BACKGROUND ON MINIMUM TAX

Under current law, individuals are required to pay the greater of the federal regular income tax or the federal alternative minimum tax. Under the alternative minimum tax, individuals are not permitted to deduct state or local income taxes or property taxes, personal exemptions, miscellaneous itemized deductions, and several minor tax preferences.

The individual minimum tax was originally enacted in 1969, and has been revised many times. The last major revision of the minimum tax was made by the Tax Reform Act of 1986. Initially, all of the various versions of the minimum tax had three characteristics in common.

1. They were designed to ensure that individuals with relatively large incomes pay some minimum amount of tax, notwithstanding the fact that the individual may have used otherwise allowable tax preferences to reduce his or her regular income tax to zero. Each version initially was targeted towards items considered to be tax preferences, such as accelerated depreciation, capital gain exclusions, and percentage depletion benefits.

2. The rates of the alternative minimum tax were dramatically lower than regular tax rates. The lower rates meant that even individuals who were subject to the alternative minimum tax still retained a portion of the benefit from the items subject to the tax. Initially, the minimum taxes were compromises that reduced, but did not eliminate, the benefits of the preferences subject to the taxes.

3. The minimum tax affected a relatively small portion of individuals. Also, the percentage of individuals subject to the tax (hereafter referred to as the "AMT participation rate") increased as income increased.[1]

All of that began to change in the mid 1990s, when Congress began to remove most items that have traditionally been considered to be tax preferences from the minimum tax. In 1992, percentage depletion for oil and gas and most intangible drilling costs were eliminated as items of tax preference subject to the minimum tax. In 1993, the untaxed appreciation in

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[1]Present Law and Background Relating to the Marriage Penalty, Education Tax Incentives, The Alternative Minimum Tax, and Expiring Tax Provisions, Joint Committee on Taxation, June 22, 1999, pages 27 and 28.

value of property contributed to charities was eliminated. In 1997, the depreciation preference was substantially cut back. In 1997, when the capital gains rate was reduced, the minimum tax capital gain rate was also reduced, effectively meaning that lower capital gain rates are not a tax preference. As a result of those Congressional actions, the only items that might be considered as tax preferences that are subject to the minimum tax are gain on the exercise of incentive stock options, the deduction for interest on home equity loans, and otherwise tax-exempt interest on private activity bonds.

Even the remaining "preferences" are relatively minor sources of AMT liability. **Now, virtually all alternative minimum tax liability is attributable to three items that few people would consider to be tax preferences: the deduction for personal exemptions, the deduction for State and local taxes, and miscellaneous itemized deductions.**[2]

The difference between the regular tax rates and the minimum tax rates began to shrink in the 1980s, largely as a result of the large reductions in the marginal rates enacted by the 1986 Tax Reform Act. In 1990 and 1993, Congress increased regular income tax marginal rates and alternative minimum tax rates. The real change occurred with the 2001 Act, when Congress decreased marginal rates in the regular income tax but left the minimum tax rates alone. The 2001 Act has reversed the prior relationship of minimum tax rates to regular tax rates. Now, virtually all individuals with incomes above the AMT exemption (for joint returns $58,000 for taxable years 2003 and 2004, $45,000 thereafter) and below the point at which the phaseout of that exemption ends (for joint returns $382,000 for taxable years 2003 and 2004, $330,000 thereafter) will find that their marginal tax rates in the minimum tax equal or exceed the marginal rates in the regular tax. Individuals in that wide income range will face minimum tax marginal rates of 26%, 32.5%, and 35%. In 2010, virtually all taxpayers with income between $50,000 and $200,000 will face higher marginal rates in the AMT than in the regular income tax.[3]

Finally, the minimum tax has changed from a tax that applies to a relatively small fraction of individuals to a "mass tax." **Prior to the 2001 Act, approximately one percent of all individuals were liable for the minimum**

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[2]Removing those three items from AMT would reduce the number of taxpayers subject tot he tax by 92%. See Burman, Leonard E., William G. Gale and Jeffrey Rohaly, "The AMT: Projections and Problems," Tax Notes, July 7, 2993, page 115.

[3]Berman et al, July 7, 2003, Tax Notes , page 114.

tax. The 2001 Act reduced regular tax rates but not minimum tax rates. As a result, there will be an explosion in the number of individuals who are subject to the minimum tax in the future. Following is a chart showing the percent of individuals by income class who will pay the minimum tax in the future. **The minimum tax effectively repeals the deduction for state and local taxes for individuals that are subject to that tax. In effect, the 2001 Act increases the burden of state and local taxes because most individuals with incomes high enough to itemize their deduction will find themselves subject to the minimum tax.**

2001 Income Levels (thousands of dollars)	**2010 AMT Participation Rate**[4]
Returns for which no tax due	neg.
0-15	neg.
15-30	0.2
30-50	6.9
50-75	36.6
75-100	72.9
100-200	92.0
200-500	96.2
500-1,000	49.3
1,000+	24.1

The 2001 Act changed the minimum tax in a dramatic way. **The fact that it has been estimated that repealing the minimum tax would cost more than repealing the regular tax is stark evidence of that changing nature.**[5]

The minimum tax disproportionately affects individuals who live in states with relatively high state and local taxes.

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[4]Berman et al, Tax Notes, July 7, 2003, page 110.

[5]See Berman et all, Tax Notes, July 7, 2003, pages 108 and 109.

Appendix G

ON TAX REFORM, REPUBLICAN LEADERS HAVE SAID ONE THING BUT DONE ANOTHER

Republican leaders repeatedly have talked about the need to make the tax system simpler and more fair. But over the last several years, they've actually enacted legislation that makes the tax code more complicated and less fair, while undermining enforcement efforts by the Internal Revenue Service. Here is an example of their comments:

"So we want to move towards a simpler tax code that takes less time to fill out, that is easier for the American people . . ." (Former Speaker Newt Gingrich (R-GA), 4/8/97)

"The tax code has over the years become increasingly politicized, and is seen less as a simple tool for raising revenue than as an instrument for social and economic engineering. In turn, this has spawned a virtual industry of tax specialists and special interest lobbyists, while exponentially increasing the complexity of the code . . . The current system is indefensible; it is riddled with special interest tax breaks . . . Today's tax code is so complex that many Americans despair that only someone with an advanced degree in rocket science could figure it out. They are wrong. Even a certified genius such as Albert Einstein needed help in figuring out his Form 1040." (Former Speaker Gingrich, 1/22/96)

[My goal is to] "tear out the income tax by its roots and discard it and replace it with a new form of taxation." (Rep. Bill Archer (R-TX), former Chairman of the Ways and Means Committee, 4/4/95)

"Because of the tax code's mind-numbing complexity, millions of hard-working men and women waste countless hours every April. We're pushing forward with our campaign to reform the tax code. We're making it fairer, flatter, simpler, and less burdensome to the American people." (Majority Leader Tom DeLay, 4/7/01)

"Major tax reform, simplifying the tax code, including introducing a flat tax or a sales tax." (Majority Leader DeLay, 6/30/03, responding to the question, "What is the substance of your agenda?")

“Americans want our tax code to be reasonable and simple and fair. These are goals that unite our country, and these are goals that have shaped my plan.” (President George W. Bush, 3/17/01)

“I am impressed by the fact that he has instituted tax reform – a flat tax. He and I share something in common; we both proudly stand here as tax reformers.” (President Bush, referring to Russian President Vladimir Putin, Washington Post, 7/27/01)

“The tax code is an abomination. It runs unnecessarily to thousands of pages. Many Americans hire tax preparers because they cannot understand the forms and instructions and they are afraid of being punished if they make a mistake. We can take immediate steps to restore some common sense to the tax code and make it simpler and more fair.” (Former Treasury Secretary Paul O’Neill, 4/15/02)

“Just as abusive tax avoidance transactions threaten voluntary compliance, so too does the complexity of the tax laws. Complexity imposes needless costs on honest taxpayers simply doing their best to comply with the law.” (Department of the Treasury document, 1/13/04)

“We want to make it easier for those who pay their taxes, and harder for those who choose not to do so. While nobody likes paying taxes, we need to make it as simple and painless as possible.” (Treasury Secretary John Snow, 1/13/04)

“The Administration has made tax simplification a priority, and we look forward to working with Congress to achieve it. A simpler code is something we owe honest taxpayers and the worst thing of all for the tax cheat.” (John Snow, 4/20/04)

“Our tax system is too complicated; it also hurts our nation’s competitiveness.” (Speaker Dennis Hastert, 12/03)

“The President is committed to making the tax code more simple and fair.” (White House Press Secretary Scott McClellan, 2/24/04)

THE INTERNAL REVENUE CODE: A CONFOUNDING MAZE OF COMPLEXITY

"We make it too hard for them [taxpayers] to comply."
IRS Taxpayer Advocate Nina Olson, 4/9/04

The Exploding Code

The Federal income tax code has grown from 500 pages in 1913 to 45,662 in 2001 to 60,044 pages (and 25 volumes) today.

The IRS now prints more than 1,000 publications, forms and instructions.

Four common forms (1040 and Schedules A, B and D) take an estimated 28 hours, 30 minutes to prepare. In 1988, when the IRS began tracking this information, the average paperwork burden was 17 hours, 7 minutes.

The 1040EZ form, the simplest form in the IRS inventory, now requires 3 hours, 43 minutes to complete, up from 1 hour, 31 minutes in 1988.

The short form (1040A) has more than 80 pages of instructions and twice the number of lines that appeared in the standard Form 1040 in 1945.

It costs taxpayers an estimated $100 billion each year in accounting fees and the value of their time to complete their tax returns, according to Joel Slemrod of the University of Michigan.

Individuals, businesses, tax-exempt public and private entities spend nearly 6 billion hours complying with the tax code.

Fifty-eight percent of taxpayers use a tax professional today compared with 48 percent in 1990.

The Dreaded Alternative Minimum Tax (AMT)

The AMT requires taxpayers to decipher a separate 8-page instruction booklet, a 12-line worksheet, and a 65-line form – even if the taxpayer, in the end, finds that he or she does not owe the AMT.

The IRS estimates that taxpayers spent more than 29 million hours completing and filing AMT forms.

Nearly 3 million taxpayers will have to pay the AMT this year. The number will explode to 30 million by 2010, according to the Congressional Budget Office.

By 2010, the AMT will ensnare one-third of all households and 97 percent of families with two children and incomes between $75,000 and $100,000, according to the Brookings Institution and Urban Institute.

Specific Examples of Complexity and Unfairness

There are five different tax breaks for families with children (dependency exemption, head of household filing status, the child tax credit, the child and dependent care tax credit, and EITC), and all five define a qualifying child differently.

Taxpayers overpay their taxes by an estimated $1 billion a year because they fail to claim itemized deductions, opting for the standard deduction instead, according to the General Accounting Office.

About one-quarter of taxpayers who are eligible for the earned income tax credit, which is designed to help the working poor, fail to claim it because it is too complicated.

Tax preparers are responsible for nearly 70 percent of errors and overclaims on returns claiming the EITC. (IRS)

An Enormous Burden on Small Businesses and the Self-Employed

IRS estimates that the average taxpayer with a self-employed status has the greatest compliance burden in terms of preparation – 59 hours.

Small businesses overpaid their taxes by $18 billion in 2000 and 2001 because of return errors, a GAO report found in 2002.

Tens of thousands of farmers overpaid taxes by an average of more than $500 because they failed to take advantage of income averaging, according to a Treasury Department report in March 2004.

Disconcerting Public Attitudes

In a 2003 survey by the Kaiser Family Foundation and Harvard University's Kennedy School of Government, nearly 9 out of 10 Americans said the federal income tax system was complex. Ninety-five percent cited the many different deductions and tax credits and the rules on how to claim them; 61 percent said there were too many different tax rates; 63 percent said it required too much record keeping; and 59 percent said the forms were too hard to fill out.

An IRS survey in 2003 found that 17 percent of taxpayers believe that it is acceptable to cheat on their taxes, an increase of 6 percent since 1999.

How Republicans Have Made the Code Even More Complicated

The 2001 tax law added 214 million hours in 2001 alone to the paperwork burden.

Republican tax cuts since 2001 have added more than 10,000 pages to the Internal Revenue Code.

Republicans have made 212 separate changes to the tax code since 2001: 142 in the 2001 tax bill and 30 others in 2001; 18 in the 2003 tax bill and 12 others in 2003; 10 changes in the tax treatment of pensions this year.

These figures do not include the 109 tax changes called for in the House-passed version of the FSC/ETI bill this year.

Changes in the tax treatment of capital gains has greatly complicated the burden for taxpayers. The IRS estimates that it takes 7 hours, 58 minutes for the average taxpayer to complete Schedule D, the form for reporting capital gains from the sale of capital assets such as stock or mutual funds.

Schedule D itself has 53 lines.

The IRS also estimates the following paperwork burden for other common tax forms: Schedule A (Deductions), 5.5 hours; Schedule B (Interest and dividends), 1.5 hours; Schedule C (Self-employed workers and sideline businesses), 10.5 hours; Schedule E (Rental property), 6 hours.

More than 42 million taxpayers, about two-thirds of those making more than $30,000 a year, will lose some or all of their Bush tax cuts to the minimum tax by

2013, according to Leonard Burman of the Urban Institute and William Gale of the Brookings Institution.

“Three major tax bills enacted in three years have vastly complicated the tax code, and a fourth Bush tax-cut bill is in the works.” (New York Times reporter David Cay Johnston, the author of “Perfectly Legal: The Covert Campaign to Rig Our Tax System to Benefit the Super Rich – and Cheat Everybody Else,” 2/15/04)

<u>"OUTGUNNED AND OUTMANNED"</u>

The IRS Does Not Have the Resources to Enforce Compliance

"Enforcement activities are still at an unacceptable level simply because the IRS does not have the resources needed to accomplish its mission. It continues to be outgunned and outmanned."

Nancy Killifer, Chair, IRS Oversight Board, in testimony before the House Ways and Means Subcommittee on Oversight, 3/30/04

The IRS estimates that there is a $311 billion "tax gap" due to under-reporting, under-payment and non-filing. As a result, the IRS leaves billions of dollars on the table simply because it does not have the resources to do its job.

Deputy Treasury Secretary Samuel Bodman told the Senate Finance Committee in March that the IRS walked away from more than 2 million delinquent tax accounts last year, totaling nearly $16.5 billion. The agency pursued just 18 percent of the abusive tax shelters that its agents discovered.

The number of Americans who believe cheating is acceptable has risen from 17 percent in 2003 from 11 percent in 1999, according to an IRS survey.

President Bush's FY05 budget request for the IRS ($10.7 billion) would shortchange the agency's collection activities, leaving a half-million delinquent tax accounts uncollected, 15 million calls unanswered and nearly 46,000 audits unscheduled, according to the IRS Oversight Board. The Board says another $230 million is needed.

Total tax prosecutions declined to 483 in 2003 from 1,431 in 1981.

The percentage of no-change audits has grown from 14 percent in Fiscal 2001 to 18 percent in 2003.

Audits for <u>all businesses</u> were down from 3 per 1,000 tax returns in 1999 to 2 per 1,000 in 2003. Face to face audits for <u>corporations</u> were down from 15 per 1,000 to 7 per 1,000. For the <u>largest corporations</u> – those with assets of $250 million or more – face-to-face audits dropped from 347 per 1,000 to 290 per 1,000, according to the Syracuse University Transactional Records Access Clearinghouse.

Only 0.73 percent of business tax returns were audited in the fiscal year that ended 9/30/03, down from 0.88 percent the year before. In 1997, 2.62 percent of business tax filers could expect to be audited.

Individuals were audited at a rate of 6.5 per 1,000 returns in 2003, up from 5.7 in 2002. However, that increase is largely attributable to an increase in mail audits. Face-to-face audits remained flat.

In 2003, the IRS says its agents probed more than 2,200 tax shelter returns, each of which took an average of 7½ months to unravel.

From 1996 to 2000, no corporate taxes were paid by 60 percent of large corporations, according to the General Accounting Office.

Corporate taxes now account for about 7.5 percent of overall federal tax receipts, down from a high of 40 percent during World War II.

Of the 1.3 million companies that GAO analyzed, 63 percent had no federal tax liability in 2000.

Only 6 percent of corporations had liability of more than 5 percent of pre-tax income.

At the end of 2003, there were 16,517 IRS agents and officers. In 1995, there were 24,217. Individual returns during that time period have increased by 15.7 million.