Fixing the AMT By Raising Tax Rates

By Gene Steuerle

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House Ways and Means Select Revenue Measures Subcommittee Chair Richard E. Neal, D-Mass., recently told reporters that fixing the alternative minimum tax was likely to involve increases in statutory tax rates rather than cutting back on preferences in the tax code. He said the former was ''probably more realistic.'' (For further coverage, see *Tax Notes*, Mar. 26, 2007, p. 1182, *Doc 2007-7365*, *2007 TNT 57-2*.)

Or is it? Raising rates at first seems easier than dealing with preferences that people want to keep. However, the simple fact is that real reform involves winners and losers. The only way to avoid that problem is to keep the status quo. But the status quo isn't tenable either: Taxpayers are increasingly dissatisfied with an AMT that continually raises their tax burdens, and in fairly arbitrary ways.

So what to do? Let's start with the economics. Relative to increasing tax rates, broadening the tax base and limiting preferences is almost always the superior choice: It not only promotes economic growth but it is fairer to all taxpayers. Because both preferences and higher rates cause distortions, combining the two is particularly bad. Moreover, higher statutory tax rates increase the value of all other deductions and exclusions that aren't even part of the discussion. For instance, suppose one increases tax rates so that state and local tax deductions can be used more widely. Then the value of fringe benefits and nontaxable perks on the job also increase, and people can be expected to demand and take more of them.

There's another side to the equation, however. It's one thing to try to limit preferences. It's another to be sneaky about it, which is essentially the way that the AMT works. If the AMT really did target only preferences that should be limited anyway, it might not be that bad. However, several ''preferences'' in the AMT aren't really preferences at all, such as the dependent exemption for children and legitimate employee business expenses. To top matters off, some taxpayers face higher rather than lower tax rates in the AMT when they earn additional income.

From an economic perspective, therefore, the best solution would be to limit preferences as much as possible in the tax code, and then keep rates as low as possible along the way. A traditional large-scale reform would go well beyond the AMT, defining the tax base as best as possible, and, once that base was established, picking the rate schedule that would raise the desired level of revenue. If some remnant of the AMT must be kept as a second-best solution, the preferences that are kept should be ones that are least justifiable as part of the regular tax. Reform in the latter case would concentrate first on removing from the AMT those items that least belong there. For that group only, a case can be made for taxing people directly through statutory tax rates rather than by arbitrary restrictions in those deductions.

Even fixing those items that are the least justifiable components of the AMT requires hard work. For instance, Adam Carasso of the Urban Institute and I have examined the many ways that dependents are being treated in the tax code, ranging from the earned income tax credit and the child credit to the dependent exemption to the phaseout of the dependent exemption to the inclusion of the dependent exemption in the AMT. We suggested a combined reform that would integrate all those elements into one along the way to reforming that part of the AMT. So many other things are already scheduled to ''happen'' to the way children are treated in the tax code — the child credit is scheduled to decline from $1,000 to $500, it is not indexed for inflation, the dependent exemption is scheduled to phase out at higher income levels (then not phase out, then phase out again) — that AMT reform of the treatment of children is by itself quite incomplete.

That brings us to the political complications. Elected officials in both Congress and the executive branch currently have little desire to identify losers anywhere at any time for any purpose. For almost 10 years, they have been engaged almost entirely on the giveaway side of the budget — increasing spending and cutting taxes. Recognizing who pays for government or for reform has been avoided like the plague. Meanwhile, fixing the AMT is hardly the primary problem they face. They also must decide when and how to extend particular items in the 2001 and 2003 tax cuts, how to get the deficit under control in the short run, and how to deal with the serious long-term fiscal problems largely associated with changing demographics and ever-rising health costs.

Suppose Neal is right — there is more willingness to increase statutory tax rates than to limit preferences as part of an AMT fix. My guess is that for the Democrats that mainly means increases in tax rates on the richest taxpayers. But those are not necessarily the upper-middle-income and lower-upper-income taxpayers who would be subject to higher AMT rates if the law remains unchanged. If higher tax rates on the rich are used to provide AMT relief, however, the move could easily usurp attempts to let higher rates take their place as part of a more permanent extension of some of the 2001 and 2003 tax cuts, as part of deficit reduction, or as part of a fix for our longer-term fiscal woes.

There is some good news for the public in this political quandary: Only real reform offers itself as a reasonable way to deal with all those issues.