



## Tax Policy Center

Urban Institute and Brookings Institution

### Questions for the Record in Response to Testimony Before the U.S. Senate Committee on Finance Given by Leonard E. Burman, Director, Tax Policy Center

#### Questions from Chairman Baucus

*1. Will the 4% surtax completely pay for repeal of the AMT?*

The proposal is approximately revenue neutral, assuming that President Bush's tax cuts are not extended. We estimate that it would reduce tax revenues by \$7.5 billion over the 2007-2017 period. JCT estimates might differ, but the surtax rate or the income thresholds at which it applies could be adjusted up or down to achieve revenue-neutrality.

If the Bush tax cuts are extended beyond their scheduled expiration in 2010, replacing the AMT with a 4-percent surtax would reduce revenues by a significant amount over the budget period. That means that the surtax rate would have to increase and/or the income thresholds be lowered to achieve revenue neutrality.

*2. Dr. Burman, under your proposal to offset the costs of AMT repeal with a 4% surtax on high income taxpayers, you state that about 90% of taxpayers would see no change in their effective capital gains rates. Could you explain this?*

Most taxpayers are unaffected by the proposal because they are not currently subject to AMT and have incomes below the threshold for the surtax.

Many AMT taxpayers would also be unaffected. Long-term capital gains are subject to alternative, lower tax rates of 5 percent or 15 percent, depending on tax bracket. Those rates apply under both the regular income tax and the AMT. As I note in my testimony, some taxpayers actually face higher effective tax rates on capital gains under current law because of the implicit surtax created by the phaseout of the AMT exemption. That phaseout raises marginal tax rates on capital gains (and ordinary income) by 6.5 or 7 percentage points depending on a taxpayer's AMT tax bracket. Eliminating the AMT cuts marginal effective tax rates for those taxpayers. Under the proposal, some high-income taxpayers would face an additional tax of 4 percentage points due to the surtax. That is smaller than the effect of the AMT exemption phaseout, so some of these taxpayers would still be better off on net, but taxpayers with incomes above the end of

the exemption phaseout would face a higher effective rate. On balance, 5.5 percent of tax units would face higher effective rates and 4.6 percent would face lower rates.

*3. In your written testimony you state that AMT creates enormous marriage penalties. Could you explain how this is the case?*

Several features of the AMT lead to marriage penalties. First, the AMT exemption for couples is less than twice the level for singles. In 2007, the exemption is \$45,000 for married filing joint returns and \$33,750 for singles. Thus, two singles could earn \$67,500 in income (if split evenly between them) before having a penny of taxable income subject to the AMT; if they married, the exemption would only shelter \$45,000 of income from tax. Second, the threshold for the phaseout of the AMT exemption is only slightly higher for couples than it is for singles (\$150,000 versus \$112,500) and the second AMT tax bracket (28 percent) applies at exactly the same income level for singles as for couples. As a result, a couple that married and must combine its income on a joint return is much more likely to lose all or part of the AMT exemption and have more income subject to the higher 28-percent tax bracket than they would if they remained single (again assuming that their incomes are similar).

*4. How does the individual AMT impact small businesses?*

To answer that question, we looked at tax units that report income from schedules C, E, or F on their income tax returns. These schedules correspond to self-employment income (C), rent and royalty income (E) and farm income (F). We project that about 26 percent of tax units with *any* income from those sources will be subject to the AMT in 2007, compared with 16 percent of all returns. (See attached table 1.) This is entirely because returns reporting business income tend to have higher incomes than those that do not. Thus returns with business income are more likely to be in the income ranges most affected by the AMT. Interestingly, within income classes, returns with business income appear to be slightly less likely to be affected by the AMT. For example, we estimate that about 36 percent of all returns with incomes between \$75,000 and \$100,000 will owe AMT in 2007, but among returns with business income, only 31 percent will be affected by the AMT.

Not all returns with business income actually correspond to businesses as we ordinarily think of them. Many individuals who earn wages also earn consulting income or fees for serving on boards of directors or such that are reported as schedule C income. Some very wealthy people own farms as a hobby and report some income on schedule F. If businesses are defined as those for which at least half of income comes from schedules C, E, or F, the difference between businesses and others virtually disappears. By that definition, about 16 percent of businesses are affected by the AMT, roughly the same percentage as the population at large. (See Table 2.) Among high-income returns, those reporting predominantly business income are much less likely to owe AMT. Only 11 percent of those with incomes over \$1 million that report substantial business income owe AMT compared with 34 percent of the population at large. It appears that high-

income business owners are less likely to have AMT preference items than high-income wage earners.

*5. What do you think about Mr. Graetz's proposal to hold off on any type of AMT reform and implementing a patch that goes to 2009 or 2010?*

I am skeptical. I agree with Mr. Graetz that it would be ideal to address the AMT in the context of fundamental tax reform and it is also true that the AMT will add some impetus to tax reform efforts—since it is such an egregious example of poor tax policy. But I also believe that the AMT has insidious effects on our income tax—makes it less fair, more complex, less efficient, and masks the costs of large tax cuts like the 2001-2006 tax cuts and could make extension of all or part of those tax cuts appear much less costly than they really are. If it were possible to fix permanently or repeal the AMT now in a fiscally responsible way, I would not hold that major improvement in the tax law hostage to a hypothetical future tax reform. The perfect should not be the enemy of the good.

*6. Hassett's proposal suggests repealing the AMT and capping the mortgage interest deduction, and eliminating other tax benefits such as the child tax credit. What do you think about this proposal? Who will benefit and who will be harmed?*

I like the idea of financing AMT repeal through base broadening. That was the approach proposed by President Bush's tax reform panel and it makes a lot of sense. Repealing the state and local tax deduction would raise more than enough revenue to finance repeal of the AMT (assuming the president's tax cuts expire in 2010) and would be a highly progressive change. Currently, most households get no benefit from the state and local tax deduction because they do not itemize deductions. Most nonitemizers would be unaffected by repealing both the tax deduction and the AMT. Taxpayers on the AMT lose all or part of their state and local deduction. Many would be better off under the proposal. The main beneficiaries from the status quo are very high-income people who get very large state and local tax deductions (written off at high tax rates) and many of whom are unaffected by the AMT. They would pay much higher taxes under the proposal.

Taxing municipal bond interest would similarly affect primarily high-income people.

Some would complain that these two options would hurt state and local governments, but both the state and local tax deduction and the exemption of municipal bond interest are inefficient tools to aid governments. The state and local deduction provides the greatest benefit to states with many high-income people (who are most likely to itemize and gain the most when they do), but those are the states that least need federal assistance. The exemption of bond interest is inefficient because states savings in terms of lower interest rates are much smaller than what the federal government loses in tax revenues. It would be preferable from a budgetary standpoint to convert the value of the interest savings into direct grants to states.

Capping the mortgage interest deduction would also be progressive and efficient. Even though the housing market is currently in a slump, overall most economists believe that the tax subsidies for homes result in housing price inflation and too much capital being invested in housing and not enough in other sectors of the economy.

There are also good arguments for capping the tax exclusion for employer-based health insurance—primarily that it would reduce the incentive to purchase overly generous health insurance—and a cap would be generally progressive, since the largest tax benefits from the exclusion go to taxpayers with high incomes. However, repealing the tax exclusion altogether would cause many millions of Americans to lose their employment-based health insurance. Unless it were done in the context of overall health insurance reform, repeal of the exclusion would likely cause many people with low and moderate incomes, especially those with health problems, to become uninsured.

Eliminating the child tax credit and fully taxing Social Security benefits would be very regressive. The child tax credit is one of two main refundable tax credits that provide substantial benefit to low-income working families. Higher-income seniors are already subject to tax on part of their Social Security benefits. Taxing all Social Security benefits would mean that many millions of seniors would have to file income tax returns and pay higher tax.

Finally, it is worth noting that reducing regular income tax rates without corresponding changes to the AMT would be counterproductive to the goal of cutting the number of AMT taxpayers. A better approach from my perspective would be to use the base broadeners to repeal the AMT and only reduce rates if revenues allow. Indeed, one of the options in my testimony would do that—eliminate both the AMT and the state and local tax deduction and reduce regular income tax rates by 2 percent. If other base broadeners were also adopted, the rate reductions could obviously be larger.

*7. One of Mr. Degen's 3 criteria for a workable AMT fix is to limit the scope of the AMT to taxpayers that are engaging in the most egregious tax avoidance? Do you agree and how would it work?*

I agree in principle, but the current AMT does not seem to have much effect on those engaged in aggressive tax sheltering. The main reason is that capital gains are subject to the same low rates under the AMT as under the regular income tax. Prior to 1987, capital gains were fully taxed under the AMT, and the capital gains exclusion—available under the regular income tax but not the AMT—represented the single largest AMT preference item. If capital gains were fully taxed under the AMT, that would raise revenue that could be used to eliminate or reduce middle-class preference items, such as the deduction for state and local taxes, or to raise the AMT exemption.

## Questions from Ranking Member Grassley

*I want to have you both talk a little more about the burdens the complexity of the AMT places on tax preparers, taxpayers as well as the IRS.*

*Dr. Burman, in your written testimony you talk about how complexity makes planning difficult for taxpayers, I'd ask if you could elaborate on that.*

Planning requires knowledge of your marginal tax rate and the credits and deductions to which you are entitled. For example, there is a tax credit for hybrid vehicles, which is allowed under the regular income tax but not the AMT. Congress clearly intended for the credit to encourage taxpayers to purchase more fuel-efficient vehicles, but someone who may be subject to the AMT is likely to discount the credit. Indeed, claiming the credit may itself cause some taxpayers to be affected by the AMT.

As I noted in my testimony, most taxpayers on the AMT face higher effective marginal tax rates than they do under the regular income tax. Tax rates affect decisions to work, save, and make choices such as contributing to a 401(k) or making a charitable deduction. Taxpayers cannot make rational decisions if they do not know what their tax rate is.

More fundamentally, uncertainty about one's tax status creates a financial risk for taxpayers with no corresponding benefit to the government.

And, finally, some people are just confused by the AMT and may make bad decisions for that reason. For example, I've been told by people who should know better that they get no benefit from charitable contributions because they are on the AMT. In fact, charitable contributions are allowed against the AMT and, since the AMT tends to raise marginal tax rates, most affected taxpayers benefit *more* from charitable deductions than they would under the income tax. *Consumer Reports* magazine, which usually gets its facts straight, reported that mortgage interest deductions were curtailed under the AMT. That is certainly not true for traditional mortgages.

**Table 1**  
**Distribution of AMT Taxpayers with Income or Loss Reported on Schedules C, E, or F**  
**By Cash Income Class, 2007<sup>1</sup>**

Cash Income Class (thousands of 2006 dollars) <sup>2</sup>	All Tax Units					Tax Units with Income or Loss Reported on Schedules C, E, or F				
	Number (thousands)	Percent of Total	Subject to AMT <sup>3</sup>			Number (thousands)	Percent of Total	Subject to AMT <sup>3</sup>		
			Number (thousands)	Percent of Total	Percent within Class <sup>4</sup>			Number (thousands)	Percent of Total	Percent within Class <sup>5</sup>
<b>Less than 30</b>	64,592	43.3	4	0.0	0.0	8,554	26.7	0	0.0	0.0
<b>30-50</b>	27,400	18.3	339	1.5	1.2	4,672	14.6	42	0.5	0.9
<b>50-75</b>	21,294	14.3	1,891	8.1	8.9	5,059	15.8	338	4.1	6.7
<b>75-100</b>	13,139	8.8	4,751	20.3	36.2	3,806	11.9	1,183	14.2	31.1
<b>100-200</b>	16,685	11.2	11,806	50.5	70.8	6,081	19.0	4,195	50.3	69.0
<b>200-500</b>	4,475	3.0	4,014	17.2	89.7	2,441	7.6	2,172	26.0	89.0
<b>500-1,000</b>	756	0.5	432	1.8	57.1	534	1.7	304	3.6	56.9
<b>More than 1,000</b>	396	0.3	133	0.6	33.7	316	1.0	105	1.3	33.1
<b>All</b>	149,332	100.0	23,371	100.0	15.7	32,003	100.0	8,340	100.0	26.1

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1).

(1) Calendar year.

(2) Tax units with negative cash income are excluded from the lowest class but are included in the totals. Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis. For a description of cash income, see <http://www.taxpolicycenter.org/TaxModel/income.cfm>

(3) Includes those with direct AMT liability on Form 6251, with lost credits, and with reduced deductions.

(4) Represents the percentage of all tax units within that income class that are subject to the AMT.

(5) Represents the percentage of tax units with income or loss reported on Schedules C, E, or F within that income class that are subject to the AMT.

**Table 2**  
**Distribution of AMT Taxpayers with Income Reported on Schedules C, E, or F Greater than or Equal to 50 Percent of AGI**  
**By Cash Income Class, 2007<sup>1</sup>**

Cash Income Class (thousands of 2006 dollars) <sup>2</sup>	All Tax Units					Tax Units with Income on Schedules C, E, or F Greater than or Equal to 50 Percent of AGI				
	Number (thousands)	Percent of Total	Subject to AMT <sup>3</sup>			Number (thousands)	Percent of Total	Subject to AMT <sup>3</sup>		
			Number (thousands)	Percent of Total	Percent within Class <sup>4</sup>			Number (thousands)	Percent of Total	Percent within Class <sup>5</sup>
<b>Less than 30</b>	64,592	43.3	4	0.0	0.0	4,568	51.7	0	0.0	0.0
<b>30-50</b>	27,400	18.3	339	1.5	1.2	1,190	13.5	17	1.2	1.4
<b>50-75</b>	21,294	14.3	1,891	8.1	8.9	771	8.7	44	3.0	5.7
<b>75-100</b>	13,139	8.8	4,751	20.3	36.2	514	5.8	134	9.3	26.1
<b>100-200</b>	16,685	11.2	11,806	50.5	70.8	896	10.1	607	42.2	67.7
<b>200-500</b>	4,475	3.0	4,014	17.2	89.7	613	6.9	555	38.7	90.6
<b>500-1,000</b>	756	0.5	432	1.8	57.1	171	1.9	68	4.7	39.6
<b>More than 1,000</b>	396	0.3	133	0.6	33.7	113	1.3	12	0.9	10.9
<b>All</b>	149,332	100.0	23,371	100.0	15.7	8,841	100.0	1,436	100.0	16.2

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1).

(1) Calendar year.

(2) Tax units with negative cash income are excluded from the lowest class but are included in the totals. Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis. For a description of cash income, see <http://www.taxpolicycenter.org/TaxModel/income.cfm>.

(3) Includes those with direct AMT liability on Form 6251, with lost credits, and with reduced deductions.

(4) Represents the percentage of all tax units within that income class that are subject to the AMT.

(5) Represents the percentage of tax units within that income class that have income on Schedules C, E, or F greater than or equal to 50 percent of AGI who are subject to the AMT.