

2-12-2016

Consolidation of Educational Tax Credits

Michael Hynson
San Jose State University

Follow this and additional works at: <http://scholarworks.sjsu.edu/sjsumstjournal>



Part of the [Taxation-Federal Commons](#)

Recommended Citation

Hynson, Michael (2016) "Consolidation of Educational Tax Credits," *The Contemporary Tax Journal*: Vol. 5: Iss. 2, Article 12.
Available at: <http://scholarworks.sjsu.edu/sjsumstjournal/vol5/iss2/12>

This Focus on Tax Policy is brought to you for free and open access by the Graduate School of Business at SJSU ScholarWorks. It has been accepted for inclusion in The Contemporary Tax Journal by an authorized administrator of SJSU ScholarWorks. For more information, please contact scholarworks@sjsu.edu.

Repeal the Alternative Minimum Tax

By: Branden Wilson, *MST Student*

What is the AMT?

The alternative minimum tax, or AMT, can be described as a parallel tax system that operates on a different set of rules. The AMT is an income tax. It affects individuals, corporations, estates and trusts. When tax day comes around, taxpayers need to figure out how much tax they owe for the year under the regular tax rules, then again under the AMT rules, and pay whichever amount is higher. Also, it is necessary to consider possible AMT exposure throughout the year with additional record keeping and planning. The AMT was intended to make sure that certain high income individuals or businesses paid at least some tax.

The AMT applicability to individuals, works similarly to the regular income tax but it has different rules on how to calculate taxable income. It has two tax rates for ordinary income, 26 and 28 percent. Capital gains are taxed at the same rates under the AMT. Corporations are taxed at a flat 20% rate under the AMT. The individual AMT has exemptions with limits, so it does not impact the lowest earners. The exemption amounts are \$53,600 for taxpayers filing Single, \$83,400 for Married Filing Jointly, and \$41,700 for Married Filing Separately. The individual AMT phases out at \$119,200, \$158,900, and \$79,450 for taxpayers filing Single, Married Filing Jointly, and Married Filing Separately respectively. The AMT treats the exercise of incentive stock options as taxable gains upon exercise, even if the underlying securities have not been sold. The

major difference between the regular income tax and the AMT is that the AMT does not allow some of the deductions allowed under the normal tax rules. This makes it stealthy as it creeps up to surprise a taxpayer who is denied a large state tax deduction allowed under the regular tax rules and becomes a victim to a higher tax under the AMT.

The taxpayers most likely to get pulled into the AMT are middle-to-high income earners who live in high tax states and have children. Under the normal income tax rules a taxpayer may deduct state and local taxes paid on Schedule A of the Form 1040. This is not allowed when calculating AMT liability. Also there are no dependent deductions under the AMT, so people with kids or the ones who are taking care of others, could be surprised when these deductions disappear. Until recently, the exclusion amounts were not indexed for inflation and therefore, every year an increasing amount of taxpayers were subject to the AMT. The American Taxpayer Relief Act raised the exclusion limits permanently and indexed them for inflation so as to help prevent an increasing number of lower income individuals from being pulled into the AMT every year. Inflation indexing did help take the edge off of the AMT, but taxpayer advocate groups, politicians, and taxpayers alike plead for its complete repeal.

Even the IRS's own National Taxpayer Advocate cries out for the repeal of the AMT. In the NTA's 2013 Full Report to Congress, Legislative Proposal #1 was "Repeal the Alternative Minimum Tax" citing that it adds too much complexity to the tax system and it doesn't function like it was originally intended.⁴³ You know something is wrong

⁴³ The Taxpayer Advocate 2013 Full Report to Congress, Legislative Recommendation #1

with a part of the system if even the IRS wants to get rid of it. The AMT adds unnecessary complexity to the tax system by not only making it difficult to figure out how much tax is owed, but it needs to be done twice. The report suggests that if Congress really wants the revenue generated by this rule, they should change the regular tax system to get the same result. Making taxpayers figure out their tax owed under two different sets of rules and rates is pointless and unnecessarily redundant. This report also points out that the AMT hits the wrong taxpayers, meaning it was originally intended for certain very wealthy taxpayers who sometimes legally avoided paying all Federal income tax under the regular tax rules, but now it seems to miss its target.

Who is affected by AMT?

The AMT could affect every American taxpayer. It affects individuals when their income reaches a certain level and some deductions begin to disappear. It affects C corporations with special rules pertaining to calculating taxable income. All C corporations are exempt from AMT for the first year and could be exempt for future years based on gross receipts. To qualify as a small C corporation for AMT purposes average gross receipts must not exceed \$7.5 million for the three taxable years ending before the current tax year. However, for its first three years the average gross receipts must not exceed \$5 million.⁴⁴ If in any taxable year the C Corporation loses its small business corporation exemption it will be subject to the AMT in all future tax years even if gross

receipts decrease to small business levels in future years. The income that passes through S corporations, partnerships, and LLC's flows through to the owners and is potentially subject to the AMT. Estates and trusts are also subject to the AMT. All in all, almost every taxpayer and type of entity is a possible target for the AMT at some level.

A Brief History of the AMT

The first version of the AMT was called the minimum tax and was enacted as part of the Tax Reform Act of 1969.⁴⁵ Congress was upset to learn via witness testimony that some 155 high income individuals were not paying any income tax at all. These individuals were making over \$200,000 at the time, which amounts to more than \$1.4 million after inflation today. They were utilizing rules allowed under the regular income tax to effectively reduce their tax liability to zero. When Congress learned about this phenomenon, they were upset that some of the individuals with the most means to pay were in fact not paying at all!

The minimum tax was then changed to something more like what we have today, in 1982 by the Tax Equity and Fiscal Responsibility Act of 1982.⁴⁶ This is when it became the parallel tax system where you calculate both and pay the higher one. Rates changed over the years. In 1999, a bill was passed by both houses that would have repealed the AMT, but it was vetoed by the President.⁴⁷ In 2003, a law was passed that taxed capital gains under the same rates as the regular income tax. As mentioned above, in 2012 the exemption limits were indexed for

<http://www.taxpayeradvocate.irs.gov/userfiles/file/2013FullReport/Repeal-the-Alternative-Minimum-Tax.pdf>

⁴⁴ IRC §55(e)

⁴⁵ Pub. L. 91-172, Dec. 30, 1969, 83 Stat. 487

⁴⁶ Pub. L. 97-248, Sep. 3, 1982, 96 Stat. 324

⁴⁷ Taxpayer Refund and Relief Act of 1999, H.R. 2488, 106th Cong. (1999)

inflation, which was a big step in the right direction.

Complete repeal has been a tough sell for proponents because of how much tax revenue the AMT generates for the government.

Application of the Ten Principles of Good Tax Policy

Whenever considering an addition, modification or repeal of tax policy, it is important to critique the proposal using the ten principles of good tax policy as provided by the AICPA. This is a well-balanced and objective way to really expose the strengths and weaknesses of any proposed tax change. Below is a comprehensive analysis of the AMT as it is currently.

Principles of Good Tax Policy Worksheet

Criteria	Does the proposal satisfy the criteria? (explain)	+/-
<p>Equity and Fairness – Are similarly situated taxpayers taxed similarly? Also consider any different effects based on an individual’s income level and where they live.</p>	<p><i>While the AMT could affect all taxpayers, it tends to affect some more than the others. The Alternative Minimum Tax does not meet the principle of equity and fairness because it is more likely to affect taxpayers with children, those living in high tax states, or those with high personal expenses.</i></p> <p><i>Under regular tax rules taxpayers with children get a dependency deduction, under the AMT they do not. Under the regular tax rules, taxpayers can deduct their state and local taxes while under AMT they cannot. Under AMT taxpayers need to add back certain expenses such as legal fees and employee business expenses that can be deducted under the regular tax rules above 2% of AGI. So the AMT is inequitable to those who have children, live in higher tax states or that have certain personal expenses.</i></p> <p><i>The AMT affects taxpayers with income levels higher than the exemptions amounts, so it will be more likely to affect higher income individuals. It definitely does not affect low income taxpayers. Although mortgage interest is still deductible under the AMT which is more beneficial to higher income taxpayers with large home loans. Also the capital gain rates being the same for both regular income tax and AMT is more beneficial to high income taxpayers who likely have more income from capital gains.</i></p> <p><i>The AMT does not meet the criteria for the principal of equity and fairness looked at from either the perspective of vertical or horizontal equity.</i></p>	<p>-</p>

<p>Certainty – Does the rule clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined?</p>	<p><i>Because the AMT is due at the same time as the regular income tax, if in fact it is determined that the AMT is owed, it is certain. Although the way the AMT is calculated differs in terms of rates, allowable deductions, and exclusion amounts, they can be looked up just like rules under the regular tax system. So although burdensome to calculate the tax owed with two different sets of rules, the fact that one or the other is definitely due on tax day makes the AMT satisfy the principle of certainty. It is certain that one tax or the other will be due on tax day determinable by the rules set forth by the law.</i></p>	<p>+</p>
<p>Convenience of payment – is the tax due at a time that is convenient for the payer?</p>	<p><i>The AMT almost satisfies the principle of Convenience of Payment. Because some or most of the taxpayers which the AMT will apply are wage earners, they have withholding from their paychecks throughout the year based on their projected income calculated with the regular income tax regulations and rates. This makes paying the regular tax very convenient because it is pretty much done for them all year long. Sure the AMT is due on the same day as the regular tax if it is owed. The problem is that if the withholding has not been enough to satisfy the amount owed under the AMT rules, it will not be convenient for the taxpayer. So a taxpayer could be inconveniently surprised when they find out that they owe additional tax under the AMT rules and may not be able to pay on time triggering penalties. Unless a taxpayer has a good understanding of the tax rules under both tax systems or has a tax professional advising them, it is likely that a tentative minimum tax addition will come as an unwelcomed surprise.</i></p>	<p>-</p>
<p>Economy in collection – Are the costs to collect the tax at a minimum level for both the government and taxpayers? Also consider the time needed to implement this tax.</p>	<p><i>The AMT fails again to meet the criteria for the principle of economy in collection because it requires so many extra hours of preparation time to comply with. In order to comply with the AMT, taxpayers need to calculate their taxes in two different ways to see which one is higher. Millions of hours are spent recalculating taxable income under the AMT rules every tax year even if ultimately there is no additional tax owed. In addition to the taxpayers taking more time to compute potential AMT liability, the IRS revenue agents would also need to do calculations under both sets of rules to audit compliance. More hours spent on doing calculations and figuring out if everyone is complying with the law is very costly. The millions of hours spent on this AMT could instead be spent doing more productive</i></p>	<p>+/-</p>

	<p><i>activities.</i></p> <p><i>If the AMT were to be repealed, there would likely be additional administrative and compliance costs related to MTC carryovers. Credits accumulated by the taxpayers who have been subject to the AMT over the years, would need to be dealt with, if the AMT were no longer around. However, these amounts could likely be settled in one tax year and would not present an ongoing problem.</i></p>	
<p>Simplicity - can taxpayers understand the rules and comply with them correctly and in a cost-efficient manner?</p>	<p><i>One of the major issues with the AMT is that it is not simple. The AMT fails to meet the principle of simplicity because it takes what is owed under the regular income tax rules, throws it out, and makes taxpayers recalculate taxable income under a completely different set of rules. Most American taxpayers would probably say the tax system is complicated and I imagine they would be referring to the regular income tax. The AMT further adds complexity to an already complicated tax system by making taxpayers do extra record keeping and calculate their tax twice.</i></p>	-
<p>Neutrality - The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.</p>	<p><i>The AMT fails to meet the principle of neutrality because it can affect the business decisions of taxpayers. When an employee receives incentive stock options from their employer they may be subject to the AMT. This is because the AMT taxes the paper gain realized when an employee is granted and exercises stock options. The difference between the option contract value and the market value of the underlying security is a taxable event under the AMT, even if the shares are not sold. This can definitely have an effect on the economic decisions of taxpayers. If the gain is large enough the taxpayer payer may have to sell the securities against their will to come up with the money to pay for the tax on the gain. While under regular tax rules they could have held the stock and not been taxed until it is eventually sold, which could result in different economic results for better or worse.</i></p> <p><i>Also businesses may decide to use different depreciation methods or lease rather than buy property or equipment to simplify calculations under the two tax systems.</i></p>	-

<p>Economic growth and efficiency – will the tax unduly impede or reduce the productive capacity of the economy?</p>	<p><i>The AMT somewhat meets the criteria for the principle of economic growth and efficiency. Because it mainly affects the taxpayers in the \$100,000 to \$200,000 range, most taxpayers who are hit by this tax will be able to pay it. Occasionally a taxpayer near the lower bound of the exclusion amount under the right circumstances may be surprised by an AMT hit. However, a wage earning taxpayer can end up being subject to the AMT, who would have otherwise used the money to start a business, which would stimulate the economy by hiring employees or adding to the GDP. This is an example that has unduly impeded the economy. I would consider AMT a draw under the principle of economic growth and efficiency because it could go either way.</i></p>	<p>+/-</p>
<p>Transparency and Visibility – Will taxpayers know that the tax exists and how and when it is imposed upon them and others?</p>	<p><i>The AMT does not meet the criteria for the principle of transparency. This is because of its parallel nature that doesn't present itself until the conditions are just so that it is owed. Public education doesn't do much in the way of financial literacy and certainly doesn't try to explain our tax system. For most American's the first lesson in taxes is when a first paycheck is received and the recipient wonders where the rest of the money went. So the AMT is a tax you don't realize is there, until you have to pay it, unless you work with taxes for a living. The AMT is anything but transparent. The rules are out there but you have to find them. The AMT is a stealthy tax because it doesn't allow for certain tax deductions allowed under the regular tax rules and can catch a taxpayer off guard when it is time to file. Imagine a taxpayer is accustomed to receiving a large state tax deduction and one year when conditions are right they fall into AMT and are denied this deduction and become subject to additional tax. Uncertainty around whether a taxpayer will be in the AMT category or the regular tax category makes tax planning more difficult, which makes it less transparent. Only tax savvy individuals or businesses will see the signs that point to possible AMT exposure.</i></p>	<p>-</p>
<p>Minimum tax gap – is the likelihood of intentional and unintentional non-compliance likely to be low?</p>	<p><i>The AMT does not meet the criteria for the principle of minimum tax gap because individuals or businesses that are surprised by a larger than anticipated tax at the end of the year will be less likely to voluntarily comply. It is easy to comply with tax payments when the employer does the withholding for the taxpayer all year long based on the</i></p>	<p>-</p>

	<p><i>regular tax rates and rules. But after working hard all year paying property taxes and taking care of children, when a substantial under payment is due because of the AMT rules, a taxpayer is less likely to pay or be able to pay. The reason for automatic withholding is partly to increase voluntary compliance and when the automatic withholding is not enough to pay the bill, the taxpayer will likely feel cheated. Studies show that voluntary compliance suffers when a taxpayer receives a surprise tax due on their return. Although the IRS could easily compute and catch taxpayers who don't calculate or pay their AMT liability, because the potential to catch a taxpayer off guard, the AMT lowers voluntary compliance. For this reason, the AMT does not meet the minimum tax gap principle.</i></p>	
<p>Appropriate government revenues – will the government be able to determine how much tax revenue will likely be collected and when?</p>	<p><i>The AMT does meet the principle of appropriate government revenues because the ten year budget clearly reflects income from the AMT. Repealing the AMT, would lower revenues for the government unless it is done with comprehensive reform to offset the lost revenue from the AMT repeal. But the amount of revenue received from the AMT as a percentage of total income has steadily increased since its inception in 1969. The government has gotten comfortable with the increasing stream of income and is unwilling to part with it easily. However, the whole reason for enacting the AMT in the first place was to catch a handful of rich people avoiding tax by utilizing rules available to them under the regular income tax code. If Congress doesn't want people to avoid taxes by using these tax preference items, it should change the regular tax code, not use a parallel tax system to catch their legislative short comings.</i></p>	<p>+</p>

Conclusion

In conclusion, it is clear that the AMT does not meet the guiding principles for good tax policy as provided by the AICPA. The matrix provided, shows many more minuses than pluses. Repealing the AMT would be a great step in the direction of simplifying our US tax system and increasing voluntary compliance. If a complete repeal is not possible by itself, elimination of the AMT with modification to the regular tax system to help recapture some lost government revenue might be a good second choice. The regular tax code could be modified by eliminating certain tax preferences, which were the reason, why the minimum tax was enacted in the first place. *Instead of having a minimum tax or alternative tax, we should minimize or eliminate the tax preference items that allow*

taxpayers to avoid paying tax. The tax code should be as simple as possible to make it easier to follow and to increase voluntary compliance. If Congress wants the revenue from the taxpayers paying the AMT currently, they should write into law more straight forward rules that raise the same amount of funds more transparently without relying on a shady parallel tax system. Taxpayers should be able to easily understand how much they owe, understand why they owe it, and know how it is calculated. Simplicity helps everyone involved. It makes preparation, compliance, enforcement and audits easier. It would require less time to figure everything out, less government resources to administer and oversee, less computing power, and less internet bandwidth. I would even go as far as to say it would make taxpayers happier.