Stuart J. Sweet, President **May 1, 2007**

CONGRESS LACES UP SHOES TO TACKLE THE ALTERNATIVE MINIMUM TAX

The most important tax fight since 2001 is about to break out.

Late last week, Democrats on the House Ways and Means Committee announced they had reached agreement on how to overhaul the reviled Alternative Minimum Tax (AMT). This is no small matter. Just "patching" the AMT, so that the number who already have to pay this tax does not increase, would cost $800 billion over ten years – an amount equal to half of the Bush tax cuts. Full repeal could run as high as $1.3 trillion or more. Investors should seriously weigh House Ways and Means Chairman Charlie Rangel's prediction that his AMT fix will clear the House "by Memorial Day or soon after the Memorial Day recess." Rangel (D-NY) is unlikely to make such a bold statement unless other House Democratic leaders, including Speaker Nancy Pelosi (D-CA), have signed off on the Committee plan, and they have the House votes to pass it.

The House will deliver its bill to a receptive Senate. Finance Committee Chairman Max Baucus has said that he favors full AMT repeal, but he will take what he can get. Months ago, when Congressman Rangel said his Ways and Means Committee would pass only a one-year AMT patch this year, Baucus responded by saying any AMT patch should be two years. He also has said that Democrats want to provide the middle class tax relief, and "The AMT is the right place to start."

What about the White House? It has voiced support for a "revenue-neutral" AMT fix. Testifying before the House Budget Committee in February, OMB Director Rob Portman said the AMT is "misguided tax policy." He also said that the Administration's budget assumes a "revenue-neutral" AMT fix. This means that the Bush Administration has accepted the principle that very large, offsetting tax increases can be found to pay for AMT reform! On February 16, 2007 the Wall Street Journal confirmed that the Administration does not view a "revenue-neutral" bill, one that fixes the AMT while raising revenue in other ways, as a "tax increase."

At least a one to two year AMT patch seems assured, but CAN places the odds of permanent AMT reform passing this Congress at 50 percent.

How the AMT Works and Why "Something Must be Done"

The Alternative Minimum Tax really should be called the "Mandatory Maximum Tax." Federal taxpayers must pay whichever is higher, the AMT or the "regular" income tax. Under the AMT, taxpayers get many fewer deductions and credits than under the regular income tax. Instead, married taxpayers filing jointly, basically, get an AMT standard deduction of $62,550 while the AMT standard deduction for single taxpayers is $42,500. After subtracting the standard deduction from adjusted gross income, AMT taxpayers pay 26 percent on the first $175,000 of "AMT taxable income" and 28 percent above that. For many, the de facto AMT rate they face is 32.5 percent or 35 percent because the AMT standard deduction "phases out" between $150,000 and $400,000 in AMT income – the equivalent of a 25 percent surcharge on top of the 26 percent and 28 percent rates. There is one important exception; long-term capital gains and dividend income face a maximum tax rate of 15 percent, just as they do under the regular income tax. The indirect effect of the current "phase out surcharge" on taxpayers earning $150,000 to $400,000 is to raise the capital gains and dividend tax rate to 21 percent.

The problem facing Washington politicians is that the number of taxpayers who will have to pay the "mandatory maximum tax" will explode unless Congress and the Administration come to terms. Under current law, the AMT standard deduction for married couples in 2007 will fall from $62,550 permanently to $45,000, and from $42,500 to $33,750 for singles, ambushing 23 million unsuspecting taxpayers who will have to fork over an unexpected $60 billion next April. In 2006, 2.5% of taxpayers were affected by the AMT; in 2010, that number rises to 17.9% unless Congress acts. Since the AMT tax brackets are not indexed, by April 2011, 31 million Americans would pay the AMT. The Congress' Joint Committee on Taxation describes the current AMT law in http://www.house.gov/jct/x-10-07.pdf.

Trading In "Tax Cuts for the Rich" with "Tax Cuts for the Rest of Us"

Congressional Democrats are anxious to avoid being blamed for raising taxes, especially in the first year after the American people returned them to power. At the same time, they have adopted a "pay-as-you-go" policy which requires that both tax cuts and spending increases have to be "paid for" by offsetting tax increases or spending cuts. To "pay for" permanent AMT relief and also to provide additional small tax cuts to many families, House Democrats apparently have decided to raise taxes on one million Americans at the highest income levels. The details should be released soon. What Rangel and others have said "on background" is the following. It could be changed before being released or passed by the full House.

$750 billion in Ten-year tax cuts from the "floated proposal"

- Taxpayers making $250,000 or less would no longer be subject to the AMT.
- Taxpayers making between $250,000 and $500,000 would face a smaller AMT.
- The earned income tax credit for modest income workers would be expanded.
- The child tax credit would be extended past its 2010 sunset date.

$750 billion in Ten-year tax increases from the "floated proposal"

- The top two individual income tax rates under the "regular income tax" would become 38 percent and 40 percent, up from 33 percent and 35 percent.
- Taxpayers with incomes greater than $500,000 would face higher AMT tax rates – possibly 31.5 percent, up from the current 28 percent.
- Capital gains and dividend income would be subject to the AMT, – boosting the rate on such income from 15 percent to 31.5 percent and even higher if a "phase out surcharge" remains.
- Enforcement of capital gains laws would be increased by requiring securities brokers to report purchases and sales to the IRS. Real estate brokers or settlement attorneys would have to report real estate property sales.
- Tax rules applying to the personal compensation of hedge fund managers could be increased by redefining much of their income earned under the "two percent of assets and 20 percent of profits" formula as current, ordinary income.
- Offshore "tax shelters," unspecified "outdated" deductions and credits could be targeted.

There is no realistic way to "pay for" substantial AMT repeal without making significant changes in other federal taxes, principally the regular individual income tax. Early reaction from tax-cutting conservatives is harsh. In Monday's *Wall Street Journal*, Steven Moore described the House Democratic plan, which he believes would boost the top marginal individual income tax rates even higher than the "floated proposal," as a "$650 Billion Tax Hike" concluding, "Yet Reaganomics, alive nearly everywhere else, is dead in the halls of the United States Congress."

Given the large "cost" of doing so, and the desire of Congressional Democrats to create a very popular bill by making "only the rich pay" while everyone else gets a tax cut, it is clear that House Democrats want to drive the top marginal income tax rate up, perhaps quite sharply. To think in broad terms, under the House Democrats' leaked proposal, the top 1 percent, or 1.3 million, "rich" taxpayers would see their tax rates and tax burdens leap sharply while another 40 million to 100 million received tax cuts. *There is a fifty percent chance that such a cunning plan, or something similar, will be signed into law by President Bush or be overridden by Congress if he were to veto it.*

Municipal Bond Holders: The Clear Potential Winner

One strategy for investors to take advantage of the tax punishment being prepared for the rich is to anticipate new demand for suddenly tax-favored securities. Buy investments the rich will buy later, but before they do so, because their tax rates go up. Prices on such securities may be heading higher. One clear choice is to buy municipal bonds, the longer duration the better. Any bill that becomes law is likely to help long-term municipal bond holders considerably.

Not all municipal bonds are created equal in the eyes of the U.S. Treasury, however. The interest received from owning the general obligations of state and local governments typically is free of federal tax. If state and local debt obligations are deemed to be "private activity bonds," however, they are subject to federal tax, and likely will be in the future. Caveat emptor.

For equity investors, the way to outperform may be to buy publicly-traded mutual fund companies that offer municipal bond funds. They may see an inflow of funds from "the rich" bailing out of now more highly taxes equities into the safe havens offered by munis. Here are four you may wish to consider: Schwab (**SCHW**), T. Rowe Price (**TROW**), Eaton Vance (**EV**), and Nuveen (**JNC**).

The other way may be to raise cash. It is hard to see how the U.S. equity market will like the news that the rich may be pulling out of stocks and piling into munis.

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