S. HRG. 107–170

EASING THE FAMILY TAX BURDEN

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

FIRST SESSION

MARCH 8, 2001

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

75–103—PDF WASHINGTON : 2001

For sale by the Superintendent of Documents, U.S. Government Printing Office
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EASING THE FAMILY TAX BURDEN

THURSDAY, MARCH 8, 2001

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:03 a.m., in room 215, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Also present: Senators Baucus and Lincoln.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. I would call another meeting of the Senate Finance Committee to order, and thank everybody who is in attendance as we look once again at some of the proposals to reduce the income tax burden of working families through a doubling of the child tax credit and to help married couples, and also consider in that process President Bush's proposals along that line, although not exclusive to those.

I think we can all agree with President Bush's principle that there is no more important task than properly raising children. With respect to education, his principle is to leave no child behind.

Now, unfortunately, we have the Tax Code. That Tax Code is structured in such a way that it leaves hard-working, income taxpaying families behind. It took several years and several tries, but in 1997 we were finally able to provide a $500 child credit for families.

While that is a good start, this figure does not even approach the cost of raising a child. While we will never be able to offset all the costs in that direction, President Bush's proposal to double the child credit to $1,000 provides much-needed assistance to working families. Tax relief for married couples has long been a journey for us, but I think that we will finally reach the promised land this year.

There is a growing consensus that we must provide income tax relief for married couples, both those who have a parent staying at home as well as those couples where both husband and wife work.

Along this line, I am very pleased by a proposal put forth by House Democrats for their tax cuts embracing the idea that we should help marriage, regardless of whether one parent or two parents work.

I am confident that we can find common ground in this area and that we will report legislation that promotes and strengthens marriage by providing income tax relief to married couples, marriages with a stay-at-home parent and marriages where both husband and wife work.

There are many ways that we can achieve this goal of providing income tax relief for married couples, and we will explore those options today. So, consequently, we are going to take a look at the question of Alternative Minimum Tax.

It is important that we address the AMT, because we do not want, with one hand, to give income tax relief for working families, if we do that through the expansion of the child credit, assisting married couples, or reduction of rates, while on the other hand we would be taking part of that money back under the Alternative Minimum Tax.

Beyond just ensuring that the AMT does not limit the benefits provided under President Bush's tax proposal, we must, of course, look to a long-term fix at the Alternative Minimum Tax. The AMT places a growing burden of complexity and taxation on more and more Americans every April 15. This is something that both Senator Baucus and I discussed at yesterday's hearing: simplicity.

Roughly one in seven taxpayers will come under the shadow of the Alternative Minimum Tax by the end of this decade, and that is according to the General Accounting Office. That figure will significantly be higher if President Bush's tax plan is adopted, and that is according to the Joint Tax Committee of the Congress.

So the Alternative Minimum Tax looms over all that we do here, and must be addressed. Today we will be given a primer on the AMT. This is no easy task. We will also look at different ways that we can address the AMT.

Today's meeting of the Finance Committee may be a little dry, but it is also issues that are very important. The issues today are important to the seamstress working at home, taking care of her children, doubling the child credit and helping working families where both the husband and wife are involved.

Our effort in this committee to provide them all tax relief and allow them to keep more of the money they earn will make a real difference in the lives of these working parents struggling to give their children a better life.*

It is my privilege now to turn to Senator Baucus for any opening comment he might have.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you, Mr. Chairman.

Thank you, Senator Hutchison, for appearing today. I look forward to your advice.

Mr. Chairman, I just want to compliment you again on the way you are approaching this subject. That is, we are not rushing to judgment here in passing a tax bill immediately. Rather, we are taking a bit of our time to have hearings and explore various options; at the last hearing, the various effects that rates have in different ways and the EITC, and of course, today, Alternative Minimum Tax, marriage penalty, and the child credit.

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*For more information on this subject, *see also*, Joint Committee on Taxation staff report, "Overview of Present Law and Economic Analysis Relating to the Marriage Tax Penalty, the Child Tax Credit, and the Alternative Minimum Tax," March 7, 2001, JCX–8–01.

Obviously these are not easy issues. The interaction among the various provisions is sometimes complex, but obviously we want to do what we can to simplify it to serve the American people in a way that the vast majority of Americans think is fair.

With respect to the marriage penalty, I think it is important for us to remember that this is not the result—that is, the current marriage penalty—of some nefarious plot to penalize marriage end encourage sin.

That is not the vision in the law. Rather, it is the result of very difficult choices that this Congress has to make about how we tax individuals compared with couples in a progressive system. It is kind of a zero-sum game.

It is mathematically impossible to come up with a way that, given separate treatment of individuals and marrieds in a progressive system, that it is totally even and fair to everybody from their perspective. We just have to do the best we can.

Probably, it is because our workforce is changing. We have many more couples. People, as couples, are much more likely to face a marriage penalty. Clearly, it is something we should address.

There are a lot of possibilities, many of which are considered by this committee. House Republicans, House Democrats, Senate Republicans, and Senate Democrats have all kinds of ideas; hopefully, today we will get a better sense of which make the most sense.

In the past, I have supported optional separate filing. Why? Because that allows couples to choose to file either singly, as individuals, or jointly. That totally eliminates the marriage penalty. It is the one provision which does.

On the other hand, it is more expensive than some of the other suggestions and it is also potentially complicated, although, I might add, the State of Montana and other States utilize that system to address the penalty problem.

The President's proposal is, I think, a good one. It is less expensive. It is less comprehensive, but it is focused on the couples that need relief the most.

With respect to the child credit, there is clearly broad support for a significant increase. But, as we increase the child credit, I think it is important to consider how it interacts with some other provisions relating to children, such as the personal exemptions and the Earned Income Tax Credit.

More specifically, yesterday, several witnesses—and several members of this committee, I might add—expressed concern about the high marginal rate for working families with relatively low incomes.

The President himself has expressed concern about this. The high marginal rate is caused primarily by the phase-out of EITC benefits and the marriage penalty, but the child credit also is a factor. I am looking forward to exploring the interaction.

With respect to the AMT, I commend to the committee the good work of Senator Lincoln in this area. I know that Senator Thompson has other good ideas. But we have to be honest about the AMT and address it directly.

I must say, I am slightly disappointed that the administration is not addressing AMT. By saying you will have these big tax cuts, but failing to address the AMT problem. You have one hand giving while the other is taking it away.

Nevertheless, I feel strongly that the Congress will do all that we can, given the revenue constraints, to address it. It is not going to be cheap, but it is necessary to address it. Clearly, it is not right that the AMT takes away what Congress provides in the statute.

Thank you, Mr. Chairman. Let us get on with it.

The CHAIRMAN. All right.

We have one of our colleagues with us, Senator Kay Bailey Hutchison, from Texas. She is going to testify about legislation that she has been involved with for a long period of time, and was active in a very important amendment on the floor of the Senate last year that was very successful in broadening some of these issues that penalized married couples.

We will turn it over to you now to say to us whatever you have on your mind.

STATEMENT OF HON. KAY BAILEY HUTCHISON, A U.S. SENATOR FROM TEXAS

Senator HUTCHISON. Thank you, Chairman Grassley, and thank you, Ranking Member Baucus. I want to, first of all, commend you for your openness to look at the marriage penalty as one of the key components that we must address in this first tax relief bill.

Both of you have been active in this area, and your door has been open, which I appreciate, because I think we can have a more comprehensive and simpler marriage penalty tax relief than some of the other proposals.

I would hope that we would take a good first step, and then very much hope that, as surpluses increase, we would be able to come back for a second tax relief bill that would provide even greater relief from the marriage penalty tax.

The marriage penalty tax is one of the most egregious, anti-family aspects of our Tax Code. We have passed marriage penalty relief in Congress on a very bipartisan basis twice, but it was vetoed by the former President.

This time, we have a President who definitely believes that relieving the marriage penalty is a priority. He has made a proposal, but he has already shown a willingness to work with different proposals that might be an improvement. I have talked personally to the President about it, and he is very open and wants to do the right thing with respect to marriage penalty relief.

Twenty-one million American couples suffer from the marriage penalty tax, for no apparent reason other than because they are married. They did not get salary increases, they just got married, and yet their taxes increased. The average penalty paid is $1,400 a month.

Let me give you an example. Heather Diederich and Willie Simmons live in Tyler, TX. They are engaged to be married May 26. I met with them 2 weeks ago. Both work at Brookshire's, a local grocery store chain. Heather is a single mother of a 3-year-old boy and makes $20,000 a year. Willie makes $19,000 a year. When they get married, they will owe $1,600 more in taxes.

Other than love, what incentive do they have to get married? Love is very important, but they should not pay a penalty for doing the right thing. Sixteen hundred dollars would be a half a year's rent in Tyler, TX. Mr. Chairman, we must solve this problem.

I am pleased that the President has made marriage penalty relief a part of his tax plan. But I would like to suggest that there be certain standards for the bill that comes out of the Finance Committee. First, the marriage penalty relief should not add another layer of complication for taxpayers. Simplicity is a very important part of marriage penalty relief. Our married couples need to see, clearly and simply, what relief they are getting.

Second, marriage penalty relief should ensure that all married couples are treated equally. We should strive to bring relief to as many couples as possible. I think the President's plan is somewhat narrow, and I think some of the other alternatives are somewhat narrow. I want to address the issue head-on of the so-called marriage bonus.

The President's plan hits the real tax penalty, but it does not address all married couples who need this extra relief. For the most part, the so-called bonus arises in single-earner families.

For example, a man who earns $40,000 a year, is engaged to a single mom who earns no income. If they get married, he will pay less income tax than he did as a single person and, therefore, would receive the so-called bonus.

But let us keep in mind that his $40,000 income will now have to support three people instead of just one. His expenses have increased. So by getting married, it is not a bonus situation.

Would it be fair for that couple to pay more in tax than a similar family in which both spouses work outside the home? The answer, clearly, is no.

For the last 4 years, I have introduced every configuration of marriage penalty relief and I have studied the mechanisms for correcting the penalty. I believe the simplest and fairest way to address the issue is to do two things.

First, increase the standard deduction for married filing jointly so that it is twice that of an individual. Now, everyone does not take the standard deduction. If you itemize, you would not get this help.

But many couples, especially in the middle and lower income brackets, do use the standard deduction. Just doubling it would give them a strong measure of relief. It would add $1,500 that you do not pay tax on, and I think that is very important.

The second thing, is to widen the 15 percent tax bracket. Now, we did that in a bipartisan way in Congress last year. By just widening the 15 percent bracket, you help every single married couple, especially those just outside the 15 percent bracket. So, you will touch almost every married couple.

If we do both these things, it would cost $183 billion over 10 years. According to the Office of Management and Budget, the President's proposal, which reinstates the 10 percent second earner deduction, would cost $112 billion.

These two revenue estimates are not that far apart. I believe we could close the gap by phasing in the 15 percent bracket expansion at a slightly slower pace. If you did not want to take it from some other part of the tax relief plan, if you phase it in at a slower pace than we did in last year's bill, we could achieve the savings to stay basically within the $112 billion that is in the President's plan, but with a plan that would cover every single married couple and give some measure of relief.

Now, I do not think this is enough. I do think we should eliminate the marriage penalty entirely, which would mean doubling each bracket. But I also would say that if we take this first step, then if we see larger surpluses and we are able to have a second tax relief plan, I would put the very highest priority on doubling what I hope will be the 25 percent bracket and the 33 percent bracket.

But I think simplicity, fairness, and coverage of all couples are the most important aspects as you make the very tough decisions that your committee will make in addressing the marriage penalty tax.

I appreciate that you are looking for that fair way to do it, that you would treat every married couple the same regardless of whether it is a single-income family or a double-income family. I think we can eliminate it. I think we can take this first step. I hope that you will do it in the simplest, fairest way.

Thank you very much.

[The prepared statement of Senator Hutchison appears in the appendix.]

The CHAIRMAN. Does your cost accounting, when you said spread out over a longer period of time to fit it into the President's time, figure how long that is compared to the slower way, or the faster way we were doing it last year?

Senator HUTCHISON. It is 10 years versus 6.

The CHAIRMAN. All right.

Senator HUTCHISON. The last time we passed marriage penalty relief, it was phased in over six years. We could instead phase it in over 10.

The CHAIRMAN. So then that $112 billion would be a 10-year phase-in.

Senator HUTCHISON. Approximately $112 billion.

The CHAIRMAN. Sure.

I guess maybe Senator Baucus did not have questions. I thank you very much.

Senator HUTCHISON. All right. If I could, I thought that he might address his plan.

The CHAIRMAN. Say whatever you want to say then. Go ahead.

Senator HUTCHISON. I want to say, I think his plan is also totally fair. The only reason that I would say that my plan would be better, is because his plan is much more expensive and we do not have that much allocated right now. But, also, I think that his plan is more complicated.

The IRS says that it would take 80 lines on the IRS form. I cannot tell you that that is true. That seems amazing to me. But it is a more complicated approach, and it certainly will take more processing requirements to have some people choose to file jointly and some separately.

Although, I would hand it to him, his is totally fair. But if we are going to take the first step within the basic $112 billion that is now allocated, I think doubling the standard deduction and doubling the 15 percent bracket is probably our best shot.

So, I would hope that you would look at that, and then if we have more money down the line, perhaps we could double each bracket. But I commend him for also making this a priority and just say that we will be giving a lot more help to families through the $1,000-per-child tax credit and through the rate reductions.

So, that is going to alleviate some of the pain of the marriage penalty. If we address marginal rates as well, then I think we are going to give substantial relief to married couples and families.

The CHAIRMAN. The balancing of cost, fairness, and complexity is very difficult for us here. When you do one, it affects the other.

Senator HUTCHISON. Exactly. That is why I think, keep it simple, keep it fair, and make sure every couple, single-earner or double-earner, gets some relief.

The CHAIRMAN. I thank you, Senator Hutchison.

Senator HUTCHISON. Yes. Thank you so much, Senator Grassley.

The CHAIRMAN. Now I have an opportunity to welcome our second panel. I would like to have Mr. White on my left, and then Mr. Zelenak in the middle, then Mr. Ellwood on the right.

Mr. James White is Director of Tax Administration and Justice Issues at the U.S. General Accounting Office, and he is going to speak mostly today about the Alternative Minimum Tax.

Then following Mr. White, we have Lawrence Zelenak. Mr. Zelenak is professor of Law at the University of North Carolina Law School. He will be testifying about reducing the tax burden on married couples, as well as the Alternative Minimum Tax.

Then we have, from Harvard University, David Ellwood, professor of Political Economy there, speaking to the Finance Committee about child tax credits and his proposal to help low-income families.

I welcome you all to the committee. Each of you may have a very long statement that will be included in the record, then we ask you to summarize as you like. The most important thing is, though, understand your entire statement will be printed in the record and you will not have to ask. Then we will have questions after each one of you are done testifying.

We will start with Mr. White.

STATEMENT OF JAMES WHITE, DIRECTOR, TAX ADMINISTRATION AND JUSTICE ISSUES, GENERAL ACCOUNTING OFFICE, WASHINGTON, DC

Mr. WHITE. Mr. Chairman, Ranking Member Baucus, and members of the committee, I am pleased to participate in today's hearing.

My statement will focus on the Alternative Minimum Tax, or AMT, for individual taxpayers, how it works, its projected growth, and some of its effects.

I will begin with the rationale for the AMT. The AMT was created to reduce the ability of some higher-income individuals to escape paying taxes on income by using exclusions, deductions, credits, and so on. For 1997, the most recent year with data, IRS estimates that about 14,000 taxpayers would not have had any income tax liability without AMT.

Next, I will discuss how AMT works. A key concept is that the AMT is a separate tax system that parallels the regular individual income tax system. Compared to the regular individual income tax, the AMT has different rules for determining taxable income, different tax rates, and different tax credits.

The graphic, which is also on page 4 of my statement, shows the two parallel tax systems in greatly simplified form. The regular tax system is on the left side, the AMT is on the right. In Step 1, taxpayers calculate their regular tax. They add up income from salaries, interest, et cetera, to get the top line.

Then they subtract the next three lines. Exclusions, such as moving expenses, the standard deduction or their itemized deductions, and their personal exemptions for themselves, spouses, and dependents. This gives taxable income, which is then multiplied by the relevant tax rate to get the regular tax liability before credits.

Finally, tax credits are subtracted to get regular tax liability. This last part can be complicated. Certain credits, mainly business credits, are limited by AMT, even though they are credits against the regular tax. Taxpayers with such credits skip to Step 3.

Most taxpayers go to Step 2, where they are required to complete a worksheet to determine if the AMT applies. If the AMT does not apply, they stop and pay their regular tax. If the AMT does apply, taxpayers go to Step 3.

In Step 3, taxpayers start with the regular taxable income from Step 1. Remember, this was calculated by subtracting from income exclusions, deductions, and exemptions. Taxpayers now add back many of these same exclusions, deductions, and exemptions, some completely, some partially.

The effect of adding back much of what was subtracted under the regular tax is to make the tax base for the AMT broader than for the regular tax. More income may be subject to tax.

Taxpayers also subtract the AMT exemption, $45,000 for joint filers subject to phase-out. Today, the size of this exemption tends to prevent low- and middle-income taxpayers from being subject to AMT.

Unlike exemptions under the regular tax, the AMT exemption is not adjusted for family size. Thus, all else equal, taxpayers with more dependents are more likely to be subject to AMT.

Finishing Step 3, AMT taxable income is multiplied by the relevant AMT rate to get AMT liability before credits. In Step 4, taxpayers compare their regular tax liability before credits to their AMT liability and pay whichever is greater, minus allowable credits.

My next point covers the projected growth in taxpayers affected by AMT. Currently, the AMT affects about 1.3 million taxpayers, 1.3 percent of taxable returns, with revenue estimated at almost $6 billion for 2000.

The solid line in Figure 2 on page 10 of my statement shows how the number of affected taxpayers is expected to grow based on current law. The projections are from research at Treasury, but the Joint Committee on Taxation has similar projections.

By 2010, the AMT is expected to affect about 17 million taxpayers, about 1 in 6, with about $38 billion in revenue. Over the entire period, AMT is projected to increase taxes by about $189 billion.

There are two main reasons for this growth. First, the AMT is not indexed for inflation. The regular tax is indexed, so the taxes as a percent of income do not increase due to inflation.

The AMT is not indexed for inflation, so taxes as a percent of income increase over time. Consequently, more and more taxpayers find that their AMT liability exceeds their regular tax liability and they become subject to AMT.

The dotted line in Figure 2 shows the impact of inflation is significant. The dotted line is the number of taxpayers affected by AMT if the AMT was to be indexed for inflation. The solid line on top shows the number of taxpayers affected by AMT under current law with no indexing.

There is a second reason for the growth in taxpayers affected by the AMT. Under current law, AMT rules will limit the use of personal credits in the regular tax system after this year.

This is due to an expiring provision of the Tax Code, and explains why I have been using the awkward terminology "taxpayers affected by the AMT." Some taxpayers who do not pay AMT will have their regular tax liability increase because of limits on using credits.

The dashed line in Figure 2 shows the number of taxpayers affected by AMT without the limits, and the solid line on top shows the number affected with the limits.

Finally, I would like to summarize the impacts of the AMT. One impact, is to increase the compliance burden on taxpayers. Even a very simplified picture of the AMT, such as my Figure 1, the first figure I had up, shows its complexity. Not surprisingly, the tax that is complicated for taxpayers is also complicated for IRS to administer.

Another impact is on the distribution of the tax burden. As I said up front, the AMT was designed to ensure that higher income taxpayers are not able to escape all tax liability.

Looking at the left side of Figure 3 on page 16 of my statement, for the year 2000, AMT taxpayers are at the higher end of the income distribution. The growth projected for the AMT alters this distribution. The right side of Figure 3 shows the distribution of taxpayers affected by AMT in 2010. Millions of middle-income taxpayers will be affected.

Figure 4 gives a different perspective of the impact of the AMT and the distribution of the tax burden, but the message is similar. The left side shows AMT liability for each income class in 2000, while the right side shows it for 2010. By 2010, middle income taxpayers have billions of dollars of AMT liability.

Another impact of the AMT is on economic incentives. Compared to the regular tax, the AMT has a different base and rates. Thus, the economic incentives created by the AMT differ from those of the regular tax.

The last AMT impact I want to mention is the potential to neutralize regular tax system tax reductions. Taxpayers already subject to AMT get no benefit from a reduction in regular taxes, they do not pay regular taxes.

Additionally, some taxpayers who now pay the regular tax might find the tax reductions cut their regular tax liability to below their AMT liability. They would then have to pay the AMT liability.

This concludes my statement. I would be happy to take questions.

[The prepared statement of Mr. White appears in the appendix.]

The CHAIRMAN. Thank you.

Now, Mr. Zelenak.

STATEMENT OF LAWRENCE ZELENAK, REEF C. IVEY II PROFESSOR OF LAW, UNIVERSITY OF NORTH CAROLINA, CHAPEL HILL, NORTH CAROLINA

Mr. ZELENAK. Thank you, Mr. Chairman.

I will, first, address marriage penalty relief, then the AMT.

Despite occasional claims to the contrary, the existence of income tax marriage penalties is not due to legislative perversity or ineptitude. Rather, marriage penalties are an unfortunate byproduct of the pursuit of other policy goals.

Given the decisions to have a progressive tax rate structure and joint returns for married taxpayers, there must be marriage penalties, marriage bonuses, or both. There could be a joint return system with no marriage penalties, but it would feature large bonuses for one-earner couples.

Conversely, a joint return system with no bonuses would feature large penalties for two-earner couples. The current system is a compromise. It produces both penalties and bonuses, but in smaller amounts than under either of the polar approaches.

I will briefly discuss several possible approaches to marriage penalty relief. First, providing married taxpayers with rate brackets twice as wide as the brackets for unmarried taxpayers and a standard deduction twice as large.

This would eliminate all marriage penalties due to the basic rate structure and to the standard deduction. It is subject, however, to several possible objections. First, it is not narrowly targeted at marriage penalties. Slightly more than half of the revenue loss would benefit couples already enjoying marriage bonuses. Second, most of the tax relief in this approach goes to higher income couples. Third, this approach would eliminate less than half of all marriage penalties. There are three sources of marriage penalties this approach does not address: marriage penalties in the Earned Income Tax Credit, marriage penalties created by the phase-outs of various tax benefits, and marriage penalties created by the special rate schedule and standard deduction for heads of households.

The second basic approach is the same as the first, except on a smaller scale. For example, it would be possible simply to give couples filing joint returns twice the standard deduction available to unmarried taxpayers. Obviously, this would eliminate only a small percentage of all marriage penalties.

An interesting feature of this approach, is that it is strongly targeted to moderate income taxpayers. The vast majority of higher income taxpayers itemize their deductions, making the standard deduction irrelevant to them.

A variation on this approach would be to limit the standard deduction marriage penalty relief to two-earner couples, by making the increased deduction amount available only against the income of the lower-earning spouse.

Another variation would be to make the joint return standard deduction and the bottom rate bracket twice as large as the corresponding amounts for unmarried taxpayers, but not to provide equivalent relief in higher brackets.

In contrast with standard deduction relief, even the highest income couples would benefit from the expansion of the lowest rate bracket. This limited relief for affluent couples may be an attractive compromise.

The third basic approach is optional separate filing. Under this approach, a married couple could file a joint return or two separate returns as if unmarried, depending on which resulted in lower combined tax liability. This attacks marriage penalties without increasing existing bonuses or creating new ones.

There are two major objections. The first is complexity. Many couples would have to prepare three tentative returns in order to determine which filing strategy would result in a lower tax burden. Also, there would be complexity in allocating items of income and deduction between spouses. The second objection is philosophical incoherence. The purpose of joint filing is to impose equal tax on equal income couples, but optional joint filing defeats the purpose.

The fourth basic approach is the two-earner deduction. From 1981 to 1986, a two-earner couple was allowed to deduct 10 percent of the earned income of the lower-earner spouse, with a maximum deduction of $3,000. The administration has proposed restoration of this deduction.

This would eliminate about one-third of all marriage penalties. Although the benefit of the deduction would, of course, be limited to two-earner couples, it would not be perfectly targeted to victims of marriage penalties. About 20 percent of the revenue loss would result from the creation of new bonuses or the enlarging of existing bonuses.

A possible objection to this approach is that it imposes a higher tax on, for example, a one-earner couple earning $60,000 than on a two-earner couple with each spouse earning $30,000. This might even be described as a homemaker penalty.

This can be defended, however, as accomplishing a sort of rough justice in light of the extra, non-deductible expenses of being a two-earner household.

The fifth approach is EITC marriage penalty relief. As a percentage of income, EITC marriage penalties tend to be much larger than marriage penalties from other sources, and they fall on particularly vulnerable victims.

The bills which have been introduced to address these penalties all take the same basic approach, increasing by a few thousand dollars the joint return income threshold at which the phase-out begins. This would not come close, however, to eliminating such marriage penalties.

Finally, the sixth approach is attacking marriage penalties from the various phase-out provisions. In the absence of optional separate filing, alleviating these marriage penalties from the phase-outs of the personal exemption, itemized deductions, the child credit, and so on, is labor-intensive work. Each provision must be individually examined and amended. Nevertheless, this approach merits consideration.

As I stated at the outset, we are faced with the problem of tax marriage penalties because of our commitments to progressive marginal rates and to joint returns. If either of those commitments is removed, the problem vanishes. There would be no marriage penalties, for example, under a truly flat tax.

Similarly, requiring all taxpayers to file separate returns regardless of marital status would eliminate both marriage penalties and bonuses. On the other hand, it could be viewed as imposing penalties on one-earner couples and it would involve some difficult issues in allocating income and deduction items between spouses.

I would like to turn, now, to the AMT. The classic AMT taxpayer, at whom the tax was originally aimed, is someone with large investment tax preferences, such as ACRS deductions and incentive stock options.

Although the tax continues to target such preference items, in recent years AMT demographics have started to change, and many of the victims of the AMT do not fit the classic profile.

The increasing effect on moderate-income taxpayers without investment tax preferences is explained partly by the fact that the regular tax is indexed for inflation while the AMT is not, and partly by the fact that many of the differences between alternative minimum taxable income and regular taxable income do not relate to investment-type preferences, but to such plebeian tax breaks as employee business expenses, the deduction for State and local taxes, and personal exemptions. After 2001, non-refundable personal credits, including the child tax credit, will also be disallowed under the AMT.

An example in my written testimony shows how a couple with just $80,000 of gross income, four children, and modest itemized deductions, could face a substantial AMT liability in 2002, unless the law is changed.

This is not a high-income couple, and they have only the most garden-variety regular tax deductions, yet the AMT will cost them over $2,000 and will increase their total tax liability by almost 40 percent. Far from being pushed into the AMT because of sophisticated tax shelter investments, they have been pushed into the AMT basically by their children.

Another surprising sort of AMT victim is the taxpayer who receives a taxable damage award—for example, on account of employment discrimination—and who must pay attorney's fees out of this award. The attorney's fees will be classified as miscellaneous itemized deductions and disallowed entirely for purposes of the AMT. Although some courts have managed to avoid this result by creative interpretations of the definition of gross income, other courts, including the Tax Court, have been unwilling to follow their lead.

As you have heard, according to research at Treasury, if there are no legislative changes, if the scheduled disallowance of personal credits becomes effective, and if the AMT exemption amounts continue to be eroded by inflation, by 2010 the number of taxpayers affected by the AMT will be 17 million, compared with only 1.3 million last year. In addition, research indicates that the AMT will become increasingly focused on residents of high tax States.

The situation will be even more severe if the administration's proposed reductions in the regular tax are enacted without corresponding reductions in the AMT. The Joint Committee on Taxation has estimated, in that case, that the total number of AMT-affected returns in 2010 would be almost 27 million.

It is also worth noting that there is a significant marriage penalty built into the structure of the AMT. It would be ironic if Congress passed significant marriage penalty relief under the regular tax, only to throw millions of taxpayers into an AMT marriage penalty.

There are several options for reform. Although complete repeal of the individual AMT is certainly a possibility, it is not necessary. The AMT can be preserved for its original purpose, while greatly lessening its impact on taxpayers with modest incomes.

The major reform possibilities include the following. First, inflation indexing of the AMT. There is no obvious policy justification for not indexing the AMT exemption amount and rate structure when the corresponding features of the regular tax are indexed. A sensible reform would consist of a one-time catch-up adjustment to reflect past inflation and prospective inflation indexing as well.

Second, allow family size adjustments under the AMT. By this, I mean personal exemptions and the child tax credit. There is also no obvious policy justification for imposing the AMT merely because a taxpayer has a large family. The current situation is especially disturbing, because it is only moderate-income taxpayers who are pushed into the AMT by reason of their large families. For higher income taxpayers, personal exemptions and the child tax credit are phased out, even under the regular tax. So, a large family is an AMT risk factor only for taxpayers with moderate levels of income.

Finally, reconsider the applicability of the AMT to various other tax benefits. The deduction for State and local taxes is the most obvious candidate for reconsideration, both because of its practical importance and because it is not clear what policy concerns justify its disallowance under the AMT.

It is also worth considering whether it is necessary to disallow other personal credits, such as the child care credit and the higher education tax credits under the AMT.

Finally, the AMT disallowance of miscellaneous itemized deductions merits reconsideration, at least in the attorney's fee context, and perhaps more generally.

Thank you for your attention, and I look forward to answering any of your questions.

[The prepared statement of Mr. Zelenak appears in the appendix.]

The CHAIRMAN. Thank you very much, Mr. Zelenak.

Now, Professor Ellwood.

STATEMENT OF DR. DAVID ELLWOOD, LUCIUS N. LITTAUER PROFESSOR OF POLITICAL ECONOMY, HARVARD UNIVERSITY, CAMBRIDGE, MA

Dr. ELLWOOD. Thank you, Mr. Chairman. It is a real honor to be here to talk about child credits.

As you know, over the years lawmakers have enacted a variety of tax policies designed to help families with children. These policies really do make a critical difference, and I think President Bush really is to be congratulated for his focus on doubling the child tax credit from $500 to $1,000. Heaven knows, it is all the more difficult these days to both nurture and provide for children.

But as so often happens in tax policy, one of the things we have got to be aware of is, as we enact one policy or another policy, all with very good reasons, they interact in ways that sometimes are ironic or unexpected.

In this case, what one finds is when we think about how many benefits we provide to families with children, we give the most support to the working poor and the wealthy, and the least to the middle class.

Now, besides having a question of being unfair, this middle class parent penalty also creates the toll gate to the middle class that President Bush is so fond of talking about, and I think quite properly.

The reason is, if you are a family that is starting at working poor and thinking about increasing your earnings, working hard to increase your work, your earnings, or by marriage, what happens is, when your income goes up your child benefits go down. That serves as a penalty for both marriage, as well as creating some very high marginal tax rates.

In addition, all these complicated benefits create real complexity for the tax system. I think they really add to errors, and I hear yesterday you heard a fair amount about some of the EITC complications.

Now, if you will pardon me for a moment, I do want to briefly discuss three of the major tax benefits and kind of show how they interact. They are all shown here on this chart. The three ones are: the dependent exemption, the Earned Income Tax Credit, and the child credit. What is interesting, is each of these actually benefits a different group of taxpayers in terms of their incomes.

The dependent exemption is a $2,800 deduction, in effect, from your income. You calculate your income, you take $2,800 per kid off the top, and then you calculate your taxes.

The value of that exemption grows the higher your tax rate, so that the value of that exemption which is shown in the top chart there, and also in my testimony, is highest at the highest income levels. Of course, it is of no value to someone who owes no taxes.

At the other end of the distribution, we have the Earned Income Tax Credit. The Earned Income Tax Credit, as Senator Longess said when it was first introduced, is a work bonus. It is designed to reward work, particularly for minimum wage families.

The current one is really designed to ensure that a full-year, full-time minimum wage worker will not be poor. This is highly targeted, therefore, around the wages that minimum wage workers would earn. It is phased in rapidly, but then by $30,000 it is phased-out.

Then there is a third benefit, which is the child tax credit. It is a $500 credit, and it can only be used to offset existing taxes. Therefore, it is of no use to people that do not owe taxes. It is only fully usable to people that owe at least $500 per child, $1,000, in this case, for two kids. It also phases out starting at $110,000.

So here are the three. They each make some sense. They are logical. But then the question is, what happens when you put all of the pieces together? That is shown on this chart.

This is the total combination of these three benefits for taxpayers at different incomes. So what you see here, is for the lowest income earners, those around $10,000, $12,000, they get a very high benefit for having two children. The higher income, $100,000, upper middle class income families, they get a fairly high benefit. But in between, there is something that is the middle class parent penalty.

Why is that a problem? Well, one of the questions is just plain fairness. Why are we helping wealthy folks more than others? But there is a second question, which is the marginal tax rates, the toll gate for middle class. As the family earns more money, we take away their child benefits and, as a result, they are worse off. Perhaps even most importantly to me, in light of this hearing, there are the marriage penalties.

What happens when a woman, a single parent, is earning $15,000 and considers marrying a man earning $15,000? She is starting at the $15,000 peak of the mountain and she is going to end up in the bottom of the valley. So, by getting married, she will lose all these tax benefits.

In effect, his income taxes away her EITC and other benefits and they end up with a subsidiary marriage penalty, which is, by the way, the highest marriage penalties in terms of percentage of income as anywhere in the tax distribution. It is really caused by this middle class parent penalty.

Now, one other problem is complexity, which I mentioned before. Each of these policies has a different definition of child, slightly, a different definition of support, and so on. You can really end up with a lot of errors in the Code, and it is certainly complex.

Next, let us talk about what President Bush is trying to do. President Bush has proposed doubling the current child tax credit and slowing or extending the part at which it phases out. So you can see if, for someone earning $90,000 with two children, instead of getting $1,000 under the current law for two children, they would now get $2,000. So, that clearly would be a benefit to them.

But again, since it only can be used to offset current law, current taxes, anybody below $36,000 with two kids does not get the full benefit of this. So the effect of this is to mostly provide benefits to folks at the upper end. You can see, it especially is helpful for people above $120,000, $130,000.

Now, when you put this on top of the EITC deductions and look at all the different elements in the Bush proposal, including the marriage penalty relief and so forth, this is the pattern we see. This is how much money the government will pay to families with different incomes to help them with their children.

At the bottom end where we have got the working poor we have the EITC, at the top end we have child tax benefits of other sorts. The striking feature here is, who do we give the least to? A $30,000-a-year married couple with two kids. Those are the folks that we are doing the least for.

As a result, although the Bush plan is an important step in the right direction and to be commended, what is striking is this middle class parent penalty remains. As a result, although the Bush plan is very good at reducing the marginal tax rates faced by some working families, it leaves very large marriage penalties.

Once again, a family that starts at $15,000 on the top of that mountain and marries, ends up in the valley. They have lost these child tax benefits by getting married, so we end up with, still, very high marriage penalties.

By the way, the place in the distribution I think we ought to be most concerned about is down where people are working hard just to get by. A very sizeable penalty. By the way, one other feature about the Bush plan, of course, is it leaves in place all the existing credits and the complexity.

I think there is an alternative that, at least, this committee should consider. There are a number of different alternatives, and I would be happy to discuss any of them. But perhaps the most important, the one idea, would be to think about a way to simplify this whole system and get an integrated child tax benefit for working families.

The idea here would be, let us, yes, give a little extra to the working poor because we do want to ensure this principle that if you work you should not be poor—it just mimics what we currently do—but do much better by the middle class, by $30,000- to $60,000-a-year earners, ensure that every kid, you get about $1,500 per child.

This kind of plan, therefore, would dramatically reduce marriage penalties, it would get rid of the toll gate for the middle class, and ultimately be a much more fair and simple system, one so that taxpayers do not have to go through three or four different credits just to figure things out. Thank you.

[The prepared statement of Mr. Ellwood appears in the appendix.]

The CHAIRMAN. Thank you, Professor Ellwood.

We will take 5-minute rounds. Let us do it that way to start with, then we can have more.

Senator BAUCUS. If you want, just go ahead.

The CHAIRMAN. All right. You had better be careful about that suggestion.

I am going to start with Professor Zelenak. Last year, it became clear that individual income taxes had spiked as a percentage of GDP, largely because of the booming economy and the tax cut of 1993.

Americans ended up paying a record level of individual income taxes. I had charts that showed 10.2 percent GDP, and it had doubled between 1993 and 2000. Quite frankly, it is because of this tax surplus that we have the surplus that the Federal Government enjoys today.

Now, last year in a speech, Secretary Summers tried to minimize this fact by saying, “The tax burden for most American families is at the lowest in a generation. For a family of four with half the median income, about $29,000, Federal income tax and payroll taxes are a smaller share than at any time since 1977.

For a family of four with median income, about $59,000, Federal income tax, plus payroll tax, our share of income burden is lower today than at any time since 1978. Their Federal income tax burden alone is the smallest since 1966."

Now, it is true that because we have the $500-per-child tax credit, that many middle income families with children did enjoy a tax cut. As one who pushed hard for the child tax credit, and sometimes over Presidential vetoes, I am very happy that middle income tax families with children got some relief.

Now, unfortunately, there are a lot of families without children, who did not fit the profile made out by Secretary Summers. For example, a young couple just starting out in marriage who face the marriage penalty face higher taxes, in part, thanks to higher taxes from the 1993 tax increase. Basically, these families were left out. So, I am asking you, if it is true, as helpful as the $500-per-child tax credit was, it did not address the higher taxes paid by many married couples.

If so, does it not mean that the family tax burden has risen dramatically for many families that do not fit the examples cited by former Secretary Summers and others who opposed last year's marriage tax penalty?

Mr. ZELENAK. Senator, I think the explanation for what seems to be a contradiction, is that when Americans have been better off in real terms in recent years, that means a larger percentage of all income is taxed in the higher brackets and people are paying a higher percentage of tax to the extent they are more affluent.

But obviously you are correct, that a lot of people are, nevertheless, subject to marriage penalties. Obviously, a child tax credit does nothing to alleviate marriage penalties for a couple without children.

For that matter, I think something that is worth focusing on specifically with respect to marriage penalty relief, is a couple with children actually suffers a larger marriage penalty than is generally recognized, because they could get divorced, continue to live together, one of them could file as a single taxpayer and the other could file as head of household, and in fact they would have a better situation than if they were simply two unmarried taxpayers.

Even the most generous of the proposals only allows them to file as if they were two unmarried taxpayers. None of the proposals allow them to file as one unmarried taxpayer and one head of household. So, in fact, in that respect, the marriage penalty situation is even worse than is generally understood.

The CHAIRMAN. On another point, last year we passed fairly sweeping income tax relief for married couples. This year, President Bush is also committed to providing relief for these married couples.

Would you describe for us, please, Mr. Zelenak, these two efforts, and highlight any major differences between the two proposals?

Mr. ZELENAK. Well, they are quite different, indeed. What was passed last year, if I remember correctly, was doubling the standard deduction, doubling the 15 percent bracket, and also limited relief under the Earned Income Tax Credit.

By contrast, the current administration proposal is to allow a two-earner deduction equal to 10 percent of the income of the lower-earning spouse, up to a maximum deduction of $3,000.

The administration's proposal is more closely targeted to victims of marriage penalties. It is obviously available only to two-earner couples, which would not have been true of what was passed last year.

On the other hand, from the point of view of distributional analysis, there might be something to be said in favor of last year's approach, which gives more of its benefit to couples at the lower income levels.

One other point worth mentioning, though, is something which commonly gets lost in discussions of the effect of joint returns. There is another unfortunate effect of joint returns which has nothing to do with marriage penalties, as such. By marriage penalty, I mean, you get married and your income tax liability is higher than if you weren't married. But there is another effect, which is, assuming a couple is already married, joint returns discourage them from being a two-earner couple because a very high rate of tax would be imposed on the income of the second earner, typically the wife, if she decides to go out into the workforce, because her income will be stacked on top of the existing income of the husband.

Last year's approach did nothing in particular to address that. One of the virtues of the administration's proposal is it does lessen that burden on the second earner.

The CHAIRMAN. Yes.

I am going to ask Professor Ellwood to look at an analysis that does not dispute the point that you made about the notch for $30,000-a-year income families, as far as the application of the marginal tax rate. But I would like to have you look at the impact that it actually has on taxpayers.

In your testimony, you suggested that there is this middle class parent penalty for persons between $30,000 and $60,000. Obviously, that is alarming. Apparently, the chart shows a penalty of roughly $700 for those in that income range.

But I think our chart shows that what you identified is not really a penalty, because the truth is that those in that range have lower marginal rates than those above or below. Now, that is a fact.

But when you compare the income taxes everyone pays, with and without the child tax benefit, that is, the personal exemption, the $500 child credit, and the EITC, you discover—and I want to say our chart illustrates this—that, in fact, those in the $30,000 to $60,000 bracket do not pay $700 more in taxes than those above or below them.

Would you comment on that, even to the point of, if we are wrong? I hope I am not.

Dr. ELLWOOD. You are not wrong, Senator. Let me try and explain the issue. Remember, President Bush is fond of talking about the problems facing a $25,000-a-year single parent who wants to earn additional money, the toll gate to the middle class he talks about, and so forth.

What is going on here, if you look on you chart, your chart shows two things. One, is a variation on my chart about the notch and the current law, and in the second it shows marginal tax rates. You see, there is a big spike in marginal tax rates right around $25,000, $30,000, I believe, in first looking at it.

What is going on there, is because, as she earns more money, we are taking away her Earned Income Tax Credit, and in addition she is facing real taxes, we are getting up to a 20 percent reduction in the Earned Income Tax Credit, plus another 15 percent in taxes. She is paying 36 percent.

Once she gets down to the bottom, at the margin, additional dollars do not benefit or hurt her. So, it is not surprising at all, once you get down to the bottom of the valley. It is like, you walk down a hill, you get down to the bottom of the valley, you walk across the valley, you are no longer going down.

But there is a different point that I really want to emphasize. We have talked a lot about marriage penalties at the upper end of the distribution. In many ways, they are much more severe at the bottom. That is real in terms of what this is all about.

And do not trust me. The Heritage Foundation, the conservative Heritage Foundation, is so troubled by the marriage penalties at the low income after the Bush plan that they have proposed spending another $5 billion a year changing EITC to reduce those marriage penalties.

What is going on is straightforward. Because of the middle class parent penalty, if I get into the middle class either through earnings or whatever, I take away some child tax benefits. Now, I am not saying what we are doing is massively raising your taxes, I am saying we are taking away benefits we give to you when you are working poor. I hope that is helpful.

The CHAIRMAN. Let us say the Bush plan would be adopted the way he has suggested. It would ameliorate some of this.

Dr. ELLWOOD. The Bush plan will help on marginal tax rates a great deal. It will help slightly on marriage penalties. But, again, it is the Heritage Foundation.

The CHAIRMAN. But you will not have this big gap, right, after his plan?

Dr. ELLWOOD. Well, I do not know. If you can show that chart with the Bush plan again. What it will do, is this little bump in marginal tax rates will go away.

The CHAIRMAN. All right. Yes. That is what I mean.

Dr. ELLWOOD. President Bush has, quite correctly, worried about that and it reduces the marginal tax rate. But, again, take a look. Who are the families that are going to get the least help from the child benefits and everything else, at the end of the day, from all these things together? You are looking at $30,000-a-year families.

It is just a question of fairness. Do we want to be giving more help through tax benefits of various sorts to the upper income families, or $120,000-a-year families, versus $30,000-a-year families?

The CHAIRMAN. Will that not be the 6 million people, though, that are not going to be on the tax rolls any more under the Bush plan?

Dr. ELLWOOD. Oh, yes. There is no question that part of what is going on here, is you cannot get the full benefit without it. But remember, we do say, because we want to make sure if you work you are not poor. Ronald Reagan called the EITC the best anti-poverty, the best pro-family, the best job creation plan ever created. He was right. It has been wildly successful.

But we take it away faster than we provide the support in other tax benefits, so as a result we end up with a situation where, at the end of the day, $30,000-a-year families are not going to get that much support out of this kind of thing.

As I say, I really am troubled by the marriage penalty. That is why the Heritage Foundation is talking about this, too. This is not a right, or left, or any kind of issue. I think it is a real concern.

There are various ways you can think about going after it, but I think there is a real question about fairness, there is a question about incentives, and there is a question about complications. Remember, this is built up from a whole series of different ones that have different rules for different children, and so on. So the real question is, can you make it simpler and more fair?

The CHAIRMAN. Senator Baucus?

Senator BAUCUS. Yes. I would like to follow up on this general point.

Mr. Zelenak, you have mentioned, as I think Mr. Ellwood is now saying, that the marriage penalty caused by the EITC is particularly severe. In fact, as we know, there is no distinction made between married EITC recipients and single recipients in the calculations I have. The provision, therefore, can result in a marriage penalty as high as $6,500, but most commonly results in penalties of about $1,000, and maybe $3,000.

I have, really, two questions. One, how great, or how much greater, is the marriage penalty facing people in these income levels, the EITC situation, compared with those that are not?

To what degree, therefore, is it a disincentive to marry among low-income taxpayers? Does the penalty cause a disincentive to work and, therefore, earn higher income? If you could just talk about that a little bit, please.

Mr. ZELENAK. The EITC can be both. It is certainly a disincentive to marriage in some situations. It can also be, in some situations, a disincentive to work.

Your $6,500 example is, I think, correct, but based on an extremely unlikely set of circumstances.

Senator BAUCUS. That is right.

Mr. ZELENAK. But it is very easy to construct plausible circumstances where the penalty is in the range of $1,000 to $2,000. That is, in absolute dollar terms, similar to the penalties that we see people suffering under the standard deduction and the rate brackets, and as a percentage of income it is much higher.

While I have been unable to find any empirical studies as to the extent this actually discourages marriage, it would be odd if it did not. I mean, some people making about $20,000 would be suffering about a $4,000 marriage penalty by deciding to get married. It would be strange if some people were not discouraged from being married by that kind of a penalty.

Senator BAUCUS. Let us take several examples. The one I gave is more extreme. But, more common, let us take a single mother with one child, earning, say, $17,000, and a single father with a child at $16,000, with a total of $33,000. The EITC benefit would be zero, if married. That is a penalty of $3,700.

Let us take a single mother with two children, earning $12,000, a single father with no children earning $12,000, combined $24,000 in income. The EITC benefit for the single mother with two kids is $4,000. Married, the benefit would be $1,700, resulting in a marriage penalty of about $3,000.

Mr. ZELENAK. There are two technical sources of this penalty. One, is that the maximum amount of the credit is the same whether you are married or unmarried. So if two people, both of whom are entitled to the maximum credit, get married, then automatically they have lost one of those credits by getting married.

In addition, the phase-out is based on the combined income of both spouses and the phase-out range is exactly the same whether you are married or unmarried.

Senator BAUCUS. Right. Right.

Mr. ZELENAK. So it is an extreme marriage penalty any way you look at it.

Senator BAUCUS. Right. So what is the solution here?

Mr. ZELENAK. I wrote an article last year, chewing on that for about 20 pages, and could not find anything totally satisfactory.

Senator BAUCUS. So when you chewed it all up, what did it come down to?

Mr. ZELENAK. Any place you push, you are going to have a problem at the other end. But I would say, for starters, for a down payment, do at least this. At least increase the starting point of the phase-out for marrieds by several thousand dollars over the starting point of the phase-out for singles.

The problem is, of course, any time you do anything to alleviate marriage penalties, you are potentially creating singles penalties. We do not want to have penalties for single parents either, especially at low-income levels. But I think the current situation is so extreme, that there is an awful lot to be said in favor of at least doing that much.

Senator BAUCUS. So the phase-out, today, begins at, what $13,000?

Mr. ZELENAK. Yes. And it is exactly the same, whether you are married or not.

Senator BAUCUS. Right.

Mr. ZELENAK. So I would suggest something like, if you keep the unmarried phase-out at $13,000, move the married phase-out to $17,000 or $18,000.

Senator BAUCUS. But beginning the phase-out then, it ends up being totally phased out at incomes up around $40,000.

Mr. ZELENAK. Yes. That does not bother me, that somebody making $40,000 is still entitled to a small earned income credit, partly because it is going to be so small at that point, and partly because they are still paying tax. So, they are still net taxpayers because the credit, in that situation, merely reduces the positive tax liability.

The other issue, which has nothing to do with marriage, as such, is the work disincentive effect that comes from the phase-out. If you have two children, the phase-out rate is just over 21 percent.

If you put that on top of the 15 percent rate that you are paying anyway, plus the Social Security tax, plus State income tax, a lot of people in the income range of $30,000 or so are paying a marginal combined State/Federal tax rate of about 50 percent. That is not a marriage penalty issue, as such, but it is certainly an EITC issue. That, I think, could use attention, too.

Senator BAUCUS. What about optional separate filing. Would that eliminate the problem?

Mr. ZELENAK. It could, if you wrote it that way. If I remember correctly, the version of optional separate filing that the Senate passed 2 years ago said the credits would still be determined on a joint return basis, even if you filed separately for other purposes.

So if you wanted to solve the problem that way, you would also have to have credits determined on a separate return basis. That gets into problems of its own, because then that means potentially a spouse of a billionaire who takes a job paying $10,000 a year would be entitled to the Earned Income Tax Credit, and some people find that troubling.

Senator BAUCUS. How often do you think that might occur?

Mr. ZELENAK. Not often.

Senator BAUCUS. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Baucus.

Now, Senator Lincoln.

Senator LINCOLN. Thank you, Mr. Chairman.

Just to touch briefly on a couple of things, and I hope I will have time.

I know everyone has talked on this committee, and the economists we have had before the committee have mentioned it, both conservative and liberal, as Mr. Ellwood has mentioned. From each side, everyone, actually, with probably the exception maybe of the White House, agrees that something has to be done to fix the problem of the AMT.

There are many changes that have been presented to us for the Tax Code in this bill and other bills, many of which will probably have a real effect on the AMT.

In the bill that I introduced on the AMT with Senator Lugar, we have tried to identify some of the things that we think are unfairly represented in the AMT. I know that my colleagues have identified others in the areas they have looked at. I am sure that we will negotiate changes in the bill and the right balance will come to the surface. I certainly hope so.

But the core of our bill in AMT reform is in increasing and in indexing the AMT exemption amount. Whether we determine that it is reform rather than repeal that we believe is the right policy, or the right policy that we can actually afford, would you agree that modernizing the exemption amount for inflation is fundamental to the AMT reform?

Mr. ZELENAK. Senator, it seems crucial to me. I cannot imagine any argument against doing it, other than the pure revenue cost. It makes no sense to have the regular tax indexed for inflation and not have the AMT.

Senator LINCOLN. Yes.

Mr. ZELENAK. I crunched some numbers. The last time the AMT exemption amounts were increased for inflation was, I believe, 1993. The joint return exemption currently is $45,000, and it was $45,000 8 years ago. If you retroactively increased it for inflation since then, it would be over $55,000 today.

So, I would very much support the approach of your bill to have a one-time retroactive increase along those lines, and then prospectively index for inflation.

Senator LINCOLN. Mr. White, did you have a comment on that?

Mr. WHITE. No. I would agree with that. Certainly, if you want to address the growth in the coverage of the AMT that is projected for the future, the big driver is inflation. So, indexing is the obvious option to consider for controlling that growth.

Senator LINCOLN. Considering the current state of the law and the fact that, regardless of the proposed expansions of the child credit—it has been said 17 million taxpayers will fall under the AMT—can allowing the child credit exemption for the AMT do enough to keep the AMT from keeping into the middle class? Can that do enough?

Mr. ZELENAK. I think, not by itself. Not without an inflation adjustment as well.

Senator LINCOLN. That is kind of what I was leaning towards.

Mr. ZELENAK. In fact, I believe that the administration's proposal actually increases the credit and allows the credit against the AMT. Even with that, there is a forecast of something like 27 million taxpayers subject to the AMT by 2010.

Senator LINCOLN. Mr. Ellwood, I have had a chance to look over your proposal, and told your colleague Mr. Liebman yesterday, that I looked forward to working with the two of you to bring reform to EITC and to modernize that child tax benefit in our Code. Your charts have been enormously helpful to me, and I hope they have to other members of the committee.

I would just like to point out in this hearing that the overwhelming bulk of Arkansans, in fact, about 88 percent, never make it to the level of household income where the benefits of the dependent exemption and the child tax credit start to rise out of that trough on your chart.

So, I do not have a question, really. I just wanted to offer that I am very interested in working with you to transform the EITC to better understand what proposals we can do to modernize and to make it more efficient, to reduce the mistakes, and certainly eliminate the fraud that was brought up in a previous hearing, but to make sure that the family credits are working to help real families in Arkansas, and across this Nation.

Just briefly, on the marriage penalty. Mr. Zelenak, it was mentioned, I know, in Senator Kay Bailey Hutchison's testimony about what her plan actually does. I, along with everybody else, understand that the singles penalty that you brought up just a moment ago, both parents in our State predominantly have to work if they want to put food on the table and do not want to be on the dole.

So, as Senator Hutchison had said in her testimony, a couple earning those kinds of wages are much more likely to pay a marriage penalty than to get a marriage bonus.

My question is, once we finally take the important step in eliminating the marriage penalty, is it fair that people who do not have the choice of establishing a one-earner family, people like the overwhelming majority of my constituents, as I have mentioned, that pay taxes into a system—maybe not income taxes, but taxes into a system—that, in effect, subsidizes one-earner couples, will we not have to just come back and eliminate that singles penalty again a few years down the road?

Mr. ZELENAK. I think that is a distinct possibility. The problem, of course, is that we have actually been down this road before. The history is that, in 1948, Congress passed a bill which did basically what Senator Hutchison's proposal would do.

Senator LINCOLN. Right.

Mr. ZELENAK. And 21 years later, in 1969, there was such an outcry about resulting singles penalties, that Congress decided it had to do something about that. That is what created the marriage penalties we have today. So, there is a real possibility of sort of an endless recycling of approaches to the taxation of marriage in response to whoever is getting a bad deal at the moment.

There is nothing you can do in the income tax treatment of marriage where somebody will not have a plausible complaint that they are getting treated unfairly.

That is why I started my testimony, actually, by saying the current system is, while I think it can be improved, a good-faith attempt to deal with a very difficult issue. I think that going back to the 1948 approach does run the risk that you will be back here a few years later talking about the singles penalty.

Senator LINCOLN. So it is just kind of a recycling type thing. Yes.

Well, I certainly appreciate all of you gentlemen, and look forward to the committee calling on you for your wisdom again, and working with you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Lincoln.

Professor Ellwood, what is the estimated cost of your proposal? And we try to do things around here on a 10-year basis, assuming we would not pass the Bush tax cut.

But I would like to have you take into consideration the fact that yesterday we had testimony showing that, in the Earned Income Credit program, 31 percent of the payments are improperly made, and some of that is due to fraud.

Do your cost estimates in your initiative assume this sort of fraudulent activity, particularly, if it is as high as 31 percent? If not, what figure do you use to account for the reality of improper payments?

Dr. ELLWOOD. Well, let me start with just the question of, suppose we did nothing other than this to the Tax Code. It is an unlikely scenario. But that would cost something in the range of $27 billion a year, so multiplied by 10 years is $270 billion. Why is that? Because all of the money, 100 percent of it, is going to middle-income, $30,000- to $60,000-a-year families.

Now, we use the same methodology, by the way, that the Joint Tax Committee and others do, so it takes into account some of the current expenses.

That said, I think the fraud thing actually goes the other way. I think part of what goes on, and I think you heard some of this yesterday, is the EITC is very complicated and, by the way, the rules are different. The EITC is, you have got to live with the kid six months. For a dependent exemption, you have got to support the kid. Different ages.

In fact, I think some of what goes on, is people are genuinely confused, or at a minimum, purposely confused, even. It seems easy to understand why you could have a problem in a Tax Code where you can legally claim a child for one tax credit and be breaking the law for claiming them for a different kind of tax benefit.

So I think actually, if you could, you should simply the system, make it uniform. Why is it we count 17-year-olds in one, and 18-year-olds in another? Why is it we decide whether you live with a kid for one, and whether you support the kid for another? You can see why that is just open for lots of those kinds of problems.

I should also say, about the additional cost, if one were to pass a $1,000 tax credit, just that part, that would cost $20 billion. So the difference between this and that is about $7 billion a year, and it may be a little less, maybe a little more, and we should get more reliable cost estimates to take into account those things.

But I actually believe this is a way to reduce the fraud and reduce the errors in the system, but there is no way of doing it absolutely.

The CHAIRMAN. Assuming this is accurate, that two-thirds of the 31 percent is fraud and one-third confusion, would that make you change your mind?

Dr. ELLWOOD. No.

The CHAIRMAN. You still feel the same way?

Dr. ELLWOOD. I really do. Again, if what you are suggesting is we are going to take middle class families that are already filing for taxes, they already have to report their children, and so forth, they are still doing that, indeed, they are paying positive tax liability, if they like, now, on the number of kids, they could reduce their taxes.

Why you think those ordinary, hard-working folks that are reporting substantial incomes are now going to risk their entire life by committing fraud, I am not convinced that this part of the distribution is going to be a huge worry.

We already have all those incentives in place because, if you claim a child deduction, you can get it. So, as I say, I think simplifying will reduce it. Again, I have no way of justifying it, other than by the logic of that. Simplification often gets rid of error.

The CHAIRMAN. Professor Zelenak, if the Bush proposal was fully phased in, the 10 percent rate for married couples, at double the width as opposed to single couples, so from zero to $6,000, the 10 percent rate applies. For married couples, it would be zero to $12,000.

Now, when it comes to the 15 percent rate, it is not double. The single rate, at 15 percent, applies to income from $6,000 to $30,950, but only up to incomes of $41,000 for married individuals filing joint returns.

Now, some have suggested that we should consider widening that band at the 15 percent rate to double. What would be the impact of such an effort for both married couples where one stays at home and where both couples work?

Mr. ZELENAK. Well, it would benefit any couple whose income reached the 15 percent bracket, whether they stayed at home or worked. So, it would reduce marriage penalties, but it would also increase marriage bonuses.

Senator, along those same lines, I actually would like to call your attention to the 25 percent bracket.

The CHAIRMAN. Yes.

Mr. ZELENAK. I know the distributional interest tends to be at the lower level, but I think it is fair to be concerned about marriage penalties at all income levels.

The current administration proposal, and I guess this is the same as the House bill as well, has potential for very severe marriage penalties in the 25 percent bracket, where the unmarried 25 percent bracket ends at $156,000 and the joint return bracket ends only slightly higher, about $190,000.

As you know, to eliminate all potential for marriage penalties, if the single bracket is $156,000, the married bracket would have to end at $312,000. That is similar to the way the current law imposes large marriage penalties in the higher brackets.

But I think it is a problem. I think we ought to be concerned not just about penalties in the 10 and 15 percent bracket, but also in the 25 percent bracket. As the bill currently exists, that penalty is really severe.

The CHAIRMAN. Senator Baucus, would you like to ask another question?

Senator BAUCUS. Yes. Just a couple, Mr. Chairman.

I just want to assure that when we attempt to reform the EITC, we reduce some of the complexity. At least, do our very best to do so. I mean, it is incredible why it is 18 for one purpose, 17 for another, and all that.

I hope we look, as well as we can, to determine how many of the errors are intentional and how many are not. GAO did testify, in a certain sense, that two-thirds were intentional.

On the other hand, the GAO also went on to say that, because their assessments were judgmental and made without specific criteria, they are too imprecise to be included in the IRS report.

In addition to that, since then there have been developments. I think there is a Federal Case Registry Database which can be used to determine the problems, error rates, and the cause of the error rates.

I do not know if it is a good idea, but Treasury has proposed allowing the IRS authority to automatically deny cases where any inconsistencies are reported from the database.

My guess, Mr. Chairman, is that a lot of the errors are due to complexity. It is just so complex. Some of it is intentional, there is no doubt about it. People want to get away with something they can get away with.

But we can solve both problems, I think, by reducing a lot of the complexity. Then it is harder and less likely that mistakes will be made, and it is less likely you can get away with cheating. I think we should go the extra mile to try to simplify the EITC and add more consistency.

Yesterday, for example, it was just amazing, all the different points that were raised in that 56-page book, as I recall. The EIG, or breakpoint, or whatever it is, when a mother earns a little less than the grandmother, then the grandmother's income counts, not the mother's.

That is just one of many problems that occur here that we just created ourselves. And I suspect we created most of them because, it has been my experience on this committee for so many years, most of the tax decisions made here are made not for policy reasons, but they are budget driven.

So it might be 17 or not 18 in one case, and you could save a little bit of money. It is to save the money, and we pay no attention to policy or the inconsistency with some other provision. Now it is starting to catch up with us. I think we have an opportunity now to try to eliminate and cut back a lot of the unnecessary complexity.

The CHAIRMAN. Yes. We have had 2 days of hearings where the same points have kept coming out. I would hope that what you are suggesting would be a natural follow-up after we get the IRS response to our letter.

Senator BAUCUS. Right. I remember last year in the tax bill, I pushed as strongly as I could to get this committee's adherence to a provision we enacted, namely, that the IRS tell us what additional complexities we are causing by this proposal that we are contemplating.

I must tell you, Mr. Chairman, I was quite amazed at the lack of interest in this committee in following up on that.

The CHAIRMAN. Well, there is always a lack of interest of Congress following its own suggestions.

Senator BAUCUS. You are telling me. [Laughter.] That is true, but it does not make it right.

The CHAIRMAN. No, it does not make it right. You are right. Not at all.

Now, Senator Lincoln, then we will close.

Senator LINCOLN. No further questions.

The CHAIRMAN. Well, listen, this has been very interesting and enlightening, and obviously, things that are going to be before this committee in less than two months, as Senator Baucus and I try to work out a tax bill to get to the Senate floor sometime early May.

So from that standpoint, thank you very much. We appreciate your cooperation.

Hearing adjourned.

[Whereupon, at 11:32 a.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

PREPARED STATEMENT OF DAVID T. ELLWOOD

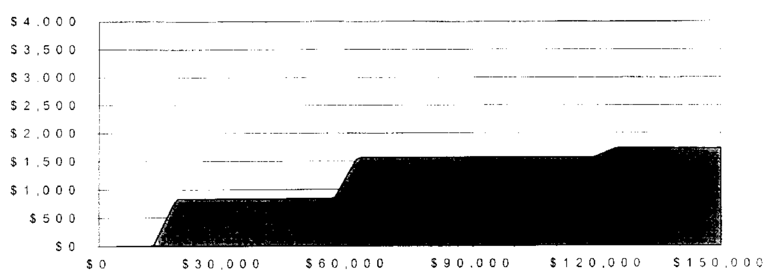
Mr. Chairman, Ranking Member Baucus, distinguished members of the Committee. It is a great honor to appear before you today to discuss child tax credits.

Over the years, lawmakers have enacted a variety of tax policies designed to help families with children. These policies make a critical difference in the lives of many citizens. Now President Bush has proposed significantly expanding that support by doubling the current child tax credit from $500 to $1000. The President properly recognizes the need to focus particular help on parents who struggle to nurture and provide for their children in an increasingly complex world.

Yet ironically, when we look at the combined effects of the various different supports for children, we find that they provide the greatest benefits for the working poor and the wealthy, while doing far less for middle income families. Thus our current system creates a kind of middle class parent penalty. Not only does this seem unfair to the middle class, it also creates what President Bush has properly labeled the "toll-gate to the middle class." As a working poor family's income rises through either work or marriage, and the family moves towards the middle class, they stands to lose sizable tax benefits. They face both high marginal tax rates and sizable marriage penalties. And the hodgepodge of child benefits that create these problems also adds complexity to the tax system.

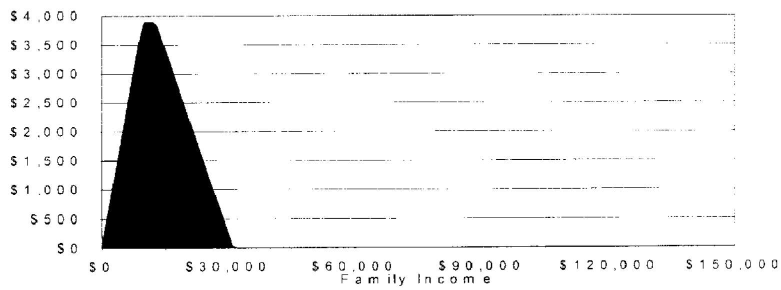
MAJOR CHILD TAX BENEFITS

There are three major benefits tied to children in the tax code: the dependent exemption, the Earned Income Tax Credit, and the child tax credit. Interestingly each offers different benefits to families at different incomes. The pattern of benefits are shown below.

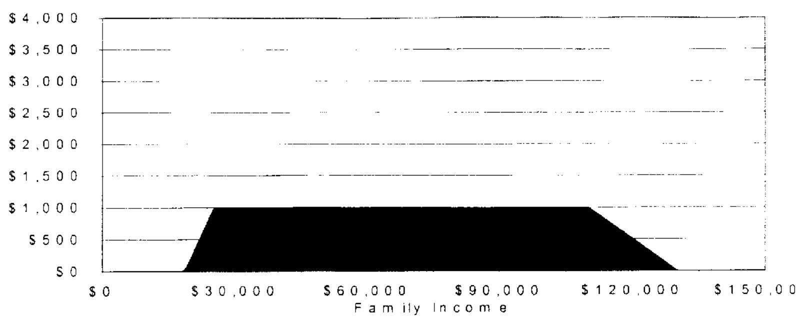


Value of the Dependent Exemption for Two Children in a Married Couple in 2000

Value of the Earned Income Tax Credit for a Family With Two Children in 2000



Value of the Existing Child Tax Credit and Proposed Bush Expansion for Two Children in a Married Couple in 2000



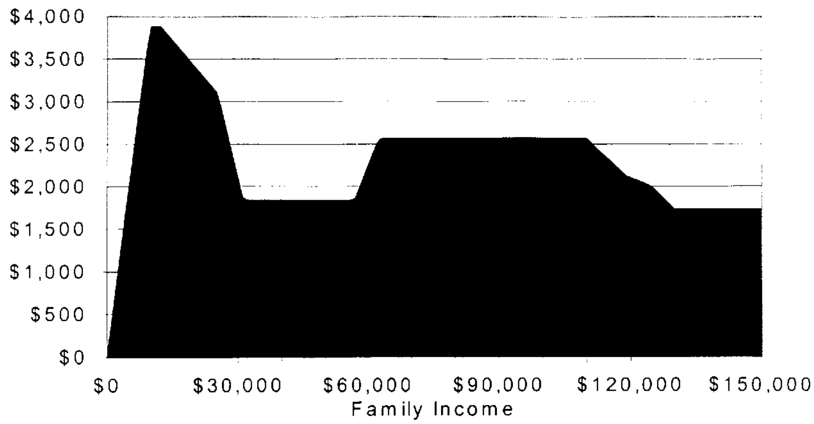
The *dependent exemption* reflects the added expenses of children and allows parents to deduct $2,800 for each child they support. As with any deduction, its value rises as the tax bracket rises. Thus it has no value for people who owe no taxes. For a family in the 15% bracket with two children, it is worth $840. For a family in the 31% bracket, it is worth $1736.

The *Earned Income Tax Credit (EITC)* was introduced in 1975, in part as a way to offset the payroll taxes that low-income taxpayers must pay. It was expanded greatly under Ronald Reagan who called it the "the best antipoverty, the best pro-family, the best job-creation measure to come out of Congress." The credit is targeted on families with full-time earnings around the minimum wage who can get the maximum benefit of almost $4,000. Families with incomes above $32,000 get nothing at all. It is fully refundable, meaning families can get the credit regardless of their taxes owed.

Finally there is the $500 per *child tax credit* which was adopted in 1997 and that President Bush would like to double. The credit is non-refundable, so it only helps people with tax liabilities. Married couples must typically have incomes over $25,000 to get the full benefits of the credit. The credit is phased out starting at $110,000 for a married couple.

Each of these make sense in isolation. But when combined the total benefit is shown below:

FIGURE 4



Combined Value of Child Tax Benefits From EITC, Exemptions, and Child Tax Credit
Married Couple with Two Children

Benefits for families in the $30,000 to $60,000 range are considerably lower than those for families near $15,000 or $100,000. This dip in benefits is the middle class parent penalty.

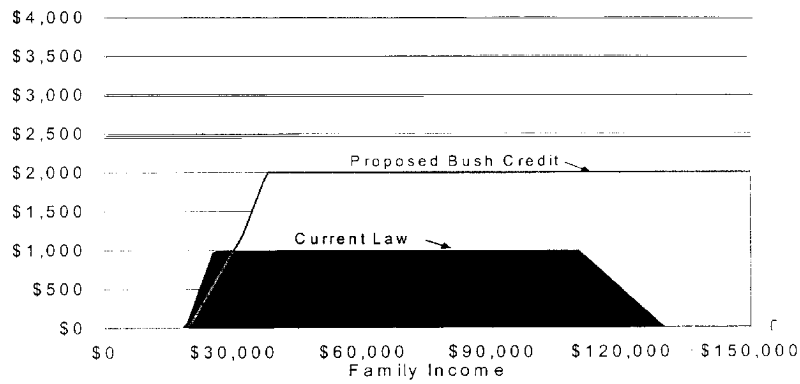
WHY IS THE MIDDLE CLASS PARENT PENALTY IMPORTANT?

- *Equity*—It is hard to understand why the nation offers support for children in such different ways and why it chooses to provide more aid to higher income parents than to middle income ones.
- *High marginal tax rates*—Child tax benefits fall off particularly sharply at incomes between $25,000 and $32,000. Because child tax benefits are being cut so sharply as earnings rise, working parents face effective marginal income tax rates over 35% and over 40% if payroll taxes are included. If one takes account of the loss of other benefits such as food stamps or child care subsidies, effective tax rates for families in the range of $20,000 to $30,000 can reach 80%.
- *High marriage penalties*—When a mother of two who earns $15,000 marries a childless man earning the same amount her family income rises from $15,000 to $30,000. As a result she loses many of her child tax benefits. This serves as a marriage penalty. Indeed such a couple will pay $2,700 more in taxes if they marry. As a percent of their income, this penalty is vastly higher than the penalty for couples at almost any other income level.
- *Complexity and Errors*—The array of child related tax benefits have conflicting rules about who can claim which children that lead to confusion, errors, and even fraud. A family can sometimes quite legally claim one type of child benefit, but be breaking the law if they claim another.

STRATEGIES FOR REDUCING THE MIDDLE CLASS PARENT PENALTY

The Bush Tax Credit

President Bush has offered a sizable tax cut plan which includes reductions in marginal tax rates, an increase in the child tax credit from $500 to $1000, and changes the rules so that the child credit does not begin to phase out until family income reaches nearly $200,000. The value of this credit to families at different incomes can be seen below.

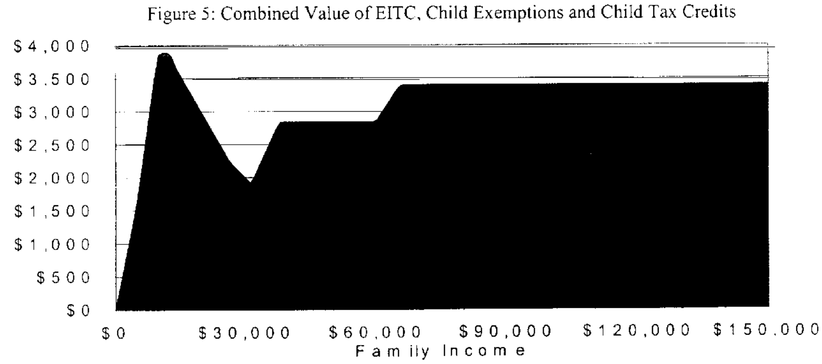


The Bush Child Tax Credit As Compared To Current Law

Thus a family earning $60,000 with two children would get twice as much in credits as before. Because the benefits are in the form of a child credit increase which can only be used to offset taxes, a couple with two children would not qualify for the full credit until their income reached at least $36,000—more if they have 3 or more children. Nearly half of all children in *tax-filing families* would not get the full credit. The biggest winners from the child credit proposal would be families with incomes over $130,000.

The combined child tax benefits that will exist if the entire Bush plan were adopted, including the tax credits, altered marginal rates, and marriage penalty relief are shown below.

Figure 5: Combined Value of EITC, Child Exemptions and Child Tax Credits



The Bush plan helps families with incomes over $25,000. It does reduce marginal tax rates. At the same time, one can see that a sizable middle class parent penalty remains. Families earning $30,000 get far less support than those who are richer.

Unfortunately this plan does little to reduce the marriage penalty facing a single parent earning $15,000. Marriage penalties would fall just from $2,700 to $2,400. Indeed the conservative Heritage Foundation has proposed spending an additional $5 billion per year for "more effective use of the Earned Income Tax Credit to promote stable marriage among low income parents."

A Unified Child Tax Credit for Working Families

An alternative plan is to create an integrated child tax credit, one with a single definition for children that could replace the three benefits in current law. Under this plan, benefits would phase-in just as the current EITC does. It would have a three tier benefit structure for a family with two children: $3888 (comparable to the maximum of the EITC) for families with incomes between $10,000 and $18,000, phasing down very gradually (at a 10 percent rate) to $3,000 ($1,500 per child) for families between $30,000 and $110,000, and phasing down again to a benefit of

$2,000 ($1,000 per child) for families with incomes above $130,000. The structure of benefits for a family with two children is shown below. The plan would also increase support for working families with three children. Such families could qualify for the full $1,500 per child when family income reached just under $10,000.

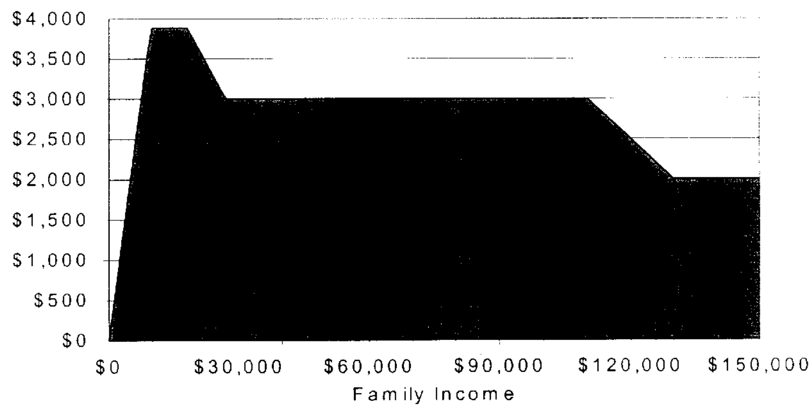


Figure 6: Unified Child Tax Credit for Working Families--Three Tier System

An integrated system such as this would target more support on middle class families, do even more to reduce tax rates that constitute the tollgate to the middle class, significantly reduce marriage penalties, and simplify the tax system. No longer would parents have to compute multiple different credits and exemptions each with their own rules and face a situation where one benefit is phasing in while another phases out. It would add to the cost of a tax plan, but only slightly more than the $5 billion per year proposed by the Heritage Foundation for marriage penalty relief.

Other Proposals

Other proposals that bear on child tax benefits include other unified credit plans such as one suggested by Cherry and Sawicky, making the child tax credit partially refundable for working families as proposed by Sawhill and Thomas, creating a refundable tax credit for payroll taxes paid, extending the EITC plateau for married couples to provide marriage penalty relief, making the child credit fully refundable. Each of these would do more to help working families in the middle class. Each has its own strengths and weaknesses. I would be happy to discuss any of these with you.

Antonelli, Angela M., and Peter B. Sperry. "(600) Earned Income Tax Credit." in *A Budget for America*. Washington, D.C.: The Heritage Foundation, 2001. p. 285.

Cherry, Robert, and Max B. Sawicky. "Giving Tax Credit Where Credit is Due. A 'Universal Unified Child Credit' that expands the EITC and cuts taxes for working families." Briefing Papers. Washington, D.C.: Economic Policy Institute, 2000.

Sawhill, Isabell, and Adam Thomas. "A Tax Proposal for Working Families With Children." Welfare Reform and Beyond. Policy Brief No. 3. Washington, D.C.: The Brookings Institution, 2001. hormas (2001)

Prepared Statement of Hon. Kay Bailey Hutchison

Thank you, Mr. Chairman, Ranking Member Baucus and members of the committee for inviting me to speak at this hearing on easing the family tax burden. I am pleased to talk about ending one of the most egregious, anti-family aspects of our tax code—the marriage penalty. As a Senator, relieving the marriage penalty has been one of my highest priorities, so I am honored to testify before you today.

Right now, married couples all over America—21 million or so—are being penalized by our tax code for no apparent reason other than because they are married. The Treasury Department estimates that 48% of married couples pay a marriage penalty. According to a study by the Congressional Budget Office, the average penalty paid is roughly $1,400.

Some say that the marriage penalty only affects the well off, and that relieving the marriage penalty would primarily benefit the rich. I have heard from couples all over Texas, and I can assure you that this is not the case. Low-income, working families are affected disproportionately.

One couple in particular, Heather Diederich and Willie Simmons, live in Tyler, Texas, and are engaged to be married on May 26. Both work at Brookshires, a local grocery store chain. Heather is the single mother of a 3-year-old boy and makes $20,000 a year. Willie makes $19,000 a year. When they get married, they will be hit with a marriage penalty of $1,600.

Other than love, what incentive do these two young people have to get married? Indeed, they are faced with an unbelievable disincentive. It would save them $1,600 a year if they simply lived together. $1600 is equal to half a year's rent in Tyler.

It doesn't have to be this way. According to the Congressional Budget Office's latest projections, we will achieve a $5.6 trillion surplus over the next 10 years. This surplus is affording us an unprecedented opportunity to address inequities in our tax code, including the marriage penalty. I am very pleased that the President made marriage penalty relief a part of his tax plan. Clearly, he recognizes that the marriage penalty is a real problem faced by millions of American families and that correcting it must be a top priority.

So as the Committee examines this issue and works to craft a marriage penalty relief proposal, I would like to offer the following suggestions.

First, marriage penalty relief should not add another layer of complication for taxpayers. Our tax code is already enormously complex. Every year, America's taxpayers are forced to spend billions of dollars in tax preparation fees and millions of hours filling our complicated tax forms. Marriage penalty relief should not contribute to this already significant burden.

Second, marriage penalty relief should ensure that all married couples are treated equally. We should strive to bring relief to as many couples as possible, and we should not create a tax system in which we discriminate against certain couples solely on the basis of the division of income. Under current law, couples earning the same amount of combined income pay the same amount in taxes, regardless of whether one spouse chooses to work within the home. We need to make sure that this remains the case.

On this point, some have argued that single-earner couples should pay more in tax than two-earner couples with the same combined income. This is because single-earner couples currently benefit from what they call a marriage "bonus."

For the most part, so-called marriage "bonuses" arise in single-earner families. For example, let's say a man who earns $40,000 a year is engaged to a single mom who earns non income. Once they get married, he will pay less income tax than he did as a single person and, therefore, would be receiving a marriage "bonus."

But let's keep in mind that his $40,000 income will now have to support three people instead of just one. His expenses have increased, not decreased. By getting married, he is hardly getting a "bonus"—at least in the monetary sense of the word.

Would it be fair for this couple to pay more in tax than a similar family in which both spouses work outside the home and earn the same total income? In my view, the answer is no.

For the last four years, I have studied a number of mechanisms for correcting the marriage penalty. In the final analysis, I believe that the simplest and fairest way to address this issue is to do two things:

- Increase the standard deduction for married filing jointly so that it is twice that of an individual; and
- Widen the 15% tax bracket.

By taking this approach, we will not be adding a single ounce of complexity for taxpayers, and we won't be choosing which married couples should get relief. In effect, everyone who is married will benefit, and no couple will be discriminated against based on the division of income.

Of course, this approach does not address the marriage penalties found in the upper income brackets. However, expanding the 15% bracket and increasing the standard deduction for joint filers is a reasonable and responsible first step—one that will fit within the $1.6 trillion the President has set aside in his budget for tax relief.

Based on the Joint Tax Committee's estimates of the marriage penalty relief bill that Congress approved last year, doubling the standard deduction and expanding the 15% bracket would cost $187 billion over 10 years. According to the Office of Management and Budget, the President's proposal—which would reinstate the 10% second-earner deduction—would cost $112 billion.

These two revenue estimates are not that far apart, and I believe we can close the gap between them by phasing in the 15% bracket expansion at a slightly slower pace than we did in last year's bill, thereby achieving savings over the 10-year period.

Again, Mr. Chairman, I would like to emphasize the importance of enacting meaningful marriage penalty relief this year. I believe our failure to do so, especially at a time when the federal government is receiving record income tax surpluses, would send the wrong message to couples like Heather and Willie in Tyler. Let's give them marriage penalty relief this year, and let's do so in a way that is simple and fair.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF JAMES R. WHITE

Chairman Grassley, Ranking Member Baucus and Members of the Committee

I am pleased to participate in the Committee's hearing on family tax relief. My statement focuses on the Alternative Minimum Tax (AMT), its interaction with the regular tax system, and its projected growth in coverage. In summary, my statement makes the following points:

- AMT was designed to ensure that high-income individuals do not avoid significant income tax liabilities—for tax year 1997, about 14,000 taxpayers would not have paid any income taxes absent AMT.
- AMT operates as a separate tax system that parallels the regular individual income tax system but with different rules for determining taxable income, different tax rates for computing tax liability, and different rules for allowing the use of tax credits.
- AMT affected about 1 percent of taxpayers in 2000 and accounted for about $5.8 billion in additional tax revenue; by 2010, it is expected to increase the tax liabilities of about one out of six taxpayers and account for about $189 billion in tax revenues over the period.
- The projected increase in AMT coverage is, for the most part, attributable to inflation (the regular tax system is indexed for inflation, but the AMT is not) and to the scheduled expiration of legislation temporarily excluding some tax credits (such as child tax credits) from AMT rules.
- AMT's impacts include increased taxpayer compliance burden; increased IRS administrative cost; redistribution of the tax burden among taxpayers; changed economic incentives; and the potential to neutralize, for some taxpayers, changes to the tax system.

My testimony today is based on our August 2000 report to the Committee.[1]

RATIONALE FOR ESTABLISHING AMT

AMT was created to reduce the ability of high-income individuals to escape payment of tax on income by using tax preferences available under the regular tax system. A type of minimum tax was first enacted in 1969, following congressional testimony by the Secretary of the Treasury reporting that 155 individuals, each with adjusted gross income above $200,000 (about $1.1 million in fiscal year 2000 dollars), paid no federal income tax in 1966.

Over the intervening years, the minimum tax has been amended a number of times, producing today's AMT. Although the mechanics of AMT were periodically modified, the objective of limiting high-income taxpayers' ability to avoid significant tax liability by using tax preferences was retained.[2] According to recent IRS calculations, about 14,000 taxpayers would not have had any individual income tax liability absent AMT in tax year 1997.

HOW AMT WORKS

In general, AMT is a separate tax system that parallels the regular individual income tax system. It generates an alternative tax liability by

- applying different tax rates to a broader base of income than the regular individual income tax system does and
- limiting the use of certain tax credits available under the regular income tax.

As illustrated in figure 1, taxpayers complete a series of steps to determine if they are affected by AMT.[3]

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[1] See *Alternative Minimum Tax: An Overview of Its Rationale and Impact on Individual Taxpayers* (GAO/GGD–00–180, Aug. 15, 2000).

[2] See S. Rept. No. 313, 99th Cong., 2d sess., p. 520.

[3] This illustration generally applies to individual taxpayers required to file IRS Form 1040, U.S. Individual Income Tax Return. See appendix I for a few illustration on how individual taxpayers may have their taxes increased by AMT in 2000.

First, Taxpayers Calculate Their Regular Tax Liability

As the first step in the process, taxpayers calculate their tax liability based on their taxable income under the regular income tax. To determine taxable income,[4] taxpayers add up their various items of income, such as salaries, interest, and dividends, and then

- subtract certain allowable items, such as moving expenses and alimony, to compute Adjusted Gross Income (AGI);[5]
- subtract the standard or itemized deductions, such as home mortgage interest,[6] and
- subtract personal exemptions.[7]

Next, taxpayers determine their regular tax liability by applying the appropriate tax rates to this taxable income amount. The regular individual income tax has five marginal tax rates: 15 percent, 28 percent, 31 percent, 36 percent, and 39.6 percent for tax year 2000.[8]

The regular income tax also provides special tax rates for long-term capital gains.

[4] Generally, all income is subject to tax; however, some types of income are excluded, such as interest on tax-exempt bonds.

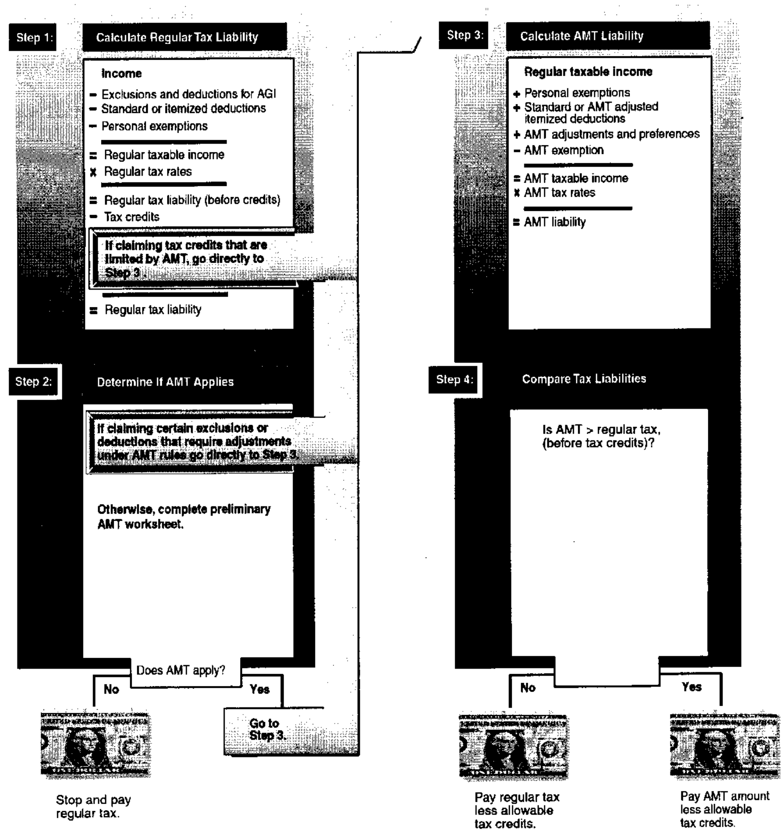
[5] Deductions for determining AGI are certain items that are specifically exempt or excluded from gross income by statute, such as the deduction for IRA contributions, moving expenses, and alimony.

[6] In 2000, the standard deduction was $4,400 for single filers; $6,450 for heads of household; $7,350 for married, filing jointly; $3,675 for married, filing separately.

[7] Personal exemptions are based on the number of dependents claimed by a taxpayer. In 2000, personal exemptions were $2,800 for each qualifying exemption, subject to phase-outs based on taxpayer income.

[8] In computing a taxpayer's tax liability, the tax rates are applied to varying levels of taxpayer income according to the taxpayer's filing status. For example, the tax for married taxpayers filing jointly is 15 percent of the first $43,850 in taxable income; $6,577.50 plus 28 percent of taxable income between $43,850 and $105,950; $23,965.50 plus 31 percent of taxable income between $105,950 and $161,450; $41,170.50 plus 36 percent of taxable income between $161,450 and $288,350; and $86,854.50 plus 39.6 percent of taxable income over $288,350.

Figure 1: Simplified illustration of Regular Income Tax and AMT



Source: GAO Analysis.

Last, taxpayers may reduce their regular tax liability with certain tax credits unless limited by AMT rules. Taxpayers with credits limited by AMT, such as the low income housing tax credit, are required to go to step 3 in figure 1, bypassing step 2, in order to determine the extent to which AMT limits apply. Under current law, taxpayers generally may not use certain tax credits, most notably the general business credit, to reduce their regular tax liability to an amount less than their AMT. For such taxpayers, AMT serves as a floor for the regular income tax below which allowable credits are disallowed but may be carried over to another tax year. Under current law, however, personal tax credits, such as the child and education credits, are not limited by AMT rules through 2001. However, beginning in 2002, taxpayer use of these credits to reduce their tax liability would be limited by AMT.

Second, Taxpayers Determine Whether AMT Applies

As the second step, taxpayers determine whether they may be subject to AMT as follows.

- Taxpayers who claim certain AMT preference items under the regular income tax that are considered AMT adjustments or preferences (for example, percentage depletion or intangible drilling costs) are automatically subject to the AMT rules and are to proceed directly to step 3—calculate AMT liability.[9]

[9] See appendix I of GAO/GGD–00–180, Aug. 15, 2000). The appendix identifies the items that automatically subject taxpayers to the AMT rules in step 2 of figure 1.

- Other taxpayers are to complete a worksheet that contains a series of income tests designed to determine whether a taxpayer's income exceeds a preliminary threshold according to the basic AMT rules.[10]

If the worksheet shows that their income exceeds the threshold, taxpayers must continue to step 3—calculate AMT liability. If the worksheet shows that their income does not exceed the threshold, taxpayers pay their regular tax liability without having to complete steps 3 and 4 in figure 1.

Third, Some Taxpayers Calculate AMT Liability

As the third step, taxpayers subject to AMT compute their AMT liability using the AMT form,[11] which requires them to recalculate their taxable income and tax liability using rules that differ from the regular income tax rules. To calculate taxable income under AMT, taxpayers essentially start with the taxable income amount reported under the regular system and then do the following:

Add back their personal exemptions that were allowed under the regular income tax.

Add back the standard or certain AMT-adjusted itemized deductions that were allowed under the regular income tax. AMT requires taxpayers to adjust certain itemized deductions taken under the regular income tax. For example, AMT disallows the deduction for state and local taxes and allows only for the deduction of medical expenses above 10 percent of AGI.[12] However, AMT does not disallow or adjust all itemized deductions. For example, AMT does not require taxpayers to add back certain mortgage interest or charitable contribution deductions to their taxable income.[13]

Add other, non-itemized, AMT adjustments and preference items taken under the regular income tax. AMT disallows certain non-itemized preference items and requires adjustments to other non-itemized deductions available under the regular income tax, including some income excluded from the regular income tax. Many of these items are related to timing of deductions allowed for certain types of business investments. In effect, the elimination or adjustment of certain preference items expands the base of taxable income under AMT.[14]

Subtract the AMT exemption amount based on filing status. The AMT exemption amount ($ 45,000 for joint filers), is generally intended to replace the personal exemptions and the standard deduction allowed under the regular income tax. The AMT exemption is subject to a phase out based on taxpayer income[15] and is not adjusted to account for family size.

Taxpayers then calculate their AMT liability by applying the AMT tax rates to their AMT taxable income. The AMT applies a 26-percent tax rate on the first $175,000 of AMT taxable income and 28 percent of such income in excess of $175,000.[16]

Fourth, Taxpayers Compare Tax Liabilities and Check the Use of Certain Tax Credits

As the fourth step, taxpayers essentially compare their regular tax liability (before credits) with their AMT liability, as shown in step 4 of figure 1. In general, if their AMT liability is greater than their regular tax liability (before credits), they must pay their AMT liability less any allowable credits. If their AMT liability is less than their regular tax liability (before credits), they pay their regular tax liability less any allowable credits.[17]

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[10] The worksheet is provided in the instructions to IRS forms 1040 and 1040A.

[11] The AMT form is IRS Form 6251, the Alternative Minimum Tax-Individuals. This form, when necessary, is to be attached to IRS Form 1040, U.S. Individual Income Tax Return.

[12] Under the regular income tax, deductions are allowed for medical expenses in excess of 7.5 percent of AGI.

[13] See appendix I of GAO/GGD–00–180, Aug. 15, 2000 for more details.

[14] Ibid.

[15] The $45,000 exemption amount is subject to a phase-out of 25 percent of AMT taxable income in excess of $150,000. The AMT exemption for single and head of household filers is $33,750, subject to a phase-out of 25 percent for taxable income in excess of $112,500. The AMT exemption amount for married individuals filing separately is $22,500, subject to a phase-out of 25 percent of taxable income in excess of $75,000.

[16] For married taxpayers filing separately, AMT applies the 26-percent tax rate to the first $87,500 of AMT taxable income and the 28-percent rate on the excess. AMT also has special rules for taxing capital gains income, which generally preserve the lower capital gains tax rates of the regular tax system (e.g., 20-percent tax rate).

[17] The foreign tax credit can also be deducted from AMT., but it may not reduce AMT by more than 90 percent. Additionally, taxpayers may be able to use part of their AMT liability, if applicable, to offset their regular tax liability in the following year. Commonly referred to as the "AMT credit," this credit is subject to restrictive conditions, and few taxpayers are eligible for it.

Currently, the AMT rules temporarily allow taxpayers to use personal credits without limitation.[18] However, taxpayers generally may not use general business credits to reduce their regular tax liability to an amount less than their tax liability computed under the AMT rules. Also, taxpayers whose AMT liability exceeds their regular tax liability may not use certain refundable tax credits (e.g., the earned income tax credit) to reduce their AMT liability to an amount less than their tax liability computed under the regular tax.

PROJECTED INCREASES IN AMT COVERAGE AND TAX LIABILITY

Currently, according to recent research at Joint Committee on Taxation (JCT) and Treasury, AMT affects relatively few taxpayers and generates a relatively small portion of additional tax liability.[19] For 2000, Treasury research indicates that about 1.3 million taxpayers—about 1.3 percent of all taxable returns—would have to remit more in tax than they would otherwise. Their additional tax liability was estimated at about $5.8 billion.

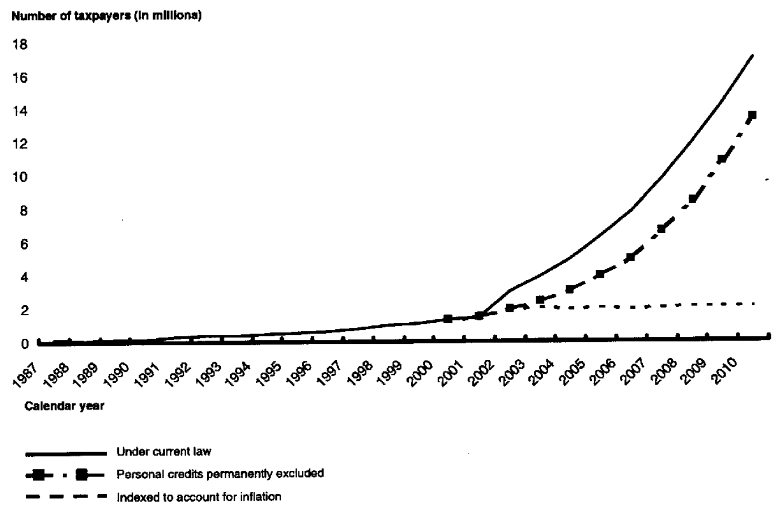
By 2010, however, AMT coverage and tax liabilities are projected to increase dramatically. (See fig. 2 for trends.) Recent research at Treasury estimated that:

- The number of taxpayers affected by AMT under current law is projected to expand from about 1.3 million in 2000 to about 17 million in 2010—a 31 percent average increase per year. By 2010, AMT is expected to affect 16 percent of all taxable returns filed by individuals, up from about 1.3 percent in 2000.
- The corresponding additional AMT liability is projected to increase from about $5.8 billion to about $38.2 billion from 2000 to 2010—a 21 percent average increase per year—for a total increase of $189 billion over this period.

[18] The Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1998 allowed taxpayers to claim their personal credits—including the child and education credits—in full against their AMT liability for the tax year beginning after December 31, 1997. The Ticket to Work and Work Incentives Improvement Act of 1999 extended that provision through 2001.

[19] For reporting purposes, we used data estimates from recent research conducted at the Department of the Treasury's Office of Tax Analysis. See Robert Rebelein and Jerry Tempalski, *Who Pays the Individual AMT?*, Office of Tax Analysis Working Paper 87 (June 2000). All estimates in this paper were made using the Treasury Department's Individual Tax Model in combination with the administration's economic forecast from the FY 2001 Budget. This working paper notes that the views expressed in the paper do not necessarily represent official Treasury positions. Accordingly, we limited our use of the paper to the data produced by the Treasury models and refer to the working paper as recent research at Treasury. Also, JCT provided us with updated tables from its report, *Present Law and Background Relating to the Marriage Tax Penalty, Education Tax Incentives, the Alternative Minimum Tax, and Expiring Tax Provisions* (JCX–39–99).

Figure 2: Actual and Projected Number of Taxpayers Affected Financially by AMT



Source: Department of the Treasury, Office of Tax Analysis Working Paper 87 (June 2000)

The additional tax liability generated by AMT has two components.

- The additional tax liability generated from individuals with direct AMT liabilities is projected to increase from $3.4 billion in 2000 to $26.4 billion in 2010. The number of affected individuals is projected to increase from 1.2 million in 2000 to 12.5 million in 2010.
- The additional tax liability generated from individuals with credits lost due to AMT is projected to increase from $2.4 billion in 2000 to $11.8 billion in 2010. The number of individuals affected by the loss of credits is projected to increase from 200,000 in 2000 to 9.4 million in 2010. Of this increase, about 4.9 million of the 9.4 million taxpayers were expected to incur both a direct AMT tax liability and a reduction in their ability to use tax credits.

REASONS FOR THE AMT INCREASES

The projected increase in AMT coverage is, for the most part, attributable to inflation (the regular tax system is indexed for inflation but the AMT is not) and to the scheduled expiration of legislation temporarily excluding some tax credits (such as child tax credits) from AMT rules.

AMT Is Not Indexed for Inflation

In the regular income tax system, the personal exemptions, standard deduction, and tax rate brackets increase based on inflation. Under AMT, however, the exemption amounts, the threshold phase-out amounts for these exemption amounts, and the AMT rate brackets remain constant.

The lack of inflation indexing in AMT causes taxpayers' AMT liabilities to increase faster than their regular tax liabilities. Real income growth—growth above inflation—will increase both regular tax and AMT liabilities. However, under the regular tax system, income growth due to inflation will generally not increase regular tax liabilities as a percentage of income because income is increasing at the same rate, but it will increase AMT liabilities as a percentage of income. The result is that over time, more taxpayers will have an AMT liability that exceeds their regular tax liability as long as there is inflation.

If the AMT parameters were indexed to account for inflation starting in 2000, according to recent research at Treasury (illustrated in fig. 2), the projected number of taxpayers affected financially by AMT over time would be relatively constant and significantly less than under current law.[20] The number of individuals affected by

[20] Under this scenario, personal tax credits would be limited by the AMT rules beginning in 2002.

an inflation-adjusted AMT is estimated at 2.1 million in 2010 compared to 17 million under current law.

Increases Attributable to Expiration of Tax Credit Legislation

In 2001, legislation that was enacted to temporarily exclude personal credits from limitation under the AMT rules is scheduled to expire.[21] Recent research at Treasury estimated that the number of taxpayers with reduced credits would increase from 200,000 in 2001 (the last year of the personal credits exclusion) to 2 million in 2002 and would rise to 9.4 million in 2010. According to JCT, the recently enacted child and education credits are expected to be affected the most.[22]

If personal tax credits were permanently excluded from the AMT rules, the projected number of taxpayers affected financially by AMT and the corresponding revenue generated would also be lower than under current law.[23] As figure 2 shows, recent research at Treasury estimated that under this scenario, about 13.4 million taxpayers would be affected by AMT in 2010 compared to 17 million under current law.

AMT HAS A NUMBER OF IMPACTS

AMT has a number of impacts, including increased compliance burden on taxpayers; increased administrative costs on IRS; redistribution of the tax burden among taxpayers; changed economic incentives in the tax system; and the potential to neutralize, for some taxpayers, changes to the tax system. The projected growth in AMT coverage would amplify these impacts.

Taxpayer Compliance Burden

Although it is difficult to concretely measure compliance burden, there is common agreement that AMT can significantly complicate the filing situation for taxpayers. The National Taxpayer Advocate ranks AMT as one of the most burdensome areas of tax law.[24]

A significant portion of AMT compliance burden is attributable to the complexity of the AMT rules. AMT requires taxpayers to compute their regular tax liability and then recompute their AMT liability using a different base of income, different exemptions, and different tax rates. AMT also applies different treatments to certain income deductions, exclusions, and credits that may be used by taxpayers under the regular income tax. As a result, affected taxpayers are required to apply two methods of accounting to some of these items; one for the regular tax and one for AMT.

According to IRS and Treasury officials, the complexity of calculating AMT liability can be most problematic for married taxpayers who consider filing separately. AMT, like the regular tax, establishes procedures that are intended to minimize or eliminate that ability of some taxpayers to allocate income arbitrarily between spouses to reduce their tax liability. If married taxpayers were to follow all recommended procedures, they would have to compute their taxes four different ways. First, they would need to compute their regular tax as if they were filing jointly and then again as if filing separately. Then they would need to determine their AMT tax as if filing jointly and then again as if they were filing separately. From these computations, the taxpayers could then determine which filing method would be most appropriate for them.

IRS Administrative Costs

The complexity of AMT and increases in the number of taxpayers affected also would complicate IRS' efforts to administer the federal tax system. According to IRS, AMT is more than just an add-on to the existing tax system. AMT involves much more than just annually processing the AMT returns filed by taxpayers such as computer-checking calculations on the returns and crediting the taxpayers' accounts with the payments. Some aspects of compliance with AMT rules can be verified only through office or field audits. According to IRS, the frontline employees who do such verification work consistently rank AMT as one of the most complex provisions with which they deal.

[21] See footnote 18.

[22] The Child Credit, the HOPE education credit, and the Lifetime Learning Credit are provisions of the regular income tax that were enacted in the Taxpayer Relief Act of 1997.

[23] This scenario does not include inflation adjustments for the AMT parameters.

[24] FY 1999 National Taxpayer Advocate's Annual Report to Congress, IRS Publication 2104 (Rev. 12–99).

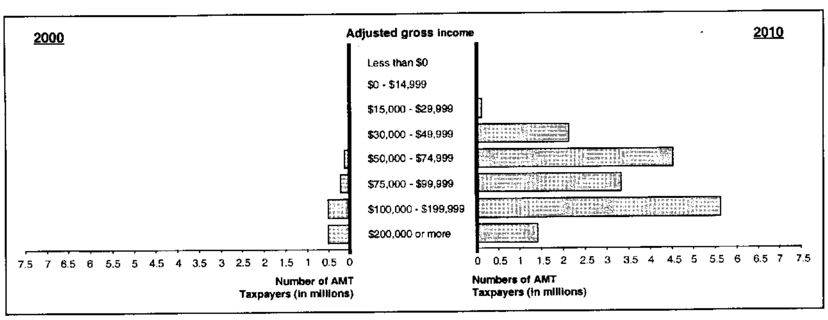
Redistribution of Tax Burden

As shown in figures 3 and 4, recent research at Treasury indicated that AMT coverage, absent any legislative change, will shift from mostly higher income taxpayers in 2000 to increasingly more middle-income taxpayers by 2010.

The recent research at Treasury provides some additional insight into the shift in the classes of taxpayers affected by AMT. In 2000, the taxpayers projected to be affected by AMT are more likely to be higher income families with many dependents. By 2010, increasingly more middle-income, moderately sized families are expected to be affected by AMT. For example, the percentage of taxpayers affected by AMT with incomes between $50,000 and $75,000 and four personal exemptions is projected to increase from about 1 percent in 2000 to 32 percent in 2010. The primary reason for this change is that for middle income taxpayers, personal exemptions are projected to be the largest and most common items to be added back into taxable income under AMT.

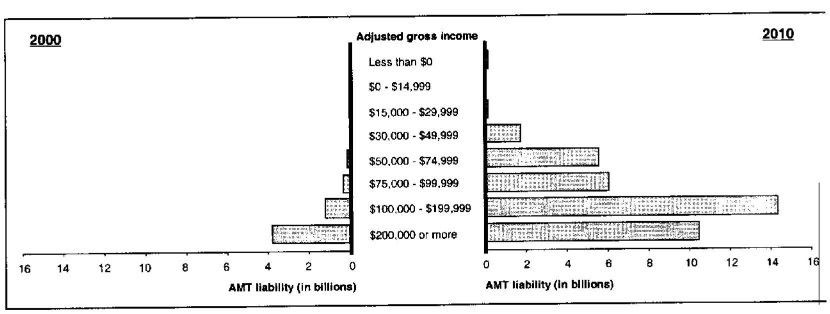
Additionally, the state where a taxpayer lives also affects AMT coverage. The projections indicate that taxpayers living in states with high income and property taxes are more likely to be affected by AMT than those in states with low income and property taxes. The apparent driving factor for this change is that state and local taxes are projected to amount to about one-half of the total preference items that are added back into the taxable income for computing AMT tax liability in 2010. (See app. II for additional information on the proportion of AMT taxpayers by state of residence.)

Figure 3: Distribution of the Number of Taxpayers Financially Affected by AMT



Note: Adjusted gross income is in constant 2000 dollars.
Source: Department of the Treasury, Office of Tax Analysis Working Paper 87 (June 2000)

Figure 4: Distribution of the Additional AMT Tax Liability



Note: Adjusted gross income is in constant 2000 dollars.
Source: Department of the Treasury, Office of Tax Analysis Working Paper 87 (June 2000)

Changed Economic Incentives

Through its different definition of taxable income and tax rate structure, AMT may affect the economic incentives created by the regular income tax.[25] If AMT coverage increases over the next 10 years as projected, more taxpayers will face those affected incentives. Two examples follow.

- According to JCT, AMT adjustments, preference items, and credit limitations may reduce incentives for taxpayers to undertake certain investments and activities that are favored under the regular tax. For example, unincorporated business owners' incentives to invest may be reduced because AMT rules regarding depreciation are less generous than under the regular tax. Also, if education credits become limited by AMT because the moratorium on the use of personal credits expires, taxpayers may have less incentive to pursue educational opportunities that qualify for these credits.
- Additionally, the current 26- and 28-percent tax rates under AMT are generally lower than the tax rates a taxpayer faces under the regular tax. Lower marginal tax rates—the additional tax owed from earning an additional dollar of income—decrease the disincentives taxpayers face to work additional hours or invest additional amounts. The extent to which the incentives and disincentives affected by AMT lead to changes in taxpayer behavior and changes in overall economic performance is uncertain.

Impact on Changes to the Regular Tax

For some taxpayers, AMT has the potential to neutralize future tax changes designed to provide tax relief in the regular tax system. As I mentioned before, AMT is a parallel tax system that imposes higher taxes on taxpayers who have higher AMT liabilities than regular tax liabilities. Thus, taxpayers who are already subject to AMT would not benefit from reductions in their regular income tax.[26]

Additionally, some taxpayers who pay the regular tax may not receive the full benefits of cuts in their regular tax. Tax reduction legislation could reduce the taxes for some individuals below the level of taxes that would be due under AMT rules.

This concludes my statement. I would be pleased to take any questions you may have.

Appendix I

Illustrations Depicting How Individual Taxpayers May Have Their Taxes Increased by AMT in 2000[27]

Illustration 1: A large family (husband, wife, and six children) had wage earnings of $80,000 in 2000. In filing their 2000 tax return, the family would not benefit from itemizing deductions because they rented a house and had no other significant tax deductions. The family was eligible to take the standard deduction, personal exemptions, and child tax credit. Under the regular income tax, the family's tax liability would be $5,377 ($ 8,377 in income tax less a $3,000 child tax credit), or about 11 percent of their $50,250 taxable income ($ 80,000 in wages less the standard deduction of $7,350 and personal exemptions of $22,400).

Under current tax law, AMT would cause this family's tax liability to increase 13 percent above its tax liability under the regular income tax. After computing AMT, the family's tax liability would be $6,100 ($ 9,100 in taxes less $3,000 child tax credit). The $9,100 tax liability results from AMT tax rules that require the family to recompute taxable income (essentially add back the standard deduction and personal exemptions to taxable income computed under the regular tax), then reduce that taxable income by a $45,000 exemption amount and then apply a 26-percent tax rate to the remainder.

Illustration 2: A retired couple, age 65, received taxable pension income totaling $80,000, interest and dividends of $10,000, and distributed capital gains totaling $125,000 from mutual fund investment in technology stocks in 2000. In filing their 2000 tax return, the couple would not benefit from itemizing deductions because they had paid off the mortgage on their house and had no other significant deduc-

[25] For discussions of the effects of AMT on economic efficiency, see Joint Committee on Taxation, Present Law and Issues Relating to the Individual Alternative Minimum Tax ("AMT") (JCX–3–98), Feb. 2, 1998, and Michael J. Graetz and Emil Sunley, "Minimum Taxes and Comprehensive Tax Reform," in Henry J. Aaron, Harvey Galper, and Joseph A. Pechman, eds., Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax (Washington, D.C.: The Brookings Institution, 1988).

[26] Similarly, tax changes that increase regular taxes would not affect those AMT taxpayers whose AMT liability already exceeded the regular tax increase.

[27] These illustrations are based on three hypothetical taxpayers. The extent to which AMT affects any individual taxpayer depends on the taxpayer's unique characteristics.

tions. Under the regular income tax, the couple's tax liability would be $40,685 or about 20 percent of their $201,358 taxable income ($ 80,000 in taxable pension income, $10,000 interest and dividends, and $125,000 in capital gains less a standard deduction of $9,050 and personal exemptions of $4,592).

Under current tax law, AMT would cause this couple's tax liability to increase about 1 percent above its tax liability under the regular income tax. After computing AMT, the couple's tax liability would be about $40,925. The $40,925 tax liability results from AMT tax rules that require the couple to recompute taxable income (essentially, add back the standard deduction and personal exemptions to taxable income computed under the regular tax), then reducing that amount by a $45,000 exemption amount (adjusted down to $28,750 because of the extent to which the couple's income exceeded the applicable $150,000 threshold for full use of the exemption). To this residual amount, AMT provides for applying a 20-percent rate to income attributable to capital gains and 26 percent to the remainder.

Illustration 3: A four-member family (husband, wife, and two children) had income totaling $265,000 in 2000, comprised of wage earnings totaling $190,000, interest and dividend earnings of $17,000, and long-term capital gains of $58,000. Given the nature of the family's expenditures, the family would benefit from itemizing their deductions when filing their 2000 tax return. Their itemized deductions would include $23,000 for state and local income taxes and property taxes, $16,000 for home mortgage interest, and $6,000 for charitable gifts. Additionally, they are eligible to deduct $4,704 for personal exemptions. Given the amount of their income, the regular tax rules limit the family's itemized deductions and personal exemptions to $45,622. Under the regular income tax, the family's tax liability would be $52,748, or about 24 percent of its taxable income of $219,378.

Under current tax law, AMT would cause this family's tax liability to increase about 2 percent above its tax liability under the regular income tax. Under AMT rules, the family's tax liability would be about $54,045 on income of $221,250 (alternative minimum taxable income of $243,000 less a $45,000 exemption amount reduced to $21,750 because of the extent to which family income exceeded the applicable $150,000 threshold for full use of the exemption). Under AMT rules, a 20-percent rate was then applied to income attributable to capital gains and 26 percent to the remainder.

Appendix II

AMT Taxpayers and State of Residence

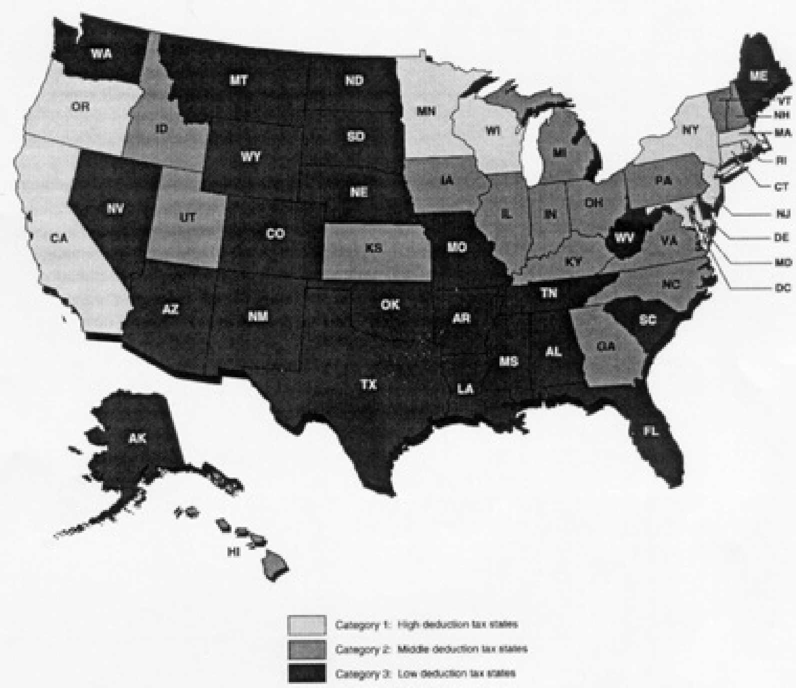
Under the regular income tax, but not AMT, taxpayers who itemize deductions are allowed to reduce their tax liability by deducting from their income the amounts paid to state and local governments for property and income taxes. States vary in their reliance on different types of taxes. For example, some rely heavily on sales taxes, which are not deductible under the regular or AMT, while others rely heavily on income or property taxes, which are deductible under the regular tax but not AMT.

In recent research at Treasury, an analysis was done to determine the effect that the payment of state and local income and property taxes had on the payment of AMT. States were ranked on the basis of the average state and local tax deductions (analyzed as a percentage of income) that were taken by taxpayers who itemized deductions and who would continue to itemize if state and local tax deductions were eliminated. The states were then grouped into three categories so that the number of taxpayers who reside in the states in each category would account for approximately one-third of the total number of taxpayers.

The research at Treasury indicated that, holding other factors constant, AMT taxpayers are more likely to live in states that rely more heavily on taxes that are deductible in determining tax liability under the regular income tax. In the Treasury research it was estimated that, in 2000, 58 percent of taxpayers affected by AMT lived in high tax deduction states, 24 percent lived in middle tax deduction states and 18 percent lived in low tax deduction states. The estimates showed that by 2010, 45 percent of taxpayers affected by AMT would live in the high tax deduction states, 32 percent would live in middle tax deduction states, and 22 percent would live in low tax deduction states.[28] The breakout of states according to the working paper's categorization is shown in figure 5.

[28] The decline was attributed to the increasing affect of another AMT provision, i.e., personal exemptions as discussed in the section on the redistribution of the tax burden.

Figure 5: States categorized by deductibility of their taxes under federal income tax law



Source: Department of the Treasury, Office of Tax Analysis Working Paper 87 (June 2000)

PREPARED STATEMENT OF LAWRENCE ZELENAK

Thank you, Mr. Chairman, for the opportunity to testify today. I will first address the question of marriage penalty tax relief, and after that I will discuss possibilities for reforming the alternative minimum tax.

MARRIAGE PENALTY RELIEF

The income tax imposes a marriage penalty whenever a husband and wife are required to pay more tax than they would be required to pay if they were not married. Under current law, many two-earner couples pay substantially more federal income tax than they would in the absence of a marriage license. Despite occasional claims to the contrary, the existence of marriage penalties is not due to legislative perversity or ineptitude. Rather, marriage penalties are an unfortunate by-product of the pursuit of other policy goals. Given the basic policy decisions to have (1) a progressive tax rate structure, and (2) joint returns for married taxpayers, it is inevitable that there will be marriage penalties, marriage bonuses, or both.

A simple example illustrates the problem. Imagine a tax system which imposes two rates of tax on unmarried individuals: a 10% tax rate on the first $40,000 of income, and a 30% tax rate on all income above $40,000. The following table indicates how this rate schedule would apply to four unmarried taxpayers.

UNMARRIED TAXPAYERS, 10% RATE ON FIRST $40,000 OF INCOME, 30% RATE ON ALL INCOME ABOVE $40,000

Taxpayer	Income	Tax Liability
Andy	$80,000	$16,000[1]
Betty	$0	$0
Carl	$40,000	$4,000[2]
Donna	$40,000	$4,000

Now suppose Andy and Betty get married, as do Carl and Donna. If their incomes remain

[1]This results from a 10% tax imposed on Andy's first $40,000 of income ($4,000 tax), and a 30% tax imposed on the remaining $40,000 of income ($12,000 tax).

[2]This results from a 10% tax imposed on $40,000 of income.

Now suppose Andy and Betty get married, as do Carl and Donna. If their incomes remain unchanged, each couple will, of course, have $80,000 of combined spousal income. Our commitment to joint returns means two couples with the same combined income should have the same tax liability. But since the combined unmarried tax liabilities of Andy and Betty ($16,000) were higher than the combined unmarried tax liabilities of Carl and Donna ($8,000), equal tax liabilities for the two married couples can be achieved only if marriage changes the tax liabilities of one or both couples. In general terms, there are three possibilities:

1. Make the joint return tax rate schedule identical to the unmarried taxpayer tax rate schedule, with the 10% bracket covering only the first $40,000 of income. Under this approach, marriage would have no effect on the combined tax liabilities of Andy and Betty, but there would be a very large marriage penalty of $8,000 ($16,000 married liability minus $8,000 combined unmarried liabilities) on Carl and Donna.
2. At the other extreme, make the 10% bracket for joint returns twice the size of the 10% bracket for unmarried taxpayers. With a 10% bracket of $80,000, marriage would have no effect on the combined tax liabilities of Carl and Donna, but there would be an $8,000 marriage *bonus* ($16,000 unmarried liability minus $8,000 married liability) for Andy and Betty.
3. A compromise approach would be to make the joint return 10% bracket larger than the unmarried taxpayer 10% bracket, but less than twice as large. Suppose, for example, the joint return 10% bracket covers the first $60,000 of income. Then each couple, when married, would owe tax of $12,000.[3] Andy and Betty would then enjoy a marriage bonus of $4,000, and Carl and Donna would suffer a marriage penalty of $4,000.

Couple	Combined Unmarried Tax Liabilities	Marriage Bonus or Penalty with $40,000 10% Bracket for Joint Returns	Marriage Bonus or Penalty with $80,000 10% Bracket for Joint Returns	Marriage Bonus or Penalty with $60,000 10% Bracket for Joint Returns
Andy-Betty	$16,000	zero	$8,000 bonus	$4,000 bonus
Carl-Donna	$8,000	$8,000 penalty	zero	$4,000 penalty

In general terms, current law follows the third approach, thus producing both marriage penalties (for two-earner couples with relatively equal incomes) and mar-

[3]This is the sum of a 10% tax on the first $60,000 ($6,000), and a 30% tax on the remaining $20,000 ($6,000).

riage bonuses (for one-earner couples and two-earner couples with very unequal incomes).[4] The break-even division of spousal income varies somewhat by income levels, but it is generally somewhere between 80%–20% and 70%–30%. In other words, a married couple with an income division more unequal than 80%–20% will almost always enjoy a marriage bonus, and a married couple with an income division more nearly equal than 70%–30% will almost always suffer a marriage penalty.

Six Possible Approaches to Marriage Penalty Relief

1. Providing Married Taxpayers with Rate Brackets Twice as Wide as the Brackets for Unmarried Taxpayers, and a Standard Deduction Twice as Large. This approach is currently embodied in S. 11 (Sen. Hutchison). This is the second of the three approaches noted above. It would eliminate all marriage penalties attributable to the basic tax rate structure, and to the standard deduction. Despite this major attraction, it is subject to several possible objections:

1. It is not narrowly targeted at elimination of marriage penalties; it will also create new marriage bonuses and increase the size of existing marriage bonuses. In 1997, the Congressional Budget Office estimated that slightly more than half (51%) of the revenue loss from this approach would benefit couples already enjoying marriage bonuses under current law.[5] In this connection, note that every marriage bonus can be viewed as the flip side of a penalty imposed on unmarried taxpayers. In terms of the hypothetical tax system described above, a single taxpayer earning $80,000 and paying $16,000 tax might feel heavily penalized if a married co-worker also earning $80,000, but with a non-earning spouse, paid tax of only $8,000.

2. The distribution of the tax relief from this approach tends to be skewed in favor of higher-income couples. The 1997 CBO study estimated that 87% of the tax savings from this approach would be realized by couples with incomes above $50,000.[6]

3. This approach is surprisingly far from a complete fix to the marriage penalty problem. In fact, the CBO study estimated that it would eliminate less than half (44%) of all income tax marriage penalties. This is because there are three sources of marriage penalties this approach does not address: (a) Marriage penalties in the earned income tax credit, which can be large in absolute dollar amounts (penalties of several thousand dollars are possible), and especially large as a percentage of income; (b) marriage penalties created by the design of the phase-outs or phase-downs of various tax benefits, such as personal exemptions, the child tax credit, and itemized deductions; and (c) marriage penalties created by the special rate schedule and standard deduction provided for heads of households. To understand the problem created by the head of household provisions, consider the actual standard deduction amounts for 2001: $7,600 for a joint return, $4,550 for most unmarried taxpayers, but $6,650 for heads of households. If the joint return standard deduction were increased to $4,550 x 2 = $9,100, that would eliminate standard deduction marriage penalties for couples without dependent children. A couple with children, however, could obtain a divorce, continue to live together, and file one unmarried return ($4,550 standard deduction) and one head of household return ($6,550 standard deduction), for combined standard deductions of $11,200. Merely increasing the standard deduction to $9,100 will not eliminate standard deduction marriage penalties for such couples. Similarly, the head of household tax rate schedule creates marriage penalties which would not be eliminated merely by making the joint return brackets twice the size of the brackets for unmarried taxpayers.

2. Smaller-Scale Versions of the Same Approach. Various smaller-scale versions of the above approach are possible. For example, it would be possible to give taxpayers filing joint returns twice the standard deduction available to unmarried taxpayers, without also enlarging their tax rate brackets. (This is the major

[4] The rate structure in the Administration's tax reform proposal, as embodied in H.R. 3, also generally follows the third approach, thus producing both marriage penalties and bonuses. However, the relationship of the unmarried and joint return 10% rate brackets in H.R. 3 produces only marriage bonuses, and the relationship of the unmarried and joint return 25% brackets is tilted in the direction of producing mostly marriage penalties (the unmarried 25% bracket ends at $156,300; the joint return 25% bracket ends at the only slightly higher level of $190,300).

[5] Congressional Budget Office, For Better or Worse: Marriage and the Federal Income Tax (1997).

[6] This is not solely a matter of marriage penalty relief primarily benefitting higher-income couples because higher-income couples are the major victims of the marriage penalty. The same CBO study estimated that couples with incomes above $50,000 suffered 64% (not 87%) of the total dollar amount of marriage penalties.

marriage penalty relief provision in the current Democratic proposal.) Obviously, this would eliminate only a small percentage of all marriage penalties, but the benefit would be significant for some moderate income couples. For example, increasing the married standard deduction by $1,500 would reduce by $225 the tax liability of a married couple with a 15% marginal tax rate. In addition to its inherently limited nature, it can be criticized for increasing existing standard deduction marriage bonuses for one-earner couples, and for not providing complete standard deduction marriage penalty relief vis-a-vis the head of household standard deduction.

An interesting feature of the standard deduction approach is that it is strongly targeted to low-middle and middle-middle income taxpayers, despite the lack of any explicit phase-out of the benefit of the standard deduction. This is because the vast majority of taxpayers at higher income levels itemize their deductions, thus making the standard deduction irrelevant to them.

A variation on the standard deduction approach, once proposed by the Clinton administration, would be to limit standard deduction marriage penalty relief to two-earner couples, by making the increased exemption amount available only against the income of the lower-earning spouse. If the increased exemption amount is $1,500, for example, this has the same effect as a tax exemption for the first $1,500 of earnings of the lower-earning spouse.

Another variation, which has received considerable legislative attention in the past few years, would be to make the joint return standard deduction and bottom rate bracket twice as large as the corresponding amounts for unmarried taxpayers, but not to provide equivalent relief in the higher brackets. Although standard deduction relief does nothing for those higher-income, two-earner couples who do not claim the standard deduction (the vast majority), even the highest income couples benefit from the expansion of the lowest rate bracket. While expansion of the lowest bracket benefits high income couples as much as anyone in terms of absolute dollar amounts, as a percentage of total tax liability the benefit falls (and eventually becomes almost trivial) as income increases. Compared with the alternatives of standard deduction relief only (with no benefit for most upper income taxpayers) and increasing the size of all joint return rate brackets (with almost 90% of the tax savings going to couples with incomes above $50,000), this limited relief for affluent couples may be an attractive compromise.

3. Optional Separate Filing. Under this approach (which was embodied in S. 1429, passed by the Senate in 1999), a married couple could file a joint return or two separate returns as if they were unmarried, depending on which choice resulted in the lower combined tax liability. Although this approach, if pushed to its logical extreme, could eliminate all tax marriage penalties, the actual bills following this approach did not go that far. First, they provided that credits would continue to be determined on a joint return basis, even for spouses otherwise filing separately; thus, EITC marriage penalties would not be eliminated. Second, they did not permit either spouse to file as a head of household, even if that filing status would have been available after a divorce.

The great attraction of this approach is its precision in attacking marriage penalties without increasing existing marriage bonuses or creating new ones. Couples already enjoying marriage bonuses will, of course, elect to continue filing joint returns. Thus their liabilities would be unaffected.

There are two major objections to this approach. The first is complexity. Many couples will have to prepare three tentative returns in order to determine which filing strategy results in the lower tax burden. Also, there will be some inevitable complexity in allocating items of income and deduction between spouses who elect to file separately. The second objection is philosophical incoherence. The standard justification for joint returns is that married couples function as economic units. Under that view, two couples with equal incomes should pay equal taxes, regardless of how the earning of the incomes is distributed between the spouses in each marriage. Optional filing will result in equal tax on the two couples *if* both couples file joint returns. But if either couple (or both) files separate returns, the two couples generally would have different liabilities. Hence the philosophical incoherence. The purpose of joint filing is to impose equal tax on equal income couples, and optional joint filing defeats that purpose.

4. A Two-Earner Deduction. From 1981 to 1986, a two-earner couple was allowed a deduction of 10% of the earned income of the lower-earner spouse, with a maximum deduction of $3,000 (based on earned income of $30,000 or more). The Administration has proposed the restoration of this deduction. Although the benefit of the deduction would, of course, be limited to two-earner couples, it would not be perfectly targeted to victims of the marriage penalty. The 1997 CBO study estimated that 20% of the revenue loss from this approach would result from the creation of new marriage bonuses or the enlarging of existing bonuses. The CBO estimated the deduction would remove 32% of marriage penalties, with 82% of the benefits of the deduction going to couples with incomes above $50,000.

A possible objection to this approach is that it violates "couples neutrality," by resulting in the imposition of a higher tax on (for example) a one-earner couple earning $60,000, than on a two-earner couple with each spouse earning $30,000. This might even be provocatively described as a homemaker penalty. Interestingly, however, I have been unable to find that any objections of this sort were made against the two-earner deduction in its previous incarnation. Perhaps the explanation is that even most one-earner couples perceived the deduction as accomplishing a sort of rough justice, in light of the extra non-deductible expenses of being a two-earner household.

It is worth noting that some tax commentators support the return of the two-earner deduction not so much for its impact on the marriage penalty, as for its effect in alleviating the work disincentive the joint return system imposes on the secondary earner in a marriage (usually the wife). If a homemaker decides to enter the paid labor force, even her first dollars of income will be taxed at relatively high rates, because her earnings are, in effect, stacked on top of the husband's earnings (this is sometimes referred to as the stacking effect). In addition, the couple must spend money to replace her homemaking services, and on nondeductible work-related expenses (such as commuting and work clothes). Yet, except for a limited allowance for child care, the tax system makes no allowance for these expenses. Thus the couple will be taxed on more than the true net economic income from her job, and at relatively high rates. This may discourage the homemaker from taking the job. Restoration of the two-earner deduction would alleviate this problem.

5. EITC Marriage Penalty Relief. As a percentage of income, EITC marriage penalties tend to be much larger than marriage penalties from other sources. These penalties also fall on particularly vulnerable victims. It would be a shame, then, if Congress enacted marriage penalty relief without addressing the marriage penalties of the EITC. The bills that have been introduced over the past few years to reduce EITC marriage penalties all take the same basic approach: increasing by a few thousand dollars the joint return income threshold at which the phase-out begins, relative to the point at which the phase-out begins for unmarried taxpayers. This would not come close to eliminating EITC marriage penalties, but it is considerably better than doing nothing.

6. Marriage Penalties from Various Phase-Out Provisions. To the best of my knowledge, no bills have been introduced for the express purpose of eliminating or reducing the marriage penalties built into the phase-outs or phase-downs of the personal exemptions, the child tax credit, itemized deductions, and various other tax benefits. Although optional separate filing would automatically operate against these sources of marriage penalties, they would be unaffected by any of the other approaches I have described. Some of these penalties are structurally extremely severe. For example, the AGI threshold for the phase-down of itemized deductions under § 68 is exactly the same for married and unmarried taxpayers. In terms of my original illustration, this would be the equivalent of giving both married and unmarried taxpayers the same $40,000 10% bracket. In the absence of optional separate filing, alleviating these marriage penalties is labor-intensive legislative work; each provision must be individually examined and amended. Nevertheless, this approach deserves serious consideration.

Conclusion

As I stated at the outset, we are faced with the problem of tax marriage penalties because of our commitments to progressive marginal rates and to joint returns. If either of those restraints is removed, the problem vanishes. There would be no marriage penalties, for example, under a truly flat tax. Be aware, however, that a flat rate above an exemption amount is really a progressive two-rate tax structure, and such a structure does not solve the marriage penalty problem. As for joint returns, it is worth noting that the commitment to joint returns dates back only to 1948, and that most other OECD countries do not have joint return systems. Requiring all taxpayers to file separate returns, regardless of marital status, would eliminate both marriage penalties and marriage bonuses, and would also eliminate the problem of wives being discouraged from entering the labor force by the stacking effect of joint returns. On the other hand, it could be viewed as imposing tax penalties on one-earner couples, and it would involve some difficult issues in allocating income and deduction items between spouses. Mandatory separate returns are probably too big a change to be on this year's tax agenda, but the idea merits serious legislative attention over the longer term.

REFORMING THE INDIVIDUAL ALTERNATIVE MINIMUM TAX

The individual alternative minimum tax (AMT) amounts to a shadow tax system, running alongside the regular tax. The base of the AMT is "alternative minimum taxable income" (AMTI), which is defined so as to disallow many exclusions and deductions which are allowed under the regular tax. After the allowance of a large exemption amount—in effect, a zero rate tax bracket—AMTI is subject to a moderate rate, semi-flat tax. The exemption amount is $45,000 for joint returns, and $33,750 for unmarried taxpayers.[7] The tax rate is 26% for the first $175,000 of income above the exemption amount, and 28% for all other income. Applying these tax rates to AMTI produces what the statute calls "tentative minimum tax." A taxpayer whose tentative minimum tax exceeds her regular tax liability must pay her regular tax and the amount by which her tentative minimum tax exceeds her regular tax liability. This is the equivalent, of course, of having to pay whichever tax is greater.

The classic AMT taxpayer, at which the tax was originally aimed, is someone with large amounts of investment tax preferences, such as ACRS deductions, incentive stock options, percentage depletion deductions in excess of basis, and tax-exempt interest income from private activity bonds. Although the tax continues to target such preference items, in recent years AMT demographics have started to change, and many of the victims of the AMT do not fit the classic profile of taxpayers with large amounts of economic income and heavy use of investment tax preferences. The increasing effect on moderate income taxpayers without investment tax preferences is explained partly by the fact that the regular tax brackets are indexed for inflation while the AMT brackets and exemption amounts are not, and partly by the fact that many of the differences between AMTI and regular taxable income do *not* relate to investment-type preferences, but to such plebeian tax breaks as employee business expenses (and other miscellaneous itemized deductions), the itemized deduction for state and local taxes, and personal and dependency exemptions. After 2001, nonrefundable personal credits—such as the child tax credit and the Hope scholarship and lifetime learning credits—will also disallowed under the AMT.

An example appended to this testimony shows how a couple with just $80,000 of gross income, four children, a home mortgage interest deduction, and a modest deduction for state and local taxes, could face a substantial AMT liability in 2002, unless the law is changed. This is not a high income couple, and they have only the most garden-variety regular tax deductions, yet the AMT has cost them over $2,000, and has increased their total tax liability by nearly 40%. Far from being pushed into the AMT because of sophisticated tax shelter investments, they have been pushed into the AMT by their *children*—or, more precisely, by the tax benefits for children (the personal exemptions and the child credits) which are allowed under the regular tax but disallowed under the AMT.[8]

Another surprising sort of AMT victim, in recent years, has been the taxpayer who receives a taxable damage award for example, on account of employment discrimination and who must pay his attorney's fees out of the award. The attorney's fees will generally be classified as miscellaneous itemized deductions (either unreimbursed employee business expenses or §212expenses for the production or collection of income), and disallowed entirely for purposes of the AMT.[9] When the attorney's fees are a large portion of the entire award, the result can be taxation under the AMT of much more than the taxpayer's net recovery. Although some courts have managed to avoid this result by creative interpretations of the definition of gross income,[10] other courts (including the Tax Court) have been unwilling to follow their lead.[11]

According to research at Treasury, if there are no legislative changes, the scheduled disallowance of personal credits becomes effective, and the AMT exemption amounts continue to be eroded by inflation, by 2010 the number of taxpayers affected by the AMT will be 17 million (compared with only 1.3 million on 2000).[12] By 2010 about 35% of total AMT liability will be imposed on taxpayers with AGIs

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[7] The exemption is phased out, beginning at $150,000 AMTI for joint returns, and $112,500 AMTI for unmarried taxpayers.

[8] See also Klaassen v. CIR, 83 AFTR2d 1750 (10th Cir. 1999) (married couple with AGI of $83,000 owed over $1,000 of AMT, primarily because of the disallowance of personal exemptions for themselves and their ten children).

[9] See, e.g., Alexander v. IRS, 72 F.3d 938 (11th Cir. 1995) (taxpayer paid $245,000 attorney's fees in connection with receipt of $250,000 taxable damages; AMT imposed on $250,000 without reduction by the amount of the attorney's fees).

[10] See, e.g., Estate of Clarks v. United States, 202 F.3d 854 (6th Cir. 2000) (amount retained by taxpayer's attorney as attorney's fees not included in taxpayer's gross income).

[11] Kenseth v. Commissioner, 114 T.C. 399 (2000).

[12] Department of the Treasury, Office of Tax Analysis Working Paper 87 (June 2000).

of less than $100,000, and about 70% of total AMT liability will be imposed on taxpayers with AGIs of less than $200,000. The Treasury research also indicates that the AMT will become increasingly focused on residents of high-tax states, because by 2010 state and local taxes will constitute about half of all preference items added back into taxable income in computing AMT liability.

These projections are dire enough, but the situation will be even worse if the Administration's proposed reductions in the regular tax are enacted, without any corresponding reductions in the AMT. The Joint Committee on Taxation has estimated that enactment of the Administration's proposals would cause an additional 12.2 million returns to be affected by the AMT by 2010; since JCT estimated 14.7 million returns would be affected by the AMT by 2010 even without legislative changes, the total number of affected returns would be almost 27 million.[13]

It is also worth noting that there is a significant marriage penalty in the AMT, because the joint return exemption amount ($45,000) is much less than twice the exemption amount for unmarried taxpayers ($33,750). This has received little or no attention in discussions of marriage penalty relief, but it would be ironic if Congress passed significant marriage penalty relief under the regular tax, only to throw millions of taxpayers into an AMT marriage penalty.

There are several options for reform. Although complete repeal of the individual AMT is certainly a possibility, it is not necessary. The AMT can be preserved for its original purpose of limiting the ability of higher-income taxpayers to reduce their tax liabilities through the aggressive use of investment tax preferences, while greatly lessening the impact of the AMT on taxpayers with modest incomes. The major reform possibilities include the following:

1. Inflation indexing of the AMT exemption amount and rate structure. There is no obvious policy justification for not indexing the AMT exemption amount and rate structure, when the corresponding features of the regular tax are indexed. The AMT exemption amounts have not been increased since 1993. If they had been adjusted for inflation since that time, the joint return exemption would be over $55,000 (instead of $45,000), and the unmarried taxpayer exemption would be over $41,000 (instead of $33,750). A sensible reform would consist of a one-time catch-up adjustment to reflect inflation, and prospective indexing for inflation.

2. Allow family size adjustments i.e., personal exemptions and the child tax credit under the AMT. There is also no obvious policy justification for imposing the AMT merely because a taxpayer has a large family. The current situation is especially disturbing, because it is *only* moderate income taxpayers who are pushed into the AMT by reason of their large families. For higher income taxpayers, personal exemptions and the child tax credit are phased out even under the regular tax. Thus, tax benefits for children will not push *higher* income taxpayers with children into the AMT, because those higher income taxpayers were not eligible for personal exemptions or the child tax credit even under the regular tax. A large family is an AMT risk factor only for moderate income taxpayers.

3. Reconsider the applicability of the AMT to various other tax benefits. The deduction for state and local taxes is the most obvious candidate for reconsideration, both because of its practical importance, and because it is far from clear what policy concerns justify its disallowance under the AMT. It is also worth considering whether it is necessary to disallow other personal credits such as the child care credit and the higher education tax credits—under the AMT. Finally, the AMT disallowance of miscellaneous itemized deductions merits reconsideration, at least in the attorney's fee context, and perhaps more generally.

APPENDIX

The following example uses regular tax inflation adjustments for 2001, but reflects the disallowance of nonrefundable personal credits against the AMT, which is scheduled to become effective in 2002. A married couple with four children has $80,000 wages, a $10,000 qualified residence interest deduction (consisting of $6,000 of interest on acquisition indebtedness and $4,000 of interest on home equity indebtedness), and a $5,000 deduction for state and local taxes. For purposes of the regular tax, their taxable income is $47,600:

[13] Letter of September 28, 2000, from Lindy Paull to Rep. Rangel, 2000 TNT 192–14. The number of affected returns would be even higher, but for the Administration's proposal to increase the child tax credit from $500 to $1,000, and to allow the credit against the AMT.

Compensation for services	$80,000	
Less:		
Qualified residence interest		$10,000
State and local taxes		$5,000
Six personal exemptions ($2,900 each)		$17,400
Taxable income		$47,600

Applying the 2001 rate schedule of §1(a), for married couples filing joint returns, yields a pre-credit regular tax liability of $7,452. Under §24, they would be entitled (but for the AMT) to four $500 child credits, which would reduce their regular tax liability to $5,452.

Of all their regular tax deductions, the only one allowed for AMT purposes is the $6,000 deduction for home mortgage interest on acquisition indebtedness. They may not deduct the interest on the home equity loan (§56(e)(1)), the state and local taxes (§56(b)(1)(A)(ii)), or the personal exemptions (§56(b)(1)(E)). Thus, their AMTI is $74,000. Of that $74,000, $45,000 is sheltered from tax by the AMT exemption amount, but the remaining $29,000 is taxed at 26%, resulting in a tentative minimum tax of $7,540. By reason of §26(a), the child credits (and other personal credits) are not allowed against the tentative minimum tax. They must pay their regular tax of $5,452, *plus* the $2,088 by which their tentative minimum tax exceeds their regular tax.

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