THE ALTERNATIVE MINIMUM TAX FOR INDIVIDUALS: A GROWING BURDEN

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Summary

The alternative minimum tax (AMT) for individuals is a separate system of income taxation that operates in parallel to the regular income tax. Taxpayers who may be affected by the AMT must recalculate their taxes using rules about income and deductions different from those that apply to regular income tax. If they owe more under the AMT than they would under regular income tax, they pay the AMT amount.

Unlike the regular income tax, the AMT is not indexed for inflation. Over time, inflation and economic growth have made the AMT affect more and more taxpayers. In 1990, the AMT financially affected only about 132,000 taxpayers. In 2000, it affected an estimated 1.3 million taxpayers, and in 2010, it is projected to affect 17 million taxpayers.

The huge increase in taxpayers who will soon be affected by the AMT has led to Congressional proposals to overhaul or eliminate it. This paper examines the main options for dealing with the AMT.

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The Alternative Minimum Tax for Individuals: A Growing Burden

I. What is the Alternative Minimum Tax (AMT)?

Individual versus corporate AMT. The alternative minimum tax, or AMT, is a separate system of income taxation that operates in parallel to the regular income tax. There are two AMTs, one for individuals and the other for corporations.[1] This report deals only with the AMT for individuals, which has more taxpayers and generates more tax revenue. In 1997, the last tax year for which statistics are available for the corporate AMT, corporation paid taxes on approximately 25,000 AMT returns, while individuals paid taxes on just 618,000 AMT returns. The corporate AMT generated almost as much revenue as the individual AMT—around $4 billion.[2] However, the corporate AMT is a relatively small and static part of federal taxation overall, though its complexity generates many complaints. The number of people affected by the AMT for individuals and the revenue the tax generates are growing rapidly. In tax year 1990, only 132,000 people paid the AMT for individuals. In 2000, it is estimated that 1.3 million people did, and under current law the number is projected to rise to 17 million in 2010. The revenue that the AMT generates is also rising, though not as fast as the number of AMT taxpayers (see Figure 1 and Table 1, on the next two pages).[3]

Purpose of the AMT. The goal of the AMT for individuals is to make everyone with significant income pay some federal income tax. The AMT has a lower top rate than the regular income tax but tries to catch more income in its net by defining taxable income (the tax base) more broadly. Compared to the regular income tax, the AMT has fewer "tax preferences"—deductions and other ways of reducing tax liability.

The AMT was originally devised to reduce certain deductions used frequently by high-income taxpayers and infrequently by other taxpayers. Hence the AMT has provisions concerning deductions for drilling oil wells, farm tax shelters, interest from tax-exempt "private activity bonds," and other things unfamiliar to the average taxpayer.

How the AMT affects taxpayers. All taxpayers *potentially* affected by the AMT for individuals file a special form (IRS Form 6251), even if it turns out after all the calculations are done that the tax does not *actually* affect their taxes directly or indirectly. In 1997, 4.4 million taxpayers filed the form, even though only about 20 percent actually had their taxes affected by the AMT.[4]

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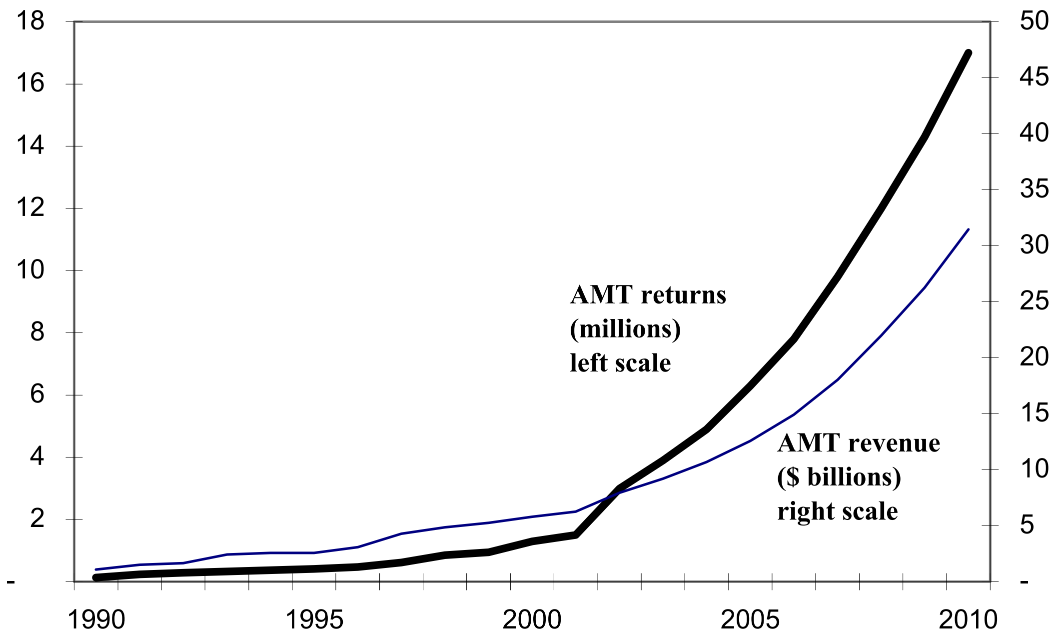
[1] In the tax code, AMT provisions for individuals and corporations are intermingled. The reason is that one target of the AMT is people who own businesses. They can treat themselves as salaried employees subject to the individual income tax or as stockholders subject to corporate taxes.

[2] Internal Revenue Service, "Selected Historical and Other Data," *Statistics of Income Bulletin,* Fall 2000, p. 207, and "Corporation Income Tax Returns, " *Statistics of Income Bulletin,* Summer 2000, table 23.

[3] Rebelein and Tempalski (2000), Table 1. These numbers are those applying under current law at the time this report was written, while President Bush's tax cut proposal was still being debated in Congress.

[4] U.S. General Accounting Office (2000), p. 15, from Internal Revenue Service data.

Figure 1. Individual AMT returns and tax collected



Source: See Table 1.

Among taxpayers who are actually affected by the AMT, some are affected directly and others indirectly. Taxpayers affected directly pay a special, higher tax—the AMT. Taxpayers affected indirectly still pay the regular income tax, but are not allowed to claim as many tax credits as they otherwise could. (A tax credit is a provision that allows a reduction in tax liability by a specific dollar amount, regardless of income. For example, a tax credit of $500 allows both taxpayers with income of $40,000 and those with income of $80,000 to reduce their taxes by $500, if they qualify for the credit.) Taxpayers who owe more under the regular income tax than under the AMT *before* tax credits, but less *after* credits, cannot pay less than the AMT amount. For them, the existence of the AMT makes the regular income tax higher than it would otherwise be.

Calculating the AMT. Calculating the AMT is a four-step process. First, taxpayers calculate their regular income tax.

Second, they determine whether the AMT may apply. Some taxpayers are automatically subject to the AMT because the tax applies to everyone who claims certain kinds of adjustments to income, such as stock options not exercised in the same year they were received. Such taxpayers go straight to the third step. Other taxpayers may be subject to the AMT if their taxable income plus certain other items exceeds $45,000 for married couples filing a joint return (half that for each spouse if they file separately), or $33,750 for a single filer or head of household.[5] Those taxpayers complete a 13-line

[5] It is estimated that in 2000 more than three-quarters of taxpayers financially affected by the AMT had incomes of $100,000 or more. See Rebelein and Tempalski (2000), table 3.

Table 1. Basic data and projections on the alternative minimum tax for individuals

	Returns filed* (millions)	Tax paid (billions of nominal dollars)	Tax paid (billions of real 2000 dollars)	Ratio of AMT returns to all individual income tax returns	Ratio of AMT revenue to all individual income tax revenue
1983	0.3	2.5	4.4	0.3%	0.9%
1984	0.4	4.5	7.4	0.5%	1.5%
1985	0.4	3.8	6.1	0.5%	1.1%
1986	0.6	6.7	10.6	0.7%	1.9%
1987	0.1	1.7**	2.6**	0.1%	0.4%
1988	0.1	1.0	1.5	0.1%	0.2%
1989	0.1	0.8	1.2	0.1%	0.2%
1990	0.1	0.8	1.1	0.1%	0.2%
1991	0.2	1.2	1.5	0.2%	0.3%
1992	0.3	1.4	1.7	0.3%	0.3%
1993	0.3	2.1	2.4	0.3%	0.4%
1994	0.4	2.2	2.6	0.5%	0.4%
1995	0.4	2.3	2.6	0.4%	0.4%
1996	0.5	2.8	3.1	0.6%	0.4%
1997	0.6	4.0	4.3	0.6%	0.5%
1998	0.9	4.6	4.9	n.a.	0.6%
1999	1.0	5.1	5.3	n.a.	0.6%
2000	1.3	5.8	5.8	1.0%	0.6%
2001	1.5	6.4	6.3	1.2%	0.6%
2002	3.0	8.3	7.9	2.3%	0.7%
2003	3.9	9.8	9.2	2.9%	0.8%
2004	4.9	11.6	10.7	3.7%	0.9%
2005	6.3	13.9	12.6	4.6%	1.1%
2006	7.8	16.8	14.9	5.7%	1.2%
2007	9.8	20.7	18.0	n.a.	1.5%
2008	12.0	25.7	22.0	n.a.	1.7%
2009	14.3	31.3	26.3	n.a.	2.0%
2010	17.0	38.2	31.5	n.a.	2.3%

Notes: *Includes only returns where taxpayers pay AMT or have credits for regular income tax limited by AMT. Many others taxpayers must calculate and file the AMT form simply to show that the AMT in fact does not affect them.

**Fall in revenue reflects effect of Tax Reform Act of 1986.

n.a. = not available.

The AMT first became the only minimum tax for individuals in 1983. Figures for 1998 to 2010 are projections.

Sources: For historical data, Internal Revenue Service, *Statistics of Income Bulletin,* various issues, and *Economic Report of the President* (2001); for projections, Congressional Budget Office (2001), table 1-2 (inflation); Rebelein and Tempalski (2000), Table 1 (AMT numbers); and Zaffino (2000), p. 90 (individual income tax totals).

worksheet provided in the instructions to IRS Forms 1040 and 1040A, the forms for the regular income tax. If the worksheet indicates that the AMT may apply, those taxpayers go on to the third step.

Third, taxpayers use IRS Form 6251, which is 50 lines long, to recalculate taxable income using the rules of the AMT instead of the rules of the regular income tax. The result of this calculation is called the tentative AMT.

Finally, taxpayers compare their regular tax before credits with their tentative AMT, and pay whichever is greater. Technically, the AMT is not the whole amount of tax calculated under AMT rules; it is only the *difference* between tentative AMT and regular income tax.[6]

The AMT has two rates. A tax rate of 26 percent applies if AMT income minus the exemption amount does not exceed $175,000. Each dollar beyond $175,000 is taxed at 28 percent. The exemption amount is $45,000 for married couples filing a joint return (half that for each spouse if they file separately), or $33,750 for a single filer or head of household. The two rates of the AMT compare to five rates currently for the regular income tax (15, 28, 31, 36, and 39.6 percent).[7] Again, the AMT allows fewer ways to reduce tax liability than the regular income tax, so it raises additional revenue despite its relatively low rates.

An example of how the AMT can increase taxes. A recent study by the General Accounting Office gives examples of how the AMT for individuals can increase taxes for tax year 2000.[8] One example is of a family comprising a husband, wife, and six children. This hypothetical family had wage earnings of $80,000, rented rather than owning its house, and had no significant tax deductions. A standard deduction of $7,350 plus personal exemptions of $22,400 would reduce its taxable income to $50,250. Under the regular income tax, the family would owe $5,377 in federal income tax ($8,377 minus $3,000 for the child tax credit).

Under the AMT, not all the deductions and exemptions that the family has taken are allowed. Instead of paying $5377, the family must pay $6100 ($9100 minus $3000 for the child tax credit). The difference of $723 is an increase of more than 13 percent over the regular income tax.

II. HOW THE AMT ORIGINATED

The minimum income tax of 1969. The AMT has its roots in a minimum income tax enacted in 1969. Congress enacted the minimum tax following testimony by the Secretary of the Treasury that 155 people with adjusted gross income above $200,000

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[6] A fuller description can be found in U.S. General Accounting Office (2000), pp. 4-9.
[7] Under the part of President Bush's tax proposal passed by the House of Representatives as H.R. 3, by 2006 the five rates of the regular income tax would become four rates (10, 15, 25, and 33 percent).
[8] U.S. General Accounting Office (2001), p. 13-14.

had paid no federal income tax on their 1967 tax returns.[9] Adjusted for inflation, $200,000 in 1966 dollars equals about $1.1 million in today's dollars. The number of individual income tax returns filed in 1967 was 71.7 million, and the number with adjusted gross income above $200,000 was 15,669. So, the minimum income tax was enacted to close perceived loopholes that affected only about one of every half-million taxpayers, and fewer than one of every hundred high-income taxpayers. By 1975, the year before Congress passed the first major change to the minimum tax, it yielded $144 million from 20,000 taxpayers, or one of every thousand dollars the federal government collected in income taxes.[10] Although the minimum tax was small potatoes in terms of the revenue it yielded, it was a hot potato politically: in 1969, more people had written to Congress to complain about the 155 people who paid no income tax than had written about the Vietnam war.[11]

The minimum income tax was an "add-on" tax of 10 percent.[12] People had to pay a 10 percent tax on the amount to which their reductions of tax liability (tax preferences) exceeded $30,000. Unlike today's AMT, the add-on tax did not have rules for calculating taxable income that were separate from the rules for the regular income tax, nor did it have a separate list of reductions of tax liability.

Congress made major changes to the minimum tax in 1976, after a Treasury study found that despite the existence of the tax, 244 taxpayers with adjusted gross income above $200,000 in 1974 had paid no income tax.[13] The rate of the minimum tax was raised from 10 percent to 15 percent and the tax base was broadened.

The AMT of 1978. By 1978, Congress became concerned that the changes it had recently made to the minimum tax were hindering capital formation. It excluded capital gains from the minimum tax but created a new tax, the AMT, to apply to capital gains for certain taxpayers. In 1982, Congress repealed the minimum tax and expanded the AMT to include most of what had formerly been covered by the minimum tax. The rate of the AMT was originally a flat 20 percent. In 1986, 1990, and 1993, Congress raised the rate of the AMT in steps to its current levels of 26 and 28 percent. The 1986 revision was also significant because it introduced the corporate AMT to replace the "add-on" minimum tax for corporations established in 1969.

The minimum tax and its successor, the AMT, have been changed often in the over 30 years of their combined existence. The Appendix shows the legislative history of the two taxes.

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[9] Barr (1969), p. 46.
[10] Internal Revenue Service, *Statistics of Income Bulletin,* Fall 2000, p. 207.
[11] Graetz (1999), p. 113.
[12] The top income tax bracket from 1970 to 1981 was 70 percent. Legislation reduced the top bracket to 50 percent starting in 1982; subsequent reductions brought the top rate down to a low of 28 percent from 1988 to 1990 (though income between certain amounts was taxed at 33 percent). The current top rate of 39.6 percent has been in effect since 1993.
[13] See Harvey and Tempalski (1997), p. 454.

Table 2. Taxpayers paying income tax even without AMT, 1998

Adjusted gross income	Number of returns paying tax	Total number of returns	Percentage paying tax
No adjusted gross income	15	994,831	0.00
$1-$5,000	2,508,204	13,218,015	18.98
$5,000-$10,000	5,748,318	13,071,278	43.98
$10,000-$15,000	7,438,543	12,901,534	57.66
$15,000-$20,000	7,925,501	11,724,272	67.60
$20,000-25,000	7.904,155	10,100,265	78.26
$25,000-30,000	7,459,538	8,192,495	91.05
$30,000-$40,000	12,778,102	13,135,034	97.28
$40,000-$50,000	9,874,395	9,973,659	99.00
$50,000-75,000	15,836,746	15,886,502	99.69
$75,000-$100,000	7,211,379	7,221,303	99.86
$100,000-$200,000	6,260,419	6,266,258	99.91
$200,000-$500,000	1,603,786	1,606,186	99.85
$500,000-$1 million	306,258	307,020	99.75
$1 million or more	171,594	172,004	99.76
Subtotal $200,000+	*2,081,638*	*2,085,210*	*99.83*
Grand total	*93,026,912*	*124,770,662*	*74.56*

Source: Internal Revenue Service, *Statistics of Income Bulletin,* Fall 2000, pp. 34-5 (Table 2, columns 1 and 32).

III. PROBLEMS WITH THE AMT

Hardly anybody is happy with the AMT. The IRS's National Taxpayer Advocate has recommended that the AMT be repealed; so have the American Institute of Certified Public Accountants, the American Bar Association's Section on Taxation, the Tax Executives Institute, and Congress's own Joint Committee on Taxation.[14] Dissatisfaction with the AMT springs from a number of sources.

The number of people who would pay no federal income tax without the AMT is small. The IRS estimates that without the AMT for individuals, about 14,000 taxpayers would pay no federal income tax.[15] (Note that not all of these are high-income

[14] Internal Revenue Service, National Taxpayer Advocate (1999), "Legislative Proposals," recommendation 50; U.S. Senate (1999), testimony of David A. Lifson and of William J. Wilkins; Joint Committee on Taxation (2001b), p. 15.
[15] U.S. General Accounting Office (2001), p. 1.

Table 3. Number and percentage of taxpayers with adjusted gross incomes over $200,000 who paid federal income tax, 1977-98

	Not adjusted for inflation			*Adjusted for inflation**		
	Returns paying tax	**Total returns**	**Returns paying tax (%)**	**Returns paying tax**	**Total returns**	**Returns paying tax (%)**
1967	15,514	15,669	99.01	n.a.	n.a.	n.a.
1974	30,886	31,132	99.21	n.a.	n.a.	n.a.
1977	53,343	53,403	99.89	45,877	45,931	99.88
1978	68,408	68,506	99.89	49,326	49,388	99.87
1979	93,661	93,731	99.93	55,504	55,542	99.93
1980	117,107	117,250	99.88	52,456	52,512	99.89
1981	137,910	138,136	99.84	50,827	50,880	99.90
1982	169,105	169,367	99.85	59,353	59,411	99.90
1983	198,161	198,608	99.78	67,172	67,310	99.80
1984	243,228	243,760	99.78	80,630	80,800	99.79
1985	295,895	296,507	99.79	95,550	95,740	99.80
1986	373,704	374,363	99.82	119,349	119,550	99.83
1987	539,110	539,967	99.84	161,096	161,408	99.81
1988	724,523	725,345	99.89	234,774	235,051	99.88
1989	784,942	786,063	99.86	217,392	217,685	99.87
1990	833,738	834,957	99.85	216,377	216,716	99.84
1991	845,454	846,707	99.85	183,141	183,442	99.84
1992	953,838	954,747	99.91	213,612	213,783	99.92
1993	992,304	993,326	99.90	201,056	201,236	99.91
1994	1,108,361	1,109,498	99.90	204,305	204,532	99.89
1995	1,271,510	1,272,508	99.92	237,568	237,770	99.92
1996	1,522,363	1,523,407	99.93	278,106	278,342	99.92
1997	1,806,711	1,807,900	99.93	334,784	335,040	99.92
1998	2,083,744	2,085,211	99.93	384,893	385,183	99.92

Notes: *The threshold is the amount needed to equal $200,000 of purchasing power in 1976 dollars. In 1998, for example, that amount was $572,934.

n.a. = not available.

Taxpayers first paid minimum tax in 1970 and AMT in 1979. Income is adjusted gross income (AGI). Some people had no tax liability from U.S. income but paid tax on foreign income; the figures for "paid tax" exclude them.

Sources: For 1967 and 1974, main text and IRS *Statistics of Income*; for 1998, Balkovic (2001), pp. 6, 9; for all other data, Parisi (2000), pp. 7, 9.

taxpayers.) As Table 2 shows, in 1998, there were almost 125 million individual income tax returns; of those, more than 93 million paid regular income tax after credits. Dividing 14,000 by 93 million gives 0.015 percent, meaning that 99.985 percent of taxpayers paying income tax were already doing so even without the AMT. Expressed another way, *the AMT added just one additional taxpayer to the income tax rolls for every 6,600 already paying the regular income tax.* Making a similar calculation limited to people with high incomes, we can determine from Table 2 that in 1998, 3,572 people with incomes of $200,000 and above paid no regular income tax. Table 3 indicates that after the AMT, 1,467 of them still paid no income tax, either regular or AMT. The difference —2,105 taxpayers—is the number of high-income people who would have paid no income tax if not for the AMT. So, *the AMT added just one* high-income *taxpayer to the income tax rolls for every 1,000 already paying the regular income tax.* The figures strongly suggest that AMT adds little to the effectiveness of the regular income tax.

The AMT has not achieved its goal of making everyone with high income pay some federal income tax. As Table 3 shows, a very small number of people with incomes over $200,000 a year still pay no federal income tax. Unadjusted for inflation, the number has never so far reached 1,500; adjusting the $200,000 threshold for inflation using 1976 dollars as the base, the number has never reached 340. (Adjusting the threshold to compensate for inflation, in 1998 it took $572,934 to provide the same amount of purchasing power as $200,000 bought in 1976.) Note in Table 3 that the percentage of people with high incomes who paid income tax barely budged from the previous year in 1987, the first year the AMT became the only minimum income tax. If the goal is to make everyone with a high income pay some federal income tax, experience suggests the AMT is not the way to achieve it.

The AMT is complex and imposes relatively high costs of compliance. The AMT imposes high costs of compliance compared to the revenue it yields. Even people only *potentially* subject to the AMT have costs of compliance beyond those of complying with the regular income tax. To make filing taxes less complex for many people, the IRS has developed "EZ" versions of some forms. The AMT is the opposite: it adds to complexity by making potentially affected taxpayers fill out two additional forms. The instructions for the 2000 version of Form 1040, excluding any of the attached schedules, are 70 pages, and the IRS estimates that total preparation time for a single return, again excluding any attached schedules, is 13 hours. The instructions for the 2000 version of Form 6251 are 8 pages, and the IRS estimates that total preparation time is 6 hours.

There are no direct estimates of the costs of compliance for the AMT. One very rough way of making an estimate is to calculate the time value of hours spent preparing the AMT. For 1997 returns (filed in 1998), these estimated costs were approximately $360 million. The AMT for individuals raised $4 billion that year, making estimated preparation costs 9 percent of the revenue the tax generated. That is more than five times as high as estimated preparation costs for the income tax generally, which were 1.6 percent of revenue generated.[16]

[16] In 1997, the last year for which data are available, there were 4.4 million AMT returns. The IRS estimated that the average time to prepare a single return was 6 hours 24 minutes. Multiplying the number

Another rough way of judging the costs of compliance for the AMT is to note that whereas 52 percent of all people filing income tax returns used paid preparers for their 1997 returns, 93 percent of the 4.4 million filers of AMT returns used paid preparers.[17] Last year, the cost of an average return filed by America's largest tax preparation firm was $96.[18] AMT returns are likely to take longer to prepare and so to cost more than an average return.

The original minimum tax legislation was 19 pages of average-size type in the statute book. With explanations and amendments, by 1999 AMT legislation took up 56 pages of small type in one printed version of the Internal Revenue Code.[19]

The AMT is not indexed. The most important features of the regular income tax (the tax brackets, standard deduction, exemptions for dependents, and so on) have been automatically indexed for inflation annually since 1985. The AMT is not indexed. Congress has periodically raised the exemption amounts for the AMT, but not fast enough to keep pace with inflation. The exemption of $20,000 that applied in 1979, the first year the AMT went into effect, is more than $53,000 in today's dollars. The current exemption amounts, in place since 1993, are $45,000 for married couples filing jointly (half that for each spouse if they file separately), or $33,750 for single filers or heads of households. To adjust for inflation since 1993, the exemptions would have to be raised to approximately $54,000 for married couples filing jointly and $41,000 for single filers.

A feature of both the AMT and the regular income tax is that neither is indexed for *real* (inflation-adjusted) growth in incomes. Even in the regular income tax, which is indexed for inflation, people move into higher and higher tax brackets if the economy is growing over the long term and average real wages are growing, too, as they normally do. Real growth in incomes tends to move everybody into higher tax brackets even if nobody's position changes relative to other wage earners. This phenomenon is called "real bracket creep."

Under current law, the number of taxpayers affected by the AMT will grow explosively in the coming years. Because the United States has low but persistent

of returns by the estimated average hours per return gives a total of about 28 million taxpayer hours spent preparing AMT forms. The average wage in the United States for 1998, when tax returns for 1997 were actually filed, was $12.78 an hour. Multiplying, that translates to an implicit cost of preparation of approximately $360 million. The IRS estimated that 1997 form 1040, without any attached schedules, took 9 hours 56 minutes to prepare. For convenience it is assumed that everyone who paid income tax only filled out form 1040, even though in reality some filled out additional forms requiring more preparation time and others filled out form 1040EZ, requiring less time. There were 93 million returns. The estimated number of taxpayer hours of preparation was therefore 921 million, which valued at the average wage of $12.78 an hour is $11.8 billion. The individual income tax raised $731 billion in revenue. Statistics in these calculations that are not from sources already mentioned above are from the Internal Revenue Service, *Statistics of Income Bulletin,* v. 20, no. 2, Fall 2000, p. 207.

[17] U.S. General Accounting Office (2000), p. 15.

[18] H & R Block press release, March 24, 2000. The figure of $96 is based on data for the first two months of 2000.

[19] Issued by CCH, Inc. The provisions of the AMT are in the U.S. Code, title 26, sections 55-9.

inflation, the lack of indexation in the AMT implies that under current law, eventually most taxpayers will move out of the regular income tax into the AMT. Even if the AMT were indexed for inflation, though, growth in real wages implies a similar trend, though occurring at a slower pace. Without a change in the law, a tax intended to apply only to high-income taxpayers will eventually become everyone's tax.

Over the last ten years, the number of people affected by the AMT for individuals has jumped ten-fold, to an estimated 1.3 million in 2000.[20] But unless current law is changed, the AMT's years of explosive growth are just beginning. By 2010 it is projected that 17 million people will be affected by the AMT: 12.1 million directly, by having to pay the AMT, and 4.9 million indirectly, by being able to claim fewer credits on their regular income tax than they otherwise would. An especially large jump will come in 2002, when certain provisions currently in effect expire. (The provisions exclude child and education tax credits from the AMT.) The number of people affected by the AMT will almost double that year.[21]

IV. OPTIONS FOR DEALING WITH THE AMT

The main options for dealing with the AMT are to keep it as it is; make comparatively minor technical changes; index it, perhaps with a one-time "catch-up" increase in the exemption amounts to restore their erosion by past inflation; make major changes to the AMT's treatment of exemptions; or repeal the AMT. Each option has been discussed at some point in recent years by Congress and by outside analysts. Table 4 lists the more than two dozen bills to change the AMT have already been introduced in the 107th Congress.

Keep the AMT as it is. As we have seen, doing nothing would mean that by 2010, ten times as many people would pay the AMT as now do. Wait even longer, and eventually the AMT would become a nearly universal tax with nearly flat rates (26 and 28 percent), though the rates would be much higher and the zero-bracket amounts would be lower than advocates of a "flat tax" have proposed.

Make technical changes. In its current form, the AMT can affect middle-income families that have many children because it limits tax preferences. Some proposals would address some "nuisance" aspects of the AMT by making technical changes, such as eliminating the AMT limits on exemptions for children and on the standard deduction. An example is H.R. 6, sponsored by Rep. Jerry Weller of Illinois, which has passed the House of Representatives. Without changes such as H.R. 6 and other bills have proposed, exemptions of child and education credits will expire at the end of this year.

Index the AMT. The AMT could be indexed for inflation, as the major items for the regular income tax have been since 1985. Moreover, there could be a catch-up

[20] These numbers include both people directly affected by the AMT by paying it and those indirectly affected by the AMT by losing some tax credits they would otherwise have. Technically, the numbers refer to tax returns and not to individuals, because some returns are filed by couples.
[21] Rebelein and Tempalski (2000), Table 1.

Table 4. Bills in the 107th Congress on the AMT for individuals, early May 2001	
Repeal of AMT	**House:** H.R. 275 (Johnson), 437 (English), 871 (Collins), 1018 (Toomey), 1040 (Armey). **Senate:** S. 189 (Bond), 492 (Thompson), 616 (Hutchinson).
Reduce AMT rates	**House:** H.R. 873 (Crane).
Increase standard deduction or exemptions	**House:** H.R. 6 (Weller), 596 (Neal), 1264 (Rangel), 1398 (Rangel). **Senate:** S. 268 (Lincoln), 551 (Dorgan).
Allow deduction for state and local taxes	**House:** H.R. 1196 (Rangel). **Senate:** S. 291 (Thompson).
Child credit provisions	**House:** H.R. 3 (Thomas), 468 (Neal).
Provisions concerning capital gains, stock options, small business stock, foreign tax credits	**House:** H.R. 1342 (Collins), 1467 (Lofgren), 1600 (Houghton). **Senate:** S. 455 (Collins), 801 (Jeffords).
Provisions concerning farmers and fishermen	**House:** H.R. 658 (Herger). **Senate:** S. 312 (Grassley), 333 (Lugar).

Note: Bills that treat multiple issues related to the AMT are listed only under their main category.

increase in exemption amounts to restore their erosion by inflation since 1993 (the last time exemption amounts were raised) or some other year. Indexing the AMT for inflation would considerably slow the growth in the number of people affected by the AMT, but ultimately it would not prevent the AMT from affecting more and more people. Over the long term, the U.S. economy can be expected to enjoy substantial grow in real (inflation-adjusted) terms. Real incomes can be expected to grow as well, creating "real bracket creep" that pushes people into higher tax brackets and into the AMT even if the tax code is fully indexed for inflation.

Make major changes to the AMT's treatment of exemptions. Major changes include changing the items that reduce tax liability. For example, under current law, taxpayers who itemize cannot deduct state taxes from the AMT, even though they can deduct them from the regular income tax. Allowing deductions for state taxes would make the AMT more like the regular income tax and would have a large effect on people subject to the AMT who live in places with high state taxes.

Another type of major change would be to increase the exemptions beyond the amounts needed to catch up to past inflation. For example, doubling the exemption amounts would make them the highest in real terms that they have ever been. The higher the exemption amounts, the more taxpayers would be taken out of the AMT back into the regular income tax. Again, though, "real bracket creep" would eventually bring taxpayers back into the AMT. The only way to prevent real bracket creep would be to index the AMT and other income taxes for growth in nominal incomes. (Growth in nominal incomes equals inflation plus growth in real incomes.) Currently, the only part of the federal budget indexed to growth in nominal incomes is not on the exemption side, but on the spending side: the top amount of wages to which the Social Security tax applies, and Social Security payments, are both indexed to growth in nominal wages.

Repeal the AMT. The most far-reaching option is to repeal the AMT. The Taxpayer Refund and Relief Act of 1999 (106th Congress, H.R. 2488) included a phase-out of the AMT for individuals and corporations from 2005 to 2007, so that starting in 2008 the tax would not exist. The bill passed the House of Representatives and the Senate but was vetoed by President Clinton on the grounds that "By using projected surpluses to provide a risky tax cut, H.R. 2488 could lead to higher interest rates, thereby undercutting any benefits for most Americans by increasing home mortgage payments, car loan payments, and credit card rates."[22] Today, the projected surpluses over the next decade are larger, there is bipartisan support in Congress for some kind of tax cut, and interest rates have peaked and then fallen since President Clinton's veto. Eight bills to repeal the AMT for individuals or for both individuals and corporations have been introduced so far in this Congress.

V. CONSEQUENCES OF REPEALING THE AMT

It is worth examining in more detail the option of immediately or eventually repealing the AMT, because that brings into sharpest focus the costs and benefits of the AMT. Moreover, proposals to repeal the AMT have drawn support both in Congress and among groups who have to deal with the tax professionally. It is noteworthy that accountants' and lawyers' groups have called for repealing the AMT even though it generates business for them. Even they find it so complex that they feel they would be better off without it. What consequences would follow if the AMT were repealed?

Reduction of projected federal revenue. Because the number of AMT filers will grow quickly under current law, so will revenue from the AMT. In 2000 the AMT raised an estimated 0.6 percent of all revenue from individual income taxes. In 2010 the AMT's share is projected to grow to the still relatively small figure of 2.3 percent. (Table 1 above shows the dollar amounts involved.) To gauge the importance of the AMT to *overall* federal revenue, one can divide those numbers in half, since individual income taxes provide approximately half of all federal revenue. Moreover, it is important to remember that the reason revenue from the AMT grows so much is that it will affect millions of taxpayers who were never intended to be its targets.

A simpler tax code. Repealing the AMT would make the portion of the tax code dealing with income taxes considerably simpler because it would apply the regular income tax to everybody, instead of maintaining two separate, parallel systems of income

[22] President of the United States (1999), p. 1.

taxation that each have their own rules. People with high incomes would still have to pay the regular income tax; for the overwhelming majority, repealing the AMT would not eliminate their income tax liability. Repealing the AMT would reduce the costs of tax compliance not just for people who currently pay the AMT, but for another group, about four times larger, whose taxes are not actually affected by the AMT but have to spend time and effort complying with it because they are *potentially* affected by it.

The link between simplicity and perceptions of fairness. Until recently, when the AMT began affecting more and more middle-income taxpayers, the amount of revenue it raised was quite small. Fundamentally, the AMT was not about revenue but about symbolism—the resentment of many taxpayers at a few people with high incomes paying no federal income tax.[23]

The proportion of people with high incomes who paid no federal income tax was minuscule before the minimum tax was introduced. Even so, the minimum tax and later the AMT were established in an attempt to target them. The attempt was a failure: a tiny proportion of people with high incomes still pay no income tax, just as before 1969. It should be noted that these people are not necessarily the same year after year, and given that they are far more likely to be audited than the average taxpayer, they have strong incentives to arrive at their reduction of tax liability by perfectly legitimate means, under the tax laws Congress has written.

After having tried and failed for more than 30 years to make everyone with a high income pay some federal income tax, it has become apparent that the tactics chosen did not work. In a tax code as complex as ours, there are always opportunities for a few high-income people to reduce their tax liability to zero. Introducing an additional tax and making the tax code still more complex did not eliminate those opportunities. Experience with the AMT suggests instead that if there is a way to make everyone with a high income pay some income tax, it is by making the tax code *simpler.* Simplifying means reducing tax rates, which reduces the influence of tax considerations on economic decisions; and broadening the tax base by reducing exemptions, deductions, and tax credits.

It may not be politically possible to achieve a system so simple and with so few deductions, exemptions, and tax credits that everyone with income above a certain level pays federal income tax. If not, Congress and the American people will confront again one of the fundamental questions about taxes: To what extent are they primarily a means of raising revenue in the most economical way, and to what extent should they be a tool of social engineering? The Congresses that enacted and extended the minimum tax and later the AMT placed a high value on trying to make everyone with a high income pay federal income tax, rather than accepting a simpler system that would allow a few high-income people (as well as many middle- and low-income ones) to pay no tax. The AMT has now grown so big and complex that it is becoming a tax on the middle class. The

[23] No data seem to be available on what other taxes are paid by people with high incomes who pay no federal income tax. They are subject to other federal taxes, such as the payroll tax; to state income and sales taxes; and to property taxes and other taxes at the local level.

quest to catch a few additional big fish in the tax net has enmeshed hundreds of thousands, even millions, of small fish.

VI. CONCLUSION

The AMT and its predecessor, the minimum tax, were enacted in an attempt to target a tiny number of high-income taxpayers. The amount of revenue the AMT raised from high-income taxpayers was very small. Fundamentally, the AMT was not about raising revenue, but about the symbolism of trying to close what most people thought of as loopholes for the rich.

The price of the AMT has been a significant increase in the complexity of the tax code. Even those who think that the symbolism justifies the price must acknowledge that the AMT has failed to achieve its goal. A minuscule proportion of people with high incomes continue to pay no federal income tax. They do so because the approach of the AMT was not well suited to achieve its goal. With a tax code as complex as ours, and with so many highly trained accountants and lawyers working hard to find perfectly legitimate means by which their clients can benefit from its many provisions, imposing another layer of complexity was a step in the wrong direction. A better approach would be to make the tax code simpler, reducing tax rates and broadening the base of the regular income tax.

The history of the AMT illustrates the need to think about unintended consequences before imposing any new tax. Because the AMT is not indexed for inflation or for real growth in incomes, the number of taxpayers it affects is growing explosively. Like the income tax itself, the AMT was enacted as an attempt to target the rich but has become a tax on parts of the middle class. If nothing is done to reform the AMT, it eventually will become the dominant type of income tax. If taxpayers and Congress could have foreseen in 1969 how the minimum tax would turn out, it is doubtful they would have approved of it.

Kurt Schuler
Senior Economist to the Chairman

Appendix. Legislative history of the AMT for individuals (major changes in *italics*)

Tax Reform Act of 1969 (P.L. 91-172)	Introduced the "add-on" minimum income tax of 10% in excess of an exemption of $30,000.
Excise, Estate, and Gift Tax Adjustment Act of 1970 (P.L. 91-614)	Allowed deduction of the "unused regular tax carryover" from the base for the minimum tax.
Revenue Act of 1971 (P.L. 92-178)	Imposed minor provisions regarding foreign income.
Tax Reform Act of 1976 (P.L. 94-455)	Raised rate of minimum income tax to 15% and lowered exemption to $10,000 or half of regular taxes.
Tax Reduction and Simplification Act of 1977 (P.L. 95-30)	Reduced minimum tax preference for intangible costs of drilling oil and gas wells.
Revenue Act of 1978 (P.L. 95-600)	Introduced AMT alongside minimum income tax and moved certain itemized deductions and capital gains to AMT. AMT had graduated rates of 10%, 20%, and 25%, and an exemption of $20,000.
Economic Recovery Tax Act of 1981 (P.L. 97-34)	Lowered AMT rates to correspond with reductions in rates of regular income tax.
Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248)	Repealed "add-on" minimum tax. Made AMT rate a flat 20% of AMT income after exemptions of $30,000 for individuals and $40,000 for joint returns.
Deficit Reduction Act of 1984 (P.L. 98-369)	Made minor changes concerning investment tax credit, intangible drilling costs, and other items.
Tax Reform Act of 1986 (P.L. 99-514)	Raised AMT rate to 21%. Made high-income taxpayers subject to phase-out of exemptions. Increased number of tax preferences. Allowed an income tax credit for prior year AMT liability.
Revenue Act of 1987 (P.L. 100-203)	Made technical corrections related to Tax Reform Act of 1986.
Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647)	Made technical corrections related to Tax Reform Act of 1986.
Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239)	Made further technical amendments.
Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508)	Raised AMT rate to 24%.
Energy Policy Act of 1992 (P.L. 102-486)	Changes regarding intangible costs of drilling oil and gas wells.
Omnibus Reconciliation Act of 1993 (P.L. 103-66)	Introduced graduated AMT rates of 26% and 28%. Increased exemption to $33,750 for individuals and $45,000 for joint returns. Changed rules about gains on stock of small businesses.
Taxpayer Relief Act of 1997 (P.L. 105-34)	Changes regarding depreciation and farmers' installment sales.
Tax Technical Corrections Act of 1998 (P.L. 105-206)	Adjusted AMT for new capital gains rates.
Tax Relief Extension Act of 1999 (P.L. 106-170)	Changed rules about nonrefundable credits.

Note: There may have been a few other quite minor changes made by bills omitted from this list. The provisions of the AMT for corporations and for individuals are mixed together in the tax code, so many bills apply to both types of AMT.

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