

SPECIAL REPORT

May 2007
No. 155

Fixing the Alternative Minimum Tax

AMT Reform Requires Changes to Regular Tax Code

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I. Introduction

In the tax returns Americans finished filing a month ago, the federal government collected tax on less than 40 percent of personal income.¹ The rest went untaxed, and only a small fraction of that was due to illegal tax evasion. Most income that escaped taxation did so in perfectly legal ways, through exclusions, deductions, exemptions and credits that Congress has written into our income tax code over many years.

The three main effects of all these special tax breaks are higher tax rates, economic inefficiency and unfairness. The rates have to be higher on taxable income to make up for all

the untaxed income. To minimize taxes, people put their money to comparatively unproductive use, making the economy less efficient and the people less prosperous. And because some people, by accident and design, are earning a lot more untaxed income than others, unfair taxation is a systemic problem.

Of course, there are people who think this uneven application of high tax rates is fair: the very beneficiaries of those tax breaks. They believe their income is special, more important or more virtuous. Once they secure a special tax break through political action, these beneficiaries have a perverse incentive to favor higher tax rates on everyone else because that makes their special provision more valuable.

Key Findings

- *The overriding flaw of our income tax system is the vast flow of funds that escapes taxation through the use of various loopholes in the tax code. The AMT corrects a small portion of this problem, albeit imperfectly.*
- *The AMT is often redundant and complex, but the basic idea behind it — taxing a broader base at lower rates — is a sound one that should serve as a guide to tax policy.*
- *Unfortunately most of the AMT “fixes” currently under consideration would move us in the wrong direction — shrinking the tax base and taxing what is left at even higher rates.*
- *The key to fixing the AMT lies in the regular tax code. By curtailing the myriad exclusions, deductions, exemptions, and credits in the code we could expand the tax base. This would allow us to raise the same revenue with lower tax rates, reduce the number of filers affected by the AMT, improve the overall quality of the tax system, boost the nation’s economic well-being, and improve tax equity.*

¹ “Personal income” is the sum of all income received by persons from all sources. For a discussion see Mark A. Ledbetter, “Comparison of BEA Estimates of Personal Income and IRS Estimates of Adjusted Gross Income,” *Survey of Current Business*, November 2006, pp. 29-36.

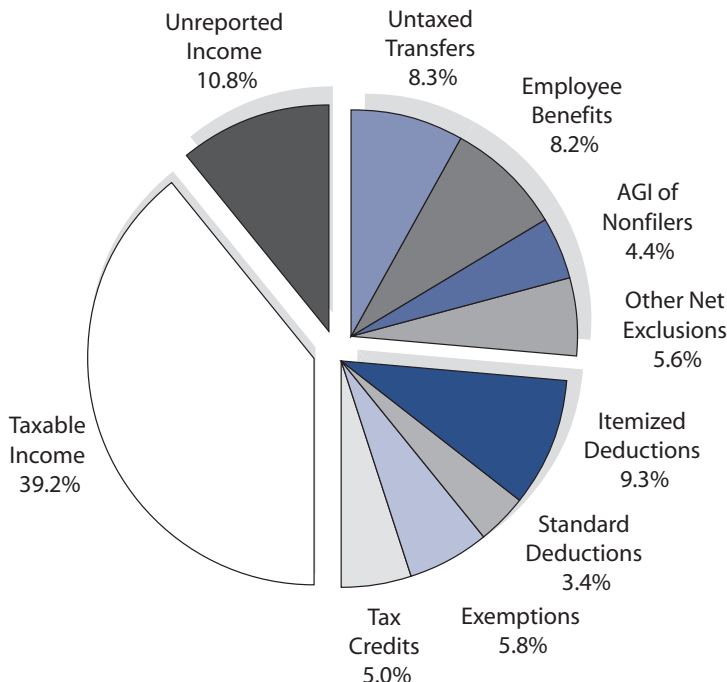
Economists have always considered these unjustified tax breaks to be an offense to efficient, fair taxation and an impediment to economic growth. But was there ever a point when the American political system considered the growing accumulation of tax preferences “excessive”? The answer is yes, in 1969 when Secretary of the Treasury Joseph Barr testified before Congress that 155 individuals had incomes above \$200,000 (about \$1.2 million in 2007 dollars) but owed no income tax. The resulting uproar led Congress to enact the so-called “add-on” minimum tax, a precursor to today’s Alternative Minimum Tax (AMT).

The AMT identifies taxpayers who have taken “excessive” advantage of legal tax breaks and forces them to re-calculate their income tax. They must add back in some of the previously untaxed income, then take a special AMT exemption (yes, even the AMT has one), and finally pay tax on this new definition of taxable income at different rates. Therefore, in theory at least, the AMT serves as a tax backstop, taxing income that would have escaped taxation.

The logical, preferable alternative to such an administratively redundant tax system would be to repeal all or some of the offending tax breaks from the regular income tax. But each of those special tax breaks has a committed group of champions who fight like dogs to preserve and expand it. In effect, by enacting the AMT and keeping it in law for decades, Congress has recognized that it simply will not repeal tax preferences that benefit politically powerful groups no matter how unjustified those tax breaks are in principle. In fact, it regularly enacts new tax breaks in the regular income tax and expands old ones, so the AMT backstop is the way Congress has settled on to limit their impact on the treasury.

It is this zero tax rate on huge sums that forces tax rates on taxable income up so high, more than twice as high as they could be.

Figure 1
Why the Majority of Income is Tax-Free
Calendar Year 2006



This report gives an overview of our income tax system, both the regular tax and the AMT, identifying major flaws and suggesting remedies. We describe the AMT’s role and answer several important questions that the Congress is contemplating right now: Where does the AMT improve the system, and what harm does it do? Who has to file the AMT return and why? When people have to pay the AMT, does it actually bring their taxes up to the level that people with similar incomes pay?

Section II gives the big picture of America’s income and taxation, identifying the vast swaths of income that go untaxed by the regular income tax. Understanding this problem is key to a rational reform of the AMT. Section III explains the mechanics of the AMT. Section IV presents the tax returns of two families as they work through these two tax systems. Section V explains why more AMT returns have been filed in recent years and explains how we can reform the regular income tax and the AMT.

Source: Tax Foundation calculations based on data from the Internal Revenue Service and the Department of Commerce’s Bureau of Economic Analysis

II. Taxation under the Regular Income Tax System

Why do commentators routinely refer to our income tax code as Swiss cheese, and not cheddar? Because if American income were cheese, the untaxed portions of our income would be large holes caused by exclusions, deductions, exemptions and credits. In fact, the holes in our taxable income are bigger than the holes in Swiss cheese.

The enormous sums of legally tax-free income fall into the two broad categories illustrated in Figure 1. More than one quarter of personal income received during 2006 was entirely excluded from the federal individual income tax base. Untaxed government transfers, in-kind compensation of employees, and a plethora of other types of income — none of these is included when the filer tallies his income on his tax form. Another 23.5 percent of

What Is Income?

Both the ordinary income tax and the AMT tax “income.” But the economic definition of income is not what Congress has instructed the IRS to tax.

Economists define income much more broadly as the money value of each year’s change in our ability to consume goods and services. In other words, a person’s annual income is equal to what he spent plus what he saved that year.

Economists count as income everything generally thought of as income — wages, salaries and investment income — but they go further, also counting big-ticket items that the IRS ignores such as government transfers and fringe benefits.

When governments give individuals Social Security or welfare payments, it clearly increases their ability to consume goods and services. The same holds true when employers make big payments for medical insurance coverage and contributions to retirement plans. But at tax time, the IRS ignores such income.

The U.S. tax system has gotten too far away from the broad, economic definition of income and needs to move back towards it, taxing more types of income at a moderate rate, rather than taxing fewer types of income at higher rates.

Although far from perfect (the AMT also does not tax government transfer payments or fringe benefits), the AMT’s definition of income is slightly broader and closer to the ideal definition of income.

personal income was included in the tax base but avoided taxation when filers claimed various deductions, exemptions, credits, and other provisions in the tax code.

It is this zero rate on huge sums that forces tax rates on taxable income up so high, more than twice as high as they could be.² Moreover, when we tax some income heavily and some not at all, taxpayers naturally change their financial activities. Often these changes are economically nonsensical, but they make tax sense. The combination of high tax rates and tax-induced economic distortions harms the nation’s economic performance and lowers the nation’s standard of living.

Totally Excluded Income

Under current law all individuals who meet the regular tax system’s filing requirements must complete IRS form 1040. Here the taxpayer must add together some of the income earned during the tax year, then subtract some items, and finally arrive at the base of the federal individual income tax system: adjusted gross income (AGI).³ In 2006 only 73.5 percent of the income earned by individuals was included in AGI, even including the AGI that was unreported by confused or criminal tax filers. That leaves plenty of room for savvy individuals to earn income outside of the ordinary income system’s tax base. See sidebar, “What Is Income?”

As illustrated in Figure 1, the largest source of untaxed income is government transfers. Those include most Social Security as well as Medicare and Medicaid payments. The other large category excluded from taxation is fringe benefits that companies give to employees in lieu of wages and salaries. The largest is employer contributions for medical insurance premiums and medical care. In fiscal 2006 the exclusion for fringe benefits cost the federal government \$160 billion in lost tax revenue.

Deductions and Exemptions

Even though AGI is already substantially smaller than income, the federal tax system does not simply levy a tax on AGI. Instead, filers are able to exclude a substantial portion of

2 Patrick Fleenor, “Taxing More, Taking Less: How Broadening the Federal Individual Income Tax Base Can Reduce Income Tax Rates,” *Tax Foundation Special Report No. 135*, October 2005.

3 Many state income tax forms begin with this figure, thereby excluding from their tax bases all the same income sources that go untaxed at the federal level.

their AGI from taxation through the use of deductions and exemptions.

There are two types of deductions, itemized and standard. Taxpayers may choose one or the other.

In theory, there are a few legitimate itemizable expenses, amounts that taxpayers should be able to subtract from taxable income. One would be a “business expense” which is any amount a taxpayer has spent to create taxable income. For example, if a salesman earned \$100 from selling widgets he bought for \$80, his net income on the transaction is \$20, the difference between his revenue and expenses.

Other justified deductions include any uncompensated losses which diminish an individual’s ability to consume goods and services without any offsetting gain. Such deductions would include uninsured losses for fire or theft.

Unfortunately, our current tax code is replete with deductions that have no theoretical justification in tax principles. These deductions are perfectly legal but perfectly awful for a tax code that seeks to raise tax revenue in an efficient and just manner. In total they reduce the income tax base by a whopping 9.3 percent (see Figure 1). Although there are many, the bulk of itemized deductions can be grouped into three main categories — deductions for taxes paid, interest (such as that on home mortgages) paid and gifts to non-profit organizations — that account for 85 percent of deductions claimed.

As an alternative to itemizing deductions, taxpayers may claim the so-called standard deduction. This is a flat dollar amount that varies by filing status. For 2006, single filers can exclude \$5,150, and that amount doubles to \$10,300 for joint filers. The elderly and blind can claim additional sums.

Taxpayers with similar incomes often shoulder vastly different tax burdens.

Generally, high-income people get more benefit from itemizing. To appeal to low-income voters, the idea of the standard deduction was conceived. It mimics the tax-reduction benefit of itemizing without any complex tax rules or paperwork requirements. As illustrated in Figure 1, the standard deduction reduces the income tax base by 3.4 percent.

Exemptions are similar to standard deductions, lump sums deducted from taxable income. But while the standard deduction is a different amount for each filing status, the exemption is a lump sum for each person listed on a tax return. For tax year 2006 the exemption is \$3,300, so a married couple with one child can deduct \$9,900, and a married couple with eight children can deduct \$33,000.

Traditionally these exemptions have been defended as a way to shield the poor from federal individual income taxation. Figure 1 shows that the use of personal exemptions reduces the income tax base by some 5.8 percent.

Should Uncle Sam allow people to deduct the major taxes they pay to state-local government? The ordinary income tax says yes, but the AMT says no. The AMT is right, and if this one rule were reversed, then almost no one would have to trouble with the AMT for many years.

After subtracting deductions and exemptions from AGI, taxpayers arrive at “taxable income.” The federal tax system applies successively higher marginal tax rates as a filer’s taxable income moves through a series of tax brackets.⁴ For tax year 2006 there are six marginal tax brackets for each of the four filing statuses.

Tax Credits

It would seem that we’ve described all the holes in the Swiss cheese, but there are many more.

⁴ In addition, income received in the form of capital gains or dividends is subject to alternative tax rate schedules.

Even after the taxpayer has whittled down his income to a much smaller amount that is considered taxable, the tax code offers numerous tax credits that taxpayers may subtract, not from what they earn, but from what they owe. That actually makes credits much more valuable to a qualified taxpayer — on a dollar-for-dollar basis — than deductions and exemptions.

Like deductions, tax credits run the gamut from the well known to the obscure. Probably most famous is the child tax credit, which permits the subtraction of \$1,000 for each child under 17. A recent obscure addition is the federal tax credit for first-time homebuyers in Washington, DC. Like the various itemized deductions, few tax credits are economically justified. Figure 1 shows that the use of tax credits reduces the income tax base by 5.0 percent.

III. Taxation under the Alternative Minimum Tax

As the above discussion makes clear, so many sources of income go untaxed under the regular income tax that it isn't hard to imagine a savvy taxpayer arranging his affairs so that he avoids income taxes altogether. That is what happened in the sixties, and when the story of these legally avoided taxes came to light in 1969, it caused an uproar. One imagines that the Congress would hurriedly eliminate some tax preferences, filling in a few holes in the Swiss cheese, so to speak. With fewer types of income untaxed, it would be impossible for anyone to combine them in a way that wiped out all tax liability. Yet Congress did not do that. Instead, it passed and President Nixon signed into law the add-on tax that became the Alternative Minimum Tax we know today.

If Congress were really going to “fix the AMT,” it would strive to improve the overall quality of the tax system.

The AMT attempts to rein in tax avoidance in a number of ways. First it requires that

filers re-calculate their income in a way that includes some sources that lie outside of AGI. This results in a tax base approximately 5 percent larger than AGI but still much smaller than a truly broad definition of income. But the AMT isn't done there.

It then limits several popular provisions that shelter income from taxation under the ordinary income tax. Finally, it curtails the use of personal exemptions and a number of itemized deductions, including those for state and local taxes paid, certain mortgage interest paid, and a number of unreimbursed job expenses.

If income were taxed comprehensively by the regular tax code, there would be no way of legally avoiding taxation, and not one taxpayer would have to file the AMT form even if the law were still on the books.

Once filers have calculated their alternative minimum taxable income (AMTI), the corollary to AGI less deductions under the ordinary income tax, they are allowed one large exemption. Similar to the standard deduction in the ordinary income tax, this AMT exemption amount varies by filing type and is gradually disallowed, or phased out, for filers with AMTIs above certain thresholds. In 2006 the exemption amount for single filers was \$42,500 and was gradually phased out for those with AMTIs above \$112,500. Meanwhile, the exemption amount for married filers was \$62,550 and was phased out for those with AMTIs above \$150,000. As we will see, the existence of such large exemptions helps to exclude most filers from taxation under the AMT.

After subtracting this large exemption from AMTI, the taxpayer must calculate the tax due on the balance. Under current law the AMT has a two-rate structure, taxing amounts below \$175,000 (\$87,500 for married filing separately) at a rate of 26 percent and amounts over this threshold at 28 percent.⁵

⁵ As with the ordinary income tax, income received in the form capital gains or dividends is subject to alternative tax rate schedules.

After calculating the AMT tax due, the taxpayer compares it with the amount due under the regular tax and pays the higher amount.

IV. Taxation of the Smith and Jones Families Under Two Tax Systems

The tax calculations in Tables 1 and 2 illustrate the starkly different effects that our nation's income tax code can have on two similar taxpayers. Here, the Smiths and the Joneses are families of four — a husband and wife with two children, ages 10 and 12 — filing joint tax returns on identical total incomes.

The Smiths

Mr. and Mrs. Smith are independent computer contractors living in a rented beach house in Miami, FL. They earn \$130,000 in cash compensation annually (see Table 1).

The two biggest deductions that many couples take relate to home ownership: the mortgage interest deduction and the deduction for property taxes paid. Since the Smiths rent, they can't benefit from either of those tax subsidies. If they persisted in itemizing their deductions, they could deduct the \$1,000 they

gave to charity, \$2,000 they spent on job-related expenses, and an amount for state tax payments (sales taxes in Florida which doesn't tax wages). However, those don't add up to an amount larger than the standard deduction, so instead of itemizing, the Smiths subtract the \$10,300 standard deduction from their \$130,000 income. Next the Smiths subtract four personal exemptions worth \$13,200 to arrive at a taxable income of \$106,500.

The first \$15,100 of the family's taxable income is taxed at the 10-percent rate for a yield of \$1,510. The next \$46,200 is taxed at the 15-percent rate for a yield of \$6,930. Finally, \$45,200 is taxed at the 25-percent rate for a yield of \$11,300. The Smiths' total income tax due before credits under the ordinary income tax is therefore \$19,740.

After calculating their tax under the ordinary system, filling out Form 1040, the Smiths fill out Form 6251 to determine whether they owe more under the Alternative Minimum Tax. They do not.

The federal tax code grants families a \$1,000 per child tax credit for each child younger than 17. Unfortunately for the Smiths, this credit is gradually phased out for joint returns with AGIs over \$110,000.⁶ As a

Table 1
Smith Family Tax Return, 2006

Compensation from Employment			
Wages and salaries	\$130,000.00		
Benefits	\$0.00		
Tax-Exempt Bonds	\$0.00		
Total Income	\$130,000.00		
Taxation Under the Regular Income Tax		Taxation Under the Alternative Minimum Tax	
AGI	\$130,000.00	AGI Less Deductions	\$130,000.00
Less: Standard Deduction	\$10,300.00	Plus: Taxes Paid	\$0.00
		Plus: Job Expenses and Certain Miscellaneous Deductions	\$0.00
		Plus: Other Tax Preferences	\$0.00
Equals: AGI Less Deductions	\$119,700.00	Equals: Alternative Minimum Taxable Income	\$130,000.00
Less: Personal Exemptions	\$13,200.00	Less: AMT Exemption	\$62,550.00
Equals: Taxable Income	\$106,500.00	Equals: AMTI Less AMT Exemption	\$67,450.00
Income Tax Before Credits	\$19,740.00	Alternative Minimum Tax	\$17,537.00
Taxed at 10%	\$1,510.00		
Taxed at 15%	\$6,930.00	AMT Liability	\$0.00
Taxed at 25%	\$11,300.00		
Child Tax Credit	\$1,000.00		
Income Tax After Credits	\$18,740.00		
Effective tax rate	14.4%		

⁶ Under current law filers of joint returns lose \$50 in cumulative tax credit for every \$1,000 their AGI is over the earnings threshold.

result, the family was allowed to subtract only \$1,000 in total child tax credits for an income tax bill after credits of \$18,740.

Since we now know their final tax due, we can divide it by their total income to calculate what economists call the “effective” tax rate. In other words, after all the various exemptions and deductions, what fraction of a taxpayer’s income is paid in tax? In this case the Smiths’ effective tax rate is 14.4 percent.

The Jones Family

Like the Smiths, Mr. and Mrs. Jones are computer programmers. They own their own home and live in New York, a state with comparatively high state and local taxes. In addition to wage income of \$104,500 the family receives \$20,000 in fringe benefits from their employers and \$5,500 in interest payments from private activity municipal bonds, for a total income of \$130,000, the same as the Smiths’ income.

When the Joneses fill out their IRS Form 1040, however, their Adjusted Gross Income is only \$104,500, not \$130,000, because only

the wage and salary income is defined as income under the ordinary income tax. But there are more goodies.

From AGI, the Joneses subtract various itemized deductions and personal exemptions: \$13,000 they paid in state-local income and property taxes, \$12,000 in mortgage interest payments, \$1,000 in gifts to charity, and \$2,010 in job expense deductions. Then they claim a \$3,300 personal exemption for each member of the family. That’s another \$13,200, which gets taxable income down to \$63,290.

The first \$15,100 of the family’s taxable income is taxed at the 10-percent rate for a yield of \$1,510. The next \$46,200 is taxed at 15 percent, yielding \$6,930. The balance is taxed in the 25-percent bracket for a yield of \$497.50. The Joneses’ total income tax due before credits under the ordinary income tax is therefore \$8,937.50.

Enter the AMT

Like the Smiths, the Joneses are required to recalculate their taxes under the Alternative Minimum Tax. This begins by re-defining

Table 2
Jones Family Tax Return, 2006

Compensation from Employment			
Wages and salaries	\$104,500.00		
Benefits	\$20,000.00		
Tax-Exempt Bonds	\$5,500.00		
Total Income	\$130,000.00		
Taxation Under the Regular Income Tax			
AGI	\$104,500.00		
Less: Itemized Deductions			
Taxes Paid	\$13,000.00		
Interest Paid	\$12,000.00		
Gifts to Charity	\$1,000.00		
Job Expenses and Certain Miscellaneous Deductions	\$2,010.00		
Equals: AGI Less Deductions	\$76,490.00		
Less: Personal Exemptions	\$13,200.00		
Equals: Taxable Income	\$63,290.00		
Regular Income Tax	\$8,937.50		
Taxed at 10%	\$1,510.00		
Taxed at 15%	\$6,930.00		
Taxed at 25%	\$497.50		
Income Tax Before Credits (Regular Tax + AMT Liability)	\$8,957.00		
Child Tax Credit	\$2,000.00		
Income Tax After Credits	\$6,957.00		
Effective tax rate	5.4%		
		Taxation Under the Alternative Minimum Tax	
		AGI Less Deductions	\$76,490.00
		Plus: Taxes Paid	\$13,000.00
		Plus: Job Expenses and Certain Miscellaneous Deductions	\$2,010.00
		Plus: Other Tax Preferences	\$5,500.00
		Equals: Alternative Minimum Taxable Income	\$97,000.00
		Less: AMT Exemption	\$62,550.00
		Equals: AMTI Less AMT Exemption	\$34,450.00
		Alternative Minimum Tax	\$8,957.00
		AMT Liability	\$19.50

income the AMT way — mostly a process of adding chunks of income back in that the ordinary income tax had permitted them to deduct: taxes paid (\$13,000), job expenses (\$2,010), as well as the \$5,500 earned on their investment in private activity municipal bonds. These adjustments expand the tax base from \$76,490 under the ordinary tax system to \$97,000 under the AMT.

The Joneses are allowed a single AMT exemption of \$62,550. The AMT then applies a 26-percent tax to the entire balance for a yield of \$8,957. Since this is larger than the tax due under the regular income tax (\$8,937.50), the Joneses are officially AMT filers. The AMT took away several thousand dollars of popular but economically unjustifiable deductions, costing them an additional \$19.50 in tax.⁷

The only tax credits the Joneses take are two \$1,000 child tax credits, which makes their income tax after credits equal to \$6,957. Unlike the Smiths, they get the full child credits because even though their total income is the same, the Joneses' AGI is under \$110,000.

Performing the same calculation of effective tax rate as we did with the Smiths, we see that even after paying extra taxes under the AMT, the Joneses pay only 5.4 percent of their total income in tax, much less than the Smiths.

What We Learn from the Smiths and Joneses

This simple example illustrates many of the shortcomings of the existing federal individual income tax. To collect \$6,957 from the Joneses, the federal government redefined their income down dramatically and then subjected what was left to a fairly high statutory tax rate of 26 percent. This rate is more than four and a half times higher than necessary to collect the same amount of revenue under a comprehensive income tax (5.4 percent).

Tax-Induced Distortions

Ideally we would like to see the Joneses' financial decisions driven by economic considerations, rather than by the tax code. Interest rates and considerations of risk should

drive investment decisions. This is what economists mean when they say they want the tax code to be “neutral.”

But as this simple example makes abundantly clear, the existing tax system is anything but neutral. Under the ordinary income tax, 23 percent of their income is tax-free, and even under the AMT, 15 percent is tax-free. Each dollar earned by the Joneses in a tax-exempt way provides them with \$1.00 in purchasing power. This gives them a strong incentive to rearrange their affairs to suit the tax code. It may cause them to refuse offers to work overtime, or it may cause them to invest in projects funded with ordinary tax-free municipal bonds, projects that may have a low value to society but make financial sense to the Joneses because of their tax advantage. The cumulative damage to society from these economic distortions is surprisingly heavy.

Equity

Even aside from economic distortions they cause, the existing tax laws take a toll on our nation. When it's perfectly legal for the Joneses to earn \$130,000 but pay only 5.4 percent of it in federal income tax while the Smiths pay almost three times as much, taxpayers lose faith in our nation's basic fairness.

Ironically, the nation's tax commentators are focusing largely on the supposed inequity of the extra \$142 that the Joneses will be paying because of the AMT. They should be writing about the inequity faced by the Smiths on the regular side of our income tax code.

V. Reforming the AMT

During much of the last four decades the AMT has affected relatively few taxpayers. In 2005, for example, just three percent of taxpayers paid taxes under the AMT system.⁸ Over the next few years this percentage could jump dramatically from three percent to 16 percent. That would mean 22 million filers would owe more under the AMT than under the regular tax on their 2007 returns. As Figure 2 shows, this figure could climb to 32 million in 2010 before falling to 15 million in 2011, but only

7 Technically, on Form 1040 the Joneses' AMT liability of \$19.50 (\$8,957 - \$8,937.50) is added to their tax under the ordinary system (\$8,937.50) to arrive at their income tax before credits, which is effectively equal to their total tax under the AMT, \$8,957.

8 Millions of other filers, however, have been required to fill out IRS Form 6251 — the Individual Alternative Minimum Tax Form — only to find that they do not have an AMT liability. Others have altered their behavior so as to avoid the AMT.

if current law goes unchanged, which seems unlikely. The rapid rise in the number of people who could find themselves subject to the AMT has led to calls for reform of the tax in Congress.

Tax-Exempt State and Local Bonds: A \$20 Billion Gift to the Nation's Wealthiest Investors

Of all the tax-free sources of income, none is more wasteful and unjust than the interest state and local governments pay on tax-exempt bonds. Unfortunately, the AMT only takes away a small part of this unjustifiable exclusion.

To see why it's so egregious, let's assume that the exclusion didn't exist. If a \$1,000 state or local government bond had to pay a 10-percent return annually, or \$100, to attract enough bond buyers, every investor would benefit equally from that investment.

However, because of the exclusion, the wealthiest investors get a better interest rate. Here's why. Back to our \$1,000 bond paying 10 percent: because of the exclusion, investors in the highest tax bracket (35 percent) are willing to buy the bonds for interest payments of 6.5 percent since the \$35 in tax savings brings their annual earnings from the bond to the desired 10 percent. The \$35 gain to state and local governments would equal the \$35 in lost federal tax revenue.

However, state and local governments need to attract other investors who don't have enough taxable income to reach the 35-percent bracket.

In the 25-percent bracket, tax-exempt bonds would have to have a minimum interest rate of 7.5 percent, the point where the amount they save in taxes, \$25 (25 percent of \$100), brings their annual earnings from the bond up to the desired level of 10 percent.

Because there is no practical way of selectively selling bonds with different interest rates to investors in different tax brackets, the highest rate necessary to clear the market for these bonds must be given to all bond holders. Therefore, investors in the highest tax bracket, 35 percent, get a better deal on the bond, earning \$110 annually instead of the \$100 earned by people in the 25-percent bracket.

In fiscal year 2005 the U.S. Treasury estimates that the lopsided nature of this provision cost the federal government more than \$20 billion. This could have been easily avoided by using direct federal grants to state and local governments rather than using the tax system.

The AMT only makes a little dent in this one, revoking the exclusion for so-called private activity bonds like the ones that fund stadiums. The majority of government bond interest is excludable on both sides of the tax code. The AMT and the overall tax system could be improved by revoking this exclusion for all government bonds.

As we have seen, compared to the vast flows of tax-free income, the loopholes plugged by the AMT are relatively small. Moreover, the tax's effect on the overall quality of the tax system is mixed.

We've briefly explained the positive side of the ledger: the AMT broadens the tax base slightly and curbs the use of tax preferences that cannot be justified from an economic perspective. However, a few of its provisions are actually worse than the corresponding law in the ordinary income tax. For example, the AMT limits the deduction for job-related expenses, which are fully justified under an ideal income tax and are, in fact, allowed under the ordinary income tax law.

The Growing Number of Filers with an AMT Liability

Figure 2 presents historical data on the number of tax returns reporting an AMT liability. It shows that since 1990, AMT returns have grown steadily. Under current law the number will increase more than seven-fold over the next four tax years, drop sharply in 2011, and then resume its upward trend.

The primary reason they increased steadily throughout the 1990s is that starting in 1985, many parameters of the regular individual income tax system — such as standard deductions, exemption amounts and bracket widths — were indexed for inflation. Meanwhile, most of the parameters of the alternative minimum tax system are not.⁹ This translates into an annual hike in AMT taxes driven by the rate of inflation that year. As a result, more and more taxpayers have faced an AMT liability over time.

Naturally, like this inflationary effect, any tax law that raises AMT liabilities or lowers regular income tax liabilities will make the AMT's backstop effect more prominent. Enter the tax cuts of 2001 and 2003, which lowered tax burdens under the regular tax substantially but made no corresponding changes to the AMT.¹⁰ Bitter debates in Congress focused on the revenue estimates, and President Bush had to settle for tax cuts estimated at \$1.6 trillion over 10 years. Champions of those tax cuts

⁹ As we will see, Congress has increased the value of one parameter, the AMT exemption, through legislation.

¹⁰ Neither act made long-term alterations of the AMT to offset changes in the regular tax system. The acts did, however, make short-run changes to AMT exemption levels.

sometimes point to the date of their final enactment in May 2003 as the date that the economy turned around, and whether it was causation or coincidence, there's no question that the economy was anemic before that and has boomed since.

These deductions are perfectly legal but perfectly awful for a tax code that seeks to raise tax revenue in an efficient and just manner.

The tax cuts most often cited as the pro-growth measures that stimulated economic growth are the dramatic cut in dividend taxes, the modest cut in capital gains taxes, and the significant cuts in wage taxes. Considering the tussle over revenue estimates between 2001 and 2003, it is inconceivable that those rate cuts could have been made without the AMT as a backstop.

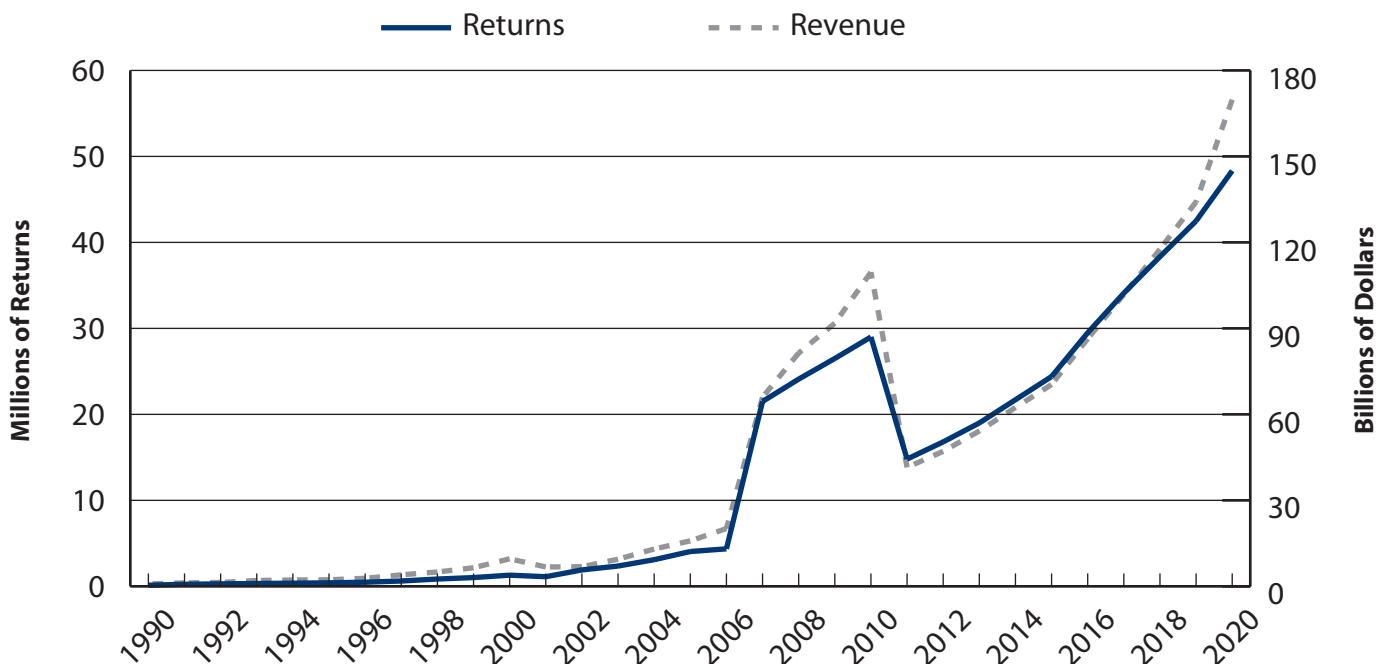
However, even though it had been well understood that the AMT would play a much

more prominent role in the nation's tax returns after the passage of those tax cuts, Congress immediately found the prospect of using the AMT as a backstop intolerable. Because it was originally enacted as a tax on millionaires, many citizens consider it to be grossly unfair to pay it themselves, no matter how the tax itself measures up to general principles of efficiency and fairness in taxation.

As a result, Congress has forestalled the filing of tens of millions of AMT returns by temporarily raising the AMT exemption in one- and two-year increments. The last such band-aid was enacted earlier this year, retroactively for the 2006 tax year. Congress raised the exemption level for couples filing joint returns from \$45,000 to \$62,550 (a 39.0 percent increase). Meanwhile the exemption for single and head of household returns was raised from \$33,750 to \$42,500 (a 25.9 percent increase). Exemptions for married couples filing separately increased from \$22,000 to \$31,275 (a 39.0 percent increase).

These large, temporary increases in AMT exemptions have effectively shielded many

Figure 2
AMT Returns and Receipts, 1990 – 2020



Source: IRS data and the Tax Foundation microsimulation model.

filers with AGIs of less than \$200,000 from an AMT liability. Those with incomes between \$200,000 and \$500,000 still find themselves paying it. When the current, one-year exemption levels expire, however, the situation will change dramatically.¹¹ The number of AMT filers in the \$100,000 to \$200,000 range will rise from 8.1 percent in 2006 to 77.2 percent in 2007. Similarly, the number of AMT filers in the \$75,000 to \$100,000 range will rise from 0.6 to 42.6 percent in 2007.

The impending surge of new AMT filers has led to political demands that Congress

pre-empt the change by “fixing” the AMT. Most proposals set a new, permanently higher exemption level or repeal the AMT entirely, and they raise tax rates in the regular income tax to preserve revenue. The Congressional Budget Office estimates that eliminating the AMT would cost the treasury more than \$700 billion over the next decade which is only a good estimate if Congress leaves the exemption level low and permits the wave of new AMT filers to pay their new AMT liabilities. The rate hikes in the regular income tax that would “pay for” AMT repeal are substantial, and many officials have targeted exactly those rates considered most likely to have boosted the economy since 2003, the tax rates on dividends, capital gains and wages.

Other, less extreme options usually involve incorporating some of the regular code’s unjustifiable deductions into the AMT, such as deductions for state-local taxes paid and certain types of mortgage interest payments. In other words, Congress would undo the AMT’s broader definition of taxable income, which is its only good reason for being.

The AMT’s Biggest Difference: No Deduction for State and Local Taxes

Should Uncle Sam allow people to deduct the major taxes they pay to state-local government? The ordinary income tax says yes, but the AMT says no. The AMT is right, and if this one rule were reversed, then almost no one would have to trouble with the AMT for many years.

To be justifiably deductible, an expense should either be un-reimbursed, such as a theft, or incurred in the business of earning income.

Even a skeptic of government services wouldn’t say he gets nothing for his state-local taxes. In fact, the services rendered for those taxes are substantial and expensive. In many cases individuals are voluntarily paying high local taxes in exchange for publicly provided goods and services that they value, such as primary and secondary education.

Young adults without children are generally indifferent to the quality of local primary and secondary schools and often reside where the public schools are poor. When they have children, however, a better public school frequently becomes a major criterion for deciding where to live, and they are suddenly willing to bear high local taxes.

No doubt there’s considerable debate over whether police protection and public school education are worth what we’re paying for them. But many things are overpriced — that doesn’t mean they’re worthless. So state-local taxes are not un-reimbursed.

Obviously, state-local taxes are not incurred as part of an income-earning business, so they fail to meet the second test for deductibility as a business expense. Therefore the AMT’s disallowance of this deduction is the economically fair and justifiable tax policy. The deduction granted on the regular side of the code, then, can be understood as a politically appealing give-away to people who live in high-tax areas and own expensive property. Naturally, the officials of high-tax jurisdictions also appreciate deductibility, both because they live there and because it makes their high taxes more palatable to the taxpayers.

Because it was originally enacted as a tax on millionaires, many citizens consider it to be grossly unfair to pay it themselves, no matter how the tax itself measures up to general principles of efficiency and fairness in taxation.

Take for example the deduction for state and local taxes. This preference is widely seen by economists as unjustified, and the AMT’s disallowance of this deduction is one of its more positive features. If the AMT were to be “fixed” by allowing this deduction, the effectiveness of the overall tax system would suffer.

If Congress were really going to “fix the AMT,” it would strive to improve the overall quality of the tax system. As we have seen, the AMT provides a backstop behind the ordinary federal individual income tax system, and it is

¹¹ The higher exemption levels — \$42,500 and \$62,550 — expired on January 1, 2007, but all commentators predict re-enactment, and they are commonly referred to as if they were still in force.

usually the unjustifiable limitations on taxable income in that system that cause the AMT backstop to kick in. If income were taxed comprehensively by the regular tax code, there would be no way of legally avoiding taxation, and not one taxpayer would have to file the AMT form even if the law were still on the books.

Ironically, the nation's tax commentators are focusing largely on the supposed inequity of the extra \$19.50 that the Joneses will be paying because of the AMT. They should be writing about the inequity faced by the Smiths on the regular side of our income tax code.

A second category of AMT reforms recognizes this and attempts to fix the AMT by getting to the root of the problem: deficiencies in the regular system. Such proposals include taxing income under the ordinary system which is currently tax-exempt. Others include eliminating unjustified provisions — such as deductions for state and local taxes paid — under both systems. Many such proposals would boost federal revenue. If revenue neutrality is desired, tax rates could be reduced to offset growth in the tax base.

The great virtue of this second category of reforms is that, properly implemented, they would improve the overall quality of the tax system in addition to reducing the number of filers affected by the AMT. This would help to minimize tax-induced distortions in the tax code, boost the nation's economic well-being, and improve tax equity.

VI. Conclusion

The perceived problems with the AMT are symptoms of larger ones affecting the overall federal tax system. The AMT was created in response to a public outcry over tax avoidance resulting from gaps in the individual income tax. Instead of plugging these gaps by taxing income comprehensively, Congress created what has become an ungainly and increasing problematic mechanism for reining in excessive tax avoidance.

If Congress wants to actually fix the AMT it needs to look to deficiencies in the ordinary tax system for solutions, rather than simply tinkering with the AMT. By taxing income more comprehensively lawmakers can fix most of the problems with the AMT and possibly even eliminate the tax. Enlarging the tax base would also give them the opportunity to cut tax rates. More importantly, such measures would improve the overall quality of the tax system. This is likely to enhance both the nation's economic well-being and equity in the tax system.



SPECIAL REPORT
(ISSN 1068-0306) is published at least 6 times yearly by the Tax Foundation, an independent 501(c)(3) organization chartered in the District of Columbia.

4–20 pp.
Single copy: free
Multiple copies: \$5 each

The Tax Foundation, a nonprofit, nonpartisan research and public education organization, has monitored tax and fiscal activities at all levels of government since 1937.

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