In 1970, the add-on tax affected 20,000 high income taxpayers and raised $100 million for the federal government (Lim & Rohaly, 2009). However, in 1974, 244 high-income households still paid no federal income tax, as reported by the U.S. Treasury (Burman et al., 2002).

After more public displeasure with the fairness of the add-on tax created in 1969, the Tax Reform Act of 1976 brought special attention to the issue of a minimum tax. As noted by Burman et al., the Tax Reform Act of 1976 added to the list of tax preferences certain itemized deductions. It also reduced the exemption amount from $30,000 to the greater of $10,000 or half of the regular income tax liability. This change greatly increased participation to the add-on tax and coupled with a rise in the applicable tax rate to 15%, minimum tax revenues were significantly increased. However, in a period characterized by high inflation and unemployment, worries started to rise around the fact that the minimum tax was reducing capital formation and economic activity (Burman et al., 2002).

As part of a response to reduction in capital formation worries, the modern and still used AMT system was created with the passage of the Revenue Act of 1978 but was still coupled with the add-on tax (Burman et al., 2002). This legislation made the AMT a parallel tax system with the regular individual income tax. However, it was not until the Tax Equity and Fiscal Responsibility Act of 1982 that the first comprehensive Alternative Minimum Tax system was created. This Act repealed the add-on tax provisions that were created in 1969 and carried over the exemption preferences that were popular with the add-on tax into the AMT. The parallelism of AMT was kept, and the principal preferences enacted in 1982 remain today. The tax rates for AMT increased from 15% to 20% as well. Even though it was a breakthrough in minimum tax reform, the newly created exemption amounts of $40,000 for married and $30,000 for unmarried taxpayers were not indexed for inflation. This, combined with the indexing of future tax rate brackets in the regular income tax system, hinted at the first problems with AMT (Joint Committee on Taxation, 2005).

As a result of these tax reform changes, AMT participation and resulting revenue quadrupled from 1982 to 1986 (Burman et al., 2002). Nevertheless, in 1986, a defining moment of AMT occurred with the passing of the Tax Reform Act of 1986. The maximum regular income tax rate was reduced to 28% and the lower capital gains rates were eliminated. Because a capital gain being taxed at preferential rates was a crucial tenet of the minimum tax rules, the AMT rules fundamentally shifted. Capital gain preferences accounted for nearly 85% of the AMT revenue before 1986, and as a result of this legislation, they became an obsolete part of the minimum tax rules and were therefore eliminated. This Act severely reduced the desire to shelter income as capital gains. The AMT rules, nonetheless, were updated to include less impactful differences between AMT and regular tax, changed the tax rate from 20% to 21%, and created the notion of a phase-out of the exemption for high income taxpayers. At this time, the AMT was still not indexed for inflation. As expected, AMT revenues dropped to pre-1982 levels (Burman et al., 2002).

The AMT did not undergo many changes from the 1986 Tax Reform Act until the present, other than expanding its reach to include more and more Americans. In 1990, when the top regular tax rate was increased from 28% to 31%, the AMT rate was increased to 24% from 21%, a corresponding 3% increase. In 1993, the top regular tax rate was increased to 39.6%. At that time, AMT rates swelled to their current rates; 26% up to $175,000 and 28% of alternative minimum taxable income over $175,000 (Joint Committee on Taxation, 2005).

The Revenue Reconciliation Act of 1997 reconciled the AMT capital gains rate to the lower rate as adopted in the regular income tax rules. This served to eliminate the fundamental tenet of AMT that capital gains were a tax sheltering activity entered into by high income taxpayers. Additionally, the Jobs and Growth Tax Relief Reconciliation Act of 2003 lowered the AMT rate on qualified dividends to those assumed in the regular tax system (Joint Committee on Taxation, 2005). Nevertheless, by 1999, the AMT accounted for just 1% of the individual income tax revenues in the United States. Despite this seemingly minimal reach, the number of returns with a positive AMT liability had doubled in the previous four years and AMT as a share of income tax revenues had doubled during that same period. In dollars alone, AMT revenues had quadrupled from 1992-1997. Nevertheless, positive AMT liability was still only seen on about 1% of total income tax returns (Burman et al., 2002).

2.2 Current AMT

Switching from past to present, the AMT is perceived as being overwhelming to compute and to plan for. Burman, Gale, Leiserson, and Rohaly (2007b) note that AMT is complex and "both the National Taxpayer Advocate (2001) and the IRS (2000) highlight the AMT as one of the most difficult areas of tax law to comply with and administer" (p. 397). In an article published in the June 2004 issue of the National Tax Journal, "the National Taxpayer Advocate identifies the AMT as 'the most serious problem faced by taxpayers'" (Feenberg & Poterba, 2004, p. 408).

AMT is calculated on a separate basis using numbers from taxpayer's regular individual income tax return. Therefore, there are effectively two tax systems in the U.S., the regular income tax system and the AMT system. As seen below, a taxpayer only pays AMT if his or her AMT liability exceeds their regular income tax liability, to the extent of such difference. I am presenting a somewhat simplified version of the calculation to avoid unneeded complexity, as seen below in Figure 1.

Figure 1: AMT Calculation

Starting point: Taxable Income
+ Personal exemptions claimed on regular tax return
+ Certain itemized deductions (medical expenses up to 2.5% of AGI, state and local taxes, unreimbursed business expenses, and other miscellaneous itemized deductions)
+ Certain preferences (private activity bond interest, etc.)
+ / - Certain other adjustments (incentive stock options exercised, accelerated depreciation, etc.)
- AMT exemption [2010 – $72,450 for married joint, $47,450 for unmarried] [Subject to income phase-out]
= Alternative Minimum Taxable Income (AMTI) after exemption
* AMT tax rates (26%, 28%)
= Tentative Minimum Tax (TMT)
- Regular income tax liability, Form 1040
= Alternative Minimum Tax liability, if any

Even if a taxpayer does not itemize deductions, he or she is still subject to the various AMT preferences and adjustments. However, if the taxpayer itemizes deductions, this calculation is substantially more difficult. As seen in Figure 1, to calculate AMT liability, AMTI after exemption is multiplied by 26% for the amount up to $175,000 and 28% on any amounts over $175,000. If this number (TMT) is greater than regular income tax liability, a taxpayer would pay the difference as their Alternative Minimum Tax (Shakin, 2010). Nevertheless, the exemption is phased out $0.25 for every $1 of AMTI before the exemption exceeds $150,000, so the exemption amount could be even less than the statutory number listed in the table. See Exhibit 2 for an example of a hypothetical family that is affected by AMT.

According to a press release by United States Senator Charles Grassley, because the AMT is not indexed for inflation, Congress has passed legislation that has increased the AMT exemption amount on a temporary basis every year since 2001 (Grassley, 2010). One reason for this is because the Bush tax cuts of 2001 (formally known as EGTRRA) substantially reduced the regular income tax and only temporarily made cuts to the AMT liability. These increasing disparities between AMT liability and regular income tax only exacerbate trends of already increasing AMT participation and revenues (Burman et al., 2002).

Even so, the Congressional Budget Office (CBO) confirmed that 3% of the total tax revenues collected in 2009, or $32 billion, were a result of the Alternative Minimum Tax, affecting about 4% of taxpayers. Furthermore, as of January 2010, the CBO estimated that 30% of taxpayers would be affected by AMT by 2030 and 60% by 2050 if current laws were kept in place (Shakin, 2010).

2.3 Inequities in AMT

Due to some of the exemptions and AMT add-backs, some taxpayers are hit with AMT liability in unfair proportions. As mentioned earlier, the AMT exemptions, phase-outs, and tax brackets are not indexed for inflation. However, AMT laws are also not adjusted for family size or towards high and low tax states (Burman et al., 2007b). As some itemized deductions are disallowed under AMT rules, those who tend to itemize deductions face a higher probability of owing AMT taxes. Therefore, those who itemize deductions for regular tax purposes might be induced to avoid itemizing, even though it would be less advantageous for regular income tax purposes. This is because not itemizing will reduce a taxpayers AMT liability and potentially be more beneficial in terms of total tax paid (Shakin, 2010).

One of the inequalities with the AMT systems seems to be with the so-called 'marriage penalty'. This 'marriage penalty' is brought about because married taxpayers filing joint returns get an AMT exemption amount of less than twice that afforded to unmarried taxpayers (Burman et al., 2002). In 2010, as noted above, married taxpayers received an AMT exemption of $72,450, while unmarried taxpayers received an exemption of $47,450. Something else to note is that married taxpayers are more likely to itemize deductions, including deductions for medical expenses, mortgage interest, and state and local taxes paid.

Another one of the perceived inequities deals with the state and local income tax deduction. The rationale for the deductibility of state and local taxes on the federal return as an itemized deduction is that the states can impose higher taxes to provide more services to their residents than would otherwise be possible (Shakin, 2010). By disallowing state and local taxes paid for AMT purposes, AMT places an undue burden on those taxpayers that are from high-tax localities and states. See Exhibits 3.1 and 3.2 detailing which states are most adversely affected by AMT.

As mentioned on numerous occasions throughout, the AMT is not indexed for inflation. This imbalance is noted given that the regular income tax system has been indexed for inflation since the 1980s. According to Meyerson (2010) with the Congressional Budget Office, "many federal programs and parts of the tax code are currently indexed to increases in the consumer price index (CPI)" (p. 1), which is an inflation measure calculated and distributed by the Bureau of Labor Statistics (BLS). The CPI measurement was used to get from a 1987 base year standard exemption of $3,000 to the 2010 standard deduction of $5,700, an increase of approximately 91% (Meyerson, 2010). Despite this 91% increase in CPI, the AMT exemption amount and tax brackets, if not for the temporary patches to partially fix the inequities over the past 9 years, would still be equal to 1986 levels.

CHAPTER THREE – THE NEED FOR CHANGE

3.1 The time has come

The future of the AMT is clear as mud. The only thing that is certain with the tax code and AMT is future uncertainty. Until there is a permanent solution, there will always be more questions than answers, and more problems than questions. As the United States sees preliminary presidential campaigning in 2011, the outcries about fiscal policy become increasingly copious and influential. Add that to the eleventh-hour agreement to extend our debt ceiling in August 2011, and the finances of the United States are in the main spotlight amongst even ordinary Americans. As Burman et al. (2007b) state, "public opinion creates important constraints on legislative outcomes, regardless of the economic merits of such views" (p. 393). With public discontent with the tax system rising, the time has come to see a change in fiscal policy, including seeing the issue of the inequities and inefficiencies of the tax code and the AMT brought up and fixed once and for all.

The time is now because AMT has overstepped its original intent and is now affecting millions of households, when it was designed to impact only hundreds. Also, if it were not for Congress passing emergency patches since 2001, the reach would be even further. Senator Charles Grassley favors permanent change to AMT because it is a difficult issue to bring up in Congress every year. He also doubts the ability of future Congresses to get to the issue that will affect millions of middle class families (Grassley, 2010).

According to IRS filing statistics, the number of returns filed with a positive AMT liability have increased from just over one million in 2001 to just under four million in 2008, for an annual average increase of over 400,000 returns each year. The number of AMT returns as a percentage of total returns filed has gone from 0.86% to 2.76% over the same time period. With that increase, AMT as a percentage of total tax liability collected by the IRS has gone from 0.73% to 2.33% in 2008 (Internal Revenue Service, 2010). This is after the temporary patches have been passed each year from 2001-2008. Without the patch, the Congressional Budget Office estimated that 27 million households would have paid AMT in 2008 (Orszag, 2008). In 1970, the individual AMT affected only hundreds of taxpayers and accounted for one tenth of one percent of total tax revenues collected (Urban-Brookings Tax Policy Center, 2008). From this, it is easy to see that not only has AMT expanded its reach to more taxpayers but it is also becoming a larger portion of our federal revenues. These higher revenues make it more difficult to obtain a comprehensive solution because as the federal government plunges deeper and deeper into national debt, its dependence on these revenues consequently rises. According to the Congressional Budget Office's long-term budget outlook published in December 2007, by 2082, over-three-fourths of American households will pay AMT, and it will account for almost 20% of federal tax revenues. There are several flaws to this long-term budget outlook like the assumption of the extension of current law, including the lack of indexing of AMT parameters, but the impact still looms large (Orszag, 2008).

According to an article published on AMT in the National Tax Journal in September 2007, Burman et al. (2007b) stated that an ideal solution would be to find a solution for the AMT as part of a complete overhaul of the tax system. The authors then concluded, however, that this is "not politically likely any time soon" (p. 398). Four short years later, in August of 2011, a published CCH Tax Briefing discussing the Budget Control Act paints a very different picture:

> The mere fact that sweeping tax reform is now being considered in connection with solving long-term deficit problems indicates a desire by many in Washington not just to

> fine tune around the edges of the tax law, but to seriously consider fundamental changes. Both sides see the economy growing through a fairer tax system. ("CCH tax briefing," 2011, p. 1)

It is clear that both sides of the aisle are recognizing the importance of changing the tax law to decrease the impending burden the national deficit will have on the economy. Furthermore, the only reason tax law is back in the crosshairs of legislators is because of the national deficit that threatens to impair the long-term economic vitality of the U.S. Moreover, when one talks about changing the tax law, reforming the AMT is at the top of the list.

3.2 Equity, Efficiency, and Progressivity

As one tries to decipher and potentially change parts of the tax system, in particular AMT, the issues of equity, efficiency, and progressivity need to be investigated. AMT, as stated previously, is essentially a separate tax system that runs parallel to and in conjunction with the traditional income tax system, and a taxpayer's AMT liability essentially sets a floor on total tax liability owed to the IRS.

AMT succeeds on one equity issue, in that it requires more high-income taxpayers to owe at least some tax than if AMT were not in place. Although high-income taxpayers are more apt to pay some AMT, so are middle-class families, who were not intended to pick up the burden of high-income taxpayers in original minimum tax legislation. On another equity issue, the AMT fails because it is not permanently indexed for inflation and current law as it stands will affect more and more people after 2012 than ever intended. AMT preferences such as dependent exemptions and state and local taxes that are allowed in the regular income tax system and not under the AMT raise many eyebrows. Dependent exemptions and state and local taxes are deductions in the regular income tax because their incidence reduces the taxpayer's ability to pay tax, and if that is the case, people wonder why they are not deductible for AMT. Also, according to the Joint Committee on Taxation (2007), AMT is horizontally equitable, as it taxes equally those with the same economic capacity but choose to engage in different tax-favored activities.

The AMT was intended to be very progressive. Contrary to the permanent lack of indexing for the AMT, the patches on AMT since 2001 have increased the progressivity of AMT. This is because the patches shield taxpayers with modest income from paying higher taxes, while maintaining that higher income taxpayers pay more income taxes. The effect of the 2008 patch for 2009 income made it so 94% of the AMT liability was borne by those with over $200,000 in income. For comparisons sake, those with incomes over $200,000 paid only 63% of the total tax liability under the regular income tax system (Lim, 2009). In this context, AMT is much more progressive than the regular income tax.

Most experts agree, however, that AMT does fail on some efficiency grounds. While no tax system can be fully efficient, AMT is rather poor in this area. For the majority of taxpayers affected by AMT, it taxes less income and imposes higher marginal rates than regular income tax. In 2009, 56% of AMT taxpayers had a lower taxable base in AMT than in the regular tax system but owed AMT because the marginal rates on that income are higher than regular income tax rates. This is a combination of higher statutory rates for AMT compared to regular income tax for some taxpayers and the increased rates because of the phase-outs in effect among those with high AMT income (Lim, 2009). In summary, equity, progressivity, and efficiency, although they can never be perfect, should be attempted to be maximized in an effectively reformed tax system.

3.3 Current Proposals

To reform the AMT system, there have been many items on the table to be changed or eliminated. These include items as mentioned by the Joint Committee of Taxation, the

Congressional Budget Office, and the Tax Policy Center, three of the most respected voices in tax policy. These ideas can be grouped into reform ideas and repeal ideas, with the repeal ideas geared more towards changes for the regular tax system if the AMT were to be repealed.

For reform ideas, all proposals start with indexing AMT for inflation, which is perceived as its fatal flaw. Indexing would mean making the fixed numbers in the AMT calculations subject to inflationary indexing, much like the standard deduction and personal exemption amounts for regular income tax (Lim, 2009). The measures subject to indexing would be the exemption amount, the rate bracket thresholds, and the amount at which the exemption is phased out. Of the many things proposed to be on the table in potential reform are allowing dependent exemptions, the standard deduction, and perhaps even the deduction for state and local taxes for AMT. Other issues could be altering the minimum tax rates or tax base, eliminating the phase-out for the exemption, or allowing nonrefundable credits from the regular tax system to offset minimum tax liability. All of these options have various implications, and some of them will be discussed as part of specific proposed solutions in the next section.

The other set of ideas consist of proposals to repeal the AMT. Because the AMT would be totally eliminated, all ideas in conjunction with repeal deal with reforming regular income tax. The main things available for reduction or elimination are many of the generous deductions afforded to taxpayers in the regular income tax system. According to Sahadi (2010) in an article published on CNN.com, tax breaks reduce the government's revenue by $1 trillion per year. According to Marron (2011), hundreds of billions of dollars in spending are disguised as tax cuts. These tax cuts represent revenue lost by the government but do not appear on the federal budget. Also, the author noted that the politics of tax breaks are much easier than the politics of increased spending, even though they have the same effect (Marron, 2011). Some of the tax cuts on the chopping block for regular income tax purposes include the elimination or reduction of the deduction for state and local taxes paid, mortgage interest, medical expenses paid, and even some miscellaneous itemized deductions. There is also mention of curbing the advantages of the preferential capital gains tax rate as well as changing the marginal tax rates faced by taxpayers. Some experts even think that repealing regular income tax and keeping AMT will improve the progressiveness of the overall tax system.

CHAPTER FOUR – PROPOSED CHANGES WITH AMT

I will now discuss some of the more prevalent and realistic options as proposed by various tax policy centers and governmental organizations and the political, social, and economic merits of their arguments. As noted above, the options are grouped into reform and repeal alternatives. The numbers used are based on current law and depending on the time of publication, may or may not fully capture the economic gains and consequences of such a proposal. Nevertheless, the numbers provide a good gauge for what is relevant and applicable into the future and will be used accordingly.

There are various reform options for the AMT that have floated around since the inception of the AMT in 1969. Over time, as tax law changes and tax law adapts to the economic environment, AMT reform options change. However, over the past five or ten years, the tax system has subjected many middle class taxpayers to AMT and reforming AMT has become a hot topic not only around Washington but also in the homes of the millions of families that owe or potentially owe AMT around the April 15 tax filing deadline.

4.1 The reform options

The basic premise behind reforming AMT and keeping it active as a tax system running parallel to the regular income tax is indexing AMT for inflation. Indexing could be done in various ways with various base years and indexing methods. The overriding theme is to index the AMT phase out exemption threshold, the AMT tax brackets, and the overall exemption amount. The exemption amount is what congressional patches have changed in an effort to keep the number of AMT taxpayers down. Burman et al. (2002) pointed out then that in 2010, indexing parameters for inflation would have reduced the number of AMT taxpayers by 70% compared to projections under current law at the time. However, revenue would decrease by $80 billion in 2010 alone (Burman et al., 2002). However, this was before the Jobs and Growth Tax Relief Reconciliation Act of 2003 was passed, which would increase this revenue number. Nevertheless, there would still be a 90% reduction in AMT liability among middle class taxpayers with adjusted gross income between $50,000 and $75,000, a substantial win for middle class taxpayers (Burman et al., 2003).

With the extension of the Bush tax cuts through 2012 and future instability in the government budget, just indexing AMT for inflation could pose problems for the government, which relies and is accustomed to receiving this excess revenue stream. For this reason, almost every reform proposal includes approximately revenue neutral reform options. These reform options are in conjunction with indexing the AMT parameters for inflation and are presented as revenue neutral to keep government revenues approximately equal as well as proposing more political feasible solutions. Again, some of these revenue numbers have been formed with various simulation models and formed over different budget periods and under significant assumptions.

The following proposals that are analyzed are all proposed by Burman et al. in different papers published on behalf of the Tax Policy Center between 2003 and 2007.

4.1.1 Option one: index and increase top three income tax rates

One option to finance the indexing of AMT is to increase the top three regular income tax rates by 12% (not percentage points). Doing so would provide a positive revenue stream for the five-year window ending in 2016, assuming reversion to income tax rates after 2012 that were enacted before the Bush tax cuts in 2001. This proposal was published in 2007 and would have been more beneficial revenue-wise in the first five years ending in 2012. Combined with indexing, this option would substantially decrease the amount of AMT taxpayers, while shifting the burden of the higher income tax revenues to those who are most likely affected by AMT. Also, by raising the regular income tax liability on the top three tax brackets, fewer taxpayers will be inherently subject to AMT. This is a very efficient and progressive solution, as it will increase the amount of tax for higher income taxpayers, while leaving the bottom 95% of taxpayers unaffected. However, it is moderately unattractive from an equity perspective, as some taxpayers will face increased regular income tax rates despite not having to owe any AMT. This in essence penalizes these taxpayers disproportionally (Burman, Gale, Leiserson, & Rohaly, 2007a). In addition, this measure is most likely politically unfeasible in most situations as the more conservative Congressional members will do anything to not let this happen.

4.1.2 Option two: index and increase AMT rates

Another way to increase revenues lost by indexing would be to just increase the AMT rates, but it would have to be by 20% (not percentage points). This is more equitable than the first option because it only affects those subject to AMT instead of generalizing the effects to the top three regular income tax brackets. This option, for those subject to AMT, will increase their tax liability on average more than the first option because more and more taxpayers will be subject to AMT. The increase in AMT participation compared to the first option is largely driven by the fact that the increased AMT rates will lead to larger tentative minimum tax, or provide a higher "floor" of tax liability (Burman et al., 2007a). Overall, assuming current law, even the 20% increase in tax rates for AMT would still not be enough to pay for the indexing of the AMT in the long run, making this an option that neither makes sense economically or politically.

Just changing the tax rate, either in AMT or regular tax, is not the most sensible option to pay for the cost of indexing AMT. Increasing rates to raise revenue is a potential political nightmare. The AMT system is fundamentally aimed at taking away the tax shelters for high income taxpayers in order to make them pay at least some tax. However, according to a tax policy article published in the National Tax Journal in 2007, over 90% of the exemption preferences in AMT are not tax shelters at all. The top preferences are for state and local taxes (59% of all preferences), dependent exemptions (22%), and miscellaneous itemized deductions (11%) (Burman et al., 2007b). Therefore, it is easy to see why changing the rates are, acting alone, insufficient to affect change in AMT in a more equitable and efficient manner.

4.1.3 Options three and four: index and disallow capital gains rates

The third and fourth options alongside the indexing of AMT revolve around disallowing the preferential treatment of capital gains in calculating AMT. Right now, the preferential rate on capital gains for regular tax is the same rate allowed in AMT. Contrary to the belief that over 90% of exemption preferences are not tax shelters, many tax specialists and governmental officials will claim that preferential capital gains rates provide high income taxpayers with a tax shelter and loophole to have a decreased tax liability, not only under regular income tax but also AMT. Not taxing capital gains at the preferential rate, but rather at ordinary tax rates, in the

AMT would enhance efficiency and equity while raising considerable revenue to complement the indexing of AMT (Burman et al., 2003).

Option three abolishes a preferential capital gains rate under AMT, serving to offset some of the revenue loss of indexing. The remainder of the revenue needed to be revenue neutral would be made up through increasing regular income tax rates on the top three brackets by a modest 2% (not percentage points). This option allows for a more progressive system but again misses the mark on the equitable point seen in option one; that is some taxpayers will pay even higher regular income tax despite not being subject to AMT.

Option four also eliminates the capital gain preference of option three and instead of increasing rates for regular income tax, increases the AMT rates by only 3%. Compared to option three, the fourth option increases AMT taxpayers by about 1 million annually, becoming less equitable but remaining revenue neutral. Both options would reduce AMT taxpayers by 80%, but considering current law, both will provide a negative cash flow to the government in the next five years as the options will not be able to keep up with the increasing revenue that AMT would create under current conditions (Burman et al., 2007a).

4.1.4 Options five through twelve: eight more indexing options

In addition to the above relatively straight forward scenarios, there are hundreds of options if one were to mix and match certain deductions and preferences in the AMT. These options, in the end, generally resort to either increasing the top three regular income tax rates or the AMT rates, depending on the extent of the avoided preference item as well if the disallowance of preferential capital gains rates is part of the scenario. This is because reducing perceived inequities in AMT causes a decrease in governmental revenues, so revenue needs to be raised somehow. Therefore, in Figure 2, I have summarized the increase in rates under various scenarios (including the previous four) that are necessary to achieve approximate revenue neutrality. These estimates are approximately revenue neutral over the 2007-2016 budget windows, as proposed in 2007 (Burman et al., 2007a). The last two columns, dealing with increase in tax rates, are mutually exclusive: the increase in regular income tax rates represents the odd numbered proposals, while the increase in AMT rates column represents the even numbered proposals.

Figure 2: Summary of Proposals presented by Burman et al., 2007a

Option #	Preference(s) to allow against AMT liability	Disallow capital gain preferential rates?	% increase top 3 tax rates	% increase in AMT rates
1 / 2	N/A	No	12%	20%
3 / 4	N/A	Yes	2%	3%
5 / 6	Dependent exemptions	No	12%	22%
7 / 8	Dependent exemptions	Yes	3%	4%
9 / 10	Dependent exemptions, standard deduction, state and local taxes, medical expenses	No	14%	38%
11 / 12	Dependent exemptions, standard deduction, state and local taxes, medical expenses	Yes	7%	16%

Options five through twelve all have various measures they change to finance reform in AMT. The fifth through eighth options address the inequities that punish family size in the AMT. Generally, a taxpayer is not allowed a deduction against AMTI for dependent exemptions, and these scenarios allow for this. Financing for this allowance alongside indexation with an increase in the top three income tax brackets, without changing the preference for preferential capital gains, is a sizable increase in rates of 12% and 22%. However, cutting the preferential capital gains for AMT in those scenarios cuts those rates needed to achieve approximate revenue neutrality by over 75% to 3% and 4%, respectively. Options five and six, however, do not substantially decrease the amount of AMT taxpayers over the budget horizon extending beyond the expiration of the Bush tax cuts. Options seven and eight, nevertheless, accomplish that objective. However, those options have the same problems seen in options one and two, relating to the equity and efficiency tradeoff (Burman et al., 2007a).

Options nine through twelve seek to reduce most of the perceived inequities in AMT law. Many feel that letting taxpayers take deductions that are afforded in the regular tax system in their AMT calculations would allow for many less taxpayers to be subject to AMT. This is indeed true, but the cost of doing so must be considered. The costs to those taxpayers in the top three income tax rates and taxpayers subject to AMT would increase substantially because of the much higher rates needed to finance indexing AMT as well as allowing essentially all itemized deductions to be deducted against AMTI. Without those preference items, the AMT would be much more difficult to differentiate from the regular tax system, as they would essentially be the same.

The Joint Committee on Taxation's report to the Senate Finance Committee in June 2007 outlines only the revenue impacts of some of the deductions people are calling for to be allowed for AMT. They do not address how to make AMT revenue neutral, only how much it would cost annually under basic assumptions. The data is for 2008-2017 budget windows assuming current law at the time, which included the expiration of the Bush tax cuts at the end of 2010. I have extrapolated this data, using the years 2008, 2012, and 2017 as my base years. I compared the revenue cost, or the amount of lost revenue, of the various options proposed as a percentage cost of permanent repeal and averaged the percentages over the three base years I used. The data is summarized in Figure 3 (Joint Committee on Taxation, 2007).

Figure 3: Revenue cost of AMT deductions

Proposed deduction allowed for AMT	Revenue cost as percentage of cost of repeal 2008-2017
State & local taxes	67.33%
Personal / dependent exemptions	59.19%
Miscellaneous itemized deductions	14.30%
Standard deduction	10.72%
All of the above	89.47%

As one can see, allowing state and local taxes alone for AMT would have the largest impact. It would be the largest revenue cost, and because of this, it is also fair to assume that this would reduce the number of taxpayers subject to AMT by the most as compared to other individual options provided there is no assumed AMT or regular income tax rate increase. However, allowing all of the above proposed deductions in AMT would decrease revenue to almost 90% of the revenue cost of repeal. The argument then is around why the government would make such drastic cuts and still keep AMT around? In the current political environment, it is unlikely the government would make such sweeping changes only to either partially fix or exacerbate the problem. If Congress was to allow all of these itemized deductions for AMT, it would most likely become easier to repeal AMT and find the missing revenue in the regular tax system.

4.1.5 Indexing Conclusions

In general, the options that involve raising the AMT rates instead of the top three income tax rates actually require more taxpayers to pay AMT than increasing the top three income tax rates. This seems more equitable than increasing the top three regular income tax rates because the proposals only enforce an increased tax liability on those taxpayers subject to AMT. However, it is also less feasible because it will increase the amount of AMT taxpayers relative to the other option, which would defeat the purpose of enforcing change. Increasing the top three regular income tax rates is more efficient because the burden of AMT is resting with those most likely to pay, but it is less equitable because it raises taxes on some taxpayers who will not owe AMT. Increasing the top three regular income tax rates only would also encourage other forms of tax sheltering among a broader group of taxpayers because a higher percentage of income is going to taxes. In either case, of the specific options proposed, the drastic negative cash flows after the expiration of the Bush tax cuts is very troubling and goes to prove that indexing the AMT, even with various revenue neutral alternatives, is not the long-term answer for achieving a more equitable, efficient, and sustainable tax system in the United States.

4.2 The repeal options

It was originally perceived that indexing AMT for inflation would provide less political barriers compared to repeal and was therefore a preferred solution. However, as time passes, more and more taxpayers and organizations are convinced that repeal is the only viable option for the betterment of most taxpayers.

Many politicians and other influential tax experts have called for the absolute abolition of the AMT. In a report by the President's Advisory Panel on Federal Tax Reform in 2005, they recommended to the president that AMT be permanently repealed (Shakin, 2010). The American Institute of Certified Public Accountants (AICPA) has stated numerous times that it recommends Congress repeal the AMT, including in testimony before the House Ways & Means Committee in April 2011 ("AICPA's call for AMT repeal," 2011). In the National Taxpayer Advocate's 2010 Annual Report to Congress, she endorsed the repeal of AMT. The National

Taxpayer Advocate is an independent office under the authority of the Internal Revenue Service (Olson, 2011). The Congressional Budget Office has stated in their Economic and Budget Issue Brief in January 2010 that "the most comprehensive approach would be to simply eliminate the individual AMT altogether" (Shakin, 2010, p. 10). As one can see, there is not a shortage of influential opinions regarding the repeal of AMT.

Repeal of the AMT alone, however, would provide some unique challenges. Most notably is the effect of the lost revenue. According to an article in the National Tax Journal in September 2007, the cost of repeal would be $106 billion in 2010 alone, with the total cost being $852 billion from 2008-2017. These numbers were calculated under the assumption of current law at the time (Burman et al., 2007b). In 2004, similar estimates, under the same set of assumptions by the same authors put the cost of AMT repeal around $700 billion over the 2004-2013 budget windows (Burman et al., 2003). As one can infer, the cost of repealing AMT is getting increasingly more costly as time progresses and we approach the sunsetting provisions of the Bush tax cuts at the end of 2012. One more equitable issue with repealing the AMT is the increase in the number of taxpayers who will pay no income tax. AMT was designed on grounds that the highest income taxpayers pay at least some income tax and repealing it alone would not accomplish this goal. Although the public would probably not react to current repeal the same way they did before a minimum tax was created, the reactions would be particularly varied. It is also important to point out that repeal of AMT would drastically decrease some of the complexities involved in tax preparation. Nevertheless, when it comes to matters of taxation, no answer is perfect and no answer will make everyone happy, and that must also be considered.

Repeal without some sort of revenue neutrality element involved is not, by most accounts, the best solution. Although the government is collecting revenues it was never meant to collect in the first place, the dependence on those AMT revenues has now slightly modified the goals of the AMT. There are many options to finance repeal but one thing must first be noted. Any revenue neutral plan for reform includes higher marginal and average rates for many taxpayers, which many experts see as a byproduct and worthy consequence of repealing AMT. Some of the many options proposed that I see as most pertinent include 1) repealing the state and local tax, 2) increasing all income tax rates, 3) increasing the top three regular tax rates, 4) cutting the preferential capital gain treatment, and 5) an AGI surtax. These five options are discussed at length by Burman et al. (2007a, 2007b); both in a Tax Policy Center publication as well as a National Tax Journal article, and the authors address these issues over a ten-year budget window ending in 2016. After summarizing these five options, I will then consider the so-called "Gang of Six" proposal, as it was released in skeleton form in summer of 2011. I will attempt to evaluate the merits of these repeal option proposals on efficiency, equity, and progressiveness.

4.2.1 Option one: repeal AMT and state and local tax deduction

The first option I consider is repealing the state and local tax deduction. Because state and local taxes were the number one preference item causing taxpayers to have to pay AMT, the President's Advisory Panel of 2005 even recommended that this be repealed as an itemized deduction. Eliminating the state and local tax deduction would raise so much more regular tax revenue that Congress could even afford to decrease the income tax rates across the board by 2% (again, not percentage points). This only affects those who itemize their deductions, and would therefore serve to effectively reduce the number of taxpayers who do indeed itemize. Therefore, this proposal would increase the progressivity of the tax system, making higher income taxpayers, the ones who are most likely to itemize their deductions, pay more tax (compared to others in the regular tax system) as a result of this lost deduction. For those lower income taxpayers who do not itemize, they will pay less tax because they were not subject to AMT, furthering the progressivity of this proposal. In total, 64% of taxpayers would face a reduction in total taxes paid (Burman et al., 2007b). However, this option is not revenue neutral if the Bush tax cuts are extended because the lower tax rates in those cuts would not be able to raise enough revenue (Burman et al., 2007a). Overall, this plan is equitable but does not substantially address the issue of the number of high income taxpayers who will not owe any income tax, as most of them shelter income through tax-exempt and capital gains income.

4.2.2 Option two: repeal AMT and increase all regular tax rates

The next proposal is repealing the AMT with an across the board increase in income tax rates of 6%. This plan is not very progressive as it raises the taxes on those least likely to pay AMT, making them share the burden of AMT repeal with high income taxpayers. In general, it would raise taxes on those in the bottom 80% of income distribution, while cutting overall taxes for those from 80th to the 99th percentiles. Overall, 60% of taxpayers would face higher income tax liabilities. Even though this plan is approximately revenue neutral and has positive cash flows after the Bush tax cuts expire, it does not make sense to impose the burden of repealing AMT on lower income taxpayers who would never pay AMT (Burman et al., 2007a, Burman et al., 2007b).

4.2.3 Option three: repeal AMT and increase top three rates

The third option addresses the increase in just the top three income tax rates. The rationale here is that taxpayers in these tax rates are disproportionately affected by the AMT and therefore it is only justifiable to make them shoulder the burden of AMT repeal. The top three income tax rates, to make this revenue neutral, would have to increase by 15%. This plan is more progressive than option two but some taxpayers will have higher taxes in these brackets and may end up paying more tax because they might not have owed any AMT under the current system. Those in the top 5% of the income distribution will face an average tax rate increase, with the group affected the most being in the 99th percentile of income. The reason for this is twofold. One reason is because the increase in tax rates affects their marginal rates the most. Secondly, those taxpayers were not likely to pay AMT in the first place because their marginal tax rates under regular income tax would be higher than their AMT rate. Overall, this plan is more progressive and equitable than option two but is not be the most politically feasible option because of the political influence the top 10% of income earners have in politics and the drastic increase in rates those taxpayers would incur (Burman et al. 2007a, Burman et al. 2007b).

4.2.4 Option four: repeal AMT and reign in preferential rate on capital gains

The fourth option I consider is the reigning in of the preferential capital gains tax rate. This is perceived to be the largest tax shelter and is a primary driving force behind the intent of the original minimum tax legislation. Dividends would revert to receiving ordinary income tax treatment and long-term capital gains would be taxed at a maximum tax rate of 20%. For middle-class taxpayers who would have owed AMT, this option modestly reduces taxes. However, the highest income taxpayers (those in the top 1%) would receive the largest hit to their post-tax income. Those highest income taxpayers are disproportionately affected because they normally are not subject to AMT, for reasons discussed previously. These taxpayers also tend to have higher amounts of capital gain and dividend income and would be subject to higher taxes on that income. Nevertheless, when the Bush tax cuts expire, this option is slated to bring in less and less revenue compared to the cost of repeal of AMT, making this a partially infeasible option (Burman et al., 2007a, Burman et al., 2007b).

It is also important to consider the behavioral effects of such a proposal. With increases in tax treatment for dividends, people over time will reduce the amount of money they are investing in public companies, as their returns are taxed at rates equal to that which their wages are taxed. It might also decrease the propensity for firms to distribute dividends if they think they can achieve a higher after-tax return than their shareholders. This is why I think U.S. corporations will have the most to say about this and will strongly oppose eliminating preferential rates for dividends. Although long term capital gains would receive somewhat preferential treatment in the tax system, there will in theory be less trading activity than times with the lower current preferential capital gains rates. According to the Heritage Foundation, "raising either the capital gains or the dividend tax rates would permanently reduce the level of economic activity. The only debate is by how much" (Foster, 2010, p. 5). Right now, that is the last thing needed, as we try to recover from a recession and avoid a possible double-dip recession. This plan is only satisfactory once unemployment rates decrease and investment in the economy increases, both of which are indeterminable at this point in time.

4.2.5 Option five: 4% surtax

The last option I consider was proposed by Burman and Leiserson (2007). Their proposal was to impose a surtax on AGI of 4% for married couples with an AGI over \$200,000 and unmarried taxpayers with an AGI over \$100,000. The statutory limits of \$100,000 and \$200,000 would henceforth be indexed for inflation in the same manner as the rest of the tax code. This plan would restore AMT to its original purpose, of making at least every high income taxpayer pay some tax. It is also highly progressive, as only those taxpayers with higher income would compute a higher tax liability. Over 80% of the taxpayers would have no change in marginal tax rates and over 90% of those taxpayers who make more than \$1 million would have a higher marginal tax rate on income. Only those with over $500,000 in income would, on average, have a higher average tax rate in 2017, which is the most accurate future baseline for my analysis based on the current law as of 2007. Not only is it extremely equitable and progressive but it also very efficient, as it imposes higher marginal rates on those with higher income. More than anything, however, it is very simple to calculate (Burman & Leiserson, 2007). Although this plan might promote aggressive forms of tax sheltering and acceleration of business losses, it is the most equitable solution of the five proposed thus far. However, the politically feasibility of such an option is tough to gauge.

4.2.6 Option six: 'Gang of Six' proposal

Option six, perhaps the most relevant of all the plans, was issued to the public forums in summer of 2011. This is relevant because it was proposed by the 'Gang of Six', which was a bipartisan Congressional task force designed for the purpose of coming up with budget reduction methods. They proposed many things in skeleton form, without specific guidance on any particular measure. There were many proposed changes to the U.S. fiscal policy, but a main suggestion deals with AMT and the tax system. They advocate the repeal of AMT like many groups and committees before them, but instead of being non-partisan like many of those groups, their dynamic is unique because they are bipartisan, so the political element is considered. This eliminates a large unknown in the realm of tax reform. However, it is important to note that even though it is a bi-partisan conclusion, their voting parties might not feel the same way and does not make passing their conclusion an easy task.

Along with repeal, this plan endorses substantially lowering the regular income tax rates and broadening the tax base. The proposal calls for only three marginal tax rates of 8%, 14%, and 23%. This can be facilitated alongside the repeal of AMT because it is proposed to completely repeal deductions for state and local income taxes as well as all miscellaneous itemized deductions. In conjunction with those, the plan calls for reducing other key deductions, such as the mortgage interest, charitable contribution, and medical expense deductions. As if that was not enough, it also calls for reduction of the preferential treatment for capital gains and dividends received. As one can see, this plan is a large conglomeration of many of the previous proposals. However, the plan can be seen as more drastic because it aims to increase tax revenues, not just finance the repeal of AMT with a revenue neutral alternative such as cutting a previous tax break ("CCH tax briefing," 2011).

Although this plan has not been scored by the Congressional Budget Office, they did release an estimate that their plan would reduce the budget deficit (through increasing revenues) by $3.7 trillion over ten years. It is important to note that this includes corporate tax, health care, and inflation measure reform, so it is not entirely related to the repeal of AMT and increased tax revenue measures. Nevertheless, the tax measures provided would substantially increase revenues over the next ten-year budget horizon ending in 2020, even considering the lost revenues from the repeal of AMT. Tax changes in total are estimated to be somewhere in the $1 trillion of $3.7 trillion total proposal ("CCH tax briefing," 2011). Overall, this plan is perceived as being politically equitable and fair, especially considering their burden of trying to come up with a reasonable solution to the massive national debt. Also, it is bipartisan, so it has a reasonable chance of succeeding politically if the kinks are ironed out. However, without specific measures and a Congressional Budget Office or other tax policy simulation, it is impossible to detect the impact these policies will precisely have on the economy and fiscal policy in the future.

4.2.7 Repeal conclusions

It is clear to many that repeal is the answer to AMT and overall tax reform. The AICPA, Congressional tax committees, tax policy watchdog groups, and the Congressional Budget Office agree on one issue – the repeal of AMT is necessary. It is not only the most likely politically but also makes the most sense from a practical taxpayer standpoint. Although tax burdens may rise with some groups of taxpayers, the complexity and unfairness of AMT will be eliminated and over time, a more progressive and equitable tax solution will be realized.

CHAPTER FIVE – REPEAL REGULAR INCOME TAX?

Repealing AMT seems like the best option given the alternatives provided thus far. However, repealing the regular income tax system is seen by some as a more viable alternative because AMT provides a floor on tax liability and therefore is more equitable. AMT also keeps the tax treatment of certain supposedly sheltering activities consistent with a fair tax system. I will now discuss the merits and the logic behind repealing the regular income tax.

According to an article in the National Tax Journal in 2007, the authors state the cost of repealing regular income tax in 2007 alone would be $63 billion, which is less than the estimated $70 billion it would cost to repeal AMT. This estimate does not take into account future revenue costs as other proposals often do. The disparity, however, is because AMT is not indexed for inflation, and more and more middle class families, as of 2007, would be subject to the tax in future years. Also, some claim that the regular income tax has a substantial amount of inefficiencies and inequities that are politically near impossible to change or shut down. Most of these revolve around tax breaks that the public enjoys the benefits of and would not sign off on (Burman et al., 2007b).

However, repealing the regular income tax system is an unrealistic and far-fetched idea. The AMT is not a shortcut to a perfect tax system and indeed has many flaws. It is not indexed for inflation and penalizes taxpayers who have large families, live in high income states, and/or are married. These are not qualities of a desirable tax system. An equitable tax system should be based on ability to pay, which would insinuate that dependent exemptions and other deductions should be included in the AMT calculation. In addition, to achieve revenue neutrality through 2017, AMT rates would need to be increased 11% (Burman et al., 2007b). With the expiration of the Bush tax cuts, these rates would even need to be increased to a greater extent. With the vast number of holes and inequities in AMT, it would be far more effective to repeal AMT and slightly alter regular income tax, than it would be to repeal the regular income tax system and make AMT a system that is more equitable and more progressive than its current version.

CHAPTER SIX – MY PROPOSAL

6.1 Background

When developing my hypothesis and proposed solution, I wanted to incorporate arguments and reasons for what I thought were important concepts. Politically speaking, my opinion is that repeal of AMT is the only way to get enough conservative and liberal support in Congress to affect change. This change I refer to is not just doing something that will patch or temporarily fix AMT problems but something that will have an immediate and everlasting impact on our tax system. Change in the regular income tax system to correct some of the inequities there will not happen unless AMT is outright abolished. Also, in this budget and economic climate of 2011, revenue neutrality is something that not only needs to be an option but also a requirement. Although the perceptions that the government is collecting revenue now that it was never intended to in the first place are indeed true, now is not the time to sacrifice the well-being of our country for ideological matters. If anything, the government should now aim to increase revenues to help get out of the vast financial obligations to the many debtors of the United States.

Fairness, efficiency, progressivity, simplicity, and transparency are features that are valued about tax systems around the globe. As I present my proposal, I do my best to increase simplicity and therefore transparency, while providing an equitable and efficient solution. These ideas are to be taken as a whole, not in the individual parts that comprise the entire proposal. However, in political discourse, the feasibility of this plan could hinge on the addition or omission of various measures. Also, another consideration that must be made is that no specific revenue effects have been calculated for this entire plan.

My solution attempts to provide a very simplistic reform idea, as well as a comprehensive solution to the tax ideals of effectiveness, efficiency, and progressivity. I advocate the repeal of AMT and propose changes to the regular income tax. The first change I propose to the regular income tax is to limit the mortgage interest deduction to the first \$500,000 of a mortgage loan on only a taxpayer's primary residence. The second change I propose is to implement a four percent surtax on AGI over \$150,000 for unmarried and \$300,000 for married taxpayers. Thirdly, I propose indexing the tax code using the chained consumer price index measure, which would be a change from traditionally using the original consumer price index. Although the charitable contribution deduction, state and local tax deduction, and the capital gains preferential rate have been widely discussed, I propose to leave them as they are. With that in mind, I will now go in-depth on each of these proposals. See Exhibits 4.1 and 4.2 for a comprehensive look at how this solution compares to the current tax system for two different hypothetical taxpayers and scenarios.

6.2 Repeal AMT

Given the stances I have taken thus far and based on overwhelming support for repeal, I propose that AMT be repealed. I make this justification on the basis that the AMT is much too complex for the average taxpayer, even the high income filers. This justification is also backed up by the numerous inequities and inefficiencies of AMT. There is a near consensus among tax scholars and the professional tax community that AMT should be repealed. Furthermore, I cannot see a reason why AMT should not be repealed that is more meaningful than my analysis concluding that it should indeed be eliminated. Now that I have concluded that AMT should be repealed, I will now focus on what I think are sound tax policies that benefit the most taxpayers in most situations, while keeping the original intent of AMT intact, something the current AMT fails to do.

6.3 Itemized deductions

The mortgage interest deduction is one of the most used deductions in the tax code. Although I recognize that home ownership is a good thing for the tax code to reward, I am proposing to curb some of the waste involved in the tax expenditure. According to the White House Deficit Commission in 2011, the mortgage interest deduction costs the U.S. government $79 billion a year ("CCH tax briefing," 2011). Senators Bowles and Simpson, the co-chairmen of the commission, proposed limiting the tax break for mortgage interest to only the first $500,000 of a mortgage loan and only on the taxpayer's primary residence. This is about half of what is allowed today (Sahadi, 2010). By limiting this deduction, the government would receive a substantial increase in revenues but not enough to fund AMT repeal alone. Therefore, I am implementing this individual change proposed by the White House Deficit Commission into my comprehensive proposal.

Reducing the mortgage interest deduction also increases fairness and progressivity in the tax system. It will subject some high income taxpayers to a higher marginal rate, as their taxable income is increased. Furthermore, reducing the mortgage interest deduction is perceived as increasing the equity of the tax system because generally those with the higher ability to pay will receive a higher tax liability. If a taxpayer is paying a mortgage on a greater than $500,000 home or has a vacation home, he or she is presumed to be able to survive not getting a tax break for that additional value. This measure also could potentially have a two-year grandfathering clause that allows deducting home mortgage interest as an itemized deduction at the full amount as it has been in previous years. This makes it so those taxpayers who are taking full advantage of current law avoid incurring a penalty for deducting excess mortgage interest than this plan allows. In any case, revenues will not be expected to grow initially but rather when the grandfathering clause expires.

The state and local tax deduction is another income tax deduction that is calculated as an itemized deduction. It has been on the table for elimination by nearly every commentator offering a solution, and it is not hard to see why. In 2004, the percent of taxpayers with AGI over $75,000 who took the state and local tax deduction was over 85%, with those taxpayers receiving over 80% of the total tax benefit of that deduction for all U.S. taxpayers. Contrast that to taxpayers who have less than $75,000 in AGI, where substantially less than 50% use the deduction, for much less overall tax benefit (Congressional Budget Office). However, with AMT being repealed, the large inequity between taxpayers in high tax localities and states and those in low tax localities and states is reduced significantly. Therefore, I have deliberately chosen not to propose a change to the regular tax treatment of the state and local tax deduction.

6.4 Four percent surtax

This option was originally proposed by Burman and Leiserson (2007) in conjunction with the repeal of AMT, and was intended to be revenue neutral over a ten-year span. Implementing a surtax on AGI over a certain limit would eliminate almost all high income taxpayers from avoiding tax. The only taxpayers that could realistically avoid all tax liability are those who had virtually all their income come from tax-exempt bond interest. As alluded to previously, this would increase average tax rates on only those highest income taxpayers, while over 80% of taxpayers will receive no change in rates. Further, this is an extremely simple calculation that requires little to no calculation effort for a taxpayer or preparer.

Burman and Lesierson's (2007) specific proposal called for the four percent surtax, which is completely revenue neutral with AMT repeal, to be levied against AGI's in excess $200,000 (married) or $100,000 (unmarried). However, I think this poses too much of a burden on middle-class and upper middle-class taxpayers, so I propose to increase those limits to $150,000 for unmarried and $300,000 for married taxpayers. Although this plan would decrease the revenue the government would receive compared to Burman and Leiserson's proposal, I believe this is a very fair alternative in making the tax system more progressive and equitable. If AMT is to be repealed, this is the best way to get the original purpose and intent of the AMT into the regular tax system and it avoids practically all tax loopholes.

6.5 Chained Consumer Price Index (CPI)

In addition to everything else, I also make an equity argument for linking the tax code to the chained consumer price index (CPI). This was analyzed by Meyerson in a Congressional Budget Office Economic and Budget Issue Brief, and I use his calculations and facts about the chained CPI for this section of my proposal. Historically, the tax code (and many other federal measures) has been linked to the original CPI and aims to estimate the effects of inflation on individual cost of living. The measure is used to index the regular income tax rate brackets, standard deduction, personal exemption, itemized deduction phase-out, and various tax credits. However, many analysts state that the CPI overestimates the cost of living because it does not take into account the effect of consumer spending patterns, while the chained CPI takes into account all changes in spending patterns of consumers. The chained CPI is also produced by the Bureau of Labor Statistics (BLS) and has been published continually since 2002, which has provided them with ample time to tweak the formula as well as see how it stacks up over time compared to the traditional CPI. The chained CPI grows more gradually than the CPI by three tenths of one percent. If this were installed for federal programs across the board, it would reduce federal spending (via Social Security and federal pension payments) and increase revenues via the tax system. Although the decrease in federal spending is beyond the scope of this paper, it's an option that should be considered in light of this proposal (Meyerson, 2010).

One problem with the chained CPI is that it is dependent on a multitude of data not available for multiple years after the date in demand. The BLS releases final monthly data two Februarys after the end of the year in question. However, it releases preliminary data on a monthly basis and although these numbers vary little from the final numbers, they nominally change nonetheless. Therefore, I propose using the twelve months preliminary data to index the tax code. Because the chained CPI is "chained" to its values in the past, it is a cumulative measure compared to its base year. Because of this, over indexing the tax code in one year will regress to under indexing the tax code the following year, providing a net zero effect over time. The Congressional Budget Office estimated that this one simple change (just for the tax code) by itself would increase revenues by $90 billion over the ten-year period ending in 2020. Overall, I believe this measure is more comprehensive and accurate than the traditional CPI and should be used to index the tax code. I have no qualms about the potential ineffectiveness of the timing delays in calculating this measure (Meyerson, 2010).

6.6 Capital gains rates and charitable contributions

The capital gains rates and charitable contribution deduction are two of the hottest topics in tax reform right now, as seen in the Gang of Six proposals, as well as mentioned by the White House Deficit Commission. The capital gains rate is seen as a major tax sheltering item for high income taxpayers and the charitable contribution deduction as seen as overused and inefficient. However, I believe the opposite. I believe the lower capital gains rates are good for the economy, at least now while in recessionary economic periods. Cutting the preferential treatment of capital gains, while producing positive income for the government, I believe would cut investment activity enough to make a considerable detrimental impact on the economy. On the other hand, eliminating or limiting the deduction for charitable contributions would drastically increase revenues, as it is one of the most used deductions alongside the state and local taxes. However, I believe allowing taxpayers to deduct a donation to a nonprofit entity is generally a good thing and should be upheld. In my proposal, I conclude the current policy regarding capital gains rates and charitable contributions are good for the economy and the moral fabric of the nation, which was founded on capitalism and altruism.

CHAPTER SEVEN - CONCLUSION

Over its course and history, AMT has seen many changes, for good and for bad. It has come to the point where something needs to be done otherwise this separate, complex, and over-used tax will make a living in middle-class taxpayer's wallets. This is not the intention of the AMT that was originally designed to increase the equity of our tax system. This is the AMT that was passed because of public scrutiny and now seeks its revenge on those who had the audacity to challenge the equity of the system.

My proposal, composed after reading countless AMT articles from reputable sources and from personal experience, is an entirely new and intuitive approach to tax reform. After careful analysis, AMT repeal is at the forefront of the discussion, followed by other factors that increase the inequities of the tax system. The proposed tax system would be more progressive, more equitable, more efficient, more simplistic, and would increase the transparency of the tax system as a whole compared to the current system in place today. After considering the political environment in scrutinizing numerous proposals, I believe if this were to go to Congress, it would have a chance of passing, after procedural and other concessions have been made, in part because it would be a revenue neutral alternative. Nevertheless, tax reform is not easy. Tax changes of a significant magnitude are never easy. However, in the best interest of this country's future, politics need to take a back seat and something needs to change. My proposal is one such viable alternative that would reduce a few, and perhaps the most important, tax inequities in our tax system today.

CHAPTER EIGHT – REFERENCE LIST

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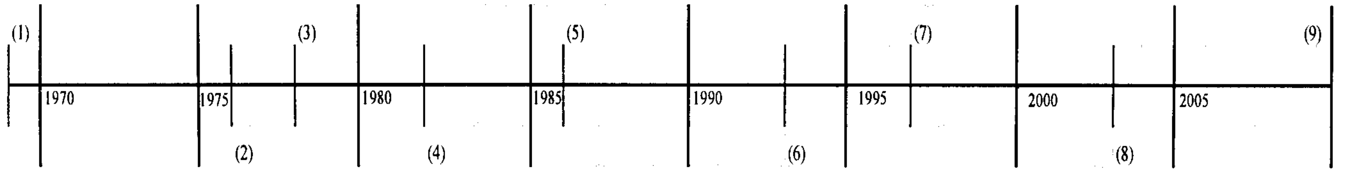
Exhibit 1: Summary of Tax Legislation Affecting AMT



(1) 1969: First "add-on tax"; 10% of certain tax preferences over $30,000

(2) 1976: Added certain itemized deductions to tax preferences, increased tax rate to 15%, exemption amount was greater of $10,000 or half of regular tax liability

(3) 1978: Alternative Minimum Tax system created, still coupled with "add-on" tax

(4) 1982: First AMT system created, tax rates increased to 20%, exemption increased to a flat $40,000 for married and $30,000 for unmarried filers

(5) 1986: Capital gains removed as AMT preference, tax rate increased to 21%, exemption phase-out introduced

(6) 1993: AMT tax rates set to current levels; 26% on the first $175,000 of AMTI, 28% on the remainder

(7) 1997: AMT rate on capital gains lowered to those in regular tax system

(8) 2003: AMT rate on dividends lowered to those in the regular tax system

(9) 2010: Most recent "patch" introduced, increasing the married exemption to $72,450 and the unmarried exemption to $47,450

Exhibit 2: Alternative Minimum Tax Example

Facts:

Family of:	6
Year:	2010
Status:	Married, Filing Joint

SAMPLE FAMILY

Regular Income Tax

Wages:		150,000
Exempt Bond Interest:		10,000
AGI		150,000
Itemized Deductions		
State and local taxes	(18,000)	
Mortgage interest	(5,000)	
Charitable contributions	(2,100)	
		(25,100)
Personal Exemptions		
(6 people at $3,650 each)		(21,900)
Taxable Income		103,000
Regular Tax Liability		18,113

Alternative Minimum Tax

Taxable Income		103,000
Plus: exempt income:		
Exempt income	10,000	
Personal exemptions	21,900	
State and local taxes	18,000	
		49,900
AMTI before exemption		152,900
AMT Exemption		
Full amount	(72,450)	
Phase-out*	725	
		(71,725)
AMTI after exemption		81,175
		* 26%
Tentative Minimum Tax		21,106
Less: Regular Tax		(18,113)
AMT Liability		2,993

Total Tax Liability	
Regular Tax	18,113
AMT	2,993
	21,106

Phase out calculation:

AMTI before exemption:	$152,900
Phase-out limit	$150,000
Amount subject to phase-out:	$2,900
Phase-out rate:	25%
Phase-out amount:	$725

Exhibit 3.1: Relative Shares of Adjusted Gross Income Deducted Under the Taxes-Paid Deduction, by State, 2004

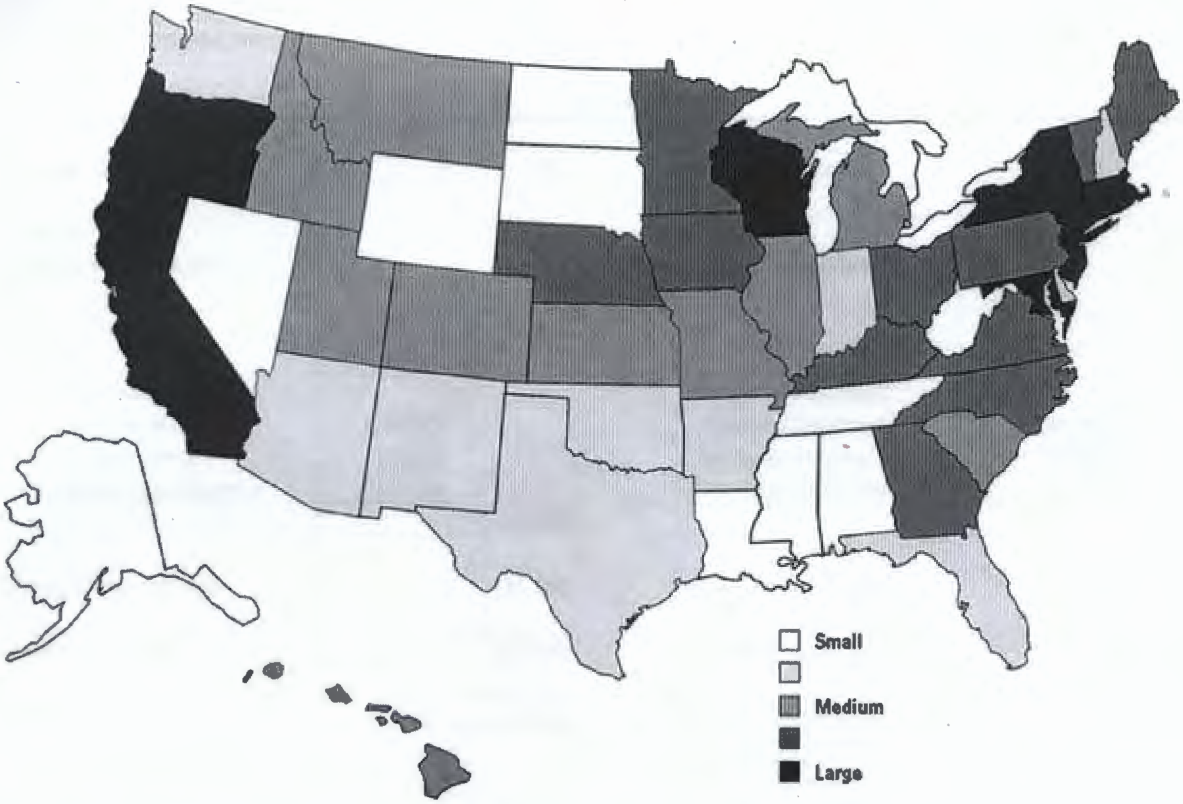


Exhibit 3.2: Percentage of Taxpayers on AMT by State, 2007

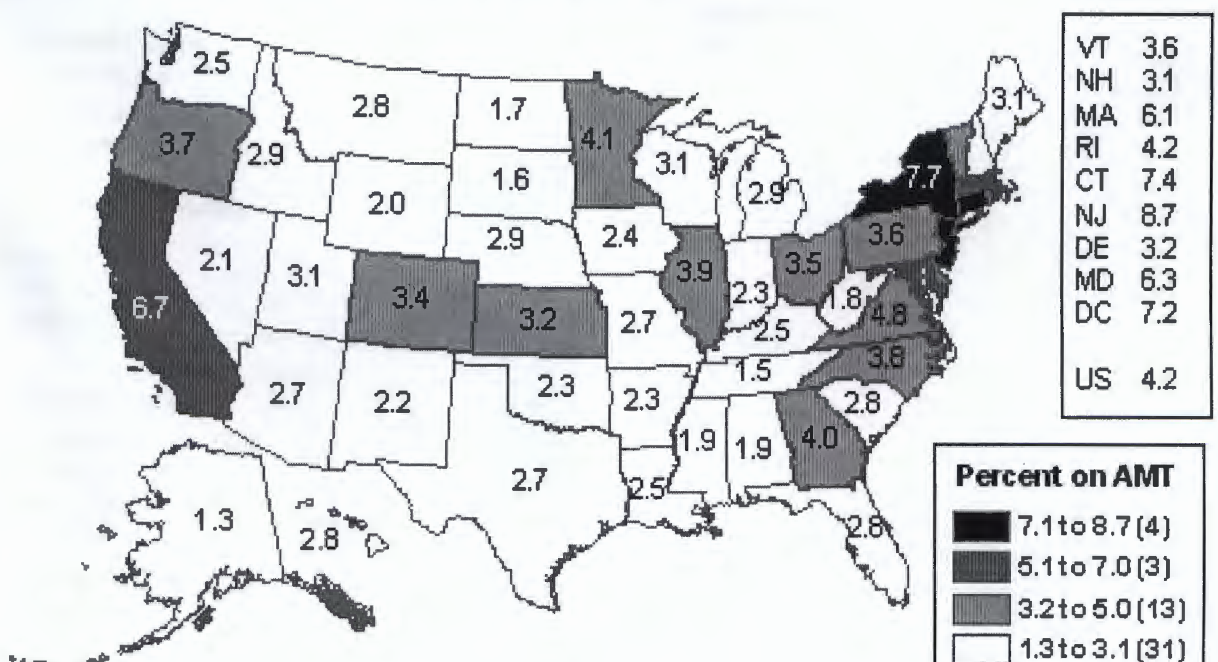


Exhibit 4.1: Scenarios Before and After

Facts:

Family of:	6
Year:	2010
Status:	Married, Filing Joint
Mortgage interest:	On $300,000 mortgage

SCENARIO 1

Regular Income Tax

Wages:		150,000
Exempt Bond Interest:		10,000
AGI		150,000
Itemized Deductions		
State and local taxes	(18,000)	
Mortgage interest	(5,000)	
Charitable contributions	(2,100)	
		(25,100)
Personal Exemptions		(21,900)
Taxable Income		103,000
Regular Tax Liability		18,113

Alternative Minimum Tax

Taxable Income		103,000
Plus: exempt income:		
Exempt income	10,000	
Personal exemptions	21,900	
State and local taxes	18,000	
		49,900
AMTI before exemption		152,900
AMT Exemption		
Full amount	72,450	
Phase-out	(725)	
		71,725
AMTI after exemption		81,175
Tax -26% on first $175,000		21,106
Less: Regular Tax		(18,113)
AMT Liability		2,993

Total Tax Liability

Regular Tax	18,113
AMT	2,993
	21,106

Regular Income Tax

Wages:		150,000
Exempt Bond Interest:		10,000
AGI		150,000
Itemized Deductions		
State and local taxes	(18,000)	
Mortgage interest	(5,000)	
Charitable contributions	(2,100)	
		(25,100)
Personal Exemptions		(21,900)
Taxable Income		103,000
Regular Tax Liability		18,113

Total Tax Liability

Regular Tax	18,113
AMT	N/A
	18,113

Exhibit 4.2: Scenarios Before and After Proposal

Facts:

Family of:	6
Year:	2010
Status:	Married, Filing Joint
Mortgage interest:	On $1,000,000 mortgage

SCENARIO 2

Regular Income Tax		
Wages:		800,000
Exempt Bond Interest:		30,000
AGI		800,000
Itemized Deductions		
State and local taxes	(60,000)	
Mortgage interest*	(24,000)	
Charitable contributions	(30,000)	
		(114,000)
Personal Exemptions		(21,900)
Taxable Income		664,100
Regular Tax Liability		202,743
Alternative Minimum Tax		
Regular taxable income:		664,100
Plus: exempt income:		
Exempt income	30,000	
Personal exemptions	21,900	
Certain Itemized deductions	60,000	
		111,900
AMTI before exemption		776,000
AMT Exemption		
Full amount	72,450	
Phase-out	(72,450)	
		-
AMTI after exemption		776,000
Tax		
26% - first $175,000	45,500	
28% - above $175,000	168,280	
		213,780
Less: Regular Tax		(202,743)
AMT Liability		11,037
Total Tax Liability		
Regular Tax		202,743
AMT		11,037
		213,780

Regular Income Tax		
Wages:		800,000
Exempt Bond Interest:		30,000
AGI		800,000
Itemized Deductions		
State and local taxes	(60,000)	
Mortgage interest*	(12,000)	
Charitable contributions	(30,000)	
		(102,000)
Personal Exemptions		(21,900)
Taxable Income		676,100
Regular Tax Liability		206,943
Total Tax Liability		
Regular Tax		206,943
Plus: 4% AGI Surtax		20,000
		226,943