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EDITORIAL

Mr. Bush's Stealthy Tax Increase

President Bush is presiding over a big middle-class tax hike.

As recently as 2000, only about one million taxpayers owed the alternative minimum tax, created by a provision in the federal tax code that is supposed to prevent multimillionaires from using loopholes to avoid paying their fair share. But by the time Americans file their 2005 taxes, some 3 million taxpayers will owe the alternative tax and by 2010, nearly 30 million taxpayers will be hit - among them, a staggering 94 percent of married filers who have children and make $75,000 to $100,000.

Big families in high-tax states - New York, New Jersey, California and Massachusetts - will bear the heaviest burden, largely because the alternative tax increasingly disallows write-offs for dependents, state income taxes and local property taxes. On average, by 2010, people who make under $100,000 and owe the alternative tax will pay an additional $1,321 in federal income taxes, while alternative tax payers who make between $100,000 and $200,000 will owe an additional $2,592.

Meanwhile, and most outrageous, only 35 percent of taxpayers who earn $1 million or more will owe the alternative tax.

Why does the alternative tax increasingly afflict middle-rung taxpayers for whom it was never intended, while largely ignoring the highest-end taxpayers it is meant for?

First, the alternative tax is not adjusted for inflation, so over time, more and more middle-income taxpayers find themselves owing it.

Second, and crucially important, is the interplay of the alternative tax and Mr. Bush's first-term tax cuts. When the tax cuts were enacted, no long-term corresponding changes were made to the alternative tax system - even though the administration was well aware that was a recipe for disaster. Not only will many families that thought they were in for lower income taxes wind up feeling shortchanged, some will find that the Bush tax cuts have done nothing at all to cut their taxes.

Here's why: The alternative tax applies to people whose income tax bills are low relative to their income. So as tax cuts reduce the liability on a filer's Form 1040, the alternative tax kicks in. In effect, it claws back all or part of the supposed savings from the Bush tax cuts. By 2010, the Bush tax cuts alone will cause an additional 17 million taxpayers to owe the alternative tax. By 2014, assuming the Bush tax cuts are made permanent, 40 million taxpayers will owe the alternative tax, nearly half of whom would never have faced it but for the tax cuts.

Meanwhile, the people who should be paying the alternative tax do not. Mr. Bush's administration, more than any other, has bestowed tax breaks on wealthy investors in the form of superlow rates on capital gains and dividends. But the alternative tax system - which regards deductions for property taxes or state income taxes as a kind of tax shelter - does not recognize this preferential treatment of investment income. That is a huge loophole. The alternative tax, whose very purpose is to prevent excessive sheltering, ignores the biggest tax breaks of all: special, low rates on capital gains and dividends that allow investors to avoid paying tens of billions of dollars in taxes every year.

Ever since the first round of Bush tax cuts were enacted, Congress has passed temporary relief measures to keep most middle-income taxpayers from owing the alternative tax, but the problem is becoming too big, too fast, for stopgaps to keep working. Mr. Bush, for his part, says that he wants to shield the middle class from the alternative tax and that his tax reform commission will recommend a solution when it makes its report in July.

But Mr. Bush needs the alternative tax - he relies on its projected revenue to mask the debilitating cost of making his tax cuts permanent. Congressional estimates say that extending them permanently will cost $281 billion in 2014. But that estimate assumes that nothing will be done to prevent the alternative tax from further burdening the middle class. If the middle class is fully protected, the cost of extending the tax cuts will mushroom to $356 billion - 27 percent higher than the official estimate. The federal budget deficit would explode.

The obvious answer is to restore the alternative tax to its true antisheltering purpose, by making inflation adjustments that will exempt the middle class once and for all and by fully taxing capital gains and dividends under the alternative system. But Congress and the administration are currently heading in precisely the wrong direction. The Bush tax breaks for investment income are scheduled to expire in 2008, but both the president and Congressional leaders are calling for extending them, at least through 2010, while proposing no corresponding long-term change in the alternative tax.

Bush administration officials and their antitax allies seem to believe that if taxpayers become angry enough at having to pay the alternative tax, they will throw their support behind any tax reform plan the administration puts forth. That is fomenting a crisis in order to appear to solve it. Is it too much to ask not to put the country through that kind of cynical exercise yet again?