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The AMT: What's Wrong and How to Fix It

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September 2007

Online at <https://mpra.ub.uni-muenchen.de/57386/>
MPRA Paper No. 57386, posted 18 Jul 2014 05:24 UTC

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Abstract - The alternative minimum tax (AMT) is a complex, unfair, and inefficient shadow tax system that threatens to affect 32 million taxpayers by 2010, many of them solidly middle class. Under current law, repealing the AMT without offsets would cost more than \$850 billion through 2017. This paper summarizes the current and projected effects of the AMT and considers options to finance repeal. One attractive option we consider would be to combine AMT repeal with a four percent tax on AGI in excess of \$200,000 for married couples and \$100,000 for others.

INTRODUCTION

The original minimum tax was an add-on tax intended to ensure that high-income people paid at least some tax. It has morphed and mutated into what is now the individual alternative minimum tax (AMT), a complex, unfair, and inefficient shadow tax system that threatens to hit 23 million households in 2007, many of them solidly middle class.

Barring a change in law, it will affect 32 million taxpayers in 2010—including half of those with incomes between \$75,000 and \$100,000, and nearly 75 percent of married couples in that income range with two or more children. It will become the *de facto* tax system for taxpayers with incomes between \$200,000 and \$500,000, 94 percent of whom will owe AMT. And, though they were the original target of the tax, the highest-income taxpayers will remain relatively unaffected by the AMT, with only 39 percent of taxpayers earning more than \$1 million in 2010 paying the AMT. In 2007, it would cost less in lost revenue to repeal the regular income tax than to repeal the AMT.¹

Clearly, the AMT has strayed far from the goals of the original minimum tax, but repealing it would be quite expensive. This paper summarizes the current and projected effects of the AMT and considers options to finance repeal.² The first section describes how taxpayers calculate AMT liability. The second section documents the projected expansions noted above and examines the driving factors behind the trends. The

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National Tax Journal
Vol. LX, No. 3
September 2007

¹ Repeal of the regular income tax is assumed to include repeal of the earned income tax credit, the child tax credit, and all personal credits not allowed against the AMT. If the credits are retained under the AMT when the regular tax is repealed, the cost would increase substantially.

² For much more detail about the AMT and reform options, see Burman, Gale, Leiserson, and Rohaly (2007).

third section discusses equity, efficiency and complexity issues. The fourth section examines reform options. The fifth section concludes.

THE INDIVIDUAL AMT: AN OVERVIEW

The AMT operates parallel to the regular income tax, with a different income definition, rate structure, and allowable deductions, exemptions, and credits.³ Taxpayers calculate “alternative minimum taxable income,” subtract any applicable AMT exemption, and then calculate tax under the AMT tax rate schedule net of applicable credits to obtain tentative AMT liability, which is what would be owed by someone who paid taxes according to the AMT rules alone. AMT liability is the excess, if any, of tentative AMT above a measure of taxes due under the regular income tax.

Alternative minimum taxable income (AMTI) is the sum of taxable income for AMT purposes, AMT preferences, and AMT adjustments. Taxable income for AMT purposes is adjusted gross income (AGI) less itemized or standard deductions less personal and dependent exemptions. Unlike regular taxable income, taxable income for AMT purposes can be negative. There is no interesting economic distinction between preferences and adjustments in general; we will refer to both as preferences, which come in two varieties. Exemption preferences broaden the AMT tax base. Deferral preferences change the timing of the recognition of income and deductions, typically to accelerate income and postpone deductions; thus, they tend to raise the current-year tax base, but at the expense of

future tax bases. The vast bulk of AMT preferences are of the exemption variety. The largest are deductions for state and local taxes, which account for 59 percent of all preferences; exemptions for adults and dependent children (22 percent); and miscellaneous itemized deductions for items such as unreimbursed business expenses and certain legal fees (11 percent) (JCT, 2007). Thus, more than 90 percent of the preference items have little to do with what most people would think of as tax sheltering. In contrast, the deferral preferences are quite small and relate most frequently to the treatment of incentive stock options (ISOs), depreciation of personal property, and passive activity losses.

AMT exemptions, exemption phase-outs, and tax brackets are not indexed for inflation or adjusted for family size. As of this writing (June 2007), the AMT exemption is \$45,000 for married couples filing jointly and for surviving spouses, \$33,750 for unmarried individuals other than surviving spouses, and \$22,500 for married individuals filing separately—the same amounts as applied prior to the enactment of the 2001 tax cuts. Since 2001, Congress has enacted a series of temporary patches that have increased the AMT exemption amount substantially. For 2006, the exemption was \$62,550 for couples and \$42,500 for single filers and heads of household. The AMT exemptions phase out for high-income taxpayers at a rate of 25 cents per dollar of AMTI over thresholds of \$150,000 for joint returns, \$112,500 for singles, and \$75,000 for married individuals filing separately.⁴ In 2007, the phaseouts end at \$247,500 for singles, \$330,000 for joint returns, and \$165,000 for married individuals filing separately.⁵

³ See JCT (2007) for an exhaustive discussion of AMT rules. A separate alternative minimum tax, which is similar in design to the individual AMT, applies to corporations. See Lyon (1997).

⁴ Besides the rules noted above, married taxpayers who file separately face additional provisions that aim to eliminate any AMT advantage of filing separately versus jointly.

⁵ The temporary increases in the value of the exemption also increase the income level at which the phaseout is complete. In 2006, the phaseout for married taxpayers ended at \$400,200, for single taxpayers, at \$282,500, and for married individuals filing separate returns, at \$200,100.

The statutory AMT tax rate is 26 percent on the first \$175,000 of income taxable under the AMT for married couples or singles (\$87,500 for married taxpayers filing separately) and 28 percent on additional amounts. The phaseout of the exemption, noted above, makes the effective marginal tax rate one-fourth larger than the statutory rate through the phaseout range. Thus, taxpayers with only moderately high incomes can face 35-percent effective AMT rates (28 percent times 1.25)—equal to the highest tax bracket under the regular income tax.

Under the AMT rules, long-term capital gains and dividends are subject to the same low rates as apply under the regular income tax.⁶ However, as under the regular tax, phaseouts can raise the *effective* tax rate on gains and dividends (as well as other income) above the statutory maximum rate. Since, as noted, the AMT exemption phases out at a 25 percent rate, the effective tax rate for taxpayers affected by the exemption phaseout is increased by 6.5 percent for taxpayers in the 26-percent AMT bracket (25 percent of 26 percent equals 6.5 percent) and by seven percent for taxpayers in the 28-percent bracket (Leiserson, 2007). Thus, the maximum tax

rate on capital gains and dividends is 22 percent (the 15-percent statutory rate plus the seven-percent implicit surtax).

As noted, AMT liability is the excess, if any, of the tentative AMT liability (reduced by any applicable foreign tax credit) over a tax liability measure based on the regular income tax. The latter measure is regular income tax liability before credits (that is, the tax due on adjusted gross income minus allowable exemptions and deductions) less any taxes due because of lump-sum distributions and less any applicable foreign tax credit in the regular tax. For simplicity, we refer to this as “regular tax liability for AMT purposes.”

After determining regular tax liability for AMT purposes and AMT liability, taxpayers return to the 1040 to calculate applicable credits. As of June 2007, the AMT does not restrict the use of personal refundable credits—the earned income credit and the child credit—or adoption and saver’s credits.⁷ Other personal non-refundable credits, however, are allowed only to the extent that the individual’s regular tax liability exceeds the tentative AMT liability. That is, those credits are effectively disallowed against the AMT.⁸

⁶ In some cases, however, capital gains are treated differently under the AMT than under the regular income tax. When depreciation deductions are recalculated, for example, the adjusted basis of the asset—and, thus, the size and possibly the sign of any capital gain—will differ for regular tax and AMT purposes. Also, under the regular income tax, exercising an ISO generates no tax liability, but selling the stock generates capital gains tax on the difference between the sale price and the option price. Under the AMT, exercising a qualified stock option generates taxable income equal to the difference between the exercise price and the option price if the stock is not sold in the same year. Selling the stock generates capital gains taxes, but only on the difference between the sale price and the exercise price.

Prior to 1986, a portion of long-term capital gains was excluded from AGI, effectively lowering tax rates on gains by 60 percent. The excluded portion of capital gains was considered a preference item under the alternative minimum tax and was, in fact, the largest single preference item. The Tax Reform Act of 1986 abolished the capital gains exclusion under the regular income tax and the AMT preference item. When preferential rates on long-term capital gains were enacted in 1997, they were also allowed under the AMT. Tax legislation in 2003 reduced the capital gains tax rate and also applied it to qualifying dividends for both the regular income tax and the AMT.

⁷ The earned income tax credit, child credit, and adoption credit are allowed against the AMT by provisions in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and will sunset with the rest of the law in 2010.

⁸ The personal non-refundable credits include the child and dependent care credit, the credit for the elderly and disabled, the Hope and Lifetime Learning credits, the credit for interest on certain home mortgages, and other less-frequently claimed credits (JCT, 2007).

A temporary provision that allowed the use of those credits expired at the end of 2006. The general business credit can reduce tax only to the level of tentative AMT liability, but unused portions may be carried backward or forward. Finally, AMT liability that is the result of timing-related preferences or adjustments generates a regular income tax credit that may be used against future income taxes if the taxpayer moves off the AMT.

Box 1 shows the calculation of AMT for a married couple with four children earning \$75,000 in 2007. It illustrates how the AMT will ensnare even middle-class families with very straightforward tax returns if Congress does not act.

TRENDS AND CAUSES

History and Projections

To project future AMT participation and revenue, we use the Urban-Brookings Tax Policy Center Microsimulation model.⁹ Table 1 shows that in 2006, the AMT affected about four million taxpayers. With the expiration of the temporary AMT patch, the number of AMT taxpayers will increase dramatically to 23 million in 2007 and 32 million, more than one-third of all taxpayers, in 2010. With the expiration of most of the 2001–2006 tax cuts in 2011, the number of AMT taxpayers will fall to 18 million, before again marching steadily upward to hit 39 million by 2017. If, instead, the tax cuts are extended, as

proposed by the President, almost half of all taxpayers—53 million—will pay the AMT by 2017.

AMT revenue follows a similar pattern, rising from \$24 billion in 2006 to \$70 billion in 2007 and \$117 billion by 2010.¹⁰ Table 1 provides two other ways to gauge the quantitative significance of the AMT. By 2010, tax returns that face the AMT will account for 52 percent of all AGI, up from 15 percent in 2006. More strikingly, we estimate that repealing the regular income tax—including all personal tax credits—would reduce income tax revenues by less (\$63 billion) than repealing the AMT (\$70 billion) in 2007.

Ironically, although the tax was intended to target the rich, people with only modestly high incomes are much more likely to be subject to the AMT than are millionaires. AMT participation rates rise with income up to the \$200,000 to \$500,000 level and then decline at higher levels (Table 2). People with moderately high incomes face much higher effective tax rates under the AMT than under the regular income tax because of the phaseout of the AMT exemption, which, as noted, creates effective tax rates as high as 35 percent. Very high-income taxpayers, whose incomes are well above the exemption phaseout range, in contrast, face a 35-percent rate under the regular income tax but only a 28-percent rate under the AMT. Thus, unless they have large AMT preferences, they pay more under the regular tax system. In 2006, only 31 percent of filers with

⁹ The data are taken from the stratified, random sample of tax returns contained in the 2001 public-use file produced by the Statistics of Income Division of the Internal Revenue Service. See also Rohaly, Carasso, and Saleem (2005). We use the term participation as convenient shorthand to refer to individuals who owe AMT, who lose personal credits because of the AMT, or who choose to take itemized deductions that are lower than their standard deduction in order to reduce or eliminate their AMT liability. Our estimates differ slightly from those reported by the Joint Committee on Taxation (2007) because of differences in underlying datasets, and assumptions about growth of income over time and other factors. The small differences are well within the range of estimation uncertainty.

¹⁰ Technically, the figures reported in the table and discussed in the text refer to calendar-year AMT liabilities, not revenue. A portion of calendar-year tax liabilities is not collected as revenue until final tax returns are filed and final-quarter estimated taxes are paid in the following calendar year.

Box 1. Calculating the AMT

A married couple with four children 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. Some, but not all, tax credits are allowed against both the AMT and the regular tax in 2007. Most importantly for this family, the child tax credit is allowed against both.

To calculate AMT liability, the couple adds their 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.

Several points about this example are worth noting. First, the family is on the AMT because they have four children, not because they are rich or aggressive tax shelterers. Second, this tax situation is about as simple as it gets; the family has no deferral preferences, no itemized deductions, no capital gains, no AMT credits from previous years, and no other complicating factors. Third, the couple will receive no long-term benefit from regular tax rate reductions, because their income tax liability is set by the AMT, not the regular income tax. Finally, as long as the AMT is not indexed to inflation, the couple's future tax payments as a share of their income will rise, even if their real (inflation-adjusted) income does not change.

AMT Calculation
Married couple filing jointly with four children, 2007

Calculate Regular Tax	Calculate Tentative AMT
Gross income \$75,000	Taxable income \$43,900
<i>Subtract deductions</i>	<i>Add preference items</i>
Personal exemptions \$20,400 (6 x \$3,400)	Personal exemptions \$20,400
Standard deduction \$10,700	Standard deduction \$10,700
Taxable income \$43,900	AMTI \$75,000
Tax before credits* \$5,803	<i>Subtract AMT exemption</i>
(Tax bracket) 15%	AMT exemption \$45,000
First \$15,650 taxed at 10%	Taxable under AMT \$30,000
Next \$48,050 taxed at 15%	Tax (tentative AMT)* \$7,800
	(AMT bracket) 26%
	First \$175,000 taxed at 26%

AMT = the excess of tentative AMT over regular income tax
AMT = \$7,800 - \$5,803 = \$1,997

* If the children are under age 17, the family could reduce its tax liability by \$4,000 because of the child tax credit. This credit is allowed against both the regular income tax and the AMT.

incomes above \$1 million were affected by the AMT, compared to 51 percent of those with incomes between \$200,000 and \$500,000. By 2010, the difference is even starker: 94 percent of those in the \$200,000

to \$500,000 income class will be affected by the AMT compared to 39 percent of those with income above \$1 million. Over time, the tax is steadily encroaching on families that most would consider

TABLE 1
AGGREGATE AMT PROJECTIONS, 2006–2017¹

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Total 2006–17
Number of AMT Taxpayers ² (millions)													
Current Law	3.5	23.4	26.5	29.3	32.4	18.5	20.9	24.0	27.2	31.0	35.1	39.1	
Current Law Extended ³	3.5	23.4	26.5	29.3	32.4	35.1	38.1	41.1	43.6	46.7	49.6	52.6	
Pre-EGTRRA Law	8.1	10.2	12.3	14.2	16.5	18.5	20.9	24.1	27.2	31.0	35.2	39.2	
Percent of Taxpayers Affected by AMT ⁴													
Current Law	4.0	25.9	28.8	31.1	33.6	17.8	19.8	22.5	25.1	28.2	31.6	34.7	
Current Law Extended	4.0	25.9	28.8	31.1	33.6	35.6	38.0	40.4	42.2	44.5	46.7	48.6	
Pre-EGTRRA Law	8.6	10.6	12.5	14.1	16.0	17.6	19.7	22.3	24.9	28.0	31.4	34.5	
AMT Revenue ⁵ (billions of \$)													
Current Law	23.9	69.8	86.3	97.6	117.4	49.4	57.2	65.9	75.2	86.7	100.0	114.8	944.1
Current Law Extended	23.9	69.8	86.3	97.6	117.4	132.4	150.2	169.7	189.7	212.6	238.0	265.2	1,752.9
Pre-EGTRRA Law	23.4	28.4	33.2	37.3	43.4	49.5	57.2	66.0	75.3	86.7	100.0	114.9	715.2
AMT Revenue/AMT Taxpayer (\$)													
Current Law	6,813	2,986	3,264	3,329	3,623	2,676	2,735	2,744	2,769	2,798	2,848	2,938	
Current Law Extended	6,813	2,986	3,264	3,329	3,623	3,778	3,944	4,129	4,347	4,551	4,794	5,047	
Pre-EGTRRA Law	2,885	2,782	2,704	2,632	2,636	2,675	2,732	2,739	2,764	2,796	2,844	2,933	
AMT Revenue as a Percentage of Income Tax Revenue													
Current Law	2.6	6.8	7.8	8.4	9.4	3.2	3.5	3.8	4.1	4.4	4.8	5.2	4.8
Current Law Extended	2.6	6.8	7.8	8.4	9.4	9.9	10.5	11.1	11.6	12.2	12.8	13.4	8.9
Pre-EGTRRA Law	2.0	2.3	2.5	2.7	3.0	3.2	3.5	3.8	4.0	4.4	4.8	5.2	3.6
Percent of AGI on AMT Returns													
Current Law	15.2	43.2	47.0	49.0	52.3	26.9	29.3	32.2	35.1	38.2	41.4	44.4	
Current Law Extended	15.2	43.2	47.0	49.0	52.3	54.3	56.3	58.3	59.7	61.4	62.9	64.3	
Pre-EGTRRA Law	15.4	18.2	20.6	22.4	24.8	26.8	29.3	32.3	35.1	38.2	41.5	44.4	
Cost of Regular Income Tax Repeal ⁶ (billions of \$)													
Current Law	204.3	63.1	56.1	52.9	47.1	213.9	211.8	209.3	208.6	206.8	204.9	204.0	1,882.8
Current Law Extended	204.3	63.1	56.1	52.9	47.1	44.4	40.4	36.2	33.2	29.1	24.8	20.9	652.6
Pre-EGTRRA Law	222.9	216.8	218.1	217.1	217.4	217.3	215.0	212.6	212.0	210.2	208.3	207.2	2,574.8

Source: Urban–Brookings Tax Policy Center Microsimulation Model (version 1006–1).

(1) Calendar years. Tax units that are dependents of other tax units are excluded from the analysis. Numbers may not add due to rounding.

(2) AMT taxpayers are defined as those with an AMT liability from Form 6251, with lost credits, or with reduced deductions.

(3) Includes all 2010 sunset provisions in current law.

(4) Taxpayers are defined as returns with positive income tax liability net of refundable credits.

(5) “Revenue” is actually calendar year tax liability. Some of that liability would be paid in a subsequent year.

(6) Includes repeal of the child tax credit and the earned income tax credit for all years as well as nonrefundable tax credits in the years in which they are not allowed for AMT purposes under current law.

TABLE 2
AMT PARTICIPATION RATE (PERCENT) BY INDIVIDUAL CHARACTERISTICS¹

Group	Current Law				Current Law Extended ²	Pre-EGTRRA Law	
	2006	2007	2010	2017	2017	2007	2010
All Taxpayers ³	4.0	25.9	33.6	34.7	48.6	10.6	16.0
All Tax Filers	2.8	18.4	24.5	27.8	37.4	8.0	12.4
Tax Filers by Cash Income (thousands of 2006\$) ⁴							
Less than 30	*	*	*	0.1	0.1	*	
30–50	*	1.3	3.0	12.2	13.0	1.4	2.9
50–75	0.2	9.0	17.1	30.1	38.8	6.9	13.1
75–100	0.7	36.2	49.9	53.7	67.2	18.1	26.1
100–200	4.8	70.8	80.4	61.7	92.3	23.4	32.0
200–500	50.9	89.7	94.3	77.7	96.8	41.3	54.2
500–1,000	49.3	57.2	72.2	27.0	73.8	22.0	22.6
1,000 and more	31.4	33.8	38.8	20.3	40.1	20.3	19.1
Tax Filers by Number of Children ⁵							
0	1.9	11.4	16.8	15.9	28.5	2.4	3.9
1	2.7	24.8	32.4	40.9	48.4	7.1	16.0
2	5.0	34.5	42.0	54.8	56.6	22.2	34.0
3 or more	7.4	39.6	48.4	65.3	64.4	39.8	50.3
Tax Filers by State Tax Level							
High	4.6	21.8	27.7	31.6	40.7	10.9	16.2
Middle	2.3	18.5	25.0	28.3	37.9	7.7	12.0
Low	1.6	15.3	21.1	23.8	33.9	5.7	9.2
Tax Filers by Filing Status							
Single	0.9	2.4	3.8	4.7	10.5	1.1	1.7
Married Filing Joint	5.1	36.7	47.9	49.7	67.2	14.5	22.2
Head of Household	1.3	10.4	17.0	33.1	35.0	8.3	14.5
Married Filing Separate	5.7	34.5	47.4	48.7	62.9	12.8	17.6
Married Couple, 2+ Kids, 75k<Cash Income<100k	0.2	59.1	73.6	92.3	92.8	57.5	74.3
Married Couple, 2+ Kids, 75k<AGI<100k	0.8	78.2	88.6	97.7	97.8	68.8	86.4

Source: Urban–Brookings Tax Policy Center Microsimulation Model (version 1006–1).

* Less than 0.05 percent.

(1) Includes returns with AMT liability on Form 6251, with lost credits, and with reduced deductions. Tax Units that are dependents of other tax units are excluded from the analysis.

(2) Includes all 2010 sunset provisions in current law.

(3) Taxpayers are defined as returns with positive income tax liability net of refundable credits.

(4) Tax units with negative cash income are excluded from the lowest income class. For a description of cash income, see <http://www.taxpolicycenter.org/TaxModel/income.cfm>.

(5) Number of children is defined as number of exemptions taken for children living at home.

middle- or upper-middle-class. By 2010, half of all tax filers making between \$75,000 and \$100,000 will pay the AMT, up from 36 percent in 2007 and less than one percent in 2006.¹¹

Taxpayers with large families, those who live in high-tax states, and those filing jointly are more likely than others to be affected by the AMT (Table 2). These characteristics can combine to create very high probabilities of falling prey to the AMT. For example, absent a change in law, by 2010, 89 percent of married couples with income between \$75,000 and \$100,000 and with two or more children will face the AMT compared to less than one percent in 2006.

Although not shown in the table, taxpayers with significant legal fees incurred in cases that generate taxable damages, such as punitive damages or damages for nonphysical injuries, are also likely to face the AMT. Such expenses are deductible under the regular income tax as miscellaneous itemized deductions (subject to a two-percent floor) but are not allowed under the AMT. That is, the full damage award is included in AMTI even though the net gain to the taxpayer is the income less the legal fees. As a result, a taxpayer with substantial legal fees will have much more taxable income under the AMT than under the regular tax. If the legal fees are high relative to the damage award, the taxpayer can actually owe more AMT than her net gain from a lawsuit (Johnston, 2003).

Sources of AMT Growth

Minimum taxes and the regular income tax have generally been modified in conforming ways over time. The two major exceptions—the failure to index the minimum tax for inflation in 1981 when the regular income tax was indexed and the absence of sustained AMT tax cuts in 2001—are the central factors behind the AMT's projected growth. Because the AMT is not indexed for inflation, growth in nominal income tends to raise AMT liability more than regular income tax liability. The 2001–6 tax cuts reduced regular income tax liability, but made only minor and temporary changes to the AMT. Both factors tend to push people onto the AMT over time.

For example, in 2007, 23.4 million taxpayers will be on the AMT under current law. If the 2001–6 tax cuts had not occurred, however, only 10.2 million would have been affected by the AMT. If the tax cuts had not occurred and the AMT exemption amounts had been indexed for inflation along with the regular income tax in 1985, only 300,000 taxpayers would face the AMT in 2007.

Lindsey (2000) attributes a substantial effect to the AMT changes made in 1993.¹² In fact, however, the 1993 changes, which raised rates in both the regular income tax and the AMT, but also increased the AMT exemption, served on net to reduce the number of AMT taxpayers. While 23.4 million taxpayers will face the AMT in

¹¹ Tax filers include all nondependent tax units filing an income tax return, regardless of whether they owe income tax. Taxpayers include all nondependent returns with positive income tax liability. The Joint Committee on Taxation (2007) reports estimates for “taxpayers,” which they define as all tax-filing units, including those that do not file tax returns and dependent returns.

¹² Lindsey stipulates two principles of “equitable minimum tax design”—that a family of four at the top of the 15 percent bracket claiming the standard deduction, four exemptions, and \$10,000 of preference items should not be subject to the AMT; and that AMT rates should be no higher than 80 percent of regular tax rates—and argues that the changes made in 1993 violated these principles and, therefore, caused the increase in the number of middle-income taxpayers potentially subject to the AMT. Using Lindsey's taxonomy, violations of the first principle are the primary source of growth in the number of taxpayers potentially affected by the AMT. However, while Lindsey implies that the 1993 changes resulted in violations of the principle for the first time, the principle was violated before the 1993 changes were implemented and the 1993 law actually caused fewer middle-income families to be affected by the AMT.

2007 under current law, if the AMT rates and exemption remained at their pre-1993 levels, we estimate that 26.6 million taxpayers would face the AMT.

ECONOMIC ISSUES

Potential Justifications

A key political rationale for an AMT is to ensure that all high-income households pay at least some federal income tax every year. On strictly economic grounds, there is little logic behind such a goal: the goal confuses tax payments with tax incidence; it focuses on an arbitrary measure of time; it focuses on one tax, rather than the tax system as a whole; and it seems to suggest that legally reducing tax burdens by \$1 starting from a large positive number is acceptable, but reducing it from \$1 to zero is not (Shaviro, 1988, 2001). Despite the cold logic of these claims, the failure of some high-income households to pay any income tax seems to be viewed by the public as a signal of serious inequities in the tax system.¹³ Public opinion creates important constraints on legislative outcomes, regardless of the economic merits of such views. To the extent that it improves perceived equity, the AMT could have value.

However, even with the AMT, some high-income tax filers still avoid all federal income tax. Balkovic (2006) reports 5,839 tax returns with expanded income over \$200,000 (or 0.2 percent of returns in that income class) reported no U.S. income tax in 2003.¹⁴ Of those returns, 4,934 reported no worldwide income tax either. Not surprisingly, tax-exempt bond interest is the largest factor contributing

to tax-exemption on almost two-thirds of returns exempt from worldwide tax. Deductions for high medical and dental expenses were the largest factor on 12 percent of returns.

A second potential rationale could arise from second-best or political economy considerations (Graetz and Sunley, 1988; Shaviro, 2001). The claim is that the regular tax contains features that are inefficient or inequitable but that are difficult, for political reasons, to shut down or directly modify. If so, it may be more feasible to make changes indirectly via a minimum tax. These arguments, however, depend on the implicit assumption that AMT rules—made by the same political agents who are subject to the same political constraints as when they make changes in the regular tax—are somehow easier to enact than regular tax rules. It is unclear why this should be true. Even if it is true in principle, we see little evidence that the *current* AMT functions as posited. For example, when tax rates on long-term capital gains were capped under the regular income tax in 1997, they were also capped under the AMT, even though the difference in tax rates between capital gains and ordinary income is probably the single largest factor behind individual income tax shelters (Burman, 1999).

Distributional Effects

The AMT is more progressive overall than the regular income tax (Table 3). In 2006, the AMT and regular tax collected about the same share of their revenues from taxpayers with incomes above \$1 million. The biggest differences occur

¹³ When Treasury Secretary Joseph Barr testified before Congress that 155 households with incomes over \$200,000 (\$1.3 million in 2007 dollars) had owed no income tax on their 1967 tax returns, it unleashed a firestorm of protest. Congress received more letters about that than they did about the Vietnam War in 1969 (Graetz, 1999).

¹⁴ “Expanded income” is a broad measure of income intended to better represent economic status than AGI. It includes tax-exempt interest, nontaxable Social Security benefits, and AMT preference items as well as several other adjustments (Balkovic, 2006).

TABLE 3
DISTRIBUTION OF AMT AND REGULAR INCOME TAX BY CASH INCOME, CURRENT LAW

Cash Income Class (thousands of 2006\$) ¹	Tax Units (thousands)		Percent of Units		Percent of AGI		Percent of Tax Liability	
	AMT Taxpayers ²	All Units	AMT Taxpayers	All Units	AMT Taxpayers	All Units	AMT ³	All Income Tax ⁴
2006								
Less than 30	1	64,638	*	43.9	*	8.5	0.2	-3.0
30-50	2	27,008	0.1	18.3	*	11.0	*	4.3
50-75	41	21,009	1.2	14.3	0.2	14.4	0.2	9.4
75-100	83	12,719	2.4	8.6	0.5	12.4	0.6	9.5
100-200	762	15,955	21.7	10.8	8.7	23.9	7.6	24.7
200-500	2,146	4,214	61.1	2.9	49.9	13.0	44.5	20.2
500-1,000	358	727	10.2	0.5	15.8	5.0	19.3	9.9
1,000 and more	120	383	3.4	0.3	24.8	12.6	27.4	25.0
All	3,515	147,237	100.0	100.0	100.0	100.0	100.0	100.0
2010								
Less than 30	14	63,641	*	41.1	*	7.6	0.1	-2.2
30-50	786	28,908	2.4	18.7	0.7	10.3	0.4	3.8
50-75	3,751	22,180	11.6	14.3	4.9	13.6	2.6	8.8
75-100	6,990	14,059	21.6	9.1	12.2	12.3	7.7	9.6
100-200	15,105	18,782	46.6	12.1	40.6	25.3	33.8	27.0
200-500	4,986	5,289	15.4	3.4	26.8	14.5	39.5	22.5
500-1,000	600	831	1.9	0.5	6.7	5.1	7.6	9.1
1,000 and more	167	431	0.5	0.3	8.3	12.0	8.4	21.5
All	32,400	154,718	100.0	100.0	100.0	100.0	100.0	100.0

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1).

* Less than 0.05 percent in absolute value.

(1) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis. For a description of cash income, see <http://www.taxpolicycenter.org/TaxModel/income.cfm>.

(2) AMT taxpayers include those with AMT liability from Form 6251, with lost credits, and with reduced deductions.

(3) Includes direct AMT liability, lost credits, and the value of reduced deductions.

(4) All income tax is the sum of regular income tax net of refundable credits plus direct AMT liability.

for taxpayers with cash income between \$200,000 and \$1 million—where the AMT collects 64 percent of its revenues and the regular tax collects 30 percent—and taxpayers with income between \$30,000 and \$200,000—where the AMT collects eight percent of its revenue compared to 48 percent for the regular tax.

The progressivity of each tax is slated to decline over time, however. The income tax share paid by taxpayers with income over \$1 million falls from 25 percent in 2006 to 21.5 percent in 2010. The share paid by those with income above \$500,000 falls from 35 percent to 31 percent, even though the share of all taxpayers in that category rises. These declines occur because the 2001–06 tax cuts are regressive, especially among the top one percent of all taxpayers (Leiserson and Rohaly, 2006). Changes in the distribution of AMT payments are even more dramatic. By 2010, the AMT will collect only eight percent of its revenue from taxpayers with income over \$1 million and 16 percent from taxpayers with income above \$500,000. The analogous figures for 2006 are 27 percent and 47 percent. The decline in AMT share for high-income taxpayers is due to the explosive growth in the number of AMT taxpayers with lower incomes. The share of AMT paid by taxpayers with income between \$30,000 and \$100,000 rises from less than one percent in 2006 to 11 percent in 2010, and the share paid by taxpayers with income between \$100,000 and \$200,000 rises from eight percent in 2006 to 34 percent in 2010.

Narrow Base, High Rates

Commentators often characterize the AMT as a tax system with a broad base and low marginal tax rates. This characterization is wrong. By 2010 almost all AMT

taxpayers will face a smaller tax base and higher marginal tax rates in the AMT than they would in the regular tax. Only for the two percent of AMT taxpayers with income above \$500,000 will the AMT base be broader and AMT rates be lower than in the regular tax (Table 4).

The confusion over the tax base arises in part because, for most taxpayers, AMTI is the sum of taxable income in the regular tax plus AMT preferences and adjustments. Because the last two items are virtually always positive, AMTI virtually always exceeds taxable income.¹⁵ However, although taxable income is the base in the regular tax, AMTI is *not* the base in the AMT. The AMT base is the difference between AMTI and the AMT exemption. Thus, any AMT taxpayer with preferences and adjustments that are smaller than the allowable AMT exemption will have more income subject to tax in the regular tax than in the AMT (where income subject to tax under AMT is AMTI minus exemptions). In 2006, about 63 percent of AMT taxpayers have more income subject to regular income tax than subject to the AMT (Table 4). The vast majority of AMT taxpayers with income between \$30,000 and \$200,000 simply do not have enough preferences and adjustments to make their AMT base exceed their regular tax base.

So why do these taxpayers owe AMT? The reason is that, again contrary to conventional wisdom, the AMT imposes higher tax rates on most taxpayers than the regular income tax. For those with modest incomes subject to the AMT, the lowest AMT rate of 26 percent is much higher than the average tax rate they face under the regular income tax, and often higher than the marginal tax rate as well. (Ninety-five percent of tax units faced marginal rates of 25 percent

¹⁵ For taxpayers with negative regular taxable income for AMT purposes (defined above), regular taxable income in the regular tax is set at zero, so that AMTI may be less than regular taxable income in rare cases even if adjustments and preferences are positive.

TABLE 4
INCOME SUBJECT TO TAX AND EFFECTIVE MARGINAL TAX RATES IN THE REGULAR INCOME TAX
AND THE AMT AMONG AMT TAXPAYERS, CURRENT LAW¹

Cash Income Class (thousands of 2006\$) ²	Percent with More Income Subject to Tax In ³		Average Adjustments and Preferences ⁴	Percent with a Higher Marginal Tax Rate In ⁵		Average Effective Marginal Tax Rate (percent) ⁶	
	Regular Tax	AMT		Regular Tax	AMT	Before AMT	After AMT
2006							
All	62.6	37.5	45,997	25.8	71.4	29.3	31.5
Less than 30	0.0	100.0	162,345	0.0	99.8	0.0	32.2
30–50	81.4	18.6	52,499	0.0	99.4	2.3	26.3
50–75	90.3	9.7	31,023	0.0	98.2	17.2	26.2
75–100	94.3	5.7	31,614	1.8	93.1	21.2	27.3
100–200	88.9	11.1	35,408	5.8	85.7	25.3	29.4
200–500	63.2	36.8	34,673	25.2	74.0	31.2	33.2
500–1,000	9.5	90.5	58,238	68.1	29.8	31.0	28.8
More than 1,000	11.4	88.6	288,691	62.2	33.6	26.9	26.6
2010							
All	87.3	12.7	23,888	7.1	89.0	23.9	28.1
Less than 30	58.2	41.8	36,700	0.0	93.1	7.1	27.6
30–50	98.6	1.4	15,368	0.0	95.9	16.4	25.6
50–75	98.7	1.3	19,134	1.9	90.3	18.0	24.9
75–100	98.9	1.1	18,488	1.0	92.1	19.3	26.2
100–200	97.0	3.0	20,979	5.8	92.0	25.8	28.4
200–500	43.2	56.8	31,209	15.9	83.3	29.2	32.5
500–1,000	10.8	89.2	64,292	69.7	25.9	31.0	28.3
More than 1,000	10.7	89.3	290,894	53.9	34.3	27.4	27.1

Source: Urban–Brookings Tax Policy Center Microsimulation Model (version 1006–1).

- (1) AMT taxpayers include those with AMT liability from Form 6251, with lost credits, and with reduced deductions.
- (2) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis. For a description of cash income, see <http://www.taxpolicycenter.org/TaxModel/income.cfm>.
- (3) Income subject to tax for the regular income tax is taxable income; for the AMT, it is AMTI net of the AMT exemption.
- (4) Amounts are in nominal dollars to facilitate comparison with AMT, exemption amounts. For 2006, the AMT exemption is \$62,550 for married couples filing jointly and surviving spouses; \$42,500 for unmarried individuals other than surviving spouses; and \$31,275 for married individuals filing separately. For 2010, the exemption amounts are \$45,000, \$33,750, and \$22,500, respectively.
- (5) The marginal tax rate for each return is calculated by adding \$1,000 to wages, recomputing income tax net of refundable credits, and dividing the resulting change in tax liability by 1,000.
- (6) Marginal tax rates represent a simple average across individuals.

or lower under the regular income tax in 2006.) Moreover, as noted earlier, in the phaseout range for the AMT exemption, effective marginal tax rates are 32.5 percent or 35 percent. This is why almost three-quarters of taxpayers with incomes between \$200,000 and \$500,000 face a

higher marginal tax rate under the AMT than under the regular income tax in 2006 (83 percent in 2010).

Overall, in 2006, 71 percent of AMT taxpayers had a higher effective marginal tax rate in the AMT. By 2010 this figure will rise to 89 percent. Only among AMT tax-

payers with income greater than \$500,000 does the AMT usually represent a cut in effective tax rate. Even in that group, however, 26 to 34 percent face higher marginal rates under the AMT.

Complexity

Although meaningful quantitative indicators of tax complexity are difficult to obtain, the *prima facie* case that the AMT is complex is overwhelming, and both the National Taxpayer Advocate (2001) and the IRS (2000) highlight the AMT as one of the most difficult areas of the tax law to comply with and administer. The key issue, though, is not the overall level of complexity, but rather what complexity allows policy makers to achieve in terms of equity, efficiency or other goals (Gale and Holtzblatt, 2002).

The deferral preferences and the calculation of the AMT credit are particularly complex. The only purpose of such rules is to ensure that all high-income taxpayers pay some federal income tax in each year, and as noted above, the AMT fails to achieve that goal. AMT complexity is also a significant and increasing problem for middle-class taxpayers for several reasons. First, AMT taxpayers with income below \$100,000 have estimated average AMT liability in 2010 of less than \$1,300, so the ratio of compliance costs to revenue raised is likely to be high. Second, the AMT makes the calculation of capital gains taxes and nonrefundable credits significantly more complex. Third, a large share of middle-class taxpayers who fill out the AMT forms end up not owing any AMT (National Taxpayer Advocate, 2001; IRS, 2000). It is hard to see any policy goal achieved by filling out superfluous forms. Interactions with the regular income tax can also be a source of complexity, but serve efficiency goals in particular cases. For example, the AMT's taxation of private activity bond interest income will reduce the subsidy afforded such

investments in the regular tax and might improve efficiency.

Some assert that the complexity of calculating taxes under both the regular tax and the AMT does not pose a real problem because most affected taxpayers rely on tax preparation software, which calculates the AMT automatically, or paid tax preparers. Although it is true that software or paid preparers reduce the computational complexity of the AMT, it turns the tax system into an inscrutable black box for many people.

In order to make informed decisions about work, saving, retirement, education, and other important matters, people should understand how the tax system affects those choices, but the AMT leads to endless confusion. Taxpayers will have a hard time predicting their marginal tax rate if they do not know whether they will be on the AMT. In addition, many people may be confused about what constitutes an AMT preference item. For example, *Consumer Reports* magazine reported in the February 2007 issue that the AMT is "snagging middle-income taxpayers with big families, people who pay lots of state tax, and those with high mortgage interest." Mortgage interest, of course, is not an AMT preference item (except on home equity lines and second mortgages used to pay for nonhousing expenses). And needless complexity contributes to public perceptions that the income tax system is unfair.

Moreover, computer software has its limitations. For example, individuals who were on the AMT in the previous year must figure out the state tax deduction that would have been allowed on their prior-year tax return before they were subject to the AMT. This is necessary in order to figure out how much of their state tax refund in the current year is taxable. This calculation is so complex that TurboTax does not do it. The software recommends that the taxpayer go back to his or her prior-year return, and keep

refiguring the state tax deduction over and over until the AMT gets down to zero. This is complex even with software. In general, the AMT provisions that link liability across years and require multiple accounting systems on an asset-by-asset basis prove difficult even for advanced software programs (Shaviro, 2001).

POLICY OPTIONS

An ideal solution would address the AMT in the context of a complete overhaul of the tax system. Such changes are beyond the scope of this paper, however, and are not politically likely any time soon. Accordingly, we focus on options to repeal the AMT in a fiscally responsible manner—that is, without increasing the deficit over the ten-year budget period. There is an infinite array of possible options. We focus on five to illustrate the options and trade-offs. A more detailed list is in Burman, Gale, Leiserson, and Rohaly (2007). We also briefly discuss the option of eliminating the regular income tax while retaining the AMT.

Repeal the AMT

Repealing the AMT in 2007 without offsetting the revenue lost would eliminate the AMT’s drawbacks, but it would significantly increase budget deficits and be regressive. The revenue loss would be \$106 billion in 2010 and \$852 billion through 2017 under current law. If the President’s tax cuts are extended, the cost would approximately double to about \$1.7 trillion. Filers in the top one percent would receive an average reduction in taxes equal to 1.1 percent of after-tax income in 2007 (Table 5). Those in the 95th to 99th percentile would see an average increase in after-tax income of 2.6 percent.

Eliminating the AMT would also increase the number of high-income households that paid little or no income tax. We estimate that about 4.5 percent of tax units with cash incomes over \$1 million would pay less than one percent of their income in income tax in 2007 without an AMT, up from 2.8 percent under current law.¹⁶ This estimate assumes no change in behavior. To the extent that the AMT deters tax sheltering, its elimination

TABLE 5
AMT REPEAL OPTIONS: PERCENT CHANGE IN AFTER-TAX INCOME BY CASH INCOME PERCENTILE, 2007¹

Offset Option	Percent Change in After-Tax Income by Cash Income Percentile							
	0-20	20-40	40-60	60-80	80-90	90-95	95-99	99-100
No offset (stand-alone repeal)	0.0	0.0	0.0	0.2	0.9	1.4	2.6	1.1
4% of AGI add-on tax above 100K/200K	0.0	0.0	0.0	0.2	0.9	1.3	1.6	-2.8
Repeal state and local tax deduction, decrease all income tax rates	0.0	0.0	0.0	-0.1	0.2	0.3	1.0	-0.5
Increase all income tax rates	0.0	-0.1	-0.3	-0.4	0.2	0.6	1.5	-0.2
Increase top three income tax rates	0.0	0.0	0.0	0.2	0.9	1.3	1.4	-2.0
Roll back capital gains rates, increase top three income tax rates	0.0	0.0	0.0	0.1	0.7	1.1	1.1	-3.4

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1).
(1) Calendar year. Baseline is current law.

¹⁶ We do not estimate the number or percentage of tax units with exactly zero tax liability because of limits in our underlying dataset. The IRS deliberately “blurs” tax returns for high-income households in the public-use tax return data file to prevent disclosure. While this has little effect on the precision of revenue estimates or distributional tables, it might be more significant for measures of taxpayers with a particular amount of tax liability. Because of blurring, some tax units will appear to have a small amount of tax liability when, in fact, they were untaxable (and others will appear untaxable when they, in fact, paid a small amount in tax).

could result in many more high-income households with little or no tax liability. The best option to address this, however, would be to adopt in the regular income tax whatever effective anti-tax shelter measures exist under the AMT.

The financing of AMT repeal could help offset these effects. We discuss five options that, coupled with AMT repeal, would be approximately revenue-neutral over the next decade: (1) imposing a four percent of AGI surtax above \$200,000 for couples (\$100,000 for singles); (2) repealing the state and local tax deduction and *reducing* income tax rates by two percent; (3) increasing regular income tax rates by six percent; (4) increasing regular income tax rates in the 25-percent and higher brackets by 15 percent; and (5) increasing regular income tax rates in the 25-percent and higher brackets by 12 percent and repealing the 2003 tax cuts for capital gains and qualified dividends.

One attractive option would be to combine AMT repeal with a four percent tax on AGI in excess of \$200,000 for married couples or \$100,000 for other tax filers.¹⁷ This would sharply reduce the number of high-income tax filers who pay no federal income tax. It would be approximately revenue-neutral over the 2007–17 budget window. Through 2010, even with the four-percent add-on tax, the top effective tax rates on ordinary income and capital gains would remain below the pre-EGTRRA levels of 39.6 and 20 percent.

Overall, in 2007, about three times as many people would face a cut in marginal tax rates on ordinary income as would face higher rates under the option (Table 6). Because the surtax rate is relatively small in comparison to the large increases in marginal tax rates resulting from the AMT, eliminating the AMT more than offsets the

effect of the surtax on marginal tax rates for most people who are affected. The vast majority of affected taxpayers with incomes under \$200,000 and more than one-third of those affected with incomes between \$200,000 and \$500,000 would face lower effective rates. About 90 percent of tax units would see no change in their effective capital gains tax rates. For those with a change, the majority would pay higher rates, but a significant number of taxpayers would see a cut because of the elimination of the AMT exemption phaseout. The bottom line is that, unlike a rate increase alone, which would reduce incentives to work and save, the proposal improves work incentives for most taxpayers and is a mixed bag in terms of saving.

This option is highly progressive. Taxpayers in the 60th through 99th percentiles would, on average, receive a tax cut from the proposal through 2010 (Tables 5 and 7). Even after 2010, only taxpayers in the top five percent would, on average, receive a tax increase. And that increase would be relatively small for those in the 95th to 99th percentiles, amounting to only one-tenth of one percent of after-tax income in 2011 (Table 8). The top one percent would pay higher taxes, averaging between 2.8 and 3.6 percent of after-tax income throughout the budget window.

The proposal also has the advantage of returning the AMT to its original purpose—guaranteeing that high-income people pay at least some tax. Like the original minimum tax, the surtax is an addition to regular tax rather than an alternative tax system. It would be extremely simple to calculate. And it would significantly reduce the number of taxpayers who can avoid income tax altogether (although those with income only from public-purpose tax-exempt bonds would continue to be able to avoid tax).

¹⁷ See Burman and Leiserson (2007) for more discussion of this option.

TABLE 6
OPTIONS TO REPEAL THE AMT
DISTRIBUTION OF TAX UNITS BY CHANGE IN MARGINAL TAX RATE, 2007¹

Cash Income Class (thousands of 2006 dollars) ²	Change in Marginal Tax Rate on Wages			Change in Marginal Tax Rate on Capital Gains		
	Percent with Increase	Percent with Decrease	Percent with No Change	Percent with Increase	Percent with Decrease	Percent with No Change
Repeal AMT						
Less than 100	0.1	5.5	94.4	1.0	1.1	97.9
100-200	4.6	63.0	32.4	20.7	18.5	60.8
200-500	20.7	68.4	10.8	18.5	58.2	23.3
500-1,000	38.9	17.1	44.0	32.9	9.7	57.3
More than 1,000	20.5	12.0	67.5	20.1	4.3	75.7
All	1.4	13.9	84.7	3.9	4.8	91.3
Repeal AMT & Implement 4% Surtax on AGI Above 100/200K						
Less than 100	0.1	5.5	94.4	0.9	1.1	98.0
100-200	15.2	59.8	25.0	25.6	16.2	58.2
200-500	59.6	34.6	5.8	27.8	48.7	23.5
500-1,000	83.9	11.0	5.1	65.3	4.7	30.0
More than 1,000	90.8	7.9	1.4	69.5	2.6	27.9
All	4.2	12.5	83.3	5.0	4.2	90.8
Repeal AMT, Repeal State and Local Tax Deduction & Reduce Tax Rates by 2%³						
Less than 100	2.5	60.2	37.3	2.8	10.8	86.4
100-200	10.6	88.4	1.0	20.6	23.1	56.3
200-500	24.3	74.0	1.8	11.8	63.0	25.1
500-1,000	41.2	57.0	1.8	26.7	31.8	41.4
More than 1,000	22.1	75.3	2.7	13.4	41.1	45.6
All	4.3	63.5	32.2	5.2	13.9	80.9
Repeal AMT & Increase Tax Rates by 6%						
Less than 100	58.2	4.1	37.6	11.6	1.1	87.4
100-200	79.4	19.3	1.3	30.1	11.9	58.1
200-500	49.2	48.7	2.1	20.3	56.1	23.6
500-1,000	88.3	9.9	1.9	59.4	6.0	34.6
More than 1,000	89.2	8.4	2.4	57.2	3.4	39.4
All	60.3	7.2	32.5	14.2	3.9	81.8
Repeal AMT & Increase Top Three Tax Rates by 15%						
Less than 100	0.2	5.5	94.3	0.9	1.1	98.0
100-200	17.0	58.1	24.8	19.7	16.4	63.8
200-500	68.1	24.6	7.3	19.9	54.2	25.9
500-1,000	79.9	13.7	6.5	58.2	5.9	35.9
More than 1,000	85.8	10.4	3.8	56.6	3.4	39.9
All	4.7	12.0	83.3	4.0	4.4	91.6
Repeal AMT, Roll Back Capital Gains Rates, & Increase Top Three Tax Rates by 12%						
Less than 100	1.4	5.6	93.0	60.0	0.4	39.6
100-200	16.0	61.6	22.4	81.2	9.5	9.2
200-500	50.6	44.7	4.7	35.9	46.8	17.3
500-1,000	82.3	12.4	5.3	70.7	4.2	25.0
More than 1,000	89.6	8.6	1.8	70.5	2.6	26.9
All	5.1	13.0	81.8	61.5	2.9	35.7

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1).

Number of AMT Taxpayers (millions). Baseline: 23.4; Proposals: 0.0.

(1) Calendar year. Baseline is current law.

(2) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see <http://www.taxpolicycenter.org/TaxModel/income.cfm>.

(3) The estimates in this table show marginal rates for federal taxes holding constant state taxes paid. A more complete consideration of marginal rates without this limitation would show somewhat different results.

TABLE 7
AMT REPEAL OPTIONS: PERCENT CHANGE IN AFTER-TAX INCOME BY CASH INCOME PERCENTILE, 2010¹

Offset Option	Percent Change in After-Tax Income by Cash Income Percentile							
	0-20	20-40	40-60	60-80	80-90	90-95	95-99	99-100
No offset (stand-alone repeal)	0.0	0.0	0.0	0.4	1.5	2.1	3.6	1.4
4% of AGI add-on tax above 100K/200K	0.0	0.0	0.0	0.4	1.4	1.8	2.5	-2.4
Repeal state and local tax deduction, decrease all income tax rates	0.0	0.0	0.0	0.2	0.8	1.0	2.1	-0.3
Increase all income tax rates	0.0	-0.1	-0.3	-0.2	0.7	1.2	2.6	0.1
Increase top three income tax rates	0.0	0.0	0.0	0.4	1.4	1.9	2.4	-1.7
Roll back capital gains rates, increase top three income tax rates	0.0	0.0	0.0	0.3	1.2	1.7	2.1	-2.8

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1).
(1) Calendar year. Baseline is current law.

TABLE 8
AMT REPEAL OPTIONS: PERCENT CHANGE IN AFTER-TAX INCOME BY CASH INCOME PERCENTILE, 2011¹

Offset Option	Percent Change in After-Tax Income by Cash Income Percentile							
	0-20	20-40	40-60	60-80	80-90	90-95	95-99	99-100
No offset (stand-alone repeal)	0.0	0.0	0.1	0.4	0.6	0.6	1.1	0.7
4% of AGI add-on tax above 100K/200K	0.0	0.0	0.1	0.4	0.5	0.3	-0.1	-3.4
Repeal state and local tax deduction, decrease all income tax rates	0.0	0.0	0.1	0.0	-0.3	-0.7	-0.6	-1.0
Increase all income tax rates	0.0	-0.2	-0.4	-0.3	-0.3	-0.6	-0.2	-0.9
Increase top three income tax rates	0.0	0.0	0.1	0.4	0.5	0.3	-0.6	-3.3
Roll back capital gains rates, increase top three income tax rates	0.0	0.0	0.1	0.4	0.5	0.3	-0.3	-2.6

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1).
(1) Calendar year. Baseline is current law.

Instead of increasing effective tax rates, repeal could be financed by base broadening under the regular income tax. The President's tax reform panel proposed to eliminate the income tax deduction for state and local taxes (among many other measures) as a way to finance AMT repeal. The tax deduction is an inefficient instrument to help states—primarily benefiting states with high average incomes (since lower-income people usually do not itemize and, even when they do, the deduction is worth little to them because they are in low tax brackets).¹⁸ Moreover, since the tax deduction is an AMT preference, over time, fewer and fewer taxpayers would

be able to gain its full benefits under current law.

Assuming that the 2001-2006 tax cuts expire as scheduled at the end of 2010, repealing the state and local tax deduction would raise more than enough revenue to finance AMT repeal, allowing for a two percent reduction in income tax rates. The net effect of AMT repeal, state and local tax deduction repeal, and income tax rate reduction has very small effects on overall tax burdens by income group (Tables 5, 7-9). This occurs because, although AMT repeal is regressive, repeal of the state and local income tax would be quite progressive. Most taxpayers in the bottom 60

¹⁸ See Rueben (2005) for a general discussion, or Burman and Gale (2005) in the context of the proposal made by the President's Advisory Panel on Tax Reform (2005).

TABLE 9

AMT REPEAL OPTIONS: PERCENT CHANGE IN AFTER-TAX INCOME BY CASH INCOME PERCENTILE, 2017¹

Offset Option	Percent Change in After-Tax Income by Cash Income Percentile							
	0-20	20-40	40-60	60-80	80-90	90-95	95-99	99-100
No offset (stand-alone repeal)	0.0	0.0	0.3	0.9	1.0	1.4	1.8	0.7
4% of AGI add-on tax above 100K/200K	0.0	0.0	0.3	0.9	0.9	1.1	0.3	-3.3
Repeal state and local tax deduction, decrease all income tax rates	0.0	0.1	0.3	0.6	0.1	0.1	0.1	-1.0
Increase all income tax rates	0.0	-0.2	-0.2	0.2	0.0	0.2	0.4	-0.9
Increase top three income tax rates	0.0	0.0	0.3	0.9	0.9	1.0	-0.2	-3.4
Roll back capital gains rates, increase top three income tax rates	0.0	0.0	0.3	0.9	0.9	1.1	0.1	-2.7

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1).

(1) Calendar year. Baseline is current law.

percent of the income distribution take the standard deduction, so that the primary beneficiaries of the state and local tax deduction are those at the very top of the income scale who escape the AMT.

This option has significant effects on marginal tax rates. Almost 64 percent of households would face lower marginal rates on ordinary income, while almost 14 percent would pay lower rates on capital gains (Table 6). The tax cut on wage income arises primarily because of the modest reduction in rates and is generally small, but also because of eliminating the AMT. The tax cuts on capital gains also arise from AMT repeal, but also because the lower income tax rate means that the phaseout of itemized deductions creates a slightly (two percent) smaller effective tax surcharge than it does under current law.¹⁹ Interestingly, more people face marginal rate increases under this option than under repeal. This occurs because repeal of the deduction pushes some taxpayers with modest incomes into higher income tax brackets.

A natural alternative option to consider is AMT repeal coupled with an across-the-

board increase in regular income tax rates. AMT repeal coupled with the resulting six percent (not percentage points) increase in regular income tax rates required to raise the same revenue would make the tax system less progressive than current law. In general, it would raise taxes on those least likely to owe AMT under current law—those in the bottom 80 percent of the income distribution—and cut taxes substantially on those with incomes in the 80th to the 99th percentiles. Unlike the other options, this option would increase marginal tax rates for most taxpayers. More than 60 percent would face higher rates on ordinary income and 14 percent would face higher rates on capital gains and dividends. The latter effect may seem surprising, as the option does not directly alter capital gains tax rates, but it occurs because of the implicit surtax created by the phaseout of itemized deductions, which would be six percent higher under this option.

Since repealing the AMT primarily benefits higher-income taxpayers, it makes sense to offset the revenue losses by increasing only top income tax rates. Another option would increase statutory

¹⁹ Under current law, itemized deductions phase out at a two-percent rate for taxpayers with incomes above certain thresholds (\$156,400 for most taxpayers in 2007). Like the phaseout of the AMT exemption, the deduction phaseout implicitly creates a surtax, which in this case equals two percent of the statutory tax bracket. The surtax applies to capital gains as well as ordinary income. Thus, an increase in ordinary income tax rates increases the effective tax rate on capital gains and dividends for taxpayers affected by the phaseout. (Note that, due to tax law changes in EGTRRA, this provision is being phased out, but it will return at its original three-percent rate in 2011 if the tax cuts are not extended.)

rates of 25 percent or more by 15 percent. Through 2010, only the top one percent of households face an average tax increase, amounting to about two percent of after-tax income. This occurs because very-high-income earners are most affected by the rate increases and do not tend to benefit as much from repeal of the AMT since they tend not to be on the AMT in the first place. Through 2010, those in the 90th to 99th percentiles receive the largest average tax cuts under this plan, between 1.3 and 1.4 percent of after-tax incomes in 2007, and between 1.9 and 2.4 percent in 2010. By 2017, the regular income tax rate increases dominate, and those in the top five percent of the income distribution receive an average tax increase.

Finally, AMT repeal could be an opportunity to rein in tax shelters in the regular income tax. For example, rolling back the 2003 tax cuts on dividends and capital gains would reduce somewhat the incentive to convert ordinary income into these tax-preferred forms. It would also raise some revenue to allow for a smaller increase in ordinary income tax rates. The top three income tax rates would increase by 12 percent under this option. The option would cut taxes by a modest amount for middle- and upper-middle-income taxpayers and increase taxes significantly for high-income taxpayers, especially through 2010 when current law allows for substantial reductions in the rates on capital gains and dividends. Taxpayers in the top one percent of the income distribution would, on average, pay additional taxes equal to 3.4 percent of after-tax income in 2007. These households lose out for three reasons—they are most affected by the income tax rate increases, they have a large amount of

capital gains and dividends, and many taxpayers in this group do not owe AMT (and, thus, receive no benefit from repeal). After 2010, the tax increase at the very top would still be quite substantial, averaging about 2.6 percent of after-tax income. In 2007, taxpayers in the 60th to 99th percentiles would see a modest tax cut, averaging between 0.1 and 1.1 percent of after-tax income. By 2017, while those in the 60th to 95th percentiles continue to benefit modestly, taxpayers in the 95th to 99th percentiles would, on average, see virtually no change in after-tax incomes.

Repeal the Regular Income Tax?

Some observers have argued that, rather than repealing the AMT, a better solution would be to repeal the regular income tax. The claim is that the AMT is nearly a flat-rate tax with only two statutory rates, 26 and 28 percent, both of which are significantly lower than the top statutory rate of 35 percent under the regular income tax. In addition, the AMT applies those lower rates to a broader income base, since it eliminates various special tax breaks that exist in the regular tax system. Since the AMT applies lower marginal rates to a broader tax base, it is a more efficient way of raising revenue than the regular tax system.

This analysis is incorrect for reasons already noted.²⁰ First, the AMT actually imposes four marginal tax rates, not two. The phaseout of the AMT exemption creates higher phantom tax rates of 32.5 and 35 percent, the latter equal to the top rate under the regular income tax.²¹ Most taxpayers face higher effective marginal tax rates under the AMT than they would under the regular income tax. And the

²⁰ For more detailed discussion, see Burman and Weiner (2005).

²¹ Although the AMT generally preserves the lower statutory tax rates on capital gains and qualified dividends that exist under the regular tax system, the effect is diminished by the phaseout of the AMT exemption. Rather than the advertised 15 percent rate, taxpayers with incomes in the phaseout range can face effective marginal tax rates as high as 22 percent on gains and dividends. See Leiserson (2007) for details.

relatively high AMT exemption actually means that the AMT tax base is often smaller than the regular income tax base. The AMT is far from the broad-base, low-rate tax system that tax reformers seek. In addition, it is worth noting that the AMT contains substantial marriage and family penalties and is not indexed for inflation, hardly the features one would want in a tax system. Lastly, if the regular income tax were repealed, AMT rates would have to rise by about 11 percent to maintain revenue-neutrality through 2017.

One could begin to reform the AMT by indexing it for inflation, eliminating marriage and family penalties, eliminating the phaseout of the exemption and raising rates to account for the revenue loss from those items and from the repeal of the regular income tax. But a better option might be to simply incorporate the AMT's most desirable features into the regular income tax. As we showed in the case of the state and local tax deduction, this base-broadening approach has the added virtue of allowing for cuts in marginal income tax rates while maintaining revenue neutrality.

CONCLUSION

Although the goals of the AMT—ensuring high-income taxpayers pay at least some amount of tax each year, and reducing inefficient tax sheltering—may command public support, the AMT is a highly imperfect way of achieving those goals. In particular, under current law, the AMT will come to plague the middle- and upper-middle-income classes with undue complexity, a narrower tax base, and higher marginal tax rates than under the regular income tax.

As the AMT expands, though, the political benefits of achieving a solution increase as well. We show that a number of revenue-neutral repeal options are available. All of these plans produce winners and losers—it would be impossible to

design a sensible revenue-neutral alternative to the AMT that does not—but many would cut taxes modestly on the middle class, have relatively small effects on many of those with higher incomes, and reduce the number of high-income filers who pay no taxes.

Acknowledgments

The authors thank Roberta Mann, Kim Rueben, Jerry Tempalski, David Weiner, Bob Williams and participants at the National Tax Association Spring Symposium for helpful comments and suggestions. Views expressed are those of the authors alone and do not necessarily reflect the views of the Urban Institute, the Brookings Institution, their boards, or their funders.

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