



# BRIEF ANALYSIS

## The Surtax: Worse Than the Alternative Minimum Tax

by Michael Schuyler

The individual alternative minimum tax (AMT) was originally designed to tax wealthy households who paid little income tax due to deductions and credits they claimed. However, today's AMT is hitting more and more middle-class households in spite of temporary fixes (such as raising the threshold of income not subject to the AMT). The last temporary patch expired at the end of 2006. If Congress does not act, it is estimated that the number of AMT taxpayers will mushroom to over 23 million this year. Some Democrats are floating a proposal developed by the Tax Policy Center (a joint undertaking of the Urban Institute and the Brookings Institution) to repeal the AMT and replace it with a 4-percentage-point surtax on adjusted gross incomes in excess of \$100,000 for singles and \$200,000 for couples.

**How a Surtax Would Work.** It sounds like a simple solution, but the surtax would act more like the AMT in disguise. It would be pegged to adjusted gross income (AGI) — income before subtracting personal exemptions, the standard deduction, itemized deductions and tax credits. Hence, like the AMT, the surtax would not allow for personal exemptions, the standard deduction, state and local taxes, or certain miscellaneous expenses. But it would go further than the AMT and disallow many other legitimate deductions and credits. It would hit *all* tax filers with AGIs above \$100,000 for singles and \$200,000 for couples, regardless of how much regular income tax they pay. As a result [see the figure]:

- Affected taxpayers now in the 25 percent income tax bracket would see their marginal tax rate increase to 29 percent, higher than the 28 percent rate prior to the Bush tax cuts.
- The marginal tax rate for taxpayers in the 28 percent income tax bracket would jump to 32 percent, higher than the pre-Bush 31 percent bracket.
- Taxpayers currently in the 33 percent bracket would pay a marginal tax of 37 percent, which is higher than the pre-Bush 36 percent bracket.

- For taxpayers in the 35 percent bracket, the marginal rate would increase to 39 percent, which is almost as high as the pre-Bush 39.6 percent.

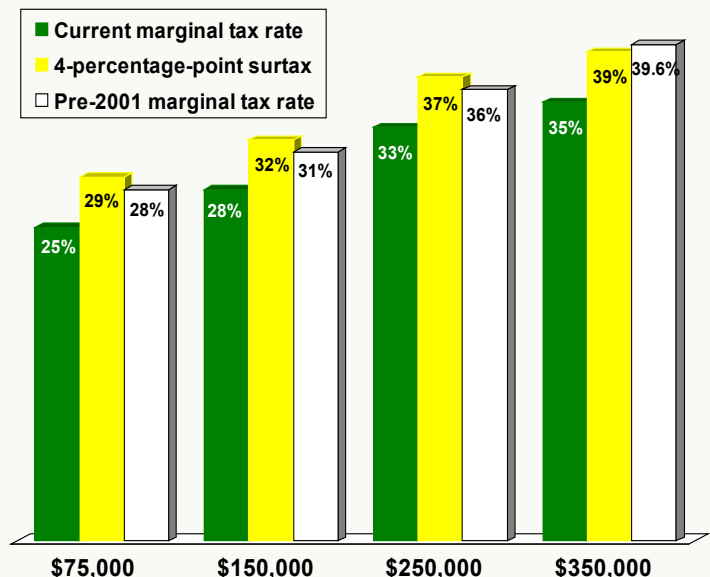
The surtax would also apply to other forms of income:

- The rate on long-term capital gains, which was reduced from 20 percent to 15 percent in 2003, would go back up to 19 percent for taxpayers subject to the surtax.
- Only the marginal rate on qualified dividends, which would rise from 15 percent to 19 percent, would remain appreciably below what it was prior to the Bush tax cuts, when dividends were taxed at the ordinary rate.

**Economic Effects of the Surtax.** Since the surtax would be based on adjusted gross income instead of taxable income, it would affect households surprisingly low on the income ladder.

- For a single filer with itemized deductions equal to 20 percent of AGI, the 4-percentage-point surtax would begin at a taxable income of \$76,600, which is in the regular income tax's 25 percent bracket.

**Marginal Tax Rates at Various Income Levels**  
(married filing jointly)



Sources: Len Burman and Greg Leiserson, "A Simple, Progressive Replacement for the AMT," Tax Policy Center, Urban Institute and Brookings Institution, May 23, 2007; IRS data.

■ For a couple with two children who claim itemized deductions equal to 20 percent of AGI, it would begin at a taxable income of about \$147,000, which is in the regular tax's 28 percent bracket.

Many of these people have considerable discretion in how much they work, spend and save. A surtax would reduce work effort, reduce saving and investment, and increase tax avoidance and evasion. The economic damage would be especially serious because the millions of people the surtax would target are among the most productive and economically dynamic people in society. For example:

■ As high-productivity, upper-income people cut the time and intensity of their work effort due to a higher tax rate on their labor, they employ fewer people, reducing job creation.

■ As upper-income individuals save and invest less due to a higher tax rate on their capital income (at the corporate or shareholder level, or on income from noncorporate businesses), the rate of capital formation will drop, reducing plant and equipment purchases and construction of buildings and other structures.

In essence, part of the tax burden is shifted to the rest of the population, and middle- and lower-income workers would indirectly bear a significant part of the burden of the surtaxes on higher-income individuals. They would also suffer if they own shares directly or through pension funds because the higher tax burden on capital would reduce the value of stocks. Moreover, middle- and lower-income households additionally bear some of the tax as consumers, because output is reduced, and consumers of all income levels must make do with fewer, higher-priced goods and services.

**Revenue Effects of the Surtax.** Ironically, the surtax or any other revenue raiser that Washington uses to fix the AMT would collect much less revenue than estimates predict. Official revenue scoring models assume tax increases have no ill-effects on employment, investment, productivity, output and growth. For example, the authors of the Tax Reform Act of 1986 expected a large revenue gain when the top tax rate on long-term capital gains rose from 20 percent to 28 percent. Instead, the stock market crashed in 1987, and capital gains realizations were depressed for years. The 1986 increase in the

capital gains tax collected much less revenue than the government's static revenue estimates had predicted.

Treasury studies in the mid-1980s found that the 1980 cut in the capital gains tax rate to 20 percent had increased revenues just by spurring realizations. Those studies did not consider the additional revenue gains resulting from a higher stock market, additional investment and higher productivity and wages. But they do occur in the real world.

Following the enactment of the 15 percent cap on tax rates for long term capital gains and qualified dividends, many firms either increased their dividend payouts or began paying dividends. Consequently, there has been a surge in taxes from non-withheld sources, including capital gains and dividends. Enacting a 4-percentage point surtax would at least partially undo these positive behavioral changes, would raise little revenue or do sufficient economic damage to result in a revenue loss.

**The Surtax versus the AMT.** The best that can be said for the 4-percentage point surtax or some other large tax increase is that it does not look quite so bad if it is assumed to be the only alternative to the out-of-control AMT. Leonard Burman and Gregory Leiserson of the Tax Policy Center correctly note that the 4-percentage point surtax would be simpler than the complex AMT. They write, "The proposed add-on tax would be extremely simple: subtract the threshold (\$100,000 or \$200,000) from AGI and multiply the difference (if any) by 4 percent. Add that to income tax." The surtax attains its simplicity, however, by being even guiltier than the AMT of using an overly broad tax base that disallows many of the adjustments found in the normal income tax.

**Solution: No AMT, No Surtax.** The history of the AMT offers the caution that a tax initially billed as applying only to the rich can quickly extend its reach far down to the middle class. Policymakers are talking about repealing the AMT permanently, but enacting a large surtax in its place. On the grounds of tax efficiency, simplicity and fairness, the AMT should be repealed immediately and not replaced with some other, massive tax hike.

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