

THE BROOKINGS INSTITUTION

5 on 45:
On Trump's taxes and the AMT

Wednesday, March 15, 2017

PARTICIPANTS:

Host:

ADRIANNA PITA

Contributor:

WILLIAM G. GALE

The Arjay and France Fearing Miller Chair in Federal Economic Policy

Senior Fellow, Economic Studies

Director, Retirement Security Project

Co-Director, Urban-Brookings Tax Policy Center

The Brookings Institution

PITA: You're listening to 5 on 45 from the Brookings Podcast Network: analysis and commentary from Brookings experts on today's news regarding the Trump administration.

GALE: My name is Bill Gale. I'm a senior fellow in Economic Studies at the Brookings Institution and co-director of the Urban-Brookings Tax Policy Center. I want to talk today about something called the alternative minimum tax, the AMT. The AMT is a technical, somewhat obscure part of the tax code, but is getting its fifteen minutes of fame because of Donald Trump. Yesterday, Trump's tax return for 2005 was leaked to a reporter. On the return, Trump shows about \$153 million in adjusted gross income, and just under \$37 million in income taxes, but he didn't pay much regular income tax. Of the \$37 million in income tax, almost all of it, \$31 million, was due to the alternative minimum tax. Many people have never heard of the AMT. Many others get it confused with automatic teller machines, or ATMS. So let's talk through some questions and answers about the AMT.

First question, what is it? The AMT is a parallel tax system to the regular income tax. Most people don't know this, but everyone has to calculate their income tax in two ways, under the regular income tax and under the AMT. You pay the higher of your regular income tax or your AMT liability. Now, it turns out that all low- and moderate-income households are exempted from the AMT, so for most people the AMT does not matter, which may be why most people have not heard of it. But for higher-income households, the AMT can matter a lot. The AMT allows fewer deductions than the regular income tax, but it imposes a lower tax rate. The highest AMT rate is 28%, as opposed to 39.6% under the regular income tax. All told, about 4.7 million paid the AMT

in 2016, according to the Tax Policy Center. The tax hits particularly hard for people with incomes between \$200,000 and \$1 million per year. It hits less hard for those with incomes above \$1 million.

Second question, why do we have an AMT? A minimum tax came about in the 1970s after it was revealed that some high-income households in the 1960s paid no income taxes. The goal of the minimum tax was to ensure that all high-income households did pay at least some positive amount of income tax in each year. The minimum tax has been reformed several times since then, with the current AMT being the outcome of all of that. But in short, the basic idea behind an AMT is that in a modern, complicated income tax, there will always be some ways to shelter income and take deductions that were not anticipated when the laws were written. These unintended loopholes can lead to situations where extremely high-income households do not owe any income tax. The existence of the AMT is an admission that we can't stop all of these unforeseen consequences on a case-by-case basis. Rather, the AMT tells taxpayers that they can use all of the specific deductions in the law, but we're going to cap the overall amount of deductions that they can take. The AMT is, in essence, an overarching limit on people's ability to use tax deductions and shelter income.

Third question, does the AMT do its job well? The short answer is not always. The AMT fails on two accounts. First, it limits tax deductions that most people don't think of as egregious shelters. For example, the vast majority of people who end up on the AMT are there not because of some wild sheltering scheme, but rather because they have large families and so they get several personal exemptions, or because they live in high-tax states and so they have large deductions for state and local income

taxes. This is not the aggressive sheltering activity that the AMT was intended to prevent, and it mainly captures people with income between \$200,000 and \$1 million per year. A second problem with the AMT is that many people with extremely high income – income in the millions of dollars – do not end up paying any income tax despite the AMT. That is, the AMT doesn't quite capture what we want it to. It doesn't police shelters as well as it could. But the AMT is not a total waste. Trump's 2005 returns show that in some cases, the AMT does, in fact, force high-income taxpayers to pay substantially higher tax rates. Trump's average tax rate under the regular income tax was only 4%. This is less than most middle-income families pay. But with the AMT, his total income tax rate was 24%. We don't know why Trump was on the AMT, but we do know that it was not because of personal exemptions or state income taxes, so there was some legitimate reason, presumably related to tax shelters that he took.

Last question: is there a better way to tax people? That's a simple one – yes, of course. No one can look at our tax system and say it's the best of all possible worlds. The AMT is at best a compromise, a second-best solution. The goal should be to tax income the right way. If we don't like the deductions or loopholes that are letting extremely high-income households avoid taxes, we should address them correctly with legislation. But such changes are a pipe-dream under normal circumstances, and are even more unrealistic given Republican control of both houses and the White House. The one thing we are certain they will not do is raise taxes on the wealthy.

One final note: both Trump's tax plan and the House GOP plan would repeal the AMT, but would not close the loopholes that allow high-income households to pay low taxes. That would be a big mistake, and would open the floodgates for further tax

sheltering. So the uneasy compromise that generated the AMT in the first place would likely have to continue until more fundamental reforms can be enacted.

PITA: If you've been listening to 5 on 45 and like what you're hearing, please take a minute to rate and review us on iTunes, and don't forget to follow us and the rest of the Brookings Podcast Network on Twitter @policypodcasts.