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A stylized world map in shades of teal and blue, showing the continents. It is positioned behind the "Insights from the" text box.

Insights from the
FEDERAL RESERVE BANK OF DALLAS

The Looming Challenge of the Alternative Minimum Tax

by Alan D. Viard

The alternative minimum tax has grown to the point where it will soon raise taxes for millions of Americans, many of them middle-income workers.

The United States adopted its first minimum income tax in 1969 in response to reports that a few hundred high-income individuals had avoided paying any income taxes. From these humble beginnings, the alternative minimum tax (AMT) has grown to the point where it will soon raise taxes for millions of Americans, many of them middle-income workers who weren't the targets of the original law.

While the AMT applied to 200,000 taxpayers in 1990, roughly 4 million will pay it this year, according to the Urban-Brookings Tax Policy Center. But that is only the beginning. Under current law, the AMT rolls will explode to 22 million in 2007. The AMT's revenue yield follows a similar pattern, having risen from \$2 billion in 1990 to \$22 billion this year. It's projected to nearly triple to \$65 billion in 2007.¹

AMT: Broader Base, but Lower Rates

Under the regular income tax, taxpayers subtract deductions and exemptions from gross income to obtain taxable income. A tax schedule then translates taxable income into tax liability before credits. Credits are then subtracted to obtain the tax.

The AMT has the same basic structure, but with different rules at each stage. There are a few differences in how gross income is computed:

- Interest on private-activity municipal bonds, such as those used to finance industrial projects, is excluded under the regular tax but included under the AMT.

- In computing sole proprietors' and partners' business income, the AMT uses slower depreciation schedules and puts more restrictions on the use of one year's losses to offset other years' income.

- The AMT taxes holders of incentive stock options when they exercise the option, while the regular tax waits until the stock is sold.

Under the regular tax, taxpayers can claim the larger of the itemized deductions or the standard deduction, which is \$10,300 for married couples. The AMT has no standard deduction and disallows some itemized deductions:

- State and local taxes cannot be deducted.

- Only medical expenses exceeding 10 percent of income are deductible; the regular-tax threshold is 7.5 percent.

- Interest on home-equity loans can be deducted only if the loan proceeds are used for home improvements.

- Miscellaneous itemized deductions,

including workers' unreimbursed job expenses, investment-related expenses and attorney's fees paid by winners of some taxable damage awards, cannot be claimed. The regular tax allows these deductions if they exceed 2 percent of income.

On the other hand, the regular tax starts phasing out some itemized deductions when income exceeds \$150,500; the AMT doesn't impose the phaseout.

The regular tax allows a \$3,300 per-person exemption for the taxpayer, spouse and each child, although the exemptions are phased out at high income levels. The AMT doesn't allow the exemptions.

Although most taxpayers have larger taxable income under the AMT than under the regular tax rules, the AMT has a more favorable tax schedule. The 2006 rates are listed below. The 32.5 and 35 percent brackets effectively phase out the benefits of the \$62,550 tax-free amount.*

<\$62,550	0
\$62,551 – \$150,000	26%
\$150,001 – \$220,040	32.5%
\$220,041 – \$400,200	35%
>\$400,200	28%

The AMT allows most of the regular tax system's major credits in 2006. The main exception is that sole proprietors and partners can't claim business-related credits, such as the low-income housing credit. But they may be able to offset the lost credits against their regular tax in other years.

*Both the regular tax and the AMT provide a special maximum rate of 15 percent for dividends and long-term capital gains. Effective rates may be higher due to interaction with other tax provisions.

The AMT's spread has added substantial complexity to the tax code, imposing burdens on taxpayers and the economy. A variety of reform options could address these problems, but difficult choices would have to be made to offset the resulting revenue losses.

The AMT's Growing Reach

The individual AMT is separate from the regular individual income tax, with different rates and rules (see box).² The AMT taxes income at lower rates than the regular system, primarily because the first \$62,550 of income is tax-free in 2006.

At the same time, the AMT has a broader base than the regular income tax because it disallows some deductions, exemptions and credits, limiting the extent to which they can be used to reduce tax liability. Unlike the regular tax, the AMT doesn't allow deductions for state and local taxes. Nor does it permit a variety of itemized deductions, including unreimbursed job expenses and investment-related expenses. The AMT doesn't allow the \$3,300 personal exemption that taxpayers, spouses and dependents receive under the regular tax. These three items accounted for most of the gap in taxable income between the AMT and the regular system, as reported by AMT taxpayers in 2002 (*Chart 1*).

Households must pay the larger of the two tax bills. So the AMT kicks in when the effects of its broader base outweigh the impact of its lower tax rates.

Through 2006, inflation has been largely responsible for the spread of the AMT. The regular system's bracket ranges are indexed to the Consumer Price Index so that inflation doesn't push taxpayers into higher brackets. But the AMT's brackets aren't indexed to inflation. As the CPI has moved upward, the AMT rates have risen automatically relative to the regular schedule, pushing more Americans into the AMT.³

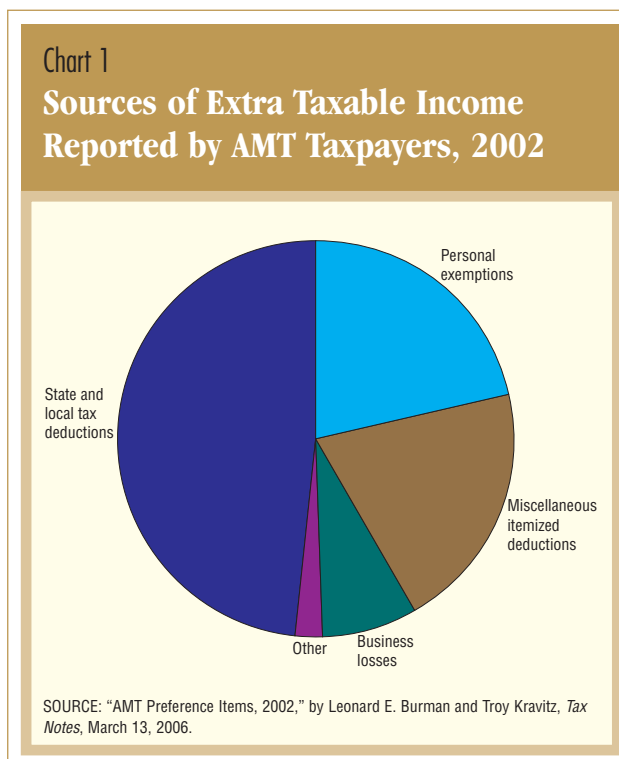
During the next four years, the AMT's spread will be largely driven by

recent tax cuts—the 2001 tax reduction and subsequent legislation—with some reinforcement from inflation. Tax reductions that offer relief from the regular income tax, without changing the alternative tax, tend to expand the AMT rolls by lowering some people's regular tax liability below their AMT liability. This result can be offset, of course, if the legislation also grants AMT relief.

The recent tax cuts include substantial regular tax relief through 2010. They also provide offsetting AMT relief, but most of it is currently scheduled to expire at the end of 2006. (Congress has repeatedly extended the AMT relief for a year or two at a time.) Starting next year, the tax-free threshold falls and many credits, such as those for child care and higher education costs, become unavailable under the AMT.⁴

The loss of credits and the change in the two tax systems' relative tax rates are largely responsible for next year's sharp rise in the number of Americans subject to the AMT. For married couples in 2006, tax liability is lower under the AMT than under the regular system at any given level of taxable income (*Chart 2*). The tax rate gap in favor of the AMT is even larger for unmarried taxpayers.

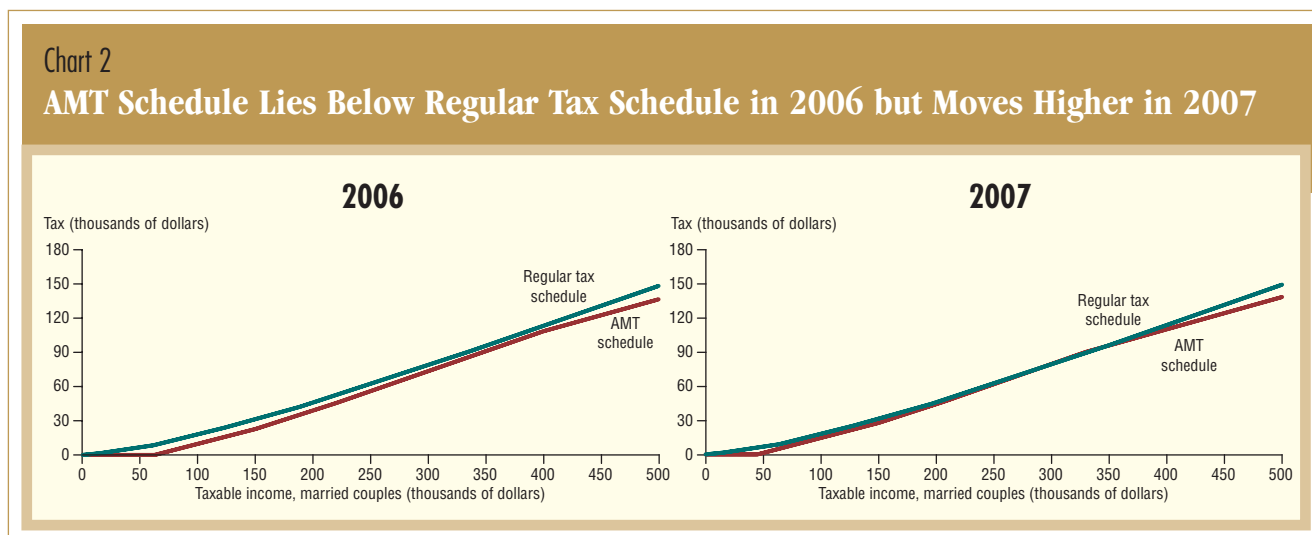
In 2007, however, the annual inflation adjustment pushes the regular tax schedule down slightly, while the



AMT schedule moves significantly higher because the tax-free threshold falls from \$62,550 to \$45,000. As a result, the tax schedules are significantly closer. Indeed, married couples' AMT schedule lies slightly *above* the regular tax schedule for taxable incomes between \$290,000 and \$346,000.

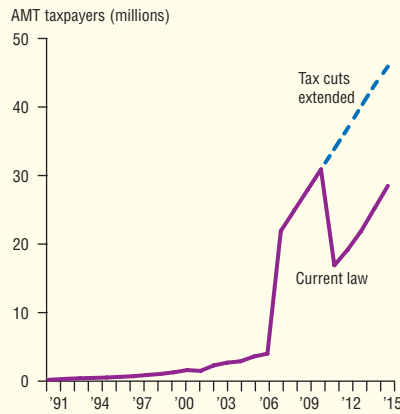
Looking farther ahead, the recent tax cuts are scheduled to expire at the

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*Any taxpayers
affected by the
AMT's restrictive
rules face the risk
of having to
pay it.*

Chart 3
**AMT Rolls Projected to
Explode in 2007**



SOURCE: Urban-Brookings Tax Policy Center, Table T06-0083 (May 2006); author's calculations.

end of 2010. As regular tax liabilities rise for many households, the AMT rolls will sharply contract from 31 million in 2010 to 17 million in 2011. But the number of taxpayers affected by the AMT will remain much larger than today, reflecting the impact of inflation. And the AMT rolls will further rise to 28 million in 2015 as inflation continues.

Congress has considered extending the tax cuts. Under this scenario, the AMT would reach 34 million taxpayers in 2011, growing to 46 million in 2015 (*Chart 3*).

Who Pays the AMT?

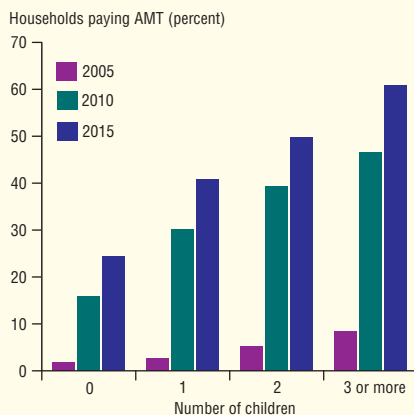
Any taxpayers affected by the AMT's restrictive rules face the risk of having to pay it. They include workers exercising incentive stock options or paying unreimbursed job expenses, holders of private-activity municipal bonds, winners of certain taxable damage awards and investors in low-income housing partnerships. Residents of high-tax states may fall into the AMT because it takes away their state and local tax deductions. Because the alternative system denies personal exemptions for taxpayers, spouses and children, larger families are significantly more likely to pay the AMT (*Chart 4*).

The likelihood of paying AMT is greater at income levels where the AMT schedule is high relative to the regular rates. Taxpayers with incomes of \$200,000 to \$500,000 (in 2005 dollars) are most likely to pay AMT because, as previously noted, that's where the difference in the two tax schedules virtually disappears (*Chart 5*). The fraction of taxpayers in the \$100,000–\$200,000 range paying AMT also becomes quite high in 2010 and 2015.

Compared with unmarried taxpayers, married couples face AMT schedules that are less favorable relative to the corresponding regular tax schedule. As expected, couples are more likely to pay the AMT (*Chart 6*).

These groups aren't wealthy

Chart 4
**Larger Families More
Likely to Pay AMT**



NOTE: The 2015 computations assume extension of the recent tax cuts.

SOURCE: Urban-Brookings Tax Policy Center, Table T05-0086 (June 2005).

households using arcane loopholes to escape tax liability. Their exposure indicates that the AMT is reaching a growing number of middle-income taxpayers who haven't engaged in tax avoidance but have merely claimed personal exemptions and other routine deductions. If current law remains in place, they will be forced to deal with the AMT and all of its complexity.

Complications Caused by the AMT

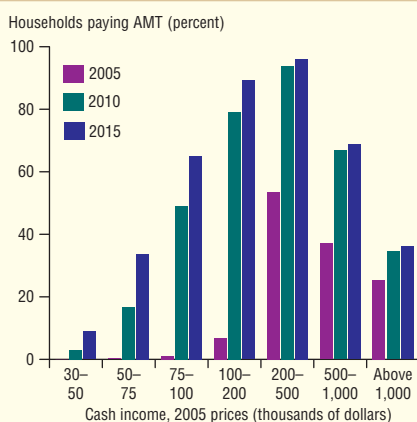
The AMT imposes significant computational burdens on American households. The Form 1040 instructions ask taxpayers to complete a 16-line worksheet to determine whether they should compute the AMT on Form 6251. That form, in turn, has 55 lines, accompanied by nine pages of turgid instructions. Completing it often requires revising schedules attached to the regular tax return. Each year, millions of taxpayers slog through Form 6251 only to learn that they don't owe the AMT.

The burdens extend to AMT taxpayers who use business or capital losses or foreign tax credits from other years to reduce current tax liability. They must make AMT computations for those other years, even if they were then on the regular tax.

The AMT and the regular tax could have been made entirely separate, with taxes computed from scratch under each set of rules. But Congress has provided for interaction between the two systems, which can result in anomalies. For example, because AMT capital gains and dividend computations "borrow" a number from the corresponding regular tax computations without accounting for the differences between the systems, it's possible for tax liability to rise as more deductions are claimed.⁵ Moreover, taxpayers who claim the standard deduction for regular income tax purposes can't itemize for AMT purposes, so some taxpayers must itemize solely to avoid AMT liability.

Another complication involves differences in timing rules. If the regular

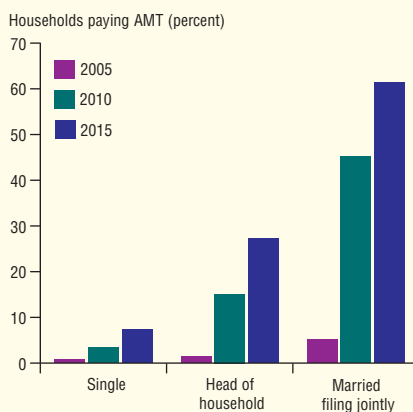
Chart 5
\$200K–\$500K Income Group
Most Likely to Pay AMT



NOTE: The 2015 computations assume extension of the recent tax cuts.

SOURCE: Urban-Brookings Tax Policy Center, Table T05-0086 (June 2005).

Chart 6
Married Couples More
Likely to Pay AMT



NOTE: Unmarried taxpayers caring for children are heads of household; other unmarried taxpayers are single. The 2015 computations assume extension of the recent tax cuts.

SOURCE: Urban-Brookings Tax Policy Center, Table T05-0086 (June 2005).

The AMT is reaching a growing number of middle-income taxpayers who haven't engaged in tax avoidance but have merely claimed personal exemptions and other routine deductions.

The complexity of our two-headed tax system has led to widespread—perhaps universal—agreement that reform is needed.

tax allows an expense to be deducted in an earlier year while the AMT allows it to be deducted in a later year, a taxpayer who is on the AMT in the earlier year and on the regular tax in the later year never deducts the item. To provide relief for taxpayers in this situation, Congress allows any AMT liability due to differences in timing rules to be credited against future regular tax liability to the extent that it exceeds future AMT liability. But that requires filling out Form 8801, which is 46 lines long, with four pages of complicated instructions. (The bulk of overall AMT liability is due to lost deductions and exemptions, rather than differences in timing rules, and therefore can't be credited against future regular taxes.)

Having two tax systems also gives rise to added tax planning. For example, AMT taxpayers have an incentive to shift payments of state and local taxes and unreimbursed job expenses into years in which they're liable for the regular tax.

The complexity of our two-headed tax system has led to widespread—perhaps universal—agreement that

reform is needed to prevent these burdens from being imposed on additional tens of millions of taxpayers.

Reform Options

Despite agreement on the need for reform, a spirited debate rages over what direction it should take. Some tax experts call for retaining the AMT but limiting its spread. Others advocate returning to a single tax system by repealing either the AMT or the regular tax.

Those who favor keeping the AMT contend it should apply to a small number of higher income households that use selected tax preferences, as Congress originally intended. They see the AMT as a useful step to address unwarranted tax preferences that inefficiently divert resources to tax-favored economic activities and unfairly favor certain groups but that are too politically popular to repeal. Adopting an alternative tax that denies these preferences is one way to limit the savings taxpayers can get from them. The advocates of retaining the AMT agree, though, that it shouldn't cover the broad range

of taxpayers now facing exposure.

Supporters of this approach propose extending the AMT relief scheduled to expire at the end of 2006, thereby forestalling the AMT explosion slated for next year. They also generally favor indexing the AMT brackets, particularly the tax-free threshold, to inflation. Some proponents would go further and restore some of the deductions now disallowed by the AMT, such as personal exemptions, state and local taxes and unreimbursed job expenses.

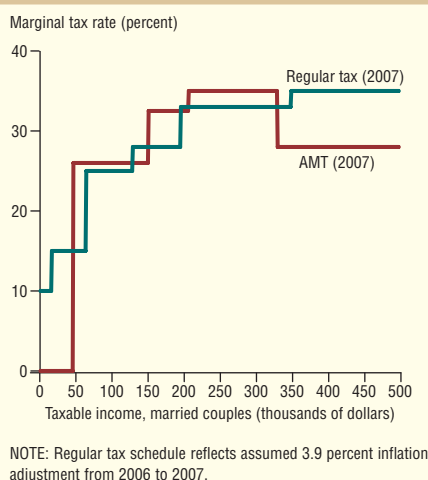
Other tax experts contend that the complexity of two systems simply can't be justified. They acknowledge that the regular tax includes some unwarranted tax preferences but see selectively limiting such preferences through a second tax system as a poorly designed remedy. Outright repeal of the AMT has been endorsed by the Internal Revenue Service's National Taxpayer Advocate, the staff of the Joint Committee on Taxation of the U.S. Congress and the President's Advisory Panel on Federal Tax Reform.⁶

A few supporters of returning to a single system suggest going in the opposite direction—repealing the regular tax and retaining the AMT. A number of economists have long argued that the best income tax is a broad-based one with lower marginal tax rates. At first glance, the AMT seems to be exactly such a tax. Although there is some truth to this observation, some caveats should be noted.

The AMT marginal tax rates aren't always that much lower than the regular tax's marginal rates; sometimes, they are actually higher (*Chart 7*). A large portion of the AMT's lower rates reflects the tax-free threshold's zero rate. Once the AMT kicks in, the marginal rate jumps to 26 percent, well above the regular system's 15 percent. The highest marginal rate under each system is the same—35 percent. The AMT applies its 35 percent marginal rate to an intermediate income range—\$206,000 to \$330,000 in 2007.⁷ At the highest incomes, the AMT's marginal rate is indeed lower—28 percent rather

Chart 7

AMT Marginal Rate Can Be Higher Than Regular-Tax Marginal Rate



than 35 percent. A recent study found that being on the AMT raised marginal tax rates for some taxpayers and lowered them for others.⁸

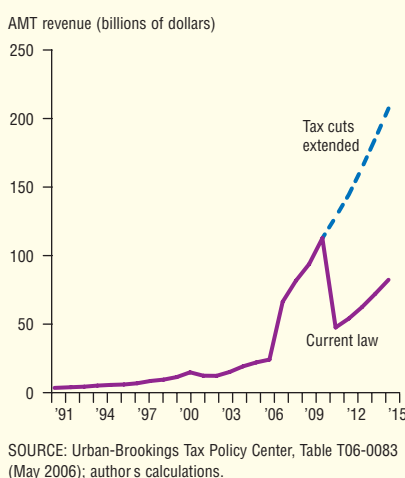
The treatment of state and local taxes also affects the marginal tax rate. Under the regular tax, effective marginal federal tax rates are somewhat lower than the official rates because state and local taxes are deductible. Take a worker in the 35 percent regular income tax bracket facing a 6 percent marginal state income tax rate. His marginal federal rate is really only 32.9 percent because federal taxes apply only to the 94 percent of income left after paying state taxes. No similar reduction occurs under the AMT because it disallows state and local tax deductions.

The AMT's base, moreover, isn't that much broader than the regular system's. Supporters of a broad-based, low-rate income tax generally call for the taxation of fringe benefits, government transfer payments and interest on municipal bonds. They even advocate taxation of the rental value of owner-occupied homes or, at least, repeal of the mortgage-interest deduction. The AMT does very little to fulfill this base-broadening agenda.⁹

In some cases, the AMT's base may be *too* broad. Supporters of a broad-based income tax agree that the costs of earning income should be deductible. Yet, the AMT denies deductions for unreimbursed job expenses and investment-related expenses, and it taxes some lawsuit winners' damage awards with no allowance for attorney's fees. Denying these deductions is inappropriate unless the expenditures are actually personal consumption rather than costs of earning income.

Another harsh feature of the AMT has drawn some attention. Workers who buy stock by exercising an incentive stock option and later suffer a loss can end up owing AMT on gains they did not retain. Consider a worker who exercises an incentive stock option, paying \$100,000 to buy shares worth

Chart 8
AMT Raises Significant Revenue



\$500,000. He later sells the stock after its value falls to \$200,000. Under the regular tax, the worker pays tax on a \$100,000 capital gain at the time of sale. Under the AMT, he owes tax on \$400,000 at the time he exercises the option and has a \$300,000 capital loss at the time of sale. However, only \$3,000 a year of that loss can be deducted against income other than capital gains. Some workers at high-tech firms, whose stock values plummeted after 2000, have AMT bills they may never be able to pay.¹⁰

If a single tax system is adopted, it should probably differ from the AMT.¹¹ It should also probably differ from the regular income tax. Indeed, many economists argue that the best tax system is a consumption tax because it eliminates the income tax's penalty on saving. Under that criterion, both the regular income tax and the AMT fall short.

Policymakers have failed to adopt a long-term solution to the AMT problem, although they have repeatedly extended AMT relief for a year or two at a time. Disagreement over the best

way to reform the AMT is one reason policymakers have been slow to act. But the budgetary implications may be even more important.

As the AMT spreads, it will bring in large amounts of revenue (*Chart 8*). It is projected to generate 9 percent of individual income tax revenue in 2010, increasing to 12 percent in 2015 if the tax cuts are extended. AMT repeal would require the government to forgo this revenue, a difficult prospect at a time of large budget deficits. Revenue losses from limiting the spread of the AMT, rather than repealing it, would be smaller, but not by much.

If Congress extends the tax cuts beyond 2010, the AMT raises more revenue and reforms impose larger revenue losses. In general, a commitment to prevent the spread of the AMT means that the budgetary cost of regular tax relief includes both its direct revenue losses and those from the required offsetting AMT relief.

Addressing the revenue loss from AMT repeal requires a choice between paying now and paying later. Failing to replace the AMT revenue would result

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in still greater government borrowing, forcing spending cuts or tax hikes in the future. Replacing the revenue would require spending cuts or tax hikes today.

Little political support exists for large spending cuts. On the revenue side, an AMT offset might include increases in marginal income tax rates. For example, a one-tenth increase in marginal rates could replace AMT revenue in 2010.¹² Of course, higher marginal tax rates can have undesirable economic effects.

Another way to increase revenues would be to remove unjustified preferences from the regular tax system. In its income-tax reform option, for example, the President's Advisory Panel on Federal Tax Reform suggested repealing the AMT and replacing part of its revenue by revoking the regular system's state and local tax deduction, which the panel viewed as unjustified. Another approach would combine AMT repeal with a sweeping tax reform that includes at least a partial move to consumption taxation, as the panel suggested in its second reform option. Any such reform would involve difficult and controversial trade-offs.

Faced with these unpalatable options, policymakers have delayed addressing the AMT problem. Surely, though, the time has come to fix a tax system that everyone agrees is broken.

Viard is a senior economist and research officer in the Research Department of the Federal Reserve Bank of Dallas.

Notes

¹ Urban-Brookings Tax Policy Center, Tables T05-0085 (June 2005) and T06-0037 (February 2006) and author's calculations.

² The corporate income tax system also features an AMT. It lies outside the scope of this article.

³ As real incomes rise due to economic growth, taxpayers move into higher brackets under both

the regular tax and the AMT. In general, economic growth could either raise or lower the number of people paying AMT. At present, growth tends, on balance, to increase the number of people paying AMT.

⁴ The tax cuts provide some longer-lasting AMT relief; they allow the \$1,000 child credit, the earned income tax credit and the adoption credit to be claimed under the AMT through 2010.

⁵ For a technical explanation, see, "In AMT? Even the Capital Gains Rate May Be Higher for You," by Kris Hill, *Tax Notes*, April 5, 2004, pp. 119–22.

⁶ National Taxpayer Advocate, 2003 Annual Report to Congress; *Study of the Overall State of the Federal Tax System and Recommendations for Simplification*, Staff of the Joint Committee on Taxation of the U.S. Congress, April 2001; *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*, President's Advisory Panel on Federal Tax Reform, November 2005.

⁷ As previously noted, this anomaly occurs because the tax-free amount is being phased out over this income range.

⁸ "The Alternative Minimum Tax and Effective Marginal Tax Rates," by Daniel R. Feenberg and James M. Poterba, *National Tax Journal*, vol. 57, part 2, June 2004, pp. 407–27.

⁹ The AMT taxes interest on private-activity municipal bonds and disallows the deduction for interest on some home-equity loans. For extensive discussion of the ideal of a broad-based income tax, see *Comprehensive Income Taxation*, Joseph A. Pechman, ed., Washington, D.C.: Brookings Institution, 1977.

¹⁰ "Bankruptcy Deadline Looms for Those with AMT/ISO Problems," by Warren Rojas, *Tax Notes*, Oct. 3, 2005, pp. 32–33, and "Windfall Never Came: Big Tax Bill Did," by Floyd Norris, *New York Times*, March 31, 2005, describe the plight of the affected high-tech workers. On July 29, 2006, the House passed a tax-reduction and minimum-wage-increase bill that included relief for these workers. On August 3, the Senate rejected a motion to limit debate and proceed to vote on the bill.

¹¹ This conclusion is also reached by Leonard E. Burman and David Weiner in "Suppose They Took the AM Out of the AMT?" *Proceedings of the National Tax Association 97th Annual Conference on Taxation*, Washington, D.C., National Tax Association, 2004, pp. 447–58, and George K. Yin in "Enacting Tax Reform in the Face of Fiscal Calamity," *Tax Notes*, July 3, 2006, pp. 61–63.

¹² Urban-Brookings Tax Policy Center, Table T05-0091 (June 2005).

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