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by Leonard E. Burman, William G. Gale, and Jeffrey Rohaly

The AMT: Projections and Problems

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I. Introduction

The individual alternative minimum tax (AMT) operates parallel to the regular income tax, imposing a different income definition, allowable deductions, and rate structure. The AMT grew out of a minimum tax that first took effect in 1970, due to legislation enacted in response to public outrage in the wake of testimony by Treasury Secretary Joseph W. Barr (1969) that 155 high-income households had paid no income tax in 1966. Although it has historically applied to only a very small share of taxpayers, the tax is projected to grow rapidly over the next decade, transforming it from a class tax to a mass tax. The growth of the AMT will create problems of equity, efficiency, complexity, and transparency in the tax system. It will also inevitably force policy makers to focus more attention on the issue, in part because many reform options will prove expensive.

This column provides new projections of AMT taxpayers and revenues, and uses the projections to examine some broader implications for tax policy and the AMT. The results reported here update our previous work on the AMT.[1] The updates incorporate the January 2003 economic projections from the Congressional Budget Office, the features of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), and a major update of the Tax Policy Center microsimulation model.[2] In general, although the updates change the estimates slightly, the principal trends, conclusions, and concerns are similar to those found in earlier work. In particular, we find that:

- **AMT coverage will skyrocket.** By 2010, the AMT will affect 33 million taxpayers — about one-third of all taxpayers — up from 1 million in 1999. This would make the AMT about as common as the mortgage interest deduction is today. The AMT will be the *de facto* tax system for households with income between $100,000 and $500,000, more than 92 percent of whom will face the tax.
- **AMT expansion will encroach dramatically on the middle class.** Households with income less than $100,000 will account for 52 percent of AMT taxpayers in 2010, up from 9 percent today. They will account for 23 percent of AMT revenue, compared with just 5 percent in 2003. In 2010, the tax will affect 37 percent of households with income between $50,000 and $75,000 and 73 percent of households with income between $75,000 and $100,000 (compared to about 1 percent for each group in 2002).
- **The expansion occurs because the AMT is not indexed for inflation and because of the 2001 tax cut.** Holding real income fixed, the lack of indexing raises AMT liabilities every year, while the tax cut reduces regular income tax liabilities. The 2001 tax cut will more than double the number of people subject to the AMT in 2010 (from 14 million to 33 million). If the AMT had been indexed when the regular income tax was and

[1] The earlier analysis is contained in Burman, Gale, Rohaly and Harris (2002) and Burman, Gale and Rohaly (2002). Other discussions of the AMT include: General Accounting Office (2000), Graetz and Sunley (1988), Gravelle (1988, 2001), Harvey and Tempalski (1998), Joint Economic Committee (2001), Karlinsky (1995), Leonard (1998), Rebelain and Tempalski (2000), Shaviro (1988, 2001), and Tempalski (1996).

[2] Unless otherwise noted, all of the projections in this paper derive from the Tax Policy Center Microsimulation Model. The current version of the model is based on data from the 1999 public-use file produced by the Statistics of Income Division of the Internal Revenue Service (IRS). The file contains about 132,000 records with detailed information from federal individual income tax returns filed in the 1999 calendar year. A statistical match with the March 2000 Current Population Survey provides demographic and other information to supplement the tax data. The tax model has two components: a statistical routine that uses forecasts from the Congressional Budget Office, the IRS, and the Bureau of the Census to "age" or extrapolate the 1999 data to create representative samples of the filing and nonfiling population for future years, and a detailed tax calculator that computes the regular income tax and AMT liability for all tax units in the sample under current law and under alternative policy proposals. See http://taxpolicycenter.org/commentary/model.cfm for additional details.

had the 2001 tax cut not been enacted, fewer than 300,000 households would face the AMT, now or in 2010.

- **By 2008, it would cost less to repeal the regular income tax (leaving the AMT in place) than to repeal the AMT.**
- **The AMT penalizes taxpayers who marry and/or have children.** Couples will be more than 20 times as likely as singles to face the AMT in 2010. Because the AMT prohibits deductions for dependents, 64 percent of married couples with two or more children will face the AMT, 97 percent among those couples with income between $75,000 and $100,000. About 5.7 million taxpayers will face the AMT in 2010 simply because they have children.
- **The AMT is notoriously and pointlessly complex.** The Internal Revenue Service and the National Taxpayer Advocate have flagged the AMT as one of the most complicated tax provisions to comply with and administer. Most people required to fill out the AMT forms end up owing no additional taxes. The AMT also creates complicated interactions with the regular income tax.
- **The AMT raises marginal tax rates.** By 2010, the AMT will impose higher marginal tax rates than the regular income tax does for 93 percent of AMT taxpayers.
- **The AMT reduces the number of high-income filers who pay no income tax.** In 2003, an estimated 600 tax filers with incomes exceeding $1 million will avoid all income tax, but at least 2,700 would have if not for the AMT. But even if the goal of having every high-income tax return filer pay some income tax in each year is accepted, the AMT seems an extraordinarily cumbersome way to advance that goal.
- **The AMT is poorly targeted.** More than 90 percent of current AMT taxpayers face the tax only because they have dependent exemptions, standard deductions, or itemized deductions for taxes paid, medical costs, or miscellaneous expenses. These provisions have nothing to do with egregious or aggressive tax sheltering.
- **Reforming the AMT will likely prove expensive and politically difficult.** Repealing the tax would cost about $600 billion between 2004 and 2013 under current law. If the non-AMT provisions of recent tax cuts are extended permanently, AMT repeal would cost more than $1 trillion over the next decade, above and beyond the cost of the non-AMT extensions.

This article examines how a tax that was originally aimed at 155 taxpayers could grow under current law to target 33 million. Section II provides a brief discussion of the AMT. Section III presents new projections of AMT taxpayers and revenues. Section IV explores how the growing role of the AMT affects the equity, efficiency, and complexity of the tax system. Section V concludes. A companion column will address options for reform.

II. Background[3]

The original minimum tax in 1970 was an "add-on" that applied mainly to income from capital gains, which was (and is currently) taxed at highly preferential rates. In 1978, Congress created an "alternative" minimum tax that operates in parallel with the regular income tax. In 1982, the original add-on tax was eliminated and most of its provisions were incorporated in the AMT.

The AMT has been altered repeatedly since then, usually but not always at the same time as changes in the regular income tax. For example, the Tax Reform Act of 1986 broadened the base of both taxes and the 1993 tax act raised marginal rates under both. Two major exceptions to the general rule account for much of the explosive growth. The Economic Recovery Tax Act of 1981 cut taxes and indexed the regular income tax for inflation, but did not index the AMT. More recently, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) cut regular income tax rates, but made only minor or temporary changes to the AMT.

Currently, taxpayers who may be subject to the AMT must calculate their tax liability twice: once under the regular income tax rules and again under AMT. If AMT liability proves higher, taxpayers pay the difference as a surcharge on their regular income tax. Technically, the difference paid is their AMT. Taxpayers must calculate an AMT worksheet if their income exceeds certain thresholds and must calculate AMT liability if directed to by the worksheet or if they have certain types of income called deferral preferences, which are defined below.

To calculate the AMT, taxpayers start with their adjusted gross income and subtract deductions and exemptions to yield regular taxable income for AMT purposes.[4] They then add items that are paradoxically called "AMT preferences," which fall into two categories. Exemption preferences allow taxpayers a variety of deductions, exclusions or credits in the regular tax, but not the AMT. These include personal exemptions, the standard deduction, and itemized deductions for state taxes and miscellaneous expenses. Middle-income taxpayers are the most likely to be hit by exemption preferences. These preferences, however, have little or nothing to do with tax sheltering and consequently are hard to justify on policy grounds.

Deferral preferences allow taxpayers to postpone regular income tax payments or shelter income by hastening deductions or delaying income recognition. The

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[3]The history of the AMT and rules for calculating the AMT are described in much greater detail in Burman, Gale, Rohaly, and Harris (2002).

[4]This can differ from taxable income in the regular income tax because taxable income for AMT purposes can be negative, whereas taxable income in the regular income tax cannot be less than zero.

Table 1: Aggregate AMT Projections, 2003-2013[1]

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Total 2003-13
Number of AMT Taxpayers[2]												
Pre-EGTRRA Law	4.2	4.9	6.0	7.2	8.7	10.3	12.0	14.3	16.8	19.3	22.5	
Current Law	2.4	3.2	12.7	16.5	21.2	26.4	29.9	33.1	16.8	19.3	22.5	
Current Law Extended[3]	2.4	3.2	17.5	20.7	23.9	27.2	30.3	33.5	36.4	39.2	41.8	
AMT Revenue[4]												
Pre-EGTRRA Law	14.5	16.3	18.7	21.2	24.8	29.2	33.7	39.7	47.1	55.2	64.6	364.9
Current Law	15.9	18.0	37.4	49.7	62.2	85.1	100.9	124.1	47.1	55.2	64.6	660.2
Current Law Extended	15.9	18.0	46.4	58.1	69.9	88.1	103.1	126.5	145.6	167.8	191.5	1,031.0
AMT Revenue as a Percent of Income Tax Revenue												
Pre-EGTRRA Law	1.6	1.6	1.7	1.8	2.0	2.2	2.3	2.6	2.9	3.2	3.5	2.4
Current Law	2.1	2.2	4.0	4.9	5.7	7.3	7.9	9.1	2.9	3.2	3.5	4.8
Current Law Extended	2.1	2.2	5.1	5.9	6.6	7.7	8.3	9.5	10.2	10.9	11.6	8.0
Percent of AGI on AMT Returns												
Pre-EGTRRA Law	9.0	10.1	11.6	13.1	15.1	17.2	19.2	21.9	24.6	27.4	30.7	19.3
Current Law	10.6	12.3	28.0	33.8	39.6	46.0	49.0	52.5	24.6	27.4	30.7	33.1
Current Law Extended	10.6	12.3	35.2	39.5	42.7	46.8	49.6	53.0	55.2	57.2	58.8	44.4
Cost of Income Tax Repeal[5]												
Pre-EGTRRA Law	220.0	222.0	221.9	225.4	223.3	221.4	220.1	217.0	214.9	210.7	207.9	2,404.4
Current Law	188.8	184.3	102.0	93.9	87.9	74.2	68.2	52.4	214.9	210.7	207.9	1,485.1
Current Law Extended	188.8	184.3	74.9	70.6	66.5	57.6	54.2	46.4	41.7	37.1	33.0	855.1

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0503-1).
Notes:
[1]Calendar Years. Numbers may not add due to rounding.
[2]In millions. AMT taxpayers are defined as those with either an AMT liability from Form 6251 or those with lost credits.
[3]Includes all 2010 sunset provisions in EGTRRA and all non-AMT provisions in JGTRRA.
[4]In billions of dollars. Taxpayers are defined as returns with positive income tax net of refundable credits.
[5]In billions of dollars. 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.

AMT rules limit the extent to which taxpayers can use deferrals by, for example, allowing less generous depreciation deductions. Compared with exemption preferences, deferral preferences are more consistent with the original goals of the AMT, have a greater tendency to affect high-income filers, but are more complex and generate less revenue.

Once a taxpayer adds in all preferences and tallies income, the next step is to subtract the AMT exemption. The first $175,000 of remaining income is taxed at a statutory 26 percent rate, with additional income taxed at a 28 percent rate. Because the AMT exemption itself phases out at a 25 percent rate over higher income ranges, the effective tax rate can be as high as 35 percent. The AMT exemptions, tax brackets, and exemption phase-out thresholds are not indexed for inflation.

Like the rest of the tax code, the AMT is riddled with expiring provisions, or sunsets, and these are important in understanding the projections discussed below.[5] First, the AMT exemptions are currently $58,000 for married couples and $40,250 for singles and heads of households. Prior to EGTRRA these exemptions were $45,000 and $33,750, respectively. EGTRRA raised the exemptions to $49,000 and $35,750 through 2004. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) raised the exemptions to their current levels, retaining the sunset at the end of 2004. In 2005, the exemptions are set to return to pre-EGTRRA levels. Second, taxpayers may use personal nonrefundable credits to offset AMT liability, but this provision expires at the end of 2003. Third, taxpayers may use the child credit to offset AMT liability, but only through 2010.

III. Projections

A. Aggregate Projections

Table 1 presents new projections of AMT coverage and revenues and related items for calendar years 2003-2013. We present three sets of estimates to illustrate how basic economic trends, recent legislation, and proposals to make that legislation permanent have affected or would affect the AMT. The first baseline is based on tax law as it existed at the beginning of 2001, before any of President Bush's tax cuts were enacted.

[5]Gale and Orszag (2003) provide information on the increasing use and the magnitude of sunsets in the tax code.

The second incorporates current law, including all of the tax changes that have been made since President Bush took office — including EGTRRA in 2001, the Job Creation and Worker Assistance Act of 2002 (JCWA), and JGTRRA in 2003.

The third baseline is called "current law extended"; in this baseline, we extend (or make permanent) all of the *non-AMT* provisions of EGTRRA that expire in 2010 and all of the *non-AMT* expiring provisions in JGTRRA, but we allow all provisions regarding the AMT to expire as scheduled.[6] This baseline is not intended as a prediction; indeed, we expect that policymakers will have to deal with the AMT before EGTRRA's scheduled expiration date precisely because the consequences of ignoring it are so dire, *especially if the provisions of EGTRRA and JGTRRA are extended*. The extended baseline shows the pressures to deal with the AMT, as well as the huge revenue cost, assuming that policymakers carry through with their avowed intent to make the expiring current law provisions permanent.

The first point is the key role of inflation in generating a rising trend of AMT taxpayers. Under pre-EGTRRA law, 4.2 million taxpayers would have faced the AMT in 2003, rising gradually to 14.3 million in 2010 and then to 22.5 million in 2013. This trend reflects the fact that the AMT is not indexed for inflation, but the regular income tax is. Thus, to the extent that inflation raises nominal incomes, taxpayers' regular income tax liability is not affected, since the brackets, exemptions and standard deductions are indexed for inflation, but their AMT liability rises, throwing more of them onto the alternative tax.

The second point relates to the long-term effects of recent tax legislation. By 2010, the number of AMT taxpayers rises to 33.1 million under current law. Because the provisions of JCWA and JGTRRA expire before 2010, the result implies that EGTRRA will raise the number of AMT taxpayers by 18.8 million (=33.1-14.3) by 2010, and thus will more than double the number of taxpayers facing the AMT. Starting in 2011, the figures for current law are the same as for pre-EGTRRA law, since all of these tax cuts expire by the end of 2010.

In contrast, if the AMT had been indexed for inflation along with the regular income tax in the 1981 tax cut, and if EGTRRA had not been enacted in 2001, the number of AMT taxpayers in 2010 would be about 268,000, less than 1 percent of the 33 million projected under current law, and about 0.25 percent of all taxpayers (not shown). That is, the long-term growth of AMT taxpayers may be attributed almost entirely to the failure to index the AMT in the 1981 tax cut, when the regular income tax was indexed, and the failure to permanently adjust the AMT in the 2001 tax cut, when regular income tax rates were cut substantially.

[6]We would also have extended the non-AMT provisions of the Job Creation and Worker Assistance Act of 2002, but there are no such provisions that are included in the TPC tax model.

The third point relates to the short-term effects of the recent tax cuts. Under current law, 2.4 million taxpayers face the AMT in 2003, compared to 4.2 million under pre-EGTRRA law. The difference occurs because the 2001 and 2003 tax cuts raised the AMT exemption (through 2004) and the 2002 tax cut extended the use of nonrefundable credits against the AMT (through 2003). By 2005, however, when all of these temporary provisions expire, the number of AMT taxpayers jumps to 12.7 million under current law, more than twice the figure under prior law.

The fourth point focuses on the long-term implications of extending the tax cuts. Extending the non-AMT expiring provisions (as described above) would imply that 41.8 million taxpayers would face the AMT in 2013, compared to 22.5 million under either current or pre-EGTRRA law.

The final point relates to the short-term implications of extending current law. If the non-AMT provisions of the recent tax cuts were extended, the number of AMT filers would increase to 17.5 million in 2005, as opposed to 12.7 million if the non-AMT provisions are allowed to expire as scheduled under current law.[7] The difference occurs because various provisions of JGTRRA scheduled to expire after 2004 would, if extended, significantly reduce regular income tax liability but not AMT liability.[8]

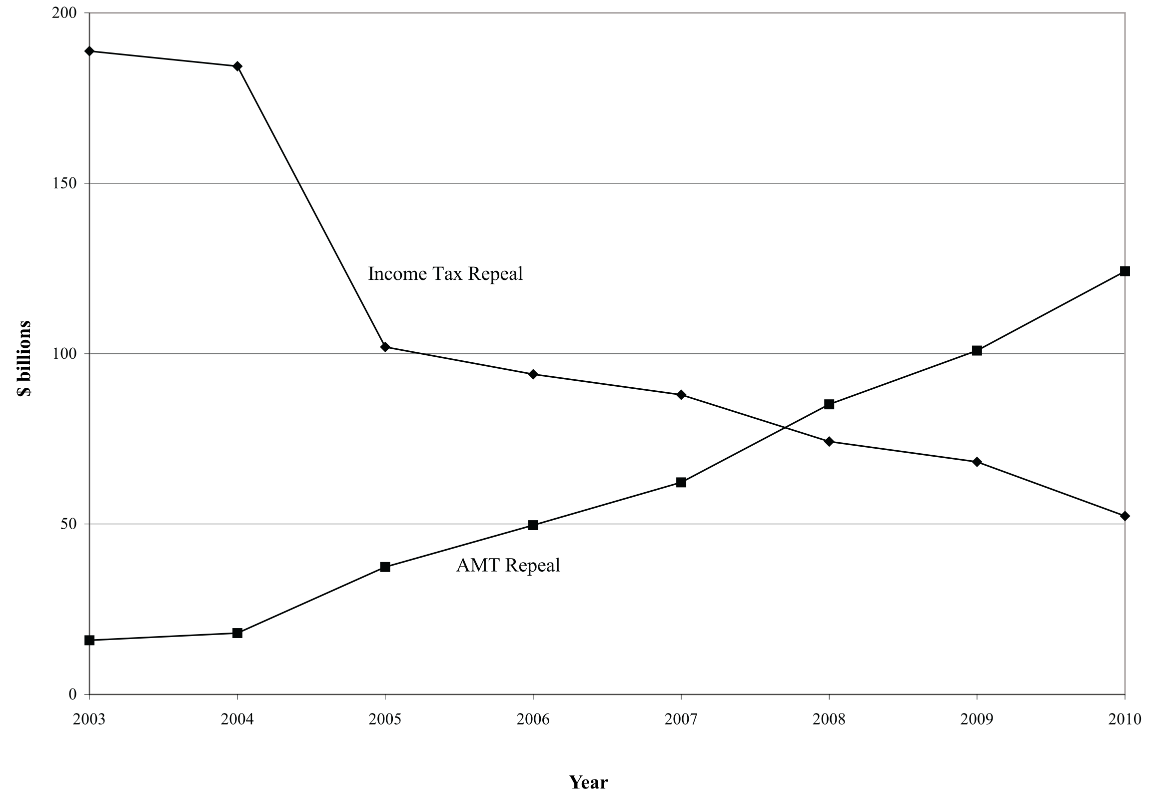
Table 1 also reports other measures of the expanding reach of the AMT. AMT revenue (which is also a measure of the minimum cost of repealing the AMT) would have been $365 billion under pre-EGTRRA law over the 2003-2013 period. It would be $660 billion under current law, and more than $1 trillion if the non-AMT provisions of the recent tax cuts were extended. By 2013, AMT revenue is projected to be $64.6 billion under current law and $191 billion — 1.1 percent of projected GDP (CBO 2003) — if the non-AMT provisions of EGTRRA and JGTRRA are extended.

In 2003, AMT tax returns account for 11 percent of AGI. By 2010, that share is projected to rise to 52 percent. If the non-AMT provisions of recent tax cuts are extended, the share rises to 59 percent by 2013.

[7]If the AMT exemption levels and use of refundable credits were extended along with the non-AMT provisions, 3.6 million taxpayers would face the AMT in 2005.

[8]For example, the elimination of the "marriage penalty" in the standard deduction and 15 percent tax bracket is scheduled under current law to expire after 2004 and then gradually return to its 2004 levels over the next five years. Also, the 10 percent bracket expansion expires after 2004 and returns in 2008 (Joint Committee on Taxation 2003). The difference between the number of AMT taxpayers under current law and current law extended shrinks over time as the various provisions that were accelerated to 2003 and then allowed to expire in 2004 under current law are then reinstated later in the decade. By 2009, almost all of these provisions would have been restored, so for those years the main remaining difference between the current law and current law extended scenarios are the lower tax rates on dividends and capital gains enacted in 2003, and the fact that indexation of the 10 percent bracket was accelerated in the 2003 act.

Figure 1: Revenue Loss of Income Tax Repeal and AMT Repeal Under Current Law



Under pre-EGTRRA law, AMT revenue as a share of total income tax revenue would have remained below 3 percent through 2011. But AMT revenue rises to 9 percent of income tax revenue in 2010 under current law, and to 12 percent in 2013 if the non-AMT provisions of recent tax cuts are extended.

Finally, Figure 1 shows perhaps the clearest measure of the expanding reach of the AMT: By 2008, it would cost less to repeal the regular income tax (keeping the AMT in place) than it would to repeal the AMT (keeping the income tax in place). In 2008, total income tax revenues are projected to be $1,163 billion, including $1,078 billion from the regular income tax and $85 billion from the AMT. AMT repeal would therefore reduce revenues by $85 billion. Repealing the regular income tax would reduce revenues by the entire $1,078 billion it would otherwise collect, but it would raise AMT revenue by $1,004 billion, so that the net revenue loss is just $74 billion.

B. Projections by Taxpayer Characteristics

Table 2 (on the next page) provides more details on the pattern of AMT coverage. In 2003, about 2.6 percent of taxpayers will be affected by the AMT.[9] The AMT currently affects very few taxpayers with AGI below $100,000. For taxpayers with incomes exceeding $100,000, current AMT participation rates rise sharply and peak at 55 percent in the $200,000 to $500,000 income range. For higher levels, AMT participation falls, but even for the highest income group, those exceeding $1 million, almost 20 percent face the AMT.[10]

Over time, the share of taxpayers on the AMT rises substantially, from 2.6 percent in 2003 to 12.8 percent in 2005 and 30.4 percent in 2010 under current law. These figures are considerably higher than those under pre-EGTRRA law: 5.9 percent in 2005 and 12.7 percent in 2010. If the non-AMT provisions of the recent tax cuts are extended, 37 percent of taxpayers will face the AMT by 2013.

AMT participation trends by income level are shown in table 2 and figures 2 and 3 (p. 111). Few households with AGI below $30,000 will face the AMT over the next decade. Households with higher incomes will be hit hard. The AMT will cover 37 percent of taxpayers with AGI between $50,000 and $75,000 in 2010, up from less than 1 percent in 2003. The tax will affect 73 percent of taxpayers with AGI between $75,000 and $100,000 in 2010, compared to only 1 percent today. For tax-

[9]A taxpayer is defined as a return filer with positive income tax liability after tax credits.

[10]The reason AMT participation falls as income rises above $500,000 is that regular income tax liability is boosted by the large share of income that is taxed at the highest marginal regular income tax rate.

Table 2: AMT Participation Rate (percent) by Individual Characteristics[1]

	Current Law[2]				Current Law Extended[3]	Pre-EGTRRA Law	
Group	**2003**	**2005**	**2010**	**2013**	**2013**	**2005**	**2010**
All Taxpayers[4]	2.6	12.8	30.4	19.1	37.1	5.9	12.7
All Tax Filers	1.8	9.3	22.4	14.6	27.2	4.4	9.7
Tax Filers by AGI (thousands of 2002$)							
Less than 30	*	*	0.2	0.4	0.5	0.1	0.2
30-50	0.1	1.5	6.9	8.5	12.5	1.7	5.0
50-75	0.5	9.5	36.6	29.1	49.8	8.9	19.7
75-100	1.1	27.4	72.9	37.7	81.9	15.6	27.0
100-200	9.3	54.3	92.0	49.8	96.7	15.4	32.2
200-500	55.3	83.5	96.2	56.9	96.6	28.9	48.3
500-1,000	28.9	27.4	49.3	12.1	51.2	12.6	12.2
1,000 and more	19.3	18.7	24.1	12.0	25.8	12.6	12.1
Tax Filers by Number of Children[5]							
0	1.2	3.7	15.4	5.7	20.2	1.1	2.8
1	1.8	11.3	29.1	22.0	34.2	3.0	11.3
2	3.5	26.4	44.4	44.0	49.8	12.5	32.9
3 or more	6.0	35.4	50.9	57.6	57.7	33.0	50.6
Tax Filers by State Tax Level[6]							
High	1.7	11.0	23.5	17.5	28.0	5.5	12.0
Middle	0.7	7.9	22.4	14.5	27.2	3.7	9.0
Low	0.4	5.8	18.6	11.2	23.8	3.0	7.1
Tax Filers by Filing Status							
Single	0.5	1.1	2.4	1.5	3.7	0.5	1.0
Married Filing Joint	3.7	20.9	53.5	34.0	64.7	9.4	21.7
Head of Household	0.8	4.0	9.2	10.1	13.2	3.0	6.9
Married Filing Separate	4.4	18.4	47.1	26.0	57.5	11.5	19.2
Married Couple, 2+ kids, 75K<AGI<100k	1.0	65.3	97.2	95.5	98.9	46.4	84.4

* Less than 0.05 percent.
Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0503-1).
Notes:
[1]Includes returns with AMT liability on Form 6251 and those with lost credits.
[2]Includes the Job Creation and Worker Assistance Act of 2002 and the Jobs and Growth Tax Relief Reconciliation Act of 2003.
[3]Includes all 2010 sunset provisions in EGTRRA and all non-AMT provisions in JGTRRA.
[4]Taxpayers are defined as returns with positive income tax liability net of refundable credits.
[5]Number of children is defined as number of exemptions taken for children living at home.
[6]State codes are not provided on the SOI public-use file for individuals with 1999 AGI above $200,000. Figures here include only those taxpayers for which we have state-of-residence information.

payers with incomes between $100,000 and $200,000, AMT coverage will rise from 9 percent today to 92 percent in 2010.

For taxpayers with incomes exceeding $200,000, the AMT is already a significant issue and will become far worse under current law. As noted above, the tax already affects more than half of all households with income between $200,000 and $500,000, and by 2010, the figure will rise to 96 percent. At higher income levels, AMT coverage falls, but even so almost half of taxpayers with income between $500,000 and $1 million and almost a quarter of taxpayers with incomes exceeding $1 million will face the AMT by 2010, under current law.

AMT participation is higher for taxpayers in high-tax states, taxpayers with children, and taxpayers who are married, because the tax does not allow deductions for taxes paid or dependent exemptions, and contains significant marriage penalties. Middle-income taxpayers in certain situations will be virtually certain to be on the AMT absent a change in law. For example, by 2010, 97 percent of married couples with AGI between $75,000 and $100,000 (in 2002 dollars) and with two or more children will be affected by the AMT, compared with 1 percent in 2003. If the tax provisions expiring in 2010 are extended, that percentage will rise

(Text continued on p. 112.)

Figure 2: AMT Participation Rates, 2003-2010
(Tax Filers With AGI < $100K, Current Law)

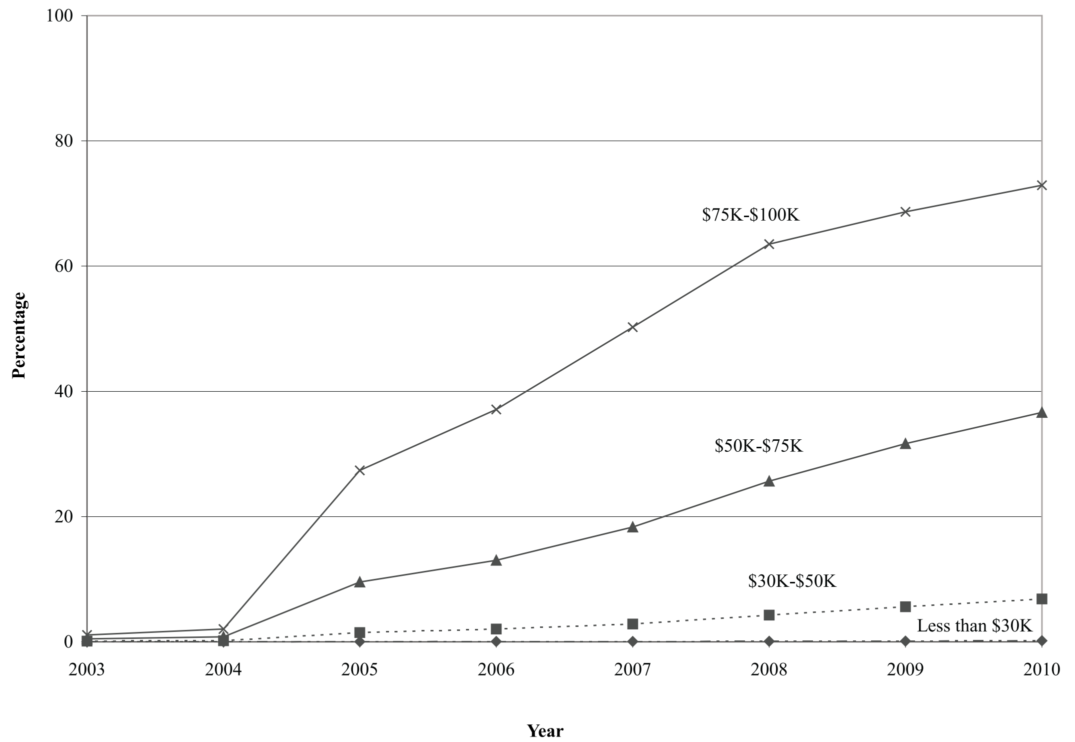


Figure 3: AMT Participation Rates, 2003-2010
(Tax Filers With AGI > $100K, Current Law)

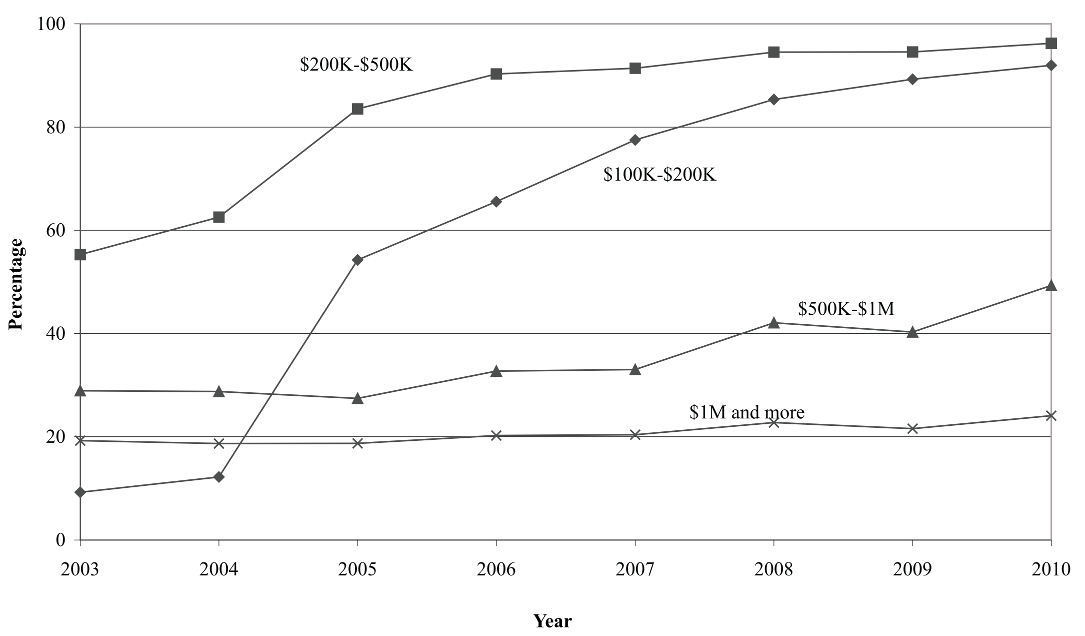


Table 3: AMT Revenue Per AMT Taxpayer ($)[1]

	Current Law[2]				Current Law Extended[3]	Pre-EGTRRA Law	
Group of AMT taxpayers	**2003**	**2005**	**2010**	**2013**	**2013**	**2005**	**2010**
All	6,578	2,940	3,751	2,875	4,578	3,094	2,779
By AGI (thousands of 2002$)							
Less than 30	26,894	8,229	2,672	1,977	1,387	5,944	2,494
30-50	1,386	761	809	1,041	957	942	926
50-75	2,286	971	1,301	1,602	1,828	1,093	1,329
75-100	3,089	1,187	2,023	2,030	2,832	1,437	1,779
100-200	2,971	2,146	3,661	2,672	5,018	2,516	2,459
200-500	5,694	6,582	12,206	6,828	14,277	7,321	6,326
500-1,000	21,185	21,759	20,496	41,280	21,572	32,702	38,499
1,000 and more	100,583	101,864	117,302	150,853	116,281	118,229	139,233
By Number of Children[4]							
0	8,276	4,403	3,391	3,741	4,104	7,574	5,046
1	6,077	2,397	3,235	1,899	4,075	3,594	2,009
2	5,330	2,257	4,436	2,607	5,665	1,895	2,013
3 or more	4,606	2,711	5,050	3,506	6,181	1,968	2,696
By State Tax Level[5]							
High	2,418	2,049	3,294	2,587	4,324	1,806	2,161
Middle	2,899	1,635	2,649	2,056	3,620	1,521	1,778
Low	3,543	1,547	2,456	2,000	3,286	1,573	1,777
By Filing Status							
Single	8,633	5,182	4,749	5,004	4,401	7,843	5,671
Married Filing Joint	6,681	2,948	3,946	2,999	4,994	3,065	2,857
Head of Household	3,317	1,637	1,643	1,448	1,784	1,487	1,317
Married Filing Separate	4,039	1,919	2,088	2,139	2,477	2,080	2,120
Married Couple, 2+ Kids, 75k<AGI<100k	2,508	1,149	2,855	2,509	4,077	1,279	1,760

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0503-1).
Notes:
[1]Includes AMT liability on Form 6251 and lost credits.
[2]Includes the Job Creation and Worker Assistance Act of 2002 and the Jobs and Growth Tax Relief Reconciliation Act of 2003.
[3]Includes all 2010 sunset provisions in EGTRRA and all non-AMT provisions in JGTRRA.
[4]Number of children is defined as number of exemptions taken for children living at home.
[5]State codes are not provided on the SOI public-use file for individuals with 1999 AGI above $200,000. Figures here include only those taxpayers for which we have state-of-residence information.

to almost 99 percent in 2013. Almost all parents with two or more kids and incomes between $100,000 and $200,000 will be on the AMT by 2010.

If EGTRRA and JGTRRA had not been enacted, AMT coverage rates would be substantially lower in 2010. In contrast, if the provisions scheduled to expire in 2010 are extended, the share of taxpayers on the AMT will continue to grow dramatically through 2013 (and beyond, although not shown on the table).

Finally, it is worth noting that the AMT represents a substantial tax on those affected. On average, the AMT will amount to a surcharge of $3,751 in 2010. (See Table 3.) That amount is actually lower than the average tax in 2003 — $6,578 — which reflects how the nature of the AMT is changing. Over the decade, the AMT will be transforming from a “class tax” — a surtax on a small number of mostly high-income taxpayers — into a “mass tax” — a surtax on a large number of mostly middle-income families. The average tax bill will be declining, but the number of AMT taxpayers will be rising several-fold.

IV. Implications

The projections above are of concern because the AMT is a complex tax with questionable effects on equity and efficiency. As the tax expands, more taxpayers will be subject to increasing complexity and the equity and efficiency implications of the tax.

A. Equity

The AMT was originally motivated in part by a minimalist notion of vertical equity — that high-income people should pay at least some income tax each year. The logic of such a goal may be questionable on purely

Table 4: Distribution of AMT and Regular Income Tax by AGI, Current Law

2003

AGI Class (thousands of 2002$)	Tax Units (thousands)		Percent of Units		Percent of AGI		Percent of Tax Liability	
	AMT Taxpayers[1]	All	AMT Taxpayers	All	AMT Taxpayers	All	AMT[2]	All Income Tax[3]
Less than 30	7	87,663	0.3	58.0	-0.4	13.9	1.2	-1.2
30-50	25	24,097	1.0	15.9	0.2	14.8	0.2	8.6
50-75	87	18,056	3.6	11.9	0.8	17.4	1.2	13.0
75-100	106	9,519	4.4	6.3	1.4	12.8	2.1	11.4
100-200	852	9,201	35.2	6.1	19.5	19.0	15.9	22.9
200-500	1,203	2,176	49.7	1.4	52.0	9.8	43.0	17.9
500-1,000	104	359	4.3	0.2	10.0	3.8	13.8	8.3
1,000 and more	36	185	1.5	0.1	16.5	8.5	22.5	19.1
All	2,419	151,256	100.0	100.0	100.0	100.0	100.0	100.0

2010

AGI Class (thousands of 2002$)	Tax Units (thousands)		Percent of Units		Percent of AGI		Percent of Tax Liability	
	AMT Taxpayers[1]	All	AMT Taxpayers	All	AMT Taxpayers	All	AMT[2]	All Income Tax[3]
Less than 30	127	94,973	0.4	56.5	*	11.8	0.3	-0.9
30-50	1,734	25,262	5.2	15.0	1.7	12.4	1.1	7.0
50-75	6,881	18,787	20.8	11.2	10.7	14.6	7.2	10.8
75-100	8,594	11,788	26.0	7.0	17.9	12.8	14.0	11.4
100-200	12,315	13,392	37.2	8.0	39.7	22.4	36.3	26.4
200-500	3,119	3,241	9.4	1.9	21.1	11.7	30.7	19.0
500-1,000	257	520	0.8	0.3	3.9	4.4	4.2	7.9
1,000 and more	65	270	0.2	0.2	4.9	9.9	6.2	18.3
All	33,092	168,234	100.0	100.0	100.0	100.0	100.0	100.0

* Less than 0.05 percent in absolute value.
Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0503-1).
Notes:
[1]AMT taxpayers include those with AMT liability from Form 6251 and those with lost credits.
[2]Includes direct AMT liability and lost credits.
[3]All income tax is the sum of regular income tax net of refundable credits plus direct AMT liability.

economic grounds, but it appears to command public support. The AMT was also motivated by broader goals of improving the horizontal and vertical equity of the tax system.[11]

The alternative minimum tax has succeeded in holding down the number of high income tax filers who pay no federal income tax. We estimate that in 2003, roughly 600 tax filers with adjusted gross incomes above $1 million will pay no federal income tax, but at least 2700 high-income tax filers will owe no income tax before the AMT.[12] If the existence of the AMT discourages taxpayers from attempting to shelter income, the number paying no income taxes without an AMT

[11]For example, the JCT (1970) describes congressional views of the purpose of the original minimum tax: "The prior treatment imposed no limits on the amount of income which an individual . . . could exclude from tax as a result of various tax preferences. As a result, there were large variations in the tax burdens placed on individuals . . . with similar economic incomes . . . [I]ndividuals . . . [who] received the bulk of their income from such sources as capital gains or were in a position to benefit from . . . tax-preferred activities tended to pay relatively low rates of tax. In fact, many individuals with high incomes who could benefit from these provisions paid lower effective rates of tax than many individuals with modest incomes. In extreme cases, individuals enjoyed large economic incomes without paying any tax at all. Similar statements can be found regarding the purposes of subsequent reforms to minimum taxes (JCT 2001a).

[12]These represent rough estimates from the TPC simulation model, which is based on data from the SOI Public Use File (PUF). For disclosure-avoidance reasons, when creating the PUF, SOI sorts all records by the level of wages and salaries within broad strata, and, for every three successive returns, replaces actual wages with the average wage among the three. Similar blurring procedures are used for state and local tax deductions. Among high-income households, this blurring can result in large changes in tax burdens on particular returns (though presumably not in the aggregate), which makes determination of the number of zero-tax filers difficult. By way of comparison, Balkovic (2003) finds that 464 taxpayers with adjusted gross incomes above about $600,000 paid no U.S. income taxes in 2000.

Table 5: Income Subject to Tax and Effective Marginal Tax Rates in the Regular Income Tax and the AMT Among AMT Taxpayers, Current Law[1]

AGI Class (thousands of 2002$)	Percent With More Income Subject to Tax in[2]		Average Adjustments and Preferences[3]	Percent With a Higher Marginal Tax Rate in[4]		Average Effective Marginal Tax Rate (Percent)[5]	
	Regular Tax	AMT		Regular Tax	AMT	Before AMT	After AMT
2003							
All	**65.8**	**34.2**	**39,246**	**32.0**	**67.5**	**30.0**	**31.3**
Less than 30	19.1	80.9	502,231	0.0	99.6	1.6	25.8
30-50	82.0	18.0	19,343	3.7	94.3	11.7	21.5
50-75	85.4	14.6	23,740	4.1	94.2	18.7	26.2
75-100	89.8	10.2	27,679	3.3	94.7	19.6	26.7
100-200	89.2	10.8	24,292	11.0	88.5	27.5	30.7
200-500	52.5	47.5	31,933	46.7	53.2	33.9	33.2
500-1,000	5.3	94.7	92,399	81.8	17.7	32.1	27.8
More than 1,000	7.4	92.6	480,214	76.5	22.1	29.6	26.7
2010							
All	**87.3**	**12.7**	**14,377**	**7.2**	**92.6**	**24.4**	**28.5**
Less than 30	86.0	14.0	54,377	0.0	100.0	16.3	29.2
30-50	98.6	1.4	8,463	3.4	96.1	17.7	26.2
50-75	99.1	0.9	11,145	0.4	99.5	18.0	26.7
75-100	99.1	0.9	10,132	8.3	91.7	24.7	27.2
100-200	92.6	7.4	12,609	1.5	98.4	26.8	29.9
200-500	10.6	89.4	26,390	36.1	62.9	31.8	32.3
500-1,000	0.9	99.1	84,468	87.9	8.4	33.2	27.9
More than 1,000	1.9	98.1	478,357	69.7	17.8	30.1	27.0

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0503-1).

Notes:

[1]AMT taxpayers include those with AMT liability from Form 6251 and those with lost credits.

[2]Income subject to tax for the regular income tax is taxable income; for the AMT it is AMTI net of the AMT exemption.

[3]Amounts are in nominal dollars to facilitate comparison with AMT exemption amounts. For 2003, the AMT exemption is $58,000 for married couples filing jointly and surviving spouses; $40,250 for unmarried individuals other than surviving spouses; and $29,000 for married individuals filing separately. For 2010, the exemption amounts are $45,000, $33,750, and $22,500 respectively.

[4]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.

[5]Marginal tax rates represent a simple average across individuals.

could have been much higher. Nevertheless, it is unclear why millions need to pay the tax currently to stop several hundred or a few thousand from paying no tax.

Moreover, although the AMT is more progressive than the income tax, both the regular income tax and the AMT will become less progressive over time. The progressivity of the regular tax will decline because the 2001 tax cuts increasingly benefit higher-income taxpayers over the course of the decade (Burman, Maag and Rohaly 2002; Gale and Potter, 2002). The progressivity of the AMT will also decline as it comes to affect millions of middle-class families.

Table 4 shows that filers with income under $100,000 (in 2002 dollars) will account for 52 percent of AMT taxpayers in 2010, up from 9 percent in 2003. Those filers will account for 23 percent of AMT revenues, compared with 5 percent in 2003. Only 10 percent of AMT revenues will come from taxpayers with incomes above $500,000 in 2010, compared with 36 percent in 2003. That income group will account for 27 percent of income tax revenues in 2003 and 26 percent in 2010. Thus, AMT's ability to boost the progressivity of the income tax will erode in the future.

The alternative minimum tax also raises horizontal equity issues. By reining in tax shelters, the AMT significantly reduces the variance of average effective tax rates among taxpayers with similar incomes. Burman, Gale, and Rohaly (2003) report that the AMT reduces the variance by 17 percent for taxpayers with incomes between $200,000 and $500,000 in 2003. By 2010, the

AMT will reduce the variance of effective tax rates by more than 30 percent for those taxpayers, and by almost 20 percent for those earning between $50,000 and $75,000.

However, a full measure of horizontal equity must adjust for differences in ability to pay tax created by factors other than income; specifically, it might include adjustments for factors like charitable contributions or extraordinary medical expenses that are now written into the regular tax code. The AMT allows some of these adjustments, such as deductions for charitable contributions and casualty losses, but disallows others such as child exemptions and deductions for certain medical expenses. It also significantly increases marriage penalties. Thus, a judgment on how the AMT affects horizontal equity will necessarily involve considering which elements of the current tax code are necessary to reflect ability to pay.

B. Efficiency

The most plausible economic rationale for a minimum tax of some sort is that it could be a second-best backstop for a porous income tax. By reining in unwarranted tax shelters that lawmakers for some reason could not address directly, the tax might reduce distortions and limit tax sheltering. Under certain assumptions, this could make the tax system more efficient. Although the notion of the AMT as a base-broadening, rate-lowering tax was plausible in the past, it is not today. In the early years of the alternative minimum tax, shelters were booming. Shelters served to reduce or eliminate taxes for many high-income filers and typically worked by combining assets that generated capital gains and expenses that were deductible. The AMT likely limited those shelters and arguably improved economic neutrality in large part by reducing the generosity of the deductions and taxing capital gains at the same rate as other income. Before 1985, about 85 percent of AMT preferences related to capital gains (Harvey and Tempalski 1997).

The alternative minimum tax, however, no longer targets tax shelters. A much larger share of its revenue now comes from run-of-the-mill provisions like the disallowance of personal exemptions and standard deductions. The Tax Reform Act of 1986 combined with the near-elimination of inflation sharply curtailed tax shelter activity (Samwick 1995). Because the 1986 tax reform taxed capital gains at the same rate as ordinary income, capital gains were eliminated as an AMT preference item. When tax preferences for capital gains were re-established in 1990 and expanded in 1997 and again in 2003, the role of capital gains in sheltering income rose, but capital gains were not reinstated as an AMT preference item. Thus, the preferential treatment of capital gains, the linchpin of many individual income tax shelters, is not addressed at all in the AMT. Likewise, the recent reduction in tax rates on dividends carries through to the AMT, and so will allow additional sheltering (Burman, Gale, and Orszag 2003).

The clearest way to show that the AMT is not well directed at tax shelters is to note that immediately removing the major exemption preferences — that is, allowing personal exemptions, dependent exemptions, deductions for state and local income and property taxes, and miscellaneous expenses in the AMT — would reduce the number of taxpayers affected by the AMT by 92 percent, to about 230,000. By 2010, a similar change would reduce the number of AMT taxpayers by about 75 percent relative to current law. That is, the vast majority of AMT taxpayers now and in the future end up facing the tax for reasons having nothing to do with sheltering.

Finally, one of the enduring myths about the alternative minimum tax is that, whatever its other faults, it taxes a broader base of income at lower marginal rates than the regular income tax. The facts are almost exactly reversed; that is, the AMT often results in less income subject to tax but at higher marginal rates than under the regular income tax. Table 5 shows that the share of AMT taxpayers with less income taxed in the AMT than in the regular income tax is projected to rise from 66 percent in 2003 to 87 percent in 2010, including 99 percent of AMT taxpayers with AGI between $30,000 and $100,000. The share with higher marginal tax rates under the AMT than under the regular tax will rise from 68 percent in 2003 to more than 90 percent in 2010.

To see how these results could arise, a couple earning $75,000 with six children would have $40,700 of taxable income under the regular tax in 2005, assuming that they took the standard deduction.[13] Neither the personal exemptions nor standard deduction would be allowed against the AMT, but the couple would be entitled to an AMT exemption of $45,000, yielding income subject to AMT of $30,000 — less than taxable income under the regular tax. They would nevertheless owe AMT because their marginal tax rate under the AMT — 26 percent — is much higher than their regular income tax bracket of 15 percent. Over time, more and more taxpayers will find themselves in a similar position, as inflation further erodes the value of the AMT exemption.[14]

C. Complexity

The National Taxpayer Advocate (2001) and the Internal Revenue Service (2000) have called the alternative minimum tax one of the most difficult and complex areas of tax law. Many taxpayers must keep two separate sets of books because of the deferral preferences — the AMT rules on the timing of income recognition and deductions that differ from regular income tax rules. These rules reduce the number of high-income tax filers that pay no income tax and thus serve an identifiable goal. The same goal could be advanced much more simply, however, by scaling back deferral preferences in the regular tax, rather than requiring taxpayers to juggle two separate, complicated calculations.

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[13] Taxable income would equal $75,000 minus $25,600 in personal exemptions (8 times $3,200 per person) minus a standard deduction ($8,700), which leaves $40,700. The personal exemption and standard deduction amounts for 2005 are projected.

[14] In 2003, this family would not be on the AMT because the applicable exemption level through 2004 is $58,000.

Table 6: Effect of the AMT on EGTRRA Income Tax Cuts, 2010

AGI Class (thousands of 2002$)	Percent of Tax Filers With No Cut Due to AMT	Percent of Cut Taken Back by AMT
All	**5.1**	**33.8**
Less than 30	*	*
30-50	0.7	1.2
50-75	4.0	15.3
75-100	4.8	37.2
100-200	24.1	65.0
200-500	45.1	71.8
500-1,000	9.3	15.9
More than 1,000	8.1	8.2

* Less than 0.05 percent.
Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0503-1).

Much of the rest of AMT complexity appears to be completely pointless. Most people who must currently fill out the AMT forms end up owing no additional tax. Increasingly, the tax will impose greater compliance burdens on middle-class taxpayers, a group that was never the tax's main target. Moreover, the complexity also makes predicting marginal tax rates and understanding tax rules much more difficult.

D. Transparency

The AMT makes the tax system less transparent in many ways. As one example, state income tax payments are said to be deductible. Among tax filers that choose to itemize their deductions in 2003, 94 percent will receive the full benefit of the state and local tax deduction; the remainder face the AMT and so will lose part or all of the benefit of that deduction. By 2010, the percentage with curtailed benefits rises dramatically. Only 50 percent of those who itemize their deductions in the regular tax will be able to receive the full benefit; the rest will be on the AMT. This makes it difficult to characterize the tax system as either allowing the deduction or not.

Also the AMT makes it difficult to describe tax cuts accurately in the public debate. For example, both the 2001 and 2003 tax cuts are said to reduce marginal income tax rates significantly, and each act reduces other aspects of income taxes, too. But AMT taxpayers will not receive the full benefit of those cuts. Table 6 shows that in 2010 the last year in which the income tax cuts enacted in 2001 are in effect, the AMT will "take back" 34 percent of the regular income tax cut that would have occurred if the AMT did not exist. The clawback rises to 65 percent for households with income between $100,000 and $200,000 and 72 percent for those with income between $200,000 and $500,000.

V. Conclusion

Lack of inflation indexing in the alternative minimum tax expands the reach of the tax each year. Meanwhile, the recent tax cuts will further reduce regular income tax burdens while the recently legislated AMT relief is only temporary. Caught amid these trends, one in three American taxpayers will soon be squeezed by a problematic tax that almost none of them were ever meant to pay. While the goals of the AMT may command public support, the AMT does not meet those goals very well. In particular, under current law, the AMT will come to plague the middle class, with undue complexity, a narrower tax base, and higher marginal tax rates than under the regular income tax.

To date, neither political party has been willing to shoulder the responsibility or the resources for addressing the problem. The good news is that as the reach of the alternative minimum tax expands to encompass ever more taxpayers, the political benefits of seeking out a solution will expand as well. A number of sensible options for reform are available. These will be discussed in the next column.

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REVENUE AND TAX POLICY BRIEF

CBO

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The Alternative Minimum Tax

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

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

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

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

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

Calculating the AMT

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

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

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

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

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

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

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

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

Projected Growth of the AMT

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

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

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

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

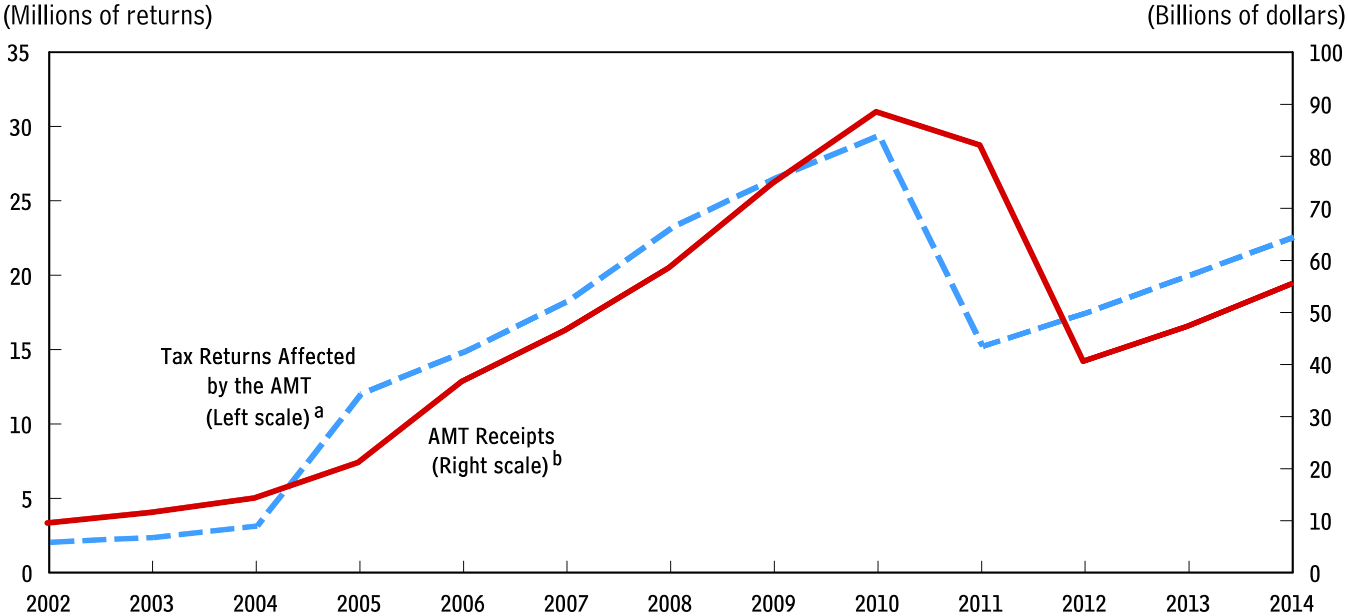
7. This discussion of the treatment of credits derives from Leonard E. Burman and others, *The Individual AMT: Problems and Potential Solutions,* Urban-Brookings Tax Policy Center Discussion Paper No. 5 (Washington, D.C.: Urban Institute, September 2002).

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

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

Figure 1.

Projected Effects of the Individual Alternative Minimum Tax



Source: Congressional Budget Office.

a. Calendar year basis.

b. Fiscal year basis.

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

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

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

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

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

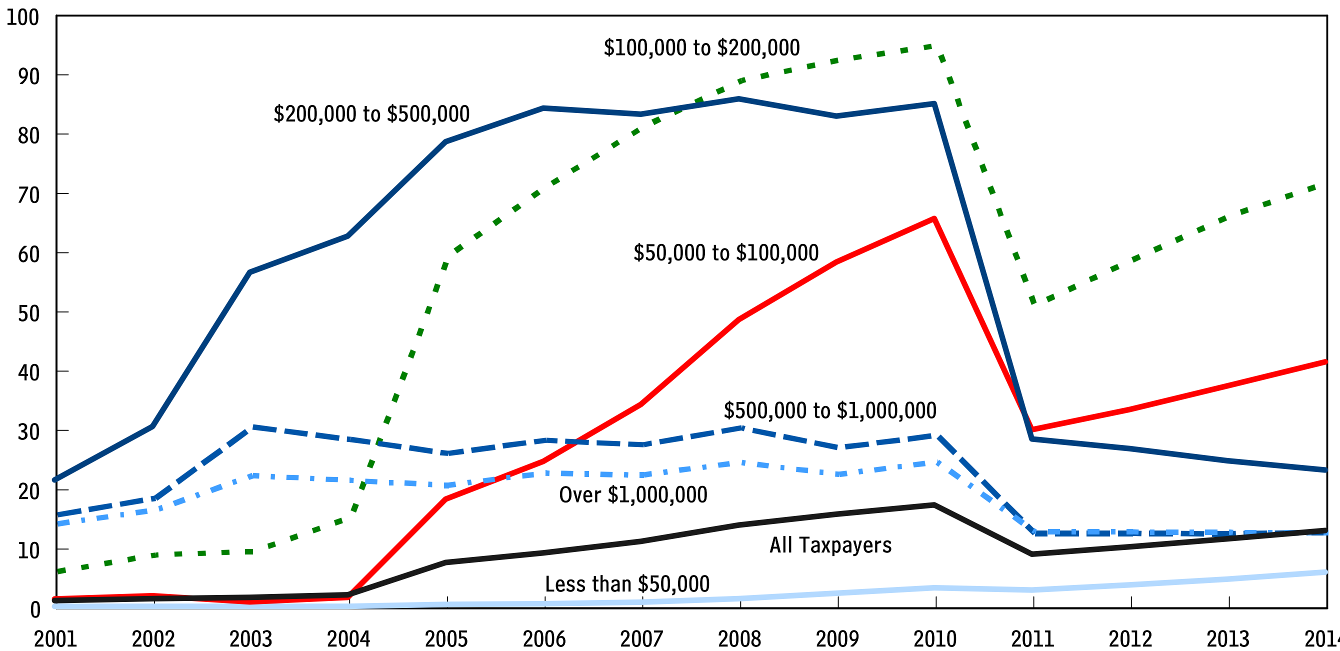
11. Income categories used in this brief are measured in 2003 dollars.

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

Figure 2.

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

(Percentage of taxpayers)



Source: Congressional Budget Office.

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

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

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

Box 1.

Calculating the Alternative Minimum Tax

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

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

AMT Calculation

(Dollars)

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

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

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

Economic Effects and Burden of the AMT

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

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

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

Box 2.

The Effect of Inflation on the Alternative Minimum Tax

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

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

Effect of Inflation on the AMT

(Dollars)

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

Source: Congressional Budget Office calculations based on 2004 parameters.

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

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

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

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

Changing the AMT

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

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

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

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

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

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

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

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

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

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

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

Conclusions

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

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

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

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