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Congress Fiddles While Middle America Burns: Amending the Amt (And Regular Tax)

Linda M. Beale[†]

† Associate Professor, University of Illinois College of Law. This article is an expansion and further development of ideas first presented at the ABA Tax Section's May 2004 Individual AMT Panel in Washington, D.C. I am especially grateful to John Colombo, Richard Kaplan, Roberta Mann, and Gail Richmond for their helpful comments and suggestions. I would also like to thank Zachary Christensen, University of Illinois College of Law Class of 2005, for his helpful research assistance. Any errors or omissions, of course, are my own responsibility.

> [L]aws and institutions no matter how efficient and well-arranged must be reformed or abolished if they are unjust.‡

I. INTRODUCTION

The Emperor Nero is said to have fiddled away while Rome burned, oblivious to the damage he himself had caused. The Empire never truly recovered. Will this generation's grandchildren look back at the current Congress and condemn it for similar frivolity? It may well be claimed that Congress has frittered away the next generation's future by passing tax cuts providing excessive benefits to the wealthy while letting the alternative minimum tax fall more and more broadly. This article argues that Congress could restore some modicum of tax sanity for ordinary Americans by a combination of changes to the regular and alternative minimum tax.

The current alternative minimum tax (referred to herein as the AMT) is a "back-up" tax system with flatter rate brackets and a broader tax base than the regular income tax.[1] The base (called "alternative minimum taxable income") is essentially derived from the regular income tax base by making certain "adjustments" and adding back in certain "preference" items that are disallowed for AMT purposes.[2] These adjustments and disallowed tax preferences (both generally referred to herein as "AMT preferences") include reduction in the amount of accelerated depreciation that may be taken into account for AMT purposes, disallowance of the deduction for interest on certain home equity loans, and required inclusion of otherwise excluded tax-exempt interest on certain private activity bonds.[3] The first $175,000 of income included in the AMT base in excess of a specified AMT exemption amount is taxed under the AMT at a rate of 26%. Excess alternative minimum taxable income above that $175,000 bracket is taxed at 28%. Capital gains, however, still enjoy preferential rates as under the regular tax.[4]

The AMT, originally intended for the superrich, developed over time as a kind of secondary boundary fence to ensure that taxpayers cannot overuse various incentive provisions to slip out of the tax system without paying some portion of their economic income to the federal fisc.[5] Several

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‡ John Rawls, A Theory of Justice 4 (revised ed., 1971, 1999).

1. The AMT is set forth in the Internal Revenue Code (the "Code") at §§ 55-59.

2. IRC § 55(b)(2) (requiring adjustments and disallowing tax preference items); § 56 (setting out adjustments); § 57 (listing tax preference items).

3. IRC §§ 56(a)(1), 56(e), 57(a)(5).

4. IRC § 55(b).

5. See infra Part III.C. Just what portion should be paid as a minimum has been little discussed. Most might be expected to agree that wealthy taxpayers owe more than a de minimis share of their income to the federal government. A reasonable goal, considering the importance of progressivity, see infra Part II, might be to have the

features of the budgetary context, the AMT and the regular tax system, however, suggest that the AMT will increasingly reach into the pool of middle-income taxpayers over the next few years. This is in large part due to the 2001 and 2003 tax cuts, which significantly lowered tax rates, and the lack of indexation of the AMT rate brackets and exemption amount. Taxpayers with incomes of less than $100,000 may account for as many as 52% of the entire pool of AMT taxpayers in 2010, up from about 9% in 2003.[6] The increase in taxpayers subject to the AMT over time creates a quandary – the longer Congress waits to limit the scope of the AMT, the more it will cost to do so. It has been projected to cost more to repeal the AMT in 2013 than it would cost at that time to repeal the regular income tax.[7]

There is no easy solution to this AMT quandary. Regular tax repeal is not the appropriate answer, since that would further benefit taxpayers at the very highest income brackets, who now pay regular tax at high marginal rates rather than the AMT.[8] The alternative of AMT repeal is urged by a number of commentators, supported by what appear to be strong arguments stated in forceful language.[9] They note the "stealth" nature of the AMT, in

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wealthiest taxpayers pay an effective tax rate that is at least several percentage points higher than the average effective tax rate paid by middle-income taxpayers. The 1978 House Ways & Means Committee suggested that an effective tax rate of 25% on taxable income and preferences was a reasonable target. See 1978 House Report, infra note 296, at 201-02. These criteria suggest a minimal target of an effective tax rate for the superrich of at least one quarter of their economic income, assuming that the base adequately reflects economic income. Other commentators, however, have arrived at a slightly lower figure. See Malamud, infra note 294.

6. Leonard E. Burman, William G. Gale & Jeffrey Rohaly, The AMT: Projections and Problems, 100 Tax Notes 105, 105 (July 7, 2003). The Treasury Department predicts that 51.3 million taxpayers will pay increased taxes due to the AMT by 2015. Department of the Treasury Office of Public Affairs, Fact Sheet: The Toll of Two Taxes: The Regular Income Tax and the AMT (Mar. 2, 2005), at http://www.treas.gov/press/releases/reports/factsheet_thetolloftwotaxesupdate.pdf (updating a similar 2004 fact sheet released by the Treasury Department, at http://www.treas.gov/press/releases/js1293.htm?, indicating 46.4 million would pay AMT in 2014).

7. Id.

8. See, e.g., Mark A. Luscombe, Alternative Minimum Tax – Our Future Flat Tax?, Taxes, Nov. 2003, at 3 (explaining that very high income taxpayers pay the regular tax rate rather than the AMT, even though the AMT base is broader, because the highest marginal rate under the regular tax exceeds the highest AMT rate).

9. See, e.g., Daniel Shaviro, Tax Simplification and the Alternative Minimum Tax, 91 Tax Notes 1455, 1455-56 (May 28, 2001) (providing an overview of the strong commentary advocating AMT repeal that labels the AMT the "biggest headache" and "asininely stupid"); Shawn Tully, Taxpayer, Beware!, Fortune, June 23, 2003, at 48 (calling the AMT a "morally corrupt rip-off"); Mary Beth Franklin, Prisoners of the AMT, 2003 Kiplinger's Personal Finance 60 (calling the AMT "a ticking time bomb");

that many ordinary taxpayers are unaware of its existence or ill-informed about the interplay of various provisions.[10] They critique the apparent lack of consistency with regular income tax policy, because the AMT sometimes takes back the benefit of specific provisions targeted by Congress to particular statuses, such as the state tax or medical expense deductions.[11] They point out the complexity of multiple computations to determine tax liability and the internal complexity of the AMT provisions themselves.[12] To catch the attention of ordinary Americans and illustrate the reach of the system, various special interest groups highlight the stories of sympathetic "victims" of the elimination of particular preference items.[13]

Those arguments, however, gloss over the negative impact of AMT repeal, when combined with the significant tax reductions for wealthier taxpayers under current federal tax law (including the decrease in taxation of capital gains and dividends, as well as the likely permanent reduction or elimination of estate taxes). AMT repeal would burden ordinary taxpayers with either future tax increases or benefit reductions, if the tax cuts already enacted are not substantially rolled back and no other changes are made.[14] At a time when there is significant and increasing disparity of incomes among taxpayers,[15] AMT repeal would remove one of the tools from the tax system toolbox for defeating high-income taxpayers' ability to shelter economic income and reduce their federal tax burdens. Even prior to the 2002-2003 tax cuts, analysts noted that the benefit of AMT repeal would accrue to higher-income households: "the average tax cut for all households with income above $200,000 [roughly 3% of taxpayers] would rise by $11,000."[16] AMT repeal would thus exacerbate the trend that is shifting the overall federal tax burden away from high-income taxpayers.

Assuming that any attempt to reverse entirely the 2001 and 2003 income and estate tax cuts would meet with insurmountable political

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Shailagh Murray, Firestorm Looms on Minimum Tax, Wall St. J., July 1, 2003, at A4 (calling the AMT a "creeping menace").

10. See David Cay Johnston, Your Taxes: A "Stealth Tax" Is Creeping Up On Growing Numbers Of Americans, N.Y. Times, Feb. 17, 2002, at 317. See infra Part IV.B for further discussion of the transparency issue.

11. See infra Part IV.D for discussion of this issue.

12. See infra Part IV.C for discussion of this issue.

13. See infra Part IV.E for discussion of this issue.

14. See infra Part III.B for discussion of this issue.

15. See infra Part III.A for discussion of this issue.

16. William G. Gale & Samara R. Potter, An Economic Evaluation of the Economic Growth and Tax Relief Reconciliation Act of 2001, 55 Nat'l Tax J. 133, 149 (2002) (citing Jerry Tempalski, The Impact of the 2001 Tax Bill on the Individual AMT, U.S. Treas. Memo (2001)).

resistance,[17] this article argues that there may be a middle road of AMT reform. Distributive justice principles and a general goal of achieving greater coherence within the overall tax system should guide the reforms: these principles should undergird any assessment of the degree of complexity considered permissible and any balancing of tradeoffs between larger deficits and increases in tax burdens (or lost benefits) for particular groups of taxpayers. Generally, distributive justice will be served if AMT reforms more successfully target higher-income taxpayers, to ensure that they shoulder at least some reasonable share of the national tax burden based on a fuller measure of their true economic income. Coherence will be increased if, whenever possible, any AMT and regular tax changes increase transparency, ensure policy consistency between the regular income tax and the AMT, and avoid unnecessary complexity in both systems. In particular, both fairness and coherence will be enhanced if AMT amendments can completely relieve ordinary taxpayers (intended as a non-technical term to include married taxpayers filing jointly with economic incomes less than $100,000 or single taxpayers with economic incomes less than $50,000) from any AMT burden. At the same time, realistic domestic and international revenue needs demand that the price of AMT reforms be met through significant concurrent changes to the regular tax system – and the disallowance of additional preference items through the AMT system.

The argument proceeds as follows. Part II briefly explains the normative perspective, founded on distributive justice principles and a demand for coherent structure, that I believe should guide tax policymakers in making the difficult choices among possible tax reforms. Part III discusses in greater detail the effects of recent amendments to the Code on progressivity, deficits (and the national debt burden), and the reach of the AMT. Part IV considers the most common arguments for outright repeal of the AMT stemming from the resulting downward creep and concludes that there are strong normative, and practical, reasons to retain the AMT despite its flaws. As an alternative to repeal, Part V proposes specific provisions to re-target the AMT to higher income taxpayers and, acknowledging that this cannot be accomplished solely within the AMT, suggests possible harmonizing changes to the regular tax. Part VI concludes.

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17. See, e.g., Meade Emory, Letters to the Editor: Estate Tax Debate Simply Kicked Over 10 Years and to a Very Uncertain Time, 91 Tax Notes 1765 (June 4, 2001) (noting that "opponents of the estate tax simply believe that the body politic will not allow a tax increase of the size represented by the estate tax and Congress will simply extend the repeal of that tax"). But see Martin A. Sullivan, Unfinished Business: The Disappearing Tax Act of 2001, 91 Tax Notes 1652 (June 4, 2001) (noting that the possibility of the estate tax "spring[ing] back to life at the beginning of 2011, one year after it's repealed, and with a top rate of 55 percent" is "absurd and untenable and will never stand" but suggesting that if there are no surpluses, permanent repeal is unlikely).

II. Normative Principles: Coherence and Distributive Justice

Tax policymakers have relied on a number of different criteria for selecting among alternative tax systems. Some of these criteria appear endogenous to tax and the pragmatic needs for an understandable and administrable tax system, such as a general preference for less complex provisions over more complex provisions. Some, such as the concept of structural coherence, relate to the attributes of structures that permit aggregates of items and rules to cohere into an identifiable system or institution. Other criteria, such as fairness or efficiency, derive from general philosophical and economic thought about the way legal and social systems operate and the principles that should guide them. This Part suggests that two such criteria are critical in thinking about AMT reform.

Relying on Dworkin's jurisprudential theory of integrity, I have argued elsewhere that legal systems, such as a tax system, should be construed as a coherent whole, and modifications to the system should be designed and interpreted to conform with that coherent whole.[18] Structural coherence includes within it some concept of consistency across variations. Thus, we generally think that principles of tax law applicable in particular contexts should be consistent with principles of tax law applicable in other contexts, whenever possible. The principle of conservation of basis exemplifies this concept of coherence. Basis tracks after-tax investment, and is adjusted upwards when the investment is increased or downwards when the investment is decreased. We would expect the same principle to apply to adjust basis in the context of personal purchases (such as homes) that applies in the context of corporate investments, to taxable exchanges or to nonrecognition transactions. Structural coherence does not mean, however, that apparently similar rules must be consistent across all contexts. Instead, to the extent there are apparent conflicts between similar rules in different contexts, coherence requires that those conflicts should be susceptible to explanation in terms of overarching themes that justify or provide the rationale for the different contexts themselves.

In the context of AMT reform, coherence cannot require uniformity between the AMT and the regular tax. The essence of the AMT is that it is an alternative system that effects changes compared to the results otherwise extant under a system consisting solely of the regular tax. To be an alternative context, there must be (at least some) different rules. Thus, while consistency across contexts supports coherence and results in a simpler

18. See Book-Tax Conformity and the Corporate Tax Shelter Debate: Assessing the Proposed Section 475 Mark-to-Market Safe Harbor, 24 Va. Tax Rev. 301, 363-70 (2004) (discussing the importance of coherence as a structuring principle, drawing from Dworkin's constitutional theory of integrity, as expounded in Ronald Dworkin, Freedom's Law: The Moral Reading of the American Constitution (Oxford Univ. Press 1996)).

overall system, it is not sufficient to argue, without more, that such and such a provision in the AMT is inconsistent with a superficially similar provision in the regular tax. The rationale for the AMT must be examined, as well as the rationale for the particular type of rule in both systems, to determine what coherence demands.

Fairness is another evaluative criterion that is almost universally considered important for tax policy. Although there is no fixed consensus regarding the core principles that should be applied to evaluate the fairness of a tax system or of particular tax rules, a number of different concepts have been developed and discussed over time. Two common concepts rooted in philosophical thought are ability to pay and benefits received, each generally accompanied by a basic humanitarian view that any tax base should exempt at least a bare subsistence amount for the least-well-off in society.[19] At first glance, these concepts appear straightforward, but there is considerable uncertainty as to their scope because of the difficulty in determining commensurability of either ability to pay or benefits received.[20] In spite of these uncertainties, most acknowledge that tax systems should raise necessary government revenues from those who are most able to pay them

19. See, e.g., Philip D. Oliver, Tax Policy: Readings and Materials 176, 178 (Foundation Press, 2d ed. 2004) (quoting Charles O. Galvin & Boris I. Bittker, The Income Tax: How Progressive Should It Be? (1969), in which Bittker points out that ability to pay, benefits received and other principles such as equality of sacrifice and reduction of inequality have long been used as justification for progressivity and that some progressivity is inevitable to account for subsistence exemptions). But see Stephen Holmes & Cass R. Sunstein, The Cost of Rights: Why Liberty Depends on Taxes (W.W. Norton & Co. 1999) (distinguishing between "[t]axes [that] are levied on the community as a whole, regardless of who captures the benefits of the public services funded thereby" and "[f]ees ... [that] are charged to specific beneficiaries in proportion to the services they personally received").

20. Oliver, supra note 19, at 176-77 (again quoting Bittker, who suggests that all four principles reduce to a concept of determining the appropriate level of individual "sacrifice" to fund government, without a satisfactory theory of commensurability). For a discussion of the New School economists' development of the ability-to-pay concept and their response to conservative arguments for the benefits-received concept, see Ajay K. Mehrotra, Building the Modern American Fiscal State: Progressive-Era Economists and the Intellectual Foundations of the U.S. Income Tax (2004), at http://www1.law.ucla.edu/~taxpolicy/Documents/2005/Papers/Mehrotra/Akm%20UCLA%20Tax%20Sym.pdf (contrasting libertarian theories that emphasize the individual and support taxation on the basis of benefits received (i.e., property rights protection) with the ability-to-pay concept, based on a theory that taxes are an obligation of citizenship and serve to counterbalance inequalities created by wealth aggregation). For more detailed analysis of the benefits received theory as a theoretical basis for progressive taxation, see the following: Galvin & Bittker, supra note 19, at 48-55; Edwin R.A. Seligman, Progressive Taxation in Theory and Practice 150-204 (1908); Walter J. Blum & Harry Kalven, Jr., The Uneasy Case for Progressive Taxation, 19 U. Chi. L. Rev. 417, 451-55 (1952).

and in ways that permit those less fortunate to maintain a decent standard of living. Some also consider it reasonable to justify tax burdens, at least in part, in terms of the public and private benefits people receive from the government's protection of property rights and individual liberties and provision of a stable and supportive environment for commercial markets, contracting and litigation.[21] While these two concepts of ability to pay and benefits received may not provide a sharply delineated normative justification for a particular tax system, they are consonant with a tax regime that raises government revenues disproportionately from those who are able to amass disproportionate levels of wealth and enjoy disproportionate levels of actual and virtual consumption,[22] status, and power because of that

21. See, e.g., Liam Murphy & Thomas Nagel, The Myth of Ownership: Taxes and Justice (Oxford Univ. Press 2002) (arguing that taxation should be viewed as one of the institutions of government without which property and other rights could not exist, and that fair distribution of the tax burden should not be based on mere comparisons of each person's pre-tax income).

22. Edward McCaffery has consistently advocated abandonment of the income tax base for a consumption tax on the grounds that the only concern about wealth is its use, not its amassment. See, e.g., Edward J. McCaffery, Ten Facts About Fundamental Tax Reform, 101 Tax Notes 1463, 1464-65 (Dec. 22, 2003) [hereinafter, Ten Facts] (asserting the superiority of a postpaid consumption tax because it taxes income when spent rather than when it flows into a household, thus advantaging deferred consumption over current consumption); Edward J. McCaffery, The Fair Timing of Tax (Sept. 2003), U.S.C. L. Sch. Olin Research Paper No. 03-21, at http://ssrn.com/abstract=441344 [hereinafter, Timing] (similar position); Edward J. McCaffery, The Uneasy Case for Wealth Transfer Taxation, 104 Yale L.J. 283 (1994) [hereinafter, Uneasy Case] (similar position); Edward J. McCaffery, The Political Liberal Case Against the Estate Tax, 23 Phil. & Publ. Aff. 281 (1994) [hereinafter, Liberal Case] (similar position). In contrast, treatment of "virtual consumption" as relevant to the fairness inquiry suggests that a consumption tax that reaches only use fails to fully tax consumption, which should include the added status, power, influence and personal security afforded by the mere possession of wealth. See Anne Alstott, The Uneasy Liberal Case Against Income and Wealth Transfer Taxation: A Response to Professor McCaffery, 51 Tax L. Rev. 363, 370-71 (1996) [hereinafter, Response] (criticizing McCaffery's "[u]ntenable [d]istinction [b]etween [p]ossession and [u]se" because of its disregard of the influence that can be enjoyed without wealth consumption); Thomas R. Ireland, Inheritance Justified: A Comment, 16 J. L. & Econ. 421, 421 (1973) (stating that "the primary functions of wealth accumulation are not in fact leaving wealthy heirs, but rather the status and social power inherent in holding a variety of wealth forms"). A consumption tax that failed to reach this virtual consumption would be flawed, in much the same way that an income tax base that fails to reach imputed income is flawed. Furthermore, the fairness concerns that appear to support a consumption tax base, that privileges private savings over consumption, fall short of the demands of liberal egalitarianism. See Alstott, supra, at 370-83 (discussing these ideas in depth).

wealth.[23] These concepts suggest that the tax system should be able to allocate the burdens of support of the government among those most able to pay for, and most likely to benefit from, the enhancement of the physical, fiscal, commercial and social environment provided by that government for the benefit of the polity.

Commentators also frequently refer to the concepts of horizontal and vertical equity as components of the "ability to pay" tax fairness concept.[24] As generally understood, horizontal equity requires that taxpayers with the same ability to pay be taxed alike, while vertical equity requires that people with different abilities to pay be taxed differently. Vertical equity supports a progressive tax system that imposes graduated rates ranging from 0% (an exemption from tax) for those at the bottom to relatively high rates applicable at the top of the scale. As with the ability-to-pay concept generally, horizontal and vertical equity both require an answer as to what "counts as" the same ability to pay. Is income the appropriate measure, or should we also consider wealth? The decision as to what items to include may predetermine the equity conclusion. The uncertainties, and the related debate over progressivity, go back to the origins of the federal income tax in the 1860s, when Congress considered whether to have a flat rate system or a graduated rate structure.[25] In spite of periods of stronger opposition,

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23. For example, Holmes & Sunstein note that many uses of tax revenues, including the many services that defend private property, accrue to the benefit of the wealthy. Holmes & Sunstein, supra note 19, at 14-15, 24-25. Marjorie Kornhauser provides a more extensive discussion of the argument for progressive rates based on the benefits received theory in Marjorie E. Kornhauser, The Rhetoric of the Anti-Progressive Income Tax Movement: A Typical Male Reaction, 86 Mich. L. Rev. 465, 491-97 (1987) (noting that connecting redistribution to progressivity may be misleading, to the extent that higher income taxpayers enjoy disproportionate benefits).

24. The discussion of horizontal and vertical equity in this paragraph of the text relies primarily on an exchange between Richard Musgrave and Louis Kaplow. See, e.g., Richard A. Musgrave, In Defense of an Income Concept, 81 Harv. L. Rev. 44 (1967) (arguing that horizontal and vertical equity are aspects of a single fairness measure); Louis Kaplow, Horizontal Equity: Measures in Search of a Principle, 42 Nat'l Tax J. 139 (1989) (arguing that vertical equity is the appropriate fairness measure because focus on horizontal equity merely preserves the status quo); Richard A. Musgrave, Horizontal Equity, Once More, 43 Nat'l Tax J. 113 (1990) (reconsidering his conclusion that horizontal equity is derivative of vertical equity); Louis Kaplow, A Note on Horizontal Equity, 1 Fla. Tax Rev. 191 (1992) (disputing the independent importance of horizontal equity); Richard A. Musgrave, Horizontal Equity: A Further Note, 1 Fla. Tax Rev. 354 (1993) (restating the case for horizontal equity).

25. See, e.g., Joe Thorndike, An Army of Officials: The Civil War Bureau of Internal Revenue, 93 Tax Notes 1739, 1751, 1758-59 (Dec. 24, 2001) (describing the discussion in the Senate Finance Committee regarding the rates for the Revenue Act of 1864, in which Republican Sen. Grimes argued for graduated rates because of rich taxpayers "greater ability to pay" and against consumption taxes because they are

Congress has consistently treated progressivity as a fundamental aspect of the federal tax system,[26] and scholars who take seriously the need to define the normative foundations of tax policy continue to explore this ongoing consensus in favor of progressivity. For example, in a recent article, Thomas Griffith suggests that a redistributively progressive tax increases people's happiness because of the primary importance of relative, rather than absolute, incomes.[27]

Under their broadest interpretations, horizontal equity seems to mandate the maintenance of the status quo, while vertical equity seems to require the dismantling of the status quo. This inherent conflict supports location of the determinative principles in a broader, exogenous framework of distributive justice rather than a tax-specific framework of competing fairness concepts.[28] In considering the importance of progressivity to AMT reform, therefore, I take as fundamental two principles that echo through the foundations of modern theories of law and society: first, that society, through the tax system, should allocate the tax burden according to capacity, without requiring a sacrifice from those fundamentally unable to pay; and second,

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"broadly regressive" and later repeal of the income tax due to an upper class "anti-tax crusade" aimed at discrediting the progressive tax system).

26. See, e.g., M. Susan Murnane, Selling Scientific Taxation: The Treasury Department's Campaign for Tax Reform in the 1920s, 29 Law & Soc. Inquiry 819 (2004) (discussing the use of propaganda by proponents of the Mellon proposal for reduced surtaxes on the wealthy in the context of a long-existing consensus favoring progressivity, which created support for some reduction in the steepness of the rate structure, on the basis that wealth creation by high-income beneficiaries of the rate reform would trickle benefits down to those in lower income brackets, but retained a strong concept of progressivity).

27. Thomas D. Griffith, Progressive Taxation and Happiness, 45 B.C.L. Rev. 1363, 1381-88 (2004). See also Marjorie E. Kornhauser, Educating Ourselves Towards a Progressive (and Happier) Tax: A Commentary on Griffith's Progressive Taxation and Happiness, 45 B.C.L. Rev. 1399, 1401-02 (2004) (asserting that "despite apparent widespread criticism of progressivity, most people do not oppose some degree of redistribution by means of a progressive tax"). Another recent article considers empirical evidence for inequality aversion and concludes that individuals' preferences reflect mixed concerns for their own payoffs and for averting inequality for others. See Lucy F. Ackert, Jorge Martinez-Vazquez & Mark Rider, Tax Policy Design in the Presence of Social Preferences: Some Experimental Evidence, Fed. Res. Bank of Atlanta Working Paper No. 2004-33 (Dec. 2004), at http://www.frbatlanta.org/filelegacydocs/wp0433.pdf (reporting on student experiments testing preferences for various tax models).

28. The primary competitor to a philosophical concept of distributive justice as the *grundsatz* of tax policy is economic theory. See, e.g., Paul R. McDaniel & James R. Repetti, Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange, 1 Fla. Tax Rev. 607 (1993) (concluding that normative content can derive only from economic or philosophical theories). Economic efficiency is neither irrelevant to, nor an improper consideration in, the development of the specifics of a tax regime that is founded on distributive justice principles.

that society, by means of the tax system, should move towards a more egalitarian distribution of resources in support of a framework in which all members of society are treated with equal respect. These distributive justice principles derive from the personal liberty reserved to each person *as an actor within the social community*: the individual deserves respect on his or her own terms *from* the social community, and that respect requires that the individual have equal access to opportunities to prosper and engage in meaningful relationships *within* the social community.[29] According to John Rawls, individuals can cooperate in determining the characteristics of a just society by placing themselves in a position of ignorance about their own attributes.[30] Christian theology assumes that individuals can make just decisions by applying the "Golden Rule" to do unto others as they would have done unto themselves. Essential to both these philosophical and theological approaches to justice are an understanding of the personal worth of the individual and of the individual's rights to a meaningful and respectful relationship with community members.[31]

These principles also stem from the nature of a democratic polity that requires a viable national dialogue[32] and disdains both dictatorship, the

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29. See, e.g., Amartya Sen, Development as Freedom (Knopf, 1999) (stressing the importance of equal access to opportunity to both economic development and human freedom).

30. John Rawls, A Theory of Justice 118-23 (Belknap Press Rev. Ed. 1999).

31. See generally Philip N. Pettit, Rawls' Political Ontology (Fall 2004), Pol., Phil. & Econ. (forthcoming), at http://ssrn.com/abstract=600704 (explaining Rawls' view of political society as a cooperative venture that is neither a solidarist agency nor an aggregate of singular agents because of the engagement in political debate about the appropriate concept of justice). Elizabeth Anderson emphasizes the importance of "creat[ing] a community in which people stand in relations of equality to others" in her elaboration of democratic egalitarianism's goal of addressing our needs as humans (rights to shelter, food and other necessities), as participants in a social community (access to education, public accommodations, medical facilities) and as citizens (rights to vote and voice one's opinions), in Elizabeth S. Anderson, What is the Point of Equality?, 109 Ethics 287, 289, 317-19 (Jan. 1999). Democratic egalitarianism, as set forth by Anderson, does not lead to a requirement of equal distribution of resources, but it requires sufficient redistribution to abolish socially created oppression and support a community of reciprocation and consultation. Id. at 313 (contrasting a relational theory of equality with a purely distributional theory of equality); id at 320 (noting requirement of "effective access to enough resources to avoid being oppressed by others and to function as an equal in civil society"). It may be, however, that only a roughly equal distribution of resources can prevent class stratification and co-option of government for the benefit of the wealthier and hence more powerful classes.

32. See Anderson, supra note 31, at 322-24 (discussing the development of an overlapping consensus in democratic societies); Bruce A. Ackerman, Social Justice in the Liberal State 5 (Yale Univ. Press 1980) (discussing the "comprehensive insistence on dialogue" as a fundamental requirement for determining the nature of a cooperative

concentration of power in one person, and oligarchy, the concentration of power in a group of people of certain status.[33] Whatever the exact nature of the underlying principle that both facilitates and derives from the dialogue among members of a society, the concept supports a theory of redistribution, supported by progressive mechanisms, to protect that dialogue by preventing undue accumulation of brute power in the hands of a few.[34] Recent academic commentary has increasingly focused on the negative impact of inequality of asset distribution on both economic growth (which is a societal goal because it offers the possibility of lifting the standard of living of all members of the society) and democratic institutions (which themselves make possible individual liberties within the state infrastructure).[35] These studies show a

society); Robert Putnam, Making Democracy Work: Civic Tradition in Modern Italy (Princeton Univ. Press 1993) (similar insistence on the importance of civic dialogue).

33. See, e.g., Reuven S. Avi-Yonah, Risk, Rents, and Regressivity: Why the United States Needs Both an Income Tax and a VAT, 105 Tax Notes 1651, 1654-55 (Dec. 20, 2004) (presenting arguments for curbing excessive accumulations of power, and discussing Michael Walzer's view, in Spheres of Justice: A Defense of Pluralism and Equality (1983), that redistributive taxes are required to curb the harmful effects of concentrations of wealth); Reuven S. Avi-Yonah, Book Review: Why Tax the Rich? Efficiency, Equity, and Progressive Taxation: Does Atlas Shrug? The Economics Consequences of Taxing the Rich. Edited by Joel B. Slemrod, 111 Yale L.J. 1391, 1407-09 (2002) (noting the concern that accumulations of wealth and power constrains civic republicanism).

34. Commentators have long recognized the link between progressivity and redistribution, with varying emphasis on the income base and on taxation of wealth transfers at death. See, e.g., Henry C. Simons, Federal Tax Reform 12 n.9 (Univ. of Chi. Press 1950) (making the case for "steep progression" in the income tax "to correct excessive economic inequality and to preclude inordinate, enduring differences among families or economic strata in wealth, power, and opportunities"); Steven A. Bank, The Progressive Consumption Tax Revisited, 101 Mich. L. Rev. 2238 (2003) (emphasizing liberals' focus on the link between progressive taxation and an income base in analyzing progressive consumption tax arguments); Alstott, Response, supra note 22, at 364 (highlighting the importance of "an estate tax and, under some conditions, a progressive income tax" in "correcting disparities in the distribution of wealth and power that tend to undermine important principles of justice").

35. See, e.g., Joel S. Hellman & Daniel Kaufmann, The Inequality of Influence (Dec. 2002), at http://ssrn.com/abstract=386901 (noting that inequality of wealth leads to inequality of influence and subversion of institutions and referencing the literature on inequality) [hereinafter, Inequality]. See generally Alan B. Krueger, Inequality, Too Much of a Good Thing, 1-75, 11, in James J. Heckman & Alan B. Krueger, Inequality in America: What Role for Human Capital Policies? (MIT Press 2003) (noting marked recent trend towards greater inequality in the US compared to other advanced economies and summarizing reasons that inequality harms democratic societies by leading to a "more polarized and static society"); Edward L. Glaeser, Jose A. Scheinkman & Andrei Shleifer, The Injustice of Inequality (Aug. 2002), Harv. Inst. Research Working Paper No. 1967, at http://ssrn.com/abstract=321261 (presenting a model of institutional subversion by the wealthy for their own benefit); Abhijit Banerjee & Andrew Newman,

"strongly negative impact" of inequality on important institutional attributes such as fairness and impartiality of courts, levels of tax compliance, and bribery.[36] Further, scholars have explored the government's right to utilize a portion of an individual's purported earnings for societal purposes (with redistributive effect, unless a direct quid pro quo for benefits received) based on the role of society in providing the framework in which the accumulation of those assets is possible.[37]

In pursuing distributive justice, it is "the overall progressivity of the fiscal system, not that of any single instrument within it, [that] really matters."[38] Justice is not satisfied by progressive rate structures *per se*, but rather requires redistributional results that reduce inappropriate concentrations of power by moving towards a more egalitarian equilibrium, taking tax bases and wealth transfer provisions into account.

One further aspect of the demands from justice should be noted. For democratic egalitarianism to succeed among a diverse citizenry, there must also be a feedback loop. Rule of law, that is, demands transparency, so that citizens can understand, comply with, and support or object to the applicable laws. This demand for transparency is perhaps heightened in respect of tax systems, which must necessarily cover a wide range of economic transactions and situations and hence involve complex sets of rules. Transparency therefore requires that diverse and full information about the tax system be readily available – including information about the potential applicability of special rules such as the AMT. Furthermore, because the allocation of the tax burden among taxpayers is such a central aspect of tax justice, full information about the distribution of income, payroll, estate and gift tax burdens among groups of taxpayers must be published by the government in a form widely available and comprehensible to the members

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Risk Bearing and the Theory of Income Distribution, in 58 Rev. of Econ. Studies 211-34 (1991) (discussing effects of inequality of income distribution); Klaus Deininger & Pedro Olinto, Asset Distribution, Inequality, and Growth (2000), World Bank Policy Research Working Paper No. 2375, at http://econ.worldbank.org/docs/1128.pdf (confirming that highly unequal asset distribution has negative impact on growth and on educational intervention).

36. See, e.g., Hellman & Kaufman, Inequality, supra note 35 (reporting the "substantial literature" regarding the ability of the wealthy to use their superior resources to impact economic growth and governmental or political institutions and focusing on the "crony bias" that develops to subvert institutions).

37. See, e.g., Murphy & Nagel, supra note 21 (developing a theory of taxation based on the role of governmental institutions in furthering individuals' productivity); Joel Slemrod, The Economics of Taxing the Rich, in Does Atlas Shrug? The Economic Consequences of Taxing the Rich, 1, 8-10 (Joel Slemrod, ed., 2000) (noting the arguments for equality from ability to pay and inequality of political power, as well as the difficulty in ascertaining what inherent right an individual may have in what is earned because of the role of government in making that income possible).

38. Shaviro, supra note 9, at 1461.

of the polity. The people must be able to understand the redistributive effects of government policies (or lack thereof) so that those effects can be taken into consideration in the dialogue among the citizenry regarding fundamental principles.

III. TAX CUTS, THE FEDERAL BUDGET, AND AMT APPLICABILITY

In addition to the normative principles set out in the prior Part, other considerations relevant to the potential for AMT reform include the current drive towards overall Code amendment, the federal budgetary situation, and the interaction of those factors with the AMT. Recent changes in the tax law reflect an apparently growing trend towards non-taxation of investment earnings and the closing of the tax liability gap between ordinary taxpayers and those at the highest income levels.[39] One cause of this trend is the renewed fascination with consumption tax proposals, usually in the guise of a flat, wage-based tax replacing the graduated, wage-and capital-based income tax.[40] Capitalizing on ordinary Americans' desire for simplicity, lack of understanding of the ultimate redistributive effects of various provisions,[41]

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39. Internal Revenue Service, Strategic Plan 2005-2009, 18 (July 2004), at http://www.irs.gov/pub/irs-utl/strategic_plan_05-09.pdf (last visited July 24, 2004) (indicating that about one-third of the approximately $300 billion "tax gap" is due to high-income individuals).

40. A thorough review of consumption tax proposals is well beyond the scope of this article: the various theories have been thoroughly vetted in a range of commentary. See, e.g., Robin Cooper Feldman, Consumption Taxes and The Theory of General and Individual Taxation, 21 Va. Tax Rev. 293, 296 & nn.1-2 (2002) [hereinafter, Consumption Taxes] (noting the considerable attention currently being given to flat tax proposals and referencing in the notes several of the key proposals and commentary); Avi-Yonah, supra note 33, at 1652-53, 1660-61 (providing a brief discussion of various consumption tax proposals, including prepaid and postpaid (cash flow) consumption taxes). The recent interest in consumption taxes stems most directly from books by Robert Hall and Alvin Rabushka that familiarized a broader public with the basic concepts. Robert E. Hall & Alvin Rabushka, Low Tax, Simple Tax, Flat Tax (1983); Robert E. Hall & Alvin Rabushka, The Flat Tax (2d ed. 1995) (introducing the contemporary flat tax proposal).

41. See Baron & McCaffery, infra note 254 (showing that a range of heuristics and biases interferes with people's understanding and support of redistribution, and that people do not generally understand the reduction in progressivity that results from tax expenditures and cuts in government services). This lack of understanding underscores the importance of government dissemination of information about distributional effects highlighted in Part II. Perhaps not surprisingly, various consumption tax supporters advocate elimination of distributional tables. See, e.g., Joseph J. Thorndike, Tax Analysts Exclusive Conversations: Daniel J. Mitchell, 103 Tax Notes 416, 419 (Apr. 26, 2004) (advocating elimination of distributional tables from Congressional studies of tax changes or reflection only of lifetime consumption and not income, in accord with the Heritage Foundation's position in support of a flat consumption tax); Jason J. Fichtner,

and frustrations with a federal income tax system that is often characterized as "too complex, too easily evaded by the wealthy, and too likely to distribute the burdens of taxation to the people least able to bear it,"[42] proposals for a flat consumption tax have enjoyed varying support for the past thirty years.[43] Up until recently, however, proposals phrased in terms of eliminating the income tax system as we know it have not fared well with the American public or with Congress.[44]

A Comparison of Tax Distribution Tables: How Missing or Incomplete Information Distorts Perspectives (Joint Econ. Comm., Dec. 2003), at http://www.house.gov/jec/tax/12-19-03.pdf (arguing on behalf of flat tax supporter Jim Saxton that many tax distribution tables are "incomplete" and "misleading" and may "unduly influence" tax policy makers and attacking in particular distributional tables that reveal non-standard information about tax cuts, such as the impact on economic family units or the impact when imputed income from housing is taken into account).

42. Bank, supra note 34, at 2238.

43. See, e.g., Hall & Babushka, supra note 40 (proposing a flat tax that is a variant of a value-added tax); Daniell J. Mitchell, Heritage Foundation, Flat Tax or Sales Tax? A Win-Win Choice for America, The Heritage Foundation Backgrounder No. 1134, at 1 (Aug. 14, 1997) (advocating replacement of the income tax with either a flat tax or a national retail sales tax because the income tax system "not only penalizes productive behavior, but also violates the fundamental constitutional principle of equal treatment under the law"), at http://www.heritage.org/Research/Taxes/BG1134.cfm; William D. Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 Harv. L. Rev. 1113 (1974) (in the seminal article in the renewed debate over tax bases, arguing that a consumption tax reduces inequities, distortions, and complexities present in the income tax system). Steve Forbes also ardently advocated a flat tax during the 1996 presidential campaign, with the support of House majority leader Dick Armey. Lawrence Zelenak, The Selling of the Flat Tax: The Dubious Link Between Rate and Base, 2 Chap. L. Rev. 197, 198 (1999). At the same time, Bill Archer, chair of Ways and Means in the House, joined Richard Lugar in advocating a national retail sales tax generally to replace the current income tax system. Americans typically understand the reform proposals as calling for a flat rate structure, although most flat-taxers admit that there will need to be a zero bracket to protect the least fortunate Americans from bearing an untenable tax burden. These flat tax proposals have, however, "always concealed the more radical proposal to exempt savings and investment from the tax base." Bank, supra note 34, at 2238. Under the generally accepted Haig-Simons definition, income is the sum of savings and consumption. See Robert M. Haig, The Concept of Income – Economic and Legal Aspects, in The Federal Income Tax 1, 7 (Robert M. Haig, ed. 1921). A consumption tax that eliminates tax on the return to investment or savings therefore has smaller scope than an income tax.

44. See, e.g., Ryan J. Donmoyer, In Election Year Gambit, House Votes to Scrap Code, 79 Tax Notes 1533 (June 22, 1998) (discussing H.R. 3097, the Tax Code Termination Act, introduced by Rep. Largent, which would discard the current income tax system in favor of a flat consumption tax). The House passed the bill, which was referred to the Senate Finance Committee. 144 Cong. Rec. S6563 (June 18, 1998). The bill never made it to the Senate floor.

In spite of its past reluctance, Congress has recently expanded existing provisions that treat retirement savings favorably and enacted new provisions that have transmuted the federal tax system into a hybrid system with a number of consumption tax features.[45] One commentator has termed it an "evolution," rather than revolutionary tax reform.[46] The 2001 tax legislation (referred to herein by its acronym, EGTRRA) increased traditional and Roth IRA contribution limits from $2,000 to $5,000 in 2008 and 401(k) account contributions from $10,000 to $15,000 in 2006 (with indexing to maintain those amounts).[47] New provisions permit taxpayers in their prime earnings years (over 50) to make even larger contributions ($1000 more for IRAs, $5000 more for 401(k)s).[48] EGTRRA also created a new Saver's Credit, declining from 50% for those with incomes of $30,000 or less to 10% for those with incomes between $32,000 and $50,000.[49] Other provisions that treat savings preferentially include the flexible medical savings plan.[50] These savings provisions are generally of benefit only to those with sufficient income to increase their savings; moreover, the medical savings account requires both a sufficient salary and ability to plan ahead for regular medical expenses. Recent administration proposals call for expanding existing provisions to permit personal savings plans with tax-free yields that can be used for *any* purpose,[51] a proposal that, if enacted, would likely lead to renewed calls for an unlimited savings allowance or other version of a

45. See, e.g., McCaffery, Ten Facts, supra note 22, at 1465 (noting the expansion of savings accounts as part of a move towards a flat, wage-based tax).

46. Daniel S. Goldberg, The U.S. Consumption Tax: Evolution, Not Revolution, 57 Tax Law. 1 (2003).

47. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, §§ 601(a), 611(d), 115 Stat. 38.

48. Id. at §§ 601(a)(2)(B), 631(a).

49. Id. at § 618.

50. IRC § 223, enacted by the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, Pub. L. 108-173, 117 Stat. 2066 (Dec. 8, 2003), provides for health savings accounts whereby contributions are deductible, earnings are not includible in gross income while held in the account, and distributions used for qualified medical expenses are excluded from income.

51. See Press Release, Office of Public Affairs, The President's Savings Proposals: Tax-Free Savings and Retirement Security Opportunities for All Americans (Feb. 2, 2004), at http://www.treas.gov/press/releases/js1131.htm (detailing the savings initiatives included in the administration's fiscal year 2005 budget); H.R. 4078, 108th Cong. (2004), as introduced by Representative Johnson in the House on March 31, 2004, and S. 2263, 108th Cong. (2004), as introduced in the Senate that same day by Senator Thomas. These additional incentives for savings could cost the Treasury as much as $300 billion over the next decade. Leonard E. Burman, William G. Gale, & Peter R. Orszag, The Administration's Savings Proposals: Preliminary Analysis, 98 Tax Notes 1423, 1423 (Mar. 3, 2003).

consumption tax.[52] This agenda to exempt investment has been applauded in particular by those on the extreme right, such as Grover Norquist, who support wage-based taxation.[53] Continued piecemeal expansion would inevitably benefit the super-wealthy, whose incomes easily exceed their consumption, most of all.[54] The tax cuts themselves have also starkly changed the direction of the Code. Rates have declined precipitously,

52. Enactment of more unrestricted savings plans would likely make possible a return of the 1995 Senate proposal for a consumption tax, called the USA Tax for its primary emphasis on an unlimited savings allowance. See USA Tax Act of 1995, S. 722, 104th Cong (1995) (providing for a progressive rate of 19-40% on a cash flow consumption base that allows an "unlimited savings allowance" deduction). See also Joel Slemrod & Jon Bakija, Taxing Ourselves: A Citizen's Guide to the Great Debate Over Tax Reform 262-71 (MIT Press, 3d ed. 2004) (discussing rates necessary to raise revenues under various consumption tax proposals; suggesting that a national retail sales tax rate of as much as 40% might be required , and that a rate of about 35% would be necessary for the graduated "X-tax" proposed by David Bradford). A new tax reform panel, meeting first in February 2005, has already begun investigation of the possible replacement of the income tax with a consumption tax base. See, e.g., Opening Statement by Senator Connie Mack, President's Advisory Panel on Federal Tax Reform (Feb. 16, 2005) (emphasizing the comparison of income and consumption tax bases); Louis Kaplow, Income and Consumption Taxation: Central Concepts (Feb. 16, 2005) (presentation to the reform panel contrasting the two bases); William G. Gale, A Comparison of Income and Consumption Taxes: A Presentation to the President's Advisory Panel on Federal Tax Reform (Feb. 16, 2005). These presentations are available at the panel's website at http://www.taxreformpanel.gov.

53. See Grover Norquist, Step-by-Step Tax Reform, Wash. Post, June 9, 2003, at A21 (asserting that Bush is taking "deliberate steps" towards a "single-rate tax," including abolishing the estate and capital gains taxes, creating accounts that permit unlimited tax-free savings, permitting businesses to deduct all business investment, and abolishing the AMT).

54. Some assert that a progressive consumption tax avoids these harms. See, e.g., McCaffery, Timing, supra note 22 (arguing that a progressive cash-flow consumption tax is fair because it increases the tax burden when capital transactions are used to enhance labor earnings); Edward J. McCaffery, Fair Not Flat: How to Make the Tax System Better and Simpler (Univ. of Chi. Press 2002) (similar). Others have argued that the only difference between an income and consumption tax is a tax on the purportedly nominal risk-free return of capital. See, e.g., David F. Bradford, Consumption Taxes: Some Fundamental Transition Issues, in Frontiers of Tax Reform 13, 129 (Michael J. Boskin ed. 1996) [hereinafter, Fundamental Issues] (distinguishing consumption and income taxes based on treatment of risk-free return); Daniel Shaviro, Replacing the Income Tax with a Progressive Consumption Tax (Sept. 2003), NYU L. Sch. Pub. L. Research Paper No. 70, at http://ssrn.com/abstract=444221 (last visited Oct. 21, 2004) (arguing that consumption tax only exempts nominal risk-free return and burdens even unspent wealth). But see Avi-Yonah, supra note 33, at 1656-58 (arguing that the income tax reaches risky returns and that the risk-free return is higher than posited by proponents of consumption taxation).

especially rates on capital gains. EGTRRA also phased in repeal of the estate tax (though slated as only temporary repeal, unless changed).

These changes to the Code highlight increasing equity concerns. The increase in the federal deficit and federal debt burdens, combined with the targeting of the tax cuts, result in a substantial intergenerational transfer. The looming applicability of the AMT to a majority of taxpayers, rather than to those with substantial financial security, is inextricably linked to the first two results. As noted by two prominent tax analysts, "[n]o permanent tax cut proposal can be sensibly discussed without addressing the alternative minimum tax."[55] The next three Sections explore each of these developments in more detail.

A. Overall Federal Tax System Progressivity

America is characterized by increasing income disparity, with more people living in poverty while more CEOs earn millions.[56] Even as the gap between the rich and the poor in the United States expands into a chasm,[57]

55. William G. Gale & Peter R. Orszag, Should the President's Tax Cuts Be Made Permanent?, 102 Tax Notes 1277, 1277 (Mar. 8, 2004) (noting that the Bush administration's 2005 budget does not address the long-term AMT problem). See also Alan J. Auerbach, William G. Gale & Peter R. Orszag, Bush Administration Tax Policy: Introduction and Background, 104 Tax Notes 1291, 1294 (Sept. 13, 2004) (predicting that if the AMT is not amended, it will "eventually erase all of the income tax cuts provided in the 2001 and 2003 legislation").

56. See, e.g., U.S. Census Bureau, 2003 American Community Survey, Change Profile 2001-2002 tbl. 3 (Aug. 15, 2003) [hereinafter, 2003 ACS Change Profile], at http://www.census.gov/acs/www/Products/Profiles/Chg/2002/0102/Tabular/010/010 00US3.htm (showing that approximately 1.3 million more Americans were living in poverty in 2002 than in 2001); David A. Hartman, Does Progressive Taxation Redistribute Income? 3 (Feb. 2002), Inst. for Pol'y Innovation Policy Report No. 162, at http://www.ipi.org (reporting that "since [1971] there has been a steady increase in before and after tax income share of the top 10 percent [of income earners], necessarily matched by declining income share before and after tax of the remaining 90 percent"); James Maule, How Much is Enough? (June 28, 2004), at http://www.mauledagain.blogspot.com (last visited Oct. 21, 2004) (noting that the two top-paid CEOs in a recent Philadelphia Inquirer report earned $35.9 and $34.9 million in 2003, with average CEO pay increases at 33% and median earnings at $700,000, while the typical dentist in the Philadelphia area earns $132,000 a year). Thus, even among professionals, there are substantial gaps between income brackets of the haves and the have-mores.

57. See, e.g., 2003 ACS Change Profile, supra note 56, at tbl. 3 (showing that the percentage of Americans living below the poverty line increased from 12.1 in 2001 to 12.4 in 2002 and that the number of families in poverty increased from 6.6 million to nearly 7 million in 2002); Angie Rodgers & Ed Lazere, DC Fiscal Policy Institute, Income Inequality in the District of Columbia is Wider than in Any Major U.S. City 1 (July 23, 2004), at http://www.dcfpi.org/7-22-04pov.pdf (reporting that the top 20% of

the rich continue to be the primary beneficiaries of both the gradual erosion of the income tax base towards a near-flat wage-based system and the package of 2001-2003 tax cuts.[58] The expanded retirement savings possibilities provide little, if any, benefit to the majority of ordinary wage-earners, most of whom cannot afford to contribute the maximum amount permitted by pre-2001 limits;[59] instead, the new provisions benefit those who were constrained by the former limits – those who "are already the best-prepared for retirement."[60] The 2003 tax cuts contributed even more clearly

households in DC have 31 times the average income of the bottom 20%); Richard Westin, Modifying the Federal Tax Framework to Stimulate Employment Without Violating GATT Principles, 103 Tax Notes 335, 337 (Apr. 19, 2004) (noting that the wealthy are getting wealthier and the top tax rates are declining, citing Caroline Tolbert, Direct Democracy and Institutional Realignment in the American States, 2003, 118 Political Science Quarterly 467 (Sept 22, 2003)); Bob Herbert, Oblivious in D.C., N.Y. Times, June 30, 2003, at A21 (noting that "the wealthiest 400 taxpayers accounted for more than 1 percent of all the income in the United States in 2000, 'more than double their share just eight years earlier'"); Alstott, Response, supra note 22, at 367 & n.20 (in 1996, citing articles by Wolff, Bradsher and Gramlich indicating that "already-large inequalities in income and wealth in the United States continue to grow"); Jon E. Hilsenrath & Sholnn Freeman, Affluent Advantage: So Far, Economic Recovery Tilts to Highest-Income Americans, Wall St. J., July 20, 2004, at A1 (noting increased wage and income disparities accompanying a surge in luxury brand consumer spending by the wealthy).

58. See Citizens for Tax Justice, Effects of First Three Bush Tax Cuts Charted 1 (June 4, 2003), at http://www.ctj.org/pdf/allbushcut.pdf (top 1% will receive an average 15% cut in federal taxes between 2003 and 2010 while bottom 20% will receive an average cut of only 10% and the next three quintiles will receive average cuts of only 12%, 9% and 7%). See also Dana Milbank & Jonathan Weisman, Middle Class Tax Share Set to Rise: Studies Say Burden of Rich to Decline, Wash. Post, June 4, 2003, at A-1 (noting that "[c]onservatives and liberals alike agree that Bush's tax policies have shifted more of the tax burden to the middle class"). William Gale and Peter Orszag conclude that making the tax cuts permanent will cause the average tax rate of the top 1% of taxpayers to fall more than that of any other group, with an average tax cut (in dollars) that is 80 times that for middle-income taxpayers. William G. Gale & Peter R. Orszag, Bush Administration Tax Policy: Distributional Effects, 104 Tax Notes 1559, 1560 (Sept. 27, 2004). Gale and Orszag also conclude that the after-tax income of the poorest 20% of Americans will rise only .3% by 2011, while the after-tax income of the richest 1% will increase by 6.4%. Id. at 1561 tbl. 1.

59. See Len Burman & Troy Kravitz, Lower-Income Households Spend Largest Share of Income, 105 Tax Notes 875, 875 (Nov. 8, 2004) (reporting on data from Consumer Expenditure Survey that shows that low-income families exhaust "virtually all" their incomes while high-income (over $200,000) families "spend less than 40 percent"); Richard L. Kaplan, Book Review of Kevin Phillips, Wealth and Democracy, 101 Mich. L. Rev. 1987, 1996-99 (2003) (suggesting that increasing retirement savings incentives will increase economic inequality).

60. William G. Gale & Peter R. Orszag, A New Round of Tax Cuts?, 96 Tax Notes 1397, 1398 (Sept. 2, 2002).

to the gap between the rich on the one hand and the middle class and poor on the other.

> [The tax cuts] raise[d] the after-tax income of most people by less than 1 percent – not nearly enough to compensate them for the loss of benefits. But people with incomes over $1 million per year will, on average, see their after-tax income rise 4.4 percent.[61]

A key aspect of the evolving wage-based system is the reduction in the taxation of wealth and investment income.[62] The federal tax system now falls considerably less heavily on those with investment income and gains from stockholdings and other assets. Prior to the enactment of the 2003 tax legislation (generally referred to by its acronym, (JGTRRA),[63] dividends were taxed at ordinary income rates.[64] The 2003 act reduced the rates applicable to net capital gains in the two capital gains brackets to 5% and 15% (from 10% and 20%, respectively) and also reduced the tax on corporate dividends, even when they are paid out of corporate income that has not been subject to U.S. tax, to the net capital gain rate.[65] Those rates will further reduce to 0% and 15% in 2008, although they are currently slated to

61. Paul Krugman, Stating the Obvious, N.Y. Times, May 27, 2003, at A25.

62. See, e.g., Jan M. Rosen, Who Wins, and Who Is Skipped, in the Tax Cut, N.Y. Times, June 8, 2003, at § 3-9 (noting that the 2003 tax cut was "heavily tilted toward higher-income taxpayers because they tend to have the most investments and because they get the biggest rate reductions").

63. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752.

64. These rates, of course, already reflected EGTRRA's reduction of pre-2001 rates (from 39.6% for the highest bracket). See Economic Growth Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 101, 115 Stat. 38.

65. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, §§ 301-302, 117 Stat. 752. See generally Joint Committee on Taxation, Summary of Conference Agreement on H.R. 2, the "Jobs and Growth Tax Relief Reconciliation Act of 2003," (JCX-54-03, May 22, 2003) (overview of tax changes), at http://www.house.gov/jct/x-54-03.pdf; Robert Willens, Jobs and Growth Tax Relief Reconciliation Act of 2003 Gives Substantial Tax Relief for Dividends and Meaningful Tax Relief for Net Capital Gains, 103 Daily Tax Report J-1 (May 29, 2003) (discussing the highlights of the new law, with particular attention to changes in treatment of capital gains and dividends). Since dividend rates are reduced even when out of income that has not been taxed at the corporate level, the benefit is even more substantial. See, e.g., Martin A. Sullivan, Warmed-Over, Watered-Down, Bare-Bones Dividend Relief, 99 Tax Notes 777 (May 12, 2003) (describing the origin of the proposals for a uniform rate on dividends and noting that they violated Treasury's own proposition that all income should be taxed at least once).

revert to the pre-2003 rates in 2009. The wealthy are the disproportionate beneficiaries of that reduction in rates.[66]

The various provisions that move the tax system closer to a consumption tax system, without maintaining significant other taxes on wealth or wealth transfers, also benefit most the highest income taxpayers (those with incomes in the top 1%) and leave the tax burden falling most heavily on wage earners.[67] The superrich are also supersavers – they have more income than they can spend, even when they consume well beyond the standards of the remaining 99% of the population. As frequently noted by commentators, more than two-thirds of the income of the 400 richest Americans is long-term capital gains,[68] and the wealthiest 5% receive 60% of all investment income.[69] In addition to the statutory shelters for capital gains,

66. This disproportionate benefit was already evident after the 1997 reduction in capital gains rates. See, e.g., Joel Slemrod, The Fortunate 400, 100 Tax Notes 935, 936 (Aug. 18, 2003) (analyzing the IRS income statistics for 1992-2000 and concluding that even in that period the average tax rate on the 400 highest income taxpayers *declined* 7 percentage points, at the same time that it *increased* for all taxpayers in the aggregate, primarily because of the 1997 reduction in the preferential rate on capital gains and the high proportion of capital gain income enjoyed by the ultra wealthy).

67. See, e.g., Department of the Treasury, Blueprints for Basic Tax Reform 159 (Jan. 17, 1977) [hereinafter, Blueprints] (acknowledging that a flat income tax, even with a zero bracket rate for an exemption amount, would decrease the tax burden on the top brackets while increasing taxes on the majority of the population); Feldman, Consumption Taxes, supra note 40, at 296 (noting that "[c]ommentators generally view consumption taxes as . . . regressive [so that] if the United States were to shift from an income tax to a consumption tax, the wealthy would benefit while the poor would suffer greater tax burdens"). The cash flow consumption tax set out in the 1977 tax reform proposals admittedly taxed wages higher than capital, but justified it as a reward for savings balanced by application of tax to recipients of wealth transfers when the wealth was consumed rather than reinvested. Blueprints, supra, at 135-37. To address the concern that the cash flow tax placed no restraint on wealth accumulation, the study proposed retention of an estate and gift tax, at rates to achieve the desired equalization of initial wealth. Id. at 139.

68. See, e.g., Martin A. Sullivan, The Rich Get Soaked while the Super Rich Slide, 101 Tax Notes 581, 583 (Nov. 3, 2003) (based on IRS's Spring 2003 SOI Bulletin, noting that two-thirds of the adjusted gross income reported by the top 400 taxpayers from 1992 through 2000 was net capital gain); David Cay Johnston, The Loophole Artist, N.Y. Times, Dec. 21, 2003, at § 6-18 (same); see also Michael Parisi & Scott Hollenbeck, Individual Income Tax Returns 2002, SOI Bulletin 13 fig. F (Fall 2004), at http://www.irs.gov/pub/irs-soi/02indtr.pdf (showing that the 5,000 highest-earning taxpayers (those earning $10 million or more) in 2002 had 40.3% of their total AGI from long-term capital gains).

69. Institute on Taxation & Economic Policy, Federal Taxation of Earnings Versus Investment Income in 2004, App. I (May 2004), at http://www.itepnet.org/earnan.pdf. See also Edmund L. Andrews, Big Gap Found in

dividends and other investment assets, analysts estimate that as much as 24% of investment income is simply not reported on tax returns; in contrast, wages are subject to a withholding tax system that ensures that income (and payroll) taxes are paid by wage earners.[70] Investment income, of course, is entirely exempt from payroll taxes (e.g., Social Security, Medicare), which average an additional 15.3% of ordinary Americans' wage income (including employee and employer amounts). Those with considerable wealth, who may receive substantial amounts of low-taxed dividends, may also be able to make significant charitable contributions, reducing their tax bill even further.[71] The lopsided result is an average income tax rate on unearned income of merely 9.6% – less than half the tax on wage earnings.[72] As a consequence, in spite of being in the highest income brackets, the superrich with adjusted gross income over $10 million pay an average overall tax rate of only 25.9% (29.4% for those slightly less rich, with adjusted gross income from $2-10 million).[73] In fact, according to Martin Sullivan's analysis using

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Taxation of Wages and Investments, N.Y. Times, May 8, 2004, at C2 (reporting on a *Citizens for Tax Justice study that extrapolated from IRS data).*

70. See Robert S. McIntyre, Do Fat Cats Pay Less?, American Prospect 16, May 2004, at 16 (noting that failure of the tax laws to require brokers to report capital gains means that an estimated 25% of capital gains subject to taxation are simply not declared on tax returns: "big-time investors can pretty much make up their own numbers, and many of them do"); Johnston, supra note 68 (noting that much of the money involved in tax-avoidance strategies for the wealthy "pass[es] without showing up anywhere in the official income statistics").

71. See, e.g., The 2004 Slate 60 (Feb. 28, 2005), at http://www.slate.com/toolbar.aspx?action=print&id=2112691 (based on statistics compiled by the Chronicle of Philanthropy, setting forth a chart of the 60 largest American charitable contributions of the year, including Bill and Melinda Gates' pledge of $3.4 billion to their foundation and John Templeton's payment of $550 million to his foundation); Floyd Norris, The $32 Billion With a Bonus in Tax Breaks, N.Y. Times, July 22, 2004, at C1 (reporting that Bill Gates will receive a $3 billion dividend from Microsoft, which he intends to contribute to his foundation; the dividend will be taxed at the low 15% rate, while the charitable deduction for the gift of the dividend income to the Gates Foundation will offset his ordinary income, taxed at a 35% rate).

72. Robert S. McIntyre, supra note 70. See also Andrews, supra note 69 (noting the CTJ study's conclusion that the average tax on earnings is 2.5 times the average tax on investment income, after the application of the 2003 tax cuts).

73. Internal Revenue Service, Individual Returns Analysis Section, Individual Returns 2001, tbl.1.1 (col. 19), at http://www.irs.gov/pub/irs-soi/01in11si.xls. *Preferential tax provisions reduce the income tax considerably for many taxpayers with* income in the latter range. Vice President Cheney and his wife paid an effective tax rate of only 12.7% on their income, considerably lower than the 29% rate paid by the average in the $1 - $2 million group. David Cay Johnston, A Taxation Policy to Make John Stuart Mill Weep, N.Y. Times Week in Review, Apr. 18, 2004. See also Sullivan, supra note 68, at 581 (reporting information from the IRS's Spring 2003 Statistics of Income Bulletin showing rapid increase in income growth for the very topmost 400

Forbes' wealthiest 400 list, the tax rate on economic income for the 400 wealthiest taxpayers in the country was only 9%.[74]

Further, the superrich are the primary beneficiaries of the gradual phase-out of the estate tax.[75] The estate tax raised approximately $23.5 billion in 2001, with the superrich paying a substantial portion of overall estate tax revenues.[76] In that year, the federal estate tax affected only about 2% of unrealized appreciation of capital assets of dying taxpayers in any one year.[77] Since the bulk of an estate, especially of the superrich, is untaxed appreciation, elimination of the tax on intergenerational transfer means that this gain may never be subject to tax and directly contributes to disparities in wealth, and the power that accompanies wealth, among U.S. taxpayers.[78]

William Gale, Peter Orszag, and Isaac Shapiro recently analyzed the distribution of the 2001-2003 tax cuts, assuming that they are fully in effect, made permanent, but not yet financed by either spending reductions or

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taxpayers earning at least $87 million, from .5% of all income in 1992 to 1.1% in 2000, while share of all federal income taxes declined from 26.4% to 22.3% and noting that this is a new phenomenon connected to the preferential net capital gains rate, which has been extended through the 2003 tax cuts that are "especially beneficial to the super rich").

74. Sullivan, supra note 68, at 583.

75. Because of the use of peculiar sunsetting gimmicks to claim that the tax cuts did not create an intolerable long-term deficit, the estate tax is ostensibly slated for awakening from the dead on the first day of 2011, with the same exemption amounts and rates as existed prior to the onset of its demise in 2002. Note that the phrase "without taxation" is actually broader in meaning than some may realize. Capital assets are the majority of the assets of the superrich, and the lifetime appreciation of those assets grows without taxation due to the realization system. If no estate tax applies, there is no tax at the most obvious point for realization to occur, the final transfer of those appreciated assets by the owner to another person.

76. Internal Revenue Service, Statistics of Income Division, Estate Tax Returns Filed in 2001: Gross Estate by Type of Property, Deductions, Taxable Estate, Estate Tax and Tax Credits, by Size of Gross Estate, tbl. 1 (col. 83-84) (Aug. 2003) (showing that in 2001, 52.3% of estate tax revenues came from only 6.8% of estates, those with assets exceeding $5 million, and the wealthiest 469 (or 0.9% of) estates, those with assets exceeding $20 million, paid 20.7% of the total estate tax revenues), http://www.irs.gov/pub/irs-soi/01es01gr.xls.

77. William H. Gates Sr. & Chuck Collins, Wealth and Our Commonwealth: Why America Should Tax Accumulated Fortunes 84 (Beacon Press, 2002) (noting that under current law, 98% of capital gains growth is exempted at death).

78. See id. at 83 (bulk of estate assets are untaxed appreciation); id. at 84 (noting that "unrealized capital gains make up about 37% of the value of estates worth between $1 million and $10 million and over 56% of estates worth more than $10 million").

offsetting tax increases.[79] Under these assumptions, although many taxpayers get some tax cut, the benefit is decidedly in favor of higher income taxpayers: tax cuts range from a de minimis 0.1% change in after-tax income (including Social Security and Medicare determinations) for a meager 5.9% of the lowest-income households with less than $10,000 annually to a substantial 7.1% change for more than 98% of the households with more than $1 million annually.[80] The lopsided effect of the tax cuts is especially clear when the long-term impact is considered, including the method (tax increases or spending cuts) used to finance this intergenerational transfer.[81] Although the exact method of financing has not yet been determined, the proposed budget for FY 2006 projects substantial cuts to non-defense discretionary programs, which will likely affect ordinary taxpayers most heavily.[82]

> Once the financing is included, the 2001 and 2003 "tax cuts" are best seen as net tax cuts for about 20-25 percent of households, financed by net tax increases or benefit reductions for the remaining 75-80 percent of

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79. William G. Gale, Peter R. Orszag & Isaac Shapiro, Distribution of the 2001 and 2003 Tax Cuts and Their Financing, 103 Tax Notes 1539, 1540-41 & tbl. 2 (June 21, 2004). Of course, some of the tax cuts have already been financed at the state and local level by increased property and sales taxes. See, e.g., Jonathan Weisman & Neil Irwin, Taxes Cut, Not Saved, Wash. Post, July 25, 2004, at F1 (noting that "property and sales taxes at the local level have clawed back as much as 27 percent of the federal income tax cuts").

80. Gale, Orszag & Shapiro, supra note 79, at 1541. Earlier studies based on the 2001 tax cuts showed much the same result. See, e.g., Citizens for Tax Justice, Year-by-Year Analysis of the Bush Tax Cuts Shows Growing Tilt to the Very Rich 1 (June 12, 2002) (stating that by 2010, the richest 1% with average 2010 incomes of $1.5 million would garner 52% of the 2001 tax cuts (assuming all the changes were made permanent by then)), at http://www.ctj.org/pdf/gwb0602.pdf.

81. The issue of how to fund the massive deficit is beginning to require the attention of the Federal Reserve Bank, with Chairman Alan Greenspan suggesting that the tax cuts for the wealthy could be made permanent by cutting back Social Security and Medicare benefits. See Greg Ip, Greenspan Favors Entitlement Cuts, Wall St. J., Feb. 26, 2004, at A2.

82. President's FY 2006 Budget, Overview 4 (Feb. 7, 2005), at http://www.whitehouse.gov/omb/budget/fy2006/overview.html (proposing to limit growth in discretionary spending to less than the projected inflation rate and suggesting reduction or elimination of 150 non-defense programs). See also Citizens for Tax Justice, Bush Budget Calls for Giant New Tax Cuts, Huge Reductions in Most Federal Programs (Feb. 7, 2005) (indicating that interest payments will grow to almost one-fifth of on-budget outlays, while cuts to discretionary programs will range from 11% to 56% as shares of the economy by fiscal 2010, with the primary increase projected for discretionary programs slated to pay for the new Medicare drug benefit), http://www.ctj.org/pdf/bushbudg.pdf.

> households . . . [with an] annual net transfer of resources from low- and middle-income households to high-income households [that] would be sizable.[83]

The Gale, Orszag and Shapiro study projects an annual transfer of 15-35 billion dollars from lower-income households to households with incomes exceeding $1 million.[84] The lowest-income households are the worse off under either financing mode – with losses of 2.5% or 21% of their income.[85] On the other hand, taxpayers with more than $1 million in income would receive annual net transfers ranging from $60,000 to $135,000.[86] "The annual tax cut among households with income above $1,000,000 would equal $144,000 (in 2004 dollars), which exceeds the total income of 94 percent of households."[87]

A further study confirms those results. Assuming that each household pays the same dollar amount to finance the tax cuts ("equal-dollar financing"), the tax cuts worsen the lot of more than 75% of taxpayers, including nearly every household in the bottom two quintiles, while 11% of households in the top quintile would be better off.[88] The top quintile would be the only group to experience an average net tax cut, with an average benefit of $4,958, and households in the top 1% would have an average net tax cut of more than $54,000.[89] Similarly, assuming that each household pays the same percentage of its income to finance the tax cuts ("proportional

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83. Gale, Orszag & Shapiro, supra note 79, at 1539. See also Budgetary Shock and Awe, N.Y. Times, Mar. 25, 2003, at A16, (wondering how Congress could plan a further "$500 billion in tax cuts for the upper 1 percent of taxpayers" funded by "deep cuts of $475 billion in vital programs for the bottom 99 percent"); Dale Russakoff, Budget Woes Trickle Down: Hard-Hit State and Local Governments Say Bush and Congress left Them to Make Cuts, Raise Taxes, Wash. Post, July 15, 2003, at A1 (noting the effect of unfunded mandates for education, health care and homeland security on states facing deficits of approximately $100 billion, resulting in local program cutbacks); Bob Herbert, Tax Cut Casualties, N.Y. Times, June 26, 2003, at A33 (suggesting that cutbacks in services and tax increases including state college tuition hikes, fare increases, property tax increases, sales tax increases, water fee increases are related to "massive tax cuts for the very wealthy").

84. Gale, Orszag & Shapiro, supra note 79, at 1539.

85. Id.

86. Id. at 1540.

87. Gale & Orszag, supra note 55, at 1278. This average annual tax cut figure does not include the estate tax nor, in comparing the impact on low-income households, the effects of spending cuts that may be used to pay for the tax cuts and which "are likely to hit lower-income families much harder than higher-income households." Id. at 1286.

88. Gale & Orszag, supra note 58, at 1561 tbl. 2. Financing is set at a level that would offset the annual revenue loss due to the tax cuts. Id. at 1562.

89. Id.

financing"), a majority of households in every quintile, but only 39% in the top 1%, would be worse off: the average net tax cut for the top 1% would be $22,335.[90]

These statistics demonstrate a decline in the fair allocation of the tax burden that threatens to undermine the ability of the tax system to serve justice and thus merits attention in any reform that is undertaken of the AMT or the regular tax. One thing is clear: the superrich have very high savings rates, while ordinary wage earners whose incomes are fully subject to payroll taxes necessarily spend most or all of their after-tax income.[91] Since the wealthy are simply unable to consume a significant portion of their wealth, they benefit the most from the potential elimination of the estate tax and the move towards a consumption tax base.[92] Put together with the recent rate cuts, these evolving changes in the tax system have a profound potential to increase disparities of resources among American citizens, for this and future generations, with particularly harmful inequalities between the richest and poorest Americans that have far-reaching implications for democracy.[93]

90. Id. at 1562 tbl. 3.

91. Even ardent consumption tax advocates admit this fact readily. See, e.g., Andrews, supra note 43, at 1151 (indicating that since "[m]ost people spend most of their ordinary income for current consumption," "to that extent a consumption-type personal income tax would be no different from the existing tax").

92. See Burman & Kravitz, supra note 59, at 875 (noting that, because low-income families exhaust "virtually all" their incomes while high-income (over $200,000) families "spend less than 40 percent," consumption taxes would have to have very high rates on higher-income families to avoid shifting the tax burden onto lower-income households).

93. Various commentators have discussed the disadvantages of concentrated accumulations of wealth, both to economic growth and to our unique American democracy. See, e.g., Kevin Phillips, Wealth and Democracy: A Political History of the American Rich (Broadway Books 2002) (summarizing the history of wealth accumulation and the influence over the political system attributable to the power and status that accompany great wealth); Jeff Madrick, The Power of the Super-Rich, N.Y. Review of Books 25, July 18, 2002 (reviewing Phillips' book). As Madrick notes in his essay, the 1980s saw a rapid increase in wealth disparity, when deregulation and rising stock markets, combined with Reagan's tax cut for high-income Americans, allowed the gap between rich and poor to grow to "widths unseen since the 1920s and 1930s." Id. See also Robert S. McIntyre, Just Taxes, & Other Options, in Less Taxing Alternatives (Citizens for Tax Justice, Mar. 1984) (noting that various economists have concluded that economic success tends to occur in countries with relative equality of income and wealth, whereas countries with concentrated wealth are less likely to have successful economies).

B. Federal Debt and Deficit Growth

The deficit story is a fairly simple one to recite. The Bush administration's budget for FY 2002 touted a projected 10-year budget surplus of $5.6 trillion, a result of a "gusher of unexpected revenue" from 1996-2000,[94] as the rationale for tax relief that would "[l]et[] taxpayers keep roughly one-fourth of the surplus they produced ($1.6 trillion over 10 years)" while creating a $231 billion surplus in 2002.[95] Indeed, before the effect of the first round of Bush tax cuts, the federal budget for FY 2001 showed a surplus of approximately $128 billion (which includes the Social Security surplus).[96] After the 2001 tax cuts took effect, there was a FY 2002 deficit of $157.8 billion.[97] In spite of this deficit, the House Budget Committee Republicans proposed a budget with a further projected deficit for FY 2003 of $221 billion (including the estimated $38.7 billion cost over ten years of the additional tax incentives passed in early March 2002).[98] By February 2004, the White House Office of Management and Budget (OMB) projected a federal deficit for FY 2003 of $375 billion.[99] For FY 2004, the OMB announced an expected deficit of $445 billion,[100] and for FY 2005, $331

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94. Bush Administration, A Blueprint for New Beginnings: A Responsible Budget for America's Priorities 14 (Government Printing Office, Washington 2001) [hereinafter, 2001 Budget], at http://www.whitehouse.gov/news/usbudget/blueprint/blueprint.pdf.

95. Id. at 7.

96. Congressional Budget Office, The Budget and Economic Outlook: Fiscal Years 2006-2015, App. F, tbl. 1 (Jan. 25, 2005), at www.cbo.gov under the tab "historical budget data" [hereinafter, CBO Historical Budget Data]. See also Bush Releases Agenda for Tax Relief, Highlights & Documents, BNA Tax Analysts Doc. 2001-3977, at 2028 (Feb. 9, 2001) (noting, in early February of 2001 before passage of the tax cuts, that the federal budget was "facing an enormous surplus").

97. CBO Historical Budget Data, supra note 96, at App. F, tbl. 1.

98. See GOP Proposes $28 Billion for Tax Cuts During Next Five Years, 2002 TaxDay Item C.1 (CCH Mar. 14, 2002) (summarizing a March 13 hearing of the House Budget Committee), at http://tax.cch.com/primesrc/bin/highwire.dll (last visited March 14, 2002). For some perspective on the size of the Bush tax cuts, see The Tax Foundation, The Bush Tax Plan: How Big is the Tax Cut? (May 29, 2003, updated June 14, 2004) (reporting that the aggregate Bush tax cuts are more than triple the Reagan 1981 tax cuts in constant 2003 dollars), at http://www.taxfoundation.org/bushtaxplan-size.htm (last visited July 16, 2004).

99. Office of Management and Budget, Budget of the United States Government, Fiscal Year 2005, at 365 tbl. S-1 (Feb. 2, 2004), at http://www.whitehouse.gov/omb/budget/fy2005/pdf/budget/tables.pdf (last visited Feb. 8, 2005).

100. Office of Management and Budget, Budget of the United States Government, Fiscal Year 2005, Mid-Session Review 1 (July 30, 2004), at http://www.whitehouse.gov/omb/budget/fy2005/05msr.pdf (last visited Feb. 8, 2005) [hereinafter FY 2005 Mid-Session Review]. See also William Neikirk, U.S. Economic

billion.[101] The FY 2006 budget document now projects a FY 2005 deficit of $427 billion.[102]

Those budget figures do not include the costs of making the tax cuts permanent or of reforming the AMT. By the spring of 2003, a Goldman Sachs projection (assuming the 2001 tax cuts were made permanent, a prescription drug benefit was added to Medicare, AMT reform protected lower-income taxpayers and appropriations grew only modestly) estimated that the deficits over the next ten years would be $4.2 trillion if the Social Security surplus were included or $6.7 trillion otherwise.[103] The 2003 tax cut added at least an additional $400 billion in costs over ten years.[104] Even the OMB attributed 23% of the change in the budget balance from the April 2001 surplus of $237 billion to the July 2003 deficit of $455 billion to the 2001-2003 tax cuts.[105] One estimate of the deficit by 2013 attributable just to the 2001 and 2003 tax cuts (assuming that they are made permanent) is $1.133 trillion.[106] Some commentators have accused the Bush administration

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Growth Slows, Chi. Trib., July 31, 2004, at C1 (noting that these new administration figures omit key items, such as the war in Iraq and Afghanistan, expiring tax provisions, and a continuing defense buildup).

101. FY 2005 Mid-Session Review, supra note 100, at 3 tbl. 1.

102. President's FY 2006 Budget, supra note 82, at 3 (projecting a deficit of 3.5% of GDP or $427 billion).

103. See Bob Kerrey et al., No New Tax Cuts, N.Y. Times, Apr. 9, 2003, at A19 (indicating that under these same assumptions, the ratio of publicly held debt to GNP would climb to 50% from the low of 33% in early 2001).

104. See, e.g., John D. McKinnon, Caution: Tax Cuts Are Bigger Than They Appear in Budget, Wall St. J., May 19, 2003, at A1 (noting that the price of a permanent dividend tax cut would be $400 billion over ten years instead of the $124 billion for the temporary measure). The various sunsetting provisions that were included in the 2001 and 2003 tax cuts in order for the legislation to come under the targeted costs make estimates of long-term costs difficult. The McKinnon article reports the estimated price of the dividend tax cut over ten years, assuming that it is made permanent. Of course, if corporations pay unusually large dividends during the initial years of the cut because they project that it will not be made permanent, the tax cost of the provision would increase. See, e.g., Norris, supra note 71 (discussing the Microsoft extraordinary dividend).

105. See Office of Management and Budget, Budget of the United States Government, Fiscal Year 2004, Mid-Session Review 3-4 (July 15, 2003), at http://www.whitehouse.gov/omb/budget/fy2004/pdf/04MSR.pdf (last visited Feb. 8, 2005).

106. See Deficit Delusions, Wash. Post, Aug. 29, 2003, at A22 (noting that the cumulative deficit through 2013 would be $4.3 trillion under the assumptions given, which is three times the Congressional Budget Office's official projection based on elimination of tax cuts according to the sunset provisions).

of "reckless disregard" in pushing such large tax cuts in the face of increased military and other spending.[107]

Similarly, the Bush budget for 2002 acknowledged that publicly held U.S. debt had declined from $3.8 trillion to $3.4 trillion between 1998 and 2000.[108] Including the federal government's non-publicly held debt (i.e., borrowing from Social Security for general expenditures), the U.S. debt at the beginning of 2001 was approximately $5.7 trillion.[109] As of February 8, 2005, the federal debt had reached slightly more than $7.6 trillion.[110] Borrowing to finance tax cuts, the fight against terrorism, and routine government operations is projected to cost $3.60 for each dollar of the tax cuts over the next 6 years.[111] Taxpayers in the $28,000 to $45,000 income range "are especially hard hit by federal borrowing"[112] as interest rates rise and federal funds for public goods especially important to lower-income households, such as education and health care, dry up.

The tax cuts play a significant roll in the growth of federal deficits and debt and will play an even greater role in future decades if they are made permanent. For example, if EGTTRA's repeal of the estate tax (passed through sunset gimmicks that phased in a gradual reduction in rates and completely eliminated the tax only for 2010, reverting to 2000 law for years after 2010) were made permanent, the cost for just the second decade, from 2011 to 2022, is estimated at an astounding $4.1 trillion[113] – just about sufficient to pay off the entire current amount of publicly held federal debt.[114]

Commentaries from liberal and conservative sources alike acknowledge the rapid shift from budget surpluses to years of budget deficits in conjunction with the 2001-2003 tax cuts.[115] The Joint Economic

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107. See, e.g., Daniel Shaviro, Reckless Disregard: The Bush Administration's Policy of Cutting Taxes in the Face of an Enormous Fiscal Gap (Sept. 2003), NYU L. Sch. Pub. L. Research Paper No. 71, at http://ssrn.com/abstract=444242.

108. 2001 Budget, supra note 94, at 29.

109. Bureau of the Debt, Treasury Department (online debt statistics), at http://www.publicdebt.treas.gov (last visited for this purpose Feb. 8, 2005).

110. Id. (showing debt of $7,617,143,521,850.79). Of the more than $7.6 trillion in current debt, almost $4.4 trillion is held by the public. Id.

111. Citizens for Tax Justice, We're Paying Dearly for Bush's Tax Cuts 4 (Sept. 23, 2003) (using data from Congressional Budget Office, The Budget and Economic Outlook: An Update (Aug. 2003) to project that from 2002 to 2007 the tax cuts will amount to $1.036 trillion, which will increase the national debt by $3.763 trillion), at http://www.ctj.org/pdf/debt0903.pdf.

112. David Cay Johnston, Studies Say Tax Cuts Now Will Bring Bigger Bill Later, N.Y. Times, Sept. 23, 2003, at C2.

113. See Gates & Collins, supra note 77, at 104.

114. See supra note 110 and accompanying text.

115. Two statements are illustrative:

> The plan was: a $400 billion federal budget surplus this year and a national debt of $2.1 trillion heading rapidly to zero. That was the

Committee report optimistically implies that the economy may be able to grow itself out of the debt even with the huge tax cuts.[116] Other commentators note that rampant inflation could also theoretically solve the debt problem, though at immense social and long-term economic costs.[117] The former is at best unlikely, and the latter is troublesome. A glance at recent articles in the national media reveals growing concern that deficits may eventually lead to reductions in savings available for capital investment, less attractiveness of Treasury debt to foreigners (who now account for roughly 40% of U.S. debt holders), a currency crisis, and big bills for future generations of taxpayers.[118] Commentators on both sides of the political spectrum generally acknowledge that the deficit and the related federal debt have potentially significant and far-reaching impacts on economic growth, interest rates, consumer purchasing power, net national savings, international monetary policy, and the need to provide safety nets for the least well off, among other issues.[119]

> plan back in January 2001 . . . [and] [t]hat was the official prediction of the nonpartisan Congressional Budget Office. Now, we have a new plan . . . for a $500 billion deficit. The national debt is $4.4 trillion and headed to more than $6 trillion over the next 10 years.

Michael Kinsley, A Bad Way to Cut the Debt, Wash. Post, July 2, 2004, at A15.

> The federal government had budget surpluses in the fiscal years from 1998 to 2001, but it had a deficit in fiscal 2002, and recent estimates suggest deficits will continue for the next several years.

Kurt Schuler, Joint Economic Committee, Deficits, Taxation, and Spending (Comm. Print, Apr. 2003) (from the cover summary), at http://www.house.gov/jec/tax/deficits.pdf.

116. Schuler, supra note 115, at 4-5, 13.

117. Kinsley, supra note 115.

118. See, e.g., Greg Ip, As Fear of Deficits Falls, Some See a Larger Threat, Wall St. J., July 12, 2004, at A1 (noting that the current administration and Congress are "more complacent" about deficits, but "a deficit-induced crisis may be far likelier" than when the Reagan administration found it had to enact tax increases to minimize the impact of tax-cut induced deficit explosion); Steven Rattner, What a Rate Increase Can't Hide, N.Y. Times, July 1, 2004, at A21 (discussing interrelated problems of tax cuts, deficits, interest rate increases, consumer loss of buying power); Craig Karmin, Foreigners Seem to be Souring on U.S. Assets, Wall St. J., July 26, 2004, at C1 (reporting that growth of trade deficits, loss of Asian interest in U.S. Treasurys, and general loss of foreign interest in U.S. stocks and bonds could lead to climbing interest rates and less purchasing power for the U.S. dollar); Alstott, Response, supra note 22, at 388 & n.98 (providing references supporting the statement that the decline in net national savings is considered to be largely due to the federal budget deficit); Peter A. McKay, Inflation Can Have Illusory Allure, Wall St. J., July 12, 2004, at C3 (indicating hopes that a gradual increase in Federal Reserve rates will not cause an economic slowdown, though "even small amounts of inflation can cut into stocks' value").

119. See, e.g., Rattner, supra note 118 (noting some of the concerns that back a "national consensus to reduce the budget deficit").

Burgeoning deficits pose a particular problem for ordinary taxpayers, who are the primary beneficiaries of spending on federal social programs. Commentators have suggested that the Bush administration has adopted a "starve the beast" strategy that cuts taxes first and uses the resulting deficit to spur deep spending cuts.[120] Such a strategy may be effective, because taxpayers are both tax and deficit averse – i.e., they prefer lower taxes, but are not willing to use deficits to achieve them; yet, once lower taxes have created a deficit, they will likely support spending cuts rather than higher taxes to remove the deficit.[121] Whether deficits or spending cuts result, tax cuts come at a significant cost to ordinary taxpayers.

C. Expanding Scope of the AMT

Perhaps the most contentious result of the 2001 and 2003 tax cuts is the impending applicability of the individual AMT to many ordinary taxpayers.[122] Put simply, lowering the regular tax rates while leaving the AMT rates as they were prior to the tax cuts (applying on a broader AMT base) ensures that the AMT will require more taxpayers to pay additional tax compared to their regular tax computation.[123]

The AMT traces its origins to a 1969 Treasury study that attributed the ability of some high income taxpayers to pay far less in tax than ordinary taxpayers to four tax provisions: the exclusion for net capital gains (resulting, through a different mechanism, in preferential treatment similar to today's preferential capital gains rate), the deduction for untaxed appreciation on

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120. Jonathan Baron & Edward J. McCaffery, Starving the Beast: The Psychology of Budget Deficits 3 (Sept. 2004), USC L. & Econ. Research Paper No. 04-24, at http://ssrn.com/abstract=589283. The fiscal year 2006 budget proposals do attempt to cut spending to make up for the gaping deficits. See supra note 82 and accompanying text.

121. Id. at 8-9. Taxpayers appear to support spending cuts only in the abstract, indicating opposition when asked to identify particular cuts. Id. at 14. Tax cuts are thus most likely to be supported when they are not matched with specific spending cuts. Id. at 14-16.

122. See, e.g., Amy Feldman, The Tax of Unitended Consequences, Money, Sept. 2003, at 86 (stating that "much of what the government gave with the regular income tax breaks, it will soon take away with the alternative minimum tax"); Tully, supra note 9 (noting that the 2001 tax cut lowered marginal rates and reduced net capital gains taxes, but had "the perverse effect of throwing far more people into the AMT").

123. William G. Gale & Peter Orszag, Overdrawn Account, The New Republic, Feb. 4, 2004, at http://www.tnr.com/doc.mhtml?pt=nVvqEonAErWe%2FI49JqBEr2%3D%3D (last visited Feb. 5, 2005) (indicating that the AMT will erase one-third of the tax cuts by 2009, if those cuts are made permanent without AMT reform).

charitable contributions, tax-exempt interest, and the depletion allowance.[124] The 1969 Congress enacted an add-on minimum tax,[125] intended to defend against the ability of the superrich to avoid a fair share of the federal tax burden through "extreme concentrations of tax incentives."[126] Congress considered it "intolerable" that "taxpayers with substantial incomes have found ways of gaining tax advantages from provisions placed in the code primarily to aid some limited segment of the economy."[127]

Probably the most important of the regular tax incentives subject to the original minimum tax was the then-existing regular-tax exclusion for

124. Dept. of the Treasury, Tax Reform Studies and Proposals, Part 2 (1969), at 132-42 [hereinafter 1969 Treasury Study]. The Treasury proposal would have placed a 50% ceiling on the amount of economic income that a taxpayer could shelter with tax preferences and would have applied graduated tax rates from 7% to 35% to that broader base. Id. at 132-33. Noting that limitations on the availability of beneficial tax provisions were not new to the tax system, the study emphasized the need for an overall limitation such as the minimum tax to ensure that high-income taxpayers "mak[e] a fair tax contribution to the Government in relation to the amount of their true income." Id. To protect those at the lower income scale, the study would have permitted a special "alternative standard deduction" of $10,000 for a joint return ($5,000 for individual taxpayers), limiting the tax "to individuals who are deriving substantial benefits from the tax preferences involved." Id. at 134. See also Nina E. Olson, National Taxpayer Advocate 2003 Ann. Rep. to Cong. 7 (Dec. 31, 2003) [hereinafter 2003 NTA Report] (discussing the Treasury study).

125. Tax Reform Act of 1969, Pub. L. No. 91-172, § 301(a), 83 Stat. 487, 580-86 (minimum tax provisions); H.R. Conf. Rep. No. 91-782 (1969) (describing the minimum tax as enacted and the list of preferences to which it applied), reprinted in 1969-3 C.B. 644, 658-60.

126. Glenn E. Coven, The Alternative Minimum Tax: Proving Again that Two Wrongs Do Not Make a Right, 68 Cal. L. Rev. 1093, 1096 (1980).

127. Committee on Ways and Means Report on the Tax Reform Act of 1969, H.R. Rep. No. 91-413, at 1(1969), [hereinafter, 1969 Ways & Means Report], reprinted in 1969-3 C.B. 200,200. The House version of the bill would have allocated certain itemized deductions between taxable and tax-exempt income and required a taxpayer to include one-half of the sum of listed preferences (otherwise excludable) in adjusted gross income. Id. at 55-60. The goal was to ensure that "individuals with significant amounts of tax-free income [] pay tax on *at least one-half of their economic income.*" Id. at 2 (emphasis added). The minimum tax as enacted was a 10% surcharge to the regular income tax that applied (after offset for a then-generous $30,000 exemption amount that applied in addition to an exemption for the regular income tax liability) to specified tax-avoidance techniques, including the one-half of a taxpayer's net long-term capital gains excluded under §1202 for regular income tax purposes, excess investment interest expense, accelerated depreciation of personal property subject to a net lease, amortization of pollution control facilities, and depletion in excess of property basis. See S. Rep. No. 91-552 (1969), reprinted in 1969-3 C.B. 423.

50% of a taxpayer's capital gains.[128] Those excluded net capital gains were subject to tax under the minimum tax, along with a few other preferences that were considered central to the ability of some wealthy taxpayers with substantial economic income to pay very little tax under the regular tax system. The minimum tax was expected to reach about one in 500,000 taxpayers, those with incomes of at least $200,000 (more than $1 million in 2004 dollars).[129] As explained in the legislative history of the 1986 Tax Reform Act:

> [T]he minimum tax should serve one overriding objective: to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits. Although these provisions may provide incentives for worthy goals, they become counterproductive when taxpayers are allowed to use them to avoid virtually all tax liability. The ability of high-income individuals . . . to pay little or no tax undermines respect for the entire tax system. . . . [E]ven aside from public perceptions, . . . it is inherently unfair for high-income individuals . . . to pay little or no tax due to their ability to utilize various tax preferences.[130]

In 1978, the minimum tax was supplemented (and eventually replaced) by the AMT in its current form – a parallel tax with its own base and rate schedules and separate exemption amount.[131] It "require[s] people to

128. Coven, supra note 126, at 1097. At the time of the enactment of the minimum tax, capital gains were treated preferentially by excluding 50% of all net capital gains from income. Currently, capital gains are generally included in income, but they are treated preferentially by taxing them (and dividends) at a preferential rate that is substantially lower than the rate on ordinary income.

129. See Kurt Schuler, Joint Economic Committee, The Alternative Minimum Tax for Individuals: A Growing Burden (Comm. Print, May 2001) [hereinafter, JEC AMT Study], at http://www.house.gov/jec/tax/amt.pdf. See also Robert Rebelein & Jerry Tempalski, Who Pays the Individual AMT? (Office of Tax Analysis, U.S. Dept. Of the Treasury, OTA Paper No. 87, June 2000) (citing outgoing Treasury Secretary Barr's statement that no 1967 federal income tax was paid in respect of 155 income tax returns with adjusted gross income of more than $200,000), reprinted in 2000 TNT 135-33, ¶ 5 (July 13, 2000).

130. S. Rep. No. 99-313, at 518-19 (1986), reprinted in 1986-3 C.B. Vol. 3.

131. Revenue Act of 1978, Pub. L. No. 95-600, §§ 402(a), 421(a), (g), 92 Stat. 2763 (1978) (enacting AMT provisions for capital gains, but retaining minimum tax provisions for other preferences); H.R. Conf. Rep. No. 95-1800, at 263-68 (1978), reprinted in 1978-3 C.B. Vol. 1 521, 597-602 (describing the relationship between the minimum tax and the new alternative minimum tax). The 1978 AMT had four rate brackets (0, 10, 20 and 25%) and an exemption amount of $20,000; it added only two

recalculate their taxes under alternative rules that include certain forms of income exempt from regular tax and that do not allow specific exemptions, deductions, and other preferences."[132] Taxpayers determine their liability under both the regular and AMT systems and pay the one that is greater. As a result, the AMT can increase total tax liability merely because of the taxpayer's aggregate preferences that reduce the tax base for regular tax purposes.

Although the AMT originally targeted tax-avoidance possibilities of the superrich (e.g., the net capital gain exclusion) and thus affected "less than 1 percent [of taxpayers] in any year before 2000,"[133] the individual AMT is now poised to affect a much broader group of taxpayers. This is in part because the AMT exemption amount and rate brackets are not indexed to inflation, but even more because the regular income tax cuts are not matched by similar permanent cuts in the AMT. The AMT is projected to affect approximately 29 million taxpayers in 2010, up from 3 million in 2004.[134] A quirk of the interrelationship between the tax cuts and the AMT is that the AMT will gradually eliminate the benefit of the tax cuts for middle income taxpayers on the upper end of the scale – what one commentator calls the AMT "take-backs."[135] A 2003 statistical analysis by Burman, Gale and

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preference items back into the base – excluded capital gains and itemized deductions. See generally Craig D. Vagt, The Alternative Minimum Tax – A New Approach for Individuals, 45 N.Y.U. Ann. Inst. on Fed. Tax'n 36-1, 36-1 to 36-11 (1987) (providing a history of the minimum and alternative minimum tax). The AMT has been substantially revised several times since, including in the Tax Reform Act of 1986, Pub. L. No. 99-514, § 701, 100 Stat. 2085 (which changed the treatment of capital gains, among other significant amendments), and the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13203(a), 107 Stat. 312 (which imposed the 26% and 28% AMT rates, rather than a single AMT rate, on AMT income above the exemption amount). The idea of the 1978 reform, however, was the same as today's AMT: broadening the base through elimination of specified preferences and flattening the rate schedule applicable to that base.

132. Congressional Budget Office, Revenue and Tax Policy Brief No. 4, The Alternative Minimum Tax 1 (2004) [hereinafter, the "CBO Study"], at http://www.cbo.gov/ftpdocs/53xx/doc5386/04-15-AMT.pdf.

133. Id.

134. See Auerbach et al., supra note 55, at 1294; see also Nina E. Olson, 2004 National Taxpayer Advocate Ann. Rep. to Cong. 383 (Dec. 31, 2004) [hereinafter 2004 NTA Report] (noting that the Treasury Department's Office of Tax Analysis projects that by 2010, 34 percent of individual taxpayers who pay income tax (a total of 34.8 million taxpayers) will be subject to the AMT).

135. Al Davis, New Household Tax Cuts are Strongly Affected by AMT and Vary Over Time, 92 Tax Notes 293 (July 9, 2001). As Davis explains,

> An AMT "take-back" occurs when, because of the AMT, a taxpayer gets less of an actual tax cut than the cut in the regular income tax. Because the AMT is a floor on the income tax for a

Rohaly at the Urban Institute suggested that by 2010 the AMT would eliminate 70% of the tax cut for taxpayers with gross income between $100,000 and $500,000 and 42% of the tax cut for taxpayers with gross income between $75,000 and $100,000.[136] A more recent study suggests that 97% of taxpayers with two children and incomes of $75,000 to $100,000 will be affected by the AMT by 2010, and 44 million will be affected by 2014.[137]

Congress has not acted to deal comprehensively with the interaction of the regular tax cuts and the AMT. Instead, it has passed annual fixes that increase the AMT exemption to prevent, for the few years to which the fix is applicable, the vast majority of middle-income taxpayers from having to pay the tax.[138] Congress' failure to do more is due to the enormous costs of simultaneously making the tax cuts permanent and eliminating the extended reach of the AMT into lower tax brackets. The Congressional Budget Office has estimated that full AMT repeal would reduce tax revenues by roughly $600 billion over ten years, even assuming that the 2001-2003 tax cut sunsets take effect as planned.[139] Gale and Orszag estimate that indexing the AMT under current law would cost $428 billion, while the combined cost of indexing the AMT and making the tax cuts permanent would be $1.76 trillion.[140] Even repeal advocates such as the National Taxpayers Union admit

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> taxpayer, cutting the regular tax below this floor gives the taxpayer no further benefit.

Id. at 294. See also Robert S. McIntyre, Bush's Most-Favored Taxpayers, American Prospect, July 1, 2002, at 17 (finding that more than half of the benefit of the 2001 tax cut would go to the richest 1%, if there were no further AMT relief after 2004).

136. Burman, Gale & Rohaly, supra note 6, at 105.

137. Leonard E. Burman, William G. Gale, Matthew Hall & Mohammed Adeel Saleem, AMT Relief in the FY 2005 Budget: A Bandaid for a Hemorrhage 1 (Feb. 3, 2004), at http://www.urban.org/UploadedPDF/1000601.pdf.

138. See Gale & Orszag, supra note 55, at 1280 tbl. 1a (summarizing the EGTRRA and JGTRRA changes, whereby the 2001 act increased the AMT exemption amount to $35,750 for singles and $49,000 for married taxpayers, from the pre-EGTRRA amounts of $33,750 and $45,000, while JGTRRA increased the exemption for 2003 and 2004 to $40,250 and $58,000, respectively); Dustin Stamper, House Clears 'Tax Cut of the Week' – A Short-Term AMT Fix, 103 Tax Notes 625 (May 10, 2004) (discussing the 2004 proposal in H.R. 4227 to provide a further one-year repair to the AMT exemption limits by indexing the 2004 limits to inflation for 2005, resulting in a $58,950 exemption for joint returns and $40,900 for individuals, rather than a reversion to the 2002 levels, a change costing $17.8 billion over 10 years).

139. See CBO Study, supra note 132, at 7 (citing $600 billion revenue loss over the next ten years to repeal the AMT, under current law); Sen. Sarbanes' Statement, 150 Cong. Rec. S2256 (Mar. 8, 2004) (discussing the proposed budget for FY 2005 and noting that the cost to extend the proposed AMT fix out 10 years would be $658 billion, versus the one-year cost of $23 billion in the administration's budget).

140. Gale & Orszag, supra note 55, at 1283.

it could cost as much as $800 billion over ten years to repeal the AMT and make the 2001-2003 tax cuts permanent.[141] These estimates make clear that the cost of repeal would be significant, and that cost will be substantially increased if the 2001-2003 tax cuts are made permanent. Full repeal would, of course, have other implications for the overall federal tax system, especially for progressivity.[142] Congress' approach has therefore been one of piecemeal reform to prevent the worst combined effects of the AMT and new tax cuts while "postponing hard choices."[143]

IV. AMT REPEAL OR REFORM?

Proponents of AMT repeal have made a variety of arguments, beginning immediately after the 1978 enactment of the current version of the add-on tax and continuing, in increasingly strident form, today.[144] An early commentator writing in 1980, for example, acknowledged that curtailing high-income taxpayers' excessive claims for deductions and exclusions was an important way to improve the overall equity of and compliance with the tax system, but argued that the AMT was "ill-conceived in every respect" because of its cumbersomeness and inequitable application.[145] He particularly complained about the use of the AMT mechanism to limit preferences when Congress could have achieved the same (or better) results through less cumbersome fine-tuning of the regular tax system.[146] Today's commentators have similar objections: the most recent report of the National Taxpayer

141. See Matthew S. Bailey, The Individual Alternative Minimum Tax: No Alternative But Repeal (NTU Policy Paper No. 114, Apr. 22, 2004), reprinted in 2004 TNT 79-23, ¶40 (Apr. 23, 2004).

142. See, e.g., Shaviro, supra note 9, at 1461 (prior to the enactment of the 2001-2003 tax cuts, noting that full AMT repeal "would make the system less progressive than otherwise, notwithstanding that the bullet is not quite aimed at the top").

143. Floyd Norris, Help Grandparents of Rich Kids Now. Deal with Real Problems Later., N.Y. Times, Feb. 6, 2004, at C1 (noting that the Bush administration does not seem "eager to deal with the prospect of the alternative minimum tax . . . harming many middle-class taxpayers").

144. See, e.g., Bailey, supra note 141, ¶¶2, 4, 7 (calling the AMT at various points "an alternate universe in the twilight zone," a "seeping wound," and "unfair"). See also supra note 9 (noting the strongly pejorative language typically used to describe the AMT).

145. Coven, supra note 126, at 1094. Coven noted that the tax penalized preferences without regard to the magnitude of income distortion caused and was "regressive relative to income before reduction by preferences." Id. at 1096. This was particularly true for the capital gains preference, where the tax only reduced the effective exclusion from 60% to 59.2% for those with half a million of gains, but reduced the exclusion to 56% for those with $200,000 of gains. Id. at 1101-02.

146. See, e.g., id. at 1108.

Advocate considers the AMT one of the most serious problems taxpayers face and labels AMT repeal a "Key Legislative Recommendation."[147]

Critics attack the AMT on five main grounds: (I) its failure to adequately target the superrich and instead to take back the tax cuts from middle- and upper-income taxpayers (the *downward creep argument*); (ii) its lack of transparency for ordinary taxpayers who are often inadequately informed (if not totally unaware) of the potential applicability of the AMT to their situation (the *transparency argument*); (iii) its lack of consistency with regular income tax policy (the *consistency argument*); (iv) its addition of a layer of complexity, both in terms of the initial determination of whether the AMT may be applicable and the particular mechanisms of AMT applicability (the *complexity argument*), and (v) its apprehension of taxpayers with various kinds of lump sum payments, such as stock options and contingent attorney fee awards (the *"accidental taxpayer" argument*[148]).

The following sections briefly discuss each of these arguments in turn. It should be noted at the outset that these arguments often overlap. The complexity of the AMT provisions increases their lack of transparency, while any inconsistency with the regular income tax may play a role in the downward creep of the AMT. The primary concern raised by the "accidental taxpayer" situations is one of fairness: revenue leveling devices that are permitted under the regular tax, such as deferral of income on exercise of incentive stock options, may not be permitted under the AMT, creating a "gotcha" effect. The other arguments – lack of transparency, complexity, lack of consistency – evoke broader fairness concerns as well in a voluntary tax system that relies (in part) on self-reported compliance.

A. Downward Creep

There are two main types of arguments made about the downward creep of AMT liability to lower-bracket taxpayers. Critics attack the AMT because the downward creep appears inconsistent with the original purpose of the minimum tax. Furthermore, those calling for repeal of the AMT attack it as unfair because of its effect in rolling back the 2001-2003 tax cuts for those with incomes between $100,000 and $500,000. This section explores those arguments.

Commentators complain that the AMT fails to achieve its original purpose of ensuring that the wealthiest taxpayers pay some federal income tax.[149] As we have seen, when the original minimum tax legislation was

147. See 2004 NTA Report, supra note 134, at 2-3.

148. The genesis of this term lies with the ABA Individual AMT Task Force.

149. See, e.g., 2003 NTA Report, supra note 124, at iv (indicating that "the AMT appears to function . . . randomly, no longer with any logical basis in sound tax administration or any connection with its original purpose of taxing the very wealthy who escape taxation"); 2004 NTA Report, supra note 134, at 383 (stating that "[w]hile

enacted, Congress focused on the ability of 154 individuals with adjusted gross incomes exceeding $200,000 to pay no 1967 income tax at all.[150] The AMT was designed to limit very high income taxpayers' use of a few preferences that could literally wipe out their tax liability in spite of their considerable economic income, resulting in an unfair sharing of the tax burden.[151] Congress made further changes in 1976, again reacting to a study that indicated 244 high-income taxpayers paid no tax in 1974, even with the AMT system in place.[152] In spite of the refinements, critics argue that the AMT has not added huge numbers of non-taxpaying filers to the tax rolls. One calculation indicates that the AMT system adds about 14,000 taxpayers annually to the tax rolls, or one high-income taxpayer for every 1,000 high-income taxpayers already paying some amount of income tax under the regular tax system.[153] The Joint Economic Committee study scoffs at these numbers and suggests that the better way to deal with high-income tax evaders than to catch so few with the AMT is to repeal the AMT and reduce taxes.[154]

The AMT is clearly an imperfect method for ensuring that all high-income taxpayers pay some tax. It is not so clear, however, that the ability of the AMT to ensnare this number of high-income taxpayers should be scorned. For the years for which the calculations were made, the relative rates of the regular and AMT systems were such that the regular income tax liability likely exceeded the AMT liability (which was based on a broader base but at generally lower rates), except for those taxpayers with preference items or other adjustments that were significant in the aggregate, such as stock option exercises or itemized deductions that were phased out under the AMT. Even the National Taxpayer Advocate acknowledges that "repealing the AMT will result in some taxpayers owing nominal or no tax."[155] If the AMT only adds 1 for every 1000 high-income payers, that number is itself not insignificant. This is especially true when one considers that, without an

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the AMT was originally designed to prevent wealthy taxpayers from escaping tax liability through the use of tax avoidance transactions, it now affects large groups of middle-class taxpayers with no tax avoidance motives at all").

150. See 1969 Ways & Means Report, supra note 127, at 9; 2003 NTA Report, supra note 124, at 8 & n.11.

151. 1969 Ways & Means Report, supra note 127, at 1 (noting that "only by sharing the tax burden on a fair basis is it possible to keep the tax burden at a level which is tolerable for all taxpayers").

152. See JEC AMT Study, supra note 129, at 5.

153. Id. at 6-8 (using 1998 return numbers and results of a 2001 GAO study to calculate these numbers).

154. Id. at 14.

155. 2003 NTA Report, supra note 124, at 17 (citing the Brookings/Urban Institute study estimating that 2,700 taxpayers with incomes more than $1 million who would not otherwise have paid any tax were caught by the AMT in 2003).

AMT system, considerably larger numbers of high-income taxpayers might engage in aggressive tax-avoidance planning around the very items currently made difficult to use in tax sheltering because of the AMT.[156]

Underscoring the complaint regarding failure of purpose is the predicted encroachment of the AMT system on upper-middle-income taxpayers. One cause for the broader reach, of course, is Congress' change in the treatment of preference items under the AMT over the years since the original enactment. The original AMT focused on deductions that might be taken by owners of property, a group that we have seen can be expected to be made up predominantly of the wealthy. Thus, AMT preferences under the 1969 legislation included the portion of net capital gains excluded under the pre-1986 Code regular tax and excess depreciation or amortization deductions permitted under the regular tax.[157] The 1976 amendments, however, added a tax preference for itemized deductions, essentially limiting itemized deductions other than medical and casualty losses to no more than 60% of adjusted gross income. Further amendments over the years, in 1986, 1993, and 1997, eliminated some of the preferences that could be expected to be used predominantly by the very wealthy (e.g., the ultimately short-lived AMT preference for untaxed appreciation on charitable deductions). The amendments, while providing a specific ability-to-pay exemption amount for AMT purposes, also resulted in treating as AMT preferences a number of items that we think of, at least in part, as ability-to-pay exemptions – the standard deduction, miscellaneous itemized deductions, state and local tax deductions, a larger portion of medical expenses, and various credits.[158] The rationale behind these changes appears to be somewhat different from the original goal of targeting disallowed preferences narrowly to the very wealthy. They appear aimed at *any* taxpayer that might have a large number, in the aggregate, of the kinds of expenses that tend to have a highly personal element. This retains the flavor of the original purpose of the AMT to target the wealthy while undoubtedly broadening the group of taxpayers to which it may apply, in order to ensure that no taxpayers are able to lower their tax liabilities to a *de minimis* level compared to their economic incomes merely because they are able to aggregate a large number of subsidies or incentives (credits), "rough justice" deductions (the standard deduction), and expenses that may carry a highly personal flavor (miscellaneous itemized deductions). In several instances in which taxpayers have claimed that the AMT should not apply to a once-in-a-lifetime income jump or undo investment and job

156. Johnston, supra note 68 (quoting tax lawyer Jonathan Blattmachr of Milbank, Tweed, Hadley & McCloy, who commented that "[t]here are lots of things you would not even think about because of the alternative minimum tax, . . . [b]ut if you repeal it, then there are all sorts of things to start thinking about").

157. See 2003 NTA Report, supra note 124, at 7 & n.8 (listing preference items in the 1969 revenue act).

158. IRC §56.

credits offered under the regular tax system, courts have pointed out this somewhat broader purpose of the AMT.[159]

A further salient feature responsible for the broader reach of the AMT is the failure of the AMT income brackets, exemption amount and phase-out thresholds to be indexed for inflation, whereas the corresponding regular tax parameters are so indexed.[160] As a result, each year as inflation causes the regular tax brackets and thresholds to creep upward, the AMT brackets and thresholds remain stagnant. Accordingly, the AMT ensnares more and more taxpayers for whom the applicable marginal regular tax rate is sufficiently lower than the AMT tax rate, or the broadened AMT base is sufficiently broader than the regular tax base, to cause the AMT liability to exceed the regular tax liability. In addition, as discussed in Part III.C, the interaction of tax cuts with the lack of AMT indexation results in an inexorable downward creep of applicability of the AMT to lower-bracket taxpayers who would otherwise have received a greater benefit from the 2001-2003 tax cuts. Those urging AMT reform argue that this downward creep is particularly inconsistent with the AMT's stated goal of ensuring that the wealthiest Americans pay some share of the federal tax burden,[161] given Congress' stated aim of reducing the tax burden for all taxpayers through the 2001-2003 tax cuts.

There can be no denying the inconsistency of downward creep with the narrow original minimum tax purpose. It seems apparent, however, that the harm caused by downward creep is more a question of fairness due to decreasing progressivity in the overall tax system than it is a problem of incoherence.[162] The AMT can be construed as structurally coherent if it is cast as a back-up system that attempts to ensure that those with economic

159. See, e.g., Maryhelen Bettner v. Comm'r, T.C. Memo 1991-453 (where a low-income taxpayer received a net long term capital gain from the sale of an apartment building that subjected her to the AMT, finding that "[w]hile it is apparent that the congressional purpose in enacting the minimum tax was to assure that the wealthy would pay their fair share of taxes, the statute by no means discriminated between the wealthy and the nonwealthy"); Huntsberry v. Comm'r, 83 T.C. 742, 749 (1984) (noting that the AMT was structured quite differently from the original minimum tax, in that it applied graduated rates to "a new concept" of income of which preferences were just one component).

160. 2004 NTA Report, supra note 134, at 383 (stating that "[t]he AMT is ensnaring an ever-growing number of taxpayers because . . . the AMT 'exemption amount' is not indexed for inflation" and noting that if the original exemption amount of $30,000 in 1969 had been indexed for inflation, it would today be approximately $153,500 instead of only $45,000 for married taxpayers and $33,750 for most other taxpayers).

161. See, e.g., JEC AMT Study, supra note 129, at 10 (noting that "a tax intended to apply only to high-income taxpayers will eventually become everyone's tax").

162. See, e.g., Gale & Potter, supra note 16, at 134, 138-39.

income, whether wealthy or merely upper-middle income taxpayers, cannot make undue use of personal expenditures to avoid their fair share of the tax burden. It does, in fact, perform that function in a significant number of cases.[163] That slightly different view of the AMT casts certain preferences (e.g., deduction for state and local taxes, miscellaneous itemized deductions) as reflecting a substantial element of personal consumption and thus appropriately limited under the alternative system.[164] It suggests there can be too much of a good thing and requires a final weighing of the aggregate use of incentives that may fortuitously accrue to one taxpayer and that would otherwise let that taxpayer avoid taxes on economic income.

Even applying this perspective, however, it remains bothersome if the combination of the tax cuts (including estate tax repeal) and the operation of the AMT results in an overall shift of the federal tax burden away from high-income taxpayers and onto ordinary taxpayers. The answer to this argument is not repeal of the AMT, but rather restoration of the overall redistributive potential of the tax system through changes to both the AMT and the regular tax, as necessary. This option will be explored in Part V, below.

B. Transparency

The argument from purpose can be viewed as one aspect of an argument about the importance of transparency in a self-assessment tax system that relies to a considerable extent on the willingness of taxpayers to report all items of income fairly. Prior to 2000, most ordinary taxpayers were probably unaware of the alternative tax system.[165] Because of the interaction of the 2001-2003 tax cuts with the AMT provisions, however, these ordinary taxpayers may well be surprised to find that they have to do extra

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163. For example, although the Cheneys paid a rate of tax in 2003 that was significantly below the average rate paid by others in the $1-$2 million income group – 19% on reported income (12.7% effective tax rate on total economic income) compared to the 29% average – , they paid more than they otherwise would have because of the application of the AMT to their income. See Johnston, supra note 73.

164. See supra text accompanying note 159 and accompanying text (discussing the Huntsberry and Bettner cases) and the discussion in Part IV.D, infra.

165. See, e.g., Statement of David A. Lifson, Tax Division of the American Institute of Certified Public Accountants, to the House Committee On Ways And Means, Hearings On the Revenue Provisions in the President's Fiscal Year 2000 Budget (Mar. 10, 1999) (noting that "[m]ost sophisticated taxpayers understand that there is an alternative tax system, and that they may sometimes wind up in its clutches; unsophisticated taxpayers, however, may never have even heard of the AMT, certainly do not understand it, and do not expect to ever have to worry about it"). Only about 40,000 taxpayers with AGI less than $50,000 owed any AMT in 2001 (and even these taxpayers may have had higher gross incomes because of above-the-line deductions). See 2003 NTA Report, supra note 124, at 5 n. 3.

calculations to be sure that they are not potentially liable for the AMT. In the process, they may miss allowable deductions or, if they have a one-time "minimum tax credit" from an earlier payment of AMT, they may fail to use the allowable credit. Because of the inconsistency between the AMT and regular tax systems and the failure of required interest reporting to make any distinctions among types of interest, some taxpayers may not understand or comply with the different AMT treatment of various types of interest.[166] The average additional tax liability for AMT taxpayers is $6,000.[167] If unaware of the AMT, taxpayers may not have set aside sufficient funds to pay the tax and may have failed to make required estimated tax payments. As a result, new AMT taxpayers may be more likely to be subject to underpayment penalties.[168] This lack of transparency in the tax system is likely to cause considerable resentment, as taxpayers feel that making the extra calculations is an unreasonable burden and, if they indeed have to pay the AMT or a related penalty, that they have been cheated out of the additional tax amount required, without fair notice of its potential applicability.

While the importance of transparency cannot be denied, it is not clear that the transparency argument is itself a strong reason for outright repeal of the AMT, rather than other solutions to the quandary. Part of the reason the AMT is not transparent is the rhetoric that is used by Congress, practitioners, and academics alike to describe it, often in the context of campaigns to support particular reforms that will benefit particular constituent groups.[169] Our tax system includes several different tax regimes –

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166. For example, the AMT allows a deduction for interest paid on mortgage loans that are used to purchase a home, but it does not allow a deduction for interest paid on home equity loans that are used for personal consumption.

167. 2004 NTA Report, supra note 134, at 383 (citing Leonard E. Burman et al., The Individual Alternative Minimum Tax: A Data Update, tbl. 3 (Aug. 30, 2004), reprinted in 2004 TNT 175-15 (Sept. 9, 2004)).

168. Id. at 384.

169. See, e.g., Timothy Carlson, Letter to Sen. Grassley (Oct. 2, 2003) (on file with author) (arguing without substantiation that ISO exercise results in punitive taxes on phantom gains, resulting in "[m]any persons [who] have stopped working because the IRS is taking everything they own"). Further examples are provided in the materials referenced in note 9, supra. This rhetoric is particularly harmful to democratic deliberations. Advocacy groups' demonization of the AMT, as though it were an external cancer on the tax system rather than a working part of that system, threatens to overpower reasonable policy debate with colorful but misleading sound bites that distort the facts. For example, Matthew Bailey of the National Taxpayers Union accuses "the *government*" of "punish[ing] the very activities that *Congress* seeks to encourage," as though two different actors enacted the AMT and the regular tax. See Bailey, supra note 141, at ¶46 (emphasis added). Of course, tax policy debate has long been a focus of political maneuvering and the accompanying use of cultural constructs to depict taxpayer stereotypes. A new group of critical tax scholars is beginning to give this tax rhetoric the attention it deserves. See, e.g., William Blatt, Why Did Congress Repeal the

payroll taxes ostensibly dedicated to Social Security and Medicare, transfer taxes governed by the gift and estate tax regimes, and income taxes governed by the regular and alternative tax regimes. We cannot evaluate overall distributional effects without understanding the combined effects of all of these tax systems, and taxpayers also need to understand how these systems interrelate in order to participate in informed debate about tax policy.[170] If someone claimed not to be sufficiently aware of the regular income tax, we would rightly scoff at them. There is no reason that the approach should not be the same for the AMT, and the resources should be spent to ensure that taxpayers become better informed about the overall tax system.

Congress chose to enact the 2001-2003 tax cuts without at the same time resolving the inconsistency with the AMT that the amendments created. The Administration was aware of the problem the tax cut would create.[171] Congress' failure to make the AMT fully compatible with the tax cuts suggests an ulterior aim: either the tax cuts were never intended to reach to the population that will be most negatively affected by the downward creep of the AMT, or Congress counted on ordinary taxpayers' consternation with the encroaching AMT to permit it eventually to eliminate the AMT in spite of the inevitable deficit. We overlook that history if we imply that the AMT is a "stealth tax" that unintentionally takes away the tax cuts. In suggesting appropriate reforms, therefore, responsible tax commentary should look at the AMT in conjunction with the 2001-2003 regular tax cuts and consider ways to enhance dissemination of information about the AMT. Part V attempts to carry out this approach to the AMT.

C. Complexity

The AMT as it existed prior to the 2001-2003 tax cuts was already a highly complex system, requiring separate computations and careful reading of instructions to ensure that proper adjustments had been made.[172] The

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Estate Tax But Not the Gift Tax?, Rutgers-Newark Critical Tax Conference (Apr. 2004), at 6-8, at http://taxprof.typepad.com/taxprof_blog/2004/06/blatt_on_retent.html (last visited July 1, 2004) (noting the use of cultural constructs in debates about taxation).

170. See, e.g., Baron & McCaffery, infra note 254, and accompanying text.

171. See, e.g., Shaviro, supra note 9, at 1456 (noting that "[d]espite any such concerns [about the impact of the AMT if substantial tax cuts were enacted], President Bush has proposed tax cuts largely identical to those he urged during the campaign, without AMT relief. Moreover, his advisers have been issuing strong statements to the effect that Congress should not at this stage make costly additions to his short list of proposals").

172. See, e.g., Bailey, supra note 141, at ¶17 (quoting former IRS Commissioner Rossotti's statement that the AMT is "intricate and ambiguous"); Shaviro, supra note 9, at 1457-58 (discussing compliance, transactional and rule complexity).

majority staff of the Joint Economic Committee (JEC) prepared a study in 2001 that emphasized the "growing burden" represented by the AMT for individuals. Noting that a wide array of groups have called for AMT repeal, the JEC AMT Study focuses on the imminent explosion of AMT applicability and the burden imposed in terms of AMT complexity and related high costs of compliance,[173] and suggests that the problem the AMT was designed to attack is not of sufficient importance, and the AMT is not sufficiently targeted, to merit retention of the supplemental tax system.[174] The study describes the AMT process as follows:

> Calculating the AMT is a four-step process. First, taxpayers calculate their regular income tax.
>
> Second, they determine whether the AMT may apply. Some taxpayers are automatically subject to the AMT because the tax applies to everyone who claims certain kinds of adjustments to income, such as stock options not exercised in the same year they were received. Such taxpayers go straight to the third step. Other taxpayers may be subject to the AMT if their taxable income plus certain other items exceeds $45,000 for married couples filing a joint return (half that for each spouse if they file separately), or $33,750 for a single filer or head of household [the then-current AMT exemption amounts; these have been temporarily increased through 2005]. Those taxpayers complete a 13-line worksheet [12 lines in 2004] provided in the instructions to IRS Forms 1040 and 1040A, the forms for the regular income tax. If the worksheet indicates that the AMT may apply, those taxpayers go on to the third step.
>
> Third, taxpayers use IRS Form 6251, which is 50 lines long, to recalculate taxable income using the rules of the AMT instead of the rules of the regular income tax. The result of this calculation is called the tentative AMT.

173. JEC AMT Study, supra note 129, at 6-10 (noting the groups that have criticized the AMT, the lack of AMT indexation, and the expectation that the number of affected taxpayers will grow "explosively"); 2004 NTA Report, supra note 134, at 383-84 (stating that the tax "impos[es] onerous compliance burdens" and reporting that 75 percent of AMT taxpayers hire a practitioner to prepare their returns, which is "hardly surprising" given that "taxpayers often must complete a 12-line worksheet, read eight pages of instructions, and complete a 55-line form simply to determine whether they are subject to the AMT).

174. JEC AMT Study, supra note 129, at 6-8.

> Finally, taxpayers compare their regular tax before credits with their tentative AMT, and pay whichever is greater.[175]

A considerable cause of the complexity and compliance cost is the requirement that taxpayers who may well not be subject to the AMT must work through at least the short AMT worksheet to determine whether they must make the more detailed calculations on Form 6251, entailing additional hours of tax return preparation time and hassles.[176] Repeal would, of course, resolve the issue, but at a high cost in both loss of revenues and potential loss of taxpayers from the tax rolls.[177] Another solution, that appears to increase the coherence of the AMT system, is to institute a bright-line income threshold test for applicability of the AMT. Such a test would ensure that no ordinary taxpayer under the selected income threshold has to devote any tax preparation time to AMT calculations and would at the same time exempt those taxpayers from AMT liability, furthering the core purpose of the minimum tax to target the wealthy and taxpayers with excessive preferences. Part V develops this suggestion further.

Even if ordinary taxpayers are exempt from the AMT through an income-threshold test, however, the AMT itself remains a complex system with a number of required computations for those taxpayers who would still be required to carry out the full AMT analysis. Various items must be recomputed for AMT purposes, including home mortgage interest,[178] investment interest,[179] depletion deductions,[180] and depreciation.[181] Undoubtedly, these recomputations require time and lead to both frustration and error. For 1997, the JEC AMT Study estimates that the overall cost of compliance with the AMT may have been as high as $360 million.[182] The IRS estimated that the AMT system added 29 million hours to overall

175. Id. at 2-4.

176. See Instructions to Form 1040, Line 44, Worksheet to See If You Should Fill In Form 6251 – Line 44 at 35 (2004).

177. See, e.g., supra notes 138-139 and accompanying text.

178. Equity lines of credit used for purposes other than home purchases, construction or improvement or that exceed the amount originally financed are not deductible for AMT purposes. See, e.g., Internal Revenue Service, 2004 Instructions for Form 6251, Line 4, p. 2 (2004).

179. A taxpayer with investment interest must fill out a new Form 4952 to recompute with appropriate AMT adjustments. Id. at Line 8, p. 2.

180. Id. at Line 9, p. 2.

181. Id. at Line 17, p. 3.

182. JEC AMT Study, supra note 129, at 8. The JEC majority staff argues somewhat speciously that the AMT is "not about revenue but about symbolism – the resentment of many taxpayers at a few people with high incomes paying no federal income tax.." Id. at 13. The study then asserts that the answer to tax avoidance is to simplify the Code, which means "reducing tax rates." Id. at 14.

taxpayer return preparation time in 2000.[183] While these estimates may be high, they do suggest that AMT complexity should be addressed, if possible, in structuring any AMT reform. The priority of reducing complexity, however, may be limited compared to other reform goals, particularly in the context of choosing between AMT repeal or AMT (and regular tax) reform. Sophisticated taxpayers in the higher income brackets generally can be expected to have complicated finances and to rely on sophisticated tax planning advice. Accordingly, the likely application of AMT complexity, including recomputations, to this group is less of a tax policy concern.

A further aspect of the complexity of the AMT is the uncertainty surrounding the relationship between the AMT and the regular tax due to the sunsetting provisions used in the 2001-2003 tax acts.[184] Congress has so far taken a piecemeal approach. Unwilling to let the hammer of the AMT fall quite as heavily as it would without any action, Congress increased the exemption amounts for 2001 through 2004 in the 2001 tax bill and then increased the exemption again when it enacted the 2003 tax bill.[185] In 2004, Congress extended the increased exemption amount to 2005.[186] Clearly, the uncertain future reach of the AMT creates complexity and corresponding transparency problems for many taxpayers. Any solution that resolves the uncertainty would be an improvement in the tax system. Repeal would, of course, eliminate the problem, but is extremely costly. Thoughtful steps to re-target the AMT, with corresponding changes to the regular tax to increase the harmony of the two systems, would be just as effective in removing the uncertainty and perhaps more realistically possible in the current economic and political climate. Part V further explores this alternative.

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183. See Internal Revenue Service, Annual Report from the Commissioner of the Internal Revenue on Tax Law Complexity, at 26 (June 5, 2000).

184. See, e.g., Gale & Potter, supra note 16, at 162 (noting that the 2001 tax cut made a pre-existing problem more expensive and difficult to resolve and thus added "uncertainty about its evolution").

185. See Economic Growth and Tax Reconciliation Relief Act of 2001, Pub. L. 107-16, §701(a)(1)-(2), 115 Stat. 38, 148 (amending IRC §55(d) to increase the exemption from $45,000 to $49,000 for married taxpayers (and from $33,750 to $35,750 for others) in 2001-2004); Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. 108-27, §106(a)(1)-(2), 117 Stat. 752, 755 (amending IRC §55(d) to increase the exemption amount to $58,000 for married taxpayers and $40,250 for others). Congress had first increased the exemption from its original $30,000 level in 1993. Omnibus Budget Reconciliation Act of 1993, Pub. L. 103-66, §13203(b)(1)-(3), 107 Stat. 312 (increasing the joint return exemption to $40,000 and the single taxpayer exemption to $33,750).

186. Working Families Tax Relief Act of 2004, Pub. L. No. 108-311, § 103(a), 118 Stat. 1166, 1168.

D. Consistency

One aspect of the AMT that adds to complexity and lack of transparency is its inconsistency with the regular tax system in respect of various commonly applicable provisions.[187] The regular tax system provides numerous incentive provisions (generally termed "tax expenditures") enacted by Congress to accomplish economic objectives. Congress has also allowed a number of deductions for regular tax purposes even though they are entirely personal expenses or have a highly personal flavor – the mortgage interest deduction (including interest on a home equity loan that is taken out to use for personal purposes such as vacations, private plane purchases or furnishings), the miscellaneous itemized deductions (which include deductions for employee expenses that are not reimbursable by the employer), the state and local tax deduction (e.g., property and income taxes (or, temporarily, sales taxes)), and the medical expense deduction (a clearly personal expense the deduction of which has been allowed out of compassion for taxpayers with extraordinary medical expenses).[188] The AMT effectively disallows some or all of these incentives for any taxpayer for whom the aggregate of these deductions results in a regular tax liability that is less than the AMT liability with the items refigured.

1. "Ability to pay" deductions and exemptions

The AMT treats the standard deduction (used by taxpayers who do not itemize their deductions) and the personal exemptions (for taxpayers and their dependents) as disallowed preference items.[189] In their place, the AMT provides an exemption amount: $58,000 for taxpayers filing jointly in 2005 (but reverting to $45,000 in 2006) and $40,250 for individual taxpayers, including heads of households (but reverting to $33,750 in 2006).[190]

This interaction between the regular and AMT systems has a number of results that merit consideration. First, the inconsistent treatment of the standard and itemized deductions adds complexity (and perhaps inequities) to the system. The election to take the standard deduction for regular tax purposes cannot be revoked for AMT purposes, even though the standard deduction is disallowed for AMT purposes. The lack of a standard deduction (coupled with the downward creep of the regular tax due to the 2001-2003 tax cuts) will snare an increasing number of taxpayers over the next ten

187. Of course, the AMT is necessarily inconsistent with the regular tax, because it is an alternative tax system that affects the tax liability that may result from application of the regular tax system. See the discussion of the role of consistency in establishing coherence in Part II, supra.

188. IRC §§ 163(h)(2)(D), 67(b), 164, 213.

189. IRC § 56(b)(1)(E) (disallowing deductions under IRC §§ 63(c) and 151).

190. IRC § 55(d)(1)(A)-(B); see supra note 186 and accompanying text.

years.[191] In contrast, those who itemize deductions for regular tax purposes are entitled to a substantial portion of the benefit of those deductions for AMT purposes. Consequently, taxpayers who may be subject to the AMT essentially must compute their tax liabilities several different ways in order to determine the optimum combination of approaches – regular tax with standard deduction, AMT without standard deduction; regular tax with itemized deductions, AMT with adjusted itemized deductions. The multiplicity of possibilities adds complexity to any potential AMT-liable taxpayer. Perhaps worse, it is hard to reconcile the approach under the two systems. It is plausible to consider the standard deduction as a rough measure of reasonable deductions for all taxpayers that can be used rather than compute exact itemized deductions.[192] That amount, plus the personal exemptions, should shelter sufficient income for the taxpayer's necessities.[193] That rationale suggests that the same amount should be sheltered under the AMT.[194] Instead, the AMT has a separate exemption amount (generally larger than the sum of standard deduction and personal exemptions, except of course for those taxpayers with very large families) that replaces both the standard deduction and personal exemptions available under the income tax. Yet a taxpayer who itemizes for regular tax purposes can still take most of

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191. See supra Part III.C.

192. See, e.g., Robert S. McIntyre & Michael J. McIntyre, Fixing the "Marriage Penalty" Problem, 33 Val. U. L. Rev. 907, 915-17 (1999) (suggesting that the standard deduction is simpler and serves, with the personal and dependent exemptions, to exclude from income tax liability those at the poverty level); Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2004-2008, at 3 (Dec. 22, 2003) (indicating that the personal exemptions and standard deduction are viewed as defining a zero-rate bracket that is part of normal tax law), at http://www.house.gov/jct/5-8-03.pdf; Joshua Hall, Joint Economic Committee, Tax Expenditures: A Review and Analysis, at 8 (Aug. 1999) (indicating that these deductions are not treated by the Joint Committee on Taxation as tax expenditures because they "approximat[e] the level of income below which it would be difficult for an individual or family to obtain minimal amounts of food, clothing, and shelter"), at http://www.house.gov/jec/fiscal/tax/expend.pdf.

193. See, e.g., 1969 Treasury Study, supra note 124, at 128 (suggesting that a proposed increase in the standard deduction would "benefit a wide range of taxpayers by bringing that general provision into closer alinement [sic] with today's relative cost and expenditure patterns for deduction items").

194. These considerations are complicated by the differences in rate structures. A $5,000 standard deduction in the regular tax system can be considered to prevent income taxation on that amount at the individual's highest marginal rate. That rate could be above or below the basic 26% AMT rate, depending on the taxpayer's taxable income. If the standard deduction is used in the AMT with a gross income exemption threshold, it is more likely that the marginal regular tax rate would exceed the AMT rate, leaving the standard deduction worth slightly less in the AMT than in the regular tax. The difference is probably not sufficient to merit the complexity of developing two separate measures for the deduction.

the itemized deductions for AMT purposes, as well as the AMT exemption amount, in what appears to be a clear violation of basic equity goals for a tax system. The result in many cases is that a taxpayer should itemize rather than take the simplifying standard deduction.

Second, the inability to take personal exemptions for AMT purposes (coupled with other preference disallowances) may cause very large families to be disadvantaged under the AMT in comparison with their tax-favored status under the regular tax system.[195] That is, the existence of personal exemptions for dependents provides a regular tax subsidy to families while singles or couples with no children bear a disproportionately greater share of the regular tax burden. The AMT's elimination of this tax preference, while perhaps reasonable from the perspective of struggling singles or childless couples, does not harmonize with the current emphasis on tax subsidies for families with children. Again, the rationale for the treatment of families under the regular tax would appear to support equal exemption under the AMT system since it is ultimately a rough justice measurement of the amount of income sufficient to maintain a taxpayer's family above the poverty level.

The treatment of dependent exemptions as a preference may be increasingly politically difficult in the face of vociferous complaints from those very large families not in the upper income brackets who find themselves unexpectedly forced to pay the AMT because of a combination of disallowance of other preferences and the loss of personal exemptions. Clearly, there are arguments that the normatively correct tax policy should not favor very large families or that Congress found it politically expedient to appear to favor such large families but through the AMT demonstrated that it wanted to limit that favoritism, but those arguments are beyond the scope of this article.[196] Once the decision has been made to increase the minimum exemption to cover necessities for large families through the regular tax system by means of personal exemptions and other measures, it appears irrational to take the opposing position for alternative minimum tax purposes. When the decision to support large families through the regular tax system has also been publicly touted by Congress as demonstrating a significant commitment of overall federal tax policy to protection of families,

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195. This will only affect very large families, since the current AMT exemptions easily exceed the sum of the standard deduction and personal exemptions for typical families of two or three children.

196. For instance, providing additional deductions to taxpayers according to the number of children they have provides an incentive to taxpayers to have large families at the expense of all other taxpayers with smaller families, raising equity concerns. Furthermore, taxpayers with larger families impose a correspondingly larger burden on public facilities, such as schools, roads, libraries, and hospitals, and potentially may require additional amounts of welfare support, raising concerns about appropriate allocation of resources.

it adds to taxpayers' confusion about how the tax system is supposed to affect them if that commitment vanishes without any supporting rationale. Something that is considered vitally worthy of support in one system is merely treated as irrelevant in the other. This type of inconsistency of policy undermines the perception of fairness that is important to a self-assessment system.[197]

This discussion suggests that the inconsistent treatment of the "ability to pay" deductions generally complicates the tax system, renders it less transparent, and raises basic equity and compliance concerns. The "push/pull" of standard deductions and personal exemptions leaves neither system's apparent priorities satisfied. Whatever the policy decision, it appears that it would be appropriate to harmonize the AMT with the regular tax system on this issue. Part V will consider how this might be done.

2. State and Local Taxes

State and local taxes present another, somewhat similar dilemma, but there may be stronger countervailing arguments to the inconsistency argument. Although taxpayers may deduct state and local property and income taxes (or sales taxes in lieu of income taxes, but only in 2004 and 2005) for regular tax purposes,[198] the deduction is disallowed in full for AMT

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197. Similar arguments can be made about the lack of separate rate brackets and exemption amounts under the AMT for taxpayers who qualify for "head of household" status under the regular tax. The status recognizes that single taxpayers with dependent family members have additional income needs to maintain that household compared to singles without those responsibilities. See, e.g., American Bar Association Section of Taxation, Report to the House of Delegates on the Alternative Minimum Tax (May 7, 2004) [hereinafter, ABA AMT Report], at http://www.abanet.org/tax/home.html (last visited July 15, 2004).

198. IRC §§ 164(a)(1)-(3) (state and local property and income tax deduction), 164(b)(5)(A), (I) (state and local sales taxes deductible in lieu of state and local income taxes; deduction only available in 2004 and 2005), 67(b)(2) (tax deduction not a miscellaneous itemized deduction). Sales taxes were made deductible in lieu of state and local income taxes in 2004, but that deduction is set to expire after 2005. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 501(a), 118 Stat. 1418, 1520. On February 2, 2005, 59 Representatives, most of whom are from Texas or Florida, introduced H.R. 519, which would make the temporary sales tax deduction permanent. 151 Cong. Rec. H347 (Feb. 2, 2005). The discussion in this section assumes that the temporary sales tax deduction will expire as scheduled at the end of 2005 and thus refers only to property and income taxes as being deductible and treats sales taxes as not deductible for purposes of the hypotheticals. If the sales tax deduction provision were made permanent, all taxpayers would be treated equally under the regular tax system regarding their state and local taxes – i.e., it would not matter whether a taxpayer's state of residence chose to raise revenues primarily through income or sales taxes. Further, because sales tax deductions would be disallowed under the AMT, see infra note 199, the likelihood of

purposes.[199] Critics complain that the treatment of state and local taxes as an AMT preference item results in disparate treatment of taxpayers, depending on the happenstance of their state of residence and the attitude of that state towards taxation of its citizens. All else being equal, residents of high-tax states such as New York or California are more likely to pay tax under the AMT system than residents of low tax states such as Texas or Florida.[200] Taxpayers who live in states with low property taxes and no state income taxes usually will enjoy their full income after federal taxes, while taxpayers who live in a state with high property taxes and high state income taxes often will pay tax on the income that is paid to the state due to the AMT.[201] This appears, at least at first glance, as an inequity between taxpayers based on pure geographical happenstance, and one that evokes the argument against incoherence that I have suggested should be given weight in the case of the ability-to-pay deductions.[202]

It behooves us to consider, however, whether the result in this case is genuinely unfair or rather a reasonable concomitant of our federal system, under which states are entitled to (and do) raise revenues by different means, and taxpayers who move from one state to another are subject to different tax regimes and receive correspondingly different levels of provision of public goods in return for taxes paid. The state and local tax deduction should be examined from the various perspectives that help inform our concept of distributive justice. One approach is to consider whether the tax payment corresponds roughly to benefits received. If it does, then the taxpayer can be viewed as effectively purchasing consumption of public goods from the government. A number of commentators agree that state and local taxes

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a taxpayer owing tax under the AMT would not be dependent upon whether she lived in an income- or sales tax-oriented state; rather, it would be determined by whether the taxpayer lived in a low- or high-tax state, regardless of the particular tax regime used by the state. The arguments about the leveling effect of the AMT would therefore retain viability even if the sales tax deduction were made permanent.

199. IRC § 56(b)(1)(A)(ii). If a taxpayer elects to deduct state and local sales taxes, the deduction is treated the same as a deduction for state and local income taxes, IRC § 164(b)(5)(A)(i), and is therefore disallowed in full for AMT purposes, IRC § 56(b)(1)(A)(ii).

200. See, e.g., Feldman, supra note 122 (providing map illustrating high and low tax states that may result in differential applicability of AMT); Kim Rueben & Len Burman, Deductibility of State and Local Taxes, 106 Tax Notes 363, 363 (Jan. 17, 2005) (stating that one-fifth of returns that take state and local tax deductions, and 29% of all state and local tax deductions in dollar amount, are in New York and California).

201. See, e.g., Rueben & Burman, supra note 200, at 363 (stating that the deduction for state and local property and income taxes is the largest preference item under the AMT); Rebelein & Tempalski, supra note 129, at ¶¶ 38-41 (discussing difference in levels of state taxation and effect on AMT taxpayers prior to the enactment of the various Bush tax cuts).

202. See supra note 196 and accompanying text.

should not be deductible if they are "closely related to the public services that individuals receive."[203] In this view, state and local taxes are not a cost of earning income but rather a component of personal consumption.

Second, the distributive justice goal of moving towards egalitarian distribution of resources supports, at least in many circumstances, the traditional tax policy of horizontal equity – i.e., equal treatment of similarly situated taxpayers. Picture two taxpayers, one a resident of Washington state and the other a resident of Oregon. Both own their homes and earn annual salaries of $55,000. Assume that the two have identical consumption habits and pay the same amount of property tax on their homes. Washington has no income tax, but does utilize state sales taxes. Oregon has an income tax, but does not utilize state sales taxes. Under our assumption that the temporary sales tax provision is indeed temporary (and therefore disregarding it for purposes of this hypothetical), the Washington taxpayer will pay more regular federal income tax than the Oregon taxpayer, because the state sales taxes paid are not deductible. The Oregon taxpayer will have a lower regular tax bill because of the deductibility of Oregon's income taxes. Compared with a similarly situated New York State resident who is subject to high income, property, and sales taxes, our two subjects *both* pay lower state taxes and higher federal taxes, while the New York State resident pays high state taxes but gets a substantial tax benefit that lowers his federal tax bill. These taxpayers who all have similar economic profiles are ultimately treated quite differently under the regular tax system because of the multiplicity of possibilities for state taxation (various combinations of high or low state income taxes with high or low state property taxes with high or low state sales taxes). In other words, disparate treatment of taxpayers from different states is a norm in the regular tax system itself (whether or not state sales taxes are deductible) and hardly argues for duplicating the regular tax system in the AMT system in order to achieve greater fairness.

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203. See generally Louis Kaplow, Fiscal Federalism and the Deductibility of State and Local Taxes Under the Federal Income Tax, 82 Va. L. Rev. 413, 417, 422 (1996) (providing overview of commentary and generally arguing against deductibility of state taxes where there is a correlation between taxes paid and benefits received). Kaplow provides a thorough discussion of the various positions on deductibility of state and local taxes for the regular income tax system. There is no consensus. While a number of commentators agree that local taxes relate to benefits received and should not be deductible, others criticize this approach. See, e.g., Brookes D. Billman, Jr. & Noel B. Cunningham, Nonbusiness State and Local Taxes: The Case for Deductibility, 28 Tax Notes 1107 (1985); Edward A. Zelinsky, The Deductibility of State and Local Taxes: Income Measurement, Tax Expenditures and Partial, Functional Deductibility, 6 Am. J. Tax Pol'y 9 (1987). A related theory argues that tax effects are essentially capitalized in prices, so that taxes and the price adjustment perfectly measure benefits received. See, e.g., Bruce W. Hamilton, Capitalization of Intrajurisdictional Differences in Local Tax Prices, 66 Am. Econ. Rev. 743 (1976) (setting forth the capitalization theory).

Now assume that our Washington and Oregon residents each make $250,000 a year and are potentially liable for AMT tax. The Oregon resident must determine AMT liability without taking into consideration the Oregon income taxes. Inclusion of Oregon income taxes as a preference item may well result in the Oregon resident's having a tentative AMT liability. In this case, the AMT disallowance of state income tax deductions levels the playing field between the two residents. The Washington resident will pay more regular tax, but the Oregon resident will pay an additional AMT amount. Instead of creating a disparity, the AMT treatment of state taxes as a preference item in this case reduces a disparity created in the regular tax system. Thus, fairness appears to weigh in at least somewhat on the side of non-deductibility of state taxes for AMT purposes.

Let us carry the examples with hypothetical state residents one step further (again assuming non-deductibility of state sales taxes). Assume two residents of a state with an income tax and relatively high real and personal property taxes. The first resident (let's call him Worker) has a salaried income, a modest home, and one modest car. He drives a short distance to work at the local donut bakery. The second resident (let's call him Wealthy) has most of his income in tax-exempt interest (a portion of which is from qualified private activity bonds) and unrealized appreciation of stock, but he receives as much in dividends as Worker receives in salary. Wealthy has three different homes – a luxurious principal residence in the city inherited from his parents, a vacation home at a ski resort (also inherited), and a vacation home at the beach (purchased by Wealthy). There is a luxury sedan at each location and a helicopter for rapid transit between sites. Wealthy's use of each of these properties depends to a great extent on the viability of the state government in maintaining order on the roads and airways, ensuring stability of the financial systems, and other aspects. Worker pays a relatively modest property tax on house and car – let's say $2,000 annually. Wealthy pays considerable taxes on his numerous real and personal properties – let's say $75,000 annually. Both Worker and Wealthy are able to deduct their property taxes for regular tax purposes. As a result of the numerous state tax deductions and other preferences (e.g., the exclusion for tax-exempt bond interest), Wealthy pays little or no regular tax on his economic income, while Worker pays a significant regular income tax. Neither can deduct their state taxes for AMT purposes, and Wealthy is therefore required to pay some AMT amount.[204] In this case, the AMT takes away, at least in part, the

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204. See Kirk J. Stark, Fiscal Federalism and Tax Progressivity: Should the Federal Income Tax Encourage State and Local Redistribution?, 51 UCLA L. Rev. 1389, 1414 (2004) (noting that high-income taxpayers receive the most substantial subsidy from deductibility of state taxes under the regular tax system and discussing the resulting "plutocratic bias," as Vickrey called it); Rueben & Burman, supra note 200, at 363 (reporting that "the [state and local income property tax] deduction most benefits the affluent: more than half of the deductions were claimed by the 8 percent of taxpayers

subsidy to excess property ownership provided in the regular tax system and puts Wealthy and Worker on a more level footing for federal tax purposes.[205] This example makes the case even more strongly that state taxes may indeed be correlated with benefits received, so that the expense appears much more a personal consumption item than a mere involuntary cost similar to costs of earning income.[206] From a redistributive viewpoint, it appears appropriate that those who consume more (i.e., receive more of the benefits of the stable state environment) should not receive an additional benefit in respect of that consumption against their federal taxes.

As for the contribution to complexity of a preference for state taxes, there are mixed arguments. Clearly, any difference between the AMT and the regular tax system is a complicating factor per se. The question is whether the degree of added complication is merited, given the other benefits. To answer that, it is worth comparing the AMT solution to the alternative of limiting the state and local taxes preference more stringently in the regular tax system through the use of income phaseouts, ceilings on deductibility or

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with incomes exceeding $100,000 in 2002"). Rebelein and Tempalski report that the state and local tax deduction is generally the largest AMT preference for high income AMT taxpayers, which they find "not too surprising, because state and local taxes paid generally increase as income goes up." Rebelein & Tempalski, supra note 129, at ¶ 31. They find that "[f]or AMT taxpayers with AGIs greater than $200,000, state and local taxes paid are the largest preference for over 75 percent of these taxpayers in all years." Id. at ¶ 34.

205. This is more clearly shown by adding numbers to the example. Suppose that Worker has no children, earns a $50,000 salary, and takes the standardized deduction (because he has no itemized deductions other than his property taxes). Worker would have taxable income in 2005 of $41,800 ($50,000 – $5,000 (std. deduction) - $3,200 (personal exemption)) and owe $7,115 in tax. Suppose that Wealthy has no children, has $100,000 in tax-exempt interest ($40,000 of which is from qualified private activity bonds) and $50,000 in dividends, and elects to itemize because his property taxes exceed the standard deduction. Wealthy would have no taxable income and thus owe no regular tax in 2005 because his itemized deductions ($75,000) and personal exemption ($3,200) exceed the amount of dividends ($50,000) he received. Wealthy, however, would be subject to the AMT because his AMI of $90,000 ($50,000 dividends + $40,000 from qualified private activity bonds) exceeds the AMT exemption amount of $40,250, resulting in a taxable excess of $49,750. The lesser of (1) taxable excess, (2) adjusted net capital gains, or (3) the maximum amount taxed at the regular tax 10% or 15% rates less ordinary income is taxed at the preferential 5% capital gains rate for AMT purposes. See H.R. Conf. Rep. No. 108-696 (2004), reprinted in 2004 ISKCON 1029. Accordingly, $29,700 of the $49,750 would be taxed at a 5% rate and the remainder of $20,050 would be taxed at a 15% rate. Wealthy would owe AMT of $4,492.50. Wealthy has three times the economic income of Worker, but even with the AMT has a tax liability of only about two-thirds that of Worker's. This example further illustrates the way the failure of the AMT to treat capital gains as a preference limits its ability to balance the tax burdens of Worker and Wealthy. See infra Part V.A.7.

206. See, e.g., Kaplow, supra note 203.

a percentage of AGI test. Retaining the AMT for this purpose has several pragmatic advantages. First, the AMT is a pre-existing condition to any tax legislation: it is generally easier for Congress to leave something as it is than to create it anew. Except to the extent that lobbyists are able to create concern among ordinary taxpayers about a tax that has not yet struck them, ordinary taxpayers will not demand of their representatives in Congress that they act to change the AMT, especially not in ways that are intended to benefit primarily the better off. Second, if the AMT is limited to taxpayers with gross income at a high-enough threshold to ensure that ordinary taxpayers are not brought within its grasp, as recommended here, ordinary taxpayers are in fact advantaged by not having to deal with the complexity that would be added by additional phaseouts and ceilings in the regular tax system. The AMT moves the complications to the alternative system that is intended to nab more sophisticated taxpayers for whom the complexity of provisions is of less concern from a tax policy standpoint. Third, the AMT also simplifies the calculations necessary for those sophisticated taxpayers, who merely aggregate the disallowed preferences and then recalculate a tax rate. This appears to be a simpler process than requiring different ceilings and income phaseouts for different preferences, which would likely be necessary in order to capture the appropriate level of "excess" preference under a phaseout mechanism in the regular tax system.

In summary, the AMT treatment of state and local taxes is clearly inconsistent with the treatment of state taxes under the regular tax. That is the inherent result of treating any regular tax deduction as an AMT preference. The AMT treatment also unambiguously leads to disparate AMT results for taxpayers depending on their geographic location, since different states in the federal system exercise their powers to tax in different ways. When the treatment of state and local taxes is viewed in the larger context, however, it appears that the AMT preference for state taxes acts in some ways as a leveler rather than a gap creator and corresponds to basic notions of fairness in a federal system, in that those who pay higher state taxes are likely to receive correspondingly greater state benefits and the AMT acts in this way as a redistributive force. The choice between these policies should therefore be made on the grounds of the ultimate goal expected to be achieved. In Part V, I recommend a modest adjustment to the current treatment of state and local taxes for AMT purposes, in order to reduce inconsistencies between the two systems while ensuring that wealthy taxpayers cannot use their large property holdings as a free pass on the tax system. The overall result of this adjustment should provide greater structural coherence and closer fidelity to the underlying distributional rationale for the AMT.

3. *Medical Expenses*

The AMT includes one adjustment that is viewed as particularly harsh and hard to justify, in that it limits medical deductions.[207] The itemized deduction for medical expenses is limited under the regular income tax to amounts in excess of 7.5% of AGI. Under the AMT, it is further restricted to amounts in excess of 10% of AGI.[208] The question that must be addressed is whether the additional limitation under the AMT is reasonable, given the purpose of the AMT and the nature of the medical expense deduction.

One could surmise that Congress, in limiting medical expense deductions for regular tax purposes, considered ordinary medical expenses to be quintessentially personal expenditures and did not want the tax subsidy provided by a medical expense deduction to discourage the reasonable purchase of private insurance.[209] Yet certainly Congress was concerned that extraordinary medical expenses could be well outside the range of normal insurance coverage and ordinary taxpayers' ability to pay.[210] That is, the allowance of a regular-tax medical expense deduction acknowledges that some personal expenditures can be so large as to require special consideration under the tax system. The limitation on medical expenses sets a

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207. See, e.g., William D. Andrews, Personal Deductions in an Ideal Income Tax, 86 Harv. L. Rev. 309 (1972) (arguing that medical expenses should always be deductible); ABA AMT Report, supra note 197, at 8 (noting that the current AMT penalizes taxpayers unable to participate in tax-advantaged health savings plans).

208. Compare IRC § 213(a) (limiting medical expense deduction to amounts in excess of 7.5% of AGI) with IRC § 56(b)(1)(B) (limiting the deduction for AMT purposes to amounts in excess of 10% of AGI).

209. See, e.g., House Ways & Means Committee, Report on the Revenue Act of 1978, H.R. Rep. No. 95-1445, at 43 (1978), reprinted in 1978-3 C.B. 181, 217 (stating that "[t]he primary rationale" for the medical expense deduction is to cover "extraordinary medical costs – those over a floor designed to exclude predictable, recurring expenses"); Shaviro, supra note 9, at 1465 (discussing view that the medical expense deduction amounts to quasi-insurance that may be both unnecessary and socially costly); Louis Chapleau, The Income Tax as Insurance: The Casualty Loss and Medical Expense Deductions and the Exclusion of Medical Insurance Premiums, 79 Calif. L. Rev. 1485 (1991) (same).

210. See, e.g., House Ways & Means Committee, Report on the Revenue Act of 1978, H.R. Rep. No. 95-1445, at 43 (1978), reprinted in 1978-3 C.B. 181, 217 (describing the revision to the deduction for medical expenses and indicating that "[t]he primary rationale for allowing an itemized deduction for medical expenses is that 'extraordinary' medical costs – those over a floor designed to exclude predictable, recurring expenses – reflect an economic hardship, beyond the individual's control, which reduces the ability to pay Federal income tax"). The placement of the line for extraordinary medical expenses has changed over time. At the time of the consolidation of medical expense deductions in 1978, taxpayers were permitted to deduct expenses in excess of 3% of their adjusted gross incomes. Id.

threshold at a rough-justice line drawn to ensure that deductions are permitted only for genuinely extraordinary medical situations. Although any line-drawing in this situation is somewhat arbitrary, medical expenses that exceed 7.5% of AGI appear sufficiently substantial to fall within this category.

What, then, could be the justification for limiting those expenses even further for AMT purposes? Once an arbitrary line has been drawn to distinguish "ordinary" medical expenditures from those that are sufficiently substantial to merit some consideration in the tax system, why would it be reasonable to limit those deductions for any reason? One argument for increasing the limitation under the AMT is that it takes away from wealthy taxpayers some portion of what otherwise may be a subsidy for "luxury" health care that is beyond the cost of care that an ordinary taxpayer can afford. Congress may have noted, for example, that the highest income taxpayers take significantly higher medical expense deductions, when they do itemize for those expenses, than other taxpayers.[211] Under this argument, Congress could be considered to have limited wealthy taxpayers with excessive medical expenses from milking the system for deductions not genuinely merited. Congress could have considered it inappropriate to subsidize the wealthy taxpayer's ability to select the best of care at the finest facilities with the highest costs, when similar treatment is beyond the reach of ordinary taxpayers. Congress could also have considered it likely that the wealthy can arrange to have facilities prescribed for medical purposes that may not be justified if examined too closely.[212] Under this logic, an increase in the threshold for deductibility might serve as a safeguard to ensure that the government is not merely subsidizing the wealthy taxpayers' ability to enjoy luxury medical care.

The problems with this argument are threefold. The increased threshold simply discounts a portion of any medical bill, whether a luxury bill or not. The wealthy may continue to purchase luxury care and continue to utilize the medical deduction to eliminate tax liabilities, if their bills are a substantial enough portion of their incomes. Taxpayers with chronic medical

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211. See, e.g., RIA, Latest Average Itemized Deductions and Other Tax States Based on Preliminary IRS Data, 51 Fed. Tax. Weekly Alert No. 09 (Mar. 3, 2005) [hereinafter, Tax Stats] (computing average deductions from preliminary IRS statistical data that show that taxpayers in the $200,000 and up income category had average medical expense deductions in 2003 of $25,719, while taxpayers in income groups below $100,000 had average medical expense deductions of $5,454 or less).

212. Ferris v. Comm'r, 582 F.2d 1112 (7th Cir. 1978) (denying deductibility as medical expense of much of the costs of constructing luxurious pool room, including gold faucets, as not essentially medical expenses). Another argument is that the slightly lower marginal AMT rate would support a slightly higher AMT deduction to maintain rough equivalence of the exemption. If this were the rationale, however, all deductions permitted under both systems should be similarly adjusted.

problems and insufficient insurance may find themselves increasingly caught by the AMT as medical expenses continue to escalate faster than other expenses. The increased threshold is thus a very crude instrument for disallowing deductions for luxury medical care. At the same time, the increased threshold operates to penalize with higher tax bills those who have extraordinarily high medical bills not covered by health insurance. It thus appears to strike hardest at those who most need the intended benefit of the deduction. Furthermore, many higher-income taxpayers are also the ones able to participate in tax-advantaged health savings plans that entitle them to reimbursement for medical expenses up to the ceiling for set-asides, without certain limitations otherwise applicable to medical expense deductions.[213] These three factors suggest that there is not a convincing rationale for inconsistency between the regular tax and AMT systems. Once Congress concluded that medical expenses that exceed a certain percentage of a taxpayer's AGI should be deductible for regular tax purposes in order to alleviate this burden, then that amount should be deductible for AMT purposes as well. Part V incorporates this conclusion in the recommendations for AMT reform.

E. Accidental Taxpayers

The press has paid considerable attention to two groups of taxpayers who may become subject to the AMT because of an unusually large amount of income received within one taxable year. One group is comprised of employees who exercise incentive stock options (ISOs) to buy stock at a time when the stock has a very high fair market value relative to its purchase price but do not sell the stock until later when the fair market value has declined substantially. The second group is comprised of litigation plaintiffs who seek a damages remedy (e.g., a claim in a non-physical personal injury lawsuit related to employment discrimination or similar violations) and whose award includes an amount payable to their attorneys in respect of contingent attorney fees. These situations involve extraordinary items that in at least some sense may be considered "phantom income," in that the income (stock gain or attorney fee award) is not necessarily accompanied by an increase in liquidity sufficient to pay the AMT tax that is due for the taxable year of the fee award or stock option exercise.

1. Incentive Stock Options

Various commentators (and taxpayers) have raised concerns regarding the AMT impact on ISO recipients who unwittingly find

213. IRC §125. See also IRC §§220, 223 (Archer MSA and Health Savings Accounts).

themselves subject to what appears to be a confiscatory AMT liability.[214] The AMT liability arises from inclusion in AMT income of gain from the ISO exercise (i.e., the excess of the fair market value of the purchased stock on the date of exercise over the exercise price under the ISOs).[215] Ordinarily, an employee must include any bargain purchase in income as ordinary compensation for regular tax purposes, but ISO gain is excluded from this requirement.[216] A recipient must retain the stock acquired on exercise of an ISO for one year after exercise (and must not sell within the two-year period after the option grant) in order for the stock purchase to qualify for ISO treatment. Otherwise, the option exercise will be taxable under Section 83 rather than Section 421.[217] If a recipient who exercises ISOs has a high regular income with various AMT preferences or if the gain on exercise of the ISOs is substantial, there is likely to be an AMT liability as a result of the ISO exercise. In unusual cases, if a recipient who exercises ISOs does not sell some of the stock received before the end of the taxable year of exercise, he or she may have insufficient liquid assets to pay the AMT tax when it

214. See, e.g., Francine J. Lipman, Incentive Stock Options and the Alternative Minimum Tax: The Worst of Times, 39 Harv. J. on Legis. 337, 339-42 (2002) (explaining the treatment of ISOs and describing the advocacy group, Reform AMT, and its efforts to garner support in Congress for revisions to the ISO provisions); Tim Carlson, Letter to Sen. Grassley (Oct. 2, 2003) (available on file with the author) (arguing that ISO recipients should be relieved of any "excessive tax prepayments based on phantom 'value' of stock," even in those cases where they hold the stock for some time after exercise before a decline in value).

215. See IRC § 56(b)(3) (eliminating the Section 421 exclusion for AMT purposes).

216. Compare IRC § 61(a) (requiring inclusion in income of any compensation received from an employer, unless specifically excluded by another provision) with IRC § 421(a) (excluding gain from the exercise of ISOs from income for purposes of the regular tax and generally taxing appreciation upon sale of stock at long-term capital gain rates).

217. In other words, a disqualifying early disposition converts the stock options into nonqualified options. IRC § 421(b). Under § 83, the key question then becomes whether the option had a readily ascertainable value at grant. If so, the value of the option is treated as compensation income at the time of the grant, exercise is not a taxable event, and upon disposition of the stock the recipient has capital gain income or loss (which will be long-term if the stock is held for the long-term holding period after exercise of the option). See Regs. § 1.83-7. If not (and there are no restrictions on the stock acquired on exercise), then the bargain part of the share purchase is included as compensation income at exercise, and a later disposition will result in short- or long-term capital gain depending on the holding period. If the stock is restricted, no income will be recognized until the restrictions are removed, unless the holder makes a § 83(b) election. Id.

becomes due.[218] Assuming the AMT liability is paid, the employee will have a minimum tax credit that can be used, subject to limitations, against the taxpayer's future regular tax liabilities.[219] If the taxpayer sells the stock at a loss after the year of exercise, however, the AMT capital loss can only be carried forward. Such a capital loss will be recouped only if the taxpayer incurs AMT liability in future years against which the loss may be offset. For taxpayers who lose their jobs at the same time that stock purchased with ISOs declines in value (as in the case of employees with stock options who exercised options and then lost gains and jobs with the bursting of the dot-com bubble), there may be limited opportunity in the future to use the capital loss.

As other commentators have noted, the case for eliminating AMT liability for taxpayers who are subject to the AMT because of significant bargain gains in stock purchased under ISOs is not a sympathetic one, in spite of the stories of taxpayers for whom this provision has yielded harsh results.[220] First, recipients, who are predominantly top executives and not rank-and-file employees,[221] have actual economic services income from the exercise of ISOs.[222] As in any case when a taxpayer has property with significant appreciation, newly made millionaires are able to benefit by monetizing the gain through borrowing, gaining access to high-status social circles, and otherwise enjoying the fruits of the "excess" fair market value of their stock purchases. They can afford sophisticated tax advisers, and they have, at the time of their stock purchase, the ability to dispose of some of

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218. See, e.g., Lipman, supra note 214, at 339 (noting that "[i]n many cases, the AMT consequences of ISO exercises took unsuspecting employees by surprise and caught them without sufficient cash to pay their AMT on April 15, 2001").

219. IRC § 53 (providing a credit for the aggregate excess of AMT over regular tax for past years against regular taxes in future years when the regular tax exceeds the AMT). As a result, the AMT operates to accelerate the tax liability associated with the exercise of the option from disposition of the stock to the exercise date of the option.

220. See, e.g., Lipman, supra note 214, at 360-61 (describing stories on the ReformAMT web site at www.ReformAMT.com); Tim Carlson, Letter to Sen. Grassley (Oct. 2, 2003) (complaining about "devastating effects that the AMT is having on many American families who exercised ISOs in 1999-2002" and proposing large settlements to reduce the "unintended and punitive" AMT taxes assessed on those families, as well as legislative reforms to provide "permanent relief" for "taxpayers who have paid unfair and excessive tax rates"); Tully, supra note 9 (reciting, among others, the story of Bill Simmelink, who exercised ISOs for stock worth $6.5 million on which he paid $1.7 million in taxes, but later found that his wealth had shrunk when his stock's value plunged to $1.8 million).

221. See, e.g., David Leonhardt, Option Math: Why So Many to So Few?, N.Y. Times, Feb. 16, 2003, at 3-1 (reporting that the 250 biggest options-granting companies employ an average of 69,000 people but give options primarily to a few top executives, with only about 1.7% of all private sector workers receiving options).

222. ISO recipients would not exercise the options unless there were excess value in the shares.

their shares for liquidity purposes and to pay higher tax liabilities.[223] Furthermore, ISO recipients who may be subject to AMT liability because of their option exercise are not disadvantaged compared to recipients of nonqualified option grants who are required to treat the entire amount of the bargain gain as compensation income for AMT and regular tax purposes. Congress appropriately decided to limit the extent of the tax boon to ISO recipients, by imposing fairly stringent conditions on ISO treatment and by disallowing the ISO benefit for AMT purposes. Recipients have little grounds for demanding that their stock be treated in an even more advantageous manner.[224] As Shaviro notes, this sort of congressional rationing of preferences may actually "increase efficiency relative to the only politically available alternative, by reducing the overall allocative response to the preference."[225] Moreover, the concern that some recipients may be unsophisticated and unaware of the potential tax liabilities associated with the excess value can be addressed relatively simply by requiring companies that award ISOs to disclose, both at the time of award and upon exercise, the potential application of the AMT on exercise.[226] Finally, repeal of the ISO preference item would put ISO recipients in an especially privileged position in comparison with ordinary investors whose stock purchases made with after-tax dollars suffer substantial depreciation. Those investors have no remedy other than the use of the capital loss against capital gains, if any (and up to $3000 per year of ordinary income): they are not permitted to recoup their original tax payments on the invested dollars because of the loss.[227]

The problem of ISO options is, on closer examination, an example of the inappropriate demonization of the AMT. Taxpayers who have acquired considerable wealth through ISO options and yet avoided much tax liability

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223. See Lipman, supra note 214, at 369-70 (discussing the various planning strategies that ISO recipients can undertake to lessen their tax liabilities); Stanley R. Finkel & Kelly G. Besaw, Tax-Efficient Strategies for Exercising Compensatory Stock Options, July 2003 Practical Tax Strategies, at http://checkpoint.riag.com (last visited July 8, 2004).

224. See Lipman, supra note 214, at 368-70 (making a similar argument for retaining an AMT preference for the gain on ISO exercise); Shaviro, supra note 9, at 1461 (suggesting that Congress may be "willing to ration [a given tax preference that has undesirable allocative effects] via inclusion in the AMT" even though "unwilling to reduce it directly").

225. Shaviro, supra note 9, at 1461.

226. In an earlier article, I suggested that there were a number of areas in which cooperation between the Securities Exchange Commission (SEC) and the IRS could be beneficial to the purposes of both organizations. See Linda M. Beale, Putting SEC Heat on Audit Firms and Corporate Tax Shelters: Reducing Tax Risk with Sunshine, Shame and Strict Liability, 29 J. Corp. L. 219, 266 (2004). This is another example where cooperation between the agencies could help further their purposes and yield substantial benefits to ordinary taxpayers. The SEC could require general disclosure about the potential applicability of the AMT to ISOs, as part of a public company's reporting obligation. The IRS could require similar information reporting to ISO recipients upon exercise of an option.

227. See Lipman, supra note 214, at 371.

under the regular tax system are in fact members of the group originally targeted by the AMT – they have substantial economic wealth but, unlike similarly situated taxpayers receiving nonqualified options, they have been able to take advantage of a tax loophole for ISOs to avoid paying any tax on that wealth. The more substantial the bargain gain enjoyed by ISO recipients, the more appropriate is AMT liability. The fact that the wealth may be lost without ever being converted to liquid assets is not unique to these taxpayers and does not merit any unique saving provision. The only problem represented by the AMT preference for ISO grants lies in the complicated nature of all tax determinations regarding option exercises, whether for AMT or regular tax purposes, and the corresponding lack of transparency for one-time grantees who may not be sufficiently aware to avail themselves of sophisticated advisers before AMT applicability is determined. To the extent that transparency can be improved by AMT and regular tax reforms, this problem can be reduced. Amendments to provide further tax advantages to ISO recipients do not appear justified.

2. Contingent Attorney Fees

In contrast to the case for ISO recipients, a more sympathetic AMT situation involves successful plaintiffs in lawsuits who owe AMT because of a lump sum litigation award.[228] The issue arises because, as the Supreme Court recently held, a successful plaintiff's taxable income includes the entire amount of her award, including the portion that is paid to her attorney as a contingent fee.[229] The plaintiff's payment of her attorney's fees is an expense, but generally is considered to be deductible only as a miscellaneous itemized deduction (limited to those deductions in excess of 2% of adjusted gross income).[230] Under the current AMT rules, miscellaneous itemized deductions are treated as a "tainted" preference and therefore not allowed for AMT purposes.[231] The combination of these rules may cause a plaintiff to

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228. See generally Gregg D. Polsky, A Correct Analysis of the Tax Treatment of Contingent Attorney's Fee Arrangements: Enough With the Fruits and Trees, 37 Ga. L. Rev. 57 (2002) [hereinafter Polsky, Fruits and Trees] (describing the AMT trap for litigation plaintiffs); Gregg D. Polsky, The Contingent Attorney's Fee Tax Trap: Ethical, Fiduciary Duty, and Malpractice Implications, 23 Va. Tax Rev. 615 (2004) (discussing the "trap" and the various legal issues it engenders); Brant J. Hellwig & Gregg D. Polsky, Litigation Expenses and the Alternative Minimum Tax, 6 Fla. Tax Rev. 899 (2004) (discussing the "trap," the reasons it is frustrating, and implications of the trap for plaintiffs, their lawyers, defendants, and the courts).

229. Comm'r v. Banks, 125 S. Ct. 826 (2005).

230. See id. at 830 (noting that respondents could have treated the contingent attorney fees as miscellaneous itemized deductions subject to the ordinary requirements of IRC §§ 67-68).

231. IRC § 56(b)(1)(A)(I); see also Banks, 125 S. Ct. at 830 (noting that treating the contingent attorney fees as a miscellaneous itemized deduction "would have been of no help to respondents" because the AMT "does not allow any miscellaneous itemized deductions").

have a large tax payable on the portion of the award paid to the attorney.[232] The resulting AMT liability may even exceed the recovery allocated to the plaintiff by a substantial amount.[233]

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232. Consider a hypothetical developed by Roberta Mann in the course of the ABA Task Force discussions, involving Taxpayer who in 2005 is awarded $450,000 in a false imprisonment suit and pays a 33 1/3% contingent attorney's fee of $150,000. Taxpayer has a full-time job for which he receives a salary of $50,000 in 2005. Taxpayer would owe an additional $32,720 on his 2005 tax return because of the AMT's treatment of the miscellaneous itemized deduction as a "tainted" tax preference, as follows:

Regular tax determinations:	
Salary	$50,000
Judgment	$450,000
AGI	$500,000
Attorneys fees	$150,000
§ 67(a) elimination of portion corresponding to 2% AGI	($10,000)
Resulting § 212(1) deduction before phaseout	$140,000
§ 68 phase out of itemized deductions	
[reduced by *lesser of* 80% ($112,000)	
or 3% of AGI over $145,950 (2005 threshold)]	
$500,000 - $145,950 = $354,050 x 3% =	($10,622)
Applicable § 212(1) deduction after phaseout	$129,378
AGI	$500,000
Itemized deductions	($129,378)
Taxable income	$370,622
Regular Tax Liability	**$103,780**
AMT determinations:	
§55(b)(2) AMT income (AMTI)	$500,000
[taxable income as adjusted by §§ 56, 58 and increased by tax preference items in § 57; thus no miscellaneous itemized deduction § 56(b)]	
§ 55(d) Exemption amount (joint return before phaseout)	$58,000
§ 55(d)(3) AMTI phase out of exemption amount	
[Reduced by 25% of excess of AMTI over $150,000;	
$500,000 - $150,000 = $350,000 x 25%	($87,500)
Resulting §55(d) exemption amount	0
§55(b)(1)(A)(ii) taxable excess	$500,000
§55(b)(1)(A) tentative tax	
26% of taxable excess up to $175,000	
$175,000 x 26%	$45,500
plus	
28% of taxable excess over $175,000	
$325,000 x 28%	$91,000
Total AMT (assuming no credits)	**$136,500**

233. See, e.g., Alexander v. IRS, 72 F.3d 938 (1st Cir. 1995) (indicating that the plaintiff/taxpayer was required to pay taxes of $54,000 on a recovery of $5,000 after costs and attorneys' fees); Adam Liptak, Tax Bill Exceeds Award to Officer in Sex Bias

Litigation of these issues resulted in a split in the circuit courts on the question of whether contingent fees paid out of a taxable damage award or settlement are excludible from gross income or includible in gross income and deductible only as miscellaneous itemized deductions.[234] Both sides sometimes analyzed the strength of the attorney's claims to the fee under the applicable state attorney lien law: courts that found the income excludible generally found that the state lien statute grants the attorney property interests in the claim.[235] Another argument for exclusion that has appeared in the commentary suggests that attorney's fees should be capitalized as basis in the plaintiff's cause of action and thus reduce the amount realized.[236]

Two recent events – a legislative act and a Supreme Court decision – added some much needed clarity to the issue. In October 2004, Congress passed the American Jobs Creation Act of 2004 (AJCA),[237] which permits a successful plaintiff to take an above-the-line deduction for the portion of an award that is attributable to attorney fees if the award is in connection with any action involving either a claim of "unlawful discrimination" (defined as an act that is unlawful under one or more of a number of specifically enumerated laws that provide for employment-related claims) or a claim

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Case, N.Y. Times, Aug. 11, 2002, at 1-18 (reporting that plaintiff-police officer won a $300,000 award and almost $1 million in attorney's fees and costs in a sex discrimination suit, but faced a tax bill that was $99,000 larger than her award); Hellwig & Polsky, supra note 228, at 900 (stating that the adverse consequences of the AMT trap generally are severe). See also Laura Sager & Stephen Cohen, How the Income Tax Undermines Civil Rights Law, 73 S. Cal. L. Rev. 1075, 1078 (2000) (indicating that such a tax liability undoes the intended remedy of the civil rights laws).

234. Compare Raymond v. United States, 355 F.3d 107 (2d Cir. 2004) (including attorney fee awards in income); Hukkanen-Campbell v. Comm'r, 274 F.3d 1312 (10th Cir. 2001) (same); Kenseth v. Comm'r, 259 F.3d 881 (7th Cir. 2001) (same); Baylin v. United States. 43 F.3d 1451 (Fed. Cir. 1995) (same) with Davis v. Comm'r, 210 F.3d 1346 (11th Cir. 2000) (excluding attorney fee awards from income); Cotnam v. Comm'r, 263 F.2d 119 (5th Cir. 1959) (same). The Ninth Circuit has gone both ways. Compare Banaitis v. Comm'r, 340 F.3d 1074 (9th Cir. 2003), rev'd, 125 S. Ct. 826 (2005) with Coady v. Comm'r., 213 F.3d 1187 (9th Cir. 2000). See generally Edward A. Morse, Taxing Plaintiffs: A Look at Tax Accounting for Attorney's Fees and Litigation Costs, 107 Dick. L. Rev. 405, 460-73 (2003); Robert W. Wood, Tax Treatment of Settlements and Judgments, 103 Tax Notes 1134, 1134-35 (May 31, 2004) (providing an exhaustive listing of the cases).

235. See generally Polsky, Fruits and Trees, supra note 228, at 74-78 (describing the case law and positions taken by the courts).

236. For the argument and counterarguments, see Charles Davenport, Why Tort Legal Fees Are Not Deductible, 97 Tax Notes 703 (Nov. 4, 2002); Brant J. Hellwig, Tax Treatment of Legal Fees: The Debate Continues, 97 Tax Notes 1235 (Dec. 2, 2002); Charles Davenport, Capitalization of Legal Fees: Professor Davenport Responds, 97 Tax Notes 1237 (Dec. 2, 2002); Brant J. Hellwig, Davenport's Capitalization Argument Fails to Convince, 98 Tax Notes 433 (Jan. 20, 2003).

237. Pub. L. No. 108-357, 118 Stat. 1418.

against the government under the federal False Claims Act.[238] Because the AMT can arise in other cases (e.g., defamation, intentional infliction of emotional distress, or invasion of privacy),[239] the AJCA does not completely eliminate the potential for inequity. The IRS might also require a plaintiff with multiple claims, only one of which is governed by the new provision, to allocate the attorney fees among the various causes of action.[240]

In January 2005, the Supreme Court finally resolved the split in *Commissioner v. Banks*, an appeal of cases that held that contingent fees are excludible from gross income.[241] In a unanimous decision, the Court reversed the circuit courts.[242] Thus, the taxpayers had to include the total amount of their recoveries and could deduct their attorney fees only as miscellaneous itemized deductions (subject to the 2% of AGI floor). The Court's opinion, however, leaves a number of issues unresolved.[243] In particular, the Court refused to address the capitalization theory, advocated in an amicus brief by Charles Davenport,[244] because the theory was not considered in the courts below.[245]

As a result of these changes, the most sympathetic plaintiffs are protected from the loss of their statutory remedy through an above-the-line deduction. Plaintiffs in other cases, however, may still find themselves facing a tax bill nearly as large as, and in some cases larger than, their recovery from the litigation. Any AMT and regular tax reform should resolve this problem.

238. Id. § 703(a)-(b), 26 U.S.C. § 62(a)(19), (e) (2004).

239. See Robert W. Wood, Jobs Act Attorney Fee Provision: Is It Enough?, 105 Tax Notes 961, 961 (Nov. 15, 2004) (acknowledging that "employment cases have served as the poster child of inequity" though the problem may arise in other types of cases); Hellwig & Polsky, supra note 228, at 900 (noting that the AMT trap affects many claims, although employment-related claims are the most common).

240. See Wood, supra note 239, at 964.

241. 125 S. Ct. 826 (2005). The Court proceeded with the case, even though it would have come within the AJCA change, because the AJCA was not retroactively applied to the taxpayers. Id. at 831.

242. Id. at 829.

243. See generally Robert W. Wood, Supreme Court Attorney Fees Decision Leaves Much Unresolved, 106 Tax Notes 792 (Feb. 14, 2005) (analyzing the opinion and the unresolved questions outstanding).

244. See Brief of Amicus Curiae Professor Charles Davenport in Support of Respondents, Comm'r v. Banks, 125 S. Ct. 826 (2005). Capitalization treatment would have the same effect as an above-the-line deduction.

245. Banks, 125 S. Ct. at 833.

V. PROPOSALS FOR AMT REFORM

The prior Part examined various arguments for repeal of the AMT and found them ultimately unconvincing.[246] This conclusion does not disregard the flaws of the current AMT system, nor does it suggest that an ideal reform of the current tax system would retain an AMT. The conclusion is one based on normative values stressing distributive justice and coherence in the context of the current deficit situation, the overall complexity and unfairness added to the tax system by the 2001-2003 tax cuts, and the need to retain whatever tools possible to ensure that higher-income taxpayers actually pay taxes on their economic income to the federal government.

Given the force of the critiques, what changes can and must be made to address at least the most significant of these flaws? This Part proposes a set of amendments to the AMT to address the most worrisome flaws, appropriately re-target the AMT away from ordinary taxpayers and towards the rich, and make the AMT and regular tax more consistent. Part V.A sets forth a coordinated program of AMT amendments designed to address the valid concerns about the AMT while retaining the AMT's ability to force higher-income taxpayers to ante up a reasonable share of their income, including incorporation of two additional preference items to better target the AMT. Part IV.B proposes additional revenue raisers that adjust the regular tax to better harmonize with the AMT and, even more importantly, allow the worst of the 2001-2003 tax cuts to lapse into obscurity where necessary to maintain a viable tax regime that does not weigh too heavily on ordinary taxpayers.

A. Amend the AMT

This article takes the position that, while flawed, the AMT system can play a valuable role in ensuring that higher-income taxpayers cannot elude the tax collector. To serve its purpose, however, the AMT system must be revised and made more progressive rather than less so. The revisions proposed here attempt to construct a more coherent system by eliminating complexity for ordinary taxpayers, harmonizing AMT and regular tax provisions in respect of determinations regarding basic ability-to-pay amounts, and taking into account the particular situations that give rise to AMT liability.

246. See, e.g., Shaviro, supra note 9, at 1460 (suggesting that the "actual" rationales underlying the AMT are "fundamentally weak" but that there are better arguments related to "distributive and allocational issues" that "might in principle even call for retaining it (albeit perhaps in revised form)").

1. Institution of Gross Income Threshold

Ordinary taxpayers who do not have substantial economic income should not be subject to the AMT, and it should be clear that they are not subject to the AMT without their having to work through a worksheet or perform other calculations. The work required of taxpayers who may be (or think they are) on the brink of AMT applicability and must deal with AMT calculations is a deadweight loss. One simple amendment would eliminate this burdensome task for a large number of ordinary taxpayers – establishment of a gross income threshold test that would be indexed for inflation.[247] The gross income determination for the test should be based on the "total income" determination for the return, with two adjustments. Tax-exempt interest on private activity bonds and the bargain value of ISOs would be added to the return-based gross income to determine gross income for the threshold test.[248] If the threshold test were not satisfied, the taxpayer would be automatically exempt from AMT liability.

At what level should such a gross income threshold test apply to eliminate AMT eligibility? It should not be so high that it exempts taxpayers who would pay a significant tax when AMT adjustments were taken into account. Nor should it be so low that it requires ordinary taxpayers to run the AMT calculations. The primary goal of the income threshold test is to provide a convenient and easily determined line for those who on fairness grounds should not have to worry about the AMT.

Various sources provide information about the median or mean earnings per full time worker or per household. The median income per household in the country is approximately $45,000, and the median earnings per person are about $36,000.[249] The income threshold for AMT applicability should be sufficiently above that level to ensure that the AMT cannot reach

247. The test recommended here is similar to, but not the same as, the one recommended by the National Taxpayer Advocate. See 2003 NTA Report, supra note 124, at 18.

248. These two are selected because they can be very large in proportion to other income; if they were not included in the income determination, a taxpayer with substantial ISO gains could be completely exempted from making the AMT determinations.

249. See, e.g., Carmen DeNavas-Walt, Bernadette D. Proctor & Robert J. Mills, U.S. Census Bureau, Income, Poverty, and Health Insurance Coverage in the United States: 2003, Current Population Reports P60-226, at 27, tbl. A-1 and at 4, tbl. 1 (2004), at http://www.census.gov/prod/2004pubs/p60-226.pdf (showing median money income per household of $43,318); U.S. Census Bureau, Current Population Survey, 2004 Annual Social and Economic Supplement, at tbl. PINC-07, at http://pubdb3.census.gov/macro/032004/perinc/toc.htm (showing median earnings for full-time, year-round workers at $35,795 and mean earnings at $46,421); id. at tbl. PINC-08 (showing median earnings per person aged 15 and older at $26,911 and mean earnings at $36,323).

into ordinary taxpayer ranks. There are, however, a variety of statistics other than median income that might be used to set the appropriate level. For example, a study before the 2003 tax cuts found that if the 2001 tax cuts were made permanent, 95% of AMT taxpayers in 2010 with adjusted gross incomes below $200,000 would face higher marginal rates under the AMT than under the regular income tax.[250] It would be reasonable to set the threshold so that this number is significantly reduced. The National Taxpayer Advocate notes that 40% of all AMT taxpayers would have been exempt from the AMT in 2001 if an adjusted gross income test of $150,000 for married taxpayers and $75,000 for other taxpayers had applied. Further, if the original $30,000 exemption amount applicable for the 1970 taxable year were indexed for inflation, the exemption amount would have increased to approximately $146,000 in 2004.[251] This Article has generally taken the approach that the goal should be to protect from AMT liability ordinary taxpayers, defined roughly as single taxpayers with $50,000 of income or married taxpayers with $100,000, suggesting that taxpayers with incomes at or below those levels should certainly be exempted from AMT liability and from AMT calculations. Although there is likely not a direct correlation between the threshold and the AMT liability, raising the threshold will generally decrease the number of taxpayers with AMT liability and increase the cost of AMT reform. These various considerations suggest a feasible income threshold might exempt married taxpayers with gross incomes of less than $150,000 (in 2004 dollars) and other taxpayers with incomes of less than $75,000.[252]

2. *Treatment of "Ability to Pay" Deductions and Exemptions*

The income threshold test will remove a substantial portion of the problem caused by the AMT treatment of ability-to-pay deductions, since the

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250. Leonard Burman, William G. Gale, Jeffrey Rohaly & Benjamin H. Harris, The Individual AMT: Problems and Potential Solutions 31 (The Urb. Inst., Tax Policy Center Discussion Paper No. 5, 2002), at http://www.brookings.edu/views/papers/gale/20020918.pdf. See also CBO Study, supra note 132, at 3-4 (indicating that 95% of married taxpayers with adjusted gross income between $100,000 and $200,000 would owe AMT in 2010, and 90% of taxpayers with income between $100,000 and $500,000, would generally face higher AMT rates than regular tax rates).

251. These inflation adjusted numbers were determined using the inflation calculator available on the Web at http://www.bls.gov.

252. It is difficult to determine the cost of this change, but the National Taxpayer Advocates notes that use of a $150,000 threshold would have eliminated about 40% of taxpayers in 2001 who paid approximately $800 million in AMT. 2003 NTA Report, supra note 124, at 18. Lowering the threshold could lower the cost of reform, but the threshold probably should not drop below $100,000 for married taxpayers filing jointly and $50,000 for others (i.e., approximately twice the median earnings for single individuals).

group of taxpayers that should most clearly be protected from paying the AMT because of a lesser ability to pay will be eliminated from consideration. The arguments for changing the treatment of the standard deduction and personal and dependent exemption because of the inconsistency between the AMT and regular tax remain, however, for those who may be just over the threshold income. There are several alternative ways to resolve this problem, at least in theory: (i) increasing the current "one-size-fits-all" exemption amount to a single new amount that can be indexed into the future, (ii) bracketing the exemption amount with different levels for different status taxpayers, or (iii) harmonizing the AMT and regular tax by adopting the same personal and dependency exemptions for AMT purposes as used for regular tax purposes. The first alternative, increasing the exemption amount, would require a sufficient zero-percent AMT bracket for a wide range of typical families (whether made up of a single mom; one child and an elderly parent with higher than usual medical expenses; or a traditional family with one parent earning the family's living, the other a caregiver parent, and two or three young children at home). The exemption amount could again simply be set at the level that it would have been had the $30,000 original exemption amount been indexed for inflation throughout the period since 1970, or about $146,000 for 2004.[253] This approach would appear to further the original AMT purpose of targeting taxpayers with the highest incomes, but it does so at significant cost and without addressing the inconsistency and added complexity of different exemptions under the regular tax and the AMT. The one-size-fits-all solution could still leave large families vulnerable to AMT liability, yet may give very small families or single taxpayers inappropriate protection from AMT liability.

The second alternative, bracketing the exemption amount, would partially resolve the worst problems of a one-size-fits-all exemption amount. It would add considerable complexity, however, and would continue a hard-to-justify inconsistency between the AMT and regular tax system.

Accordingly, it appears preferable to harmonize the way the two tax systems provide for a basic standard-of-living exemption amount. This solution should do a number of things. First, the amendment should add a "head of household" status for AMT purposes that will duplicate the head of household status for regular tax purposes. Second, it should remove the standard deduction and personal exemptions from the AMT preference list. For AMT purposes, taxpayers would be entitled to the same personal and dependent exemptions (already indexed for inflation) that are permitted for regular income tax purposes. Third, it should retain the current regular tax indexed income thresholds for phasing out personal exemptions and apply

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253. These inflation adjusted numbers were determined using the inflation calculator available on the Web at http://www.bls.gov.

the same thresholds to phase-out the exemptions in both systems.[254] Fourth, taxpayers who elect the standard deduction for regular tax purposes (already indexed for inflation) should be treated automatically as electing the same standard deduction for AMT purposes. Taxpayers who itemize for regular tax purposes would also itemize for AMT purposes, subject to the AMT limitations on the specified itemized deductions.[255] Finally, the income phaseouts for itemized deductions should be retained and should apply for both AMT and regular tax purposes.[256] This approach reduces complexity and eliminates downward creep, while furthering the tax policy goal of ensuring progressivity by preventing high income taxpayers from avoiding tax altogether.

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254. See IRC § 151(d)(3). The phaseout is currently slated to reduce gradually for taxable years from 2006 to 2009, and to be terminated after 2009. IRC § 151(d)(3)(E)-(F). This proposal would require repeal of that provision. Phaseouts are cumbersome, and it may be that neither reinstating the phaseouts nor instituting higher rate brackets applicable to the upper end of the income spectrum is feasible politically. Based on the heuristic bias in favor of the status quo, it would appear to be more likely that support could be garnered for reinstating phaseouts. Framing of solutions would clearly affect their feasibility. See, e.g., Jonathan Baron & Edward McCaffery, Masking Redistribution (or its Absence) (July 2004), USC L. Sch. Olin Research Paper No. 04-5, at http://ssrn.com/abstract=528165 (showing that a range of heuristics and biases interferes with people's understanding and support of redistribution and that people generally do not understand the reduction in progressivity that results from tax expenditures and cuts in government services).

255. This means that some taxpayers who itemize for regular tax purposes may find that a significant portion of the itemized deductions is disallowed under the AMT. These taxpayers might therefore pay less tax overall if they do not itemize for regular tax purposes, since the standard deduction will be allowed in full for AMT purposes. Accordingly, itemizing taxpayers for regular tax purposes who may be liable for AMT tax will benefit from determining their liability with and without itemizing for regular purposes. This complicates the application vis-à-vis any taxpayer who would otherwise itemize, but that is more appropriate than the current system which forces someone who would otherwise take the standard deduction to do multiple calculations to determine if it would be preferable to itemize solely because of the application of the AMT. The latter case defeats the simplifying purpose of the standard deduction, whereas the former case appropriately encourages use of the standard deduction and its simplifying assumptions.

256. See IRC § 68. The itemized deduction phaseout is currently slated to reduce gradually from 2006 to 2009, and to be terminated after 2009. See IRC § 68(f), (g). This proposal would require repeal of those two provisions. The phaseouts raise significant revenue from higher income taxpayers. See, e.g., Tax Stats, supra note 211 (indicating that "[f]or 2003, 5.2 million higher income taxpayers lost a total of $28 billion of itemized deductions on account of [the section 68] limitation").

3. Indexing AMT Parameters

Even those who think that the current AMT is serving an important purpose cite the lack of indexation of the AMT exemption as one of the most significant problems.[257] The proposal here institutes a gross income threshold to eliminate AMT liability for ordinary taxpayers, replaces the AMT exemption with the already-indexed standard deduction and personal exemptions, and applies the regular tax system's indexed phase-outs to itemized deductions and personal exemptions. Thus, the proposal already ensures indexing of all but the gross income threshold for determining potential applicability of the AMT and the income brackets. Those key additional parameters should be indexed as well. This indexation is particularly important in preventing future downward creep of the AMT into ordinary taxpayer brackets and countering the lack of transparency for individual taxpayers who are less sophisticated and less aware of the potential applicability of the AMT.

The cost of a gross income threshold, substituting the standard deduction and personal exemptions for the single AMT exemption, and indexing the threshold, brackets, and exemptions will be significant. Some studies (based on indexing the existing AMT exemption amount, without an income threshold) have suggested that indexing alone could cost as much as $658 billion over ten years.[258] If reform of the AMT is to accomplish its goal, this cost must be offset through other changes that do not simply shift the tax burden (or the spending cuts due to tax reductions) to ordinary taxpayers. If we are serious about structural coherence and consistency between the AMT and regular tax systems to the extent possible, the costs should be met by increasing AMT collections from higher-income individuals or by increasing regular tax collections from higher-income individuals or some combination of the two.

4. Harmonization of Medical Expense Deductions

The penalizing approach of further limiting medical expenses for AMT purposes is simply too blunt a sword. It would be far better for tax administrators carefully to review provisions for deductibility of medical expenses under the regular tax system in order to restrict further the ability of wealthy taxpayers to deduct items that may be more personal than medically necessary. In any event, if medical expenses are deductible for purposes of

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257. See, e.g., Luscombe, supra note 8, at 4 ("It is hard to get too excited about an AMT problem when the AMT has largely achieved its purpose but has a principal defect of not having been adjusted for inflation. We just start adjusting it for inflation, and the problem goes away.").

258. See supra note 139.

the regular tax system, they should be deductible for the AMT system. This is one area where anything other than consistency between the two systems appears senseless.

5. Retention of Excess State Taxes Preference

Based on the arguments establishing a personal consumption element in state and local taxes, it seems reasonable not to permit more than some baseline amount of state and local taxes to be deducted. The baseline amount is not normatively required, but intended to assuage concerns of those on the borderline of AMT liability that they are not being unfairly brought within the AMT's grasp. This ceiling for the state and local tax deduction could be determined empirically based on national averages for state taxes. In 2001, average per capita state taxes ranged between approximately $300 and $1800.[259] This suggests that it would be possible to establish a generous AMT deduction ceiling for state and local taxes of around $5000. State taxes in excess of this baseline amount would be treated as a preference item as under the current AMT system.

6. Recalculation of Gain on Incentive Stock Options

As noted in Part IV, I see little merit in providing for wholesale exclusion of gain from ISO exercise under the AMT by eliminating ISO gain as an add-back AMT preference item. Although the application of the AMT to options primarily creates a difference in when the income is taken into account, removal of the preference would undermine the coherence of the AMT's targeting, since many recipients of incentive stock options are highly paid managers and CEOs.[260] Elimination of the AMT preference would also disregard the special status given incentive stock options compared to other compensatory plans as well as the monetary and non-monetary benefits accruing to those who acquire large blocks of highly valued stock under option grants. It would thus go against the distributive justice values that underlie the argument for retaining the AMT system.

In restricted circumstances, however, it may be appropriate to permit partial relief from the current impact of the AMT on those who exercise ISOs. The suggestion here is that this relief be limited to taxpayers whose stock purchased on exercise of ISOs loses all (or all but a de minimis portion) of its value in excess of the exercise price before the end of the

259. Jeanne Sahadi, Tax-Friendly Places 2003, CNN/Money, Apr. 9, 2003, at http://money.cnn.com/2003/04/08/pf/taxes/q_taxfriendly (last visited July 15, 2004). These figures are based on state reports published by the Tax Foundation, at http://www.taxfoundation.org.

260. See Leonhardt, supra note 221.

filing period for the return for the taxable year of exercise of the ISOs. This circumstance results unambiguously in considerable phantom gain to which AMT applicability may appear punitive.

As stated, the proposed relief is not intended to permit all taxpayers to limit their AMT tax liability. The provision is not proposed to apply, for example, to a typical employee/taxpayer who exercises ISOs for a significant gain, retains the stock for several years and sells the stock later for a substantial net capital gain. That gain is appropriately subject to tax under the AMT in the return for the taxable year of exercise. Nor is it intended to apply to employees who exercise ISOs for a significant gain and retain the stock for a few years (perhaps in response to tax advice that retention will result in a lower tax burden because of the characterization of the gain as long-term capital gain), only to have it ultimately decline in value below the amount on which they were taxed several years previously under the AMT. This is, in fact, a norm of capital investments: they are risky endeavours, and what brings rewards one year may punish the next. Taxpayers who accept stock option grants rather than salary and retain the stock rather than selling on exercise in hopes of cashing in on the growth of a start-up firm are essentially making a risky investment with compensation income in the hopes that they will win on both counts – avoid ordinary income rates on their compensation and have significant gains from their ownership of the stock. As discussed in Part IV, treatment of the option gain as an AMT preference is appropriate. The taxpayer enjoys the many non-monetary benefits of the wealth increase for the period that the stock remains high, including the enhanced consumption from borrowing against the stock.

Accordingly, the AMT preference item for stock option gains should be restricted to prevent AMT taxation of phantom gain only if two conditions hold: first, a taxpayer exercises ISOs when the value of the stock in excess of the exercise price represents a significant gain (referred to herein as "exercise gain"); and second, all (or all but a de minimis portion) of the exercise gain is lost because of a decline in stock value before the end of the filing period for the return for the taxable year of exercise. "De minimis" should be defined in this case to mean that the value of the stock on the date for filing of the return (the "return date value") retains less than 5% of the exercise gain reflected in the value of the stock upon exercise of the ISO (the "exercise date value"). In that case, the full exercise gain would not be included as an AMT preference item in the return for the taxable year of ISO exercise; instead, only the portion of the exercise gain reflected in the return date value would be includible. If the stock later increases in value, however, any increase in value up to but not exceeding the exercise date value would be recaptured as AMT income inclusions in the year of such increase (whether or not the taxpayer disposes of the stock). The proposed recapture provision is essentially a mark-to-market requirement for stock received on the exercise of an ISO that has benefitted from the proposed AMT exclusion of any portion of the exercise gain.[261]

7. Addition of New AMT Preference Items to the AMT

Clearly, the substantial modifications proposed to ensure that ordinary taxpayers are not caught in the AMT net will be costly. Recall that mere indexation of the AMT exemption amount, without the other changes proposed here, was estimated at more than $600 billion over a ten-year period.[262] The combination of an income threshold test, indexed standard deductions and personal exemptions, elimination of the medical expense preference, allowance of a minimum state tax deduction and minimal provision for relief for taxpayers who suffer immediate loss of value on stock received upon exercise of ISOs will reduce revenues from the AMT. In the current long-term deficit situation, it would be irresponsible to propose such substantial changes without recommending concurrent changes to offset the loss of revenue. This Subsection suggests two modifications to the AMT that can offset a portion of the cost of the other reforms while re-targeting the AMT.

a. Untaxed Appreciation in Respect of Charitable Contributions

To offset the cost of these AMT reforms protecting middle-income taxpayers from AMT liability, Congress should disallow the regular tax deduction for untaxed appreciation on charitable contributions for AMT purposes by making it an AMT preference item. Amending the AMT in this way would clearly accord with the purpose of the AMT to tax high-income individuals without permitting them to take advantage of tax preferences to zero out their income tax liability. High income individuals are by far the major beneficiaries of the charitable contribution deduction. The Joint Committee on Taxation's reports on tax expenditures for the years 2001 through 2004 indicate that, on average, taxpayers with incomes of $200,000 or more (comprising 7.7% of tax returns) garnered approximately $18.3 billion (or 49.2% of the total) in charitable contribution deductions each

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261. Mark-to-market taxation is required for very few taxpayers under the current Code. See IRC § 475 (requiring broker-dealers to mark securities to market and permitting traders and commodities dealers to do so).

262. See supra note 258 and accompanying text (referring to Statement of Sen. Sarbanes on Congressional Budget for the U.S. Government for FY 2005, 150 Cong. Rec. S 2267-68 (Mar. 8, 2004), noting that a reasonable projection for the cost of indexing would be $658 billion, which would have to be added to the $1.6 trillion ten-year cost of making the 2001-2003 tax cuts permanent without AMT reform).

year.[263] Charitable contributions tend to increase as income increases: the wealthiest taxpayers (those with incomes greater than $10 million) give a larger proportion of their assets to charity than any other group.[264] Among those wealthy taxpayers who contribute to charity, a few individuals account for most of the contributions.[265] The charitable contribution deduction can be quite large for these significant donors, both in one taxable year and cumulatively over a number of taxable years as the donor gives a series of gifts to a charitable organization.[266] Approximately 50% of the aggregate individual charitable deduction of those with incomes over $200,000 is

263. In 2004, the 3.2 million taxpayers with incomes of $200,000 or more (out of 39.6 million total returns that claimed a charitable contribution deduction) garnered approximately $17.0 billion in charitable contribution deductions (out of $34.4 billion total). Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009, 43 tbl.3 (Jan. 12, 2005), at http://www.house.gov/jct/s-1-05.pdf. In 2003, the 3.4 million taxpayers with incomes of $200,000 or more (out of 38.0 million total) garnered approximately $17.5 billion in charitable contribution deductions (out of $36.9 billion total). Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2004-2008, 32 tbl.3 (Dec. 22, 2003), at http://www.house.gov/jct/s-8-03.pdf. In 2002, the 2.6 million taxpayers with incomes of $200,000 or more (out of 38.0 million total) garnered approximately $20.0 billion in charitable contribution deductions (out of $40.2 billion total). Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2003-2007, 30 tbl.3 (Dec. 19, 2002), at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=2002_joint_committee_on_taxation&docid=f:83132.pdf. In 2001, the 2.4 million taxpayers with incomes of $200,000 or more (out of 35.1 million total) garnered approximately $18.6 billion in charitable contribution deductions (out of $37.2 billion total). Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2002-2006, 31 tbl.3 (Jan. 17, 2002). http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=2002_joint_committee_on_taxation&docid=f:76452.pdf. While these numbers include cash donations as well as property and basis amounts as well as gain, it is likely that wealthy taxpayers comprise an even larger percentage of those taxpayers donating untaxed appreciation.

264. Rachel Emma Silverman, Giving by Affluent Is Less Generous on Basis of Assets, Wall St. J., Apr. 22, 2004, at D2.

265. Gerald E. Auten, Holger Sieg, & Charles T. Clotfelter, Charitable Giving, Income and Taxes: An Analysis of Panel Data, Mar. 2002 Amer. Econ. Rev. 371, 377.

266. See, e.g., The 2003 Slate 50: Top Donations (noting Ted Turner's pledge to give $1 billion to the United Nations and indicating that he had contributed $128 million in 2003 to various organizations, most of which apparently consisted of gifts of appreciated stock), at http://www.slate.msn.com/toolbar.aspx?action=print&id=2094848 (last visited July 1, 2004); Michelle Falkenstein, Senate Widens Probe of Tax Breaks on Donated Art, ARTnewsletter Highlights (June 22, 2004) (indicating that the Art Advisory Panel in 2003 reviewed 637 items in 122 taxpayer cases – considered to be only a small fraction of the total number of donations of art items – and recommended adjustments on 51% of those amounting to approximately $69 million), at www.ARTnews.com (last visited July 1, 2004).

attributable to untaxed appreciation.[267] Based on the average total amount contributed by taxpayers with incomes of $200,000 or more between 2001 and 2004, this provision could raise approximately $3 billion annually.[268]

Charitable organizations will likely complain that treating untaxed appreciation as an AMT preference would cause drastic reductions in charitable contributions. It is clear that the primary purpose for the deduction is to provide an incentive for charitable giving,[269] and the loss of a tax deduction for AMT purposes (but not for regular tax purposes) will make charitable giving somewhat less appealing to some taxpayers than it would otherwise be. There are, however, a number of aspects to the charitable deduction that must be considered before concluding that this counterargument weighs sufficiently strongly to argue against the AMT preference provision. First, many different tax changes may interact to affect charitable giving, such as tax rate cuts,[270] but tax policy decisions are generally polycentric, with various interacting concerns determining the final policy. Thus, even though the lower rates for capital gains enacted in 1997 "substantially raised the after-tax cost of giving appreciated property to charities," consideration of the effect of a rate cut on charitable giving did not lead to congressional reluctance to enact rate decreases.[271] The change in AMT treatment will not be directly correlated with an increased after-tax

267. See, e.g., Gerald Auten & David Joulfaian, Dept. of Treas. Office of Tax Analysis Paper No. 72, 11 & nn. 3-6 (Feb. 1996), reprinted in 1996 J. of Econ. 55 (indicating that non-cash gifts comprised 30% of the contributions of donors in the data sample, but over half of the contributions of taxpayers with at least $200,000 in adjusted gross income).

268. This figure is computed by multiplying the average $18.3 billion by the estimated 50% of such deductions that are attributable to untaxed appreciation, with that product multiplied by the 28% AMT tax.

269. See, e.g., 1969 Treasury Study, supra note 124, at 194 (stating that the deduction is "principally justified as an incentive for charitable giving").

270. See generally Auten & Joulfaian, supra note 267 (providing a summary of the literature on the determinants of lifetime charitable giving and demonstrating that gifts do increase as the tax price decreases); David Joulfaian & Mark Rider, Errors-In-Variables and Estimated Income and Price Elasticities of Charitable Giving, 57 Nat'l Tax J. 25, 27 (2004) (noting that "[t]o varying degrees, studies find that the tax price is an important determinant of giving"). See also Auten et al., supra note 265, at 381 (noting that contributions may be 25 to 36% lower due to reduction in top marginal tax rates).

271. Richard E. Coppage & Sidney J. Baxendale, Capital Gain Tax Cut Has Charitable Donation Cost, 1998 Taxation For Accountants (noting cost of a gift increased 6.4%age points with decrease in capital gain rate from 28% to 20%), at http://checkpoint.riag.com (last visited July 8, 2004).

price for charitable contributions, since not all taxpayers who make donations of appreciated property will be subject to the AMT.[272]

In addition, while the charitable deduction is likely a critical incentive to some donors and the AMT disallowance will likely be sufficient to reduce some of their gifts, research has long shown that many other factors such as social awareness, altruism, and social pressure figure into the decision to donate.[273] Those noneconomic influences on charitable giving reduce the impact of the AMT disallowance. Charitable fundraising techniques also emphasize other values to donors of making contributions, such as name recognition and reputational enhancement, entrée into the exclusive inner circle of the organization, and the general value of altruistic behavior. This consumption element would continue whether or not the contribution results in an AMT liability.[274] Moreover, as the trend towards greater inequality of income increases, it is likely that the tax benefit will have less significance for at least some at the very top income brackets.[275]

Furthermore, concerns about decreased giving in response to tax changes may be overstated. Congress has recently enacted a tentative repeal of the estate tax in spite of the widespread views that the possibility of an estate tax figures largely in wealthy taxpayers' decisions to donate significant portions of their estates to charities. Charitable giving statistics suggest that those concerns were misplaced, because giving *increased* nearly 3% and charitable bequests *rose* nearly 13%, in spite of the estate tax phaseout.[276] It seems reasonable to assume that the AMT disallowance of the deduction would have much less impact than estate tax repeal, since only some taxpayers will be subject to the AMT, and the tax price is only indirectly increased because of the AMT preference.

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272. See Stephen J. Klarquist, AMT Can Reduce (or Eliminate) Benefits of Charitable Gifts, 1991 Taxation for Accountants (discussing the tax cost of donating appreciated property under the pre-1993 AMT preference for charitable contribution deductions of untaxed appreciation), at http://checkpoint.riag.com (last visited July 8, 2004).

273. See, e.g., 1969 Treasury Study, supra note 124, at 198-200 (discussing the American Association of Fund-Raising Counsel's recognition of "social awareness, generosity, social pressure, pity, and habit" as motivations for charitable giving).

274. See, e.g., Blueprints, supra note 67, at 95 (indicating that "contributors derive satisfaction from giving just as they do from other uses of resources").

275. See, e.g., Auten et al., supra note 265, at 372 (noting that giving patterns differ by income level, so increased inequality in incomes results in greater variance in donations).

276. See, e.g., Stephanie Strom, Charitable Giving Holds Steady, Report Finds, N.Y. Times, June 22, 2004, at A12 (reporting charitable contributions of $240.72 billion in 2003, an increase of 0.5% over 2002, including a hearty 10.3% increase in gifts by bequest); Rachel Emma Silverman, Charitable Giving Increased Last Year, Rising Nearly 3%, Wall St. J., June 21, 2004, at B6 (noting that the increase in bequests "comes even as the estate tax is gradually being phased out by 2010, which has spurred widespread concern in the philanthropy industry that charitable gifts and bequests might decline").

There are additional concerns about the charitable deduction itself that support treating it as a tax preference under the AMT system. Charitable deductions are especially susceptible to fraudulent overstatement due to the difficulty in arriving at accurate valuations and the lack of an adversarial relationship between donor and donee, since gifts are retained by the charitable organization rather than valued in an arm's length sale.[277] Efforts by Congress to tighten valuation requirements may help reduce the fraud, but valuation will continue to be a task that lends itself to subjective adjustments to suit the donor.[278] Of even more concern, the charitable deduction raises concerns about the fairness of the tax system, in that the wealthiest donors have the ability to choose to a large extent which public good to support through their charitable donations, but ordinary taxpayers with little disposable income support public goods almost exclusively through their tax payments, with little choice as to which types of services or goods are supported. The deduction permits a "hidden public finance . . . under private, and perhaps even individual, control."[279] These factors suggest that the gain in fairness through taxation of untaxed appreciation in respect of charitable contributions will considerably outweigh any harm from marginal reduction in contributions due to the increased tax cost because of the AMT preference.

This would not be the first time that appreciation on charitable contributions has been considered as a potential preference item. As noted, the original Treasury study under President Johnson considered untaxed appreciation on charitable donations to be one of the four most significant preferences by which wealthy Americans were able to avoid tax on economic income.[280] The House report noted that 49 of the 154 high-income

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277. For example, millionaire Herbert Axelrod, under indictment on tax fraud charges for helping a former executive hide $700,000 in a Swiss bank account, may have inflated the value of a number of rare stringed instruments in connection with bargain sales to the New Jersey Symphony Orchestra (instruments valued at $50 million and sold for $18 million) and donations to the Smithsonian (4 instruments valued by the donor at $50 million). See Jeffrey Gold, Herbert Axelrod, Millionaire Wanted on Tax Charges Arrested in Germany, Assoc. Press, June 16, 2004.

278. See, e.g., Falkenstein, supra note 266 (reporting the role of the Art Advisory Panel in monitoring over-valuations for tax purposes as part of the coverage of Senate investigations into over-valuations of charitable contributions). Congress recently tightened rules for valuations of donated property. American Jobs Creation Act of 2004, Pub. L. No. 108-357, §§ 883-884, 118 Stat. 1418, 1631-34. Specifically, taxpayers are denied a charitable contribution deduction for donations of property (other than cash, publicly traded securities, and certain intangible property) unless they meet the following requirements: (1) for contributions of $500 or more, taxpayers must include a description of contributed properties with their tax returns; (2) for contributions of $5,000 or more, taxpayers must obtain qualified appraisals and include appraisal information with their tax returns; (3) for contributions of $500,000 or more, taxpayers must attach qualified appraisals to their tax returns. Id. § 883(a). Additionally, for contributions of used motor vehicles valued over $500, taxpayers must provide written donee acknowledgments. Id. § 884(a).

279. See Blueprints, supra note 67, at 96.

280. See supra note 124 and accompanying text.

individuals who paid no income tax for the 1966 taxable year benefited from the unlimited charitable contribution deduction.[281] The House version of the 1969 bill reduced the availability of charitable deductions and treated untaxed appreciation as a preference subject to the new minimum tax, along with four other items.[282] The Senate amendment attempted to balance equity and economic concerns, resulting in reduced availability of the charitable deduction, a broader list of preferences, but not treatment of untaxed appreciation as a preference.[283] After numerous attempts to fine-tune the AMT, the 1986 overhaul of the tax system generally succeeded in lowering rates across-the-board in exchange for elimination of numerous preferences and tax shelters that had accumulated in the 1954 Code. Included in the reforms was enactment of a provision to treat the charitable deduction for untaxed appreciation on real, personal and intangible property as a tax preference for AMT purposes.[284] The legislative history to the 1986 AMT changes set forth a general rationale that strongly endorsed the original objective of the AMT to enhance progressivity by targeting excessive deductions and exclusions utilized by high-income taxpayers.[285]

The AMT taxation of untaxed appreciation on charitable contributions was regrettably short-lived. As with many of the provisions of the 1986 act which have been limited or eliminated over time, Congress ultimately back-tracked to eliminate the preference item, first as a temporary measure and then permanently in 1993.[286] Its rationale gave short shrift to the purpose of the AMT, providing instead a conclusory statement that Congress

281. 1969 Ways & Means Report, supra note 127, at 9.

282. See id. at 77-80 (proposing a minimum tax on five preferences: tax-exempt interest, excluded net capital gains, untaxed appreciation on charitable contributions, excess depreciation over straight-line, and excess farm losses).

283. S. Rep. No. 91-552, at 2-4 (Nov. 21, 1969), reprinted in 1969-3 C.B. 423, 424-25 [hereinafter, 1969 Finance Report]. The Senate report claimed that "the principal effect of including gifts of appreciated property in the minimum tax would be to reduce the benefit of the contribution and thus unduly restrict public support of worthwhile educational and other public charitable institutions." Id at 116. The list of final preferences is described in the Conference Report. See H.R. Conf. Rep. No. 91-782, at 301-02 (1969), reprinted in 1969-3 C.B. 644, 658-59.

284. Tax Reform Act of 1986, Pub. L. 99-514 §701(a) (amending the Code to add §57(a)(6), which generally disallowed the charitable contribution deduction for untaxed appreciation for AMT purposes). See H.R. Rep. No. 99-426, at 307 (1985), reprinted in 1993-3 C.B. Vol.2 1, 307 [hereinafter 1986 Ways & Means Report] (indicating that certain items should be added as preferences if the AMT were "to serve its intended purpose of requiring taxpayers with substantial economic incomes to pay some tax" and including in that list a portion of the untaxed appreciation on charitable contributions).

285. See 1986 Ways & Means Report, supra note 284, at 305-06; S. Rep. No. 99-313, at 518-19 (1985), reprinted in 1986-3 C.B. Vol. 3 1, 518-19 (quoted extensively supra note 130).

286. Omnibus Budget Reconciliation Act of 1993, Pub. L. 103-66 §13171(a), 107 Stat. 312 (amending the Code by striking §56(a)(6)).

believed that elimination of the preference would further encourage charitable giving.[287]

Restoring the preference and eliminating this windfall deduction for the wealthy would fund a portion of the necessary AMT reforms, and it would do so by focusing the tax on those that the AMT was originally designed to tax. Although there would likely be some marginal reduction in charitable gifts as a consequence, the overall impact might well be small. The importance of targeting the superrich who pay little or no tax because of high charitable deductions should be given priority in our self-assessment system.

b. Preferential Capital Gain Rates

> The greatest irony is that the truly rich do not pay the AMT. . . . That may be because their effective tax rate is well above the AMT's 26 percent threshold, but not necessarily. Last year's tax cut lowered the tax rates on most capital gains and dividends to 15 percent, and taxes paid on investments are not subject to the AMT test. That means the country club set . . . are paying effective federal tax rates that rival those of the man clipping the green for $25,000 a year.[288]

A further complication for the AMT is that the tax preferences singled out as tainted may restrain some tax avoidance but fail to target the appropriate taxpayers. Wealthy individuals own substantially disproportionate amounts of the nation's assets and have substantially

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287. H.R. Rep. No. 103-111, at 630 (1993), reprinted in 1993-3 C.B. 167, 206 [hereinafter, 1993 House Report] (House Ways & Means explanation of revenue provisions, indicating that "[t]he committee believes that the temporary AMT exception for contributions of appreciated property induced additional charitable giving" so that "by permanently extending this rule and expanding it to apply to all appreciated property gifts, taxpayers will be allowed the same charitable contribution deduction for both regular tax and AMT purposes. This will provide an additional incentive for taxpayers to make charitable contributions of appreciated property"). This provision did not fit well with the Congress' stated overall goal of enhancing progressivity.

> [T]he budget can't be brought under control by spending cuts alone—not without making deep cuts in benefits that citizens have fairly earned, inflicting hardship on people already suffering, and starving investment programs. A budget balanced by spending cuts alone will not share burdens fairly throughout society. This legislation improves the progressivity of the tax structure and requires those who benefitted from the policies of the 1980's and early 1990's to pay their share of the bill that has come due.

Id. at 3-4. The 1993 act also provided for a 50% reduction in capital gains tax on small business stock in new IRC § 1202.

288. Jonathan Weisman, Falling Into Alternative Minimum Trouble, Wash. Post, Mar. 7, 2004, at F9 (quoting Chris Sintetos, a Virginia accountant).

disproportionate amounts of the aggregate net capital gains (including most dividend income, under JGTRRA).[289] As the tax shelter debate has shown, large numbers of high-net-worth individuals have engaged in potentially abusive tax shelters that "work" by offsetting income (frequently large capital gains) with bogus losses.[290] Therefore, these same high-worth individuals are likely to be the ones who have successfully hidden substantial portions of their investment gains from tax administrators and are appropriate targets for the AMT. Furthermore, the superrich high-worth individuals that are the prime target for the AMT may have almost no income other than tax-exempt municipal bonds and low-taxed net capital gains. As a result, these high-income individuals may pay a rate of regular tax on their high incomes in excess of $200,000 that is extremely low compared to those who earn average salaries below $100,000.[291] Yet because the AMT does not treat the preferential rate for net capital gains as a "tainted" tax preference, individuals with that type of investment income are less likely to owe tax under the AMT.

A reasonable source of revenue for AMT reforms to protect ordinary taxpayers would therefore be to treat the net capital gains preferential rate (for both gains on exchanges or dispositions of property and qualified dividend income) as a tainted preference.[292] That is, for AMT purposes, net capital gain income (including that derived from qualified dividends) should be included in the AMT base and taxed at the AMT rate. In order to protect ordinary taxpayers who are just above the threshold gross income level for exclusion of AMT liability and have relatively small financial investments or small gains from sales of investment property, the AMT net capital gain provision could apply only to net capital gains in excess of a reasonable threshold amount, such as $3,000.[293] Ordinary taxpayers are not likely to have capital gains in excess of this amount other than from sales of their homes, and those gains are already generally excluded from taxation. Inclusion of excess net capital gains as an AMT preference would therefore ensure that high-income taxpayers with substantial investment gains (and

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289. See supra notes 57 - 74 and accompanying text.

290. See, e.g., Beale, supra note 226, at 229-39 (discussing various listed transactions).

291. See supra notes 72 - 74 and accompanying text.

292. Leonard Burman, William G. Gale, Jeffrey Rohaly & Matthew Hall, Key Points on the Alternative Minimum Tax (Jan. 21, 2004) (suggesting that treating capital gains as an AMT preference would provide revenues to pay for needed AMT reforms), at http://www.brookings/edu/views/Op-Ed/gale/20040121amt.htm.

293. A similar revenue result could be achieved by eliminating the capital gains preferential rate in the regular tax system, as done for a brief period in connection with the 1986 Tax Reform Act's overhaul of the Code, and taxing capital gains and ordinary income under both the regular and AMT systems at the same rates. This option of merging the two systems by eliminating regular tax preferences and taxing economic income progressively would be the normatively desirable method of solving the AMT quandary, but likely would face substantial practical hurdles that would derail enactment without a sweeping change of view in Congress.

dividend income) but very little or no wage income would pay a rate of tax greater than 15%.[294]

This, too, is an old idea whose time has returned. Prior to enactment of a revised Code in 1986, the regular tax excluded a portion of net long-term capital gains from tax, resulting in a lower effective rate on capital gains than on ordinary income.[295] Before the 1978 amendments, the excluded net capital gains were an item of preference subject to the 15% rate on minimum tax preferences (after reduction of preferences by one-half of the regular tax liability or $10,000).[296] This was considered to be one of the most important ways of ensuring that taxpayers with high economic income paid some income tax.[297] The 1978 Code amendments reduced the taxation of capital gains somewhat by taking capital gains out of the old minimum tax regime (and by increasing the exclusion from 50% to 60% for regular tax purposes), but retained treatment of capital gains as a preference in the base for the new AMT system.[298] The Ways and Means Committee explained that the combined level of taxes on capital gains was quite high under the old minimum tax regime, and it wanted to encourage investment by some lessening of taxation of capital gains.[299] The committee nonetheless decided that capital gains should be treated as a preference under the new AMT system, based on its belief "that every noncorporate taxpayer with capital gains should pay a minimum amount of taxes with respect to those gains."[300] Capital gains was removed as a preference only when the 1986 reform

294. See supra note 5; Richard Malamud, 102 Tax Notes 1427 (Mar. 15, 2004) (suggesting that the AMT should ensure that the effective tax rate on wealthy taxpayers with predominantly investment income is at least 15%).

295. See former IRC §1202 of the 1954 Code (excluding 60% of net long-term capital gains, as enacted by Section 402(a) of the Tax Reform Act of 1978, Pub. L. No. 95-600). The 1986 tax reforms later removed the preference for capital gains by including capital gains in income and taxing them at the same rate as ordinary income. Net capital gains were therefore fully includible in the AMT base as well. See, e.g., H.R. Rep. No. 99-426, at 196-97 (1986), reprinted in 1986-3 C.B. Vol. 2 1, 196-97 (describing the changes to the capital gains provisions).

296. See, e.g., H.R. Rep. No. 95-1445, at 118-19 (1978), reprinted in 1978-3 C.B. 187, 292-93 [hereinafter, the 1978 House Report] (describing the application of the minimum tax to net capital gains).

297. Matthew S. Bailey, supra note 141, at ¶36 (stating that "[t]he AMT was originally designed to capture high-end taxpayers' personal income, particularly emphasizing their capital gains income").

298. Revenue Act of 1978, Pub. L. No. 95-600, § 421(a), 92 Stat. 2763, 2871-74 (1978) (imposing the AMT on a base defined to include capital gains under former IRC § 57(a)(9)).

299. The Ways & Means Committee noted that the (old) minimum tax could result in a substantial add-on tax even when a taxpayer already paid regular taxes at high rates. 1978 House Report, supra note 296, at 118-19.

300. See id. at 119-24 (discussing the act's capital gains provisions).

removed the preferential treatment of capital gains for regular income tax purposes.[301]

B. Harmonize The Regular and AMT Tax Systems

The package of changes to the AMT proposed here will not be cheap. These costs should be offset by complementary changes in the regular tax system to move the overall system towards greater coherence.

1. Treatment of Phaseouts for Exemptions and Itemized Deductions

A modest regular tax reform that is consistent with the proposals for reform of the AMT is the reinstatement of the regular tax phase-outs for exemptions and itemized deductions. For example, section 68 currently provides for a reduction in the total amount of permitted itemized deductions, by the lesser of 3% of the excess of adjusted gross income over $145,950 (for 2005) or 80% of the itemized deductions otherwise allowable.[302] EGTTRA added Subsections (f) and (g) of Section 68 to the Code, which gradually eliminate the phaseout for itemized deductions, and Subsections (d)(3)(E) and (F) of Section 151, which similarly eliminate the phaseout of the personal exemption amount. In 2010, taxpayers will be permitted to take itemized deductions and personal exemptions regardless of income. Reinstating these phase-outs would offset some of the cost of AMT reforms and at the same time enhance structural coherence and remove complexity caused by the inconsistency between the regular and AMT system when one system has a phaseout and the other does not. Phaseouts take into account the decreasing utility of each dollar to high-income taxpayers. Retaining phaseouts ensures that the benefits of exemptions and deductions accrue to those who have the most need for them and provide further assurance that higher-income taxpayers cannot avoid all taxes on their economic income.

2. Institution of Above-the-Line Deduction for Contingent Attorney's Fees Taxpayers

Part IV presented the sympathetic case for plaintiffs in lawsuits whose compensation is reduced by the AMT treatment of miscellaneous itemized deductions in conjunction with the lump-sum nature of the judgment award. Although the AJCA eliminates this problem for many cases

301. See supra note 295. It would have been reasonable for Congress to restore the AMT capital gains preference when the preferential capital gains rate was instated in 1990. Omnibus Budget Reconciliation Act of 1990, Publ. L. No. 101-508. It is not clear whether failure to do so was simply an oversight or whether it resulted from a deliberate decision to change the historical interaction between preferential treatment of capital gains and the AMT system.

302. IRC § 68(a).

– most significantly, those involving employment-related claims – by allowing an above-the-line deduction, the *Banks* holding requiring inclusion of fees leaves a problem for other taxpayers.

A number of potential solutions might be adopted, the most reasonable of which is to extend the AJCA treatment to all types of claims. This solution increases consistency between the regular tax and AMT systems. It removes the 2% of AGI limitation for both the regular tax and AMT systems. It permits retention of the miscellaneous itemized deductions as an AMT preference, which seems appropriate because of their flavor of personal expenses and parsimonious allowance even under the regular income tax.[303] Finally, it should be relatively inexpensive to implement.[304]

3. Additional Harmonizing Changes

Several of the current AMT preferences might be eliminated through harmonization of those items with the regular income tax by eliminating them as an AMT preference or by conforming the regular tax to the AMT approach. The result would be consistency between the AMT and regular tax, and lessened complexity for both systems. Items that might be particularly appropriate, though likely difficult to change because of public and political resistance, include the mortgage interest deduction for home equity loans, a limitation on interest deductions on acquisition indebtedness, and accelerated cost recovery deductions that currently require recomputation for AMT purposes.

The regular income tax deduction for home equity loans runs counter to the stated purpose for mortgage interest deductions of extending home ownership to ordinary Americans. It introduces a wealth-based distinction that disadvantages the least well off, in that it permits existing home owners to deduct borrowing costs for personal consumption expenses that are not deductible to non-home owners. Eliminating the home equity loan interest deduction in the regular tax would make the AMT and regular tax more consistent and simpler. In addition, limitation of the acquisition debt interest deduction to interest payments on mortgages under a reasonable threshold that is more commensurate with home purchases by ordinary taxpayers, and elimination of any interest deduction in respect of mortgages on residences other than the principal residence, would further target the mortgage interest deduction to its original purpose.

Similarly, the simplified cost recovery deductions could be adopted for both AMT and regular income tax systems. Accelerated depreciation likely rewards capital investments that would have been undertaken anyway

303. It appears reasonable to disallow miscellaneous itemized deductions entirely for AMT purposes, since high-income taxpayers are more likely to have considerable non-reimbursable employee expenses (to the extent their income is wage-based) and other nondeductible expenditures.

304. See Hellwig & Polsky, supra note 228, at 932 (noting that legislation fixing the AMT trap for contingent attorney's fees "would be both simple and cheap")

or encourages overheating of investment that may not be matched by productivity gains. Reducing the recovery options would simplify both systems.

4. 2001-2003 Tax Cuts Sunsets

The best solution to any remaining cost differential because of the AMT reforms is to selectively eliminate any further phasing in of the tax cuts at the upper income range. Although likely difficult to enact politically at this juncture,[305] this mode of funding needed AMT reforms should not be rejected summarily. If the tax cuts are made permanent without AMT reform, a significant percentage of the benefits will be lost anyway to middle-income taxpayers because of the AMT system, of which Congress was aware when it passed EGTRRA. One could say, therefore, that Congress did not intend to provide tax cuts to middle income taxpayers under EGTRRA. Congress is faced with a Hobbsian choice – either repeal the AMT (and find spending cuts sufficient to account for the loss of revenue, the burden of which will fall primarily on ordinary taxpayers and in many ways undo the benefit of AMT repeal for them) or simply decline to extend the regular tax cuts further to the highest income groups. Faced with the clear purpose of the AMT to enhance rather than reduce progressivity, the latter alternative is preferable and more consistent with a structurally coherent tax system. Allowing the top-bracket cuts to sunset as scheduled in 2010 would significantly reduce the number of taxpayers with adjusted gross income between $100,000 and $200,000 who are subject to the AMT, leaving their liability to be determined through the more familiar regular tax system. Revenues from that approach would fund (through higher regular income taxes, especially on higher income taxpayers) the needed revisions to the AMT to ensure that it does not reach too low to penalize ordinary taxpayers who are not its intended targets.[306] At a minimum, therefore, Congress should eliminate the repeal of the estate tax and re-instate higher marginal rates for taxpayers in income brackets of $200,000 or more. The extent to which rate cuts are rolled back should be based on the estimates of revenues needed to finance the necessary AMT reforms.

VI. CONCLUSION

This article considers the AMT problem in the context of the 2001-2003 tax cuts, growth in federal deficits and debt burden, increasing income

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305. See, e.g., Pay for It, Wash. Post., July 17, 2004, at A18 (editorial noting that "[t]he sanest way of paying for the tax cuts is the least likely in the current political circumstances—trimming back the existing breaks gratuitously lavished on the wealthiest Americans").

306. See, e.g., Paul Krugman, Health vs. Wealth, N.Y. Times, July 9, 2004, at A19 (indicating that rolling back tax cuts for taxpayers with incomes over $200,000 would free up $631 billion over 10 years).

inequality, and a general trend towards a hybrid consumption and income tax base. Taking distributive justice and structural coherence as policy guidestars, the article proposes as the solution to the AMT quandary the retention of an AMT system with specific reforms to better target those higher income taxpayers who benefit from substantial preferences under the regular tax. To protect ordinary taxpayers from any potential AMT liability and from having to perform onerous AMT calculations, the article proposes a reasonable gross income threshold that would be indexed for inflation. To ease the burden of AMT calculations for those who may yet be subject to AMT applicability, the article proposes the consistent application of standard deductions and personal exemptions in both the AMT and regular tax (all indexed for inflation). In addition, to ensure that high-income taxpayers are appropriately targeted by the AMT, the article proposes two new AMT preferences: capital gains and untaxed appreciation on charitable contributions. To limit the growth of inequality among American taxpayers, the article argues for related, concurrent changes to the regular tax system, including retention of income phaseouts (and adoption of the phaseouts for both systems), an above-the-line deduction for contingent attorney fees in all types of cases, and retention of the estate tax. Finally, policymakers should consider withdrawing the 2001-2003 tax cuts for taxpayers in the highest income brackets to the extent necessary to fund these needed changes and ensure the overall progressivity of the tax system.