

WebMemo



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Coming Together on Tax Simplification: AMT and Extending the Tax Cuts

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Several proponents of small government oppose repeal of the individual alternative minimum tax (AMT) despite that tax's confusing strictures, bureaucratic nature, and excessive demands on the American taxpayer. This is due to an unfortunate misunderstanding of repeal's effects.

It is suggested that repeal of the AMT would actually *raise* marginal tax rates for most individuals and therefore not create positive growth effects. A closer look at AMT repeal's actual effects on tax rates, particularly in combination with extension of the 2001 and 2003 Bush tax cuts, reveals that this objection is misguided. When the Bush tax cuts are extended in conjunction with AMT repeal, marginal rates do not increase for any income class compared to current law, and the overall average marginal rate falls. In addition, average effective tax rates fall *significantly* more than with the Bush tax cuts alone. Legislators should consider the total effect of a combination policy if they want to pursue a pro-growth agenda.

A Pro-Growth Agenda. Repeal of the AMT together with extension of the Bush tax cuts would reduce average effective tax rates and marginal tax rates for all income groups compared to current law.¹ Senator John Ensign (R-NV) proposed exactly this policy as the AMT Repeal and Tax Freedom Act (S. 2318) in November 2007.

However, concern over the AMT's impact on marginal tax rates has made coming together to support such a tax policy plan difficult. For this reason, it is critical that those who favor economic growth con-

sider carefully the true economic impact of both policies, both together and separately. It quickly becomes clear that cutting taxes is pro-growth tax policy.

Average Effective Tax Rates. Marginal tax rates are only half of the story. Average effective tax rates are also important. While marginal rates often drive labor and investment behavior, total effective tax rates tell us the amount of spending power in the hands of the private citizen and the amount left in the hands of wasteful government. As the world learned from the experiment with socialism, private control of wealth is necessary for efficient use. Lower effective tax rates spur economic growth. AMT repeal reduces effective tax rates for all persons affected by the AMT and raises them for no one.

It is also critical in this regard to remember that if the Bush tax cuts are extended but the AMT is not repealed, the AMT eliminates much of the potential reduction in rates from the Bush tax cuts. Hence, though it may at first appear that the total rate reduction is not very large from repeal of the AMT, in fact the combination policy reduces rates by much more than the tax cuts alone: It actually doubles the percentage-point drop in average effective rates. (See Table 1.)

This paper, in its entirety, can be found at:
www.heritage.org/Research/Taxes/wm1888.cfm

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Table 1

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AMT Repeal with Extension of Bush Tax Cuts Best Reduces Average Tax Rates

2011	Current Law	Tax Cuts Alone	AMT Repeal Alone	Both Together	Both vs. Cuts Alone
No AGI	0%	0%	0%	0%	0%
AGI \$1 under \$5,000	-4%	-1%	0%	-1%	0%
AGI \$5,000 under \$10,000	-5%	0%	0%	0%	0%
AGI \$10,000 under \$15,000	-3%	-1%	0%	-1%	0%
AGI \$15,000 under \$20,000	-1%	-2%	0%	-2%	0%
AGI \$20,000 under \$25,000	1%	-3%	0%	-3%	0%
AGI \$25,000 under \$30,000	5%	-3%	0%	-3%	0%
AGI \$30,000 under \$40,000	7%	-2%	0%	-2%	0%
AGI \$40,000 under \$50,000	9%	-2%	0%	-2%	0%
AGI \$50,000 under \$75,000	12%	-2%	0%	-2%	-1%
AGI \$75,000 under \$100,000	13%	-1%	0%	-3%	-2%
AGI \$100,000 under \$200,000	16%	-1%	-1%	-3%	-3%
AGI \$200,000 under \$500,000	22%	-1%	-1%	-5%	-4%
AGI \$500,000 under \$1,000,000	28%	-3%	0%	-5%	-2%
AGI Over \$1,000,000	27%	-5%	0%	-5%	-1%
Total 2011—ALL	16%	-2%	0%	-3%	-2%

Notes: The "Both Together" column shows the effect of the combination policy and hence is not the simple addition of the two separate policies; the last column is the difference between the 4th and 2nd columns but may differ due to rounding. Data are for 2011 after the tax cuts would expire and are based on the in-house Heritage Foundation tax microsimulation model.

Marginal Tax Rates. The effect on marginal rates is not as simple as opponents of the tax policy claim. AMT repeal alone—if the Bush tax cuts are not extended—has different effects on marginal rates for different income classes, some positive and some negative. Those not reporting positive adjusted gross income (AGI) will see a fall in marginal tax rate. This is because the AMT was put in place to try to ensure that “the rich” always pay something.

Marginal tax rates are indeed higher with a repeal of the AMT alone, compared to current law, for three higher income classes: those between \$100,000 and \$1 million in AGI. (See Table 2.) However, the combination policy produces a different result. The \$100,000–\$500,000 AGI groups see a greater reduction in marginal tax rates compared to the Bush tax cuts alone. While the reduction in marginal rates from extension of the tax cuts alone is

tempered by AMT repeal for those above \$500,000, it is magnified for three lower income classes, and no income class sees a rise of marginal rates compared to current law.

Compared to current law, the overall average impact of AMT repeal *alone* on marginal tax rates is neutral: The overall average marginal tax rate is the same. The *combination policy*, however, produces a significant drop of 4 percentage points. The repeal of AMT is responsible for one-quarter of that drop. (See Table 2.)

The AMT Patch. What about an indefinite extension of the AMT patch? One problem with this approach is that the same political battle must be fought every year. Another problem is that the taxpayer will not know that the patch will be extended with certainty, so reduction in marginal rates may not actually affect incentives as expected.

1. “Current law” means that the Bush tax cuts expire and the AMT continues, not indexed by inflation (without a patch). Comparison with the patched AMT is discussed below.

Table 2

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AMT Repeal with Extension of Bush Tax Cuts Reduces Marginal Rates

2011	Current Law	Tax Cuts Alone	AMT Repeal Alone	Both Together	Both vs. Cuts Alone
No AGI	5%	0%	-6%	-7%	-6%
AGI \$1 under \$5,000	-5%	-1%	0%	-1%	0%
AGI \$5,000 under \$10,000	0%	-2%	0%	-2%	0%
AGI \$10,000 under \$15,000	8%	-5%	0%	-5%	0%
AGI \$15,000 under \$20,000	14%	-5%	0%	-5%	0%
AGI \$20,000 under \$25,000	16%	-3%	0%	-3%	0%
AGI \$25,000 under \$30,000	19%	-2%	0%	-2%	0%
AGI \$30,000 under \$40,000	19%	-2%	0%	-2%	0%
AGI \$40,000 under \$50,000	20%	-2%	0%	-2%	0%
AGI \$50,000 under \$75,000	23%	-1%	-1%	-2%	-1%
AGI \$75,000 under \$100,000	26%	-2%	-1%	-6%	-4%
AGI \$100,000 under \$200,000	29%	-1%	1%	-3%	-2%
AGI \$200,000 under \$500,000	34%	-2%	2%	-4%	-2%
AGI \$500,000 under \$1,000,000	39%	-9%	2%	-4%	5%
AGI Over \$1,000,000	39%	-8%	0%	-5%	3%
Total 2011—ALL	28%	-3%	0%	-4%	-1%

Notes: The "Both Together" column shows the effect of the combination policy and hence is not the simple addition of the two separate policies; the last column is the difference between the 4th and 2nd columns but may differ due to rounding. Data are for 2011 after the tax cuts would expire and are based on the in-house Heritage Foundation tax microsimulation model.

Still, it is useful to compare the marginal and average effective rates of extension of the tax cuts with the extension of the patch to extension of the tax cuts with complete repeal of the AMT. As seen in Table 3, the overall average marginal rate is unaffected, though different groups benefit, and average effective tax rates are lower with the repeal. It is significant to note that the income groups that are hurt by an increase in marginal rates with a complete repeal are actually also helped by a decrease in the average effective tax rate.

Conclusion. The purpose of the AMT was to ensure that people who take deductions pay a minimum tax; a repeal clearly will lower their effective tax rate. Furthermore, AMT repeal will not increase marginal tax rates so long as the repeal is in conjunction with an extension of the Bush tax cuts. Such a combination policy would reduce average effective tax rates significantly for all groups, fostering economic growth by leaving spending power in private hands. The effective rate reduction would be much greater than an extension of the tax cuts

Table 3

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Comparing With the AMT Patch

2011	AMT Repeal Plus Tax Cut Extension vs. Patch Marginal Rates	AMT Repeal Plus Tax Cut Extension vs. Patch Average Rates
No AGI	-6%	0%
AGI \$1 under \$5,000	0%	0%
AGI \$5,000 under \$10,000	0%	0%
AGI \$10,000 under \$15,000	0%	0%
AGI \$15,000 under \$20,000	0%	0%
AGI \$20,000 under \$25,000	0%	0%
AGI \$25,000 under \$30,000	0%	0%
AGI \$30,000 under \$40,000	0%	0%
AGI \$40,000 under \$50,000	0%	0%
AGI \$50,000 under \$75,000	0%	0%
AGI \$75,000 under \$100,000	0%	0%
AGI \$100,000 under \$200,000	-1%	0%
AGI \$200,000 under \$500,000	-2%	-2%
AGI \$500,000 under \$1,000,000	5%	-2%
AGI Over \$1,000,000	3%	-1%
Total 2011—ALL	0%	-1%

alone, and the overall average marginal rate would be lower as well.

Those who favor a simpler and fairer system recognize the need to repeal the convoluted individual AMT. Pro-growth legislators are in favor of lower taxes. Conservatives of both stripes should come together to back any bill that, without raising

other taxes, proposes repeal of the AMT and extension of the tax cuts. Such a combination policy would reduce tax rates for all citizens and ensure economic growth.

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