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SPECIAL REPORT

A Progressive AMT Fix Without Higher Tax Rates

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New "fixes" to the growing Alternative Minimum Tax (AMT) raise tax rates dramatically, and some current plans even dredge up a bad idea from Vietnam War days — surtaxes.[1] There is a better way.

Instead of raising rates on income that we're already taxing, we should start taxing income that is currently tax-free. With this approach, we can spare the middle class the burden of the AMT and at the same time lower their other tax rates, all the while collecting the same revenue.

Every AMT fix put forth thus far that fits the new pay-as-you-go rules makes the overall tax system more progressive, and in this report, we put forth a proposal that does just that — *but without raising statutory tax rates*. It is a four-year plan that will get us to 2011 when the Bush tax cuts expire. It would give the nation three years to design a more fundamental tax reform that should build on this theme: taxing previously untaxed income, which permits more moderate tax rates overall.

Revenue-Neutral AMT Relief

- *Raise the AMT exemptions to $300,000 for singles and $450,000 for couples and index them for inflation;*
- *Drop the 10 percent rate to 8.5 percent;*
- *Drop the 15 percent rate to 13.5 percent; and*
- *Drop the 25 percent rate to 24 percent.*

- *Repeal the deduction for state and local income taxes;*
- *Repeal the deduction for state and local sales taxes;*
- *Repeal the deduction for real estate taxes; and*
- *Repeal the exemption for municipal bond interest.*

Instead of raising rates on income that we're already taxing, we should start taxing income that is currently tax-free. With this approach, we can spare the middle class the burden of the AMT and at the same time lower their other tax rates, all the while collecting the same revenue.

This is the theme of every sound tax reform: a broader tax base with lower rates.

Tax Foundation's Revenue-Neutral Proposal

An astonishingly high fraction of Americans' income goes untaxed due to deductions and

1 Montgomery, Lori, "Democrats Seek Formula To Blunt AMT: One Plan Would Impose Surtax Of 4.3% on Richest Households" *Washington Post,* Friday, June 8, 2007; D01

exemptions. A large share of this untaxed income is earned by people who either pay the AMT already or soon will, so cutting back deductions and exemptions along with the AMT is a fair exchange.

This plan restores the AMT to its original, limited role of preventing a few high-income people from combining so many deductions and exemptions that they owe little or nothing. At the same time, it cuts tax rates for middle-income groups.

The plan outlined below restores the AMT to its original, limited role of preventing a few high-income people from combining so many deductions and exemptions that they owe little or nothing. At the same time, it cuts tax rates for middle-income groups.

While this plan does not overhaul the federal tax code in the fundamental way that Tax Foundation economists and other scholars have traditionally called for, its enactment would solve the current AMT problem without damaging tax rate hikes or surtaxes.

Table 1
What Share Each Income Group Would Pay Under This AMT Relief Plan
Tax Year 2007

Income Group (a)	Current-Law Share of Tax Returns	Current-Law Share of Income	Current-Law Share of Tax	Share of Tax Under Tax Foundation AMT Relief
$1 - $9,999	14.6%	1.3%	0.1%	0.0%
$10,000 - $19,999	15.0%	3.6%	0.6%	0.5%
$20,000 - $29,999	12.8%	5.1%	1.7%	1.5%
$30,000 - $39,999	10.2%	5.7%	2.4%	2.2%
$40,000 - $49,999	8.6%	6.2%	3.1%	2.8%
$50,000 - $74,999	14.5%	14.4%	8.3%	8.0%
$75,000 - $99,999	9.1%	12.7%	9.3%	8.8%
$100,000 - $199,999	10.1%	21.9%	24.0%	23.0%
$200,000 - $499,999	2.6%	11.8%	18.6%	18.6%
$500,000 - $999,999	0.6%	5.3%	9.2%	9.9%
$1 million and over	0.3%	13.2%	22.7%	24.4%

(a) Adjusted gross income (AGI).
Source: IRS public use file and Tax Foundation microsimulation model.

Four Tax Cuts that Are Offset by the Tax Increases Below

- Raise the AMT exemptions to $300,000 for singles and $450,000 for couples and index them for inflation.
- Lower three tax rates on middle- and lower-income taxpayers:
    - Drop the 10 percent rate to 8.5 percent;
    - Drop the 15 percent rate to 13.5 percent;
    - Drop the 25 percent rate to 24 percent.

Four Tax Increases that Offset the Tax Cuts Above

- Repeal three deductions that are inefficient, unjustified and mostly claimed by the same people who would be paying the AMT:
    - The deduction for state and local income taxes,
    - The deduction for state and local sales taxes,
    - The deduction for real estate taxes
- Repeal the exemption for municipal bond interest.

How Can This Plan Be Progressive If It Doesn't Raise Tax Rates?

Progressivity isn't really about the tax rates in law. It's about the fraction of income that each stripe of the income spectrum pays in tax. Because many deductions and exemptions benefit high-income people almost exclusively, repealing or limiting them makes the code more progressive without hiking rates.

Many in Congress are seeking ways to fix the AMT and at the same time make the tax system more progressive. What makes this difficult is that the AMT itself makes the tax system *more* progressive. Almost every dollar collected by the AMT has been paid by someone with a six-figure income, with the lion's share paid by people making between $200,000 and $500,000.

However, mainly because these four tax preferences benefit mostly the same high-income people who have paid the AMT, the plan will make the code more progressive overall. In particular, for tax year 2007:

- Taxpayers with adjusted gross incomes (AGI) over $1 million will pay more, even though the statutory rates would remain the same.
- Taxpayers with AGI between $75,000 and $200,000 would pay less as a group:
  - 68 percent would see a tax cut.
  - 31 percent would see a small tax increase.
- Taxpayers with AGI less than $75,000 would pay $11.5 billion less as a group:
  - 52 percent would get a tax cut.
  - 34 percent would see no change.
  - 12 percent would face a tax hike.

This subject is often discussed in terms of "tax shares," i.e., what fraction of tax collections does each income group pay? See Table 1 for a before-and-after display of how this AMT relief plan would affect each income group.

Table 2
Every Revenue-Neutral Tax Plan Has Winners and Losers
Tax Year 2007

Income Group (a)	Percentage of Tax Returns That Would Pay More (b)	Percentage of Tax Returns That Would Pay Less (b)	Percentage of Total Tax Returns Unchanged	Average Tax Change (b)	Median Tax Change (b)
All Returns	16.9%	55.1%	28.0%		– $ 7
$1 - $9,999	0.3%	17.1%	82.6%	– $ 4	$ 0
$10,000 - $19,999	3.0%	52.1%	44.9%	– $ 41	– $ 16
$20,000 - $29,999	8.5%	64.3%	27.2%	– $ 106	– $ 130
$30,000 - $39,999	13.8%	66.9%	19.3%	– $ 170	– $ 239
$40,000 - $49,999	20.3%	66.7%	13.0%	– $ 194	– $ 328
$50,000 - $74,999	31.0%	64.2%	4.8%	– $ 197	– $ 331
$75,000 - $99,999	33.9%	65.3%	0.8%	– $ 446	– $ 377
$100,000 - $199,999	28.7%	70.9%	0.4%	– $ 770	– $ 854
$200,000 - $499,999	41.2%	57.0%	1.8%	+ $ 1	– $ 1,030
$500,000 - $999,999	89.7%	6.7%	3.6%	+ $ 11,914	+ $ 7,774
$1 million and over	91.4%	5.5%	3.1%	+ $ 54,554	+ $ 24,213

(a) Adjusted gross income (AGI).
(b) Income tax after credits.
Source: IRS public use file and Tax Foundation microsimulation model.

The AMT itself makes the tax system more *progressive. Almost every dollar collected by the AMT has been paid by someone with a six-figure income, with the lion's share paid by people making between $200,000 and $500,000.*

Only for the income groups making $200,000 or more does the tax share rise under the AMT relief plan presented here.

Of course, the nation's tax returns show great variation even within income groups, mainly due to the multiplicity of deductions, exemptions and credits. Therefore, even within the groups that get a tax cut in the aggregate, some tax returns will pay more. Table 2 gives details about each income group.

In all moderate-income groups, the overwhelming majority would pay less because the tax savings from lowering the 10-percent, 15-percent and 25-percent rates would exceed the value of the lost deductions and exemptions. People in the upper-middle income ranges are saved from the AMT and they also benefit from the three rate cuts, but they lose their state-local tax deductions. For most, the tax savings outweigh the lost deductions and exemptions.

Table 3
Taxpayers Who Currently Take the Most Deductions and Exemptions Would Face Tax Hikes Under Tax Foundation Plan
Tax Year 2007

	Tax Returns That Would Pay More Tax (b)		
Income Group (a)	Percentage of Total Tax Returns Paying More (b)	Average Tax Increase for Those Returns (b)	Median Tax Increase for Those Returns (b)
All Returns	16.9%	$ 2,134	$ 384
$1 - $9,999	0.3%	$ 41	$ 18
$10,000 - $19,999	3.0%	$ 137	$ 107
$20,000 - $29,999	8.5%	$ 234	$ 169
$30,000 - $39,999	13.8%	$ 255	$ 181
$40,000 - $49,999	20.3%	$ 356	$ 256
$50,000 - $74,999	31.0%	$ 560	$ 354
$75,000 - $99,999	33.9%	$ 777	$ 474
$100,000 - $199,999	28.7%	$ 1,726	$ 734
$200,000 - $499,999	41.2%	$ 5,103	$ 2,129
$500,000 - $999,999	89.7%	$ 13,344	$ 9,143
$1 million and over	91.4%	$ 59,739	$ 27,918

(a) Adjusted gross income (AGI).
(b) Income tax after credits.
Source: IRS public use file and Tax Foundation microsimulation model.

Who Would Pay More?

As Table 2 shows, 16.9 percent of all tax returns would pay more tax if this AMT relief plan became law. They fall mostly in the highest income ranges. Almost every tax return claiming over $500,000 in AGI will pay more, and in the next highest income range ($200,000-to-$499,999) almost half the tax returns would pay more.

In Table 3 below we examine just those tax returns that would face a tax increase. Between $75,000 and $500,000, the few people who would pay more are those who receive large tax-exempt amounts from municipal bonds or whose deductions for state-local taxes are even larger than their savings from AMT relief and lower middle-income tax rates.

There appear to be some people in lower income ranges who would pay more, even though the tax changes we're suggesting would logically have only a tax-cutting effect at those levels of income. Many of those are unusual tax returns filed by people who have low current wages but valuable property or income from other sources. In other words, they are not stereotypical low-income people who take the standard deduction each year, all of whom will get a tax cut under this plan.

Table 4
Taxpayers Who Currently Take the Fewest Deductions and Exemptions Would Save the Most Under Tax Foundation Plan
Tax Year 2007

	Tax Returns That Would Pay Less Tax (b)		
Income Group (a)	Percentage of Total Tax Returns Paying Less (b)	Average Tax Cut for Those Returns (b)	Median Tax Cut for Those Returns (b)
All Returns	55.1%	$ 669	$ 384
$1 - $9,999	17.1%	$ 23	$ 14
$10,000 - $19,999	52.1%	$ 87	$ 82
$20,000 - $29,999	64.3%	$ 196	$ 206
$30,000 - $39,999	66.9%	$ 307	$ 326
$40,000 - $49,999	66.7%	$ 399	$ 410
$50,000 - $74,999	64.2%	$ 578	$ 549
$75,000 - $99,999	65.3%	$ 1,086	$ 842
$100,000 - $199,999	70.9%	$ 1,784	$ 1,430
$200,000 - $499,999	57.0%	$ 3,686	$ 3,315
$500,000 - $999,999	6.7%	$ 858	$ 930
$1 million and over	5.5%	$ 1,015	$ 1,191

(a) Income tax after credits.(b) Adjusted gross income (AGI).
Source: IRS public use file and Tax Foundation microsimulation model.

These unusual tax returns are also the reason that the average tax hike shown in Table 3 is so much higher than the median tax hike. See especially the two values under "All Returns" and under the $100,000-to-$200,000 range. According to IRS data, there are thousands of tax returns that claim more tax-exempt income than taxable income.

Who Would Pay Less?

In Table 4 below we take a similar look at just the tax returns that could expect a tax cut under the Tax Foundation plan, about 55 percent of all tax returns. They are concentrated in the income groups from low-middle income all the way up to, but not over, $1,000,000.

The most strenuous objections to the plan will come from state and local government officials of high-tax states.

At the lowest income levels, tax cuts are due to the new, lower rates we propose: 8.5 percent, 13.5 percent and 24 percent. At the middle and upper-middle ranges, those same rate cuts combine with AMT relief to outweigh the loss of the state-local tax deductions and the taxation of previously tax-exempt interest.

Who Will Oppose Such a Plan?

The most strenuous objections to the plan will come from state and local government officials of high-tax states.

Wherever taxes are highest, that's where the deductions are biggest. However, that's also where AMT payments are highest, so the relief and pain will coincide.

Also, people who have purchased tax-exempt municipal bonds would be hurt. They accepted lower interest rates in exchange for a tax exemption that would be taken away under this plan.

These two constituencies would object to these changes, but according to the principles of taxation, there is little or no justification for the tax exemption enjoyed by municipal bonds or the deduction for state-local taxes within an income tax system.

The AMT is a complex, redundant re-calculation of tax liability. By limiting its application to only the very highest earners, who almost invariably have complex, professionally prepared tax returns anyway, the tax compliance burden of the AMT is almost eliminated.

Who Will Favor Such a Plan?

More than half of all taxpayers would pay less under this plan, and another large fraction would see no change. But there are reasons beyond tax savings to favor these changes.

Table 5
Tax System More Efficient Under Tax Foundation Proposal as Most Taxpayers Face Lower Marginal Effective Tax Rates (METR)

Income Group (a)	Percentage of Tax Returns with higher METR (b)	Percentage of Tax Returns with lower METR (b)	Average METR Change (Percentage Points)	Median METR Change (Percentage Points)
All Returns	4.2%	66.8%	– 1.18	– 1.50
$1 - $9,999	0.3%	18.7%	– .25	.00
$10,000 - $19,999	1.4%	53.7%	–.76	– 1.50
$20,000 - $29,999	2.7%	70.0%	– 1.02	– 1.50
$30,000 - $39,999	3.1%	77.6%	– 1.32	– 1.50
$40,000 - $49,999	6.9%	80.1%	–.93	– 1.50
$50,000 - $74,999	4.1%	91.0%	–1.67	–1.50
$75,000 - $99,999	7.3%	90.0%	– 2.96	– 1.50
$100,000 - $199,999	7.8%	86.7%	– 2.06	– 2.00
$200,000 - $499,999	14.7%	71.1%	.64	– 2.00
$500,000 - $999,999	36.6%	24.7%	1.97	.00
$1 million and over	22.4%	38.6%	.90	.00

(a) Adjusted gross income (AGI)
(b) Marginal effective tax rate (METR), which is the percentage taken from the next dollar of income, counting all exemptions, deductions, credits.
Source: IRS public use file and Tax Foundation microsimulation model.

The AMT is a complex, redundant re-calculation of tax liability. By limiting its application to only the very highest earners, who almost invariably have complex, professionally prepared tax returns anyway, the tax compliance burden of the AMT is almost eliminated.

The current state-local deductions really amount to a subsidy for high government spending in high-tax areas at the expense of taxpayers in low-income, low-tax areas. These deductions expand the education spending gap that exists between low-income areas, where few taxpayers itemize, and high-income areas where most taxpayers itemize and take advantage of state-local tax deductions.

As Loeb and Socias (2001) point out, "The Federal Government gives large sums to high income (school) districts through tax deductions."[2] For these reasons and others, the President's Advisory Panel on Federal Tax Reform, a bipartisan group of eminent tax scholars, recommended eliminating the deduction for state and local taxes in its final report issued in October 2005.

The exemption for municipal bond interest is a similar case, except that it's even more overwhelmingly a benefit to the highest earners. Long viewed as highly inefficient by public finance economists, and partially eliminated under current AMT law, the exemption for state and local municipal bonds has no place in a fair, efficient tax system, and so this plan puts those bonds on a par with every other bond.

Finally, this proposal ensures that most lower- and middle-income groups receive tax relief in a way that is most efficient economically: lower tax rates. Nearly everyone who takes the standard deduction, typically low- and middle-income earners, would see a tax cut. Furthermore, even those middle-income taxpayers who itemize will get either a tax cut or only a small tax hike. These tax filers typically have state and local taxes, charitable contributions, and mortgage interest payments

2 Loeb, Susanna and Socias, Miguel, "Federal Contributions To High-Income School Districts: The Use Of Tax Deductions For Funding K-12 Education" (May 2001). Available at SSRN: http://ssrn.com/abstract=275074 or DOI: 10.2139/ssrn.275074

that are only slightly above the standard deduction.

These deductions expand the education spending gap that exists between low-income areas, where few taxpayers itemize, and high-income areas where most taxpayers itemize and take advantage of state-local tax deductions.

Impact of Proposed AMT Relief on Marginal Effective Tax Rates

Not every plan that makes the tax code more progressive is good for the economy; in fact, few can be devised that do, but this is such a plan because it does not raise many taxpayers' "marginal effective tax rate" (METR). This rate, all-important to economic performance, is determined by asking the question: What fraction of an additional dollar of income would be taken in tax?

Under this plan, the METR would only increase for four percent of taxpayers, and for more than two-thirds of the taxpaying public, the METR would drop. This economically beneficial result is only achievable because of the plan's general strategy of taxing income that's currently completely tax-free instead of applying even higher tax rates to the income that we're already taxing.

Table 5 looks at how taxpayers along the income spectrum would face changes in METRs at their current income level. Specifically, using the Tax Foundation's microsimulation model, we add $100 worth of wage income to each taxpayer and show the average tax increase from that $100 under the proposal put forth in this report.

For the vast majority of taxpayers, marginal effective tax rates at current income levels would be lower under our proposal than under current law. Even for the three income groups with a higher average METR and the one income group with a higher median METR, the increase would be modest: only one or two percentage points.

Conclusion

Beyond 2010, the expiration of the Bush tax cuts will change the direction of the tax code. We would recommend this plan as a bridge to that time, a three-year period when lawmakers can focus on fundamental tax reform, a major overhaul that would build on the ideas behind this plan: lower tax rates applied to more types of income.

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