BACKGROUND BRIEF: THE ALTERNATIVE MINIMUM TAX

November, 2007

Introduction

The alternative minimum tax (AMT) was designed almost forty years ago as a parallel tax system to prevent individuals with very high incomes from using special tax credits and deductions to pay little or no tax. It was not intended to become a major source of revenue for the federal government, but simply a fix to a loophole in the income tax code. But for various reasons the AMT impacts more people every year, including some taxpayers with moderate income and some taxpayers who do not receive lots of special tax benefits or deductions.

The AMT has also become an indispensable element of the tax code as it currently raises about $70 billion annually for the federal government, with that figure projected to double in the next five years.[1] The enormous magnitude of the AMT's reach and the government's considerable and growing dependence on it to finance its operations make reform a two-pronged challenge. The tax is a vital source of revenues for the government, revenues that will have to be replaced somehow since outright repeal would increase annual deficits by as much as thirty percent.

Rep. Charles Rangel (D-NY), chairman of the House Ways and Means Committee, is introduced a major ATM reform package this October, but it is unlikely to see much action in Congress before next year. Instead, Congress will almost definitely pass what is called a "patch" to the AMT – legislation that freezes the number of taxpayers who currently must pay the tax. In order to help provide context for the upcoming debate in Congress on the AMT, this background brief explains the operations of the AMT, its scope, and impact.

History of the AMT

The Alternative Minimum Tax was introduced into the tax code in 1970. In January 1969, Treasury Secretary Joseph W. Barr informed Congress that 155 wealthy individual taxpayers with incomes exceeding $200,000 (over $1 million in 2006 CPI-adjusted dollars) had paid no federal income tax in 1966.[2]

The news set off a political firestorm, with citizen pressure on Congress to investigate and remedy the inequity. Members of Congress were deluged with more constituent letters about the untaxed 155 in 1969 than about the Vietnam War.[3] Later that year, Congress enacted legislation that created a minimum tax to prevent wealthy individuals from taking undue advantage of tax

[1] Tax Policy Center (Nov 10, 2006) - T06-0266 - Aggregate AMT Projections, 2006-2017
[2] Jon Feld, Alternative Minimum Tax May Bring a Big Bill, Fidelity Investor's Weekly, February 20, 2004
[3] Op. cit.

laws to reduce or eliminate their federal income tax liability through special deductions, special credits for expenses, and preferential treatment of some income.

The new law helped to reduce the number of high-income taxpayers who otherwise would have paid no income tax. But the AMT has never been completely successful in attaining the original goal of ensuring all high-income taxpayers would pay their share of income taxes.

In 1970, only 19,000 taxpayers owed an AMT.[4] The AMT has been modified several times since and its scope has grown exponentially. Recently, the combined effects of inflation and the tax cuts to the regular income tax enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001, the Jobs and Growth Tax Relief Reconciliation Act of 2003, and the Working Families Tax Relief Act of 2004 have increased congressional concern about the expanding impact of the AMT. It is now estimated by the Congressional Research Services that if the cuts to the regular income tax are made permanent, the number of taxpayers subject to the AMT will increase from about 1.8 million in 2001 to over 41 million by 2013.[5]

This means patching or reforming the AMT becomes an increasingly expensive proposition. It is estimated repealing the AMT would cost from $718 billion to over $1 trillion between 2006 and 2016, depending on whether the tax cut provisions are extended beyond 2010. Indeed, some projections suggest by 2008 it would be less costly to repeal the regular income tax than to repeal the AMT.[6]

Last year, about three million taxpayers paid some amount of alternative minimum tax. Without congressional reform, or a “patch” to freeze the number of taxpayers currently liable, it is estimated close to 23 million taxpayers will be subject to the AMT next year.[7]

Operations and Structure of the AMT

The AMT acts as a second income tax operating parallel to the regular income tax. The AMT has its own tax base, exemption amounts, tax rates, and usable tax credits, just like the regular income tax. The amount of AMT a taxpayer owes is the amount of taxes owed as calculated under the separate AMT tax rules minus the amount calculated under the regular income tax rules.

So how do AMT rules differ from the regular income tax rules? In a nutshell, the income base for taxpayers is broadened under the AMT by disallowing certain tax credits and deductions permitted under the regular income tax, such as:

- the itemized deduction for state and local taxes;
- the itemized deduction for medical expenses to the extent it represents medical expenses of less than 10 percent of adjusted gross income (AGI);

[4] Hoover Institution: Facts on Policy: Alternative Minimum Tax, April 17, 2007
[5] CRS Report for Congress, The Alternative Minimum Tax for Individuals, RL30149, May 22, 2006. http://opencrs.cdt.org/rpts/RL30149_20060522.pdf
[6] Op. cit.
[7] Tax Policy Center (Nov 10, 2006) - T06-0266 - Aggregate AMT Projections, 2006-2017

- the standard deduction;
- personal exemptions.

In order to file their taxes accurately, taxpayers subject to the AMT must calculate their tax liability twice: once under regular income tax rules and again under the separate AMT rules. If their liability under the AMT rules is higher, taxpayers pay the difference between the two in addition to their regular income tax liability.

Example of Calculating the AMT in 2007 [8]

A married couple with four children under age 17 has an income of $75,000 from salaries and interest on their savings account. Under the regular income tax, the family can deduct $20,400 in personal exemptions for themselves and their children. They can also claim a $10,700 standard deduction. For the regular tax, their taxable income of $43,900 places them in the 15 percent tax bracket, and they owe $5,803 in taxes before calculating the AMT or tax credits. A child tax credit of $4,000 ($1,000 per child) is allowed against both the AMT and the regular income tax. Their regular income tax after credits would be $1,803.

To calculate AMT liability, the couple adds preference items—personal exemptions of $20,400 and the standard deduction of $10,700—to taxable income and subtracts the married-couple exemption of $45,000, yielding $30,000 in income subject to AMT. That amount is taxed at the first AMT rate of 26 percent, for a tentative AMT liability of $7,800. The AMT equals the difference between the couple's tentative AMT and their regular income tax, or $1,997. Thus, the AMT more than doubles this couple's taxes—from $1,803 to $3,800.

<u>Married Couple Filing Jointly with Four Children, 2007</u>

Calculate Regular Tax		Calculate Tentative AMT	
Gross income	$75,000	Taxable income	$43,900
Subtract deductions		*Add preference items*	
Personal exemptions			
(6 x $3,400)	$20,400	Personal exemptions	$20,400
Standard deduction	$10,700	Standard deduction	$10,700
Taxable income	$43,900	AMT Income	$75,000
Tax before credits	$5,803	*Subtract AMT exemption*	
Child tax credit	$4,000	AMT exemption	$45,000
		Taxable under AMT	$30,000
Tax bracket	15%	AMT bracket	26%
Tax after credits	**$1,803**	**Tax (tentative AMT)**	**$7,800**

- **AMT = the excess of tentative AMT over regular income tax before credits**
- **Tax after AMT and Credits = $1,803 + $1,997 = 3,800**
- **AMT = $7,800 - $5,803 = $1,997**

[8] Example adapted from Leonard E. Burman and David Weiner: Suppose They Took the AM Out of the AMT? The Urban–Brookings, Tax Policy Center Discussion Paper No. 25, August 2005.

The Expanding Scope of the AMT

The AMT will affect a rapidly increasing number of taxpayers in future years if no changes are made for two reasons: 1) because the AMT rules were never indexed for inflation, and 2) the Bush tax cuts of 2001 and 2003 substantially lowered taxpayers' liability under the regular income tax without changing the structure of the AMT. The reduction in taxpayers' liability under the Bush tax cuts actually increased the number of people paying the AMT by bringing the amount they owe in regular income tax below what they owe under the AMT for the first time. Therefore, substantially reducing households' taxes under the regular income tax without changing what they owe under the AMT inevitably increased the number of households that owe the AMT, as well as the amount of revenue the AMT collects.

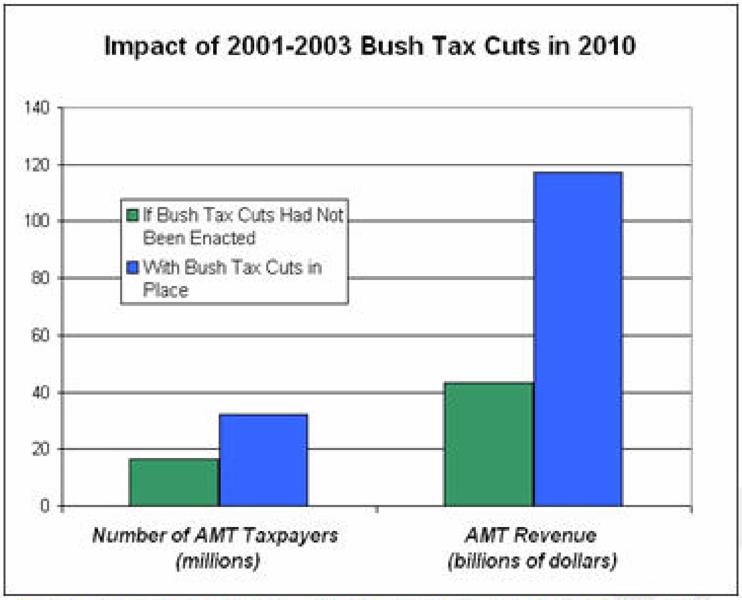

Chart adapted from Center on Budget and Policy Priorities: Myths and Realities about the Alternative Minimum Tax. Available on the web: http://www.cbpp.org/2-14-07tax.htm

This fact was an often overlooked aspect of the tax cuts proposed by President Bush during his first term. By not changing the AMT and reducing regular income tax rates, the total price tag for the tax cut packages was artificially low. Further, some taxpayers who thought they should receive a tax cut had their projected savings eaten up by the AMT.

Unintended Consequences and Anomalous Outcomes

The AMT significantly complicates the U.S. tax code, both for individual citizens seeking to comply with the law and for Congress and the executive branch in developing sound, equitable tax policy.

The National Taxpayer Advocate (NTA), the Internal Revenue Service (IRS), and Leonard Burman of the Tax Policy have called the AMT one of the most difficult tax law areas to comply with and administer. Complexity in the tax code may be justifiable if it allows policymakers to produce a fairer, more efficient tax system, but many, even those in the IRS, recognize that the AMT produces anomalous outcomes, policy distortions, and others problems. Chief among these are:

- Failure to Index AMT Exemptions for Inflation. Regular income tax standard deductions, exemptions and filing thresholds are all adjusted for inflation each year, but the AMT exemption amounts are not. The absence of an AMT indexing provision is largely responsible for the increasing numbers of middle-class taxpayers subject to the AMT.

- Disproportionate Impact on High-Tax State Residents. Because the separate AMT rules do not allow deductions for state taxes, filers in high-tax states are also more likely to face the AMT to a surprising degree. The three highest-ranking states in terms of AMT filers are:
    1. California -- 607,000 AMT returns in 2004; $2.91 billion in AMT taxes paid;
    2. New York-- 437,000 returns; $2.14 billion in AMT taxes paid;
    3. New Jersey -- 228,000 returns; $800 million in AMT taxes paid. [9]

  These three states alone account for 40 percent of the country's 3.15 million AMT returns and 46 percent of the $12.9 billion AMT dollars paid nationally. Texas, a state with a 200 percent larger population than New Jersey has roughly half the number of AMT filers.

- Impact on "Wrong" Taxpayers. The AMT no longer targets just wealthy taxpayers engaged in tax avoidance. The number of AMT filers is projected to grow to 32.4 million by 2010 [10] In that year, among taxpayers with incomes between $100,000 and $200,000, a staggering 80 percent will be subject to the AMT. Even more notable, the AMT will affect a higher percentage of taxpayers with incomes between $75,000 and $100,000 (50 percent) than taxpayers making more than $1 million (39 percent).[11]

- Complexity. The individual AMT computations are completely separate from the regular income tax computations. Per the process outlined above, taxpayers may need to fill out a 16-line worksheet and then a 55-line form just to determine whether they are subject to AMT in the first place.

- Adverse Impact on Large Families. Personal exemptions are allowed against the regular income tax, but not the AMT. Taxpayers with large families have many personal exemptions (dependents), which significantly reduce their regular income tax liability compared to the AMT. In 2006, taxpayers with three or more children were almost four times as likely to owe AMT as those with no children. By 2010, almost half of families with three or more children will find themselves on the AMT, compared to only 17 percent of those without children.[12]

- Adverse Impact on Married Couples: Most married couples pay less tax under the regular income tax than they would if they were single. Most "marriage penalties" have been eliminated and many couples receive "marriage bonuses." This is not true under the AMT. AMT tax rate thresholds are identical for married and single taxpayers and the AMT exemption is only 33 percent larger for couples than for singles.

[9] Statement of Michael J. Graetz, Professor of Law, Yale Law School at a Hearing of the Senate Finance Committee on the Alternative Minimum Tax (AMT), June 27, 2007. See Table 3 State and Local Tax Deductions by State, Tax Year 2002 and Table 4, Alternative Minimum Tax by State, Tax Year 2005

[10] Tax Policy Center, The Individual Alternative Minimum Tax: Historical Data and Projections, Greg Leiserson and Jeff Rohaly, November 10, 2006.

[11] Written Statement of Nina E. Olson National Taxpayer Advocate before the Subcommittee on Select Revenue Measures Committee on Ways and Means, U.S. House of Representatives on the Alternative Minimum Tax, March 7, 2007.

[12] Leonard E. Burman, Director, Tax Policy Center, Testimony before the Subcommittee on Select Revenue Measures, House Ways and Means Committee, The Individual Alternative Minimum Tax, March 7, 2007.

By contrast, the standard deduction for couples under the regular income tax is twice that for singles. The combination of the AMT marriage penalties, the fact married couples often have children, and the fact married couples tend to have higher household incomes resulted in married couples being more than five times as likely to owe AMT as singles in 2006. In 2007, with expiration of the temporary AMT fix, married couples will be 15 times more likely to owe AMT than singles.[13]

- Unpredictability of Estimated Tax Payments. Because the law is so complicated, it is difficult, if not impossible, to predict whether an individual will be subject to the AMT without going through all the calculations necessary to pay the tax at the end of the year. This uncertainty causes problems in paying the correct estimated tax for the year and can result in penalties for underpayment. In tax year 2004, for example, 17.1 percent of AMT returns reported an estimated tax penalty on the return as compared with 3.7 percent of non-AMT returns.[14]

Conclusion

AMT reform will be debated and reform measures will be judged for how they address the rapidly expanding scope of the tax – and correspondingly exponentially increasing revenues it raises – as well as policy distortions, unintended inequities, and complexity, Indeed, the enormous magnitude of the AMT's reach and the government's considerable and growing dependence on it to finance its operations make reform a two-pronged challenge. As the debate goes forward, whether about a short-term "patch" to halt its growth for now, or about a wholesale repeal of the tax, we will watch out and advocate for four points:

- adherence to the principles of PAYGO so any action taken does not add to our national debt burden;
- sustained progressivity, one of the actual benefits and a hallmark of the AMT harking back to its original conception;
- simplification, so taxpayers are not surprised to find themselves caught in AMT's widening web and confused by its myriad and sometimes paradoxical rules; and most importantly
- elimination of the sources of understandable resentment of taxpayers who must perform two calculations of their tax liability – and write a check for the larger of these two amounts.

[13] Burman, op. cit.
[14] Olson, op. cit.

Appendix A: Comparison of Regular Income Tax and ATM Provisions

The table below provides a side-by-side comparison of the major provisions of the regular individual income tax and the AMT, adapted from a paper by Leonard E. Burman and David Weiner, Suppose They Took the AM Out of the AMT? The Urban–Brookings, Tax Policy Center Discussion Paper No. 25, August 2005:

Provisions	Treatment under regular tax	Treatment under AMT
Marginal tax rates	10%, 15%, 25%, 28%, 33%, and 35%. Brackets are indexed for inflation.	26% and 28% (32.5% and 35% for taxpayers in the phase-out range of exemptions). Not indexed for inflation.
Standard deduction/exemption	Deduction of $9,700 for married taxpayers filing jointly, $4,850 for single taxpayers, and $7,150 for heads of households allowed in 2004 for those who do not itemize deductions. Indexed for inflation.	AMT exemption (equivalent to a deduction) of $58,000 for married taxpayers filing jointly and $40,275 for single taxpayers and heads of household in 2005; $45,000 and $33,750 thereafter (not indexed for inflation). Exemption phases out at 25% rate for high-income taxpayers.
Personal exemptions	Deduction of $3,100 per family member and dependent allowed against regular tax in 2004. Indexed for inflation. Phased out for high-income taxpayers.	Not allowed.
Head of household status	Single heads of household qualify for lower tax rates and larger standard deductions than singles.	Heads of household face the same tax rates and AMT exemption as singles.
Itemized deductions	Allowed under regular tax if standard deduction is not taken. Itemized deductions phase out at 3% rate for taxpayers with higher incomes (certain items do not phase out).	If deductions are itemized under regular tax, tax preference items are subtracted from the deductions for AMT purposes. No phase-out for higher-income taxpayers.
State and local tax deductions	Income and property taxes are allowed as itemized deductions. Sales taxes are allowed for 2004 and 2005.	Not allowed.
Miscellaneous deductions	Miscellaneous expenses including tax preparation fees, unreimbursed employment expenses, and certain legal fees in excess of 2% of AGI are allowed as itemized deductions.	Not deductible.
Home mortgage interest	Mortgage interest for the first or second home and second mortgages and home equity lines are deductible subject to certain limits	Only deductible if the proceeds are used to improve, buy, or build the taxpayer's home.
Unreimbursed medical expenses	Expenses in excess of 7.5% of AGI are allowed as itemized deductions.	Expenses in excess of 10% of AGI are allowed as itemized deductions.
Treatment of capital gains and dividends	Dividends and capital gains taxed at 5% and 15% from 2005 to 2008; 0% and 15% in 2008. Capital gains taxed at 10% and 20% from 2009 onwards while dividends are taxed as regular income.	Same.
Net operating loss	Deducted from taxable income.	Not deductible, but may be carried forward to offset future income.
Incentive stock options	Exercising an ISO generates no tax liability. Selling the stock generates capital gains taxes on the difference of the sale price and the option price.	Exercising a stock option generates taxable income equal to the difference between the exercise price and the option price if the stock is not sold within the same year. Selling the stock generates capital gains taxes on the difference between the sale price and the exercise price.

Provisions	Treatment under regular tax	Treatment under AMT
Other timing preferences	Depreciation of equipment, oil depletion allowances, allowances for intangible drilling costs, or mining exploration and development costs are allowed under regular tax.	Deductions for timing preferences are allowed at a slower rate under the AMT. These preferences generate the AMT credit, which can be taken against regular tax liability in the future years. However, these credits cannot be used to lower regular tax liability below the tentative liability for that year.
Child, adoption, and savers credits	Allowed against regular tax.	Allowed against AMT until 2010. (Savers credit expires after 2006.)
Refundable credits	Allowed against regular tax.	Same.
Foreign tax credit	Allowed against regular tax.	Same.
Nonrefundable personal credits other than above	Allowed against regular tax.	Allowed against AMT through 2005. Not allowed thereafter.
Business tax credits	Allowed against regular tax.	Only certain ones allowed.