Pick Your Battles: Weighing Bush's Dividend Cut Against AMT Reform

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Although President Bush has devoted most of his first term to crusading against "unfair" taxes and espousing long-term certainty in the code, he has thrice avoided cordoning off an alternative minimum tax trap awaiting millions of future middle-income earners.

Rather than fulfilling its intended purpose of forcing yesteryear's wealthy tax dodgers to pay income tax, the individual AMT stands poised to ensnare over the next decade more than 79 percent of families earning $75,000 or more a year. And the biggest pitfalls facing many of these unsuspecting taxpayers continue to be the government's failure to index the 26 and 28 percent AMT brackets for inflation and the limited exemption items available to defend against the tax.

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While most tax watchdogs agree that the surreptitious AMT problem stems from decades of neglect by both parties, Tax Policy Center (TPC) codirectors and economists Leonard E. Burman and William G. Gale claim Bush became a de facto reform stakeholder as soon as he advanced the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001, which effectively doubled the pool of anticipated AMT participants to 36 million by 2010.

According to the Internal Revenue Service's *Winter 2002-2003 Statistics of Income Bulletin*, approximately 1.3 million taxpayers filed under the AMT in 2001. The forthcoming EGTRRA rate reductions and the 2004 expiration of the corresponding AMT hold-harmless provisions, however, would subject a steady stream of taxpayers to the AMT beginning in 2005.

By endorsing the far-reaching dividend income tax repeal for stockholders ($396 billion through 2013) above an AMT fix, Bush has once again sidestepped an unwieldy problem that becomes more expensive to fix with each passing year. According to the latest TPC projections, Bush could have indexed the AMT — a legislative change that presidents from Ronald Reagan to Bill Clinton have left undone — for about the same amount of money as the proposed dividend cut ($418 billion).

Former Council of Economic Advisers Chair and dividend repeal architect R. Glenn Hubbard, stressed, however, that the projected pro-growth impact of the dividend cut vastly overshadows the Pyrrhic victory a piecemeal AMT assault might provide.

"You can't do 'nips and tucks' on the AMT," he said, adding that AMT challenges would be better addressed within the context of a "big tax reform discussion."

Besides, Hubbard argued, "AMT relief is not a stimulus package."

Former Joint Committee on Taxation Chief of Staff and Clarke/Bardes Federal Policy Group Director Kenneth J. Kies agreed with the dividend preference, but noted that White House allies have already heard grumblings of a 2005 reform push sure to include AMT changes. "The dividend cut is a fundamental policy change that would put us more in step with the rest of the world," he said of the timing choices, "while fixing the individual AMT is more about cleaning up a mess."

Republican lawmakers are expected to keep the clean-up effort alive by attaching another temporary AMT fix to Bush's developing tax package. The House's preliminary economic growth plan (H.R. 2) proposes increasing and extending the existing $35,750 AMT exemption for single filers and $49,000 exemption for joint filers by $4,000 and $8,000 (respectively) through 2005.

Apples and Oranges

Since January, Bush and key administration aides have touted the proposed dividend exclusion as:

- a necessary blow in the battle against double taxation;
- a fiscal insurance policy and stock market springboard;
- a stepping stone toward improved corporate transparency;
- an overdue reward for investment-savvy seniors;
- an immediate job generator with long-term reform benefits; and
- a postwar "thank you" to soldiers returning home from war in Iraq.

On two separate occasions last week, White House Press Secretary Ari Fleischer and Treasury Secretary John Snow pitched Bush's full dividend repeal as a "longer-term growth piece" and "fundamental reform" needed to stoke additional fiscal expansion.

Hubbard, on the other hand, directed Tax Analysts to a January CEA report suggesting that the dividend cut would trim the cost of capital by 10 to 15 percent — a boost he equated to a 4 to 7 percent investment tax credit — as corroboration of its stimulative effect.

"The administration has been pretty schizophrenic on that," Burman said about the interchangeable arguments the White House has used to push its dividend agenda.

'Fixing the individual AMT is more about cleaning up a mess,' Kies said.

According to Gale and Burman, leaving the AMT unattended would prove to be just as "anti-growth" as the current dividend tax overlap. They estimate that by 2010, the AMT would recapture roughly 36 percent of the total EGTRRA tax cuts and up to 70 percent of the tax relief promised to taxpayers earning between $100,000 and $500,000.

"They are certainly creating increased uncertainty by allowing this to go on," Gale charged. Burman concurred, adding, "It's [the AMT] just incomprehensible. People just can't make rational decisions."

For Kies, dealing with the AMT remains more of a complexity and a "hidden" tax concern, whereas he claims the dividend cut would deliver an immediate equity bump and kickstart the idling economy.

"Doing the dividend proposal is a bolder initiative than doing the AMT problem," Kies said. He also estimated that Bush would likely keep plugging away on his own top-tier tax priorities before moving on to more popular provisions. "When you're in an environment where you can get one major thing done, you probably don't want to pick something that would probably be easy to do later," he said.

While Hubbard maintained that it was impossible to divorce the individual AMT from the broader tax reform debate, Kies stressed that repealing the AMT could serve as a significant, stand-alone initiative.

"It's a discreet problem that could be attacked individually," Kies said, adding that there is no need to wait until irate taxpayers storm the Capitol to get moving on AMT relief. "I think we're plenty far enough into the problem already," he added.

Burman attempted to dispel the administration's "either-or" mentality on the dividend cut versus AMT reform question, noting that Treasury's 1992 tax integration study identified a number of alternate dividend proposals that cost less than Bush's outright repeal. He contended, however, that the dividend exclusion push simply reinforces the administration's myopic strategy of focusing on near-term political wins while glossing over arduous tasks like Social Security modernization and individual AMT reform.

"I think this administration has a real discount rate. They're not dealing with these other fiscal imbalances and this is just one piece," he argued. "They keep on pushing everything back. . . . But at some point, something has to be done."

Turning to Capitol Hill, Burman suggested that Congress is unlikely to advance any permanent AMT fixes until voters begin to make noise because "politically it's hard to solve a problem people don't know they have yet." Similarly, Gale said "nobody wants to use whatever chits they have to deal with this thing."

According to Gale, the mounting AMT problem has become doubly troublesome for Republicans because they currently control two-thirds of the government, and EGTRRA "made the situation significantly worse."

Meanwhile, both Burman and Gale floated similar conspiracy theories about what the administration's AMT aversion could mean long-term.

'It's [the AMT] just incomprehensible. People just can't make rational decisions,' Burman said.

"I think the administration is playing a game of brinkmanship here," Gale said, hinting that Bush wanted to let the AMT get out of control so he could use it as leverage for comprehensive tax reform.

Burman was less diplomatic. "They would like to use this and some of the other defects they've created in the tax system as a launching pad to move toward a consumption tax," he charged.

Trouble Ahead

A 2000 study from Treasury's Office of Tax Analysis and a subsequent report from the General Accounting Office estimated that about 16 percent of the public (or roughly 17 million taxpayers) would slide into the AMT by 2010.

Burman told Tax Analysts that following through on Bush's plans to lock EGTRRA permanently into the code would place around 46 million taxpayers in the AMT grasp by 2013, while allowing the 2001 cuts to expire as scheduled in 2011 would drop the number of taxpayers subject to the AMT to 26 million.

Gale and Burman have examined a number of potential AMT fixes — drawn largely from the

2001 report National Taxpayer Advocate Nina E. Olson presented to Congress last year — including a revenue-neutral retargeting approach designed to shift the AMT burden back onto upper-income earners.

The conservative fix (estimated to cost $474 billion through 2013) would allow roughly 98 percent of middle-income taxpayers, earning between $50,000 and $75,000, to dodge the 2010 AMT trap by allowing them to claim all available dependent exemptions and their personal nonrefundable credits. Gale and Burman would pay for the solution by increasing the top AMT tax rate to 35 percent (on par with the highest, post-EGTRRA marginal rate) and eliminating some capital gains breaks.

Olson told Tax Analysts that the lack of AMT indexing 'was working in a negative direction' for most taxpayers.

The AMT reform advocates maintain that the capital gains change is needed to correct a progressive loosening (in the 1990, 1993, and 1997 tax legislation) of the AMT restrictions that have made it more difficult to recapture capital gains earnings.

"Shutting that shelter would be consistent with the underlying purpose of the AMT," Gale said. Burman added that releasing taxpayers from the current multilayered capital gains system "would also make things a lot simpler."

Of course, hypothetical solutions mean little to the taxpayers, practitioners, and administration officials already facing the consequences of the AMT.

Olson told Tax Analysts that the lack of AMT indexing "was working in a negative direction" for most taxpayers and noted that "the universe of tax preferences has changed since 1969" — the birthday of the AMT's predecessor. Currently, miscellaneous state and local taxes, several dependent children, or even unreimbursed business expenses can cause many taxpayers to trigger AMT penalties.

Olson said increasing numbers of average taxpayers were relating "new wrinkles" about how they had gotten swept into the AMT with little to no warning. "It's a growing consciousness among people," she said. "And there is always a new story that I've never heard."

Hoping to mollify the "big quantum leap" in AMT growth set to coincide with the temporary EGTRRA sunset, Olson urged Congress to at least alleviate the burden on those taxpayers who are forced to wade through the tedious AMT forms only to discover they owe no AMT taxes by establishing a uniform gross income benchmark taxpayers could use to gauge their potential AMT liability. She noted, however, that setting up such a bright-line test could encourage taxpayers to recondition their earnings accordingly.

"The question is, what kind of games would people play to get to that line?" she asked.

Meanwhile, New York tax lawyer and Bancone Financial Services owner Bill Bancone said this year two more of his 200 clients got snagged by the AMT — just a 1 percent increase, but a roster he said keeps rising every filing season. "It's starting small, but it's going to get worse," he said.

Bancone noted that because they regularly pay well in excess of the 28 percent rate, most of his upper-income clients view the AMT as a nonissue. "Very high income taxpayers are not subject to this because their bracket is high enough that AMT is more of a nuisance calculation," he said.

Families earning between $100,000 and $200,000, on the other hand, continue to get hit by the AMT because they are unable to capitalize on passive losses or reclaim enough exemptions to ward off stiffer AMT tax bills — tax change that Bancone insists is more important to address than the administration's dividend exclusion proposal.

"I think it's time to hit the middle class [AMT] cut and then go back to [other cuts]," he said. ■

Full Text Citations

- **Tax Policy Center** handout. *Doc 2003-8949 (3 original pages); 2003 TNT 68-50*
- **IRS Statistics of Income Bulletin**. *Doc 2003-9965 (2 original pages); 2003 TNT 76-13*

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