

Pillsbury



Madison &
Sutro LLP

Writer's direct dial number/ email:
(415) 983-1504 / canty_jm@pillsburylaw.com

ATTORNEYS AT LAW
235 MONTGOMERY STREET
SAN FRANCISCO, CALIFORNIA 94104
MAILING ADDRESS: P.O. BOX 7880
SAN FRANCISCO, CA 94120-7880
TELEPHONE: (415) 983-1000 FAX: (415) 983-1200
<http://www.pillsburylaw.com>

April 24, 1998

Mr. Bill Archer
Chairman
Ways and Means Committee
1236 Longworth
House Office Building
Washington, DC 20515-6348

Re: Deceptive 26.5% AMT Capital Gains Rate

Dear Mr. Chairman:

As the IRS has interpreted last year's tax law, many taxpayers will find that their AMT tax rate on long-term capital gains is 26.5%.

Background

A friend recently told me that his 1040 showed an alternative minimum tax liability. I was quite surprised since I had a general knowledge of his financial situation and, as a long-time student of the AMT, thought that he would not be hit by AMT.

When I was a TLC staffer at Treasury in 1973 -1974, I was assigned to the Treasury's Minimum Taxable Income, or MTI, proposal that was a conceptual forerunner to the current AMT. I spent a considerable amount of time on the impact of MTI on capital gains. Since then, my general interest in the impact of AMT on capital gains has continued. For many years, the key problem has been that capital gains trigger substantial state income taxes for those of us who live in high-tax states; payment of large state income taxes on capital gains can then trigger AMT.

My friend had significant state income taxes in 1997 from withholding and from additional California payments in 1997 on his 1996 return. However, the amount did not seem large enough to trigger AMT since he had substantial ordinary income and short-term capital gains. He faxed me the return, which he had prepared on TurboTax, and the calculations seemed to follow the Form 6251. What surprised me was that he was not entitled to any portion of the AMT exemption amount of \$45,000 for joint returns.

26.5% Capital Gains Rate on AMT Form 6251

As I delved deeper, I realized that the AMT Form 6251 does not recalculate the exemption phaseout in its capital gain calculation.¹ Under Form 6251 the effective marginal AMT long-term capital gains (“LTCG”) rate can be 26.5% when capital gains cause AMTI to fall within the range of \$180,000 to \$330,000 on a joint return. The 26.5% rate is composed of the basic 20% AMT rate on long-term capital gains and 6.5% due to the phaseout (26% AMT tax rate times 25% phaseout for each dollar above the phaseout floor).

I have attributed this 26.5% capital gains rate to Form 6251, not Congress, because I do not believe that the Internal Revenue Code mandates the Form 6251 result. Under the special AMT capital gain rates in section 55(b)(3), the AMT tax cannot exceed the sum of the AMT tax “computed at rates and in the same manner as if this paragraph had not been enacted on the taxable excess reduced by” the capital gains that are taxed at the lower rates which taxes are then added to determine the total AMT tax. Form 6251 simply looks for the definition of “taxable excess” (AMTI less the exemption amount) computed as if LTCG were ordinary income.

What Form 6251 seems to de-emphasize is the “in the same manner” language in section 55(b)(3). Recalculating the phaseout without including the capital gains seems more consistent with the “in the same manner” language.

Congressional Intent

What did Congress intend? I have found nothing in the committee reports for the 1997 Act to suggest that Congress envisioned that long-term capital gains could be taxed at a 26.5% rate. All of the committee reports suggest simply that the 20% rate would apply for AMT purposes. I spent a couple of hours on the computer trying to find any recognition on the floor of the House or the Senate

¹ The AMT exemption is reduced by 25% of the alternative minimum taxable income (“AMTI”) in excess of a base. For a single taxpayer, the \$33,750 AMT exemption is phased out over a range of AMTI between \$112,000 to \$247,500.

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that a 26.5% rate would apply; I found nothing. I also searched several large databases and found no evidence that any of the leading newspapers, magazines or tax publications have discussed this rate. Everyone seems to think that capital gains are taxed at 20% for AMT. Not so.

This 26.5% rate is “deceptive” because there is nothing in Form 6251 that alerts the taxpayer to the fact that long-term capital gains are being taxed at any rate other than 20%. A taxpayer who picked up just about any newspaper, magazine or book dealing with taxes, would have read that capital gains are taxed at 20% for both regular tax and AMT purposes. These publications would simply be repeating what was said last year in the committee reports. For example, the conference report noted that the conference was following the House bill, with some additions not relevant here, that had provided a maximum long-term capital gain rate of 20% as well as special 15% and 10% rates. The conference report then stated (p. 382):

“These rates apply for purposes of both the regular tax and the minimum tax.”

Example 4 in Blue Book May Be Wrong

The Staff of the Joint Committee on Taxation used this identical language in its February 6, 1998 report entitled, “Present Law and Background Relating to Taxation of Capital Gains.” No mention is made of a 26.5% rate due to the phaseout. The identical language is also used in the Staff’s “Blue Book” on the 1997 Act. The Blue Book is interesting in that its explanation of the capital gain rate provisions includes 14 examples where the tax is calculated; there is no mention of a 26.5% rate. Neither of the Staff’s excellent recent reports on the AMT and on effective marginal tax rates mentions the higher potential 26.5% AMT rate on LTCG. See “Present Law and Issues Relating to the Individual Alternative Minimum Tax” (Feb. 2, 1998) and “Present Law and Analysis Relating to Individual Effective Marginal Tax Rates” (Feb. 3, 1998).

Example 4 in the Blue Book on the 1997 Act involves an individual with \$150,000 of taxable income, \$30,000 of capital gains qualifying for the 20% rate and \$20,000 qualifying for the 28% rate. Example 4 indicates that the \$30,000 gain would be “taxed at 20 percent.” This might be true but not necessarily so. The so-called 20% gains could be taxed at up to 26.5% if the regular tax deductions for state taxes were large enough to put the individual on the threshold of the AMT before adding the \$30,000 long-term capital gain.

Using TurboTax, I have mocked up simplified tax returns to illustrate the 26.5% tax rate of Form 6251, using variations on Example 4:

- Without the \$30,000 LTCG but with high property taxes and state income taxes (including 1997 taxes paid on a 1996 gain), AMTI in my Example 4A is \$146,739 but there is no AMT since AMT exactly equals the regular tax of \$31,603.
- In Example 4B, the only change is the addition of the LTCG of \$30,000. The total tax is \$39,553 which includes \$1,474 of minimum tax. The tax increase due solely to the \$30,000 LTCG is \$7,950 (\$39,553 minus \$31,603), a 26.5% rate!

As noted above, for single taxpayers, there is a band of LTCG of up to \$135,000 that could be taxed at the 26.5% AMT rate (\$33,750 AMT exemption amount divided by phaseout percentage of 25%). For a joint return, the band is up to \$180,000 (\$45,000 exemption divided by the phaseout percentage of 25%).

An AMT tax can be due even if an individual uses the standard deduction as long as the capital gains are large enough (\$143,344 or more under my calculation in Example 4C). Although the tax is quite small (\$676), it seems strange to have an AMT tax caused solely by the effect of LTCG on the phaseout of the AMT exemption.

Recommendations

I have seen nothing to suggest that Congress intended that long-term capital gains could be taxed at 26.5% rather than at 20%. This should be fixed by the IRS or by a technical corrections bill, making it clear that the AMT exemption amount is recalculated by excluding all capital gains except net short-term capital gains.

Further Musings on AMT. Repeal?

I have always found it extraordinarily difficult to explain to people when they are likely to be hit by the AMT. I have warned people to watch out for the state income tax deduction because in my experience that deduction usually causes the most problems for people in high-tax states. The list of tax preferences in section 57 is not a useful indicator of potential AMT exposure for most taxpayers now despite the fact that this is where "all the action was" in the early days of the minimum tax. The only safe advice is to have the tax professional prepare a draft return to see if AMT applies.

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I suspect that the 1997 version of the AMT has largely become a tax on capital gains and state taxes. The Staff of the Joint Committee should run its model to see if the AMT would raise much revenue if state taxes were deductible for AMT and if capital gains were excluded in calculating the AMT exemption phaseout. I suspect that the revenues raised by such an AMT would be minor, especially if investment expenses and employee business expenses were deductible for AMT purposes.

I also suspect that the staff's estimate of 8.8 million AMT taxpayers in 2008 would shrink if capital gains did not affect the exemption phaseout.

The ability to deduct state taxes will strike few members of the public as a "preference." The deduction of state income taxes seems nothing more than federal recognition of state powers and of the taxpayer's ability to pay taxes. The non-deduction of state income taxes for AMT purposes and the 3% floor on itemized deductions for regular tax purposes intrude on these concepts. Indeed, taxpayers in states with income taxes may view the 3% floor as first and foremost a disallowance of the deduction of state income taxes. Most taxpayers in these states who itemize will have state income taxes in excess of 3% of AGI. There is no discretion in paying a state's income taxes (absent leaving one's job site and the state). In contrast, a taxpayer who rents would incur no home mortgage interest or real property taxes; charitable contributions are discretionary; and few taxpayers will have enough medical expenses, casualty losses or investment expenses and employee business expenses to exceed the substantial floors on those deductions. The one deduction most itemizers have year in and year out is the state income tax deduction.

I believe the AMT has long outlived its usefulness (if ever it had any) and agree with you completely that it should be repealed before it ensnares larger and larger numbers of taxpayers. Its complexity alone makes it suspect. The Staff report on the AMT suggests that only 1% of AMT taxpayers prepared their own return. When the operation of the AMT produces a tax result that no one seems to have commented upon but which must affect hundreds of thousands of taxpayers in 1997 and 1998 alone (a 26.5% tax on LTCG), the AMT becomes deceptive for even sophisticated taxpayers. And when the items which raise the most revenue from the AMT (itemized deductions and capital gains, I suspect) can be dealt with directly through limitations, the argument for the AMT is seriously weakened.

The strongest argument in favor of the AMT is that it reduces the need to explain why a small group of taxpayers with large gross incomes may pay no tax.

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But I believe that the deception inherent in the AMT and the complexity it brings to hundreds of thousands of taxpayers overwhelm this largely public relations issue and justify the repeal of AMT. Any revenue shortfall could be made up by dealing directly with the items affected by AMT.

Very truly yours,

James M. Canty