REVENUE AND TAX POLICY BRIEF

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The Alternative Minimum Tax

For more than three decades, the individual income tax has consisted of two parallel tax systems: the regular tax and an alternative tax that was originally intended to impose taxes on high-income individuals who have no liability under the regular income tax. The stated purpose of the alternative minimum tax (AMT) is to keep taxpayers with high incomes from paying little or no income tax by taking advantage of various preferences in the tax code. The AMT does so by requiring people to recalculate their taxes under alternative rules that include certain forms of income exempt from regular tax and that do not allow specific exemptions, deductions, and other preferences. For most of its existence, the AMT has affected few taxpayers, less than 1 percent in any year before 2000, but its impact is expected to grow rapidly in coming years and affect about one-fifth of all taxpayers in 2010. In her 2003 report to the Congress, the Internal Revenue Service's National Taxpayer Advocate, Nina Olson, labeled the AMT "the most serious problem faced by taxpayers."[1]

Unlike the regular income tax, the AMT is not indexed for inflation. The accumulating effect of inflation is a key source of growing AMT coverage.

The expanding reach of the AMT imposes costs beyond higher tax liability. Not only must taxpayers complete the regular income tax returns, but more of them will need to complete the AMT forms, whose definitions of taxable income, deductible expenses, and exemptions differ from those of the regular income tax. The required calculations increase both the complexity and time required to comply with tax laws, although computer software may mitigate those costs. Taxpayers' potential liability for the AMT complicates many of their decisions beyond the tax forms themselves, including when to earn income and when to pay for potentially deductible activities.

1. Internal Revenue Service, *National Taxpayer Advocate 2003 Annual Report to Congress* (December 31, 2003), p. 5.

A range of options could address the growth of the AMT. At one extreme, extending the exemption level in effect for 2004 would postpone the expansion of AMT coverage. The revenue consequences of doing so would depend on the duration of the extension: extending it just for 2005 would cut revenues by about $18 billion.[2] Another option—indexing the AMT parameters for inflation—would prevent the alternative tax from growing simply because incomes keep pace with inflation and would lower receipts by $370 billion over the 2005-2014 period. At the other extreme, eliminating the AMT altogether would reduce revenues by nearly $600 billion over the next 10 years under current law.[3]

Calculating the AMT

Technically, the AMT is not an "alternative" tax. It is defined as the addition to regular income taxes, equal to the amount, if any, by which AMT liability exceeds regular tax liability (after applying appropriate credits). Taxpayers who potentially owe AMT must recalculate taxable income as defined by the AMT, apply alternative tax rates, allow for credits and other factors, and compare the resulting tentative AMT liability against regular tax liability. Even though the AMT is technically the excess of AMT over regular tax liability, taxpayers effectively calcu-

2. Those and all other estimates of changes in tax receipts reported in this brief are from the Congressional Budget Office. They are based on CBO's economic assumptions through 2014 and derive from CBO's tax model. As a result, they may differ from official revenue estimates that the Joint Committee on Taxation might produce.

3. That revenue cost assumes that the expiration of provisions in the Economic Growth and Tax Relief Reconciliation Act of 2001 occurs as scheduled. See Congressional Budget Office, *Budget and Economic Outlook: Fiscal Years 2005 to 2014* (January 2004), p. 81. If those tax provisions were made permanent, the cost of repeal would increase by about $300 billion over the 2005-2014 period.

late their taxes under two systems and pay the higher of the two liabilities.

For the two-thirds of tax filers who claim the standard deduction, the process is fairly simple. If they elect not to itemize their deductions, they just subtract the AMT exclusion—$58,000 for married taxpayers filing jointly and $40,250 for most other taxpayers in 2003 and 2004—from adjusted gross income (AGI) and apply the two-step tax rates of 26 percent on the first $175,000 and 28 percent on any excess.[4] If that amount exceeds their precredit regular tax liability, they owe the excess as AMT. In 2001, only about 6 percent of the 1 million taxpayers affected by the AMT claimed the standard deduction on their regular tax return.[5] That share is projected to rise to nearly one-third of the projected 29 million taxpayers who will owe AMT in 2010.

The process is more complicated for the one-third of taxpayers who itemize their deductions. They calculate taxable AMT income by adding to regular taxable income their personal exemptions and specific deductions—state and local taxes, unreimbursed business expenses, other miscellaneous deductions, and otherwise deductible medical expenses up to 2.5 percent of AGI—and then subtracting the appropriate AMT exemption. Applying AMT rates yields their precredit tentative AMT liability (see Box 1 on page 5 for an example).[6] AMT liability is the excess, if any, of precredit tentative AMT liability over regular precredit tax liability.

Under current law, taxpayers may claim personal refundable credits—the earned income credit and the child credit—against the AMT.[7] Among other personal credits, however, only the adoption, child, and individual retirement account credits are allowed without restriction against the AMT. Taxpayers may claim other personal credits and the general business credits only against their regular tax liability, and thus only to the extent that their regular tax liability exceeds their AMT liability.[8] Any unused business credit may be carried forward or backward for use against regular taxes.

For some taxpayers, AMT calculations are even more complicated. People who incur net operating losses, deduct accelerated depreciation of business assets, receive particular kinds of stock options, or engage in other selected activities that get preferential tax treatment face complex rules that determine whether they must pay the AMT. Some additions to and subtractions from income may be shifted forward or backward in time, thus requiring additional recordkeeping. Other preferences may apply only in specific circumstances. For taxpayers in such situations, the AMT involves much more than a handful of additional calculations.

Projected Growth of the AMT

Until 2000, less than 1 percent of taxpayers paid the AMT in any year. Under current law, however, the number of taxpayers affected by the AMT will grow from just over 1 million in 2001 to nearly 30 million in 2010 before falling back to about 23 million in 2014 after the expiration of the 2001 and 2003 tax cuts (see Figure 1). Twenty percent of all taxpayers—and 40 percent of married couples—will owe AMT in 2010. AMT receipts in 2010 will total about $90 billion, roughly 7 percent of total individual income tax revenue. Nevertheless, the AMT is only partially successful in imposing tax liabilities on all high-income people: in 2001, nearly 1,100 tax filers with AGI above $500,000 paid federal income taxes only because of the AMT,[9] but almost 900 people in that income range paid no federal income tax at all despite the

4. Married taxpayers filing separately have an exemption of $29,000. After 2004, the exemptions return to pre-2001 levels of $45,000 for joint filers, $33,750 for most other taxpayers, and $22,500 for married couples filing separately. The exemption phases out at a rate of 25 cents for each dollar of alternative minimum tax income (AMTI) above $150,000 for joint filers, $112,500 for single filers and heads of household, and $75,000 for married taxpayers filing separately. See further discussion on page 3.

5. In fact, the AMT may cause some taxpayers to itemize deductions, even though their itemized deductions are less than the standard deduction. See further discussion on page 5.

6. If the taxpayer qualifies for foreign tax credits, those credits are subtracted from precredit tentative AMT liability, yielding tentative AMT liability. Foreign tax credits, however, can reduce precredit tentative AMT liability by no more than 90 percent.

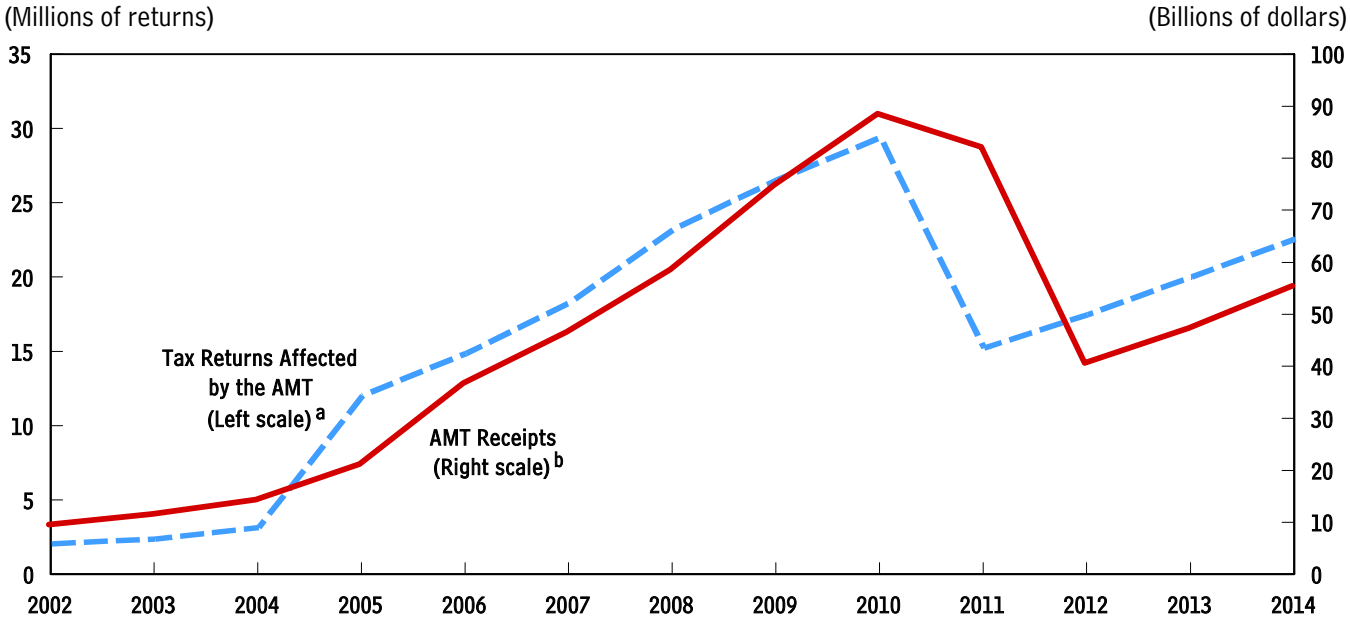
7. This discussion of the treatment of credits derives from Leonard E. Burman and others, *The Individual AMT: Problems and Potential Solutions,* Urban-Brookings Tax Policy Center Discussion Paper No. 5 (Washington, D.C.: Urban Institute, September 2002).

8. Legislation that expired in 2003 allowed taxpayers to claim personal nonrefundable credits against the AMT.

9. Other taxpayers who owe tax only because of credits disallowed by the AMT are excluded from that estimate.

Figure 1.

Projected Effects of the Individual Alternative Minimum Tax



Source: Congressional Budget Office.

a. Calendar year basis.

b. Fiscal year basis.

AMT.[10] Whether a particular taxpayer will have AMT liability depends primarily on income, number of dependents, and whether he or she lives in a locality with high property and state income taxes.

The AMT exemption protects most low-income taxpayers, and the maximum 28 percent alternative tax rate keeps most taxpayers with the highest incomes off the AMT. Among taxpayers with income below $50,000, no more than 6 percent will have AMT liability in any of the next 10 years, and that percentage will be reached only in 2014 as inflation erodes the value of the exemption (see Figure 2).[11] At the other end of the income distribution, high-income taxpayers tend not to have AMT liability because a large portion of their income is taxed at regular rates that exceed AMT rates; thus, they have high regular tax liability. Even so, about 30 percent of taxpayers with AGI over $500,000 will pay the AMT in 2010, the peak year. In comparison, about two-thirds of taxpayers with AGI between $50,000 and $100,000 will have AMT liability in 2010.

Taxpayers with AGI between $100,000 and $500,000 will be hit hardest by the AMT: in 2010, over 90 percent of them will have AMT liability. Much of their income is taxed at 25 percent or less under the regular tax, compared with the 26 percent and 28 percent rates for the AMT. As inflation erodes the value of the AMT exemption, more of their income is subject to the alternative tax. In addition, the AMT exemption phases out starting at $150,000 of alternative minimum tax income (AMTI) for married couples filing jointly, raising their marginal AMT rates by one-fourth (to 32.5 percent and 35 percent) until AMTI exceeds $382,000.[12]

Married couples filing jointly are more likely to have AMT liability than unmarried taxpayers with similar in-

10. Some of those taxpayers are exempt from U.S. tax because they claim foreign tax credits.

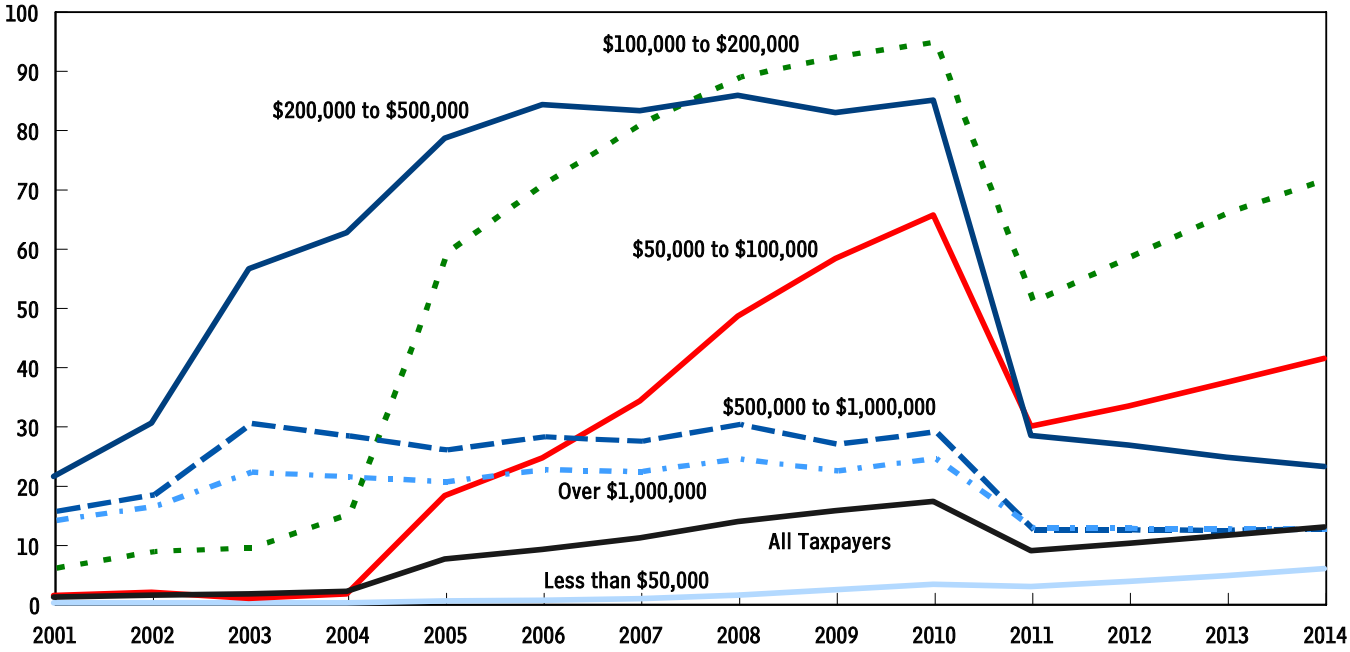
11. Income categories used in this brief are measured in 2003 dollars.

12. AMTI equals AGI plus AMT preferences and adjustments. The phaseout of the exemption occurs for singles with AMTI between $112,500 and $286,500 and for married couples filing separately with AMTI between $75,000 and $191,000, raising their effective tax rates in those income ranges.

Figure 2.

Taxpayers with AMT Liability, by Adjusted Gross Income in 2003 Dollars, Calendar Years 2001 to 2014

(Percentage of taxpayers)



Source: Congressional Budget Office.

comes. For example, CBO projects that about 95 percent of married taxpayers with AGI between $100,000 and $200,000 will owe AMT in 2010, compared with 84 percent of single filers in the same income category. Married couples face the same AMT tax brackets as other taxpayers, and their AMT exemption is only one-third larger than that of their unmarried counterparts. In contrast, the regular tax brackets and standard deduction for married couples are relatively larger—twice as large as those for single taxpayers for all but high-income taxpayers. Furthermore, because married couples generally have more dependents than single taxpayers and can claim a personal exemption for each spouse, they are hit harder by the loss of exemptions under the AMT. Similarly, taxpayers who live in places with high state and local taxes are more likely to pay the AMT than their counterparts in low-tax areas because the alternative tax denies them a deduction for those taxes.

None of the AMT parameters are adjusted for inflation. In contrast, the basic parameters of the regular income tax are increased annually to keep pace with prices. Consequently, if incomes grow only at the rate of inflation (that is, nominal incomes rise but real incomes do not), potential AMT liability increases in real terms while regular tax liability does not (see Box 2 on page 6). As a result, the simple growth of nominal incomes subjects more taxpayers to the AMT over time.

As a result of the interaction between the regular income tax and the AMT, changes in the regular tax are likely to affect the number of taxpayers liable for the AMT. An increase in regular taxes for people now subject to the AMT may move them off the AMT if their larger regular tax exceeds their tentative AMT liability. Conversely, a tax cut may increase the number of taxpayers who must pay the AMT. Avoiding those possible effects requires that changes in the regular income tax be accompanied by commensurate adjustments to the AMT. At the same time, not making such adjustments reduces the revenue gains or losses from changes in the regular income tax: tax increases yield less additional revenue and tax cuts are less costly than they would otherwise be.

Box 1.

Calculating the Alternative Minimum Tax

Consider a married couple with three children and income of $140,000, all in wages, in 2004. The couple pays $10,000 in mortgage interest and $17,000 in state and local taxes.

Under the alternative minimum tax (AMT), the couple loses their five personal exemptions and their deduction of state and local taxes. They are allowed the AMT exemption of $58,000. Graduated regular tax rates of 10 percent, 15 percent, and 25 percent apply. Under the AMT, their tax is 26 percent of AMT taxable income.

AMT Calculation

(Dollars)

2004 Regular Tax		2004 Alternative Minimum Tax	
Income	140,000	Income	140,000
Minus exemption: 5 x 3,100	-15,500	Minus mortgage interest	-10,000
	124,500		130,000
Minus mortgage interest	-10,000	Minus AMT exemption	-58,000
Minus state and local taxes	-17,000		
Taxable Income	97,500	AMT Taxable Income	72,000
Tax[a]		AMT[a]	
(Top rate of 25 percent)	17,850	(26 percent of taxable income)	18,720
		Minus Regular Tax[a]	-17,850
		AMT Liability	**870**

Source: Congressional Budget Office calculations based on 2004 tax parameters.

a. Before applying a child tax credit of $1,450, which applies under both the regular tax and the AMT.

Economic Effects and Burden of the AMT

The AMT imposes multiple costs on taxpayers and the economy. Most directly, it increases individual tax liabilities and adds complexity to the calculation of taxes. But it also may affect people's behavior in ways that have an adverse impact on the economy. Both kinds of costs must be taken into account in evaluating the alternative tax.

Although the basic AMT calculation appears to be simple, it is complex in a variety of ways. For example, it vastly complicates one of the most basic of questions: whether to itemize deductions. In the regular income tax the choice is easy: sum up all deductions that may be itemized, adjust for the phaseout if applicable,[13] compare the result with the appropriate standard deduction, and claim the larger of the two amounts. In calculating their AMT liability, taxpayers must use the same choice for deductions as for the regular tax: either itemize or claim the standard deduction. Taxpayers who claim the standard deduction on the regular tax cannot itemize deductions for the AMT. Because some itemized deductions may be

13. In 2004, taxpayers with AGI above $142,700 must reduce many of their itemized deductions by 3 percent of AGI in excess of that threshold amount but only up to a maximum of 80 percent.

Box 2.

The Effect of Inflation on the Alternative Minimum Tax

Consider a married couple with two children and income of $120,000, all wages, in 2004. They claim four personal exemptions ($3,100 each) and the standard deduction ($9,700). Assume that inflation is 5 percent every year so the regular income tax parameters are increased annually by 5 percent. The couple's income also grows at 5 percent each year and is thus constant in real terms.

For the first three years, the couple pays only the regular income tax. Beginning in 2007, however, inflation moves them onto the alternative minimum tax (AMT), which claims ever larger amounts in subsequent years. Note that the effective regular tax rate remains constant at 14.96 percent over the period, while the effective AMT rate rises from13.43 percent in 2004 to 16.15 percent in 2009.

Effect of Inflation on the AMT

(Dollars)

	2004	2005	2006	2007	2008	2009
			Regular Tax			
Adjusted Gross Income	120,000	126,000	132,300	138,915	145,861	153,154
Minus exemptions (4)	12,400	13,020	13,671	14,355	15,072	15,826
Minus standard deduction	9,700	10,185	10,694	11,229	11,790	12,380
Taxable Income	97,900	102,795	107,935	113,331	118,998	124,948
Regular Tax[a]	**17,950**	**18,848**	**19,790**	**20,779**	**21,818**	**22,909**
			Alternative Minimum Tax			
Adjusted Gross Income	120,000	126,000	132,300	138,915	145,861	153,154
Minus AMT exemption	58,000	58,000	58,000	58,000	58,000	58,000
AMT Taxable Income	62,000	68,000	74,300	80,915	87,861	95,154
AMT[a]	**16,120**	**17,680**	**19,318**	**21,038**	**22,844**	**24,740**
AMT Liability (Excess of AMT over regular tax)	0	0	0	259	1,025	1,831
			Tax Liability			
Total	**17,950**	**18,848**	**19,790**	**21,038**	**22,844**	**24,740**
			Effective Tax Rates (Percent)			
Regular Tax	14.96	14.96	14.96	14.96	14.96	14.96
AMT	13.43	14.03	14.60	15.14	15.66	16.15
Total	**14.96**	**14.96**	**14.96**	**15.14**	**15.66**	**16.15**

Source: Congressional Budget Office calculations based on 2004 parameters.

a. Before applying a child tax credit, which applies under both the regular tax and the AMT.

claimed under the AMT, however, some taxpayers subject to the AMT have lower total tax liability if they claim itemized deductions that total less than their standard deduction. The issue doubles to four the number of potential liabilities the taxpayer must calculate to determine whether he or she is liable for the AMT and how to pay the lowest amount of tax.[14]

Much of the complexity created by the AMT is ameliorated by the availability of computer software to prepare taxes. Programs available on the Internet or for installation on individual computers automatically determine whether taxpayers have AMT liability and create the required forms. Not all taxpayers have access to computers, however, and using the software can raise the costs of tax preparation for many people.

Even if complexity is mitigated by computer software, the alternative tax may cause taxpayers to change their behavior, at least to the extent that they know that the AMT may affect them. In particular, the AMT can subject taxpayers to higher marginal tax rates—the tax on an additional dollar of income—which, in turn, influences decisions about how much to work and save, potentially reducing economic efficiency. In 2004, for example, a married couple with three children, income of $200,000 (all in wages), and deductions of $10,000 for mortgage interest and $16,000 for state and local taxes would have regular tax liability of $34,819 and AMT liability of $2,101. The couple would face a marginal AMT rate of 32.5 percent, well above the 28.8 percent rate they would incur under the regular income tax.[15]

Changing the AMT

The impending rapid expansion of the AMT has generated many calls for the Congress to act to lessen its reach. Legislation in 2001 and 2003 temporarily raised the AMT exemptions, but those higher exemptions are scheduled to revert to their 2000 levels after 2004.[16] Demands for more permanent change call for a wide range of possible actions, from indexing AMT parameters for inflation to completely eliminating the alternative tax. The possibilities involve sharp tradeoffs between their revenue costs and the numbers and types of taxpayers they would benefit.

Repeal the AMT. The simplest way to deal with the growth of the AMT would be to eliminate the alternative tax entirely. Repeal would reduce tax revenues by roughly $600 billion over the next decade under current law. Eliminating the AMT would free many taxpayers from having to make a second set of tax calculations and would lower taxes for nearly everyone now subject to the AMT. For some taxpayers, however, future liabilities would rise. Under current law, people who pay the AMT because of timing issues—the treatment of incentive stock options, for example—may recoup those payments to the extent that their AMT is negative in future years. Unless special provisions were made, repealing the AMT might preclude such taxpayers from recovering previous AMT payments.

Index AMT Parameters for Inflation. The AMT's reach will grow primarily because its parameters are fixed in nominal terms, while parameters in the regular income tax are adjusted annually to take account of inflation. Indexation under current law prevents regular tax liabilities from growing simply because incomes keep pace with price inflation, but AMT liabilities have no such brake. As nominal incomes rise over time, more taxpayers become liable for the AMT. The current AMT exemption is $58,000 for married couples filing jointly and $40,250 for unmarried filers. After 2004, however, those amounts are scheduled to revert to pre-2001 levels of $45,000 and $33,750, respectively.[17] Extending the current exemption levels just for 2005 would preclude about 9 million taxpayers from incurring AMT liability that year and reduce the tax burden of others at a cost of about $18 bil-lion in forgone revenues.[18] If the 2004 exemptions were made permanent and, along with the other AMT parameters, were indexed for inflation, most of the increase in taxpay-

14. An additional complication caused by the AMT involves the question of when to incur deductible expenses. Because some deductions are denied under the AMT, taxpayers who know they will be subject to the AMT in a given year may be able to reduce their taxes in the subsequent year by delaying deductible expenses into that next year. Alternatively, they may owe less tax if they advance deductible expenses into an earlier year. Either situation requires additional calculations on the taxpayer's part.

15. As noted, the phaseout of the AMT exemption for taxpayers with AMTI over $150,000 increases the AMT tax rate by one-fourth. The 26 percent rate is thus effectively 32.5 percent, and the 28 percent rate is effectively 35 percent.

16. The President has proposed a one-year extension of the higher exemptions scheduled to expire after 2004.

17. Under current law, the exemption for married couples filing separately is $29,000 in 2004 and $22,500 in subsequent years.

ers with AMT liability over the coming decade would disappear. About 5 million taxpayers would owe AMT in 2010, a reduction of more than 80 percent from the estimated 29 million taxpayers who would otherwise owe AMT in that year. That option would reduce federal revenues by about $370 billion over the 2005-2014 period.[19]

Allow Dependent Exemptions for the AMT. The AMT currently has a disproportionate impact on large families by denying them the dependent exemptions allowed in the regular income tax. Permitting the same personal and dependent exemptions in the AMT as in the regular tax would eliminate the AMT impact for about 6 million tax units in 2010, roughly one-fifth of all taxpayers who would owe AMT in that year under current law. That option would reduce federal revenues by about $175 billion between 2005 and 2014.

Allow the Deduction of State and Local Taxes for the AMT. Taxpayers cannot deduct state and local income and property taxes in calculating their taxable income for the AMT. As a result, people in high-tax jurisdictions are more likely to have AMT liability than their counterparts in low-tax areas. Allowing taxpayers to deduct state and local taxes for AMT purposes would eliminate the AMT impact for about 10 million tax units in 2010—roughly one-third of those who would pay AMT in that year under current law. Providing that deduction would reduce federal revenues by about $360 billion between 2005 and 2014.

Combining the option to allow deduction of state and local taxes against the AMT with the option to allow dependent exemptions would have substantially larger effects. About 18 million taxpayers with AMT liability under current law would move off the AMT rolls in 2010, at a 10-year revenue cost of roughly $440 billion.

Conclusions

Over the coming decade, a growing number of taxpayers will become liable for the AMT. In 2010, if nothing is changed, one in five taxpayers will have AMT liability and nearly every married taxpayer with income between $100,000 and $500,000 will owe the alternative tax. Rather than affecting only high-income taxpayers who would otherwise pay no tax, the AMT has extended its reach to many upper-middle-income households. As an increasing number of taxpayers incur the AMT, pressures to reduce or eliminate the tax are likely to grow.

This revenue and tax policy brief was prepared by Roberton Williams of CBO's Tax Analysis Division with the assistance of Kurt Seibert and David Weiner. This brief and other CBO publications are available at the agency's Web site (www.cbo.gov).

18. The revenue costs of extending the 2004 exemption a year at a time would rise over time to a peak of $58 billion in 2010 before falling to $42 billion in 2014.

19. The number of taxpayers removed from the AMT and the revenue cost could both be reduced by lowering the 2004 exemption or by phasing out the exemption faster. For example, indexing the pre-2001 exemption levels starting in 2005 would lower the 10-year drop in tax liabilities to about $200 billion but would remove only about 40 percent of taxpayers from the AMT rolls in 2010.