Alternative Alternative Minimum Tax Reform

President Bush appointed a tax form panel to recommend reforms to the tax system. One issue that the panel cannot avoid is the alternative minimum tax. Like a gathering storm, the full force of the AMT is scheduled soon to drench millions of taxpayers in a continual downpour that only intensifies with time. Almost every elected official pledges to do something about the AMT, but just not now. The problem: Revenues are inadequate even to cover many of the other things they have promised. Thus, while different reforms of the AMT have been proposed, they cost substantial revenues that neither Republicans nor Democrats want to forego.

Most suggested reforms usually involve fairly simple steps, either increasing the exemption level for the AMT or simply eliminating the tax altogether. But those are give-away approaches that neither the administration favors nor the new panel can put forward without having to come up with the money to pay for them. There is an alternative reform, however, that requires much harder work, but represents the right way to engage reform. If applied thoughtfully and carefully, it does not need to lose nearly as much in the way of revenues and can lead to a simpler and more efficient tax system as well.

Left to its own, the AMT will eventually be imposed on the majority of taxpayers; millions more are scheduled onto its rolls over only a few years. Each year or two, Congress attempts to block some of that expansion by raising an exemption amount used to determine the AMT tax base, often indexing it for inflation for a recent past period. Indexing, however, gets more expensive over time, because the revenue gains from the AMT compound. Merely indexing for inflation, moreover, still allows the AMT to ensnare more people over time as real household income rises, whether because of real wage gains or an increase in households with rising incomes due to an increase in the number of paychecks.

A simpler reform proposition is simply to eliminate the AMT and do nothing else, but that particular reform is even more expensive. Moreover, there is a case to do something about some of the preference items in the AMT if the regular tax is not fixed; that is, the AMT does capture at least a few items that probably should be in the base tax of the regular income tax but are not.

There is an alternative way to reform the AMT, one that is not discussed much, but may well be the preferred option from a tax policy standpoint. Even if it were not, Congress may need to consider that type of alternative simply to limit revenue loss from reform. That alternative reform would go back to basics and delve into the details of the AMT tax base, item by item. Generally, that approach means taking each item out of the AMT tax base but simultaneously reforming it for the regular tax base. Simply put, Congress would decide on the treatment of an item of income or preference once and only once for the regular tax only. It would then eliminate the requirement to calculate the item in any different way for the AMT, thereby removing the duplicative structure of requiring taxpayers to calculate the item twice for two different tax bases. If enough items were reform in that manner, then the AMT could be eliminated altogether.

Memories are short, but the AMT was rejected as the best way to reform the income tax under the Treasury’s tax reform proposals in 1984. With a good regular tax, there was no reason to identify items of preference for another tax. By the time that Congress got around to amending the Treasury proposals on the way to the Tax Reform Act of 1986, however, it went through several stages of restoring some preferences to taxpayers, losing more revenues than it could afford, then coming in the back door by adding complex items like the AMT. In some cases, putting items in the AMT was an indirect way of tackling preferences; in other cases, there was little excuse for including the items because they really weren’t preferences in the first place.

For our purposes here, let us see how this alternative reform would work regarding the two biggest items in the AMT — the exemption for dependents and taxpayers, and the itemized deduction for state and local taxes.

There is really little excuse for including the personal exemption in the AMT. Consider the personal exemption for dependents. Congress now has multiple and confusing ways that it adjusts for the presence of children within both the regular tax and the AMT. Those include the dependent exemption, the dependent exemption phaseout (as part of the personal exemption phaseout), the inclusion of the dependent exemption in the AMT, the child credit, the child credit phaseout, the earned income tax credit, and the EITC phaseout.

A combined reform would simply pull all those items into one within the regular tax. At the Urban Institute, Adam Carasso and I have suggested a minimal reform of combining the EITC and child credit into a single earned income child credit (EICC). We also have suggested a broader reform that would combine the above items with the dependent exemption, dependent exemption phaseout, and AMT inclusion of the dependent exemption into a more universal child credit. Essentially, there would be one child and dependent credit that would be higher at low-income levels and more modest at middle-income levels. We would prefer to see little or no tax rates imposed through the back-door means of a phaseout. But, if politically necessary, some phaseout of that credit could displace all the other phaseouts and the inclusion of the dependent exemption in the AMT. There would essentially be one item of credit adjustment for children.
in the tax code. The taxpayer and spouse portions of the personal exemption could also be taken out of the AMT and converted into a single phaseout in the regular income tax or incorporated explicitly into the statutory tax rates. Such a step would be easy to do for the taxpayer and spouse exemptions once the adjustment for children and dependents is handled elsewhere.

Next consider the state and local tax deduction, which is not allowed for the AMT but is allowed for the regular income tax. Any limit on state and local tax deductions could be incorporated into the regular income tax under the itemized deduction schedule. The regular tax state and local tax deduction would simply be limited to the amount Congress determined necessary to maintain the revenue gain it already had in the AMT.

Ideal reform would deal with each of the preference items in the AMT separately and determine whether any limitation was required in the regular tax. However, if Congress was unwilling to tackle all items, it could still deal with a few — state and local taxes, dependent and taxpayer exemptions, and the miscellaneous itemized deduction are by far the largest — and leave some remainder, such as private purpose state and local bonds, in a residual AMT. The rate and exemption structure for that residual would also have to be adjusted. Although tackling only some of the items in the AMT is less than ideal, it would still get Congress out of its current box of pushing millions of additional taxpayers onto that crazy tax system.