Policy Watch
The Expanding Reach of the Individual Alternative Minimum Tax

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

This feature contains short articles on topics that are currently on the agendas of policymakers, thus illustrating the role of economic analysis in illuminating current debates. Suggestions for future columns and comments on past ones should be sent to C. Eugene Steuerle, c/o Journal of Economic Perspectives, The Urban Institute, 2100 M Street NW, Washington, D.C. 20037.

Introduction

In January 1969, Treasury Secretary Joseph W. Barr informed Congress that 155 individual taxpayers with incomes exceeding $200,000 had paid no federal income tax in 1966. The news created a political firestorm. In 1969, members of Congress received more constituent letters about the 155 taxpayers than about the Vietnam War. Later that year, Congress created a minimum tax to prevent wealthy individuals from taking advantage of tax laws to eliminate their federal income tax liability.

Both the original minimum tax and its successor, the individual alternative minimum tax (AMT), have applied in the past to a small minority of high-income
households. But barring a change in law, this “class tax” will soon be a “mass tax.” Current projections show the number of AMT taxpayers skyrocketing from one million in 1999 to 36 million in 2010. Without reform, virtually all upper middle-class families with two or more children will be paying the AMT by decade’s end. The AMT is notoriously complex, and its record on fairness and efficiency is mixed at best. But because of its widening reach, fixing the AMT will be expensive. By the end of the decade, repealing the AMT will cost more than repealing the regular income tax. This paper explains how a tax originally designed to target 155 taxpayers could grow to cover 36 million, discusses economic issues related to the alternative minimum tax and examines options for reform.

How the Alternative Minimum Tax Works

Taxpayers who may be subject to the alternative minimum tax must calculate their tax liability twice: once under regular income tax rules and again under AMT rules. If liability under the AMT proves higher, taxpayers pay the difference as a surcharge to the regular tax. Technically, the difference paid is their AMT.

To calculate the alternative minimum tax, taxpayers add to their regular taxable income various items that are paradoxically called “AMT preferences” and that fall into two categories. Exemption preferences allow taxpayers a variety of deductions, exclusions or credits in the regular tax, but are not allowed in the AMT. These items 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, which have little to do with tax sheltering. As a result, these adjustments are difficult to justify.

Deferral preferences allow taxpayers to postpone regular income tax payments or shelter income by hastening deductions or delaying income recognition. The 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 complex, have a greater tendency to affect high-income filers and generate less AMT revenue.

Once a taxpayer adds in all applicable preferences and tallies income, the next step is to subtract the alternative minimum tax exemption—currently $49,000 for

1 A separate alternative minimum tax applies to corporations. See Lyon (1997).
2 Throughout this paper, we compare current or recent data to projections for 2010. We choose 2010 because all of the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, the 2001 tax cut) are scheduled to expire, under current law, by the end of 2010. This creates considerable uncertainty about projections after 2010. For example, if EGTRRA were extended, 43 million taxpayers would face the AMT in 2013. If EGTRRA were allowed to expire in 2010, 26 million taxpayers would be on the AMT in 2013.
married couples and $35,750 for singles. The remaining income is then taxed at flatter rates than under the regular income tax. The statutory AMT tax rate of 26 percent applies to the first $175,000 of net income above the exemption. For income over that level, a 28 percent tax rate applies. Under the regular income tax (in 2002), the same income would be taxed at rates ranging from 10 percent to 38.6 percent. Many taxpayers’ effective AMT rate, however, is significantly higher, because the AMT exemption itself phases out at a 25 percent rate over higher income ranges. Thus, effective marginal tax rates can be as high as 35 percent (1.25 times 28 percent). The AMT exemptions and tax brackets are not indexed for inflation.4

Class Tax to Mass Tax

Under current law, about 36 million people will be paying the alternative minimum tax by 2010, almost 14 times as many as in 2002, as shown in Table 1.5 The increase in coverage will occur in all but the very lowest income classes. In 2002, for example, 3 percent of filers with income between $75,000 and $100,000 (in 2001 dollars) faced the AMT; by 2010, 79 percent of filers in that income range will pay the AMT. The AMT will become the de facto tax system for filers in the income range from $100,000 to $500,000, 95 percent of whom will face the tax in 2010. At very high income levels, the share of taxpayers on the AMT falls, because the top AMT rate is lower than the top marginal tax rate in the regular income tax. As a result, as income rises, eventually regular income tax liability overtakes AMT liability. Even so, in 2010 more than one-quarter of tax filers with incomes above $1 million will pay the AMT, up from 15 percent in 2002.

Because the alternative minimum tax does not allow exemptions for dependents or deductions for state taxes, it will impose particularly high burdens on taxpayers with children and those in high-tax states. Because the AMT exemption for couples is less than double the exemption for singles and because the tax brackets are not adjusted for marital status, the AMT imposes significant marriage penalties. In combination, these issues can raise AMT participation rates dramatically,

4 The alternative minimum tax generally preserves the lower tax rates on capital gains in the regular tax. Current law limits tax rates on long-term capital gains to 10 percent for low- and moderate-income taxpayers and 20 percent for others. Those limits apply to both the regular income tax and the AMT.

5 Unless otherwise noted, all of the projections in this paper derive from the Tax Policy Center Microsimulation Model. The model is based on data from the 1996 public-use file produced by the Statistics of Income Division of the Internal Revenue Service. The file contains about 112,000 records with detailed information from federal individual income tax returns filed in the 1996 calendar year. Imputations based on data from other sources such as the Current Population Survey supplement the tax data. The tax model has two components: a statistical routine that uses forecasts from the Congressional Budget Office to “age” or extrapolate the 1996 data to create representative samples of tax filers for future years and a detailed tax calculator that computes the regular income tax and AMT liability for all filers in the sample under current law and under alternative policy proposals. For additional information, see Burman et al. (2002, appendix).
Table 1
Aggregate Alternative Minimum Tax Projections

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>AMT Taxpayersa</td>
<td>Number (in millions)</td>
<td>2.6</td>
<td>35.6</td>
<td>17.9</td>
</tr>
<tr>
<td>As percentage of all taxpayersb</td>
<td>2.7</td>
<td>33.0</td>
<td>16.1</td>
<td>—</td>
</tr>
<tr>
<td>As percentage of all tax filers</td>
<td>1.9</td>
<td>24.2</td>
<td>12.1</td>
<td>36.3</td>
</tr>
<tr>
<td>As percentage of filers, by AGI (thousands of 2001$)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>0–30</td>
<td>*</td>
<td>0.2</td>
<td>0.2</td>
<td>*</td>
</tr>
<tr>
<td>30–50</td>
<td>0.2</td>
<td>8.7</td>
<td>6.9</td>
<td>1.0</td>
</tr>
<tr>
<td>50–75</td>
<td>1.4</td>
<td>43.2</td>
<td>25.6</td>
<td>17.6</td>
</tr>
<tr>
<td>75–100</td>
<td>3.0</td>
<td>78.6</td>
<td>34.6</td>
<td>42.3</td>
</tr>
<tr>
<td>100–200</td>
<td>10.9</td>
<td>94.0</td>
<td>40.2</td>
<td>71.2</td>
</tr>
<tr>
<td>200–500</td>
<td>35.6</td>
<td>96.7</td>
<td>53.2</td>
<td>73.8</td>
</tr>
<tr>
<td>500–1,000</td>
<td>19.4</td>
<td>54.1</td>
<td>13.2</td>
<td>18.8</td>
</tr>
<tr>
<td>1,000+</td>
<td>15.4</td>
<td>26.9</td>
<td>12.3</td>
<td>8.4</td>
</tr>
<tr>
<td>AMT Revenue</td>
<td>Dollars (billions)</td>
<td>13.0</td>
<td>141.4</td>
<td>47.0</td>
</tr>
<tr>
<td>As percentage of income tax revenue</td>
<td>1.4</td>
<td>9.9</td>
<td>3.0</td>
<td>—</td>
</tr>
<tr>
<td>Percentage of AGI on AMT returns</td>
<td>8.9</td>
<td>55.5</td>
<td>26.4</td>
<td>—</td>
</tr>
<tr>
<td>Cost of income tax repeal ($ billions)</td>
<td>204.0</td>
<td>47.0</td>
<td>211.6</td>
<td>—</td>
</tr>
</tbody>
</table>

*aLess than 0.05 percent.
a AMT taxpayers include those with AMT liability on Form 6251 and those with lost credits.
b Taxpayers are defined as returns with positive income tax liability net of refundable credits.

as spelled out in Table 2. By 2010, among married couples with two or more children and income between $75,000 and $100,000, 97 percent will face the AMT.

More generally, the expansion of the AMT implies that by 2010 more than 45 percent of tax filers will be unaffected by marginal tax rate changes in the regular income tax—half of those because they are on the AMT and half because their incomes are too low to owe regular income tax. Two-thirds of married couples will find themselves in that situation—86 percent of them because of the AMT.

Perhaps the most striking illustration of the growing scope of the AMT is that by 2010, more than half of all income will be taxed under the AMT, and repealing the regular income tax would reduce tax revenues by less than repealing the AMT. In 2010, total income tax revenues are projected to be $1,423 billion; that is, $1,282 billion from the regular income tax and $141 billion from the AMT (defined as the amount owed above and beyond regular tax liability). AMT repeal would thus reduce revenues by $141 billion in 2010. If the regular income tax were repealed, AMT revenues would increase dramatically to $1,376 billion, so the net revenue loss
would be only $47 billion ($1,423 − 1,376). The number of AMT taxpayers would double to 71 million, as even moderate-income taxpayers would face AMT liability.

Determining the causes of the expanding reach of the AMT is tricky. For example, the AMT might have been repealed in 1979, but it wasn’t. Thus, in some sense, failure to repeal the AMT in 1979 could be viewed as the cause of projected AMT growth. Despite this underlying ambiguity, we believe it makes the most sense to focus on two factors: the lack of inflation indexing in the AMT and the 2001 tax cut. As a general rule, most major tax legislation since 1980 has included changes in the AMT that broadly conform to the reforms made in the regular income tax: for example, the 1986 Tax Reform Act broadened the base of both taxes, and the 1993 tax legislation raised marginal rates under both taxes. There are two major exceptions to the general rule, though. The Economic Recovery Tax Act of 1981 cut taxes and indexed the regular tax system for inflation, but did not index the AMT. More recently, the Economic Growth and Tax Relief Reconciliation Act of

### Table 2

**Alternative Minimum Tax Projections by Individual Characteristics**

<table>
<thead>
<tr>
<th>AMT Participation</th>
<th>Current Law</th>
<th>Pre-EGTRRA Law</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2002</td>
<td>2010</td>
</tr>
</tbody>
</table>

**Percentage of filers on AMT by:**

<table>
<thead>
<tr>
<th>Number of children&lt;sup&gt;a&lt;/sup&gt;</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3 or more</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>1.1</td>
<td>15.8</td>
<td>3.4</td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>1.7</td>
<td>31.5</td>
<td>15.4</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>3.4</td>
<td>46.1</td>
<td>36.3</td>
<td></td>
</tr>
<tr>
<td>3 or more</td>
<td>8.7</td>
<td>53.5</td>
<td>53.4</td>
<td></td>
</tr>
</tbody>
</table>

**State tax level<sup>b</sup>**

| Low                            | 0.8 | 20.6| 8.9 |
| Middle                         | 1.1 | 25.1| 12.0|
| High                           | 2.9 | 25.2| 15.2|

**Filing status**

| Single                         | 0.5 | 2.6 | 1.1 |
| Married filing joint           | 3.7 | 57.5| 27.7|
| Head of household              | 1.3 | 10.1| 8.4 |

**Married filers with income between $75,000 and $100,000<sup>d</sup>**

| 0 Kids                        | 1.0 | 81.9| 5.4 |
| 1 Kid                         | 1.6 | 96.1| 29.3|
| 2+ Kids                       | 4.6 | 97.4| 86.8|


<sup>a</sup> Includes those with direct AMT liability on Form 6251 and those with lost credits.

<sup>b</sup> Number of children is defined as number of exemptions taken for children living at home.

<sup>c</sup> State codes are not provided on the SOI public-use file for individuals with 1996 AGI above $200,000. Figures here include only those filers for which we have state-of-residence information.

<sup>d</sup> Income refers to AGI in 2001 dollars.
2001 (EGTRRA) cut the regular income tax, but did not make significant, lasting changes to the AMT.\(^6\) Our simulations show that if the AMT had been indexed for inflation along with the regular income tax in 1985, and if EGTRRA had not been enacted in 2001, the number of AMT taxpayers would have remained roughly constant at 300,000 through 2010, rather than rising to 36 million.

The 2001 tax act roughly doubled the projected number of those who face the alternative minimum tax in 2010, as shown in the third column of Table 1. Before this legislation, 16 percent of taxpayers were slated to pay the AMT in 2010 (with the rise over time due primarily to the lack of inflation indexing); after the 2001 legislation, 33 percent will pay AMT. In addition, by 2010, EGTRRA will more than double the share of adjusted gross income (AGI) subject to the AMT, from 26 percent to 55 percent, and the law will triple the cost of eliminating the AMT, from $47 billion to $141 billion.

Ironically, just as the 2001 tax cut made the AMT problem worse, the AMT will undo some of the effects of the 2001 act. By 2010, the AMT will “take back” about 36 percent of the overall income tax cut enacted through EGTRRA, including more than 70 percent of the cut targeted to taxpayers with income between $100,000 and $500,000, as shown in Table 1. These effects were understood at the time; indeed, some have claimed that the AMT was left unadjusted precisely in order to reduce artificially the revenue costs and mitigate the reported distributional effects of the tax cut. Gale and Potter (2002) discuss these issues further.

Equity

The alternative minimum tax was originally motivated 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 is questionable on purely economic grounds, but it commands substantial public support, as the 1969 letter-writing campaign suggests.

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 2001, roughly 100 tax filers with incomes above $1 million paid no federal income tax, but at least 700 high-income tax filers owed no income tax before the AMT.\(^7\) If the existence of the AMT also discourages taxpayers from attempting to shelter...

---

\(^6\) Lindsey (2001) blames the 1993 tax measures for much of the growth in AMT participation, but our estimates suggest that those effects were much smaller than those attributable to EGTRRA, in large part because the 1993 act raised the highest income tax rates, whereas EGTRRA reduced marginal tax rates.

\(^7\) Our estimates are based on data from 1996 extrapolated to 2001 income levels (Burman et al., 2002, appendix). Balkovic (2002) reports that the number of nontaxpaying filers with income over $200,000 increased by 54 percent between 1996 and 1999. The corresponding increase for those with real incomes over $200,000, measured in 1976 dollars, was 48 percent. Thus, our estimates may understate the number of high-income nontaxpayers, but the qualitative conclusion that small numbers are involved is likely to be robust.
income, the number paying no income taxes without an AMT could have been much higher. Nevertheless, it is unclear why a few million people need to pay the tax currently in order 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. Filers with income under $100,000 (in 2001 dollars) will account for 53 percent of AMT taxpayers in 2010, up from 24 percent in 2002. Those filers will account for 24 percent of AMT revenues, compared with 8 percent in 2002. Only 9 percent of AMT revenues will come from taxpayers with incomes above $500,000 in 2010, compared with 33 percent in 2002. That income group will account for 30 percent of income tax revenues in 2002 and 26 percent in 2010. Thus, the 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. Our calculations show that the AMT reduces the variance by 17 percent for taxpayers with incomes between $200,000 and $500,000 in 2002. By 2010, the AMT will reduce the variance of effective tax rates by over 30 percent for such 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.

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. For example, by taxing interest income from bonds that state and local governments issue to support private activities like shopping centers or stadiums, income that is exempt from the regular income tax, the AMT reduces the subsidy afforded such investments
(Leonard, 1998). 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.

Tax on capital gains could be deferred for years and faced a low statutory rate when recognized. Deductions included highly accelerated depreciation, generous oil depletion allowances and interest payments that largely represented inflation rather than the real cost of funds (Graetz, 1997). Thus, an investment that would lose money before tax—because the income including capital gains was less than the expense—could be profitable after-tax because expenses were overstated for tax purposes and capital gains were only partially taxed. The AMT likely limited those shelters and arguably improved economic neutrality by reducing the generosity of the deductions and taxing capital gains at the same rate as other income. Prior to 1985, about 85 percent of AMT preferences related to capital gains.

However, the alternative minimum tax no longer focuses mainly on 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 the differential between tax rates on capital gains and ordinary income was reestablished in 1990 and expanded in 1997, 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 sheltering schemes, is not addressed at all in the AMT.

Finally, one of the enduring bits of conventional wisdom 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. For example, a couple earning $75,000 with six children would have $43,150 of taxable income under the regular tax in 2002, assuming that they took the standard deduction. (For this family, taxable income would equal $75,000 minus $24,000 in personal exemptions—eight times $3,000 per person—minus a standard deduction of $7,850, which equals $43,150.) Neither the personal exemptions nor standard deduction would be allowed against the AMT, but the couple would be entitled to an AMT exemption of $49,000, yielding income subject to AMT of $26,000—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.
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 2002 to 87 percent in 2010. The share with higher marginal tax rates under the AMT than under the regular tax will rise from 35 percent in 2002 to more than 90 percent in 2010.

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.

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.

Options for Reform

The underlying goals of the AMT—requiring high-income people to pay some tax, deterring the aggressive use of tax shelters and ensuring progressivity—have widespread popular appeal, but the tax itself is replete with problems. A variety of reform options could, to varying degrees, keep the baby but throw out the bathwater.

Reducing the Alternative Minimum Tax

Simply indexing the alternative minimum tax for inflation would reduce the number of AMT taxpayers in 2010 by 71 percent overall and by 92 percent for middle-class taxpayers, defined as those with AGI between $50,000 and $75,000. Indexing would reduce revenues by $418 billion through 2013 under current law (Table 3).

The middle class could be almost entirely removed from the AMT by also allowing dependent personal exemptions and nonrefundable credits, such as the tax credits for child care and education. In conjunction with indexing, these reforms would reduce the number of AMT taxpayers in 2010 by 83 percent overall
and more than 98 percent among those with incomes between $50,000 and $75,000.

Combining these reforms with two additional steps—repealing the phase out of the AMT exemption and allowing deductions for state and local taxes and miscellaneous expenses—would eliminate all of the major exemption preferences and virtually end the AMT for all but very high income tax filers. The number of AMT taxpayers would fall by more than 99 percent relative to current law. The additional steps primarily benefit high-income households; for example, they would reduce the number of AMT taxpayers with income between $500,000 and $1 million by over 90 percent. The additional measures are also expensive. The ten-year revenue cost would be $650 billion, more than 50 percent greater than indexing alone.

From here, outright repeal of the AMT is a small step, consisting mainly of the elimination of the deferral preferences. Relative to the plan above, repeal would cost just $50 billion more over the decade and reduce the number of AMT payers in 2010 by an additional 0.3 million. Repeal of the deferral preferences would be significantly regressive, however, with very large tax cuts going to the highest-income households (Burman et al., 2002).

Repealing the deferral preferences would also significantly increase the number of high-income filers who pay no income tax. The number of filers with income

---

**Table 3**

**Reform Options**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>All</td>
<td>50K–75K</td>
<td>500K–1 million</td>
</tr>
<tr>
<td>Index the AMT after 2002</td>
<td>10.4</td>
<td>−70.9</td>
<td>−92.3</td>
<td>−2.8</td>
</tr>
<tr>
<td>+ Remove middle-class exemption preferences</td>
<td>6.0</td>
<td>−83.1</td>
<td>−98.3</td>
<td>−7.8</td>
</tr>
<tr>
<td>+ Remove other major exemption preferences</td>
<td>0.3</td>
<td>−99.1</td>
<td>−99.7</td>
<td>−90.3</td>
</tr>
<tr>
<td>Repeal</td>
<td>0.0</td>
<td>−100.0</td>
<td>−100.0</td>
<td>−100.0</td>
</tr>
<tr>
<td>Revenue-neutral retargeting</td>
<td>6.7</td>
<td>−81.2</td>
<td>−97.3</td>
<td>67.2</td>
</tr>
</tbody>
</table>

*Source: Urban-Brookings Tax Policy Center Microsimulation Model and authors’ calculations.*

a Change in revenue in fiscal years; other tabulations in calendar years.

b Baseline is current law (EGTRRA expires on December 31, 2010).

c High-income is defined as having AGI greater than $1 million in 2001 dollars.

d Indexes and allows dependent exemptions and personal nonrefundable credits.

e Takes steps in the previous plan and allows deductions for expenses and taxes and repeals the AMT exemption phaseout.

f Allows dependent exemptions and personal nonrefundable credits. The preferential rates for capital gains under the AMT would be repealed, the 28 percent AMT rate would be increased to 35 percent and the AMT exemption phaseout would be repealed, all effective for 2003. The sunset of the AMT exemption increase would be repealed and the exemption and rate bracket threshold would be indexed beginning in 2005.
above $1 million who would pay no income tax would rise from 400 under the plan above to 1,500 under repeal; similarly, the number of filers with income above $200,000 who pay no income tax would rise from 6,000 under the plan above to 17,000 with repeal. These figures show the power of the deferral preferences in reducing the number of high-income filers who pay no tax. Even more nontaxpayers would exist (and the revenue costs would be larger) if AMT repeal unleashed a rash of new tax shelters.

**Revenue Neutral Reform**

All of the plans noted above would significantly reduce revenues. In the current budgetary environment, such changes may be neither feasible nor desirable (Auerbach et al., 2003). AMT reform could be financed by retargeting the tax or by coupling AMT repeal with income tax changes.

One way to retarget the AMT at very high income taxpayers and aggressive tax shelterers would be to allow dependent exemptions and personal nonrefundable tax credits, eliminate the AMT exemption phase out and index the exemption from its 2004 level starting in 2005. These reforms could be paid for by increasing the 28 percent AMT bracket to 35 percent (which would increase taxes only for those with incomes above the AMT exemption phase out, an income level of $330,000 for couples after 2004) and eliminating the preferential rates for capital gains under the AMT.

As shown in Table 3, under current law, this proposal would raise about $7 billion over the next ten years. The proposal would be highly progressive, cutting overall taxes on those with incomes under $500,000 and raising taxes on higher income filers. It would reduce the number of AMT taxpayers in 2010 by 81 percent—and by 97 percent for those with incomes between $50,000 and $75,000. But it would increase the number of AMT taxpayers among those with incomes between $500,000 and $1 million by two-thirds. Although not shown in the table, it would more than triple the number of taxpayers with incomes over $1 million subject to the AMT.

If there is to be an alternative minimum tax, this option has much to recommend it. Allowing preferential capital gains tax rates under the AMT is a major source of complexity and sheltering. Many individual tax shelters are designed to exploit the difference between the tax rates on capital gains and the tax rates on other income and expense—most notably the higher effective tax rate on interest expense (Burman, 1999). The deduction for investment interest is the most important factor explaining the nontaxation of high-income returns (Balkovic, 2002). Thus, taxing capital gains the same as other income under the AMT could arguably enhance efficiency, equity and simplicity and raise revenue that could be used to reduce the number of AMT taxpayers.

---

8 If the 2001 tax cut were made permanent, the revenue losses due to AMT reform would rise. Indexing and repeal would reduce revenues by about $600 billion and $1 trillion, respectively, through 2013. These estimates omit the added debt service costs that the government would owe if revenue fell.
Instead, if legislators could find the revenue and resolve to finance AMT repeal, the best option would be to incorporate directly into the regular income tax whatever AMT provisions are deemed good tax policy, while adjusting the rates and tax in the regular income tax to achieve revenue neutrality and distributional neutrality. For example, if the regular income tax deductions for state and local taxes and depreciation rules are too generous, reformers could eliminate these provisions for all taxpayers, not just for those paying the AMT. Inevitably, many taxpayers would face higher marginal and average tax rates under a revenue-neutral package. But replacing the hodgepodge of implicit taxes created by the AMT with well-designed explicit taxes under the regular income tax could make the tax system fairer, simpler and more efficient without spawning shelters or sacrificing tax revenues.

Alternatively, a natural source for revenue to pay for reform is the 2001 tax cut, which not only reduced revenues, but exacerbated the AMT problem. The 2001 tax cut phases in slowly over time. Burman et al. (2002) show that freezing the income and estate tax cuts at their 2002 levels, and foregoing the future cuts, would roughly pay for indexing the AMT, but would fall more than $200 billion short of paying for repeal. A partial freeze could also be combined with AMT retargeting, along the lines noted above.

Why Not Repeal the Regular Income Tax?

By 2010, it would cost more to repeal the alternative minimum tax than to repeal the regular income tax. Some commentators have suggested, with varying degrees of seriousness, that the regular tax be repealed and the AMT kept on. We believe this would be a major mistake.

If the alternative minimum tax were to become the only income tax, it is unlikely that it could (or should) remain in its current structure. The tax is not indexed for inflation. It is laced with marriage penalties and child penalties. A tax based on ability-to-pay should have an adjustment for family size, which suggests that personal exemptions should be allowed.

Those who favor a flat income tax should be clear that the alternative minimum tax is not a shortcut to that goal. After all, the AMT includes all the aspects of the regular income tax that are not explicitly erased by the adjustments under the AMT. The alternative minimum tax includes four different tax brackets (including the effect of the phase out of the exemption) at rates of 26, 31.25, 35 and 28 percent. It would certainly not be simple.

---

9 It would be possible to mimic the distribution of average tax burdens under current law even with AMT repeal. If taxpayers in each bracket were to make the same aggregate tax payment in 2010 after the elimination of the alternative minimum tax as they would under current law, the 10 percent tax rate would have to be raised to 10.7 percent, the 15 percent tax rate to 16.3 percent, the 25 percent tax rate to 29.2 percent, the 28 percent tax rate to 33.8 percent, the 33 percent rate to 43.0 percent and the 35 percent tax rate would be lowered to 33.2 percent. That is, the statutory regular income tax rate would have to rise for those in the bottom five brackets and fall in the highest income group.
Conclusion

Lack of inflation indexing in the alternative minimum tax expands the reach of the tax each year. Meanwhile, the phase in of the 2001 tax cuts will steadily reduce regular income tax burdens over time. 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. To date, neither political party has been willing to shoulder the responsibility for addressing the problem. But 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.

The authors wish to thank Brad De Long, Peter Orszag, Timothy Taylor and Michael Waldman for very helpful comments.

References


