

Mr. Chairman, Senator Jeffords, and Distinguished Members of the Committee.

Thank you for the opportunity to discuss the individual alternative minimum tax. The alternative minimum tax, or AMT, is an example of a tax provision that was intended to address a relatively small, targeted problem that has had unintended consequences, grown far beyond its original purpose, and created a far larger problem than it was ever intended to address. Unfortunately, because of the way the AMT is now intertwined with the rest of the individual income tax, a long-term solution to the AMT problem needs to be considered in the broader context of reform of the income tax.

History of the AMT

The predecessor of the AMT – the minimum tax -- was first enacted in 1969 in an attempt to insure that a small group of high-income individuals who had managed to avoid paying any income tax would pay at least a minimum amount of tax. Then Treasury Secretary Barr noted in his testimony before the Joint Economic Committee of Congress in 1969 that 155 taxpayers with incomes over \$200,000 paid no tax in 1966. The AMT we have today is projected to affect over 50 million taxpayers by 2015.

Moreover, even though the minimum tax and later the AMT did reduce the number of high-income taxpayers who otherwise would have paid no income tax, neither provision has been successful in attaining the original goal of ensuring that all high-income taxpayers pay at least some tax. Each year several thousand high-income taxpayers continue to be nontaxable, generally for various combinations of legitimate reasons and in spite of the AMT.

Several major and many minor changes since 1969 have transformed the original minimum tax into the current alternative minimum tax which, for too many taxpayers, is now a second income tax that runs parallel to the regular individual income tax. The broad reach and design flaws of the AMT result in a tax system that is complex, unfair, and discourages economic growth. Taxpayers must comply with two parallel tax systems – even for the many millions who do the calculations but ultimately have no AMT liability.

The AMT: A Looming Problem

The AMT is a parallel tax system with its own tax base, exemption amounts, tax rates, and usable tax credits. A taxpayer's AMT liability is essentially the difference between the liability calculated under the AMT and the liability calculated under the regular income tax. The AMT itself is not an especially complex tax. It is the requirement that taxpayers understand and comply with two parallel tax systems makes the AMT complex. Moreover, because many taxpayers become subject to the AMT for reasons that are not the result of tax-motivated planning, many taxpayers are not aware that they will be affected by the AMT until they complete their tax returns. They become unsuspecting – and unintended – victims of the AMT.

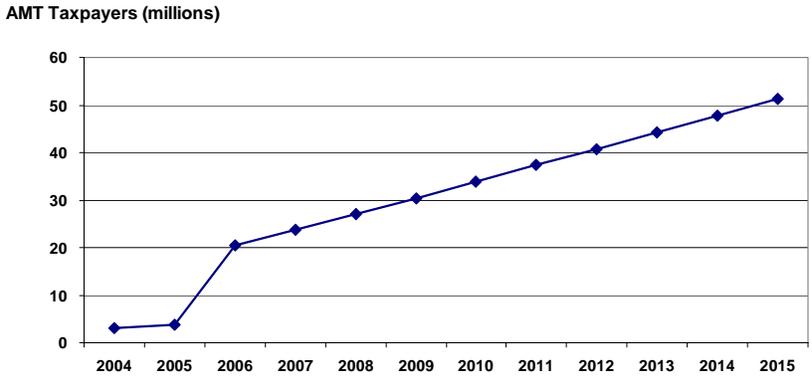
The major reason the AMT has become such a growing problem is that, unlike the regular tax, this parallel tax system is not indexed for inflation. The AMT tax rate thresholds, the AMT

exemption, and its phase-out are all fixed in nominal terms. Consequently, the passage of time and the erosive effects of inflation have steadily increased the size and scope of the AMT. Because of budgetary constraints and the large and ever-increasing amount of revenue from the AMT, solving the AMT problem in isolation would be extremely difficult.

The large AMT exemption has generally kept the vast majority of taxpayers free from the reach of the AMT. Indeed, each of the major tax cuts enacted by the Congress in the last several years have included provisions to increase the AMT exemption or other provisions to prevent a large increase in the number of AMT taxpayers. The higher AMT exemption and the provision to allow all personal credits to be claimed against the AMT – the so-called “AMT patch” – both remain in effect through 2005.

Chart 1: Number of AMT Taxpayers

Beginning in tax year 2006, after the temporary AMT provisions expire, the number of taxpayers projected to be affected by the AMT rises sharply, from 3.8 million in 2005 to 20.5 million in 2006 (Chart 1). By 2015, 51.3 million or 45 percent of all taxpayers with income tax are projected to be subject to the AMT.



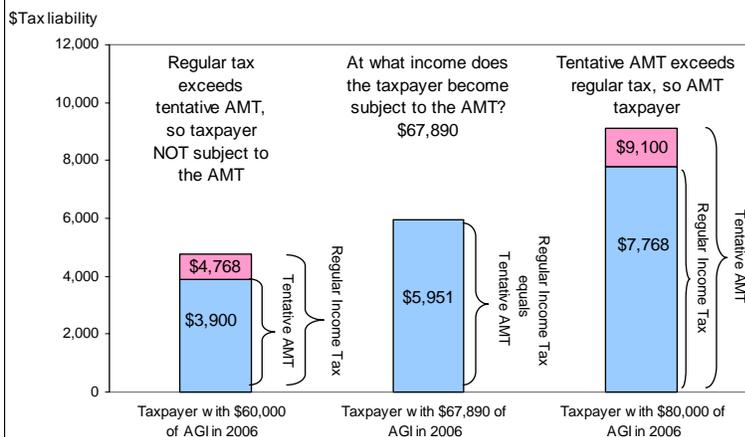
Note: Assumes EGTRRA and JGTRRA sunsets are repealed and the temporary AMT provisions are allowed to expire in 2005.

Source: U.S. Department of Treasury, Office of Tax Analysis

The AMT will increasingly affect middle-income taxpayers. In tax year 2005, about 13 percent of taxpayers with incomes between \$100,000 and \$200,000 will be subject to the AMT. But, when taxpayers file their tax returns in the spring of 2007 for tax year 2006, over 75 percent of taxpayers in this income group will be subject to the AMT.

To put this into perspective, consider how the AMT will affect a hypothetical joint filer with two children in tax year 2006 (see Chart 2). The taxpayer calculates tax liability under both the regular tax and the AMT and pays whichever is larger. The illustration reveals that in 2006 the hypothetical taxpayer becomes subject to the AMT when his income exceeds \$67,890. The AMT is no longer a tax that applies only to the high income.

Chart 2: An illustration for a joint filer with two children in 2006



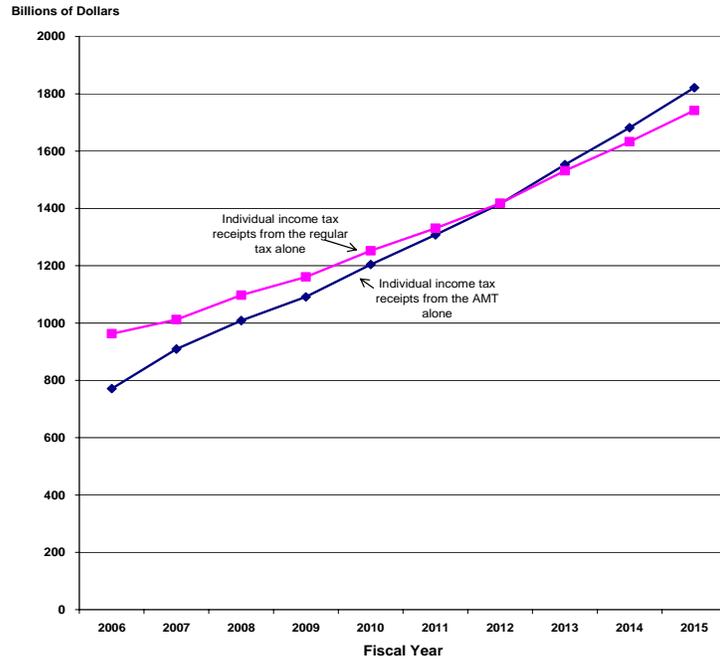
Note: Taxpayer is assumed to be married, file jointly, with two children, wage income only, and use the standard deduction.

Source: U.S. Department of the Treasury, Office of Tax Analysis.

The AMT also increasingly affects families with children because it does not allow deductions for personal exemptions. Nearly all AMT taxpayers will lose at least part of the benefit of the 2001 through 2004 tax cuts, including some who will lose all the benefit. And many unsuspecting AMT taxpayers are subject to an effective marginal tax rate of 35 percent even though the maximum statutory AMT rate is only 28 percent because of the phase-out of the AMT exemption.

The increases in the number of AMT taxpayers over the next decade will be accompanied by dramatic increases in tax revenues from the AMT. AMT revenue will increase from \$18 billion in 2005 to \$210 billion in 2015 (roughly 11 percent of total individual income tax revenue). In fact, by 2013 the revenue raised by the AMT alone actually exceeds the revenues from the regular tax (Chart 3). Both the large numbers of taxpayers affected and the large amount of revenue suggest that the AMT problem will have to be addressed in the context of broader changes to the tax system.

Chart 3: Revenue from the Regular Tax Versus the AMT



Note: Assumes EGTRRA and JGTRRA sunsets are repealed and the temporary AMT provisions expire in 2005.
Source: U.S. Department of Treasury, Office of Tax Analysis

Tax Reform and the AMT

In many respects, the AMT is a poster child for the need to reform the tax system. The AMT fails to meet all three of the criteria the President laid out when creating the Advisory Panel for Reform of the Federal Tax System. First, the AMT is not simple. The AMT requires taxpayers to comply with two parallel tax systems, often does not warn taxpayers that they have to deal with the second system, and the second system itself is unnecessarily complicated. Second, the AMT does not promote economic growth. In fact, the extra compliance costs and for many taxpayers the higher marginal tax rates imposed by the AMT discourages economic growth. And, third, the AMT is not fair. It disproportionately affects large families. It disallows some legitimate expenses incurred by taxpayers in order to earn income. It affects many middle-income and upper-middle-income taxpayers, but does not affect many taxpayers with the highest incomes.

Given the large revenue impact of the AMT and the extent to which the AMT is closely related and intertwined with the regular income tax, we need to consider broader solutions that will involve changes to the regular income tax. Thus, it is both inevitable and timely that the long-term solution to the AMT problem will be through broad reform of the income tax. Inevitable, because budgetary constraints preclude simple AMT repeal. Timely, because our overly

complicated tax system, which distorts economic decision-making and discourages economic growth, is in dire need of reform.

The current tax system imposes large costs on our economy by distorting the economic decisions of households and businesses, and tax reform that reduces those costs would encourage economic growth and improve living standards. Fundamental tax reform could increase our capital stock by 10 to 15 percent and ultimately increase real GDP by as much as 2 to 6 percent. More uniform treatment of different types of income, businesses and individuals could also produce significant economic gains by improving the allocation of economic resources and reducing economic waste.

The complexity of the income tax leaves many taxpayers with the sense that the system is unfair because others use special provisions to pay less tax. This sense of unfairness undermines voluntary compliance. It also encourages taxpayers to believe that they, too, should seek out tax minimizing strategies and behavior. In turn, that behavior only increases the economic costs and inefficiencies of our tax system.

Major revisions to our tax code occur every few years, with minor changes almost every year. Frequent changes in the tax code and uncertainty about the future make it difficult for individuals and businesses to make economic decisions. One goal of tax reform is a more stable tax system. Taxpayers should be able to plan without having to gamble about the future of the tax system.

The U.S. tax system not only imposes a cost to the economy by distorting households' and businesses' economic decisions and slowing economic growth, but it also imposes direct costs on taxpayers measured by the value of the time and resources devoted to complying with the tax system that could be put to more productive uses. According to the IRS, business and individual taxpayers spend more than 6 billion hours per year to comply with the tax system. To put this in perspective, this translates into a million and a half additional IRS agents. The total compliance costs of the income tax are estimated to be roughly \$130 billion annually – about 13 cents for every dollar in income tax revenues collected.¹ These compliance costs include both out-of-pocket costs and the time taxpayers spend to learn about the tax laws, keep and assemble necessary records, and prepare and submit tax returns.

Recent estimates are that individual taxpayers (including sole proprietors) spent roughly 3.5 billion hours annually complying with the tax system. According to a recent study based on IRS data, compliance costs for individuals – including the value of taxpayers' time – are roughly \$90 billion a year. On average, individuals spent 26 hours a year on their federal income taxes and spent an average of \$157 on out-of-pocket costs for the services of tax professionals, filing fees, software purchases, etc., in tax year 2002. Although taxpayers with self-employment income tend to have more complex affairs and spend more time and money on their taxes, even taxpayers without any self-employment income spend an average of 15 hours and \$76 in out-of-pocket costs each year determining their tax obligations.

IRS estimates that businesses spend over 3 billion hours a year complying with the tax system. One analyst estimates the total cost to be about \$40 billion annually. Recent academic research

indicates that compliance costs are the highest for the very largest businesses. Those with over \$5 million in assets reported compliance costs of nearly \$25 billion per year.

Certainly, a simpler tax system could decrease these burdens substantially and put these resources to more productive uses.

Criteria of a Well-Functioning Tax System

We suggest five criteria for evaluating proposals for tax reform: simplicity; pro-growth; fairness; fiscal responsibility; and stability.

A tax system should be easy to understand, have reasonable filing and record keeping requirements, including reduction or elimination of return filing, if possible, and have low cost and non-intrusive tax administration.

A tax system should be consistent with a strong economy. Business and household decisions should not be based on the tax code as little as possible. The tax code should promote economic growth by removing tax distortions and should maintain U.S. international competitiveness

A tax system should be fair. It should provide equal tax treatment of similarly situated taxpayers (horizontal equity) and a reasonable degree of progressivity, imposing higher taxes on those with a greater ability to pay (vertical equity).

A tax system should be fiscally sound. It should raise sufficient revenue to fund the federal programs that government chooses to provide.

A tax system should be stable. It should be resistant to frequent changes, especially those that change taxpayers' legitimate expectations.

The President's Tax Reform Panel

The President has made reforming our tax system a key priority. The President's Advisory Panel on Federal Tax Reform, named by the President earlier this year, is developing options to reform our tax system to make it simpler, fairer and more pro-growth. The Tax Panel brings a fresh perspective to tax reform. The members of the Panel are both independent and open-minded and are not wedded to particular approaches to tax reform. The Panel has a mandate to consider all options. The only constraints in the Panel's mandate are that its proposals should be revenue neutral, they should recognize the importance of housing and charitable giving to our American society, and that one of its options must include reform of the current income tax.

The Panel has been holding public hearings here in Washington, DC, and across the country to obtain the views of a wide range of knowledgeable and interested individuals about the problems with the current tax system and the merits of alternative ways to improve or reform the current system.

We are looking forward to the Panel's final report to the Secretary of the Treasury due by July 31. The options developed by the Panel will provide critical input for the recommendations on tax reform – including recommendations to address the AMT problem – the Secretary will then make to the President and the President will then make to the Congress.

Thank you again, Mr. Chairman, Senator Jeffords, and Members of the Committee for the opportunity to appear before you today. We look forward to working together with this Committee and others in the Congress on the AMT issue, on tax reform in general, and on other issues. I would be pleased to answer questions from the Committee.