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Tax Extenders and the AMT Patch: Time to Pull the Plug on Congress's Annual Dance

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Abstract
A host of annual tax-reducing provisions expired on December 31, 2011. As it does each year, before restoring these policies, Congress is sure to argue about how to "pay for" extending these tax reducers, some of which have been the law for as long as 30 years. As the debate plays out, Congress should remember that continuing these tax policies—thus preventing tax increases—is not a tax cut. Not needing to offset these policies, however, does not give Congress a free pass to avoid a long-overdue assessment of the value of each of the individual provisions that make up the larger package.

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A set of approximately 50 tax-reducing provisions, commonly referred to as "tax extenders," expired on December 31, 2011. These provisions include popular measures, such as the Research and Experimentation credit for businesses and the low-income housing credit for individuals. The tax extenders also include provisions that are economically damaging, such as the ethanol credit. Congress has to extend these tax laws every year to prevent a steep tax increase for certain groups of taxpayers. When Congress votes for the extensions, it should also evaluate each policy separately and discard those that are harmful.

The most recent extension of the tax extenders was part of the bipartisan budget deal in December 2010 that also extended the income and investment tax-relief packages of 2001 and 2003 until the end of 2012. Since the extenders had lapsed for all of 2010 already, the deal's two-year extension made the extenders retroactive for 2010 and pushed them forward one more year through the end of 2011.

As part of that same deal Congress also "patched" the Alternative Minimum Tax (AMT) to keep it from hitting middle-income families. Congress originally passed the

Talking Points

- Congress must address the expiration of the annual "tax extenders"—a set of approximately 50 tax-reducing provisions—and the AMT "patch" in 2012. Without extending these provisions, a substantial tax hike will fall on individuals, families, and businesses.
- There will be pressure by some in Congress to "pay for" extending these long-established tax policies. Doing so is unnecessary because they are not new tax cuts. The government treats them as such, since it relies on a faulty baseline established by the Congressional Budget Office.
- Preventing a tax hike is important, but not having to "pay for" it does not give Congress a free pass to avoid long-overdue assessments of the individual provisions.
- Congress should weed out those policies that are economically damaging—and it should not use the resulting revenue to pay for more spending. Instead, it should provide tax relief in other deficient areas of the tax code.

AMT in the 1970s to ensure that a small number of wealthy taxpayers "paid their fair share." Sound familiar? But because Congress never indexed the income threshold over which a family qualifies for the AMT for inflation, middle-income families that Congress never intended for the AMT would qualify for it unless Congress raises that threshold annually. So, like it does for the tax extenders, Congress passes the so-called patch annually. And, as was the case for the extenders, the AMT patch had lapsed for 2010, so its two-year extension also only lasted through the end of 2011.

Congress is now grappling with extending any of these policies because some Members of Congress incorrectly insist that their extension adds to the deficit.

Congress: Disregard the Broken Baseline

Congress engages in an annual dance around "paying for" the extension of these policies as the result of a faulty revenue baseline calculated by the Congressional Budget Office (CBO) each year.[1] Congress relies on this baseline to judge whether tax provisions are tax cuts; under current budgetary conditions it is necessary for Congress to offset tax cuts so that they will not add to the deficit.

The CBO creates its baseline for *future* government spending based on current *policy*. For instance, spending on the highway program and the Children's Health Insurance Program, as well as all discretionary-spending authorization will expire at regular intervals. Since these programs constitute current policy, the CBO then assumes that Congress will extend these spending programs and the spending will continue with built-in increases.

To construct its baseline for future revenue, however, the CBO takes a decidedly different approach, by assuming current *law* (which is different from policy because it takes expiring provisions into account). This means that the CBO incorporates any impending expiring tax policies into the baseline as a jump in revenue.

In effect, when spending authorization expires, the CBO assumes that Congress actually intends for it to continue. Yet, when tax-relief provisions expire, the CBO assumes Congress truly intends for them to expire. For example, the scheduled 2013 expiration of the 2001 and 2003 tax-reduction packages causes an enormous revenue jump in the CBO's revenue baseline for 2013 and beyond. The same applies to the tax extenders and the AMT patch each year. Thus, when Congress extends current policies, such as the tax extenders, the CBO counts the extension as a revenue decline, the same as it would a new tax cut.

But extending, or making permanent, tax policies that have been in the law for up to three decades prevents a tax hike, which is not a tax cut. It is long overdue for the CBO to fix its inconsistent baseline so that it measures spending and taxes equally, and so it can avoid the troubling re-classification of tax-hike prevention as tax cuts. In the meantime, Congress should not have to accommodate the CBO's error, and the tax-relief extenders and the AMT patch do not require offsets.

Even though there is no need for an offset, Congress should not have a free pass to indiscriminately continue *all* tax extenders without a thorough analysis of each provision.

Congress: Eliminate Bad Policies

It is unsurprising that Congress allowed the extenders and AMT patch to lapse at the end of 2011. Almost every year, Congress has left families and businesses wondering whether tax provisions they have come to expect will be available for the current year. A silver lining to this otherwise uncertain situation is that Congress can use this time to take a better approach to dealing with the extenders. Congress usually continues all the extenders without in-depth analysis of the individual policies that compose the package. This is a mistake because not all the individual policies deserve annual renewal. Congress is long overdue to end its perfunctory treatment of this important tax issue.

Some policies that are included in the tax extenders, like the Research and Experimentation credit and the policies that move the tax code incrementally toward full expensing of capital investment (away from the current depreciation system), are worthy of full consideration. But many of the extenders are unsound tax policies that are more about rewarding congressionally favored activities or groups than constructing an economically efficient tax code.

Congress should examine each of the roughly 50 provisions in the tax extenders and decide which are economically unsound and which are sound policies.

Among the most egregious policies that Congress should scrap without hesitation are those that

1. Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2012 to 2022*, January 2012, at *http://www.cbo.gov/ftpdocs/126xx/doc12699/01-31-2012_Outlook.pdf* (February 15, 2012).

incentivize the production or use of alternative energy. It is not the purpose of the tax code to tilt the energy market in favor of certain fuel sources to the disadvantage of others. This puts the tax code, and Congress, in the position of picking winners and losers among different fuel sources. The market should sort out the best sources of fuel without government interference.[2] Policies in the extenders that interfere in the energy market include:

- Credits for producing bio-diesel and renewable diesel;
- Credits for producing or selling alternative fuel and alternative fuel mixtures;
- The Alternative Fuel Vehicle Refueling Property Credit (credit for installing alternative-fuel mechanisms); and
- Income tax credits and excise tax credits for producing or using ethanol.

Congress is also fond of using the tax code to entice homebuilders and homeowners to increase the energy efficiency of houses and appliances. It is not the job of the tax code to award benefits to taxpayers that engage in congressionally favored activities. When Congress uses the tax code to encourage certain activities, thereby discouraging others, it shifts resources from non-favored areas of the economy to the favored sectors. The result is a less efficient allocation of the nation's resources. Policies in the tax extenders that favor allegedly energy-efficient products and that Congress should abolish include:

- Credit for construction of homes designated by the government as energy efficient;
- Credit for producing appliances designated by the government as energy efficient; and
- Credit for improving the energy efficiency, as defined by the government, of existing homes.

Congress also likes to use tax policy to direct private investment to particular areas of the country. When Congress does this, it reduces the beneficial impact of that new investment because those resources no longer go to the areas of the country where the market perceives they will earn the highest return, but where Congress decided. Policies that Congress should end that alter investment decisions include:

- New-markets tax credit; and
- Tax incentives for investment in the District of Columbia.

Congress: Don't Raise Taxes

Eliminating such "favoritism policies," however warranted, would constitute a tax *increase*. For this reason, Congress should treat the elimination of unsound policies in the tax extenders as a small-scale tax reform and reduce other taxes by the amount of revenue that eliminating those unsound policies would raise.

Congress should take the opportunity to improve a few areas of the tax code that are among the biggest impediments to economic growth and job creation. There is no shortage of options. Congress could:

- Lower marginal income tax rates as an intermediate step to larger-scale tax reform where rates would be reduced further;
- Reform the corporate income tax system by lowering the rate and moving toward a territorial system of taxation, away from the current system which taxes businesses on their worldwide income;
- Abolish the AMT;
- Lower the tax rate on small businesses; or
- Make permanent the policy that allows businesses to expense their purchases of capital expenditures rather than depreciate them over a number of years.

AMT Patch. As for the AMT patch, failing abolishing the AMT completely, Congress should make the patch permanent immediately. Since the AMT was never meant to fall on middle-income families and the patch is a long-held policy, Congress does not need to pay for doing so. By making it permanent Congress can spare taxpayers the annual fear that it may inflict a large, painful, and unnecessary tax hike should it fail to protect them from a tax never intended for them.

Conclusion

Now that Congress has allowed the tax extenders to lapse for 2012, it should take the time to address the individual policies in the entire package, rather than rush to extend them all like it has done time and again. While businesses and families do need the certainty of knowing

2. Nicolas D. Loris, "Real Energy Tax Reform Eliminates Subsidies," Heritage Foundation *WebMemo* No. 3404, November 3, 2011, at *http://www.heritage.org/research/reports/2011/11/real-energy-tax-reform-eliminates-subsidies*.

what will become of tax policies they enjoy, Congress can better serve the economy—and taxpayers—by ridding the extenders of harmful policies and using the revenue raised by the abolished provisions to reduce the damage that high marginal tax rates and the heavy taxation of investment inflict on the economy.

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