Count Capital Gains in AMT, 
Unify Higher Education Credits

By Deborah H. Schenk

Two assignments of the Volcker task force are to identify specific measures to close loopholes that help create the $300 billion tax gap and to simplify the code. I’ll offer one of each.

Closing the tax gap may mean reducing tax evasion and loopholes, but it also may mean raising revenue, because one of the Obama administration’s goals is to cut the budget deficit in half. Closing the tax gap through enforcement alone will not do the trick; hence, raising rates or widening the base may be necessary. Neither is politically palatable, and doing both simultaneously might be political suicide.

But there is a way to accomplish the goal that is not so transparent and might fly under the political radar: Include capital gains in the alternative minimum tax base.

That suggestion rests on the assumption that Congress will not repeal the AMT. Even though the AMT is everyone’s favorite whipping boy, it raises a lot of revenue. Indeed, the revenue from it is far greater than the tax gap, and AMT repeal would be a huge tax cut for the wealthy. So even if lawmakers are looking for ways to raise revenue to reduce the deficit, repealing the AMT will not be on the table.

So instead let’s return the AMT to its original function of closing loopholes and reducing tax preferences. The first AMT, adopted in 1969, increased the effective tax rate on capital gains. The Tax Reform Act of 1986 eliminated the capital gains preference, and as a result, capital gains disappeared from the AMT base. When the preferential rate made a quick reappearance, Congress failed to reinsert it into the AMT. Now would be a good time to do that.
If simplification is the goal, raising the rates on capital gains directly is simplest. But a second-best approach would be to effectively raise the rates by subjecting capital gains to the AMT. The AMT is already a contributor to progressivity, and effectively raising the rates on capital gains would also promote progressivity because most capital gains are lodged in the upper-income cohorts.

And as long as we are simplifying, we could use the opportunity to rid the AMT base of those items that do not belong there so as to return the base to its original purpose of scaling back tax preferences. In exchange for capital gains inclusion, remove miscellaneous itemized deductions, the standard deduction, exemptions, and the medical deduction from the AMT base. That should make it easier to avoid ending up with tax increases on those with income of less than $250,000 (a constraint imposed on the task force).

My simplification suggestion is to streamline the various provisions intended to provide benefits for higher education. As I have shown elsewhere, the current welter of provisions is unlikely to accomplish the goal of increasing college attendance because, at the margin, the provisions are not sufficient to change behavior. The tax incentives do not affect those who are not price-sensitive, and they do not decrease the cost sufficiently to enable someone who otherwise could not afford college to do so. Instead they are best viewed as a subsidy, a government transfer that reduces the after-tax cost of college.

It’s a mystery why the government would want to do that in such a complex way. Taxpayers must try to figure out whether it is more beneficial to use the HOPE or lifetime learning credits or the tuition deduction or the deduction for interest on education loans or a section 529 plan or perhaps a Coverdell plan. The tax incentives have inconsistent definitions of college costs and different eligibility rules. They have inconsistent phaseouts, with rapid phaseouts of the credits and a cliff-effect phaseout for the deduction, and they even use different definitions of income for the phaseouts. This makes it extremely difficult for taxpayers to determine which incentive provides the most benefit.

Part of President Obama’s education initiative is to raise the amount of a Pell grant — which is a good idea, as low-income
Taxpayers cannot benefit from the various tax incentives because the incentives are nonrefundable. High-income taxpayers stand to benefit significantly from section 529 plans (the tax savings are too low in lower tax brackets to provide a significant subsidy). So that leaves the “middle class” to use the other tax provisions. Much simplification could be achieved with a single targeted credit so that the value is the same for all users. (A deduction for interest on education loans is the least useful incentive, because it provides a future benefit long after tuition has been paid.)

The credit should have one simple set of rules defining eligibility. College costs should be expanded to include room and board, in part to provide parity with section 529 plans and in part to subsidize the true cost of college. A gradual phaseout should be adopted. Finally, the credit should be based on the previous year’s income so that a family could determine the amount of the subsidy when tuition must be paid. Better yet, deliver the subsidy at that time.

And, to tie the two ideas together, eliminate the education credit from the AMT base. Sweeping an education incentive into the AMT reduces its effectiveness. Instead, pull in capital gains.